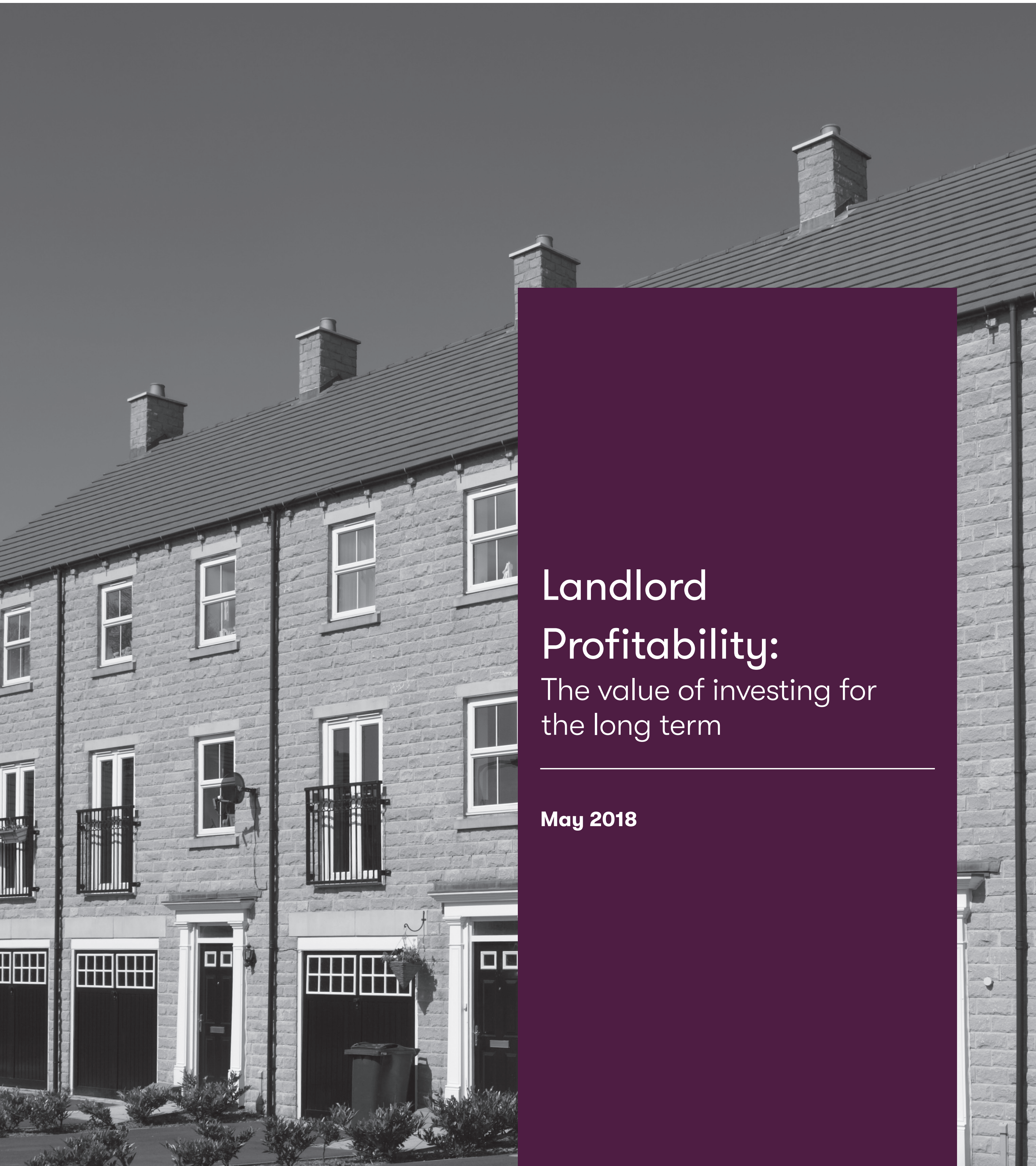
Part of the Buy to Let Britain research series



Landlord Profitability:

The value of investing for the long term

May 2018

KentReliance for Intermediaries

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Executive Summary

- A typical landlord sees an estimated net profit of £265,500 per property over 25 years, equivalent to nearly £162,000 in today's money
- Higher-rate tax landlords see smaller, yet significant profit of £203,000; £124,000 in today's money, accounting for inflation, following higher tax costs
- Basic-rate landlords contribute nearly £100,000 to the Treasury in tax over 25 years; this is £162,000 among higher-rate payers
- A typical landlord sees rental income cover the running costs of property investment, and still deliver modest profit over 25 years
- Gearing allows investors to use £74,000 deposit to access over £269,000 in capital gains

Introduction

In our latest research, we look at the financial outlook for buy to let investors, providing an illustration of the profitability of long-term property investment, and the different moving parts that potential investors should consider before taking the plunge.

The recent overhaul of the tax treatment of landlords has brought additional cost pressures for the sector. The combination of a stamp duty surcharge and the reduction in the amount of mortgage interest that higher-rate tax paying landlords are able to deduct from their tax bill has had a significant impact for many investors.

Against this backdrop of change, however, it would be all too easy to suggest that property investment has become unprofitable overnight. This is not the case. Without a profit margin, the private rental sector could not successfully function.

The combination of rental income and capital gains still offers buy to let investors the potential for investment returns. Moreover, given the UK's diminishing level of homeownership, not to mention the supply-side pressures that are supporting house prices, the growth prospects of both sources of returns are well anchored for the long term.

However, potential investors should not see buy to let investment as a licence to print money, or a 'get rich quick' scheme. It involves commitment and expertise. Investors must be prepared to run a business, managing their cost base effectively, taking appropriate tax advice – not to mention complying with the regulations that being a professional landlord entails and, above all else, treating their customers fairly.

In our detailed analysis, based on conservative projections, we explore the prospects of a typical landlord were they to hold a property for the next 25 years, looking at the income and capital gains they may receive, as well as the cost of owning such a property for the period. We also explore how this varies by location, influenced by the deposits required to purchase a buy to let property, and the rental yield prevalent in different regions.

Typical buy to let investor profile used in study*

- Tax status: basic-rate taxpayer
- Deposit: 30%
- Average buy to let property value: £246,361
- Initial rental income per property (after voids): £10,134 per annum
- Mortgage rate: 3.5%
- Investment horizon: 25 years

*See full methodology for greater detail

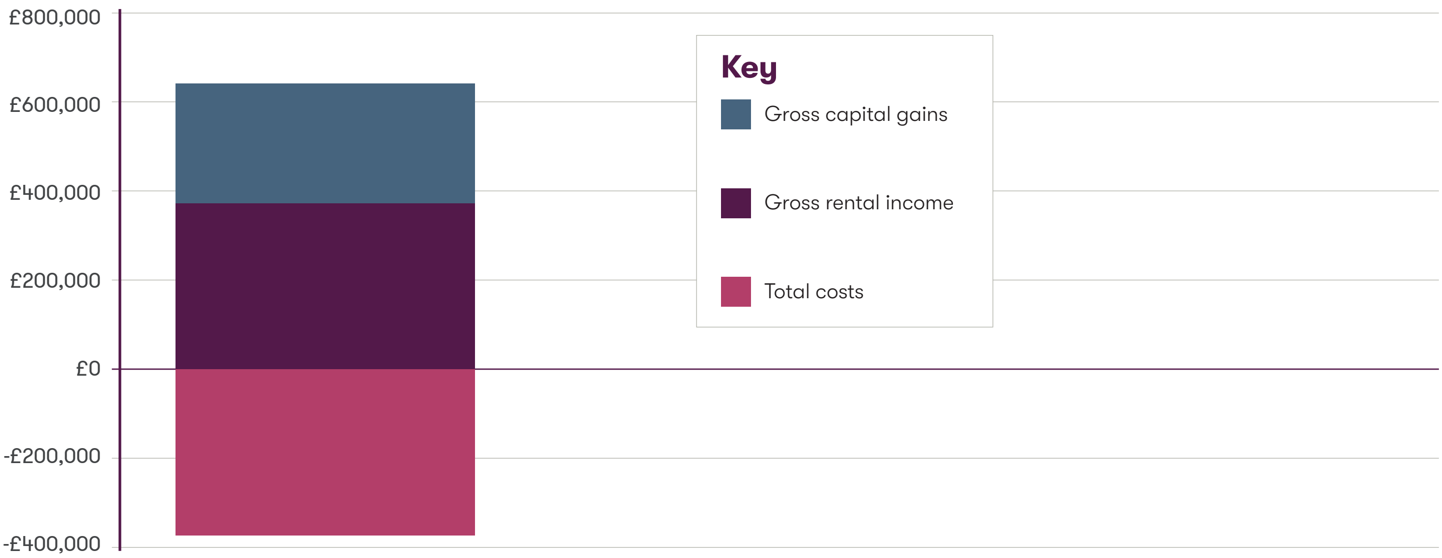
Landlords set to make £162,000 net profit per property in today's money

Recent taxation changes may weigh on many prospective property investors' minds, and have helped deter amateurs from the marketplace. However, investing in buy to let could remain a profitable exercise for the committed investor.

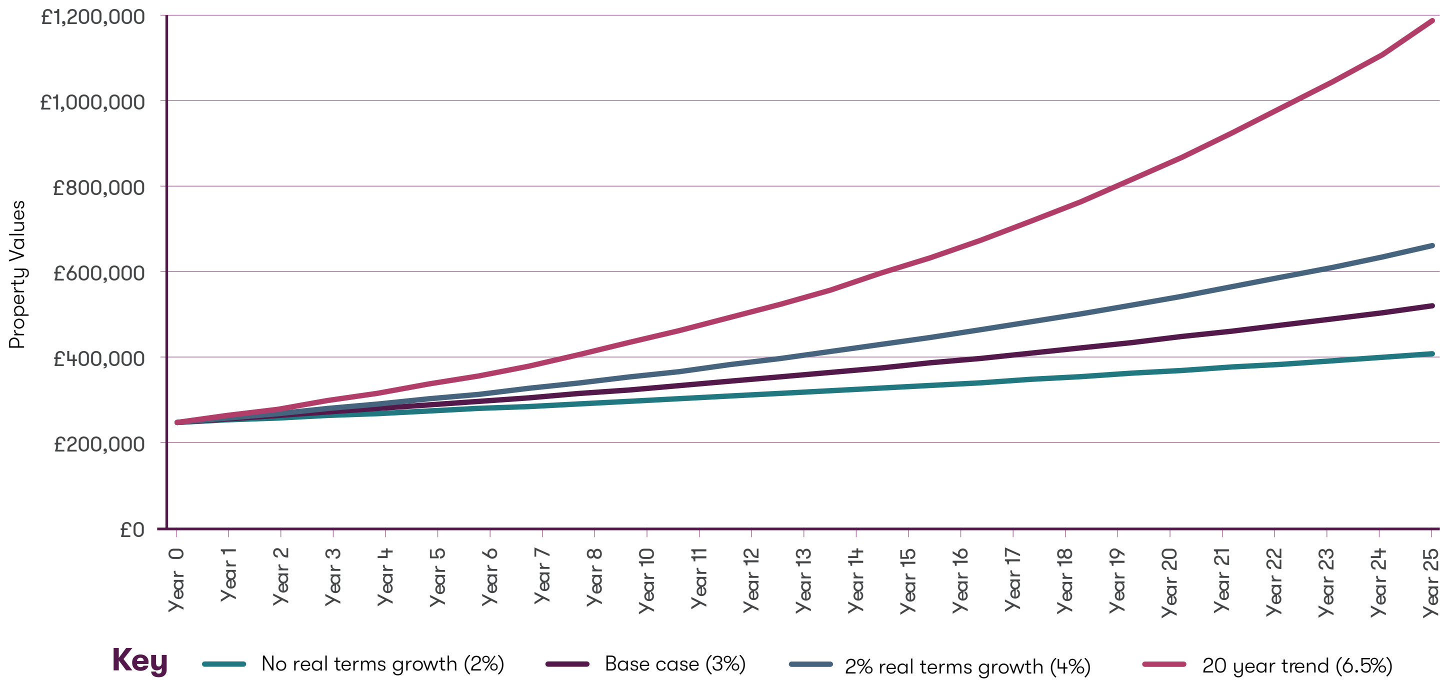
Based on our central case, we estimate that over 25 years an investor would see total net profits per property of over £265,500 in nominal terms through a combination of rental income and capital gains. Accounting for the impact of inflation, this would represent a real-terms profit of nearly £162,000.

As we shall see, a larger tax burden means a lower profit for higher-rate taxpayers, with profits falling to £203,000, which represents £124,000 in today's money.

25 years income and costs



House price growth scenarios



Gaining exposure to £269,000 in capital gains

With the average buy to let property value standing at £246,361, according to data from Kent Reliance's Buy to Let Britain report, a new landlord with a 30% deposit would need £73,908 to secure a property. Although use of mortgage finance is becoming less tax efficient, it is this leverage that allows a landlord to secure capital gains on the full value of the property, rather than simply their initial sum invested. Over the long term, this is a key driver for profits.

It is of course impossible to accurately predict house prices in 25 years' time, and these will naturally vary from location to location. In our calculations, we assume that house prices may rise in real-terms by 1% a year, reflecting the Office for Budget Responsibility's (OBR) long-term forecast for real-terms wage growth, and the Bank of England's long-term 2% target for consumer price inflation.

Over 25 years, the impact of 3% nominal annual house price growth is startling. The average buy to let property would have grown in value to a total of £515,825, allowing the investor to make a total £269,464 in gross capital gains with their initial deposit.

Even without real-terms increases, house price growth in line with 2% inflation would still deliver capital gains of nearly £158,000. By contrast, if we should see growth in excess of our base case of 3%, the picture looks even more appetising. If average house price growth over the next 25 years matched the 6.5% average annual growth in the last 20 years[1] – albeit a period of abnormal monetary policy and asset value inflation - gross capital gains would be turbo-charged to £943,000.

[1] Based on analysis of the Land Registry House Price Index

Rental income generates additional £369,495

Rental income is the bedrock of long-term investment, covering the cost of financing and maintaining a property. A typical landlord receives a pre-tax rent of £10,134 per year per property, based on current yields, and accounting for void periods each year. Our analysis suggests that over the course of a 25 year period, and also allowing for rental inflation in line with real-terms wage growth of just 1%, a typical property would generate a total rental income of £369,495.

Based on this, even if a landlord did not sell their property in the period and therefore made no capital gains, income alone would not only cover outgoings, it would also provide a profit of over £65,500 over a 25 year period.

Indeed, if we look at a landlord's typical annual cashflow, examining their annual running costs and income tax bills compared to their rental income, their cashflow not only remains positive every year, but it grows over time as rents rise relative to costs. This supports their ability to service and finance their property, and access capital growth over time.

Of course, where rental demand enables landlords to negotiate steeper rent rises each year, total rental income will naturally increase significantly over the duration. A 5% annual increase would generate income of £483,000 over 25 years.

The long-term costs of being a landlord

Purchasing, running and indeed selling an investment property is not without its costs, however. Quite aside from the time and expertise required to research a rental market, purchase a property, ensure it is maintained to a satisfactory standard for tenants, and meets regulatory requirements, property investment entails a significant financial and personal commitment.

Our calculations suggest that total costs amount to just over £373,000 over 25 years, equivalent to 58% of the total income and capital gains a landlord would receive.

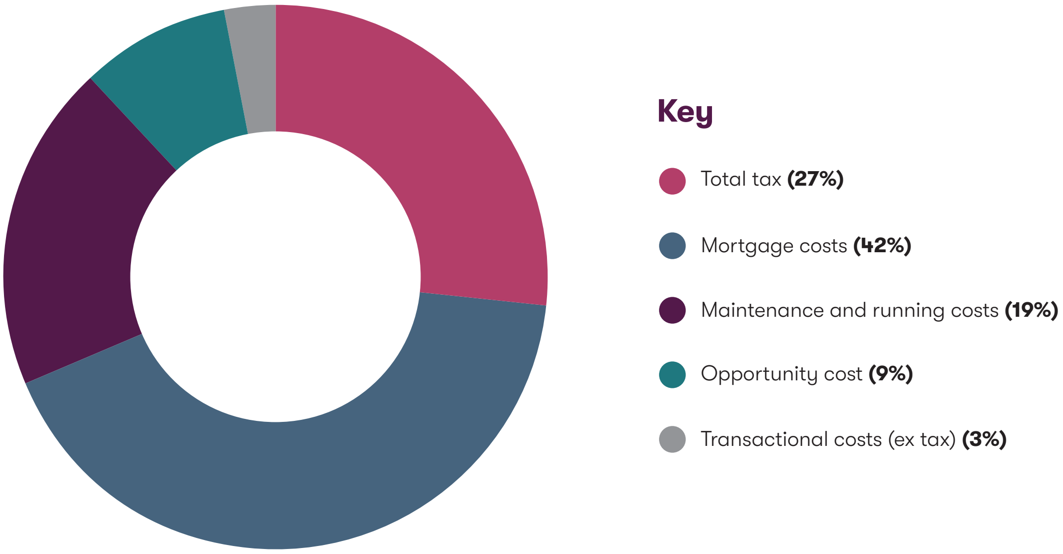
A typical landlord to contribute £100,000 in tax

One of the largest expenses for a landlord is tax. HMRC estimates that 82% of landlords are basic-rate taxpayers.[2] Over the course of the 25 year period, the typical basic-rate tax paying investor will contribute a shade under £100,000 to the Treasury, more than their initial investment. The taxes involved in buying and selling property are the largest component of a landlord's tax return. Following the addition of the 3% surcharge for stamp duty tax on second properties, a typical landlord's stamp duty totals £9,818. This pales in comparison to a capital gains tax bill of around £60,500 after 25 years of capital gains.

Total income tax for a typical basic-rate landlord amounts to over £29,000 over 25 years, with annual tax bills growing as rental inflation takes hold.

[2] https://www.gov.uk/guidance/changes-to-tax-relief-for-residential-landlords-how-its-worked-out-including-case-studies#who-can-use-the-examples

Long-term costs breakdown



Higher-rate payers see tax increases erode rental profits

For higher-rate taxpayers, the tax burden is heavier still, following the recent changes to the treatment of mortgage interest.

They will see their income tax contribution rise to nearly £88,000 over the period, three times that of basic-rate landlords. Under the previous tax regime, total income tax would have amounted to around £58,600, meaning their income tax contributions will have risen by 50%. With a larger capital gains tax bill on top, landlords in this tax bracket will contribute a total of £162,110. As a result of the heftier tax bills, the total profit for higher-rate landlords over 25 years amounts to £203,176 – 24% below that of basic-rate investors for the same property.

The main danger of the new taxation changes is the impact on cashflow. Reassuringly, the typical landlord in this tax bracket should still maintain a positive cash flow in all but one year.

Even then, the cash accumulated in the previous year more than covers any shortfall. The situation improves over the duration of the investment, rising from less than £700 in the first year, to over £5,000 in the final year as mortgage costs fall relative to income.

However, when we factor in set up costs, after running costs and income tax, rental income alone still allows a profit if a landlord was to buy and hold the property. However, standing at around just £7,000 over 25 years, it is far lower than that of basic-rate tax payers leaving higher-rate landlords far more reliant on capital gains for their total profit.

With such an increase in taxation, and the impact on rental profit it brings, it is unsurprising that many higher-rate tax paying landlords are shifting towards limited companies for more favourable tax treatment.

Mortgage costs

Mortgage interest constitutes the largest cost for geared investors. Assuming a mortgage rate of 3 percentage points above the current base rate, a landlord with a 70% LTV can expect to pay just over £6,000 a year in interest. In total, and including additional costs associated with remortgaging regularly, our analysis shows total outlay on mortgage costs stands at £157,000 over the investment period.

Unlike taxation, however, the relative monthly burden of mortgage payments should lessen with every passing year that rents rise. In contrast to rental income and the value of the property, the size of the mortgage debt remains static over time, and the monthly payments represent an ever-smaller proportion of monthly income the longer a property is held.

In the first year of an investment, mortgage interest is equivalent to nearly 60% of gross rental income. In the final year, this falls to 29%. Naturally, paying down the debt, or using increasing equity to secure more preferential interest rates, would bring down this monthly outlay more rapidly, although we have not made such assumptions in our analysis. Equally, should we see a significant change in the interest rate environment over the course of the investment, mortgage costs would rise. However, in such a scenario, yields and rental income, would likely rise more rapidly than our conservative projection.

On top of monthly mortgage payments, landlords must factor in the running costs of a property. Excluding any outlay for improving a property, a professional landlord will spend around £72,000 over the course of 25 years on maintenance, letting agent fees, utility costs, licenses and associated running costs.

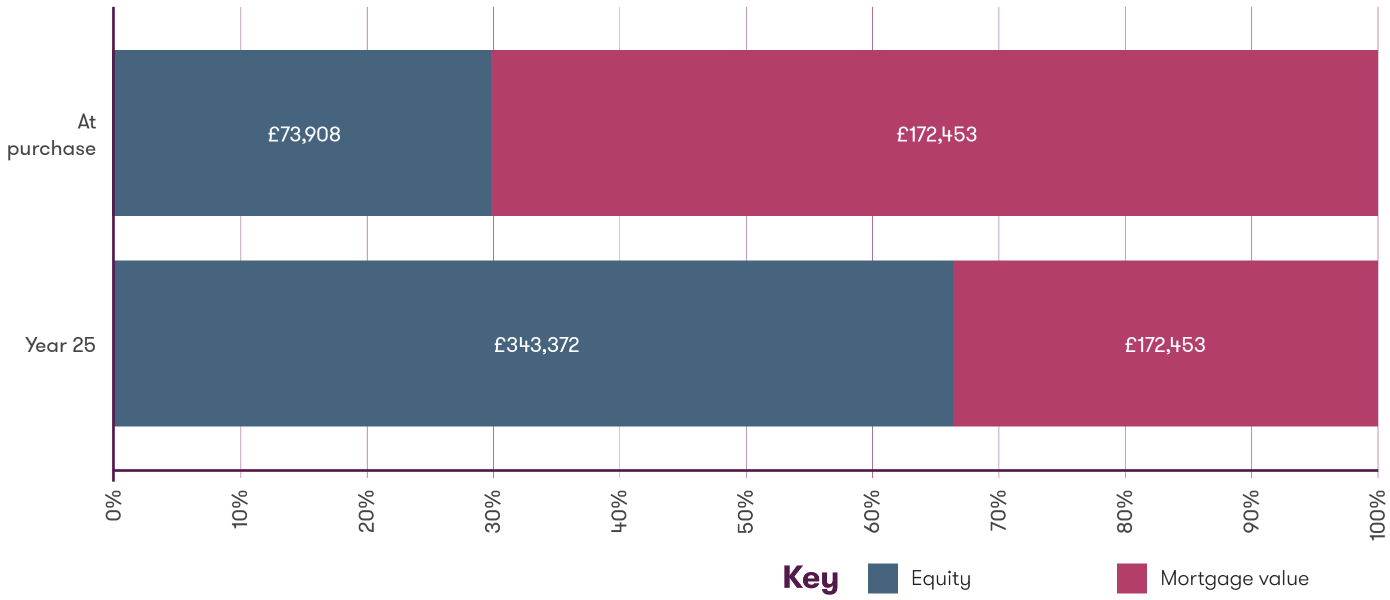
The opportunity cost of property investment
The final significant cost for consideration is the opportunity cost for an investor, such as what interest does an investor lose by opting to use their capital to buy a property, rather than place the sum in long-term savings? Were an investor to use the £73,908 to buy 10 year government bonds[3], this would generate over £34,000 in income over the period in question.

Costs in detail

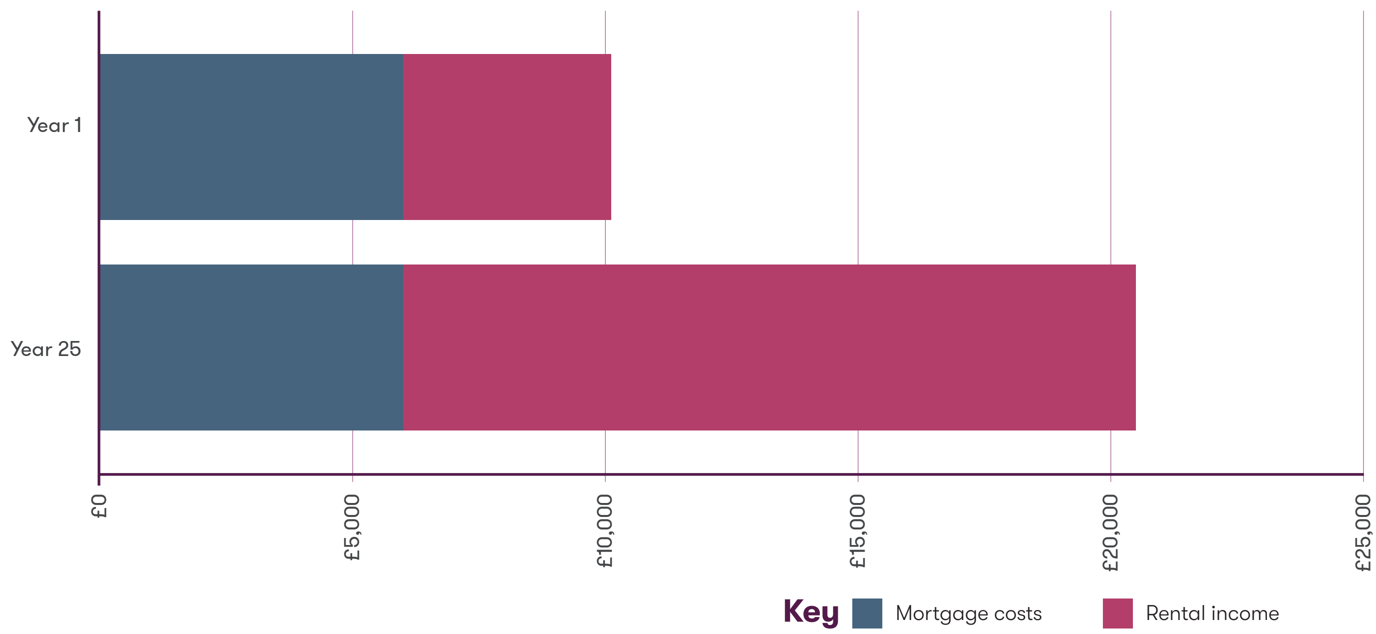
Cost type	Value
Capital gains tax	£60,509
Income tax	£29,310
Stamp duty	£9,818
Mortgage costs	£157,045
Maintenance and running costs	£72,052
Estate agency sale fees	£6,706
Legal fees	£3,747
Opportunity cost	£34,124
Total	**£373,309**

[3] Calculated using the yield on a 10-year UK government bond (1.53%) at time of writing

How gearing evolves



Mortgage costs v rental income over 25 years



Regional variation

The figures vary drastically from region to region across Great Britain, driven by significant differences in house prices, yields and importantly, the initial deposit investors must place to secure a 70% LTV mortgage.

While investors in London may see by far the largest total profit in cash terms – £308,000 in today's money – they must also supply an initial deposit of twice that of the national average.

Higher levels of rental income and capital gains also significantly increase London landlords' total costs to twice the national average – taxation, for example, is a greater burden given the higher income levels.

While those in areas such as the North West may see much smaller returns in cash terms due to lower house price values, equally investors benefit from requiring much smaller deposits (around half the size of those required nationally), much lower costs, and higher yields.

Regional variation

Region	Typical deposit	Initial rental income pa	Total rental income	Total capital gains	Total costs	Total profit	Profit in today's money
London	£158,225	£19,416	£707,876	£576,878	£779,633	£505,121	£307,887
East of England	£70,153	£8,844	£322,451	£255,774	£343,955	£234,270	£142,795
South West	£60,864	£8,245	£300,614	£221,905	£305,416	£217,103	£132,331
Yorkshire and The Humber	£37,712	£7,032	£256,364	£137,494	£213,033	£180,824	£110,218
North West	£36,883	£7,090	£258,514	£134,472	£211,102	£181,884	£110,864
Wales	£37,835	£5,112	£186,398	£137,943	£188,218	£136,122	£82,971
South East	£81,301	£9,964	£363,274	£296,417	£395,925	£263,766	£160,774
North East	£29,512	£4,389	£160,027	£107,597	£151,618	£116,006	£70,709
West Midlands	£45,027	£7,260	£264,693	£164,166	£240,186	£188,673	£115,002
East Midlands	£44,759	£7,588	£276,665	£163,188	£243,617	£196,236	£119,612
Scotland	£52,819	£8,710	£317,557	£192,574	£284,678	£225,454	£137,421
Great Britain	**£73,908**	**£10,134**	**£369,495**	**£269,464**	**£373,309**	**£265,650**	**£161,922**

Top 10 most profitable areas in London (£)

Local authority / unitary authority	Typical deposit	Initial rental income pa	Total rental income	Total capital gains	Total costs	Total profit	Profit in today's money
Kensington and Chelsea	£396,171	£48,613	£1,772,409	£1,444,410	£2,116,090	£1,100,729	£670,928
Westminster	£332,148	£40,757	£1,485,980	£1,210,987	£1,703,380	£993,587	£605,622
Camden	£273,759	£33,592	£1,224,754	£998,104	£1,355,616	£867,242	£528,611
Hammersmith and Fulham	£251,671	£30,882	£1,125,939	£917,575	£1,245,489	£798,025	£486,421
Richmond upon Thames	£218,420	£26,802	£977,177	£796,342	£1,079,697	£693,822	£422,906
Islington	£216,952	£26,622	£970,609	£790,990	£1,072,378	£689,221	£420,102
Wandsworth	£197,940	£24,289	£885,556	£721,676	£977,588	£629,644	£383,788
Hackney	£179,879	£22,073	£804,749	£655,824	£887,531	£573,042	£349,287
Barnet	£179,792	£22,062	£804,361	£655,508	£887,098	£572,770	£349,121
Haringey	£175,371	£21,519	£784,584	£639,391	£865,058	£558,917	£340,677

Top 10 most profitable areas outside London (£)

Local authority / unitary authority	Typical deposit	Initial rental income pa	Total rental income	Total capital gains	Total costs	Total profit	Profit in today's money
Elmbridge	£150,649	£18,463	£673,140	£549,256	£741,490	£480,906	£293,127
South Bucks	£149,330	£18,301	£667,245	£544,445	£734,914	£476,776	£290,610
Chiltern	£140,454	£17,213	£627,587	£512,086	£690,680	£448,994	£273,676
St Albans	£129,808	£16,365	£596,646	£473,271	£643,614	£426,303	£259,845
Three Rivers	£127,110	£16,025	£584,245	£463,435	£630,043	£417,637	£254,563
Windsor and Maidenhead UA	£126,233	£15,471	£564,044	£460,237	£619,802	£404,479	£246,542
Mole Valley	£122,869	£15,058	£549,013	£447,973	£603,036	£393,949	£240,124
Hertsmere	£114,826	£14,476	£527,780	£418,646	£568,249	£378,177	£230,511
Epsom and Ewell	£116,090	£14,227	£518,720	£423,255	£569,247	£372,728	£227,189
Tandridge	£116,066	£14,224	£518,612	£423,167	£569,127	£372,652	£227,143

Conclusion

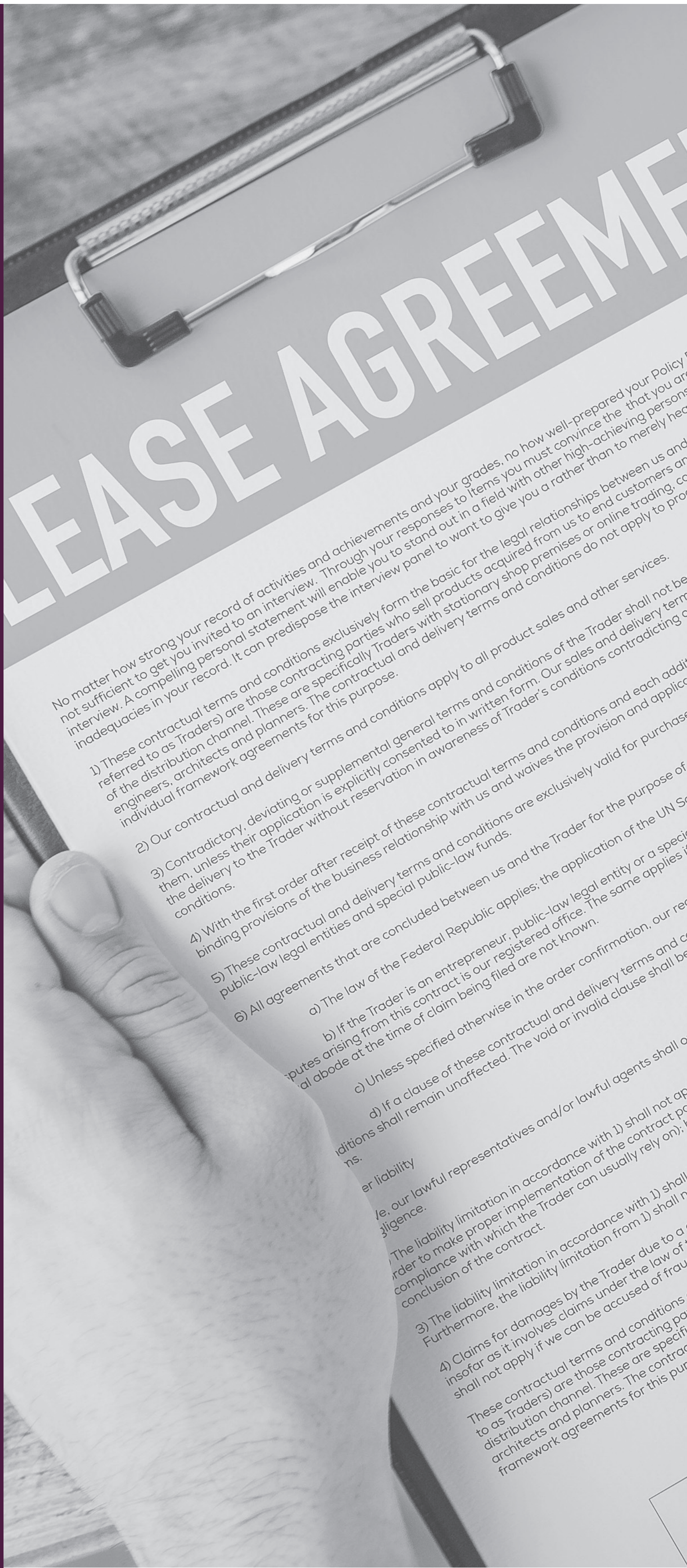
The buy to let market continues to undergo significant change. Recent regulatory and taxation changes have altered the dynamic among investors with stamp duty costs rising for all and income tax bills climbing significantly for higher-rate taxpayers. That, however, does not mean that property investment is not profitable, even if margins may have been squeezed for many.

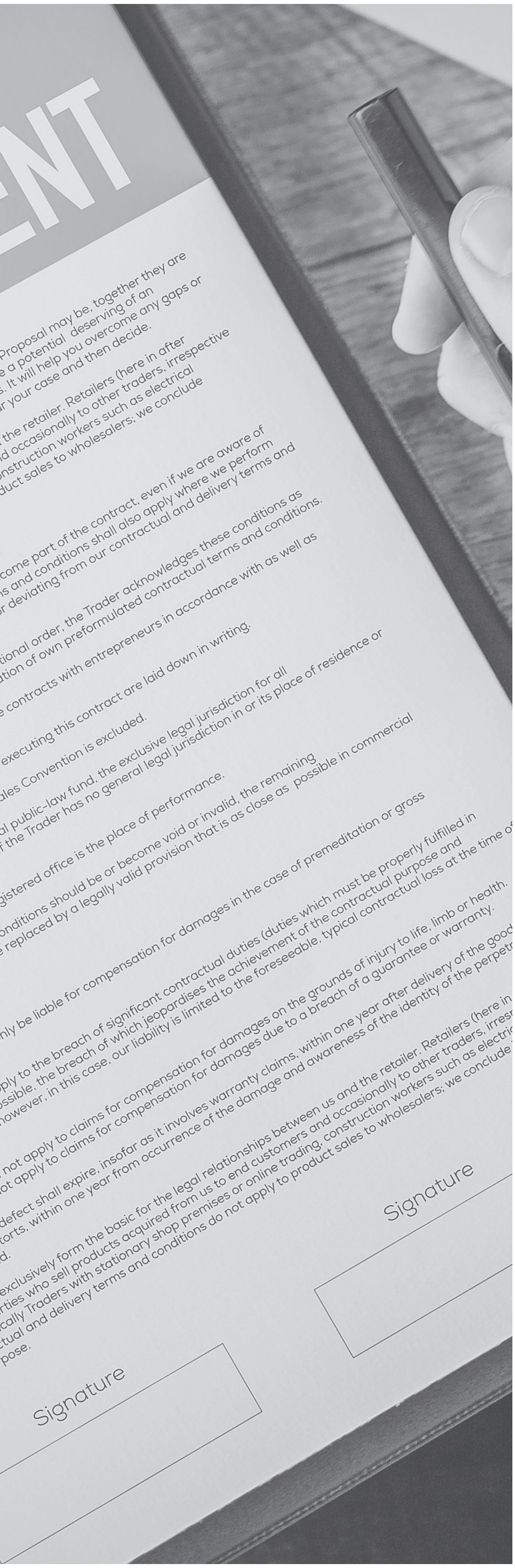
Our findings also demonstrate the value in investing for the long term, as rental income rises more rapidly than costs and house price growth has time to deliver significant capital gains. The days of short-term speculation should be well behind us. Yes, capital gains will drive significant long-term returns for landlords, but it is monthly income that allows them to meet the cost of finance and of running their property.

Like any business, a negative cash flow would prove terminal for many long-term investors, so cost control combined with regular assessment of their rental income is essential.

Reassuringly, our analysis highlights that even without the added benefit of capital gains, income over a 25 year period should not only cover a typical investor’s expenses, but deliver a modest profit on top.

As much as understanding the moving parts that underpin long-term investment is vital, it should not be the only consideration for investors. Prospective landlords should be fully aware of the risks as well as the potential rewards of investing in property, and the responsibilities they have to their tenants. As the market continues to professionalise, with a greater role being played by long-term, committed landlords, the service landlords provide to their customers should continue to improve.





Methodology

The analysis is based upon a conservative series of projections for house price, rental inflation and inflation. In the central case, both house price and rental inflation are assumed to rise in line with the OBR's furthest range forecast for real-terms wage growth (1%) and the Bank of England's 2% inflation target.

Initial rental house prices and rents have been taken from Kent Reliance's Buy to Let Britain series, which is based on detailed analysis of ONS data, alongside rental data from LSL, Citylets, BDRC Continental and the Registers of Scotland. All rents within the study account for three weeks of void periods per year. Due to data limitations, local authorities are assumed to have the same yield as the regions they are situated in, and all house prices and rents are forecast to rise in line with the national average.

The research assumes an LTV of a new investor stands at 70%, in line with the Council of Mortgage Lenders' data for buy to let house purchases.[4] The study does not attempt to forecast interest rates over a 25-year period, but utilises a constant mortgage rate of 3.5%, conservatively higher than the average five-year fixed rate at time of writing (3.43%)[5], and accounts for the cost of remortgaging every five years. Should interest rates prove significantly higher over the period of analysis, they would likely be accompanied by higher rates of inflation, and significant changes to house prices and rents.

The running costs per property of 19.5% gross rental income are based on a survey of 817 landlords, conducted in association with BDRC Continental. The model also accounts for the transactional costs associated with buying and selling property, including 1.3%[6] estate agent fees and £1419 for legal fees.[7]

The modelling also factors in the opportunity cost of investing a deposit in low risk fixed income assets for the long-term. This was based on the current yield of a 10-year UK government bond (1.53%). As HMRC estimates that 82% of landlords are currently basic-rate taxpayers, the calculations for a landlord are primarily based on the tax situation of a basic-rate taxpayer that has fully utilised their personal allowance.[8] Income tax thresholds are assumed to rise in line with inflation, allowing for fiscal drag over the 25 year period.

[4] https://www.cml.org.uk/news/news-and-views/the-black-and-white-of-buy-to-let-what-does-the-data-show/
[5] https://landlordnews.co.uk/5-year-buy-to-let-rates-yet-record-low/
[6] MyHomeMove, October 2017
[7] Post Office and the Centre for Economics and Business Research
[8] https://www.gov.uk/guidance/changes-to-tax-relief-for-residential-landlords-how-its-worked-out-including-case-studies#who-can-use-the-examples

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