Part of the Buy to Let Britain research series

Buy to Let Britain Report

Edition Seven

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KentReliance for Intermediaries

Contents

Foreword

Welcome to the seventh edition of Kent Reliance's half-yearly Buy to Let Britain report, a detailed analysis of the key trends in the private rented sector (PRS) and the buy to let (BTL) mortgage market, and a look ahead to what 2018 may bring.

2017 has proved to be another eventful year. In January, the Prudential Regulation Authority (PRA) introduced stricter underwriting criteria for landlords, ostensibly to reduce risk in new lending. April saw the Chancellor's overhaul of the tax treatment of mortgage interest begin to take effect. In October, a second round of changes was implemented, altering lenders' treatment of portfolio landlords. Landlords then saw interest rates increased from 0.25% to 0.5% in November; for many, it will be their first ever increase.

The lack of additional action in the Autumn Budget, aside from the consultation announced to encourage longer-term tenancies, will come as a pleasant surprise to many property investors who were braced for further intervention. Even so, it will take some time for landlords' confidence to bounce back from the multiple blows it has taken in the last two years. This is already impacting the supply of rental properties, especially with small-scale landlords - who haven't added to their rental stock in the last three months. By contrast, larger portfolio landlords have been less deterred, and continue to be positive net contributors to supply.

As large-scale landlords begin to play a more prominent role, professionalisation in the sector continues, with signs that the larger portfolio landlords are more likely to be adding to their stock. Meanwhile, demand for limited company lending remains robust as landlords look to mitigate the recent changes to taxation. We are seeing a fundamental shift, as buy to let moves from being a popular past-time for hundreds of thousands of amateurs, to the preserve of committed long-term investors with experience and expertise.

We examine the underlying dynamics of the sector, how returns and rents are performing, how tenant demand is changing, and importantly, how landlords are reacting to the swathes of changes they have seen in recent years.

Andy Golding, Chief Executive Officer, OneSavings Bank

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 UK Finance Executive Committee (successor to the Council of Mortgage Lenders), 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

- The expansion of the private rented sector slows, as number of households rises just 2.2% in last year, compared to expansion of over 8% seen in 2014
- Large-scale investors continue to increase their portfolios, but no growth among small landlords
- Confidence remains fragile among investors, with 41% positive about their business' prospects
- Limited company loans grow in popularity in 2017, accounting for seven in ten house purchase mortgage applications
- Recovery in house price inflation since Q1 sees total value of PRS climb to £1.4trn, up £82.6bn in last year

Lenders

- Second round of PRA changes have taken effect, creating distinct market for portfolio landlord lending and helping to further professionalise the sector
- However, stricter criteria and taxation changes hamper demand for finance; house purchase lending a third below the level seen in recent years, but signs of modest improvement in Q3
- Remortgaging is in better health, as landlords increasingly look to fix rates
- Financial stability of sector improves, with LTV of PRS falling to 17.1%, and arrears at a 10 year low

Landlords

- Average rents hit record high of £895 pcm, but annual inflation continues to slow
- Tenant demand still rising, yet sees slowest growth in at least five years
- Annual returns improve on the back of house price growth, although average yield compresses slightly to 4.4%
- Gross total returns recover from start of year, standing at £111bn across PRS
- Slowing tenant demand and house price growth sees London lose its lustre for landlords

A market within a market as tax and regulatory changes take hold

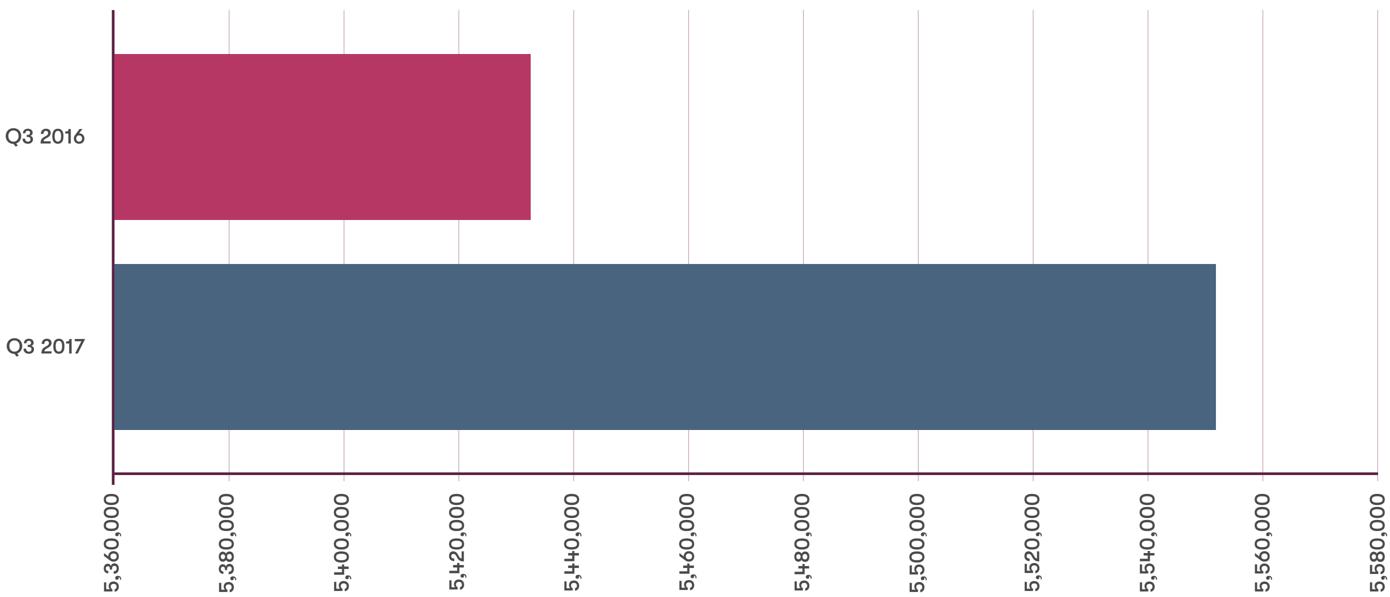
- **Growth of PRS continues to slow, as number of households increases by just 2.2%**
- **Confidence among investors remains low, but larger landlords driving expansion**

The cocktail of tax reform and prudential regulatory changes for landlords has held back the expansion of the PRS. January saw the introduction of the PRA's stricter underwriting criteria for buy to let mortgages, requiring a more detailed assessment of a landlord's finances, and stress testing the loan at a higher rate. In April, the first stage of 2015's taxation changes came into force, reducing the amount of mortgage interest landlords could offset against rental income. October then saw new underwriting standards for portfolio landlords with four or more mortgaged properties, increasing the complexity of mortgage applications.

These reforms have had a cumulative effect on landlords' behaviour, especially among smaller scale investors, and the growth of the sector as a whole.

In the last year, the PRS grew at a rate of just 2.2%, climbing in total to nearly 5.6m households by the end of September. This compares to a rate of over 8% seen in 2014, as both the supply of properties and tenant demand moderated this year.

Total households in PRS



Source: Kent Reliance, ONS

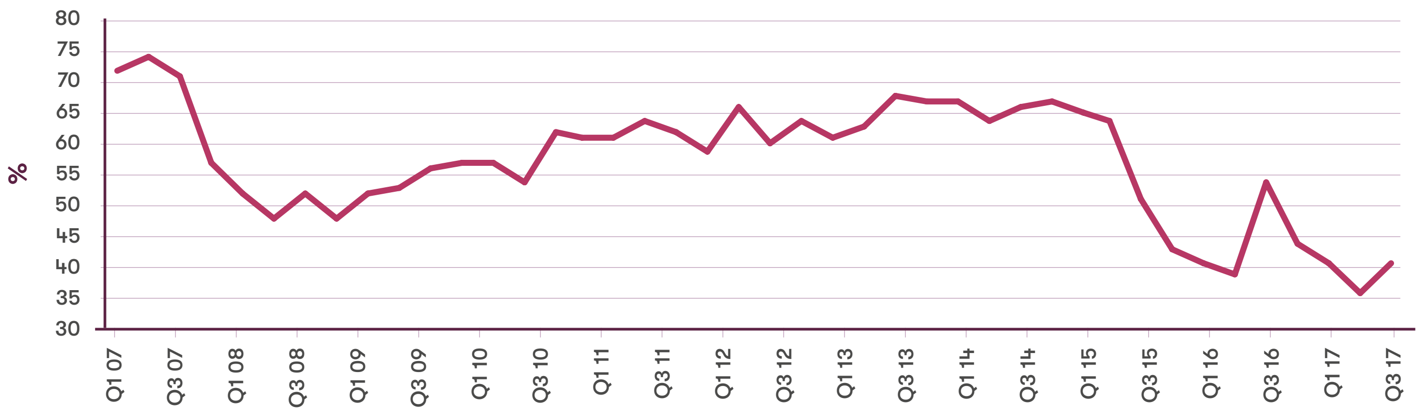
Where we have seen improving supply, it has come from larger-scale landlords. In a survey of 856 landlords, run in association with BDRC Continental, among those that bought or sold properties in the last three months, investors with more than 10 properties made a net addition of one property. Among those with less than five properties, net growth is flat. Given investors with just a single property comprise 62% of the landlord community[1], a lack of growth in this segment of the market has a disproportionate impact. In effect, we are seeing the start of a two speed buy to let market.

On the demand side, tenant demand is rising, but more steadily. Just 22% of landlords reported tenant demand increasing in the past three months. More saw tenant demand rising than falling (17%), although this represented the slowest net growth in at least five years.

After falling to a record low in the second quarter of 2017, landlord confidence has marginally recovered, climbing back to 41% - the level seen at the start of the year. However, increasing regulatory and tax burdens, and fears of future policy changes, are clearly weighing on decision-making, at the same time as running costs rise and yields are under pressure.

In the long-term, even if the combined effect of these factors is to deter amateur landlords from additional investment, any reduction in the supply of rented property this causes will only increase rents.

% of landlords positive about their business' prospects in next three months



Source: BDRC Continental

[1]The CML, December 2016

Taxation changes continue to drive demand for incorporation

Rather than sell-down or leave the sector, many have moved to manage properties through a limited company. Operating as a company means landlords are unaffected by mounting restrictions on the amount of mortgage interest that can be offset against tax for personal investors.

This has sustained demand for limited company mortgages throughout the year, especially for those purchasing property. Kent Reliance's data shows that in the first three quarters of 2017, seven in ten buy to let applications for house purchase were via limited companies, up from 45% in 2016 as a whole.

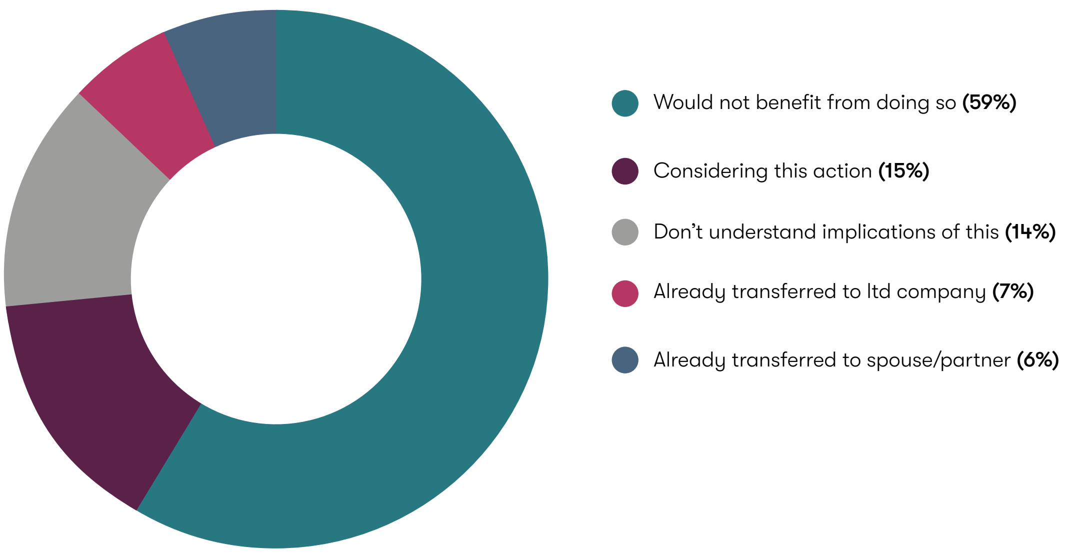
Demand for this type of specialist lending looks set to stay strong. 13% of landlords questioned had already moved properties into a limited company, or transferred ownership to a spouse to mitigate higher tax bills, and a greater number (15%) plan to do so in the future. This figure may prove conservative, given that 14% of landlords don't understand the implications and benefits of taking such a move.

As the amount of mortgage interest that landlords can offset against tax diminishes over the next four years, and tax bills rise, this is likely to spur on demand for incorporation.

Opting to form a limited company is proving more popular with larger-scale, portfolio landlords who have been hit most heavily. 28% of landlords with twenty or more properties are considering taking this step, while one fifth have already done so.

The financial benefit of moving properties into a limited company is likely to improve in the future if we see interest rates normalise. Interest rate normalisation would see the monthly cost of mortgage finance rise at the same time that the proportion of it that is tax deductible decreases. While transaction costs such as capital gains tax or stamp duty are a consideration for those moving properties into a limited company vehicle, the long-term financial argument would become more compelling.

Landlords' sentiment towards incorporation or transferring property to spouse



Source: BDRC Continental

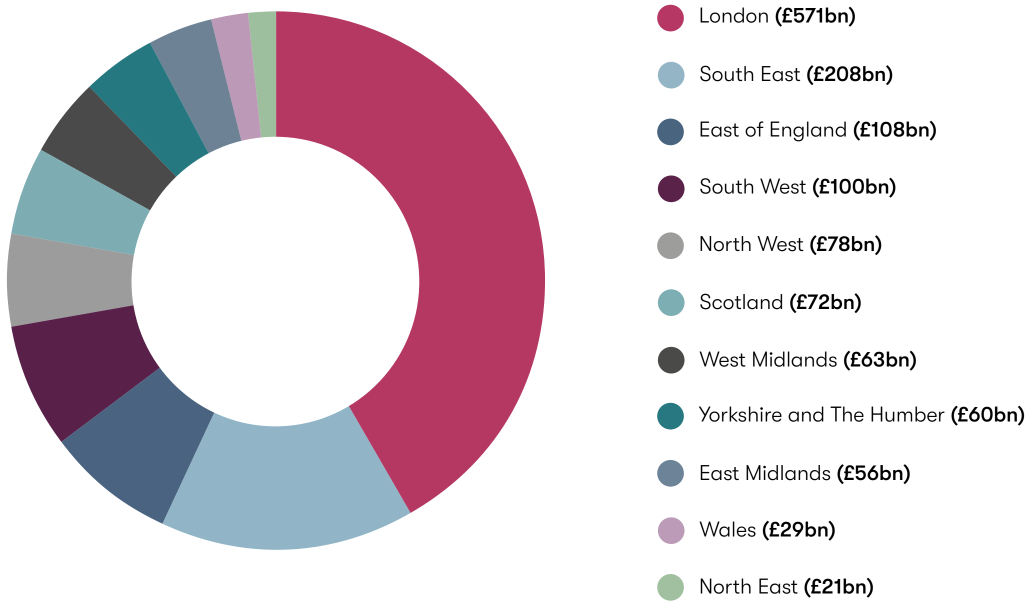
Total value of the sector climbs to £1.4trn, but de-risks as gearing falls

- **Average private rented property climbs 6.4% in value as sector adds just under £83bn in last year**
- **Overall LTV of the sector falls as capital growth outstrips outstanding lending**

The value of the average private rented property has risen by 4.2% in the last year, climbing to £245,950. Combined with the continued growth in the size of the private rented sector, the total value of private rented housing has climbed further. The value of the PRS in Great Britain currently stands at £1.4trn, a rise of £82.6bn in the last year.

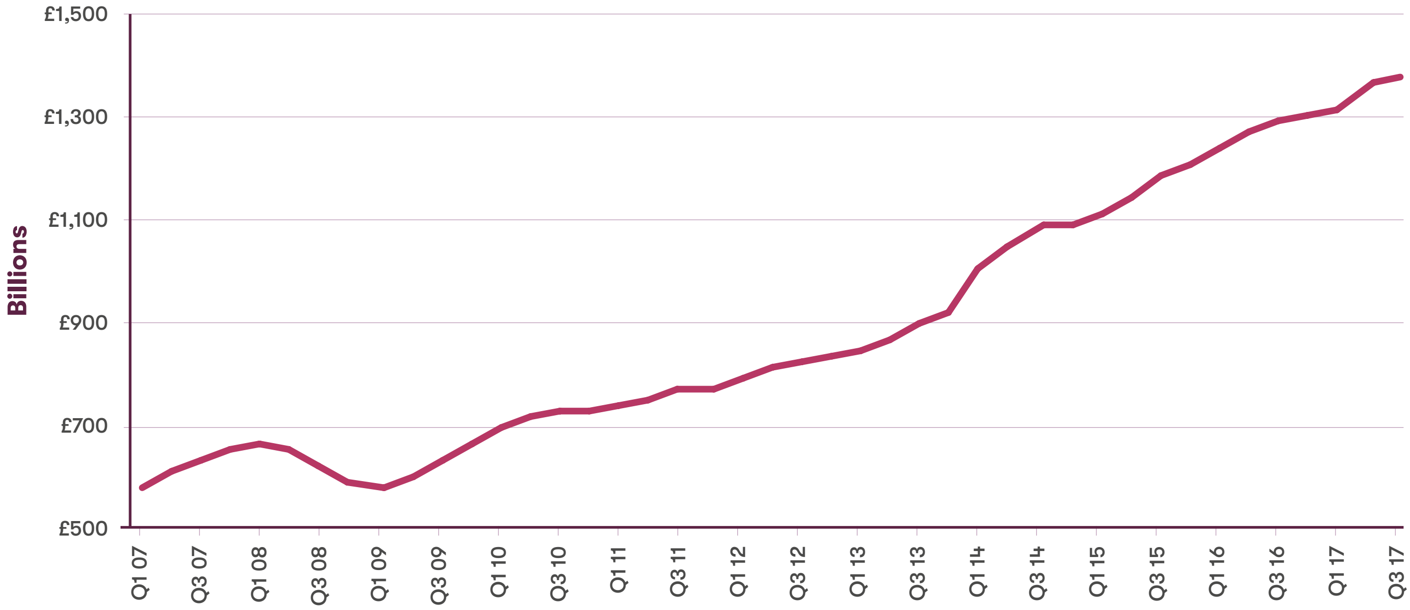
Although London accounted for nearly £22bn of this rise, it has the second slowest growth in Britain. It's 4.0% increase in value pales in comparison to the 11.4% seen in the North West, 8.9% in the South East and 8.8% in the East Midlands, as these areas benefited from far faster capital appreciation per property.

Value of the PRS by region (£bn)



Source: Kent Reliance

Total value of the PRS in Britain



Source: Kent Reliance

PRS de-leverages as it grows in value

As landlords' equity has grown, the sector has de-leveraged in the past year: solid house price inflation has outstripped a steadier increase in the value of outstanding mortgages supporting the sector. New borrowing for house purchases has been dampened by a combination of higher stamp duty costs, stricter underwriting rules, and concerns over the impact of changes to the tax treatment of mortgage interest.

With £233bn of buy to let loans currently outstanding, according to UK Finance data, the loan-to-value of the private rented sector currently stands at 17.1% - down from 17.7% a year ago, and 19% four years ago. If one of the government's goals was to diminish potential risk within the sector by reducing overall gearing, this is already happening.

Rent rises slow as London drags down national average

- **Rents climb 1.5% in last year to £895 per month**
- **London sees second slowest growth in England with tenant affordability stretched**

Rent rises continued to slow in 2017. Last quarter, they rose by an annual rate of 1.5% to £895 per month on average. This compares to 2.4% a year ago.

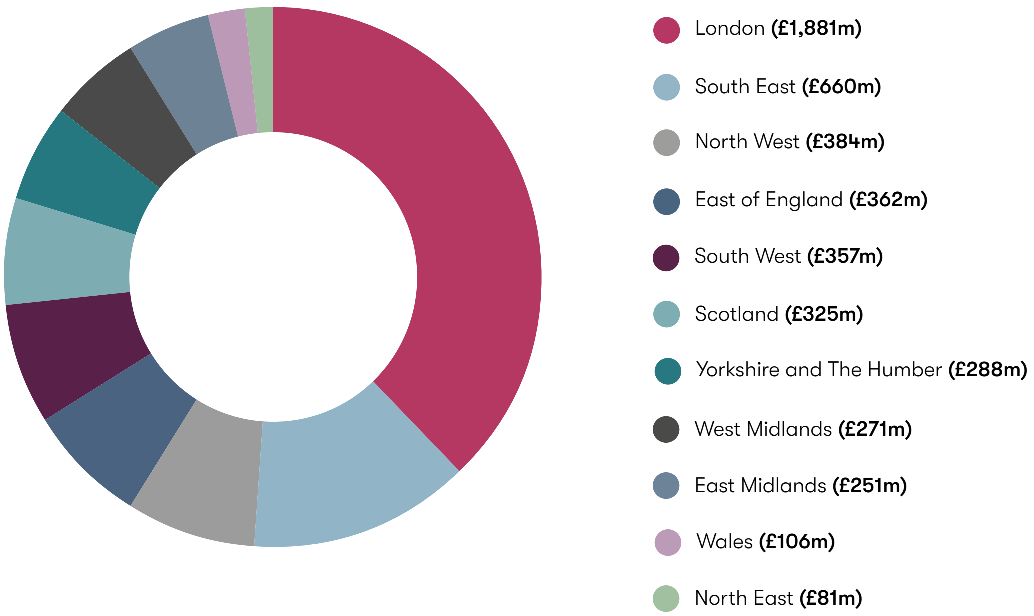
The glut of properties that came on to the market in the second half of 2016 and early 2017, a knock-on effect of the stamp duty rush last year, dampened rental inflation. But slowing rental growth is also a regional story. A year ago, London had one of the fastest rates of rental inflation in the country. At just 0.9%, it now has the second slowest in England. Given the disproportionate size of its rental population, the capital's slowdown has had a sizeable impact on the national story. Rents are rising fastest in East Midlands. Rents in the South East (2.5%) and East of England (2.4%) are also increasing more rapidly as these areas see increased competition among tenants looking to move from London to more affordable areas and endure the commute.

Across the PRS, the combination of a steadily growing tenant population and slightly higher rents has increased the total rental income Britain's landlords received in the last year. Tenants paid landlords a total of £58.8bn in the last 12 months, £2.3bn more than a year ago. London's tenants contributed £22.3bn, with the South East (£7.8bn) and the North West (£4.5bn) the next largest contributors. The total contribution of tenants in the South East grew by 5.4%, the fastest in the country.

Have rents reached an affordability ceiling?

Slow earnings growth does limit the extent to which landlords can increase rents, especially in areas of cooler tenant demand or where rents have seen more drastic increases in recent years compared to wage growth. This is especially the case in London, where rents have risen by 50% in the last decade. Even so, if an affordability ceiling had been hit, we would expect to see more warning signals in the national market. In fact, tenant finances are in reasonable shape. Landlords report that the average number of tenants in arrears in their portfolios has actually fallen in the last year. For those who experienced arrears last year, the average sum owed to a landlord across their portfolio stands at £1,774 - unchanged from a year ago.

Total monthly rent paid by region (£m)



Source: Kent Reliance

Moderate increases ahead

Although rent rises have eased in the last year, they are likely to continue to climb. 29% of landlords expect to increase rents over the next six months, ten times the number who expect to reduce them.

Rising operating costs are the key driver, cited by 72% of landlords looking to increase rents. The recent interest rate rise is unlikely to have a significant impact on rents on its own. However, if we see a return to pre-recession interest rates, it would be a long-term driver for steeper rental inflation as landlords pass on costs, and first-time buyers find it harder to buy. Taxation changes remain the key drag on the returns of buy to let landlords, and this drag becomes greater if mortgage costs rise.

Larger-scale portfolio landlords are more likely to raise rents; 43% of those with more than 20 properties expect to increase rents. Tenant churn across their portfolio provides more opportunities to do so.

Furthermore, unless operating as a limited company, they are more exposed to the prospect of higher taxation, increasing the cost of running their portfolios, which they will seek to recoup in higher rents.

Longer term tenancies ahead

We discussed at length in our last edition the double-edged sword of longer term tenancies, which can lead to landlords cherry-picking tenants, and steeper rents at the outset of a new tenancy. If the consultation announced in the Budget on the subject should find ways of stimulating interest in both the supply and demand for these, then they may prove to be a positive solution for both tenants and landlords, allowing landlords to protect their net yields without raising rents.

Yields compress but annual returns show signs of recovery

- **Total returns boosted to 8.7% by recovering house price growth**
- **London lags behind as weaker tenant demand and higher investment take hold**

With rent rises moderating, and house price growth remaining robust in the last quarter, yields have compressed marginally. The average gross yield on rental property in Britain stands at 4.4%, down slightly from 4.5% a year ago.

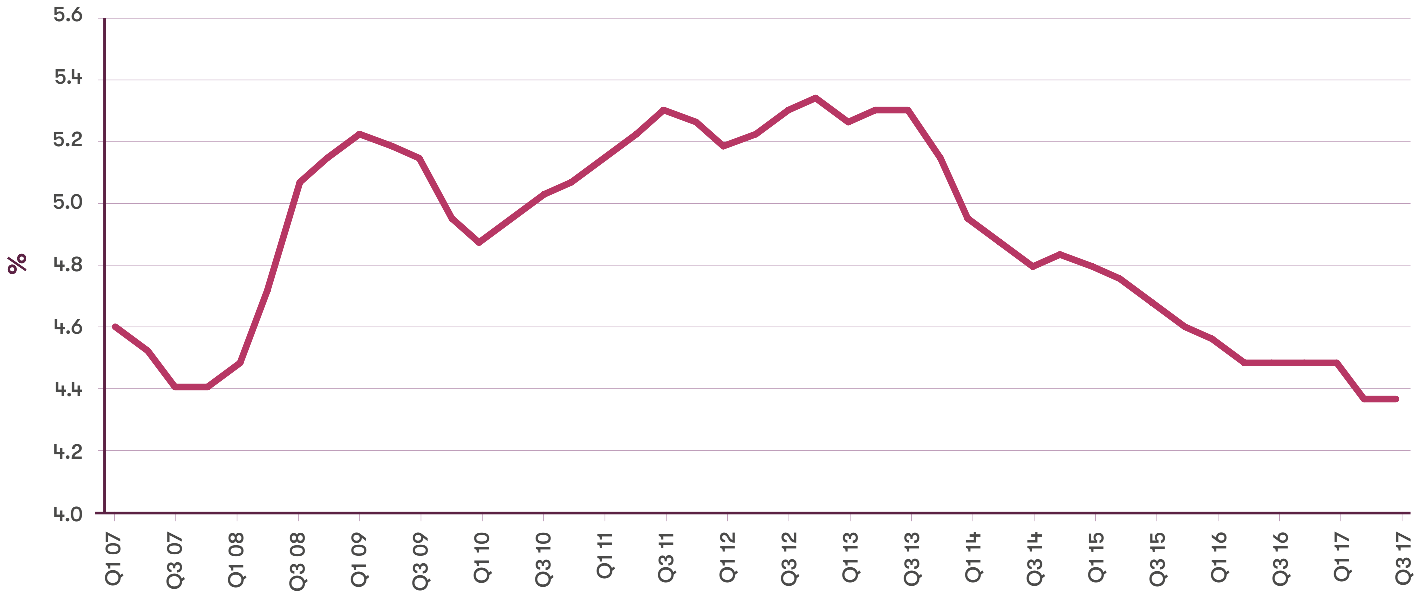
Total returns make for more positive reading for investors. The average gross annual total return for a rental property stands at 8.7%, up from 7.6% at the start of the year. This is equivalent to £20,426 per year. While London still provides the largest return in cash terms (£29,052 per year) thanks to the size of the initial investment required, it is the North West that tops the returns league table in percentage terms (15.3%). Of course, the gearing effect of a mortgage boosts pre-tax returns further – by around one percentage point on a national level.

Across the PRS as a whole, landlords collectively enjoyed total returns in the last year of £111bn, down a little from a year ago, but higher than £94.3bn seen at the start of 2017.

Landlords on the move as the economics of property investment shifts

The hunt for yield – and indeed, the geographical focus of landlords – will be determined by underlying fundamentals; the initial cost of investment and the tenant demand that supports rental income. This case for investment seems to be weakening in parts of London. Just 12% of landlords report rising tenant demand in outer London, lower than the national average of 22%. By contrast, this figure is as high as 29% in the North West and 37% in Yorkshire and The Humber. Yet at the same time the initial cost of investment is much higher in the capital; the value of a rental property in London is now over £522,000, with a total stamp duty cost of nearly £32,000 on top. Given the sums landlords are required to borrow to cover the cost of investment, London landlords will also see a greater impact from the changed tax treatment of mortgage interest. Lower transaction costs, combined with stronger tenant demand and improving total returns in areas like the North West, by contrast, means the fundamental economics of buy to let are starting to shift. This is likely to cause the supply of property in the sector to alter geographically too.

Gross yields in Great Britain



Source: Kent Reliance

Region	Current Yields	Total Annual Returns
North West	5.9%	15.3%
Yorkshire and The Humber	5.8%	13.0%
East Midlands	5.4%	11.9%
Scotland	5.4%	5.7%
West Midlands	5.1%	11.3%
North East	4.7%	11.3%
Wales	4.4%	8.0%
South West	4.3%	11.6%
London	4.0%	5.7%
East of England	4.0%	9.7%
South East	3.8%	10.8%
Great Britain	**4.4%**	**8.7%**

Source: Kent Reliance

Lending slows as regulatory change shapes buy to let mortgage market

- **Intervention by PRA and tax changes dampen buy to let house purchases**
- **Mortgage arrears fall to lowest level in a decade**

The combination of the PRA's tighter underwriting standards, higher stamp duty and tax changes has had a significant impact on landlords and the buy to let market that supports them.

House purchase activity dampened further in 2017, although it showed signs of stabilising in the last quarter. According to UK Finance data, the third quarter of 2017 saw 19,400 house purchase loans, up 7.2% on the previous quarter, and up 2.1% year-on-year. Even so, it remains around two-thirds the level seen in the two years prior to April 2016.

It is too soon to see the full impact of the second round of underwriting changes on transaction volumes among portfolio landlords, but they will not boost activity.

Remortgaging is in far better health. In the third quarter of 2017, 39,100 remortgages had been issued, up 6.3% compared to the same period in 2016. Investors continue to take advantage of rock-bottom rates while they can to lower their cost of finance and a growing proportion are looking to secure fixed rates. The first interest rate rise in a decade is likely to sustain demand for fixed rate products.

Buy to let lending: Remortgage vs House Purchase

Source: UK Finance

Arrears fall to ten year low

The PRA's intervention is in part aimed at leaving the buy to let sector better able to withstand a change in market conditions. Analysis of UK Finance data highlights the stability of the sector. The number of buy to let arrears is currently at its lowest in nearly 10 years. At the end of the third quarter of 2017, just 7,700 mortgages were three months or more in arrears – just 0.41%. The last time the number was this low was the fourth quarter of 2007, a time when there were 843,000 fewer BTL mortgages outstanding. With the overall LTV of the sector falling too, the buy to let market is well anchored to weather interest rate rises, and indeed, the pressure on margins landlords may face.

Outlook

The PRA has taken a more active role in the buy to let market, a move that is dampening demand for finance. Tax changes are now kicking in, adding additional costs for landlords, although we will only see the full effects on rents as landlords begin to submit tax returns for this tax year. These changes are slowing the growth of the PRS. It is still expanding, albeit increasingly slowly, and on present trends, will climb to 5.7m households next year, rising in value to over £1.45trn.

There is also a geographical swing taking place. Where London once led the way, it now lags behind. With an affordability ceiling reached, rents are rising fastest outside the capital, while total returns too are more attractive in areas like the North West. Tax changes are reducing net income, and more stringent mortgage finance criteria require investors to demonstrate higher yields. As a result, we expect the supply of rented properties to grow more rapidly in areas demonstrating better yields, and with lower house prices. Landlords are becoming even more discerning in their investment decision-making.

Beneath the surface, the PRS is professionalising and becoming more business-like. Amateur landlords are leaving the market. Many smaller-scale portfolio landlords are now creating business plans for the first time, and limited companies continue to grow in popularity. At the same time, stricter underwriting, and the reduced LTV of the sector point to reduced risk, which bodes well for longer-term stability.

However, there is a limit to the amount of interference the sector can absorb before we see a severe reduction in supply – an outcome that would see rents hike for tenants and reduce their ability to save for a deposit for house purchase. Landlords' confidence is clearly fragile, and as the new tax reforms gradually come into force, any further financial burdens may prove to be the straw that breaks the camel's back. The government refrained from further tinkering in the Autumn Budget, restraint that will come as a relief to property investors.

The Conservative government has traditionally prioritised home ownership over other tenures, although the Housing White Paper this year signalled a change to a more holistic approach to our housing issues. The Autumn Budget placed housing, essentially house building, as its central theme, presented on the back of increasing first time buyer numbers. However, an imbalance in the housing market still remains. The Help To Buy scheme for instance, may have provided many with that all important first step on the property ladder, but had the unintended consequence of inflating house prices and reducing affordability for others. Removing stamp duty for first time buyers purchasing homes worth less than £300,000 is well intentioned and could bring forward many transactions. But it is undoubtedly high house prices that remain the key obstacle for homeownership. Unless we see a gear-change in building to support demand, supply and availability will continue to be the dominant issues.

The government's determination to build 300,000 homes a year, supported by planning reform, is laudable. Yet, according to the government's own forecasts, the UK will have to wait until the mid-2020's to reach this level of housebuilding. In the meantime the PRS will continue to do what it does and house the UK's population, including those looking for their first home.

Methodology

The research involves detailed analysis of ONS population projections 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, 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 private rented sector. 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 Q3 2017, and references to “the last year” refers to the year to the end of Q3 2017.

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 856 landlords, conducted in association with BDRC Continental in the third quarter of 2017.

Research was conducted by Teamspirit for Kent Reliance.

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