Part of the Buy to Let Britain research series

Buy to Let Britain Report

Edition nine

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This material is for professional intermediaries only

KentReliance for Intermediaries | Part of OneSavings Bank

Contents

Foreword

Against a backdrop of political uncertainty that's driving economic uncertainty, government policy continues to distort the current housing market.

Incentives for first-time buyers such as Help to Buy have stimulated demand for homeownership, without tackling the underlying lack of supply across all tenures that would help reduce housing costs in the long term.

The private rented sector (PRS) is a case in point. Government policy has affected investors, particularly amateur landlords. Changes to mortgage interest tax relief and the stamp duty surcharge have pushed up costs, while tighter underwriting rules have made it more difficult for those seeking to expand their portfolio or indeed purchase their first buy to let property.
These changes have understandably affected the sector's growth, and investors' confidence. The expansion of supply has slowed.

However, professional landlords haven't stood idle. Holding property in a limited company structure is increasingly popular for portfolio landlords purchasing new assets, allowing for mortgage interest costs to be offset against annual tax bills. Indeed, according to Kent Reliance for Intermediaries' (KRFI) own lending figures, 71% of buy to let lending for purchases in 2018 was via a limited company. Many landlords are also remortgaging to fix outgoings by taking advantage of historically low rates, or looking where else they can trim spending, as we detailed in our recent report **The Finance of Investing.**

The good news for landlords looking to expand their portfolios is that underlying market conditions seem to be changing. Yields are climbing as rents rise faster than house prices; in London, yields are now at their highest since 2015. For committed investors, buying opportunities are emerging once more where prices have weakened.

In this report, our ninth edition of Buy to Let Britain, we examine the impact of policy changes on the buy to let landscape, the fundamentals that dictate the long-term outlook for the sector, and how landlords are reacting to changing conditions.

Andy Golding
Chief Executive Officer, OneSavings Bank

Executive summary

Market overview

- Government intervention and Brexit uncertainty has subdued the growth of the PRS.
- It's expanding by just 0.2% a year, with 5.4m properties currently in the sector.
- The value of the PRS continues to increase, although stuttering house price growth means the sector has added £6bn in the last year, the smallest rise since 2009.
- Tenant demand has moderated in the short-term, following a modest improvement in first-time buyer numbers.
- However, improving first-time buyer numbers are heavily dependent on the Help to Buy scheme, which is due to end in 2023.

Landlords

- Rents are rising at their fastest annual rate since 2017, climbing by 1.3% to £896 pcm.
- With rents outpacing house prices, average yields have risen to a two-year high (4.5%); in London, yields are at their highest since 2015.
- Landlord confidence has fallen to its second-lowest level, hitting landlords' purchase intentions.

Lenders

- The stock of outstanding buy to let mortgages has risen by 1.4%, despite reduced house purchase activity as landlords remortgage onto more favourable rates.
- Remortgaging activity accounts for three-quarters of mortgage lending in buy to let, as landlords look to lower costs and fix mortgage rates.
- 72% of UK buy to let mortgage applications for property purchases is now via a limited company.

Growth of PRS subdued as landlords' confidence is hit again

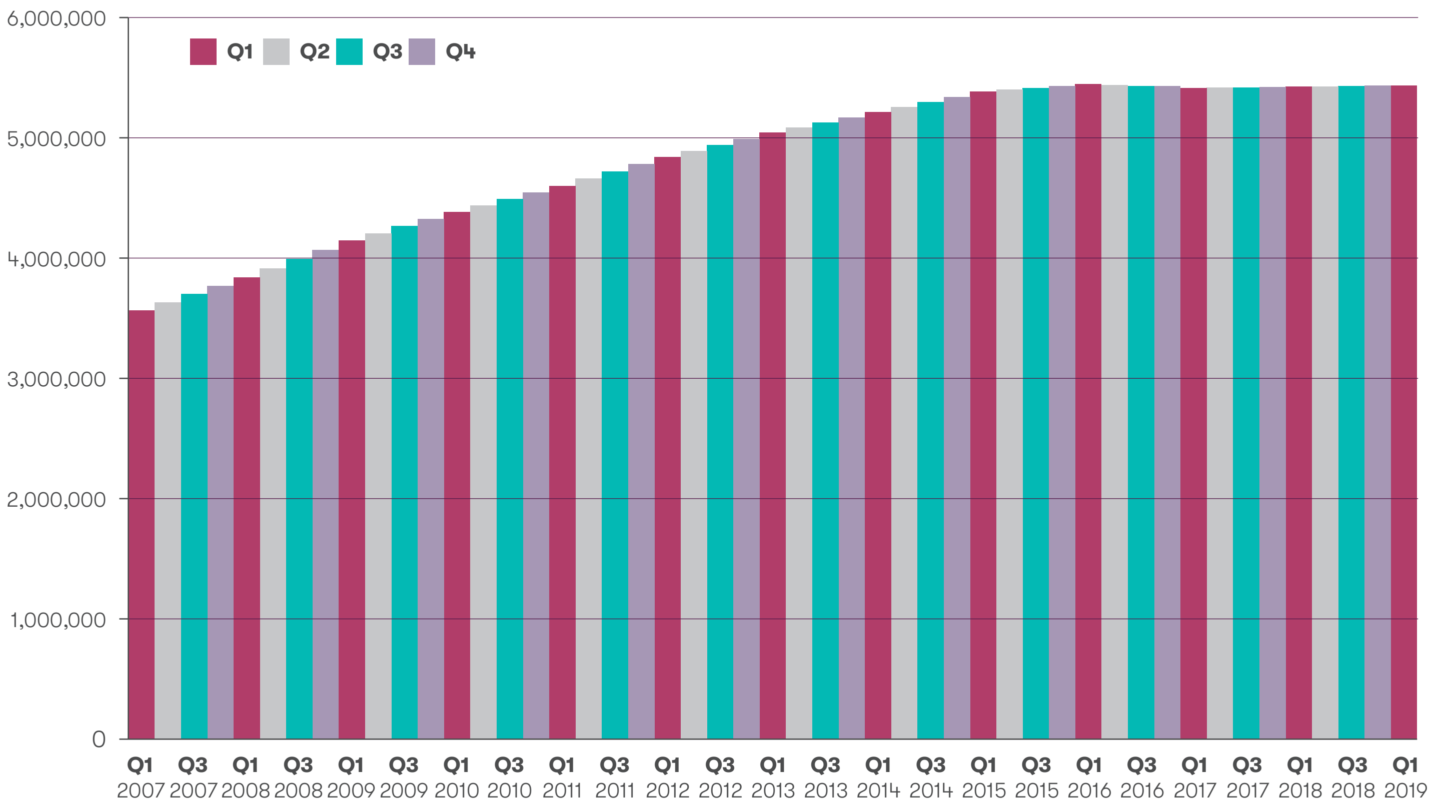
- **The number of properties in the PRS expanded by just 0.2% to 5.4m properties**
- **Landlord confidence falls to second-lowest level, hitting purchase intentions**

Recent headlines may have been dominated by reports of landlords leaving, or planning to leave, the PRS. The confidence of investors has taken a hit, but the number of homes in the sector isn't dwindling. Growth, however, has been subdued in the last three years, following government intervention and uncertainty over the economic impact of Brexit.

Incorporating the latest data from the ONS into our analysis, we estimate there are currently 5.4m properties in the PRS in Great Britain – 19.1% of all homes. The sector is currently expanding at a rate of just 0.2%, with only 11,000 properties added in the past year.

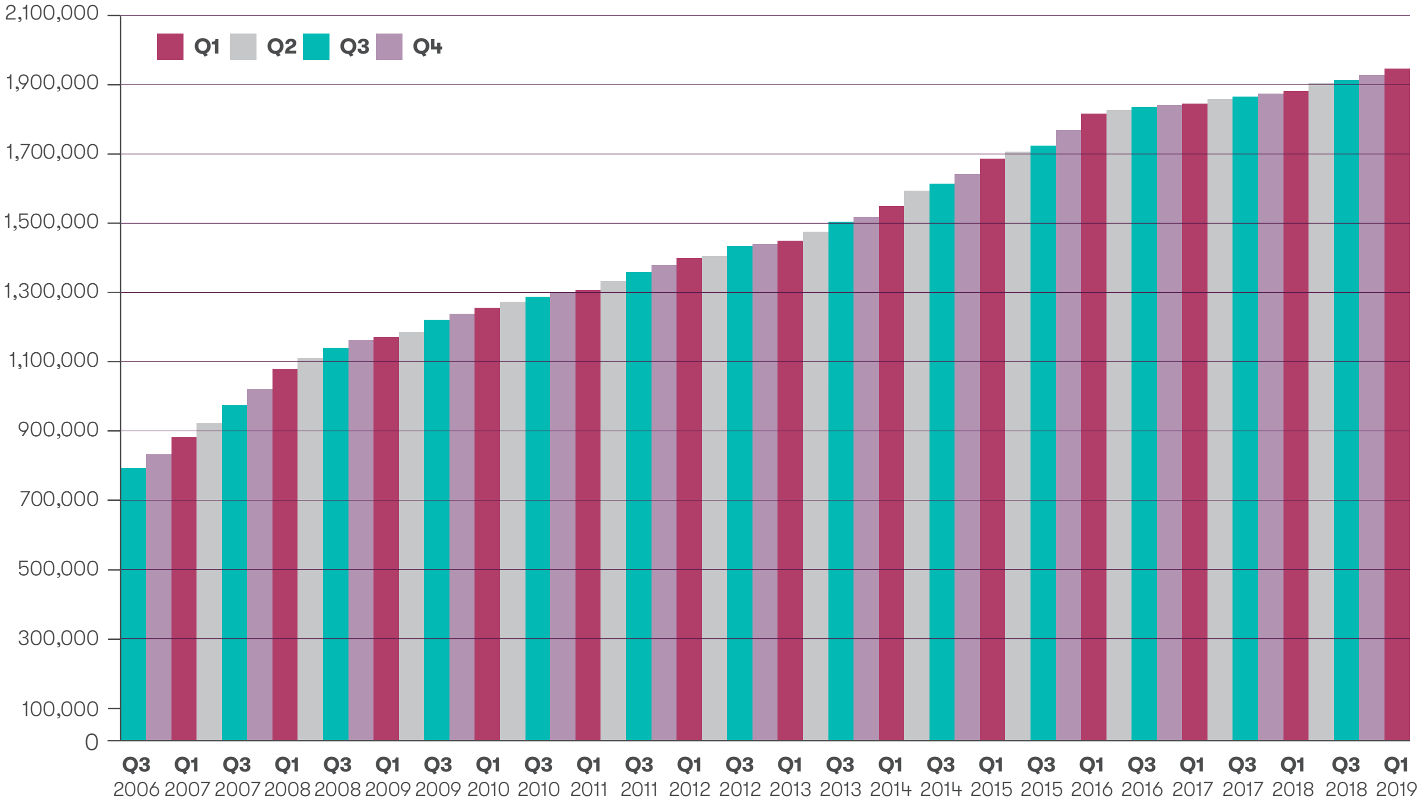
This contrasts starkly to 2012, when the sector was expanding at a rate of more than 5% (adding more than 240,000 homes a year), and the 3.3% growth seen in 2015 (when 170,000 home were being added annually), prior to the tax reforms for landlords announced in the Summer Budget.

Estimated number of properties in the PRS



Source: **Kent Reliance, MHCLG**

Number of outstanding buy to let loans



Source: **UK Finance**

The number of mortgaged properties in the PRS mirrors this slowdown. There are currently 1.9m outstanding buy to let loans, according to UK Finance[1]. This is up 1.4% compared to a year ago, in contrast to the 8.9% growth seen in 2015. Even though lending for property purchase in the sector has fallen sharply in recent years, the number of new loans remains higher than the number of mortgages being paid off each quarter.

The flurry of regulatory changes for landlords, on top of recent tax reform, has deterred amateurs from entering the market. Importantly, it has also undermined current landlords' confidence. Just 37% hold a positive outlook for their portfolio over the next 12 months, according to a survey of 827 landlords run in association with BVA BDRC. This is down from 41% a year ago and represents the lowest level since the second quarter of 2017 – the lowest on record.

[1] UK Finance data, May 2019

As a result, landlords are much less willing to add to their holdings, and many have taken the opportunity to prune the least profitable properties from their portfolios. In the first quarter of the year, those expanding their portfolio outnumbered those looking to divest by just one percentage point – 9% vs 8%.

Looking ahead, those looking to reduce their portfolio size in the next 12 months outnumber those looking to expand their holdings by two percentage points (18% vs 16%).

Nonetheless, the typical portfolio size is likely to increase as the sector continues to professionalise: those looking to sell down expect to dispose of an average of 1.9 properties, while those looking to purchase expect to buy an average of 2.3 properties.

Percentage of landlords positive about their business prospects in the next three months

Source: **BVA BDRC**

Tenant demand slows as Help to Buy boosts first-time buyer numbers

- **Slightly more landlords see tenant demand falling rather than rising**
- **One in nine first-time buyers use the Help to Buy scheme**

Tenant demand has long supported the expansion of the PRS, with the sector soaking up excess demand from first-time buyers unable to get on the property ladder, mobile workers, and those who prefer the flexibility of rental accommodation. There are indications now, however, that tenant demand is no longer strengthening at the same rate. In the latest BVA BDRC survey, 20% of landlords perceived tenant demand to rise, compared to 21% who believed it fell. Brexit uncertainty has weighed on decision-making across the property market, and the PRS is no exception. The ONS's latest English Housing Survey also suggests that household numbers in the PRS in England fell by 3% – around 162,000 households in 2017-18.

While tenant demand seems to be moderating as first-time buyer activity gradually improves, such a sharp decline seems unlikely. For instance, UK Finance data shows that first-time buyer purchases only increased by 20,000 over the same period. We would've expected a much larger rise to account for the fall in the number of households in the PRS.

It's likely that the sudden drop reflects volatility in the ONS's survey data, rather than the start of a new trend. Indeed, in 2014-15, it suggested the number of households fell by nearly 100,000, to then bounce back by 250,000 the following year. We believe it's more probable that the PRS has been broadly stable for the past three years, without the stellar growth in household numbers seen in the immediate aftermath of the financial crisis.

Help to Buy: Short-term gain, long-term pain

One of the factors influencing the slowdown in the PRS is the ongoing, if unspectacular, recovery in first-time buyer figures. However, the dependence on government intervention to bolster activity is evident. One in nine first-time buyers using a mortgage have taken advantage of Help to Buy, and it's been used in more than 170,000 purchases by first-time buyers since its launch.

While some first-timers will have used Help to Buy by choice rather than necessity to secure bigger mortgages, it has artificially increased the number of first-time buyers in the market, as well as inflating property prices. UK Finance data shows there were just 6,800 more first-time buyers in 2018 than in 2017 – a rise of less than 2%. Help to Buy drove most of this increase; the scheme's use rose by 5,270 (14%) to 42,748 last year[2].

If we remove Help to Buy purchases from the figures, first-time buyer numbers are still weaker than in 2007. Even with Help to Buy included, buyer numbers are still one-fifth lower than the average of the decade leading up to the financial crisis.

[2] Ministry of Housing, Communities and Local Government, Help to Buy data, April 2019

Annual house purchase lending to first-time buyers

Source: **UK Finance**

The big question is what happens when the Help to Buy stimulus comes to an end in 2023? While we're unlikely to see 43,000 fewer annual first-time buyer purchases per year, there's no doubt it'll undermine first-time buyer activity. Without significant funding into social housing, it'll be down to the PRS to cater for this demand – at a time when taxation and regulatory changes are disincentivising the expansion of supply.

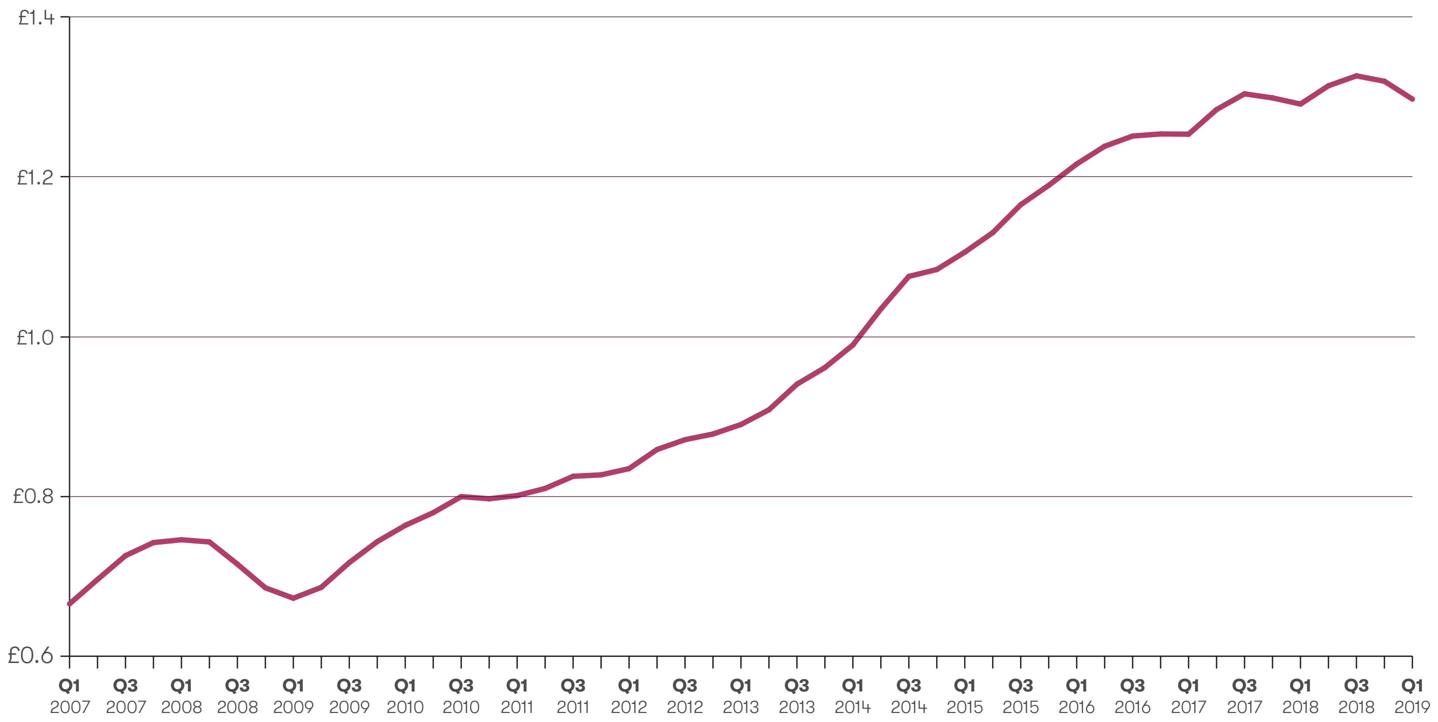
Value of property in PRS grows by slowest rate in a decade as prices fall in London

- **PRS grows in value by £6bn in the last year, smallest rise since 2009**
- **Falling house prices in London weigh on total**

Weakening house price growth, combined with the halting expansion of the sector, meant that the PRS barely grew in value in the last year. The sector is currently worth £1.3trn, having added £6.1bn in the last year. At an increase of just 0.5%, this is the slowest annual growth since 2009.

On a quarterly basis, the trend is even more pronounced. The value of the PRS fell by £22bn in the first quarter of 2019, compared to the final quarter of 2018.

Total value of the PRS in Britain (£trn)

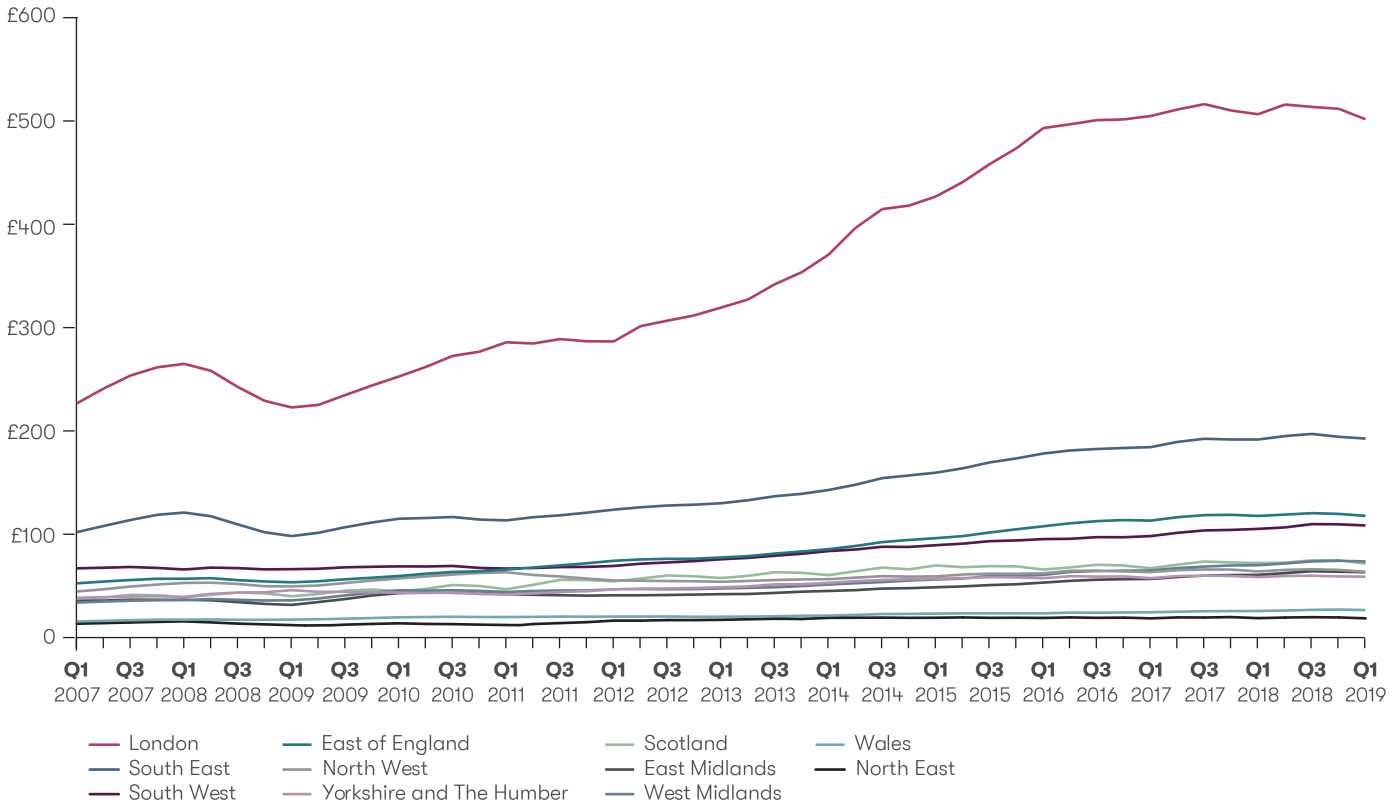


Source: **Kent Reliance, MHCLG**

London (which includes high value property in the central areas) saw the largest annual falls, with the total value of its PRS dropping by £4.9bn.

The West Midlands saw the largest rise in value, up by £3.7bn, followed by the South West (£3.3bn).

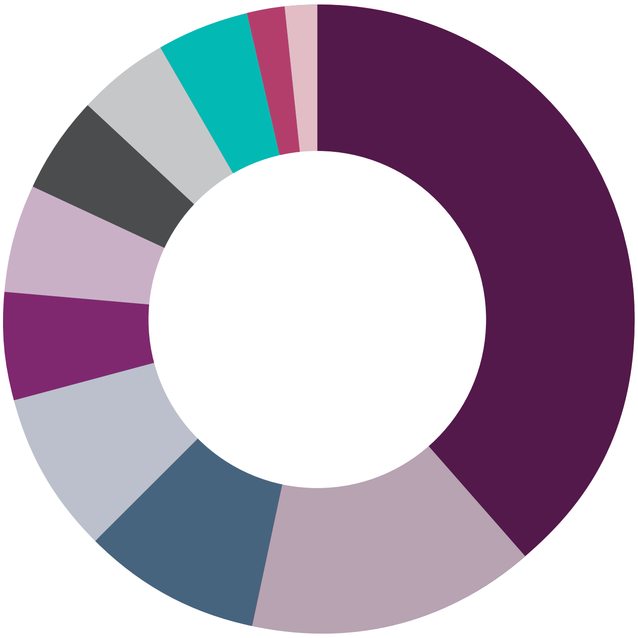
Growth in PRS by region (£bn)



Source: **Kent Reliance, MHCLG**

House prices have been a key driver. The value of the average rental property stands at £238,622, rising by just 0.3% in the last year. Values fell in four regions in the year, with the biggest annual decline in London. Here, property values have dropped by 1.9%, a far larger decline than the 0.6% annual fall a year ago. The fall in London disproportionately hit the wider national average, given the scale of the PRS in the capital. Nonetheless, even after two years of falling prices, an investor who purchased a property in London in 2009 will still have made a capital gain of more than £223,000 in the last 10 years. This is three times the gains seen nationwide.

Value of the PRS by region (£bn)



Key

- London **(£502bn)**
- South East **(£193bn)**
- East of England **(£118bn)**
- South West **(£109bn)**
- West Midlands **(£74bn)**
- Scotland **(£72bn)**
- North West **(£64bn)**
- East Midlands **(£63bn)**
- Yorkshire and The Humber **(£59bn)**
- Wales **(£27bn)**
- North East **(£19bn)**

Source: **Kent Reliance, MHCLG**

Rent rises push up yields to two-year high

- **Rents reach new record of £896 pcm, as rental growth accelerates**
- **Rent rises have pushed average yields to 4.5%**
- **London yields at their highest since 2015**

Rents tell a different story to house prices. Rental inflation has accelerated since the end of 2018, climbing to 1.3% as all regions registered annual growth. This has seen rents hit a new record high of £896 pcm, and bolstered yields.

Rents saw the fastest growth in the East Midlands, where they rose by 2.3%, and in Yorkshire and The Humber, where they increased by 1.8% from a year ago.

Across the country as a whole, landlords are collecting a total of £4.9bn in rent each month. In total, tenants paid landlords £58.1bn in the last 12 months.

Average rent paid per property (pcm)

Region	Average rent (pcm)	Annual increase
London	£1,723	0.5%
South East	£898	1.5%
East of England	£796	1.4%
Scotland	£776	0.7%
South West	£745	1.7%
East Midlands	£691	2.3%
West Midlands	£655	1.6%
North West	£636	1.2%
Yorkshire and The Humber	£635	1.8%
Wales	£457	1.1%
North East	£390	0.3%
Great Britain	£896	1.3%

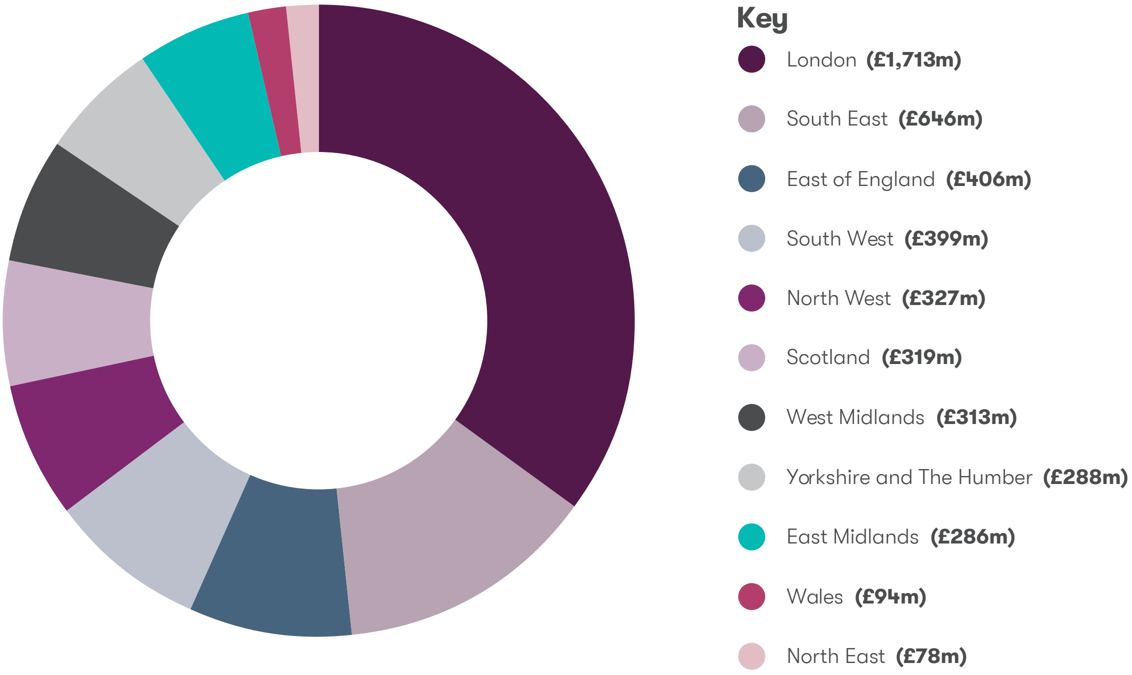
Source: **Kent Reliance**

As the costs of property investment rise (whether larger tax bills, or those associated with tighter regulation), landlords will naturally seek to recoup these in higher rents to preserve their profitability, where tenant demand allows. Indeed, 24% of landlords already expect to raise rents in the next six months, nearly five times the number that expect to reduce them.

The Government estimates the recent 2019 Tenant Fees Act will save tenants around £240m a year through reduced fees to letting agents, upfront and third-party costs[3]. However, should landlords bear the full financial brunt of this change, the typical rent in England would need to rise by 0.5% per year to cover their costs.

Improved finances among tenants has also allowed landlords more leeway to raise rents. Wages are currently rising at 3.4%[4], up from 2.9% a year ago and well in excess of inflation. This should ease affordability concerns. Should we see supply tighten, with investment deterred by government policy, rent rises are likely to accelerate.

Total monthly rent paid by region (£m)



Source: **Kent Reliance**

[3] www.gov.uk/government/news/government-action-to-end-letting-fees
[4] www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours

Yields in London climb to highest since 2015

Rents are rising at a much faster pace than house prices, driving yields to a two-year high. The average yield now stands at 4.5%, its highest since March 2017, and up from 4.4% at the end of 2018.

Rents and yields vary across the country. In London, rents have only risen by 0.5%. Nonetheless, with property prices falling, yields have reached 4.1% – their highest level since the end of 2015. Meanwhile, the North West boasts the highest yields in the country (6.2%) followed by Yorkshire and The Humber (5.9%).

Gross yields in Great Britain

Source: **Kent Reliance**

Current yields by region

Region	Current yields	Total annual returns
North West	6.2%	8.7%
Yorkshire and The Humber	5.9%	9.6%
East Midlands	5.4%	8.3%
Scotland	5.3%	5.0%
West Midlands	5.1%	8.6%
North East	5.1%	4.2%
South West	4.4%	5.6%
Wales	4.2%	7.3%
East of England	4.1%	4.1%
London	4.1%	2.1%
South East	4.0%	3.5%
Great Britain	4.5%	4.7%

Source: **Kent Reliance**

Rising yields aren't just important for the income they generate; they make it easier for landlords to access larger mortgages following the Prudential Regulation Authority's changes to introduce stricter affordability stress-testing. This could be the reason why many investors diversify their portfolio, either geographically or in terms of property type. For instance, one in five landlords now has an HMO property in their portfolio[5].

While HMOs may carry additional risks and regulations, have higher tenant turnover and are likely to require higher upkeep costs, they do generate higher levels of income. BDRC BVA's latest survey suggest the average yield for an HMO is one-fifth higher than for a typical rental property. This would mean a landlord taking in nearly £12,800 in rent each year for an HMO, compared to £10,750 for a standard property.

[5] BVA BDRC Landlord Panel, Q1 2019

Buying on the dip: opportunities emerge

The unlikely event of a long-term and sustained decline in property values would prove problematic for property investors, eroding capital gains – especially for those with tighter profit margins. However, a short-term correction in prices can be a positive for committed investors looking to grow their portfolios, particularly if rents are rising.

Firstly, rising yields allow investors to more comfortably meet lenders' affordability criteria, potentially securing a higher LTV mortgage. Secondly, the cost of stamp duty reduces as the purchase price falls.

Take London as an example. London house prices peaked in 2017, reaching an average of £527,000. They now stand at nearly £505,000. This drop means a London landlord would now pay 5.6% less in stamp duty than at the 2017 peak, as well as 4.2% less of the property's purchase price. Many investors are becoming aware that this tax bill can also be set against capital gains tax liability on disposal.

Total returns remain under pressure

On the flipside of supporting yields, sluggish house price growth has weighed on landlords' total returns over the past year. The total gross annual return stood at 4.7% across Great Britain, equivalent to £11,247.

This is down from 7.3% a year ago, when it stood at £16,986. Despite the fall, 85% of landlords report making a profit. This is down slightly from 88% at the end of 2018, when just 4% reported making a loss.

Buy to let lending: remortgage vs house purchase (volume of loans per quarter)

Source: **UK Finance**

Remortgaging dominates buy to let mortgage market

- **Remortgages account for three-quarters of buy to let mortgage lending**
- **Limited company lending now accounts for 72% of house purchase applications**

Remortgaging dominates the buy to let market. Analysis of UK Finance data shows it's consistently risen since mid-2009, and now accounts for three-quarters of buy to let lending each month. In the last 12 months, the number of remortgages rose by another 7% to 168,900[6].

Landlords have been looking to cut costs where they can, and mortgage finance has been a key area identified; many are taking advantage of historically low interest rates to lock into longer term fixed-rate deals to reduce their mortgage payments and provide financial certainty. Mortgages For Business's latest Buy to Let Index, for instance, shows that 71% of landlords opted for a five-year fix in the first quarter of 2019[7].

House purchase activity in the buy to let market remains fairly soft. The potent combination of taxation and regulatory changes, and political and economic uncertainty, has reduced appetite for house purchases. In the first quarter of 2019, there were just 15,200 loans for house purchase, down 7% year on year and down 38% compared to four years ago, when there were 24,500 in the quarter.

Limited company lending firmly entrenched in the market

When landlords undertake purchases, they do so through limited companies to mitigate the impact of the changes to mortgage tax relief, which affect individual borrowers. Analysis of our mortgage data shows that in the first quarter of 2019, 72% of buy to let mortgage applications were made through a limited company, slightly up on 2018 (71%), and significantly higher than in 2016 (45%).

[6] UK Finance data, May 2019. Data refers to year to March 2019
[7] Mortgages For Business, Q1 2019 Buy to Let Index

Conclusion

Landlords have rolled with the punches as best they can, but there's no escaping that growth has stalled in the private rented sector following four years of government intervention. Brexit uncertainty has only compounded this underlying issue. On present trends, the PRS will have grown by 23,000 homes by the end of next year, slower than the predicted growth of the overall population, and accounts for around 19% of homes.

The Government is consulting on repealing Section 21 and putting an end to serving of S21 notices with the intention to abolish so called "no-fault" evictions of tenants with two months' notice after a contract expires. It's clear that the Government intends to improve the stability within the sector where possible, providing tenants with more security against the small minority of landlords who have abused this option in the past. In many cases, however, this would leave Section 8 as the only recourse for landlords legitimately evicting tenants for breaching the terms of their tenancy. This would need significant reform from the slow and costly court process it currently entails. Otherwise, landlords would once more need to price this risk into the rents they charge.

Such change has hit the confidence of landlords, despite yields starting to improve. Professional landlords are adapting out of necessity, whilst the private rented sector holds less appeal to amateur landlords. Without some policy stability, there's now the tangible risk that the supply of rented homes will contract. Rents are already rising, and will continue to do so as landlords come to terms with higher set up and running costs, on top of larger tax bills. Neither outcome suits tenants, nor helps with the ultimate issue of housing affordability.

The professionalisation of the sector and its sustainability are clearly taking place, both worthy goals that should be supported. It's vital that investment into the sector continues to provide sufficient housing to match the demands of a growing population.

Methodology

The research involves detailed analysis of ONS population projections, ONS English Housing Survey and Ministry of Housing, Communities & Local Government data to establish the regional weighting of the PRS, its size and growth rate. Rental property prices are based on the average differential between rental property and house price data from Land Registry and Registers of Scotland, indexed against the ONS house price index. Rental data incorporates figures from Citylets, historic yield data from LSL Property Services and index data from the ONS.

All rental and property value data has been weighted to account for the changing regional composition of the PRS. Buy to let mortgage data is based on analysis of figures from UK Finance. Unless otherwise stated, the data analysed is between Q1 2007 and Q1 2019, and references to "the last year" refers to the year to the end of Q1 2018.

Landlords' views on confidence, incorporation, tenant demand, intention to grow or shrink portfolios, profitability and the impact of PRA regulation is based on a survey of 829 landlords, conducted in association with BVA BDRC in the first quarter of 2019. Research was conducted by Teamspirit for Kent Reliance for Intermediaries.

To note, all historic data, projections and forecasts are revised in each edition to account for new source data and revisions to underlying data sources.

Whilst care is taken in the compilation of the Buy to Let Britain report, no representations or assurances are made as to its accuracy or completeness.

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