The Kent Reliance

Buy to Let Britain report

Edition Four

KentReliance

A foreword

Welcome to the fourth edition of the half-yearly Buy to Let Britain report from Kent Reliance, looking at the trends in the private rented sector (PRS), and the Buy to Let mortgage market that supports it.

This edition comes at a time when the Buy to Let market is under pressure like never before. Two years on from our inaugural edition, both the PRS and the Buy to Let market now sit firmly in the sights of both politicians and regulators.

Driven by a political agenda that prioritises home ownership and a view that Buy to Let is harmful to the UK's housing market, property investors are seen as the scapegoats for the nation's housing issues, whilst regulators are turning their attention to the lenders that support the market. This constant focus on managing demand does nothing to address the real issue, which remains the lack of supply of new housing.

However, notwithstanding the various initiatives aimed at curbing Buy to Let, the reality is that the market, and the PRS that it supports are essential parts of our housing supply. It is unfortunate that this is not acknowledged by policy makers, whose actions will primarily affect the tenants who they are arguably aiming to support; the prospect of higher tax on Buy to Let is already pushing up rents.

This report follows one of the industry's busiest ever periods, as property investors moved at breakneck speed to complete purchases ahead of a new stamp duty surcharge on second homes. But the full impact of recent tax and regulatory changes is still to come.

Meanwhile, the measures announced in the Chancellor's 2015 Summer Budget have changed the way in which landlords approach mortgage finance, and spurred large landlords into forming limited companies.

As always, we have worked out the current size of the PRS and its value – and more importantly – we consider the rate at which it is growing, and how the changing tax and regulatory environment will affect its growth.

We hope you enjoy reading our Buy to Let Britain report.

Andy Golding, CEO, Kent Reliance, OneSavings Bank plc

Andy Golding, Chief Executive Officer

Andy joined OneSavings Bank as Chief Executive in 2012, and in 2014, led the business to become the first bank to float on the London Stock Exchange in a decade. He has more than 30 years' experience in financial services and has held senior positions at NatWest, John Charcol and Bradford & Bingley. Prior to joining OneSavings Bank he was the Chief Executive of Saffron Building Society, where he had been since 2004. He has held a number of positions with industry institutions, including membership of the Building Societies Association's Council and the Council of Mortgage Lenders' Executive Committee, of which he is still a member. Andy consistently and vocally champions the importance of a thriving private rented sector. He is passionate about simplicity and fairness in financial services and is a published author on the subject of financial education. OneSavings Bank trades primarily under the Kent Reliance, InterBay Commercial, Heritable Development Finance and Prestige Finance brands.

Executive summary

Market overview

- Budget changes take toll on landlords' confidence, as three quarters see government intervention as biggest threat to property investment
- Stamp duty surcharge sees Buy to Let purchases climb 176% in March
- Number of loans issued to limited companies doubled in 2015, and could be within touching distance of 100,000 in 2016 as landlords react to tax changes
- PRS in Great Britain adds 266,000 households in last 12 months, despite growth tempering
- Value of landlords' holdings climbs £156bn in last year, standing at £1.2trn

Landlords

- Monthly rents rise 3.5% to average of £872 as tenant demand climbs in last year
- Increased taxes on landlords are actually increased taxes on tenants. As an unintended consequence of rising tax costs, four in ten investors expect to increase rents in the next six months
- Average total annual return stood at £28,617 in March
- Total annual returns reach £142.1bn across country
- Total rent collected by landlords across Great Britain has risen to £4.5bn per month, a record £53bn in the last year

Lenders

- Stamp duty causes extraordinary surge in activity in Q1 2016
- Excluding March, total lending up a third in last year as market continues to meet demand
- Remortgage lending rises twice as quickly as house purchase lending
- Further regulatory change expected as PRA conducts consultation into underwriting
- Announcement of further change could cause secondary activity spike if landlords rush to complete on pre-existing criteria

2016: Finding the new normal

- Landlords see short-term confidence shaken, as three quarters see government intervention as biggest threat to property investment
- Stamp duty surcharge sees Buy to Let purchases climb 176% in March
- Limited company loans within touching distance of 100,000 in 2016 as landlords react to tax changes

The PRS in 2015 was defined by government intervention designed to raise the cost of owning rental property, in a misguided attempt to support first-time buyers. 2016 has started in the same vein. Landlords are coming to terms with the impact of higher stamp duty, much lower tax relief on mortgage interest from 2017, and a reduced wear and tear allowance.

With so much going on, it is difficult for landlords to see what the new normal will be in the long term. But investor attitudes and behaviours are changing rapidly.

Uncertainty reigns

All investors value predictability and a stable regulatory environment. Becoming a political football has caused uncertainty in the PRS, knocking the confidence of property investors. In a survey of over 1,000 landlords, run in association with BDRC Continental in the first quarter of 2016, just 41% of landlords held a positive outlook for their portfolios – an all-time low. Moreover, three quarters of investors (73%) see increasing government intervention as the biggest threat to property investment in the next 12 months. We expect confidence to recover as landlords adjust to the new normal, although it's clear landlords are apprehensive about further government action.

Stamp duty stampede shows underlying appetite

The new stamp duty surcharge has already distorted the market. March saw an unprecedented spike in activity, as landlords hurried to complete purchases ahead of the introduction of the higher stamp duty tax in April, announced in the Autumn Statement. The Council of Mortgage Lenders (CML) estimated that the move stimulated an additional 60,000 transactions in the month, including a 176% increase in Buy to Let purchases compared to February. With many having brought forward purchases, such activity in the second quarter will naturally have fallen back.

Landlord limited company rush picks up pace

A large number of landlords have already changed the way they manage their portfolios to account for reduced mortgage tax relief. Our data shows mortgage applications via limited companies increased by over 80% in 2015 compared to 2014. In 2015, more than a fifth of applications were through limited companies, compared to just 15% of applications in 2014, meaning the total number of mortgages through limited companies each month climbed to 54,750 in 2015, from 29,900 in 2014.

This rush to incorporate has not abated in 2016. It has intensified, with numbers being exaggerated by the stamp duty stampede. In the first three months of the year, four in ten applications for Buy to Let mortgages have been via limited companies. Across the whole market, just under 38,000 limited company loans were issued in the period, nearly four times the 10,100 a year ago.

This trend is set to continue. A third of landlords surveyed are considering this move, and 7% have already done so. Professional landlords with larger portfolios (20+ properties) are much more likely to incorporate. Nearly half are thinking about taking this step, and 22% have already done so. As landlords become increasingly aware of their options – not to mention begin to feel the impact of the changes on their tax returns from 2017 onwards – incorporation will grow in popularity. We expect more than half of new loans to be made in this way by the end of this year.

Industry evolves to support professional landlords

Pricing changes and broadening product options will also sustain demand for limited company lending. According to Mortgages For Business, there were 153 limited company products on the market by the end of the first quarter, and this is likely to increase. It also calculates the cost of limited company finance is falling. In December, the rates of these types of loan were 0.7% more costly than the equivalent direct mortgage, falling from 0.8% in July. As the product type becomes more mainstream, this gap will close. For instance, Kent Reliance has already moved to synchronise the pricing of its loans via limited company and LLPs with personal Buy to Let mortgages, a decision mirrored among several other key lenders.

Added to this, it is becoming common practice for lenders and brokers to ask larger-scale investors as a matter of course why they are seeking personal mortgages, rather than mortgages via a limited company.

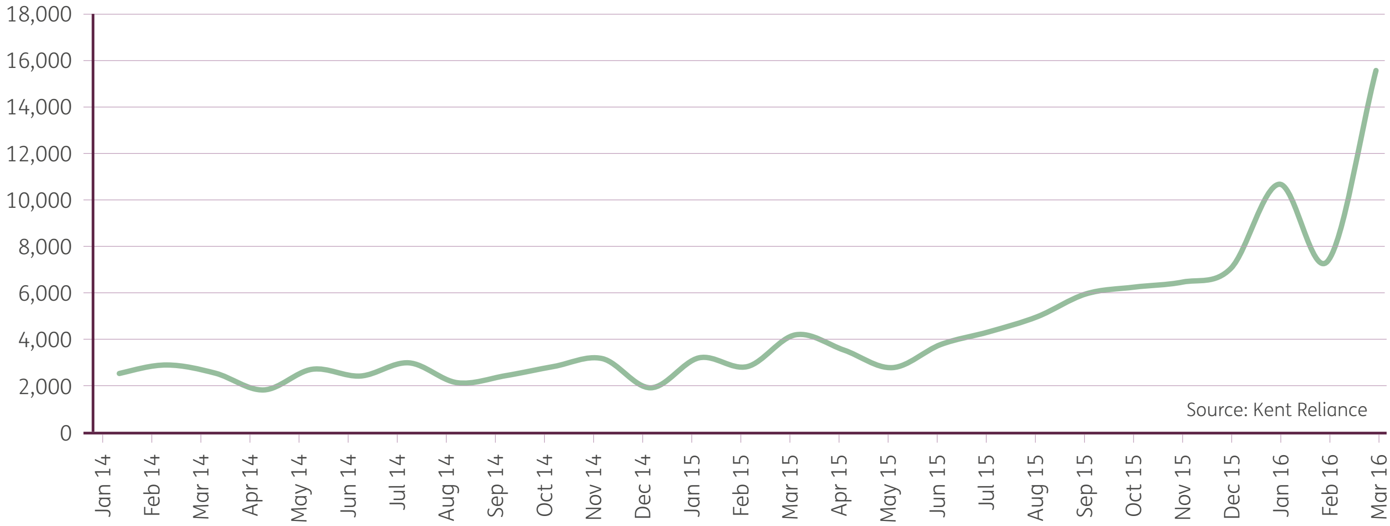
All of this will support the growth of this part of the market. On the trends of the last three months, assuming Buy to Let lending does not grow in 2016, we estimate that limited company loans will total 98,400. Even with a more conservative projection, based on the trends of the last six months, we would expect 77,600.

The benefits of incorporating

In our recent report with EY, **Buy to Let property owners: Changes to UK tax relief on finance costs**, we explain the potential benefit of incorporation for many landlords. Take for instance, an individual landlord with a Buy to Let property portfolio worth £5.4m, receiving annual rents of £189,000, with expenditure of £7,500 and finance costs of £129,600 and no other income. When the new rules are fully introduced they would pay a quarter as much annual tax if they owned their portfolio via a company. Landlords will need to factor in additional transactional and administrative costs if they do make the move, but the long-term savings will entice many.

Ultimately, government intervention won't deter large-scale landlords from the market entirely. Rather, it will expedite the professionalisation of the sector, as small portfolio amateur landlords reconsider their position. Crucially, the changes increase the importance of professional tax planning for investors.

Estimated loans to limited companies per month



A growing sector: making sense of puzzling PRS data

- PRS expands by 5.5% in last year, standing at 5.1m households
- In last ten years, PRS has increased by 2.3m households

Tenant demand is growing as a result of high house prices and a lack of housing supply. In the first quarter of 2016, five landlords saw tenant demand rise for every one that saw it fall. This growth is being mirrored by increasing Buy to Let mortgage lending, and it is clear that the PRS is still expanding.

Against this backdrop, the latest English Housing Survey made for puzzling reading, suggesting that the PRS actually fell by 99,000 households in 2014-15 (the latest period it examines). This has been met with reasoned scepticism from the CML, and rightly so. The figures simply don't add up.

First, the English Housing Survey 2014-15 suggests that the total number of households across all tenures fell by 103,000. This directly contradicts the trend seen in the ONS's own robust Labour Force Survey, which shows the number of households in England actually rose by 272,000 in the period.

Second, data from the CML shows that over the period in question, there were 29,200 more first-time buyer mortgages issued than in the previous year, an increase of 10%. This is nowhere near enough to cause a fall in the number of rented homes.

Third, for the English Survey Household numbers to be accurate, we would also have to see a fall in Buy to Let mortgages for house purchase. This, too, hasn't materialised. In the period in question, new mortgages to fund Buy to Let purchases grew at a faster rate – climbing by 14% to 102,000, and this trend in growth has continued right through to March 2016.

We believe the English Housing Survey results owe more to the volatility of short-term survey figures than representing a true contraction in the rental market.

First-time buyer loans per month

Revising our analysis to account for the volatility in the English Housing Survey and incorporating new data, we conservatively calculate the private rented sector in 2014-15 grew by 247,700 households in England, rather than shrank. This represents growth of 6.1%, compared to 8.1% in the previous year. First-time buyer numbers have improved, which has allowed more to leave the rental sector, but the supply/demand imbalance remains. The PRS is undoubtedly still growing.

Our new projections suggest the PRS in Great Britain currently stands at 5.1m households, 19.3% of overall households. The annual growth of the sector stood at 5.5% in the first quarter of 2016, down slightly from 5.7% a year ago.

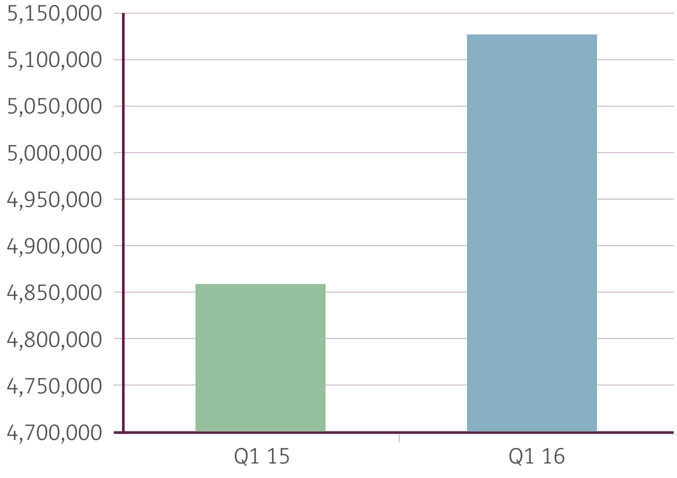
Despite slowing growth, the PRS's importance in housing the country's growing number of households has not diminished. In the last year, Great Britain's households grew by an estimated 265,000. The PRS accounted for all of the growth, rising by 266,000. Over the last decade, this is even more pronounced. In other words, it is still increasing its share of overall tenure.

While an estimated 1.8m households have been created since 2006, the PRS has expanded by 2.3m, almost doubling in size.

Annual growth in number of PRS households

Source: ONS, Kent Reliance

Total households in PRS



Source: ONS, Kent Reliance

Rents to climb as landlords absorb increased running costs

- Rents climb 3.5% in last year, to a monthly average of £872
- Three quarters of landlords planning to raise rents in next six months cite government changes

Rental income allows landlords to service the cost of their investments, meeting costs such as mortgage interest and tax. It was identified as the most important motivation for landlords to invest (57%), far ahead of long-term capital appreciation (32%).

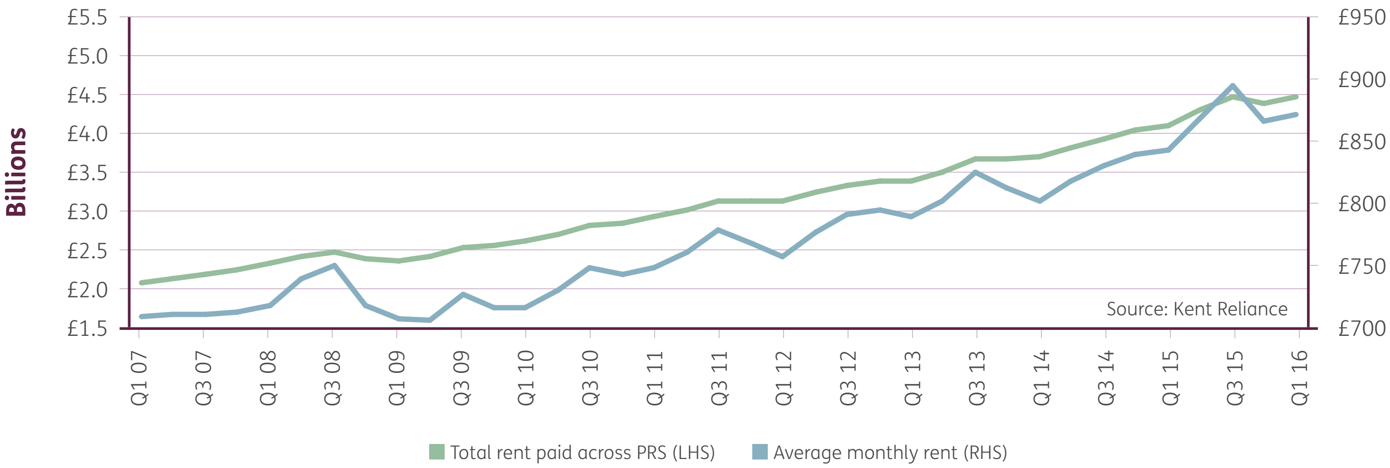
Strong tenant demand has supported rents. The average rent in Great Britain has risen by 3.5% in the last year, standing at £872 per month. Rents have grown from £865 per month in the previous quarter, but are still slightly below (-2.6%) the recent high reached in September 2015.

Several reports suggest there has been downward pressure on rents in April and May already, as a side effect of the stamp duty rush boosting supply. This will be short-lived. Alongside growing tenant demand, the changes introduced by the government will support rental prices as landlords absorb increased costs. 39% of landlords expect to raise rents in the next six months by an average of 5.6% (an increase of about £49 per month for tenants). Three quarters of landlords increasing rents directly blame the changes to mortgage tax relief for doing so, while four in ten highlight strengthening tenant demand.

Higher rents and more tenants mean landlords are collecting 9.2% more rent compared to a year ago, £4.5bn in rent per month. In the last year, tenants have paid landlords a collective £52.9bn, an increase of £5.2bn compared to the previous 12 months. This is the highest level on record.

On a regional basis, London and the South East account for more than half of all monthly rent in Great Britain (£27.3bn). The North West and South West are the net largest contributors to the national total, totalling £4.2bn and £3.8bn respectively.

Total monthly rent vs average rent per property



Monthly rent paid by region (£m)

- London **(£1,718)**
- South East **(£593)**
- East of England **(£327)**
- North East **(£75)**
- South West **(£325)**
- West Midlands **(£246)**
- Yorkshire & The Humber **(£263)**
- East Midlands **(£226)**
- North West **(£351)**
- Scotland **(£264)**
- Wales **(£93)**

Source: Kent Reliance

PRS value climbs by more than £155bn in last year

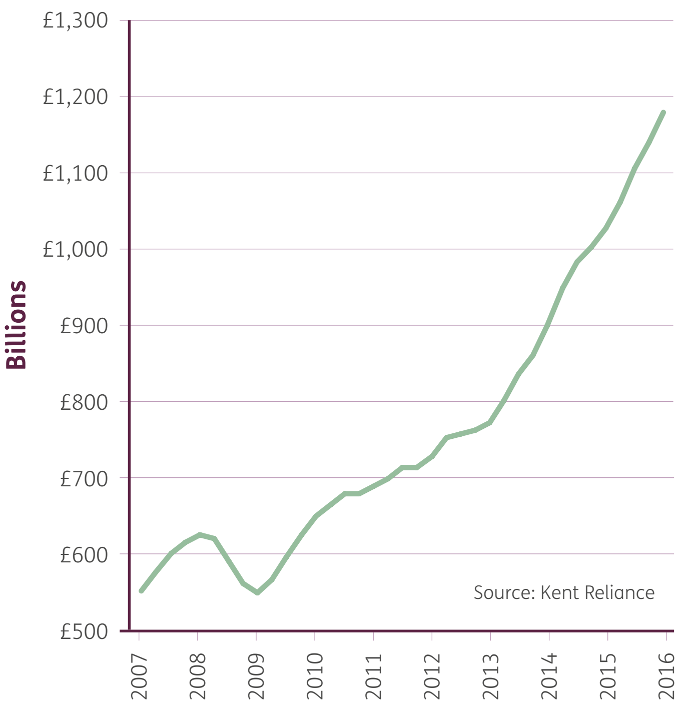
- PRS increased by nearly one sixth in value in last 12 months
- Average property sees 9% rise in value, climbing to £229,394

The total value of the private rented sector has grown by £155.8bn in the last year, the fastest growth on record. This represents an increase of 15.2%, to £1.2trn.

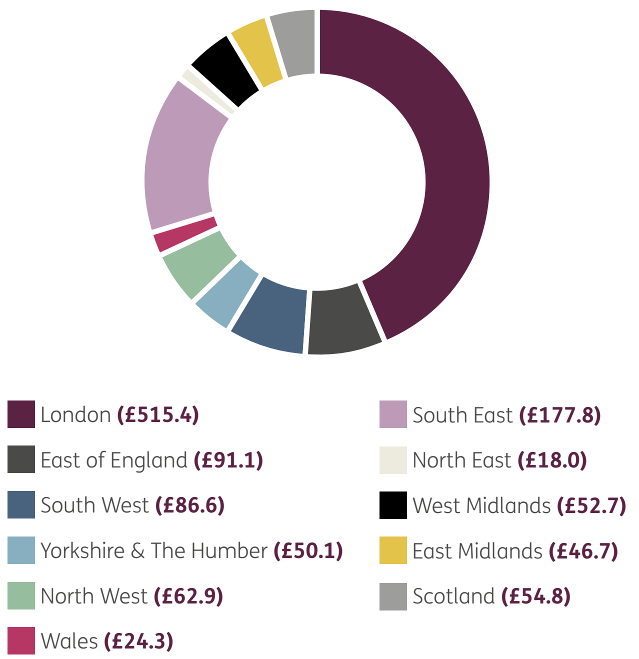
The total value of the private rented sector is dictated by the value of property and the total number of properties in the sector. As we have seen, the PRS is growing apace. Landlords have also benefited from very healthy property price inflation in the last 12 months, with the typical Buy to Let property value rising by 9% to an average of £229,394.

With more than a million homes in its rented sector, and the fastest house price growth in the last year (despite signs it is starting to slow), London is the key driver behind the sector's growing value. The capital's PRS has increased in value by £88.6bn, ahead of the South East (£25.2bn) and the East of England (£13.2bn).

Total value of the PRS in Great Britain

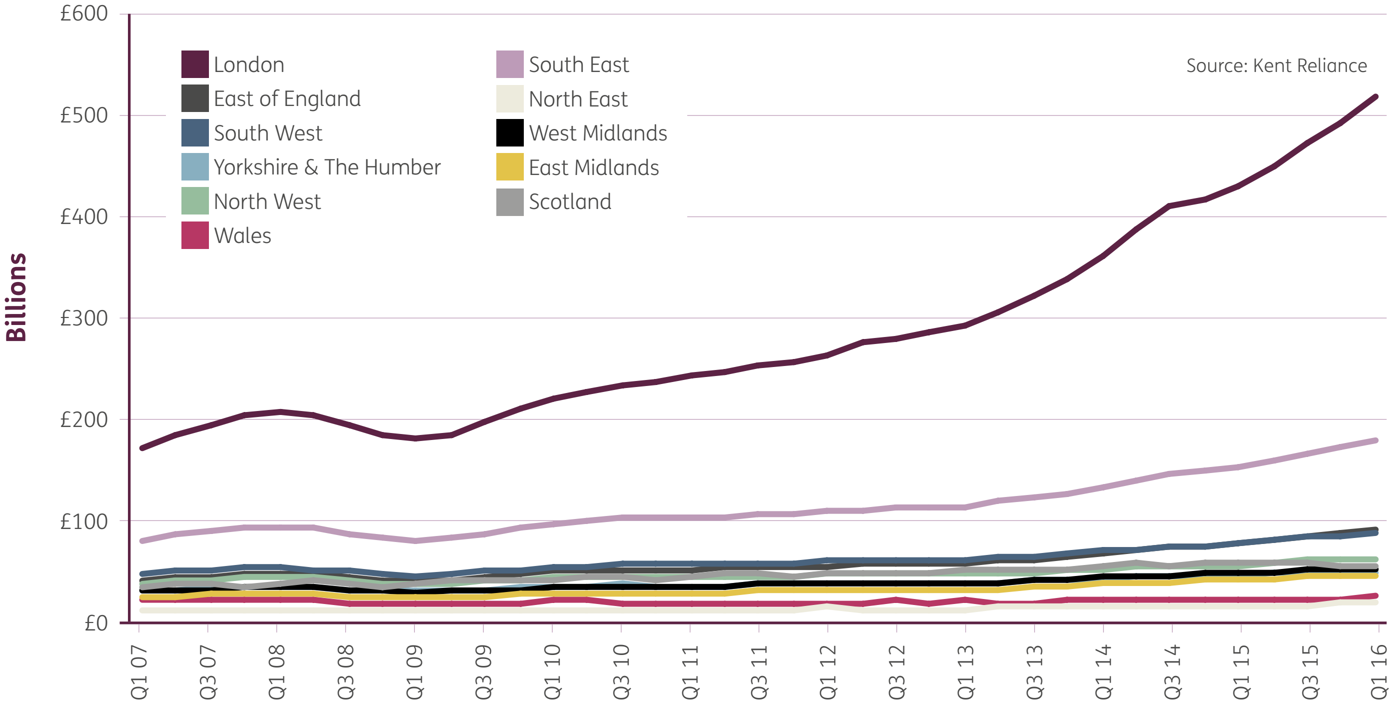


Value of the PRS by region (£bn)



Source: Kent Reliance

Growth in the PRS, by region



Property investors positive about profits, with returns hitting £142.1bn

- Despite knock to confidence, 71% of landlords prefer property over other asset classes
- Average total annual return of 13.6% per property means returns across the PRS up a combined £26.1bn

Landlords are still positive on property investment for the long term, despite government intervention. 71% of landlords rate property investment as better than other investment options, with just one in ten rating it as worse.

While 59% believe government changes will adversely affect their profitability, in the medium term, they are likely to offset the additional costs simply by raising rents. With tenant demand unlikely to change, given the difficulty getting a mortgage, and with property in overall short supply, landlords have pricing power on their side.

In fact, average total annual returns for landlords have been improving on the back of rental inflation and strong capital gains. By the end of the first quarter, the average return stood at 13.6%, with a yield of 4.6% and 9% house price inflation – £28,617 in cash terms. Returns were up from 13% a year ago, and 12.6% at the end of 2015. While recent changes will have an initial impact on returns on highly geared individual landlords, the current level of gross annual returns demonstrates that property investment will remain a profitable long-term undertaking.

The growing scale of the sector and improved returns per property mean that across the PRS, returns totalled £142.1bn in the last year, a record high. This represented an increase of £26.1bn from a year ago, up 22.5%.

London and the South East accounted for £100bn of these total returns, with returns per property climbing to £80,811 and £33,569 respectively.

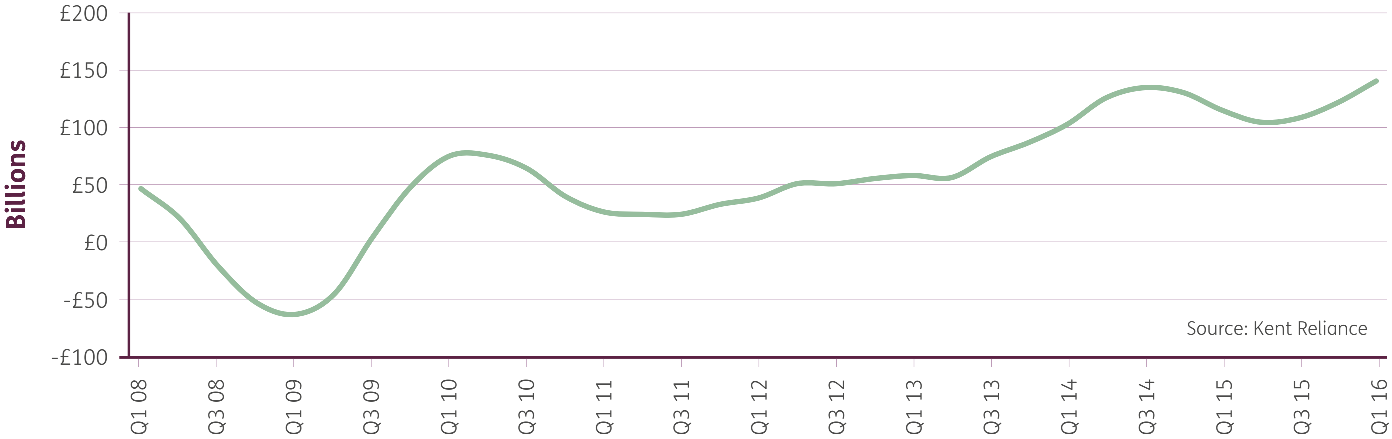
Yields are an important measure for property investors, comparing the annual rental income of the property against its value. As the value of the average rental property has grown more quickly than rents, yields have fallen. Yields stand at 4.6%, down from their recent high of 4.9% in September.

Current yields and total annual returns

	Current yields	Total annual returns
London	4.0%	18.2%
East of England	4.3%	15.2%
South West	4.5%	10.5%
Yorkshire & The Humber	6.3%	8.1%
North West	6.7%	12.5%
Wales	4.6%	8.4%
South East	4.0%	14.7%
North East	5.0%	4.4%
West Midlands	5.6%	8.7%
East Midlands	5.8%	11.4%
Scotland	5.8%	–0.3%
Great Britain	**4.6%**	**13.6%**

Source: Kent Reliance

Total annual returns across PRS



Gross yields in Great Britain


At any time
No loading
at any time
23

Buy to Let market fuels sector growth

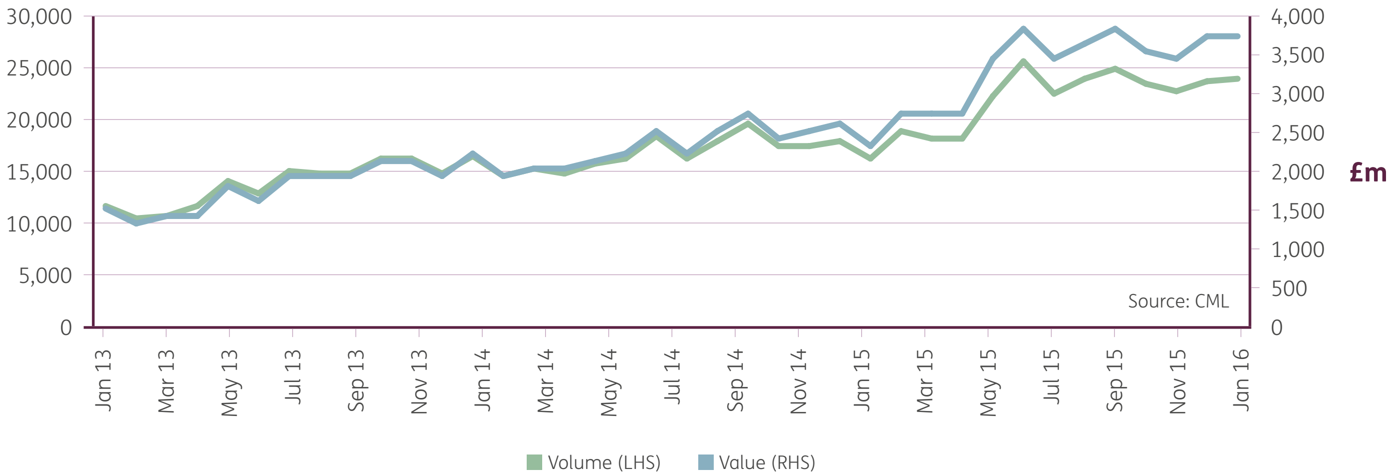
- Buy to Let lending grows a third, excluding an extraordinary March
- Buy to Let remortgaging outperforms house purchase market, up 63%

March proved to be a remarkable month for Buy to Let lending, and has exaggerated the pace of growth in the market. Even excluding this month, the Buy to Let market has grown substantially. In the year to February, 265,600 Buy to Let mortgages were issued, a third higher than in the previous 12 months.

Remortgaging activity has risen faster than purchase activity, as borrowers look to take advantage of increasingly attractive fixed rates. February saw remortgaging up by 63% year on year compared to 30% for house purchase.

The conclusion of the Prudential Regulation Authority's consultation on underwriting is likely to slow growth in some sections of the Buy to Let market, as affordability criteria tighten – although a side effect could be a more rapid increase in rents for tenants as landlords seek to demonstrate higher rental cover. When the implementation date becomes public knowledge, it could create a second spike of activity in 2016, as landlords move to take advantage of more relaxed criteria while they can. Equally, it could boost demand for remortgages, as portfolio landlords release equity from current properties to give them greater deposits for purchases, bringing down mortgage interest payments so they can meet more stringent rental cover criteria.

Buy to Let advances



Outlook

The long-term fundamental drivers for the future expansion of the PRS are well entrenched. The country is seeing the number of households continue to rise and the population swell. Moreover, the level of house building is a long way short of being able to match this growth. The government's measures to subsidise first-time buyers without increasing supply are merely pushing up house prices, while financial penalties on landlords are simply causing rents to rise.

Blaming landlords is nothing more than misdirection from a government failing to conceal its blushes on housing supply. Ultimately, the only way to bring down housing costs for renters or home buyers is to increase supply. Tinkering with tax treatment, or applying further regulation will not address this key issue. It will exacerbate it.

There are other reasons for uncertainty. A pro-Brexit vote in the EU referendum may impact money markets, and therefore interest rates and the cost of mortgages. On top of this, the PRA is currently undertaking a consultation into Buy to Let mortgage underwriting, which will likely result in more stringent affordability testing in any mortgage application, stress testing against interest rate rises, and a specialist approach to portfolio landlords.

While these moves have the potential to cause some disruption, they do not impact the underlying fundamentals supporting long-term demand from investors.

We anticipate that growth in the PRS will continue in 2016, but at a slower pace. We expect the number of households to reach 5.3m by the end of the year, and 5.6m households at the end of 2017. Allowing for the rapid rate of house price growth to cool in 2016, we anticipate the sector will be worth about £1.3trn by the end of the year.

Methodology

Kent Reliance's research team analysed ONS census, ONS population and English Housing Survey data to establish the regional weighting of the private rented sector, 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. Rental data incorporates figures taken from Citylets and yield data from LSL Property Services. All rental and property value data has been weighted to account for the changing regional composition of the private rented sector. Buy to Let mortgage data is based on analysis of figures from the CML and ARLA. Unless otherwise stated, the data analysed is between 2007 and the first quarter of 2016.

Unless otherwise stated, all survey data is based on a survey of 1,097 landlords, conducted by BDRC Continental in the first quarter of 2016.

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