The Kent Reliance

Buy to Let Britain report

Edition Three

Kent Reliance
for Intermediaries

A foreword

Welcome to the third edition of the Kent Reliance Buy to Let Britain report, a half-yearly report analysing the trends in Great Britain's private rented sector (PRS), and the buy to let mortgage market that supports it.

In our last issue we documented the rapid growth of the PRS, and the growing returns the landlord population has experienced on the back of strong capital appreciation. In fact, we highlighted landlords were facing a prospect of a 642% return on investment over the next 20 years on capital gains alone – or indeed a 1,049% return should they reinvest their equity into a second property at the earliest opportunity.

Since our last edition, the private rented sector has been in the spotlight. The Autumn Statement saw the addition of a new stamp duty levy on private rented sector purchases, while changes announced in the Chancellor's Summer Budget will affect the way in which landlords are taxed, coming into play progressively from 2017. We take a closer look at the impact this will have on the market, and how investors are already reacting to the changes. We also examine the affordability of rents, and whether the changes announced in the Budget will affect landlords' pricing.

As usual, we detail the overall value of the private rented sector and its expansion within Great Britain, incorporating the latest official data to highlight much faster than forecast, with the PRS in England alone breaching the 5 million household barrier in September.

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 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 CEO 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 is passionate about simplicity and fairness in financial services and is a published author on the subject of financial education.

Executive summary

Market overview

- Budget changes have been spur for landlords to incorporate. Demand for finance from limited companies has been rising since the changes were announced
- On present trends, number of buy to let loans issued to limited companies across the market could exceed 56,000 next year, up from 29,990 in 2014
- New stamp duty levy to add average of £6,600 to landlords' average purchase costs, and will boost demand for finance before April
- However, full impact of changes on buy to let market as a whole will take time to become clear
- Private rented sector (PRS) growing faster than projected rate, with 5.6m households in the sector in September
- Value of landlords' holdings across Great Britain hits £1.2trn, growing by £171bn compared to last year
- Key drivers of tenant demand remain entrenched, suggesting the PRS will remain a crucial component of Great Britain's housing landscape

Landlords

- Yields rise to 4.9% as average rents hit £897 per month; Budget changes likely to push rents higher
- Since recession, rents have risen by 26.7%, compared to wages rising 15.6%, stretching affordability
- Total annual returns slow from level seen last year, but still reach £121.6bn across PRS in September
- Average landlord makes total annual return of 11.3% per property at end of September, a figure likely to grow if current levels of house price inflation are maintained
- Total rent collected by landlords across Great Britain has risen to £5bn per month, up 17.9% annually

Lenders

- Buy to let mortgage market has grown in response to demand, with total lending in sector growing by more than a quarter annually
- Total value of mortgaged property stands at £485.4bn, up from £439.7bn a year ago
- Buy to let mortgage product choice increases by 41% in last year
- Product choice for incorporated landlords still limited across market, but set to grow with demand
- Lenders will be on watch for regulatory change following FPC's new powers in buy to let market

2015: A taxing year for buy to let?

- Kent Reliance sees demand for limited company mortgages hit highest on record in September
- Current trends could see 56,800 buy to let loans to limited companies across the whole market next year, 90% more than in 2014

The private rented sector, and indeed, the buy to let market have been in the spotlight in 2015, and the year has brought with it significant change. The recent Autumn Statement included an additional 3% stamp duty tax levy from April next year, while the Chancellor announced in the summer Budget that the tax treatment of buy to let mortgage interest was to change. From April 2017 landlords will no longer be able to claim tax reliefs worth 40% or 45% of the interest payments on buy to let mortgages. The maximum tax relief will be set at 20%, although the change will be introduced over a four year period. The Chancellor intends these changes to "level the playing field" between investors and homeowners, though it is likely to have unintended consequences. However, it is important to note that changes to mortgage interest tax relief will not directly impact the full private rented sector. It is the portion of this, approximately one third of the sector, which uses buy to let mortgage finance to fund investments, which will be affected.

The wear and tear allowance, too, will be subject to change. Landlords can currently deduct 10% of the net rent as an allowance for renewing and replacing furniture in furnished properties. The proposal is to replace it with relief for actual expenditure on furnishings.

The change in the way mortgage interest is treated is already creating a surge in the number of property investors looking to invest via a company, rather than securing mortgage finance personally. A company structure means investors are taxed on profits at corporation tax rates, and there are full reliefs for business costs such as mortgage interest, although there are other costs to consider. Our data shows the number of applications via limited companies saw an immediate impact from the Budget, with 40% more applications of this type in July than a year ago. This trend has continued. Limited company applications hit their highest level on our records in September, with applications of this type three times the level seen in September 2014 (+213%). In the month, one quarter of all buy to let mortgage finance demand (25%) was through limited company lending, up from 13% a year ago.

Limited company lending doubles to 5,000 per month

If this were extrapolated across the whole buy to let market, it would imply that the number of mortgages through limited companies each month has broadly doubled. In 2014, 29,900 buy to let mortgages were issued to a limited company – just under 2,500 per month. In July, August and September 2015, an average of 5,000 per month were issued, with 6,000 in September alone.

Based on the proportion of applications by limited companies in August and September, if this trend was sustained we could see 56,800 buy to let loans issued to incorporated investment vehicles next year, conservatively assuming total lending doesn't grow in 2016. This is an increase of over a fifth compared to the estimated total for 2015 (46,700) and 90% compared to 2014.

Recent months have also seen an increase in the average value of an application via limited companies, up 12.4% in September compared to a year ago. This suggests it is landlords with larger properties who are considering the move in the aftermath of the Budget, or indeed, those in geographical areas where house prices are higher.

Following the government's new stamp duty levy on landlords, it is likely that the trend will accelerate next year. The Treasury is consulting on whether corporate entities with over 15 properties would be excluded from this surcharge, an exemption that would add further incentives to incorporate from larger scale landlords seeking to minimise their tax exposure. If this comes to pass, we may even see consolidation in the market with individual landlords forming joint companies to pass the 15 property mark.

Product choice for those looking to borrow through limited companies is still constrained, however. Mortgages For Business' data suggests 12% of buy to let mortgage products are available to limited companies, though this is likely to improve as demand grows.

Tenants, not landlords, will feel the effects of buy to let tax changes

Aside from the increasing prevalence of tax planning and potential demand for incorporation, the full range of landlords' reactions to the Budget and Autumn Statement changes won't be fully clear until the changes start to come into effect. However, there are several key implications to consider.

First, the changes announced in November's Autumn Statement will trigger an upsurge in landlords looking to expand their portfolios now, in order to complete ahead of the introduction of the levy. This in turn may buoy house prices next year.

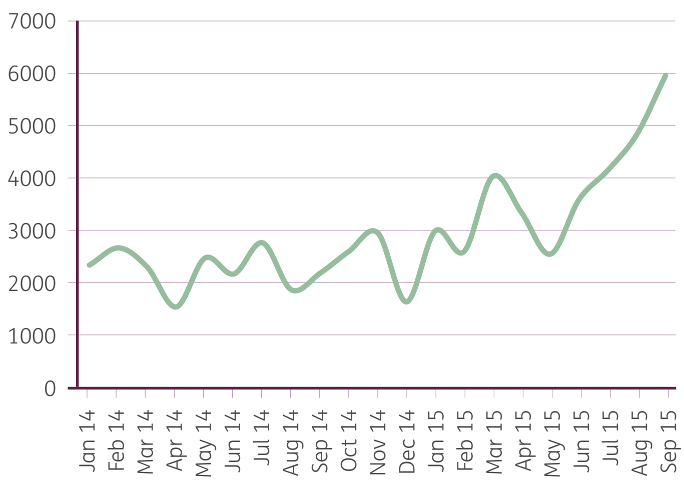
Secondly, landlords will seek to fund the higher cost of running their business at least in part through increasing rents for tenants. The Budget's changes will especially impact those higher rate tax payers or those with higher gearing. As the cost involved in running a business increases, so too must the price of the services, assuming demand is inelastic. Since tenant demand is driven by fundamentals such as high house prices, and difficulties getting a mortgage, neither of which are set to change, and is not driven by rents themselves, the Chancellor's measures risk proving counterproductive. The new stamp duty levy will only accentuate this. With the average buy to let property value standing at £220,726, a 3% additional stamp duty charge would represent an additional upfront charge of £6,622. If a landlord passed the full cost of this on, while holding a property for ten years, it would represent an increase in rent of £55 per month. With annual rental inflation currently standing at 8.3% (as we discuss below), the moves will do little to help tenants' finances, and indeed prospects for saving for a deposit.

As a result of the change to mortgage interest tax relief, some landlords will choose to liquidate all, or part of their portfolios should they not be able to cover the higher running costs. The National Landlords Association suggests 5% of current landlords may consider selling up – although this does not factor in the flow of new investors entering the marketplace, or landlords looking to expand their holdings. Nevertheless, this, combined with the higher initial investment cost, will constrain the supply of rental property, without having much impact on property values. While we still expect the PRS to continue to grow, any action that places downwards pressure on the supply of rental homes will naturally cause a greater supply and demand imbalance, pushing up rents.

The long-term fundamentals of buy to let investing, as we shall see, will continue to sustain investor demand. Ultimately, the long-term impact of the tax changes will be to make prospective investors more cautious and increase the level of due diligence they are undertaking.

We anticipate demand for finance from incorporated property investment vehicles will continue to grow as the new taxes are implemented. It is, however, crucial that investors considering this option should understand the full tax and administrative implications, alongside any impact this may have on their mortgage costs. For instance, analysis from Mortgages for Business suggests the average mortgage rate for borrowing via a limited company is 0.8% higher than an equivalent for an individual landlord. Higher finance costs may simply contribute towards rental inflation.

Estimated loans to limited companies



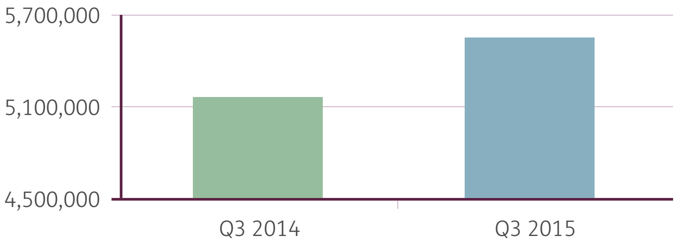
Source: Kent Reliance, CML

England's PRS breaks 5 million household barrier

- PRS growing faster than forecast, with 5.6 million households in sector
- England has reached 5 million rented households

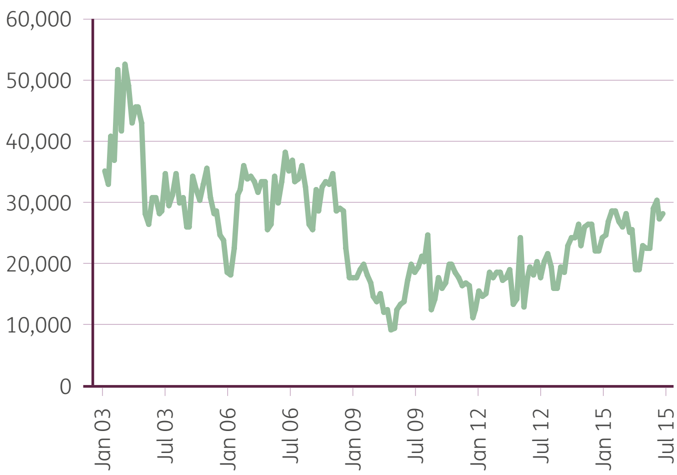
While the long-term impact of the Budget's changes is not yet clear, the PRS has continued to grow. In fact, when we factor in the latest data from the government's English Housing Survey, released since our last report, the private rented sector is growing even faster than we previously forecast. We account for this in our latest analysis. Our projections now suggest private rented households in England breached the 5 million barrier for the first time in recent history in September.

Total households in PRS



Source: ONS, Kent Reliance

Number of loans to first-time buyers



Source: CML

In Great Britain as a whole, there are now 5.6m households in the sector, with an annual growth rate of 8.4%. As a result of this rapid growth, 20.4% of all households are now within the PRS. London remains the most dominant region, representing 19.6% of the nation's privately rented households, far more than its 13.7% share of the overall population.

On present trends, 2015 will see the addition of over 440,000 households to the PRS in Great Britain.

Tenant demand continues to intensify, as the long-term issue of a lack of housing supply pushes up house prices, making saving a deposit a considerable obstacle for prospective buyers. On top of this, finance for first-time buyers is hard to come by. While September saw first-time buyer numbers climb to its highest level for the month since the recession, the year to date has seen 20.4% fewer first-time buyer loans than in 2007, and is insufficient to match the need for homeownership of a growing population.

Affordability is not why mortgage lending has yet to reach 2007's level. Halifax data shows first-time buyer house prices in Q1 2015 almost identical to their Q1 2008 equivalent at approximately £147,000. Moreover, monthly costs are much cheaper. A 90% LTV mortgage today for the average first time buyer property would cost £699 per month on average, 22% cheaper than the £906 in Q1 2008. However, as a result of regulation designed to prevent another boom and bust, it is arguably the lenders' tighter criteria, particularly in respect of affordability assessment, that are limiting access to finance and creating a bottleneck for demand, in turn underpinning the dependence on the PRS.

PRS worth £1.2 trillion as London drives growth

- Average rental property value has grown 6.5% in last year
- PRS has grown in value by £171.0 billion in the last year

The total value of the PRS is subject to two forces: the growth of the private rented sector, and rising property values. As we have seen, the rental population is growing very quickly. Rental property values too have seen brisk growth, climbing an average of 6.5% in September compared to a year ago.

These factors mean the total value of landlords' holdings has grown by £171.0bn in the last year to a total of £1.2 trn by the end of September. The rate of growth has subsided somewhat, down from a recent peak of 21.7% a year ago, but still stands at a healthy 16.0%.

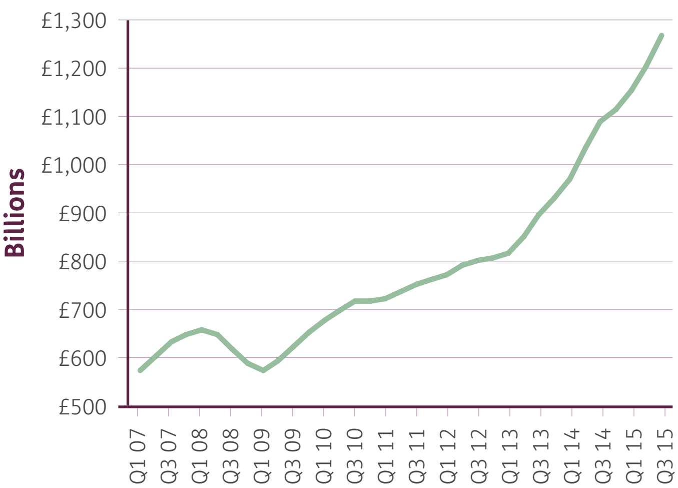
London is leading the charge, with the strongest house price increases and rental household formation. It has made up over half of the growth in the value of the PRS (£87.3bn) in the last year, breaking the £500bn barrier for the first time. The South East follows closely behind, accounting for one sixth of the sector's growth, and for 15.2% of rental sector by value.

Value of the PRS by region (£bn)

London **(£527.4)**
East of England **(£95.5)**
South West **(£93.4)**
Yorkshire & The Humber **(£56.1)**
North West **(£68.6)**
Wales **(£23.6)**
South East **(£187.7)**
North East **(£20.0)**
West Midlands **(£58.1)**
East Midlands **(£49.8)**
Scotland **(£58.1)**

Source: Kent Reliance

Total value of the PRS in Great Britain



Source: Kent Reliance

Rental affordability stretches since recession

- Average rent has reached £897 per month
- Rental inflation of 26.7% since recession has outstripped wages

The average rent per property has risen 8.3% annually, climbing to an average of £897 per month. This compares to a 6.1% annual increase in the second quarter.

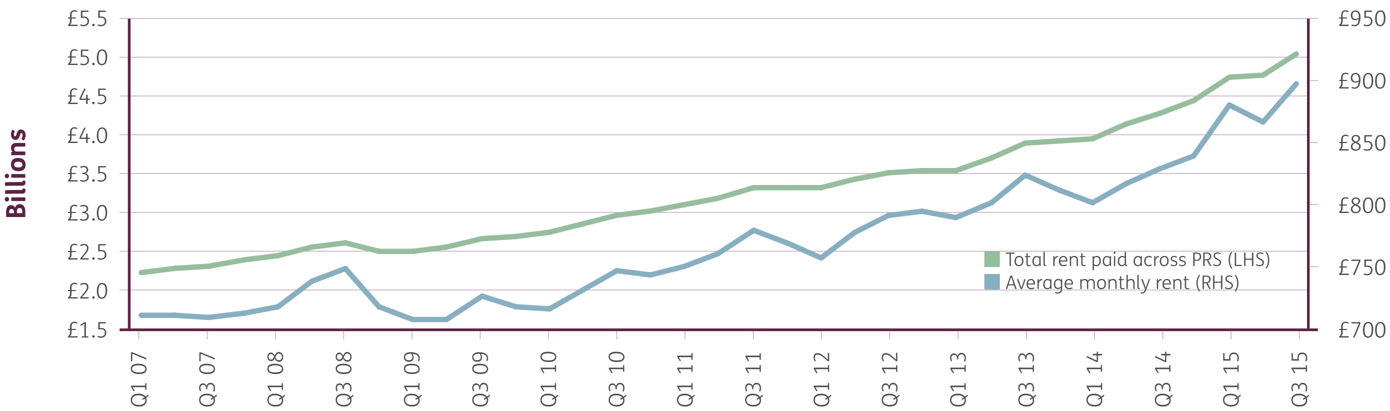
Wage inflation has improved in 2015, boosting tenant finances. However, it still lags rental inflation. Over the last year,[1] the average weekly wage in the UK has risen 3.1%.

This gap has persisted since the recession. Average wages have risen 15.6%, but rents have soared 26.7% over the same period. Meanwhile, house prices in England and Wales have risen 21.6% over the same period.[2] We would broadly expect rental increases to track house price growth, as landlords look to recoup the increased cost of investment and monthly finance costs. For first-time buyers who have a sizeable deposit and can secure mortgages, cheap mortgage finance means it is often cheaper to buy than rent. However, for those who would buy with high LTVs, renting is still frequently a more affordable option on a monthly basis, despite the rise in rents since 2009. It is also often a more accessible option, given the tighter mortgage criteria in place.

Rising rents have not yet caused widespread affordability concerns. The most recent data from the ONS suggests rental payments are not causing renters affordability issues on the whole. Just one in 20 private rented households stated they had difficulty meeting a rental payment on time in the last year, while only one in 25 wasn't up to date with their rent at the time of the survey. Of those who did admit difficulties in paying the rent, only 4.7% attributed this to rent increases.[3]

There is little property investors can do to prevent a sudden change in their tenants' finances, but understanding tenant demand in the area and pricing appropriately can increase the chances of a longer-term tenancy, reducing the likelihood of costly tenant turnover, or arrears.

Total monthly rent vs average rent per property



Source: Kent Reliance

[1] Year to August (ONS Average Weekly Earnings, October)
[2] Land Registry
[3] ONS English Housing Survey, July 2015

Monthly rental payments across Great Britain hit £5 billion

- Total rents climb 17.9% in last year
- London dominates, accounting for 37.9% of rents across Great Britain

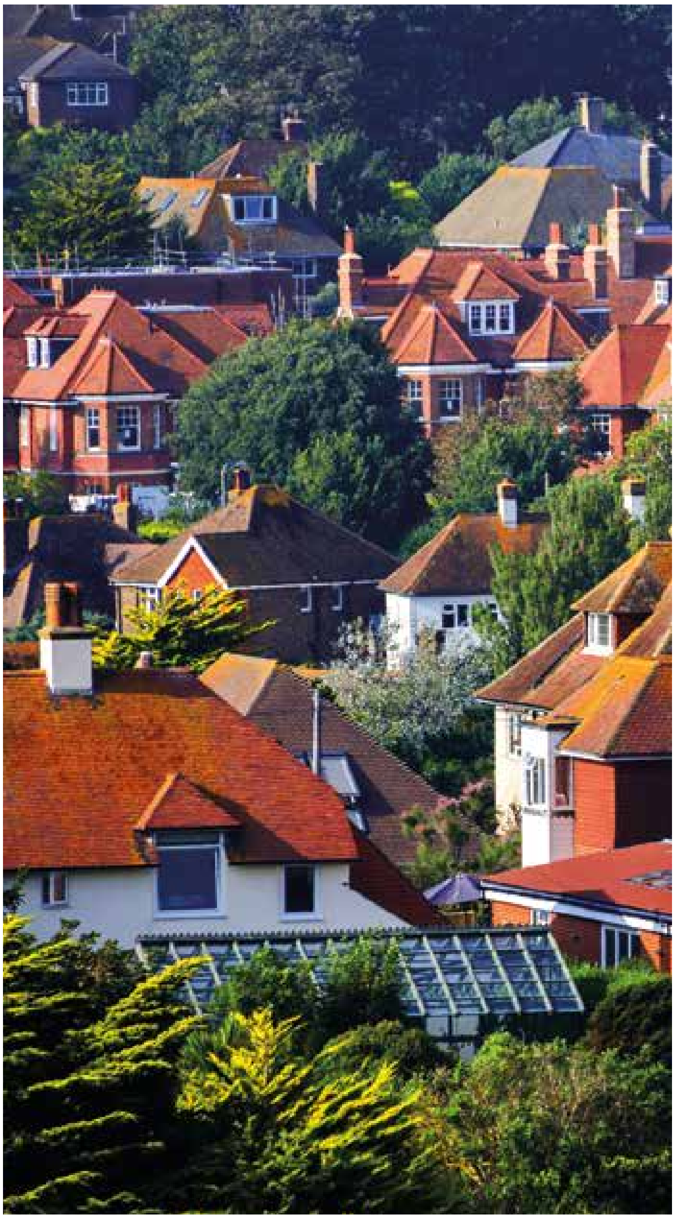
Overall, by September the total rental income collected by landlords across the country had risen to £5.0bn per month, up 17.9% year on year. Landlords collected rent of £56.7bn in the last year, up by £8.1bn compared to a year ago.

London's PRS has the greatest sway over the figures. Alone, London's tenants pay almost two fifths (38%) of Great Britain's rent, a total of over £25bn. It is followed by the South East (13.8%), and the North West (8.1%).

Monthly rent paid by region (£m)

London **(£2,181)**
East of England **(£279)**
South West **(£293)**
Yorkshire & The Humber **(£243)**
North West **(£325)**
Wales **(£91)**
South East **(£529)**
North East **(£70)**
West Midlands **(£214)**
East Midlands **(£193)**
Scotland **(£264)**

Source: Kent Reliance



Yields improve, although total annual returns dip

- Yields uptick to 4.9% in September
- Average returns ease to 11.3%, but could recover in next 12 months

Yields are vitally important to property investors, and are key to the success of any long-term investment. They demonstrate the income a property generates each year against the value of the property.

With rents rising faster than property prices in the last year, average yields have ticked up. Across Great Britain, gross yields now stand at 4.9%.

Rapid house price increases are combining with strong yields to support total returns. In September the average return stood at 11.3%, equivalent to £23,467 per property. This has eased a little from the 16.3% seen a year ago, when house price inflation was higher, but with prices again accelerating, this figure is set to rise further over the coming year.

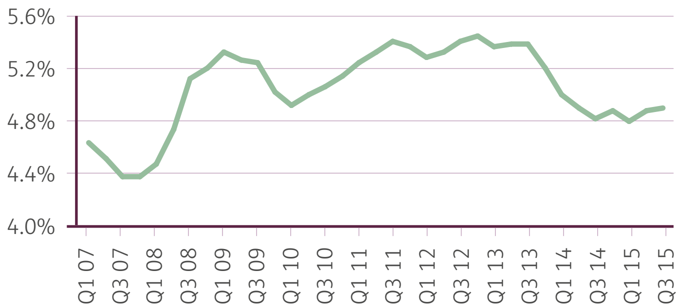
Across Great Britain, landlords have seen total gross returns of £121.6bn in the last 12 months.

London and the South East accounted for two thirds of the total annual returns across the country (£81.3bn), with returns per property of £59,369 and £29,334 respectively. Over the 12 months, all regions generated a positive annual return.

Current yields and total annual returns

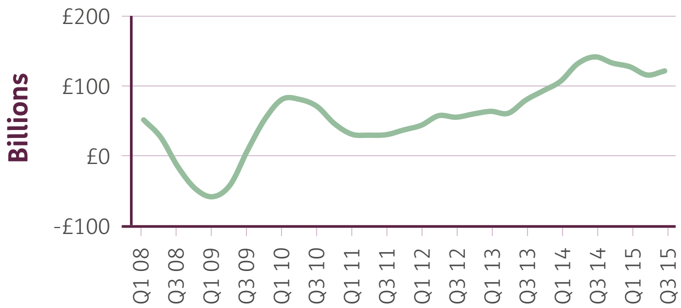
	Current yields	Total annual returns
London	4.4%	13.7%
East of England	4.4%	12.6%
South West	4.7%	9.0%
Yorkshire & The Humber	6.4%	10.1%
North West	7.1%	9.7%
Wales	4.6%	5.5%
South East	4.5%	13.1%
North East	5.0%	4.6%
West Midlands	5.7%	10.4%
East Midlands	5.9%	9.6%
Scotland	5.6%	0.3%
Great Britain	**4.9%**	**11.3%**

Gross yields in Great Britain



Source: Kent Reliance

Total annual returns across PRS



Source: Kent Reliance

Buy to let mortgage market picks up steam as choice broadens

- First nine months of 2015 see total buy to let lending higher than any of the last six full years
- Variety of buy to let products available climbs by 41% compared to a year ago

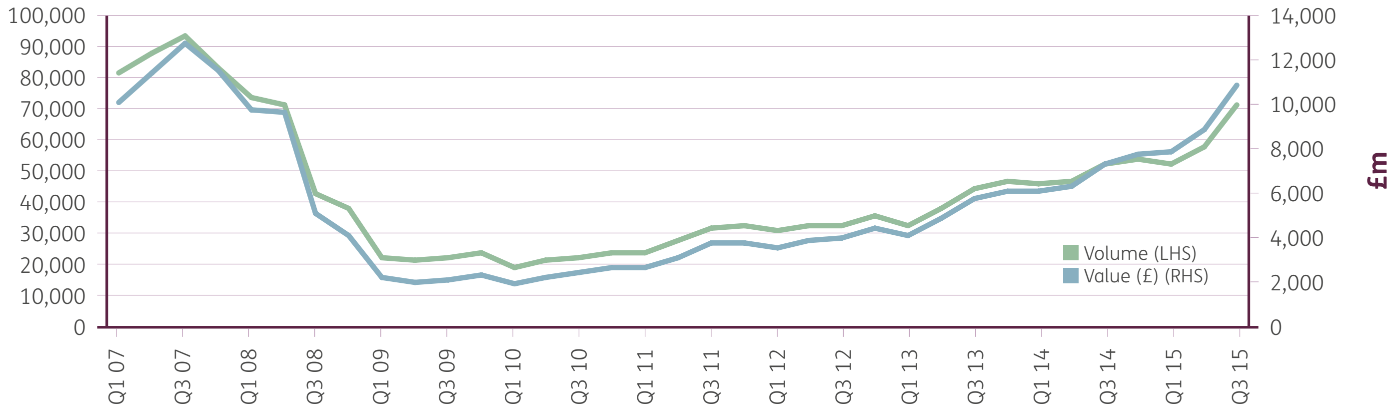
The PRS depends on a healthy mortgage market.

Gross lending to landlords in the first nine months of the year had already surpassed the level reached in each of the last six full years. Analysis of the CML's latest data shows year-to-date gross lending of £27.5bn, already £100m more than the full year total reached in 2014. 181,800 loans had been issued in the year to September, an increase of 26.5% over the same period a year ago.[3] With the total number of loans issued in September up 36.2% year on year, this trend is likely only going to accelerate in the run up to April as prospective property investors seek to act now to avoid the additional cost in the Chancellor's new tax levy.

For buy to let investors, choice continues to broaden. According to Moneyfacts' analysis, total buy to let product numbers increased by 114 in October to a total of 1,202, the highest since April 2008, and up 41% compared to a year ago.

Across the PRS, the total value of mortgaged property stands at £485.4bn, up from £439.7bn a year ago.

Buy to let advances



Source: CML

[3] CML Regulated Mortgage Survey, November

Outlook

2015 has been a year of change for the buy to let market. The impact of the Budget has yet to be felt, and it will take some time for the dust to settle on the new stamp duty surcharge. But these are not the only changes on the horizon. Greater regulation looms large.

2016 will also see the introduction of the European Mortgage Credit Directive, regulation that will help provide greater consumer protection for amateur landlords. Added to this, the Financial Policy Committee has been given authority over buy to let lending and is able to step in, should it feel a bubble is developing. We do not believe regulation is bad thing, if it is applied appropriately. It is, nevertheless, crucial that any action taken by the FPC is evidence-based, and recognises the ongoing importance – and stability – of the current buy to let market. Lenders have a common interest to ensure lending is responsible and sustainable, and the market has already come a long way since the last boom. Any action from the FPC should not derail progress the market has made, or undermine its ability to meet growing tenant demand.

Despite all of this, the fundamentals for the expansion of the PRS are set fair. Ultimately, there are not enough homes being built within the UK, meaning supply constraints will likely continue to underpin house prices and limit homeownership. Despite the new building initiative, government spending is unlikely to build the necessary social housing to meet the country's growing needs, and the private sector will need to hit overdrive to build anywhere near the number of homes to match population growth. All of this points towards a continued expansion of the PRS. We envisage the ultimate outcome of regulatory and tax treatment changes will be acceleration in the rate at which the PRS is professionalising.

On present trends, we anticipate the number of private rented households will grow to more than 6 million in 2015. Even if we see house price inflation moderate once more, this would see the value of the sector reach £1.4 trillion by the end of next year.

Methodology

Kent Reliance's research team analysed ONS census and the latest 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 the first quarter of 2007 and the third quarter of 2015.

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