Part of the Buy to Let Britain research series

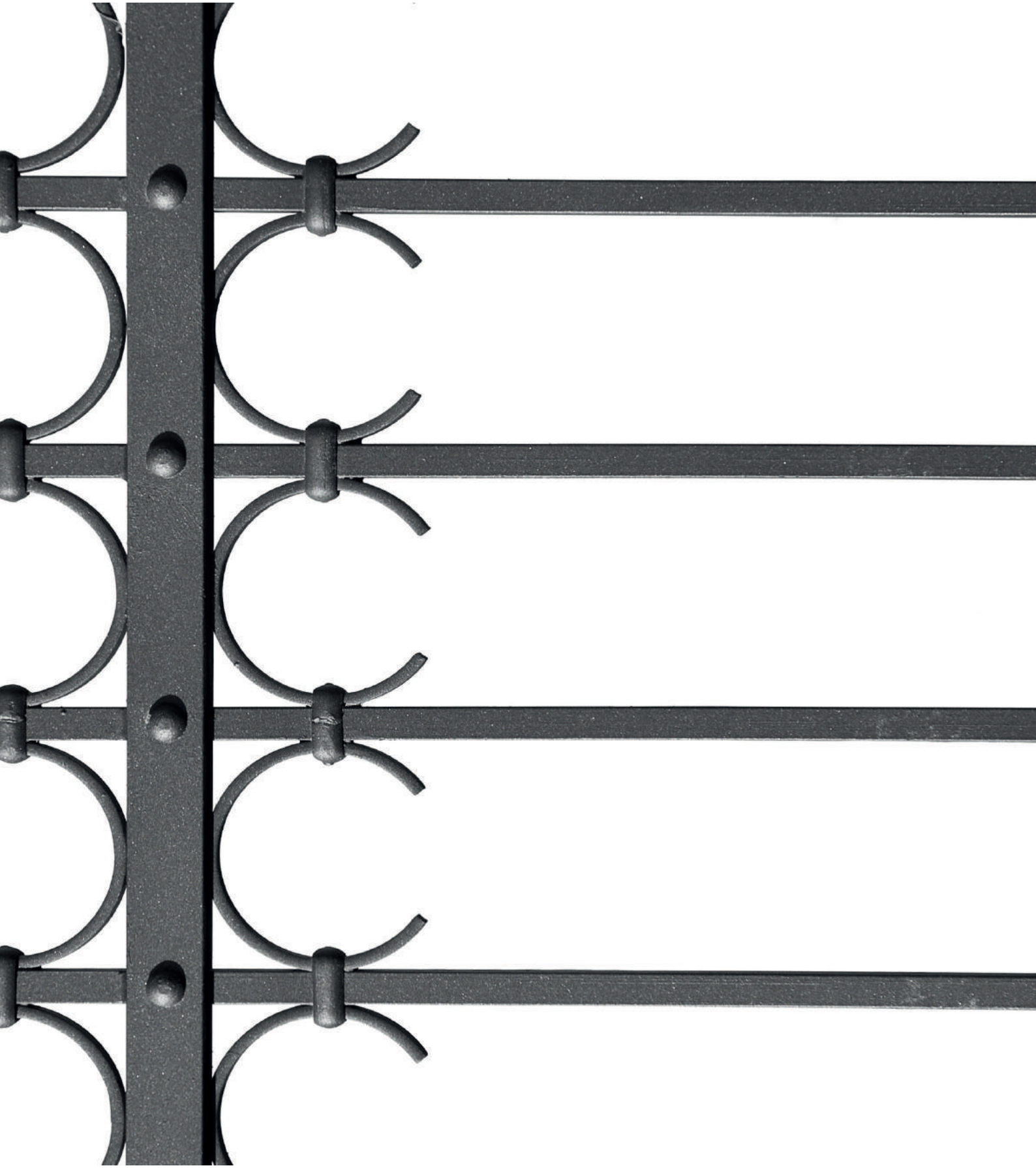
Buy to Let Britain Report

Edition Six

June 2017

KentReliance
for Intermediaries

Contents



Foreword

Welcome to the sixth 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.

Changes have come thick and fast for landlords since our last edition. First, the housing market came to the fore in the government's housing white paper in February, which recognised the need to stimulate housebuilding and loosen restrictive planning rules. This was followed by a raft of pledges in each of the political parties' manifestos ahead of the recent general election. The Conservatives promised to build 1.5 million homes by the end of 2022 while Labour committed to build 100,000 council and housing association homes a year. The failure of either party to secure a majority questions whether these promises will be met with action, however we have at least seen a firm recognition of the scale of the housing crisis.

While this will hopefully shape the wider housing market in the longer term, landlords have been getting to grips with more immediate changes. This April saw changes to tax treatment of BTL mortgages introduced, raising costs for many landlords.

The Prudential Regulation Authority (PRA) first round of changes to mortgage underwriting took effect from January, with the second; altering the way larger portfolio landlords are treated, set to come in to play in October.

Against this backdrop, costs continue to rise, even before we factor in higher tax bills for many landlords. In the last report from our Buy to Let Britain Research Series showed that the annual running costs of a buy to let property have reached £3,632 – up a quarter since 2007.

These factors are clearly beginning to drag on the growth of the sector; landlords have had to navigate the changing tides of taxation and regulation, at the same time as seeing the cost of doing business increase. We look at how they are doing so, how returns and rents are performing, and whether demand for, and access to, mortgage finance has been hit.

We hope you enjoy reading our Buy to Let Britain report, and find it a useful aid to inform discussion around the current trends and outlook for the private rented sector.

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 the Council of Mortgage Lenders' Executive Committee, of which he is still a member. Andy consistently and vocally champions the importance of a thriving private rented sector. He is passionate about simplicity and fairness in financial services and is a published author on the subject of financial education. OneSavings Bank trades primarily under the Kent Reliance, InterBay Commercial, Heritable Development Finance and Prestige Finance brands.

Executive Summary

Market Overview

- Landlords' confidence falls back in the first quarter, with 41% optimistic about their portfolios
- Growth in private rented sector slows, but it expands to 5.5 million households in Q1
- Limited company loans account for 44% of applications in Q1
- 24% of investors are considering incorporating or transferring property to spouses
- Value of landlords' holdings sees slowest total growth since 2011, but climbs £68.2bn in last year to record £1.3 trillion

Landlords

- Average rents hit record high of £889 pcm, but annual inflation eases to 1.9%
- With rents rising faster than house prices in last six months, yields edge up to 4.5%
- Landlords collect a total of £4.9bn a month in rent in Great Britain, with fastest rise in South East
- Gross total returns fall to an average of £17,804 per property, 7.8% per year
- Despite rising costs, just 4% of landlords report making a loss

Lenders

- House purchase lending falls 63% in Q1 2017, as tax reform, election and regulation slows market
- Remortgages dominate buy to let mortgage lending
- New PRA underwriting standards for buy to let to see a quarter of applicants struggle to secure finance in 2017
- The second round of PRA recommendations from October will overhaul way portfolio landlords' mortgages are assessed, boosting role of brokers and specialist lenders

Confidence slides as tax & regulatory changes take their toll

- 41% of landlords are confident over their portfolios' prospects, falling from Q4
- 19% plan to reduce their portfolios, compared to 13% who expect to expand them

Constant change in the treatment of buy to let is slowing growth in the private rented sector.

January 2017 saw the introduction of the PRA's new underwriting standards, requiring a more detailed assessment of a borrower's personal finances, and stress testing at a higher interest rate of 5.5%. This makes it more likely that landlords will need to provide larger deposits to secure the finance they need. Meanwhile, the mortgage interest tax offset investors had enjoyed was radically changed in April, increasing costs for buy to let mortgage holders.

The amount of mortgage interest landlords are able to deduct from their tax bill has been restricted to 75%, and it will reduce until 2020, when all rent will be subject to income tax – albeit with a 20% tax credit. All of this follows the recent introduction of the additional 3% stamp duty tax for purchases of second homes and investment properties last year.

On top of this, landlords face uncertainty over the prospect of yet more intervention. The rental market featured within the manifestos from Labour, the Conservatives, and the Liberal Democrats, suggests that further change may be on the cards in the medium-term.

The flurry of tax and regulatory changes, combined with recent reports of weakening house prices, has knocked landlords' confidence. This will be compounded by the election result, should the political uncertainty it has brought drag on economic growth.

Longer term tenancies prove mixed blessing

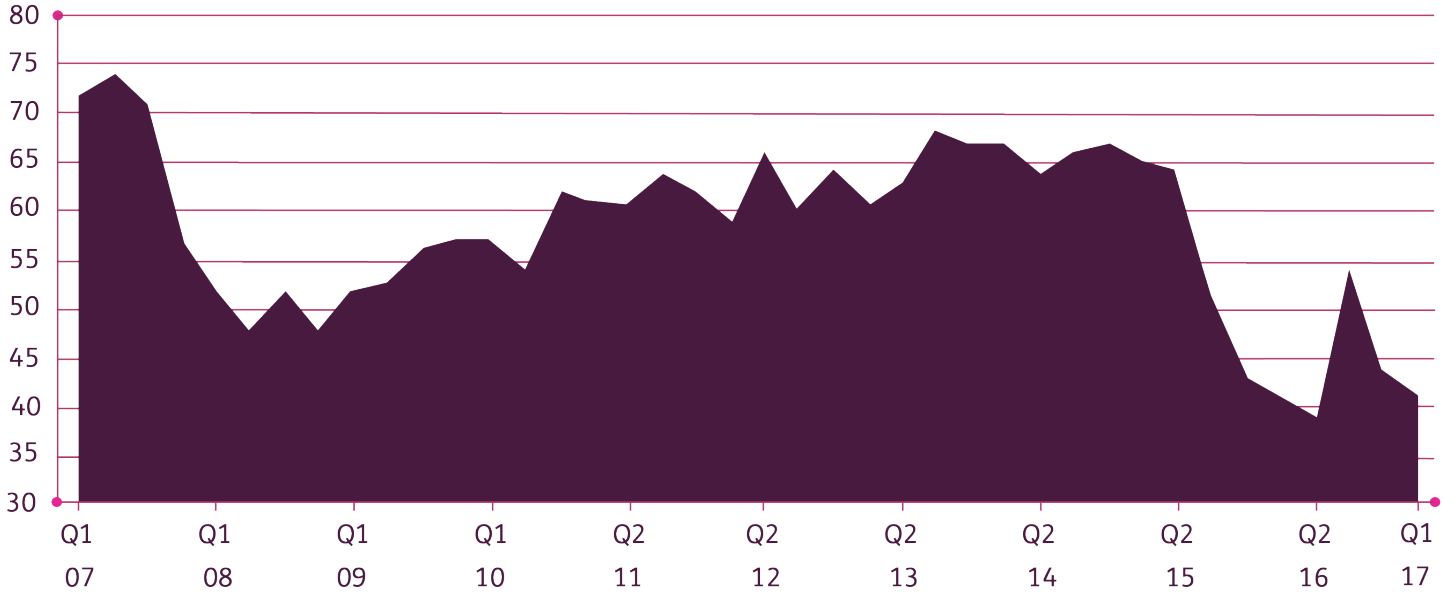
Longer term tenancies, discussed by the three main parties in the last year, seems a likely move. These can prove a mixed blessing.

In theory, they could reduce turnover and therefore costly void periods for many landlords, as well as providing greater consumer protection for tenants. However, if longer contracts do not guarantee that tenants stay for the full period, it may mean a more limited impact on tenant turnover. Furthermore, they may have unintended consequences. Fixed rents would encourage rent increases to be rolled into the start of a tenancy, in lieu of steeper annual rises, and we could see landlords less likely to rent property to tenants they perceive as a higher risk.

In a survey of 754 landlords, run in association with BDRC Continental in the first quarter of 2017, 41% were positive over the prospects of their portfolios, slightly down from 44% in the previous quarter. Those with a positive outlook still outnumber those with negative expectations, but it is a long way indeed from the 67% of landlords who were confident three years ago.

In the first three months of 2017, 10% of landlords added to their portfolios, only slightly outnumbering the 8% who reduced their holdings. However, over the next three months, 19% of landlords expect to reduce their portfolios, compared to 13% increasing. Rather than a mass exodus from the market, the shifting sentiment reflects how the reality of higher tax and running costs will undermine the supply of new rental properties. In fact, there may be some consolidation in the sector as small-scale speculators and amateur landlords leave the market as a response to tax changes affecting higher rate tax payers. This change in dynamic presents an opportunity for accelerating the professionalisation of the sector, both in terms of the size and scale of landlords, and the service many provide to their tenants.

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



Source: BDRC Continental

Private rented sector swells to 5.5 million households, but indicators of slowing growth emerge

- Number of households in sector grow by 2.3% in last year to 5.5 million
- Growth steadies as first-time buyer numbers climb 10%

On the demand side, the tenant population is growing, but it is no longer doing so at the speed of recent years. While 27% of landlords saw tenant demand increase in the last quarter, more than saw it decrease, this was down from 39% a year ago.

Healthier first-time buyer numbers are helping alleviate some of the strain on rental supply. 78,300 mortgages were lent to first-time buyers in the first quarter, up by one tenth on a year ago, according to data from the Council of Mortgage Lenders (CML).

The figures are now just 8% below their level in the first quarter of 2007. This is certainly an improvement, but we must remember that as the total number of households has grown in the last ten years, so too has the number of prospective first-time buyers.

Against this backdrop, the growth in the number of households in the private rented sector has moderated, and is now slower than we had previously forecast, even if it still slightly exceeds overall household growth.

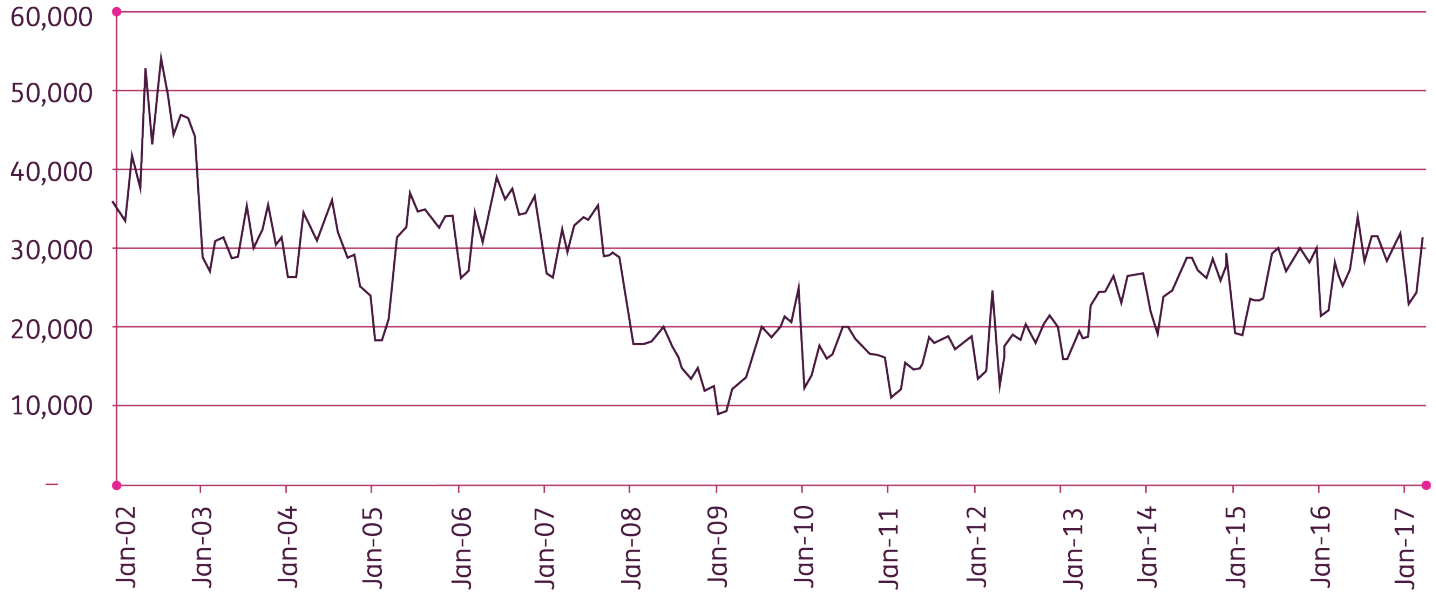
Our analysis of ONS data shows over 121,000 households were added to the PRS in the last year, taking the total number to just under 5.5 million. This represents steadier annual growth of 2.3%, less than a third of the rate of expansion seen three years ago.

Even so, it still housed 46% of the new households formed in the last year. As a result, private rented households now comprise just over one fifth (20.1%) of all households.

Slower and sustainable growth in the private rented sector is not a bad outcome, especially if it goes hand in hand with an increased supply across other tenures. Slower growth in the private rented sector becomes problematic if supply does not expand across the housing market in all tenures.

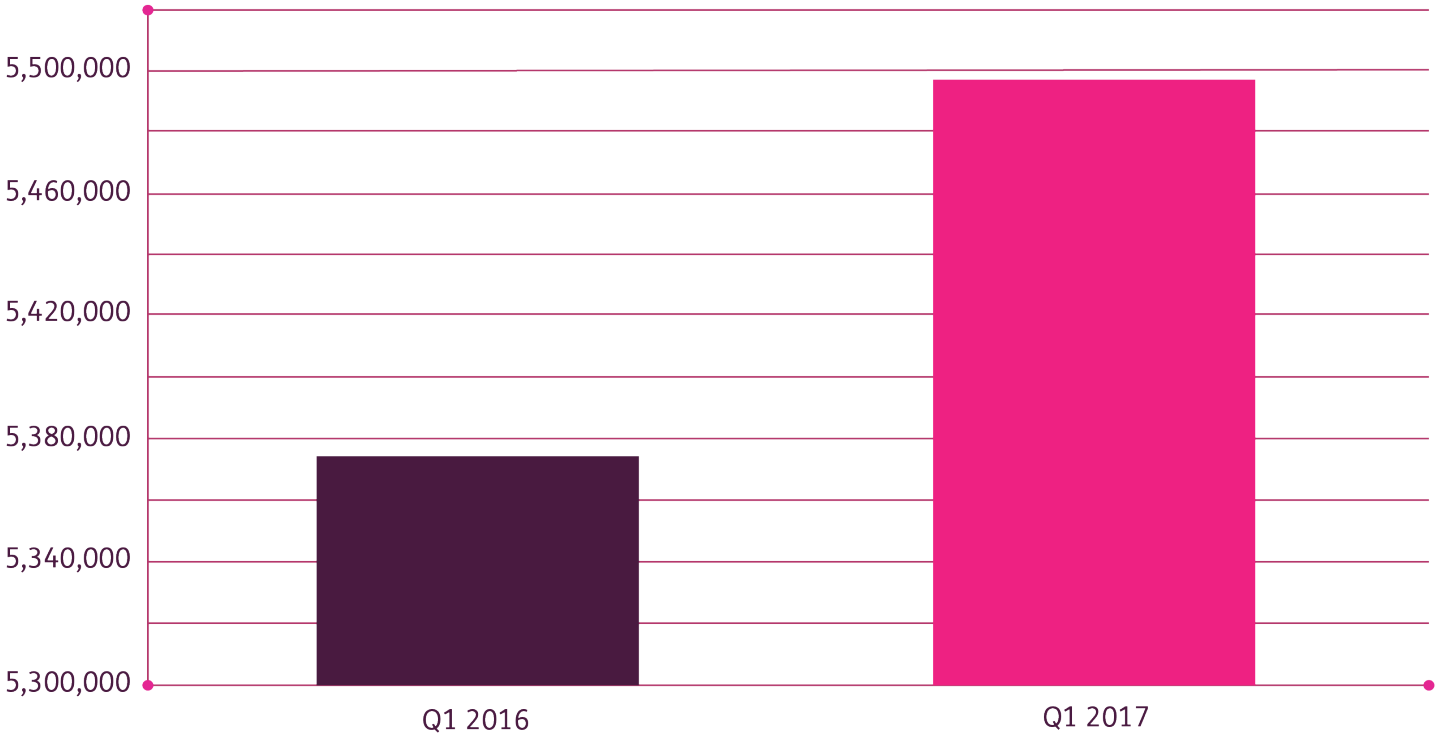
House-building has been at the forefront of political discussion, and fairly central to parties' manifestos in the run-up to the election. It is important that in spite of the political turmoil, we do not see action on this fall by the way-side.

Loans to first-time buyers per month



Source: CML

Total households in PRS



Source: Kent Reliance, ONS

Demand for incorporation sustained as limited companies account for 44% of loan applications in Q1

- Six in ten BTL mortgage applications were via limited companies in 2016
- One third of landlords now make a full-time living from their letting business

Changes to the taxation of buy to let mortgage holders has led to a sustained change in landlords' behaviour as they increasingly look to manage their portfolios through limited companies. Doing so means landlords, taxed as a company rather than an individual, can continue to offset finance costs from rental income when calculating taxable profits.

Analysis of Kent Reliance's data shows that nearly six in ten applications for buy to let mortgages were via limited companies in 2016.

Demand for limited company lending has not yet hit the record heights seen last year, but it is clearly not a flash in the pan. In the first quarter of 2017, limited company lending accounted for 44% of loan applications.

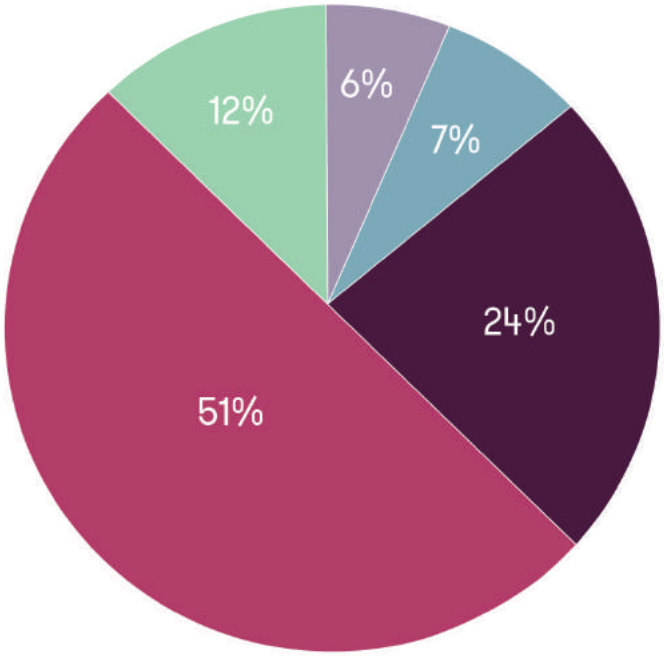
Moreover, one in four landlords (24%) are considering transferring their portfolio to limited company or a partner or spouse, and a further 12% do not yet understand the implications and benefits of doing so. Growing understanding and awareness will prove a further support for demand.

Increasing product choice highlights the fundamental shift in the market to support this type of lending. Mortgages for Business' latest figures show that the number of mortgage products for limited companies has increased by 34% from 198 in the last quarter of 2016, to 266 in the first quarter of this year.

Full-time landlords become more prominent

As a growing number of landlords form companies, and first-time or smaller-scale landlords are deterred from investment, we are seeing a growing proportion of full-time landlords in the market. According to the survey conducted with BDRC Continental, 30% of investors now make a profitable full-time living from their letting business, the highest this figure has been in four years. As this change takes place, we may see a further professionalisation of the sector, with a growing influence of long-term, skilled and experienced landlords that approach tenants as customers for their business. This will help improve both the experience of tenants and the quality of accommodation within the sector – not to mention the sector's broader reputation.

Landlords' sentiment towards incorporation or transferring property to spouse or partner



Key

- Would not benefit from doing so
- Considering this action
- Already transferred to spouse / partner
- Already transferred to Ltd company
- Don't understand implicaitons of this

Source: BDRC Continental

Sector's value hits £1.3trn but rented property prices see growth slow

- Average rental property prices climb by 3.2%, slowest growth since 2013
- PRS adds £68.2bn in the last year, growing at half the pace of last year

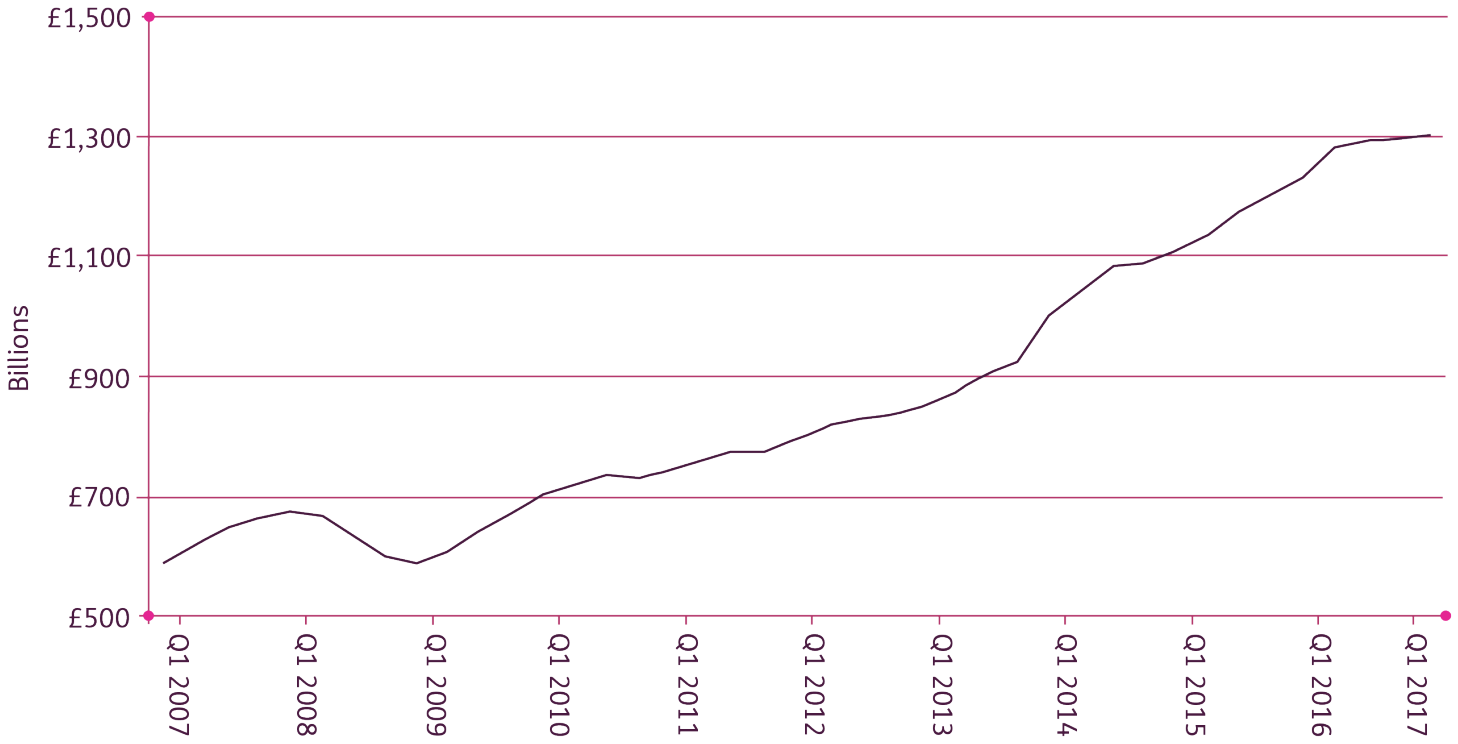
Slowing house prices in the wider housing market have spread to the private rented sector. Standing at £236,724, the value of the average rental property has risen by 3.2% in the last year, its lowest level since 2013. In fact, prices have fallen back in two of the last three quarters, driven primarily by London, the North East and Scotland.

The value of the private rented sector in Great Britain currently stands at £1.3trn. As house price growth has slowed, and the number of households entering the sector has steadied, so too has the rate at which the value of the sector is increasing. The PRS's value increased by £68.2bn in the last year and is currently increasing at a rate of 5.5% a year albeit at half the rate a year ago.

Landlords' housing wealth is not evenly spread across the UK. London accounts for 43% of the value of the PRS, £555.7bn. Given its size, it has seen the strongest growth in cash terms, up by £21.0bn.

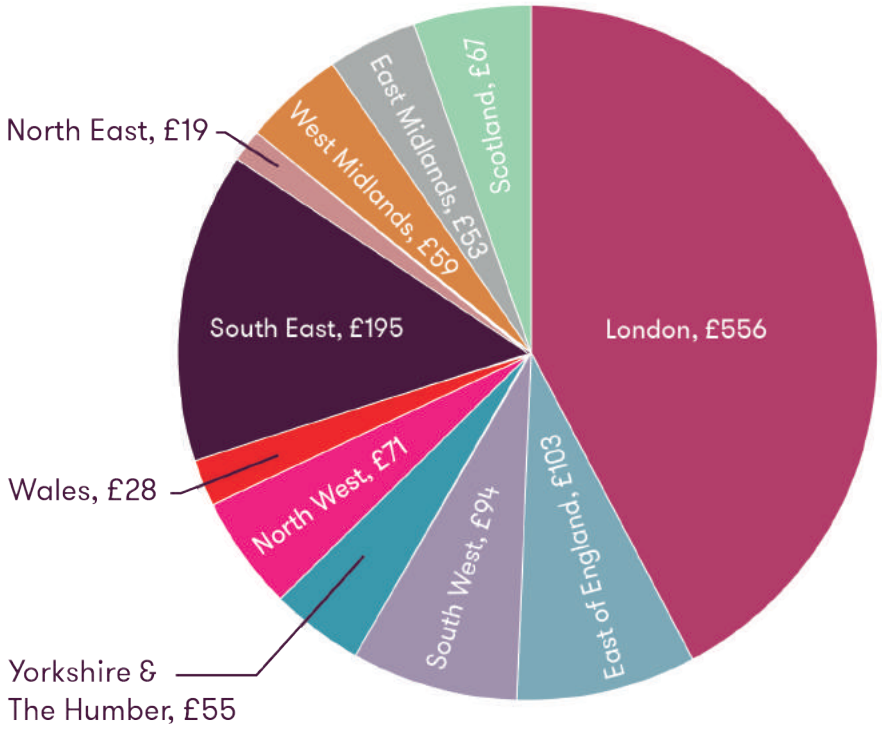
However, with house price growth in London the second weakest in the country, the total value of its PRS has actually increased more slowly (3.9%) than the national average. Although the East Midlands and East of England have far smaller rental populations, they have enjoyed more rapid price inflation. The value of their private rented sectors have risen by 9.2% and 8.9% respectively.

Total value of the PRS in Britain



Source: Kent Reliance

Value of the PRS by region (£bn)



Source: Kent Reliance

Yields are on an upwards trajectory as rents outpace house prices

- Rents rise by 1.9% in last year, climbing to record £889 per month
- As rents outpace house prices in last six months yields edge up

Average rents per property have seen gentler growth in the last year, rising by 1.9% to £889 per month. London has seen relatively low annual growth. Given that it houses over 1 million households, softening rents in the capital have been the key drag on the national figures.

Despite the annual rate of inflation easing, rents have still grown more rapidly than house prices in the last two quarters, rising by 0.6% in the first quarter of the year, and 0.2% in the previous quarter. With rent inflation outstripping that of house prices, the average yield has edged up from 4.4% in the second quarter of last year to 4.5%, reversing the trend of declining yields evident since early 2015. This will be welcomed by those looking to enter the market, or expand their portfolio – especially in the face of rising running costs and tax bills.

Weakening house price rises are likely to be a key driver in improving yields in the short-term, but rent rises look set to continue too. One third of landlords expect to raise rents in the next 6 months, compared to 3% who expect them to fall.

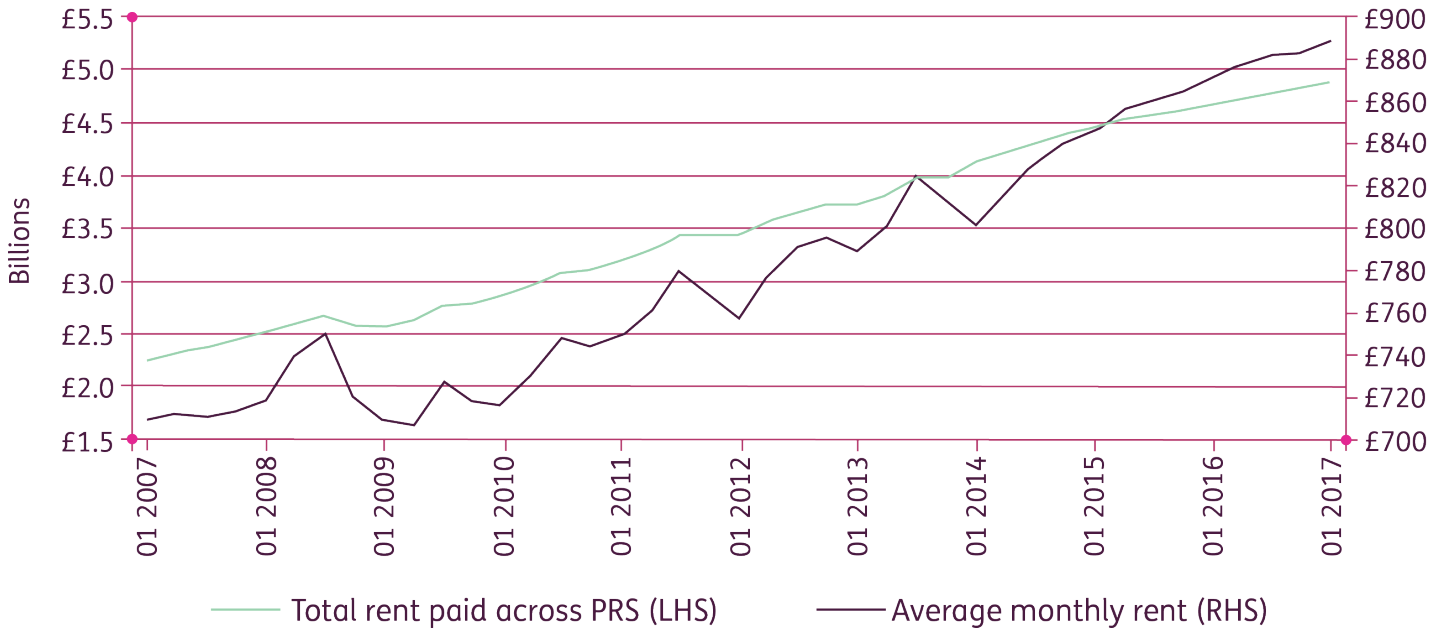
The main motivation for this rise is to cover increased running costs following the changes to taxation. While many landlords are seeking to trim expenses where they can, such as a reduced usage of letting agents, tenants are likely to shoulder the burden of increased running costs for property investment.

Furthermore, if we see the supply of rental properties coming to market undermined, as recent research from ARLA suggests[1], reversing the trend we have seen in the last year following the stamp duty surge, this will improve landlords' pricing power, and ultimately, heighten competition per property in the long-term.

Across the PRS, growth – albeit steady growth – in both the number of households and monthly rents means landlords are collecting a record amount in rent. In the first quarter of 2017, landlords collected £4.9bn in rent per month, up from £4.7bn a year ago. Although London provides by far the largest monthly rents (£1.9bn), the South East saw the fastest rise in the total rent collected, up by 5.4% to £648m, on the back of faster rental rises per property.

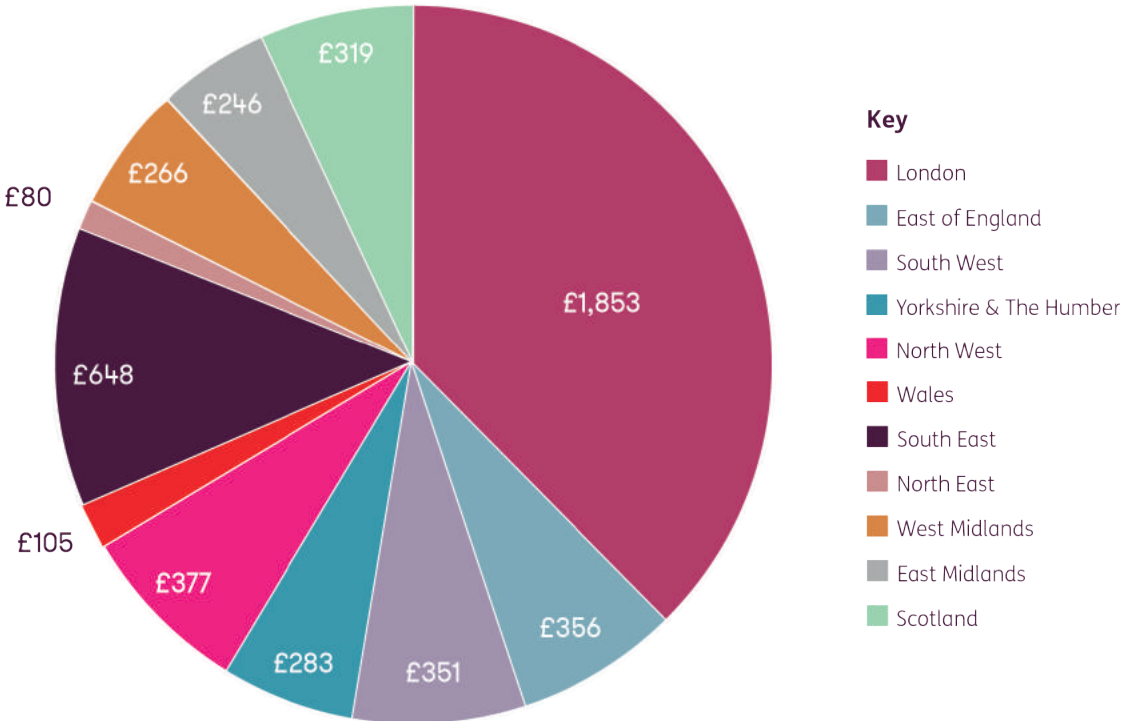
[1]ARLA Private Rented Sector report, March 2017

Total monthly rent vs. average rent per property



Source: Kent Reliance

Monthly rent paid by region (£m)



Source: Kent Reliance

Total annual returns fall back, but landlords maintain profitability

- Total annual return per property falls to £17,804, £95.7bn across the PRS
- However, just 4% of landlords report making a loss

Weaker property price growth is weighing on returns. In the last year, landlords have seen an average total gross annual return of 7.8% per property, equivalent to £17,804. This has fallen from £28,712 a year ago, when returns stood at 13.6%. Across Great Britain, landlords enjoyed total annual returns of £95.7bn in the last year, down from £150.8bn a year ago, and the record high of £170.9bn in the second quarter of 2016.

Tax rises will weigh more heavily on net returns over the next four years, especially for highly geared investors, but it's clear the sector remains lucrative for long-term investors who are able to control their costs; just 4% of landlords surveyed currently report making a loss. Furthermore, as the weighting of total returns shifts away from capital gains and towards income, it will hasten the rate at which short-term speculators are leaving the market. This will naturally provide more stability for tenants.

Lower returns will also impact the investment decisions of landlords as they review or expand their portfolios. We may see a geographical shift in investment.

Lower yields in London, for instance, following years of strong house price growth, will likely drive landlords to consider stronger yields in regions such as Yorkshire and the North West. We also expect increased interest in higher yielding sub-sectors, whether houses in multiple occupancy (HMOs) or less traditional semi-commercial or commercial property. This will increase demand for complex mortgage finance.

Total annual returns across PRS (£bn)

Source: Kent Reliance

Current yields and total returns

	Current yields	Total annual returns
North West	6.4%	12.9%
Yorkshire & The Humber	6.2%	10.3%
Scotland	5.7%	7.9%
East Midlands	5.6%	12.5%
West Midlands	5.4%	12.1%
North East	5.1%	4.6%
South West	4.5%	7.3%
Wales	4.4%	8.9%
East of England	4.1%	11.0%
South East	4.0%	7.8%
London	4.0%	5.5%
Great Britain	**4.5%**	**7.8%**

Source: Kent Reliance

House purchases dwindle as regulation and tax changes take hold

- A quarter of landlords find it more difficult to secure finance in 2017
- First quarter sees just 18,100 mortgages for house purchase, down 63%

The buy to let market has taken on a completely different complexion from a year ago. The rise of limited company lending has been startling, but it is not the only change government intervention has produced.

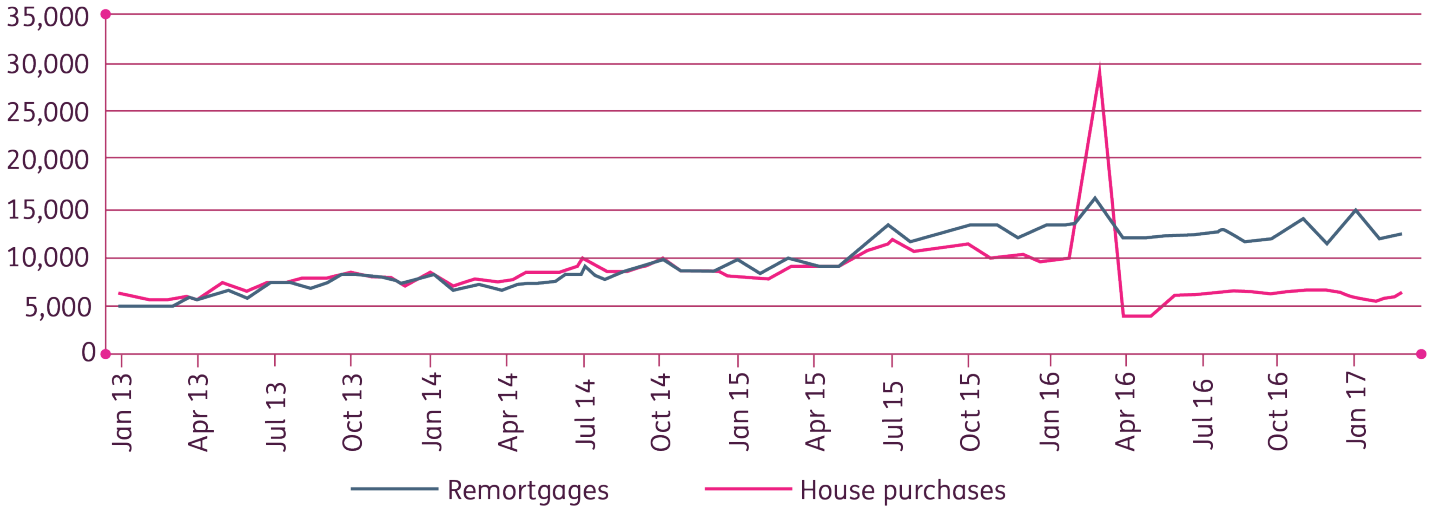
House purchase activity has fallen victim to the cumulative impact of taxation and regulatory reform. According to the CML, just 18,100 mortgages were issued for buy to let house purchase in the first three months of 2017, down 63% from the same period a year ago.

The prospect of higher taxation for buy to let mortgage holders has no doubt acted as a brake on demand, on top of higher stamp duty costs, but stricter underwriting criteria imposed by the PRA in January has had a noticeable impact too.

A quarter of landlords (24%) who have sought mortgage finance this year have found doing so more challenging, with a third of these needing to put down a greater deposit. A further 6% saw their application rejected altogether.

The strength of remortgage activity makes for more positive reading. Given many landlords refinanced ahead of purchases to beat the stamp duty deadline last spring, a significant year-on-year decline seemed probable. In fact, according to CML data, the 38,000 remortgages in Q1 2017 were just 12% fewer than in Q1 2016, and actually 2% more than in the last quarter of 2016, as investors took advantage of historically low interest rates to reduce their outgoings.

Buy to Let lending: Remortgage vs House Purchase



Source: CML

Outlook

The country's population is growing rapidly, increasing by more than 260,000 households a year. A succession of governments has yet to deliver a significant housebuilding programme to match this demand. No matter the party in power, it seems unlikely that this will change and reverse the squeeze on affordability for buyers. The private rented sector's growth, therefore, seems inevitable in the longer-term. With the election behind us, we anticipate that the PRS will reach 5.6m households by the end of the year, with its value climbing slowly to £1.32trn.

The rate of growth, however, will be tempered by recent government and regulatory intervention. As we have seen through falling house purchases, introducing regulatory change at the same time as punitive tax reform has had the effect of cracking a walnut with two oversized sledgehammers.

Moreover, ongoing political and economic uncertainty may drag on investors' confidence.

There is still another significant regulatory change for landlords to digest this year, when the second part of the PRA's underwriting standards is introduced in October. This will alter the way portfolio landlords' income and assets are assessed when applying for finance. For instance, lenders will now need to consider a landlord's existing mortgage debts and property values across their entire portfolio. This will add a new layer of complexity for portfolio landlord applicants, their brokers, and lenders. For existing lenders who do not have the established capability to do this, the increased complexity of these cases is likely to be a significant challenge.

This will create a shift in buy to let market dynamics that will suit specialist lenders rather than large-scale high street banks.

By itself, October's new rules will benefit the PRS, reducing risk and encouraging long-term stability. Nevertheless, when you consider the sheer scale of regulatory and tax reforms that have hit the sector, if they dampen demand excessively, it could prove to be a bridge too far.

The sheer scale of the gap between housing demand and supply suggests a tenure neutral approach would be prudent, encouraging investment into the private rented sector as much as social or owner-occupied housing. Unfortunately, support for the PRS was conspicuous by its absence in the recent election campaign. Policy risk remains a key obstacle for the sector over the coming years – especially given the rising popularity of political parties that have been traditionally anti-landlord in sentiment.

Brexit remains the economic elephant in the room. The terms of the UK's departure from the EU, and its effect on the economy, will be a key factor for the longer-term health of the housing market. This is less clear than ever following the election. General consensus had suggested we would see the economy soften, unemployment, and inflationary pressures increase, extending the current squeeze on household incomes. This would reduce demand from homebuyers, and hit house prices, and may deter landlords from expanding their portfolios. If we see net migration significantly reduced in the event of a hard Brexit, this would undermine demand for rental properties too, suggesting downwards pressure on rents.

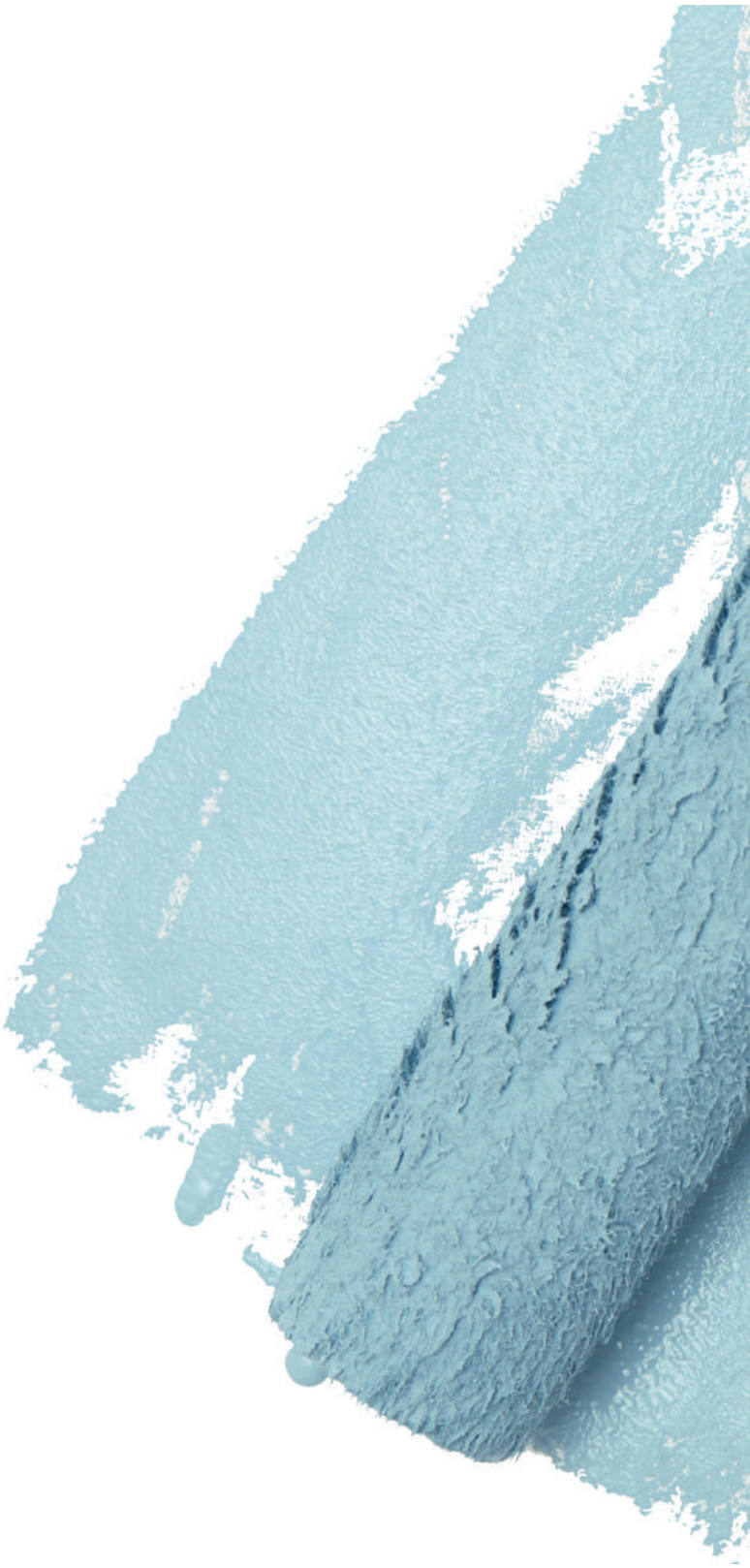
Methodology

The research involves detailed analysis of ONS population and English Housing Survey data to establish the regional weighting of the private rented sector, its size and growth rate. Rental property prices are based on the average differential between rental property and house price data from Land Registry and Registers of Scotland, indexed against the ONS house price index. Rental data incorporates figures taken from Citylets, 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 the CML and ARLA. Annual household growth is derived from ONS projections. Unless otherwise stated, the data analysed is between Q1 2007 and Q1 2017, and references to "the last year" refers to the year to the end of Q1 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 754 landlords, conducted in association with BDRC Continental in the first quarter of 2017.

Research was conducted by Teamspirit for Kent Reliance.



Contact details:

Media Enquiries

Dan Pike / Mark Baker
Teamspirit Public Relations

Email

dpike@teamspiritpr.com

mbaker@teamspiritpr.com

or call

020 7360 7878

Kent Reliance

John Eastgate

Sales & Marketing Director

01634 835763

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