Report 9

What levels of return do buy to let investors expect and need their property investment to deliver, when and how?

TDS Charitable Foundation

Funded project

About this report

This report has been created thanks to the support of the TDS Charitable Foundation. The Foundation *“works to advance education about housing rights and obligations in general”.*

In particular, the charity focuses on:

- Best practice in the management of private rented housing;
- Legal rights and obligations of those involved in the provision or management of private rented housing;
- Using alternative dispute resolution for more efficient and effective resolution of disputes between landlords and tenants.

The charity has provided a grant to Kate Faulkner who runs Designs on Property Ltd (designsonproperty.co.uk), to produce a series of reports and surveys on the private rented sector which are designed to increase knowledge on the private rented sector in England and to promote best practice.

Opinions expressed in this report are those of Kate Faulkner and do not necessarily reflect the views of Tenancy Deposit Scheme (TDS) or The TDS Foundation.

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About the authors

Kate Faulkner Bsc (Econ) MBA CIM DipM was originally a consumer in the residential property market, buying, selling, renovating and renting property for many years. At that time she was a sales and marketing professional working with major brands such as PG Tips.

Having enjoyed working in her spare time in residential property, she went on to set up one of the UK's first property portals prior to the advent of Rightmove, then used her experience to help create on- and off-line tools designed to take the stress out of corporate relocations for employees.

From here she moved to set up the Self-Build and Renovation Centre in Swindon, and subsequently helped build and professionalise a part exchange business. Kate was also a Future Homes Commissioner for RIBA.

After gaining so much experience across the property market, Kate embarked on a mission to improve the way people carry out property projects, especially within the private rented sector. So whether it is banishing cowboy builders and rogue landlords, or helping the public approach a property project as simple as hanging a door or as complex as letting or building their own home, Kate is always on hand, either via her consumer website at propertychecklists.co.uk or at the property clinics she runs around the UK, to help landlords, tenants, first-time buyer, self-builders, renovators and investors carry out their property projects in the right way, using qualified people and industry experts.

Kate's consultancy, Designs on Property Ltd, provides help and support to companies and organisations that want to communicate better to the public, or to introduce new products and services which help people carry out their property projects successfully, first time around.

She is fanatical that property facts and figures such as prices and rents should be reported correctly in the media, by the industry, and by organisations and policy-makers involved in the property market.

Kate regularly appears in the national and local media, and comments on TV, radio and in regional and national newspapers on property news items of the day. In this way she continues to pursue her chief objective, which is to help ensure the public get an independent, honest view of what's happening in the residential property market.

This report is part of a series of reports and surveys that Kate will be producing thanks to the support of the TDS Charitable Foundation.

The aim of the research provided is to improve the understanding of the private rented sector and to make recommendations on changes which will impact positively on the experience of landlords and tenants.

Sarah Walker is a freelance writer and editor with extensive knowledge of the property investment industry. A former estate agent and television presenter, Sarah has spent the last decade writing for industry publications and leading UK property companies, producing a wide range of marketing and PR content, including consumer guides, newsletters, website copy, articles and reports.

She has ghostwritten several property investment books, edited a number of others on property, business and branding, and continues to work with entrepreneurs to produce literature that supports their business enterprises.

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What levels of return do buy to let investors expect and need their property investment to deliver, when and how?

Introduction

For many years, until the global financial crash in 2007, property was regarded as a safe and highly profitable investment. UK average house prices grew from £12,970 to £184,131 – growth of almost 1,400% – over the previous 30 years. Even accounting for the recession of the early 1990s, during which the market experienced six years of falls, prices doubled every six years before it and doubled again in the six years that followed. [1]

Property investors didn't need much of a 'plan' because they were so confident about the rate at which the capital value of their investment would increase. The market boomed after buy to let mortgages had been introduced, with average prices trebling between Q3 1997 and Q3 2007. As a result, investors didn't worry too much about getting rental income; as long as it covered their outgoings they could simply remortgage periodically to release lump sums. In some prime areas, where prices were rising far more quickly than the national average, investors didn't even need to worry if they had to subsidise their buy to let on a monthly basis.

However, as the credit crunch brought most of the world's economies to a halt, it had a huge impact on investors. Some of the less 'professional' landlords simply left the market, many having lost money, particularly on new-build apartments. Those who remained realised they would have to work harder to make money from property and be much more careful about what they invested in.

The result? Investors today tend to have a very clear idea of why they are putting their money in property and what they expect property to do for them in financial terms. Many portfolio investors feel it is wise to spread their risk and those who are landlords tend to see that as their job, rather than the 'sideline' or hobby it was often viewed as in the past.

[1] Nationwide UK House Prices Since 1952: https://www.nationwide.co.uk/about/house-price-index/downloaddata

This report looks at:

- the different financial expectations and needs of investors today versus what they could expect in the past;
- the type of property investment that delivers the returns they're looking for, and
- what can get in the way of realising these returns.

Main sources

The Office for National Statistics (ONS): https://www.ons.gov.uk/

Council of Mortgage Lenders (CML, now UK Finance) research: The Profile of UK Private Landlords, December 2016: https://www.cml.org.uk/documents/the-profile-of-uk-private-landlords/the-profile-of-uk-private-landlords-20170118.pdf (automatic download)

Homelet Landlords Survey, 2017: https://homelet.co.uk/landlord-insurance/landlord-lowdown-blog/article/landlord-market-survey-2017

Shelter/YouGov Survey of Private Landlords, February 2016: https://england.shelter.org.uk/__data/assets/pdf_file/0004/1236820/Landlord_survey_18_Feb_publish.pdf

Strategic Society Centre report, 2013: http://strategicsociety.org.uk/wp-content/uploads/2013/07/Lord-C-Lloyd-J-and-Barnes-M-2013-Understanding-Landlords.pdf

Image: © Grazvydas | Dreamstime.com

Why do people invest in property?

There are four key reasons why people invest in property:

- Perceived security of the asset
- Capital growth
- Ability to employ leverage
- Rental income

Security of the asset

Property has long been regarded as a good investment and, up until the credit crunch hit, anyone who was able to put their money into bricks and mortar saw great capital returns. Whether or not a property was achieving a good level of ongoing rental income was virtually irrelevant, as the capital value was almost certainly going up by enough on its own. This was due to wages rising well in relation to inflation up to the millennium and the increasing availability of mortgage borrowing. Where people bought with mortgages, they were able to buy property that cost several times more than the amount of capital they actually had to invest themselves.

Additionally, many people are attracted to property because it's a tangible asset: they can see where their money is and that in itself creates confidence. A report published by the Strategic Society Centre in 2013 found that around three in five (63%) landlords believe investing in property is the safest way to make money and nearly half (49%) think it is the best way to save for retirement.[1]

[1] Understanding Landlords: http://strategicsociety.org.uk/wp-content/uploads/2013/07/Lord-C-Lloyd-J-and-Barnes-M-2013-Understanding-Landlords.pdf

Capital growth

In the 11 years between buy to let mortgages being introduced and the start of the global financial crisis, the average UK house price almost trebled (figures quoted are for Q4 of each year):[1]

Year	Price	Year-on-year increase
1997	£61,830	12.1%
1998	£66,313	7.3%
1999	£74,638	12.6%
2000	£81,628	9.4%
2001	£92,533	13.4%
2002	£115,940	25.3%
2003	£133,903	15.5%
2004	£152,464	13.9%
2005	£157,387	3.2%
2006	£172,065	9.3%
2007	£183,959	6.9%

Additionally, those who had owned property before the buy to let 'boom' had already seen excellent growth. Between 1976 and 1996, house prices increased by more than 350%, rising from £12,209 to £55,169 – that's four and a half times their original value.

Rapidly rising house prices are good news for investors, especially those who have taken out a mortgage, as they realise the full benefit of leverage.

The benefit of leverage

This is a big reason why investors choose to put their money in property, particularly professional investors, ie those with a portfolio. Property is one of the few investment assets that can be bought using borrowed funds, which means that when it increases in value, the investor benefits from the growth on not only their own capital, but the capital they borrowed, giving them a much better rate of return.

[1] Nationwide UK House Prices Since 1952: https://www.nationwide.co.uk/about/house-price-index/download-data

As simple example would be to look at £200,000 of capital invested in property using mortgage borrowing versus a cash purchase:

£200,000 property bought outright with cash		£200,000 used as 25% deposit on four properties worth £200,000 each	
Property value	£200,000	**Value of properties**	£800,000
Market rises by	10%	**Market rises by**	10%
Investor makes	£20,000	**Investor makes**	£80,000
Return on investment	10%	**Return on investment**	40%

By employing leverage, the same amount of capital has generated roughly four times the profit (of course, additional capital gains tax and other expenses need to be deducted).

While house prices are highly unlikely to rise again at the rates seen before the credit crunch (see Part Four for details), there is still a great deal of confidence that money is 'safe' in property. Given the continuing shortfall in new builds versus the demand for housing stock, and continued growth in both the population and the private rented sector, wise investments in some places across the UK can still reap good returns.

SUPPLY

In 2007, the Labour Government set a target of 240,000 new homes to be built each year, based on their estimate of the number of new households being created.

Annual new build completions peaked at 176,650 for the year ending December 2007, then fell steadily through 2008 to 2010. The figure subsequently fluctuated but has increased gradually since 2013-14, averaging around 146,000 for the past two years[1].

DEMAND

The population increased by 538,000 during the year to June 2016, the largest increase since 1947

ONS statistics show the population has grown by 482,000 on average over the past 10 years, with immigration being a contributing factor[2].

The private rented sector (PRS) has doubled in size since 1996, from 10% of UK households to 20%, and stands at 4.7m households for the year 2017-17[3].

[1] www.gov.uk/government/uploads/system/uploads/attachment_data/file/639725/House_Building_Release_June_Qtr_2017.pdf

[2] ONS http://www.telegraph.co.uk/news/2017/06/22/population-growth-sharpest-70-years-record-migration-levels/

[3] EHS 2016-17 https://www.gov.uk/government/statistics/english-housing-survey-2016-to-2017-headline-report

Rental returns

Added to the benefits of security of capital and equity growth is the income that can be generated by rental profits. As house price growth has slowed in the last decade, investors have been focusing more and more on rental returns, with Houses in Multiple Occupation (HMOs) in particular having grown in popularity. Letting properties by the room rather than as a whole tends to generate two to three times the level of rental income and, even after the increased costs associated with this kind of let have been accounted for, profits are usually significantly higher. For more information on this, see page 17.

While landlords who are primarily interested in long-term capital growth may not need to achieve a monthly profit from rental income, they are nonetheless interested in the level of rent they receive. For them, ensuring the rent covers their mortgage payments, ongoing maintenance costs and any managing agent's fees means they have an appreciating asset that is costing little or nothing to own.

Image: © Dangubic | Dreamstime.com

What landlords expect property to deliver

Investors' expectations have shifted considerably over the last decade, because they have had to. Until the credit crunch, investing in property was, more or less, a case of buying a property, finding a tenant and waiting for the market to rise – which it inevitably did. Rental income wasn't overly important because of the ability to refinance every couple of years, and it wasn't necessary to carry out much analysis before buying, because the gains to be made were so good, pretty much across the board.

In contrast, the vast majority of today's landlords have made a conscious decision to invest in property over other financial assets because they have assessed the potential returns. Most seem to realise the importance of knowing about the buy to let market, monitoring rental income, and understanding how their asset is performing.

That said, there is still a lot of uncertainty over long-term capital growth expectations.

In a survey of 3,726 landlords carried out by HomeLet in 2017:[1]

- 41.7% of respondents said they considered themselves buy-to-let investors
- a further 20.6% said they had made a 'private' or 'individual' property investment
- 5.9% said they had invested for their pension
- 22.5% had become 'accidental' landlords, through inheriting property or a change of personal circumstance.

This means a potential 68.2% have invested deliberately and should (ideally) have a sense of the returns they expect.

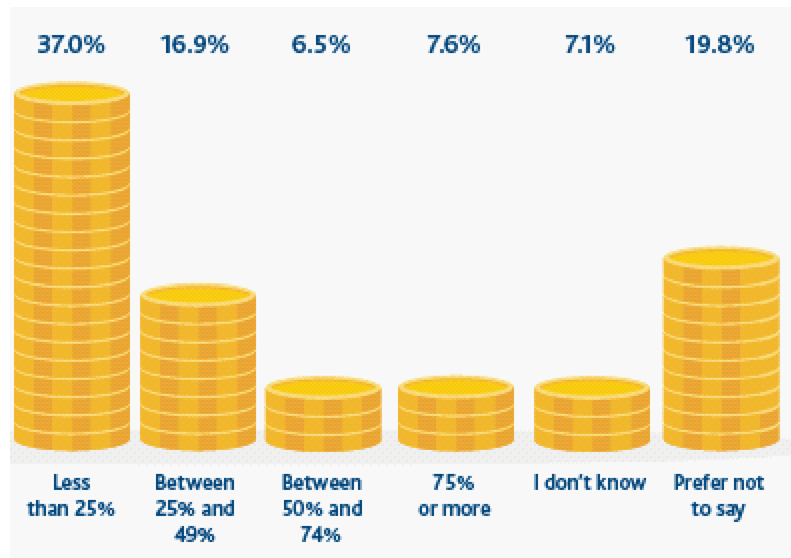
An earlier survey of 2,517 UK private landlords, published in December 2016 by the Council for Mortgage Lenders (CML, now UK Finance), found:

- 33% were investing for both capital growth and rental income
- 29% were using property as a pension contribution
- 10% were focused purely on rental income
- 8% were accidental landlords
- 4% were only interested in capital growth

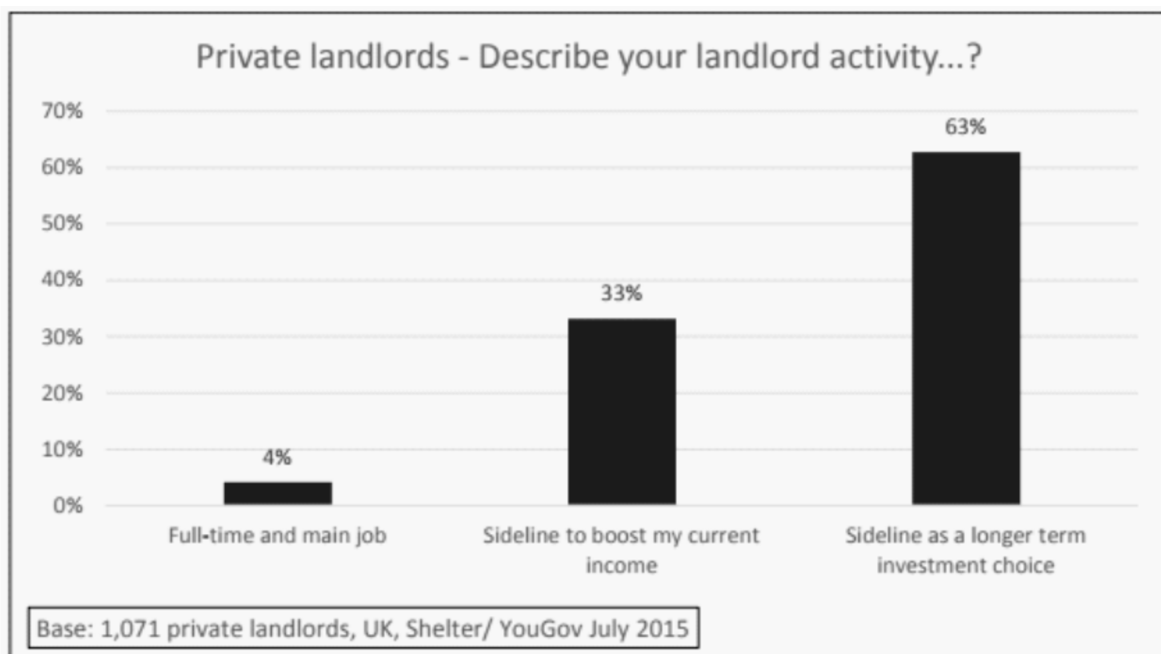
And, rather oddly, 4% said they didn't know why they had become landlords!

[1] Homelet Landlord Survey: https://homelet.co.uk/landlord-insurance/landlord-lowdown-blog/article/landlord-market-survey-2017

In terms of rental income, when asked in HomeLet's survey what proportion of their gross household income came from rent, the respondents answered as follows:



This suggests that around a third of landlords consider rental profit an important aspect of their property investment. It represents at least a quarter of their total earnings, which tallies with a Shelter/YouGov survey carried out in mid-2015:



We could assume, therefore, that the remaining two-thirds of landlords see their main reason for investing to be capital growth, with rental income more of a bonus than a primary investment strategy or goal.

Image: © Lovegtrv6 | Dreamstime.com

According to the CML (now UK Finance) survey, the average rental income of landlords was £17,300 per annum and the average net rental return was a relatively low 3%-5%. However, they stated "the current economic environment offers few investment alternatives for those seeking regular income".[1]

Worryingly, the research also found that a third of landlords do not estimate their net yield. Of the remaining two thirds who do, around 50% thought they made between 3% and 5%, although estimates ranged from negative to over 10%.

In terms of capital growth, currently there is no research to support any estimates as to what landlords expect. Given that only half of the landlords surveyed seemed to correctly estimate their returns from rental income (versus the average), it could be surmised that a far smaller number have spent any time making longer-term projections.

This report will look in further detail at how and why investors' returns have changed over the last 20 years.

[1] The Profile of UK Private Landlords: https://www.cml.org.uk/news/cml-research/the-profile-of-uk-private/

Different investment goals and the types of property investing that fulfils them

While the holy grail of property investment is to secure a good return, investors should be choosing the type of return that is most important to them and invest accordingly.

The type of return an investor is looking to achieve should, but doesn't always, dictate what kind of property investment route they go down.

Investors should focus on the three main objectives:

Investing for lump-sum returns in the short to medium term

This used to be a very popular option in the late 1990s and early 2000s, when capital values were rising quickly. An investor could buy a property, do little or no work to it and sell it just a few years later for a good profit. We look at the figures in detail in Part 4, but the headline is that investors would have made around five times as much over both three and five years before the credit crunch, compared to the years since then.

Rather than relying on capital growth, returns can also be enhanced by refurbishing, buying at a discount or developing, as opposed to benefiting from natural house price growth to deliver a short-term increase. Whereas in the past some investors would often sell the property as soon as works had finished, in order to release and either realise or reinvest their profits, nowadays it's more essential to build in extra equity at the start of what will be a long-term investment.

That said, because of the rush of investors looking for 'projects' in the early days of buy to let, combined with the explosion of DIY programmes in television encouraging homeowners to buy something that needed 'doing up', the number of properties that actually come to the market offering the opportunity to add significant value has fallen dramatically – certainly at the more affordable end of the scale. Many 'wrecks' have now been completely refurbished and simply updating a kitchen and bathroom that have come to the end of their 10-15 year life is not going to turn much profit.

In short, the days of being able to achieve lump-sum returns from capital growth in the short to medium term, without investing with cash and/or developing, are virtually over.

Investing for capital growth returns in the longer term

Despite the dramatic slowdown in the growth of house prices and with some areas still not recovering to their pre-credit crunch highs, it is still predicted that property will continue to increase

in value over 15 to 20 years. Although this growth may not keep up with inflation, it is worth landlords considering leveraging to take advantage of buy to let returns in a market which is expected to have slower capital growth.

Professional portfolio investors who want to make some investments that prioritise capital growth need to choose their methodology carefully. For example:

- Focus on established high-value, high-growth areas, such as London and other major cities
- Identify areas that are undergoing regeneration and are therefore likely to grow well in value as the infrastructure improves and business investment increases
- Buy properties which are sold at a cash discount and/or value can be added
- Build to rent, ensuring future property maintenance is kept to a minimum.

Investing for income

Regardless of whether property investors see capital growth as their priority, every landlord needs some rental income and different types of let deliver different monthly profits. There are five main ways of letting a property:

Single unit lets

This is overwhelmingly the most common investment route[1], with flats being the most popular property type (47% of buy to let landlords), followed closely by terraced houses (44% of landlords). 7% of landlords surveyed by the CML (now UK Finance) were found to own an entire block of flats. Tenants are on one tenancy agreement and will stay for an average of nearly two years, according to recent data from LSL Property Services.

In terms of income, the returns tend to be modest but consistent; average yields have been around 4.5% for the last two years. A third of landlords say their rental income is between £5,000 and £10,000 a year, although the mean income for all buy to let landlords stands at over £20,000.

[1] The Profile of UK Private Landlords: https://www.cml.org.uk/news/cml-research/the-profile-of-uk-private/

Houses in Multiple Occupation (HMOs)

An HMO is defined by the government as any property with at least three tenants who form more than one household and share kitchen, bathroom or toilet facilities. Bedrooms are let individually, often to people who don't know each other. The real benefit is they tend to generate two to three times more rental income than if the property were let as a single unit, leaving the landlord with significantly more profit, even after all the additional costs are deducted. Research carried out in 2015 revealed HMOs present a gross yield of nearly 13%, against a single-let yield of around 5%.[1]

Although 10% of buy to let landlords say they are focused purely on rental income, only 2% currently invest in HMOs – chiefly because of the additional legal obligations, administration and maintenance required. Quite simply, most landlords don't want the hassle and it tends to be more attractive to dedicated portfolio landlords, some of whom may expand into a lettings and management company for others in order to provide additional income.

Landlords of HMOs may need to license the property, although this varies from one council to another. Until October 2018, the national law states any HMO must be licensed if it has three or more storeys and is let to five or more people who form more than one household and share facilities. In October 2018 the storey element is being removed from the criteria. HMOs must also comply with additional fire and health and safety requirements. With usually five or six tenants on individual ASTs, each staying for only around six months, there is more administration to take care of as well as additional wear and tear.[2]

[1] Converting property into HMO to increase yields: https://www.arthuronline.co.uk/increase-hmo-yields/
[2] How long tenants stay in an HMO: http://abccinemas.co.uk/how-long-can-you-expect-tenants-to-stay-in-your-hmo/

Corporate/executive lets

Just 4% of landlords let their property in this way, perhaps because it is a very niche market that only tends to be viable in the more expensive parts of major cities, therefore only well-capitalised investors can afford to buy into the market.

Although landlords can charge high rents for this kind of all-inclusive accommodation, there are greater costs involved, with the property having to be of an exceptional quality and include high-end furnishings that have to be maintained at that standard. They may also be let for very short periods, so the managing agents' fees go up to reflect the extra work required. Sometimes a company is willing to lease the property from the landlord for a number of years, in which case, although they may want to negotiate on the rent, it does eliminate the risk of voids that comes between each short-term let.

Image: © Monkey businessimages | Dreamstime.com

Student lets

Around 7% of buy to let landlords let to students. While the income tends to be similar to that of any other single let unit, there is the benefit that rental agreements are usually made well in advance and for a minimum of 12 months. Students may stay in the property for the duration of their university days, meaning fewer void periods for landlords. Letting to students who are all on one AST can be beneficial because they are jointly and severally liable for the whole rent. If their parents act as guarantors, which is often the case, the chances of rental arrears and property damage are virtually eliminated.

Leasing to the council

In some areas – particularly in certain London boroughs – where there is a dramatic shortage of social housing, landlords could look to strike agreements with the local council to lease properties, usually on five-year terms. Although the rent may be less than if the property were let by the landlord directly to tenants, it gives a guaranteed rental income for the whole period of the lease, with no void periods.

Images: © Craig Mckay, Redbaron, Tatjana Krstic | Dreamstime.com

Financial considerations

If a property investment is not properly researched at the outset and its financial viability over the projected term not carefully assessed, today's investor runs the risk of finding that the returns they expected don't materialise or, worse still, when inflation is taken into account, they incur a loss.

Because things can change when a buy to let is up and running, landlords should regularly review how their investment is performing to make sure returns are being maximised and their capital is still in the best place. Given the extent to which capital growth has slowed since the credit crunch, it's never been more important to track both the rest of the property market and also the returns that other financial investments are giving. It's vital to appreciate the high levels of tax levied on those choosing to invest in the property market as opposed to other financial related investment.

Furthermore, as most investors will typically have a plan to ultimately dispose of their property assets and realise the equity/gain, it's key to ensure an exit – and its costs - are understood from the outset. This is because the way in which returns are realised – the 'when' and 'how' – will have a knock-on effect on how those returns are taxed.

Here we look in more detail at these four key areas for financial consideration:

Initial and ongoing capital investment required

Property is a capital-intensive business. While returns can be very attractive, it's important to recognise that unlike more traditional financial investments, in addition to the initial capital input (deposit, fees and refurbishment) a landlord will need to make regular capital injections, some running into tens of thousands of pounds.

Most landlords know what their regular annual outgoings are, but too few budget properly for the major outgoings that come up periodically, such as replacing the kitchen and bathroom, redoing a flat roof or fitting a new boiler.

For the 62% of landlords who only have one property, it is especially important to budget properly and keep aside enough money for these big jobs. Those who have a larger portfolio and a much higher level of monthly profit will find it easier to absorb unexpected costs. If you only have a small profit margin and take this as income, finding £3,000 for a new boiler every 10 years, for instance, may prove difficult unless you've planned ahead.

Here is a guide for how much landlords can expect to have to invest in their buy to lets over the lifetime of a long-term investment:

Potential long-term refurbishment

	Within five years	Within 6-10 years	Within 11-20 years
Decoration	£1,000	£1,000	£2,000
New/upgraded kitchen	£0	£4,000	£5,000
New/upgraded bathroom	£0	£2,000	£3,000
Repairs/new flooring	£150	£2,000	£2,500
New boiler	£0	£2,000	£3,000
Upgrade the electrics	£0	£2,500	£3,000
Exterior painting	£0	£2,000	£2,500
Guttering/soffits	£0	£0	£3,000
New windows	£0	£0	£10,000
Roof	£0	£0	£15,000

Source: The Buy to Let Show

In order to know what return the investment has delivered over time, it's vital to keep track of the initial and this additional capital invested over the lifetime of the buy to let, so it can be compared to the rental income and capital growth and, of course, is needed for tax returns.

Rent and capital values

Although it's impossible to know for certain how the property market will perform in the future, there are some fundamental indicators and trend patterns that should enable investors to make a calculated judgement before they commit to buying a property – provided the necessary research is carried out!

Rental income and a rise in capital value are the two ways landlords make money and these figures should be estimated for the whole length of the investment period, then adjusted for actuals each year. With these figures – as with all projections – it's wise to err on the side of caution and always plan for a worst-case scenario.

For example, given that wages have not, in the main, been keeping up with inflation since the credit crunch and are still more than 5% lower than in 2008, it would be sensible to assume that tenants will not always be able to afford rent increases in the coming years, whatever happens to a landlord's cost.[1]

Similarly, given that annual house price growth has been reducing since prior to the credit crunch in many areas and is currently standing at half its long term rate (7.2% annual average price growth since 2000 vs 3.2% from 2005), and Brexit is likely to extend the economic uncertainty, it may be wise to assume annual growth of only 1% or 2% for the foreseeable future.

FORECASTS

	2018	2019	2020	2021	2022
Savills	1.0%	2.5%	5.0%	2.5%	2.5%
Knight Frank	1.0%	2.0%	3.0%	3.5%	4.0%

Carrying out this kind of cautious projecting, buying and retaining only properties that are financially viable under these conditions should help ensure a robust investment.

Tax planning

Rental income is added to a landlord's other annual income to give a total figure that is taxed in line with the personal income tax bands each year. It's important for landlords to be aware that their profits from property could push them into a higher tax band, which can impact on any benefits received.

Some landlords manage to mitigate the tax applied to rental income by either owning or letting the property through a limited company. This does however have its own complications and is not something that should be entered into without advice from an experienced tax expert who takes into account all of the wealth generated and any capital gains tax and stamp duty transfer costs.

[1] The Independent: http://www.independent.co.uk/news/business/news/zero-british-wage-growth-since-global-financial-crisis-new-data-shows-a7226961.html

Once a decision has been made about how rental income will be received by the landlord, it can be factored into the annual budget and projections to help give as precise a net profit figure as possible. That will allow the landlord to ensure there is always enough money to cover expenditure and to know well in advance if they are going to need to subsidise the investment.

Next, capital gains tax (CGT) is payable when the property is sold. If the property is held for the long term, it's possible that the landlord will have remortgaged at some point to release equity. It's important to remember that CGT is applied to the increase in value between purchase and sale; it has nothing to do with the capital that the landlord is left with. A simplistic example (not accounting for fees and allowable deductions, etc) would be:

Property bought in 1998 (Q4) for £66,313 with a 75% interest-only mortgage

Mortgage loan	£49,735
Equity	£16,578
Value in 2008 (Q4)	£156,828

Remortgaged in 2008 at 75% LTV

Mortgage loan	£117,621
Equity	£39,207
Sale price in 2017 (Q3)	£210,982
Equity realised	£93,361
Total growth in value	£144,669

(Average house prices from Nationwide data)

CGT is applied to the total growth figure, less the personal allowance (£11,300 for the 2017-18 tax year), which in this case would result in a bill of £24,006 for a basic-rate tax payer and £37,343 for those on the higher rate.

For landlords planning to leave their wealth to their family, given that inheritance tax is relatively high, property may not even be the best vehicle for passing on that wealth.

There are opportunities to minimise your tax bill via allowable deductions, but these can be very complicated and property tax has its own peculiarities. As such, it's important to take specialist tax-planning advice before making any property investment, to ensure that the property is bought, owned and profited from in the most tax-efficient way.

Tracking the property's performance

Given that the days of sitting back and waiting while a property inevitably increased in value are unlikely to return, together with our current uncertain economic environment, it's more important than ever for landlords to keep on top of how their buy to let investment is performing. They have to be able to compare their property with both local and national buy to let averages and also other types of financial investment, in order to see whether their capital is working as hard as it can for them.

That means knowing the exact income and expenditure associated with the property, being able to calculate gross and net yields, and accounting for any capital growth in overall annual returns. Landlords also have to take into account the income tax and CGT payable on profits in order to be able to compare investments on a like-for-like basis.

Because buy to let property can't necessarily be disposed of quickly and attracts significant tax costs on both acquisition and disposal, it's not something that can or should be changed regularly. Every buy to let purchase should be viewed as a long-term investment, with the understanding that there will be natural market fluctuations. This is why it's so important to carry out considered research at the outset and stress-test all projected figures.

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What can impact on a landlord’s returns?

There are a number of different things than can impact on buy to let returns. Some are beyond the landlord’s control, some can largely be controlled and others fall between the two. It’s important to be aware of what can boost or potentially decimate returns, so that landlords can plan ahead, address issues at the earliest stage, and not be taken by surprise.

Competition

The risk of investing in one of many identical units was highlighted in the mid-2000s when new build flats in city centres went up at such a rate that there was massive oversupply. Many investors who had been lured in by developers’ very attractive projected rent and capital growth figures suffered huge losses when neither materialised, with a huge number of landlords falling into the negative equity trap. Some are still in negative equity today with little chance of properties recovering their value for some years to come.

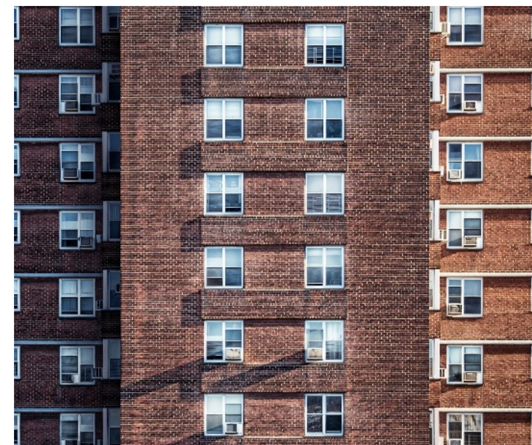
In situations like this, there are only two paths: keep hold of the property and subsidise it in the short term, hoping that it will recover in time, or sell and take the loss. Unfortunately a third option occurred due to the recession; those who had taken out high loan-to-value mortgages and were unable to afford to keep the property or sell it during the downturn had the property repossessed and lost all their invested capital.

That kind of risk can be mitigated greatly by checking with the local council planning department to see how much competition there will be for any particular type of rental property. Competition is not always easy to anticipate. A landlord who held a property for five to ten years without keeping themselves up to date with planned local developments could find themselves suddenly facing an influx of new investors and new properties that offer tenants the very latest in finish, facilities and technology.

The rapidly-growing 'multihousing' Build-to-Rent sector currently poses such a threat to landlords who have properties in areas where this type of institutional investment is taking hold. It offers tenants clean, modern living with hotel-style communal spaces and is aimed chiefly at key workers and students. More than 80,000 homes have either been completed or had planning approved. According to Knight Frank, the sector is currently worth £25bn and projected to grow to £70bn by 2022, just four years away.[1] [2]

The potential impact on returns comes in three forms:

- the possibility of longer void periods as tenants make new builds their first choice
- the cost of making substantial upgrades to an existing buy to let, to fall in line with the standard of the competition
- a possible reduction in achievable rent if demand starts to outstrip supply and tenants have more choice.



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Legislation

The raft of new lettings legislation that has come in since the Housing Act 2004 came into force in 2006 has brought with it relatively large additional costs for landlords. While the market was still strong pre-credit crunch, the additional costs were easily absorbed by rising rents and capital values, but changes over the last decade, together with the recent changes to the way landlords are taxed, have certainly had a negative impact on returns.

[1] The Guardian: https://www.theguardian.com/business/2017/sep/14/build-to-rent-the-solution-to-britains-housing-crisis
[2] Knight Frank Tenant Survey 2017: https://kfcontent.blob.core.windows.net/research/707/documents/en/the-uk-tenant-survey-2017-4743.pdf

The table below gives an idea of how costs have increased between 2000 and 2015, due to the legislative burden. Where landlords have not been able to increase rents, their returns are likely to have suffered.

Landlords' costs, excluding agents' fees

Initial average costs	2000-01	2015-16
Gas safety certificate	£40.00	£60.00
Energy Performance Certificate	-	£50.00
Domestic installation (electrical) certificate	-	£250.00
Smoke detectors and CO alarms	-	£50.00
Professional legionella risk assessment	-	£50.00
Professional fire safety risk assessment	-	£250.00
Landlord registration/licensing in certain areas	-	£400.00
TOTAL	**£40.00**	**£1,100.00**
Ongoing average annual costs		
Annual gas safety check	£40.00	£60.00
Deposit protection (insured scheme)	-	£15.00
Maintenance	£200.00	£250.00
TOTAL	**£240.00**	**£325.00**
Additional costs for licensable HMOs		
HMO licence (usually 5 years)	-	£850.00
Additional fire safety measures (alarms, extinguishers, fire doors, etc)	-	£3,000.00
Additional costs for Wales		
Landlord and property registration fee	-	£33.50
Landlord licence (5 years)	-	£144.00
GRAND TOTAL	**£560.00**	**£6,897.50**

(Costs will vary according to location and will be significantly higher in London)

Source: TDS Charitable Foundation report on Costs and Legals

Interest rate rises

One of the very few upsides for landlords in the years since the global financial crisis has been the historically low mortgage interest rates. Some of those who had taken out long-term tracker mortgage deals before the base rate hit 0.5% in 2009 have even found themselves paying zero percent interest since then. However with mutterings in the media and suggestions from market experts that we will see more base rate rises over and above the 0.25% rise in 2018, mortgage costs are likely to increase for most landlords in the next 12 months.

Although lenders undertake more stress testing since the credit crunch, it is still important for landlords to 'stress test' their projected income – at the start, when they first buy a property and then every year – to see how their cash flow would be affected by a mortgage interest rate rise. Although there's very little that can be done to avoid paying more to the lender, it might be possible to work in rent increases or cut costs elsewhere to absorb the increase.

Changes in rent and capital values

Something that landlords often don't appreciate is that rents can only be increased if tenants can afford to pay more. Regardless of whether operating costs are increasing, if a tenant's wages aren't going up, rents can't rise, or if they do, not for long.

According to HomeLet's 2017 landlord survey, more than half of landlords intend to increase rents, with just over a third (36.6%) saying they plan to do so in the next 6-12 months. 55% of those looking to do so cite inflation or market forces as the reason, with 21% saying the increase in their tax liability is the main reason. Whether they will indeed be able to put rents up, either by the amount they want to, or even at all, will be dictated by the tenants and their ability to pay.[1]

With two-thirds of landlords saying capital growth is their main reason for investing in property, that's a great many whose future financial plans could be affected by something beyond their control: how property prices perform. Savvy investors tend to build in equity at the point they buy, either by negotiating to purchase at below a property's surveyed value or buying something that can be improved, through refurbishment or extension.

Of course, both rents and capital values could perform better than expected, increasing landlords' returns, but it's important to be aware that this significant pendulum could swing either way. See page 21 for current forecasts.

[1] Homelet Landlord Survey: https://homelet.co.uk/landlord-insurance/landlord-lowdown-blog/article/landlord-market-survey-2017

Image: © Miluxian | Dreamstime.com

Long voids

Void periods, when a property is standing empty, can have a huge impact on returns, so it's important landlords take every possible step to avoid them.

A common mistake made by landlords is holding out for the rent they want and refusing to accept even a small reduction. Take the example of a property let for £800 a month. If it's untenanted for even just two weeks of the year, that's £400 in lost rental income. But if a tenant has made an offer of £775 a month and stays for a year, that's a 'loss' of only £300.

Unexpected upgrades/maintenance

Meticulous planning from the outset of a buy to let purchase should mitigate the risk of having to pay out for unexpected works, but sometimes things just go wrong. Lead flashing on a chimney could fail and go unnoticed until damp starts to penetrate inside the property. In that case a landlord might have to pay for repairs to the chimney from the outside, which is likely to require the erection of scaffolding (a significant cost). This is also likely to involve investigation and refurbishment to the interior, disrupting the tenant and possibly resulting in reduced rental income while the works are undertaken, in addition to the cost of the works themselves.

This kind of problem could cost thousands to put right and seriously impact the returns for the year, particularly if the landlord only owns one buy to let. That's why it's sensible to have a small slush fund of a few thousand pounds, to minimise the chance of budgeted returns being adversely affected by a one-off issue.

How returns have changed over the last 20 years

In stark contrast to their performance between 1997 and 2007, when capital values trebled, the last decade has not been so kind to property investors, with the average UK house price increasing by just £53,143 or 33.9% (Q4 figures quoted for each year):

	Price	Annual change
2008	£156,828	-14.7%
2009	£162,116	3.4%
2010	£162,971	0.5%
2011	£164,785	1.1%
2012	£162,924	-1.1%
2013	£174,444	7.1%
2014	£189,002	8.3%
2015	£197,044	4.3%
2016	£205,937	4.5%
2017	£211,433 (Q4)	2.7%

Source: Nationwide UK House Prices Since 1952: https://www.nationwide.co.uk/about/house-price-index/download-data

Latest research from the BBC at the end of 2017 also showed that although real values have still grown, when inflation is taken into account, figures show that 58% of wards across the UK had seen property prices being worth less today than they were 10 years ago. This is particularly concerning for landlords who have invested 100% in cash rather than utilised leverage to maximise returns.

In summary, the BBC research shows that "*Rising house prices have been confined to the South East and East of England. Average house prices in Wales, Yorkshire and the Humber, the North East and the North West have declined by more than 10% since 2007, when values are adjusted for inflation.*" [1]

Given that the annual growth rate is currently a quarter of what it was three years ago and we are facing economic uncertainty for the foreseeable future, the picture is unlikely to improve any time soon.

[1] BBC: http://www.bbc.co.uk/news/business-41582755

The difference in capital growth returns over the short to medium term

Short-term investing used to be a very popular option and many investors benefited from great returns simply by holding property for 3-5 years. This has not been possible in the last decade unless properties have been bought at a substantial discount or are focused on the high growth areas in the South.

The table below uses Nationwide's average house price and year-on-year growth figures. When put next to each other, it's clear to see the stark difference between the 'heyday' of rising house prices and the reality since the credit crunch:

PROPERTY BOUGHT IN 1998

	Sold in 2001 for £92,533			Sold in 2003 for £133,903		
Purchase price	**Growth £**	**Growth %**	**ROI***	**Growth £**	**Growth %**	**ROI***
£66,313	£26,220	39.5%	158%	£67,590	101.9%	407%

PROPERTY BOUGHT IN 2010

	Sold in 2013 for £174,444			Sold in 2015 for £197,044		
Purchase price	**Growth £**	**Growth %**	**ROI***	**Growth £**	**Growth %**	**ROI***
£162,971	£11,473	7%	28%	£34,073	20.9%	83.6%

**ROI with 25% deposit invested*
(Legal & financial fees, capital gains and other tax are not accounted for in these figures).

This slowdown in the rate of capital growth on its own may not have been too much of an issue for investors if they were benefiting from rental income returns and planning to invest – as most landlords do – for the longer term.

However, when mortgage lending tightened up following the credit crunch, the option of remortgaging was removed for many highly-leveraged landlords.

This meant that although their properties may have increased in value, they were unable to release any of the additional equity during the several years when 90% mortgages were withdrawn and the maximum loan to value dropped from 90% to 75% over that period. For example:

Property bought in 2007		**Value in 2015**	
Purchase price	£183,959	**Equity increase of £13,085**	£197,044
Mortgage LTV	90%	**Mortgage LTV**	75%
Mortgage loan	£165,563	**Maximum loan**	£154,452

How rental income has changed

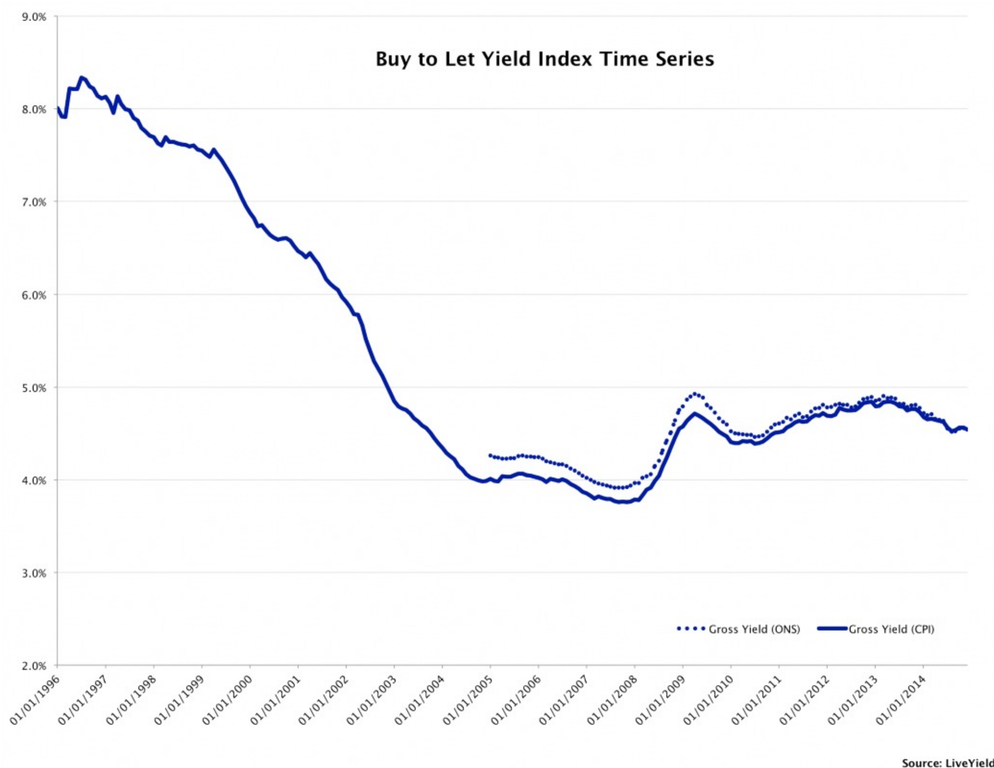
Average rental yields have also dropped, as rents have not been able to keep up with even the modest increases in capital values. That's chiefly because wage rises have not kept up with inflation since the credit crunch, so tenants have been unable to afford to pay more, even though landlords' costs have increased.

According to analysis from LiveYield, the average UK yield in 2000 was around 7%, dropping to 4.5% in 2015. As at June 2018, it stood at 4.4% for England and Wales (LSL Property Services).[1] [2]

[1] Live Yield Analysis: http://www.liveyield.co.uk/blog/buy-to-let-yields-over-time-series/uk-buy-to-let-yield-time-series/
[2] Your Move Buy to Let Index: https://lsl-assets.s3.amazonaws.com/lslps/uploads/media_file/YM-BTL-EWAUGUST-1.pdf

Image: © Feblacal | Dreamstime.com

The graph below illustrates how yields have changed over the lifetime of buy to let:



The impact of tax changes

Over the last couple of years, the government has announced and implemented a number of changes to the way landlords are taxed. In some cases, it's a direct additional tax; in others it's the removal of an allowable deduction; furthermore, there has been what amounts to a capital gains disadvantage for those who choose to invest in property, as opposed to another business. In summary:

- From April 2016, the imposition of a 3% Stamp Duty Land Tax surcharge for the purchase of second homes and rental properties. This extra 3% is on top of the standard stamp duty levy and applies to the whole purchase price for properties sold for over £40,000 – ie there is no STDL-free allowance, as there is for the purchase of a primary residence.
- From April 2016, capital gains tax rates were reduced by 8% for every asset class apart from property.
- From April 2016, the removal of the option to deduct a standard allowance for wear and tear on furnished properties, of 10% of rental income. Landlords can now only deduct what they have actually spent on buying new items during that tax year.
- From April 2017, the removal of landlords' ability to deduct all interest paid on buy to let mortgages and other financial fees from taxable income. This has been replaced by a 'flat' tax credit amounting to 20% of the interest paid – being phased in over four years.

These changes – particularly the last one – are already having a negative impact on the profitability and viability of landlords' buy to let investments, especially because many landlords took out interest-only mortgages in order to maximise cash flow and based their long-term investment plans on being able to deduct a large portion of the payments from their tax bill.

Example of the effect of the mortgage interest relief change

A landlord has five properties, each with an interest-only monthly mortgage cost of £800 – that's £48,000 a year. Assuming they are currently able to claim tax relief at the highest rate of 45%:

	Calculation	**Relief**	**Total drop in relief**
Historically	£48,000 x 45%	£21,600	
From 6th April 2017 to 5th April 2018	(£48,000 x 75%) x 45% = £16,200 (£48,000 x 25%) x 20% = £2,400	£18,600	£3,000
From 6th April 2018 to 5th April 2019	(£48,000 x 50%) x 45% = £10,800 (£48,000 x 50%) x 20% = £4,800	£15,600	£6,000
From 6th April 2019 to 5th April 2020	(£48,000 x 25%) x 45% = £5,400 (£48,000 x 75%) x 20% = £7,200	£12,600	£9,000
From 6th April 2020	£48,000 x 20%	£9,600	£12,000

In the CML survey, more than a quarter of landlords said they planned to reduce their portfolio or leave the market in the next one to five years. Of those respondents:

- 14% said it was due to the changes to mortgage interest tax relief
- 15% said it was because of other tax changes.
- Although only 3% of landlords surveyed were already running their buy to let business via limited company status, 10% of those with five or more properties said they were planning to do so, in order to mitigate the negative impact of the tax changes.

Conclusion: landlords’ expectations and plans for the future

The conclusion for landlords from this report is essentially that although property can deliver a good return, it is a lot more difficult to make money in the future than it has been in the past.

Landlords need to carry out thorough research to assess a property’s demand and supply situation – not just when they buy, but also taking into account the future impact of property building and developments.

It is also vital, and indeed a requirement, for landlords with four or more mortgaged properties, to create a business plan for individual buy to let investments. This needs to include long term maintenance costs which may be incurred, as opposed to just redecoration and kitchen/bathroom upgrades.

Finally, any decision to invest in property needs to understand:

- how the investment returns in property compare to other investments which attract lower tax
- the tax implications of investing, which could affect some benefits, such as child benefit.

Despite all of this, lower returns may still not mean people are unwilling to invest. With tenant demand expected to continue to rise, despite the government’s aims to grow home ownership, there is still profit to be made for those who can survive the reduced returns over the next few years.

Will many landlords leave the market?

With more than a quarter of all landlords surveyed by the CML saying they plan to reduce their portfolio or leave the market altogether in the next one to five years, what are the expectations of the remaining three quarters?

The vast majority of buy to let investors (77%) said they planned to either increase their portfolios a little or keep them the same, with only 4% intending to expand significantly. When asked what action they would take if their cash flow situation worsened, most said they would increase rents, but a significant 38% said they would sell some or all their properties.

In short, it looks as though the combination of increasing costs, greater regulation and rents not rising in line with inflation is likely to result in a number of landlords exiting the market, although whether this has a major impact may not be evident until 2019/20.

This in turn may lead to a possible drop in the supply of properties for rent, at least in the short to medium term.

However, given the distribution of PRS properties between landlords, it’s unlikely that this exodus will have much effect on the market in overall terms:

- 62% of landlords own only one property and make up around 28% of the market
- 7% of landlords own five or more properties and account for 38% of PRS stock.

Given that 4% of landlords surveyed said they planned to grow their portfolios, regardless of a reduction in their cash flow, it can be assumed that these are the more ‘professional’ investors, for whom buy to let is either their main or only business. As such, it’s entirely possible that they could, between them, buy properties directly from all the landlords who are selling.

Alternatively, they may invest into other existing or new properties; either way, it looks as though stock levels shouldn’t suffer.

Key steps to help ensure property investment delivers the returns landlords expect

- Clarify your own financial circumstances before investing
- Put together a detailed plan for what you need and want in the way of returns – including an exit plan
- Find out what kind of property investment will deliver those returns
- Make appropriate ongoing investment in the property
- Carry out regular financial reviews – and be willing to change either your plan or your investment, if necessary.

For more help and advice on investing in buy to let, please access the following resources:

The Buy to Let Show: Introduction to investing, running and exiting from buy to let

TDS Charitable Foundation: Advice and help for landlords, including model tenancy agreements:

Government website: guidance for tenants and landlords on renting