Investing in private renting

Landlord returns, taxation and the future of the private rented sector

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A Report for the Residential Landlords Association

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Disclaimer

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One Page Summary (A more detailed summary is provided at the end of each chapter)

1. **The central message of this report is that current returns in the private rented sector are extremely low and are likely to remain so. The resultant damage to the private rented sector could be huge, because the availability and cost of privately rented accommodation depends on landlords' making viable returns on their investments.**
2. **This research is based on a specially undertaken survey of 200 landlords' revenues and costs. The survey results were then fed into a newly designed landlord investment model to provide a detailed analysis of landlord returns. That analysis shows viable landlord returns in the UK occur only when house prices or rents are rising fast, because of the high cost and tax burdens that landlords face.**
3. **Unless rental yields increase significantly in the near future, the threat of large-scale disinvestment looms large at a time when the demand for renting is at record levels. This would have wider detrimental effects on many cities' housing markets and reverse gains made in urban regeneration and the up-grading of the nation's housing stock over the past two decades.**
4. **Adverse outcomes would include much higher rents and far more limited housing choice for those wanting to rent a home. The consequences for tenants would be grim and economic recovery would be significantly held back by a lack of affordable rental housing.**
5. **The housing market downturn since 2007 has put further pressure on residential investment returns. More stress has been added by the continued weakness of the economy and tax rises.**
6. **To sustain landlord investment, gross rental yields have to rise back to the much higher levels that existed in the late 1990s and early 2000s, prior to the dual house price and buy-to-let booms of the 2000. They depressed rental yields by encouraging an unsustainable surge in private rental supply. The market has yet to readjust back to more viable combinations of rent levels and supply.**
7. **Much-hyped recent reports of rent rises and rising rental yields ignore the impact of inflation on real returns. Moreover, real rental growth over the next few years is likely to continue to be modest, because of the current strains on household incomes and the weak economy. House prices are unlikely to fall sufficiently to restore real yields either. A supply-side crisis looms.**
8. **Renting and owning offer distinct arrays of housing-related services that appeal to different types of consumer. The UK will not become a nation of renters, despite some exaggerated claims to that effect, partly because landlords face higher costs for the service mix they provide than occurs in owner occupation. The tax system is also stacked against them and this is directly transmitted into rent levels.**
9. **Renting is taxed in ways not faced by the other two housing main tenures. Owner occupation is in several respects tax-free compared to renting. Estimates here show average rented dwellings pay £1,000 a year in tax, 17% of annual rent; whereas other tenures pay none. Much taxation of private renting is indirectly paid for by tenants. This is particularly an unfair burden on younger households.**
10. **Governments can improve the supply of rental accommodation and help keep down rents by: i) trying to reduce the cost base of renting and encourage investors by cutting regulatory compliance burdens; ii) lowering the growing tax load on renting, making taxation fairer and more efficient; iii) removing the ban on privately rented housing investment in tax-efficient pensions wrappers; and, furthermore, to boost general housing supply iv) housebuilding could be particularly effectively stimulated by encouraging targeted landlord investment through tax-reliefs.**
11. **Introducing a tax-free net rental return would be ideal, as that would simplify and lower taxation. Otherwise, capital allowances would boost post-tax returns and enable provision for depreciation.**
12. **Reintroducing tapered capital gains tax, raising annual exemption levels, and enabling the rollover of assessed tax to new properties would all further improve returns and make the private rented sector more responsive to changing patterns of demand.**

Chapter 1: Is all as well with the private rented sector as it seems?

Introduction

This report is about investment in the private renting of housing. It is about how current returns to landlords are unsustainably low; about how rents, which are now beginning to rise, are likely to rise much further in future; and about the need for policy reforms to keep the momentum of a successful private rented sector from turning into a major housing crisis for younger people.

However, before going into too much detail, many will be wondering why these statements can be made when all the commentary in the media is about a boom in private renting. So, some scene setting needs to be done before embarking on more in-depth analysis.

The fundamental point is that, yes, many people are opting to rent but there are deep problems on the supply-side. In part, these arise from the aftermath of the buy-to-let boom of the 2000s but, more importantly, they arise from some deep structural problems related in particular to the tax system.

It is now well over 20 years since modern private renting emerged out of major legislative reforms in the late 1980s. They changed the way the tenure worked by freeing up rent setting and security of tenure. That led to a long investment boom which made rental housing attractive to millions of people, either as tenants or investors, in a way it had not been for generations. However, it is now probably time to revisit a reform agenda to ensure that a vibrant, competitive, affordable rental market is maintained. Later chapters will go through the analysis and make some policy recommendations but this chapter waves some flags about why all may not be well.

'Demand outstripping supply' ... 'a rent bubble'

The headlines seem to say it all: the UK's private rented sector survived the financial crisis virtually unscathed and continues to expand rapidly. In the post-Credit Crunch era, many housing indicators have plummeted: including those for market transactions, mortgage lending and housebuilding. Owner occupation itself has declined. By contrast, demand in the private rented sector has soared.[1] Seemingly, renting should be dubbed the Teflon tenure. It appears immune to adversity and has now drawn into its fold those whose housing options have been constrained by financial tightening and a weak economy. A golden epoch for private renting now stretches back for over 20 years.

Unsurprisingly, with such signs of success, media articles about buy-to-let investments have been reappearing with growing frequency in the past few months, after a post-crisis lull. An article in the *Times* newspaper on August 29th, 2011 even talked of a rent bubble when it commented on recent increases.

The evidence of growth is strong. According to the calculations of government statisticians, the number of privately rented dwellings in England rose by a substantial 1.5 million in just eight years between 2003 and 2010; a 55% increase.[2] In the most recent four full years between 2007 and 2010 alone, the rental stock rose by over three-quarters of a million; while during that period owner

[1] Rented housing in the UK, unlike in many other countries, comes in two major forms, private and social housing, which are now nearly equal in size. In this report, renting will refer only to the private sector, unless otherwise stated.
[2] CLG.

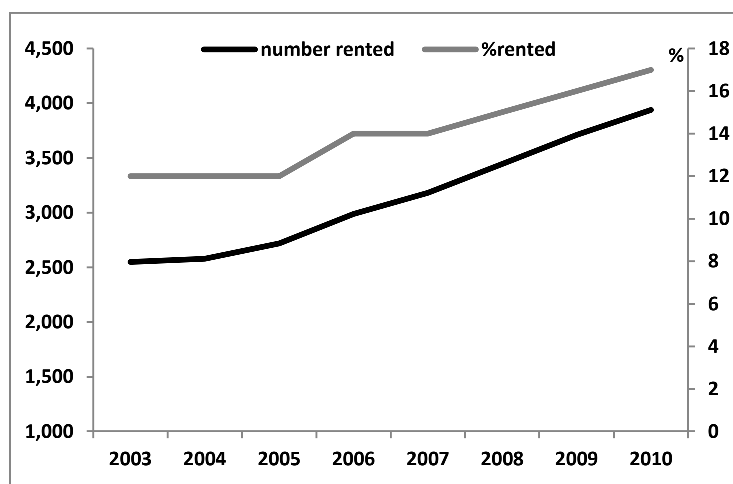
occupied dwellings fell by 280,000. As many as 17% of English dwellings are now believed to be in the private rented sector, up from 9% only two decades ago (Figure 1.1) and this expansion occurred during an era when household numbers themselves were growing fast.[3] By contrast, owner occupation's tenure share has wilted by a percentage point in each of the past four years and now stands at 65% of the housing stock, down from its early 2000s peak of 69%.[4]

The demand to rent privately has never been greater in modern times. The reasons for the growth are varied, as will be discussed in Chapter 2 below. Most importantly, they show that it is difficult to look at private renting in isolation from other housing tenures, especially owner occupation. For example, emphasis in most explanations of the recent growth in renting is put on problems related to owner occupation. Moreover, for a growing number of commentators, these homeownership problems are regarded as structural rather than simply a consequence of the unattractiveness of house purchase and selling at time of falling house prices.

In particular, focus centres on the current unfortunate situation of many potential first-time-buyers. They in aggregate had already experienced severe setbacks in the housing market boom years prior to 2007, when prices rose ever more beyond their reach for over a decade. Now, in the downswing, they are being squeezed further by tightened lending rules and so now many more are unable to enter home ownership. To make matters worse, those locked out are unable to benefit from softer house prices and, also, from the current low levels of mortgage interest rates, induced by a weak economy, which are currently negative in real terms (Figure 1.2). Bereft of a chance to own a home, so the argument goes, progressively more people are turning to renting and are likely to stay there.

Figure 1.1: Growth in the private rented housing stock, 2003-2010

England, share of all housing

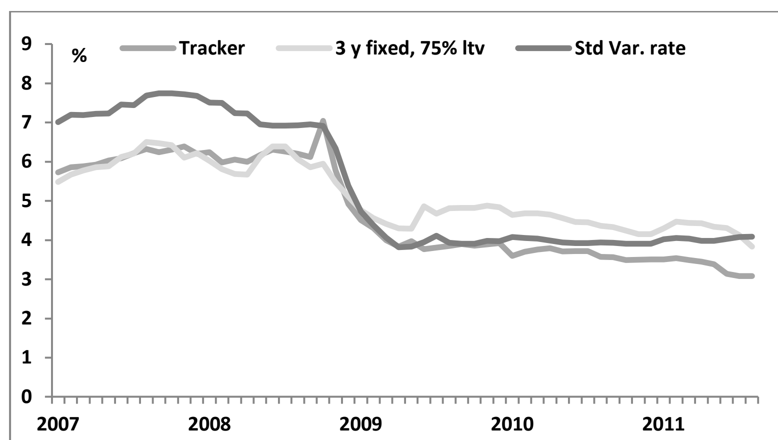


Source: CLG

[3] Although this report is about the situation in the UK as a whole, information unfortunately often refers to England alone because, since the devolution of housing responsibilities, aggregate UK data are limited and data for the other nations is often not as comprehensive nor as timely as that for England.

[4] Revised housing stock data, CLG. These revisions make comparisons prior to 2003 problematic, as they have assigned more of the nation's vacant housing stock to the private rented sector.

Figure 1.2: Mortgage interest rates Jan 2007 – Aug. 2011



Source: Bank of England

With regard to the recent declines in owner occupation, a new phenomenon, totally unexpected just four years ago, is now seen as the principal problem: the high deposit requirements of the UK's mortgage lenders. This deposit constraint is likely to persist for some time and entry criteria may become permanently higher. Moreover, despite quite marked falls in real house prices over the past few years, prices in many areas still lead to heady first-time-buyer mortgage to income multiples, even with the larger deposits now required. This not only puts off first-time buyers from purchase but also leads to additional breaches of lenders' loan criteria. That then exacerbates the impact of mortgage rationing and increases the demand for renting.

Because of the increasing concentration of younger people in renting, the catchy phrase 'Generation Rent' has recently been coined by the mortgage lender, the Halifax, and its researchers. That phrase is based on the conclusions of a survey of 20 to 45 year olds undertaken in 2011. In it, almost two-thirds of those not already owning a home said that they believed they had no prospect whatsoever of buying one. What is more, only 5% of them claimed to be making any sacrifices to save for a deposit on a home of their own.[5] This praise encapsulates the pessimism often expressed about the future of owner occupation and a belief that the private rented sector will continue to expand rapidly.

Yet, ironically, the Halifax used the press release of the Generation Rent research report to promote its own mortgages. In it, the bank highlighted that the constraints on lending are not as bad as feared by those in the survey. But Generation Rent struck a chord with many commentators and the notion added further credence to the idea that Britain is moving towards becoming a nation of renters rather than owners.

Although the private rented sector has undoubtedly expanded quickly, the view that owner occupation is in inexorable decline to be replaced by renting is almost certainly unfounded. Everyone would now accept, with the benefit of hindsight, that it was unwise at the peak of the last housing boom to base judgments solely on the recent market experience at the time. Yet, it is equally ill-advised to attempt to draw out too many trends from experience now, especially as the housing market is still only tentatively recovering from a major crisis.

[5] *The Reality of Generation Rent*, May 2011, National Centre for Social Research (for Halifax).

So, the housing market cycle should not be ignored when examining the dynamics of private renting. For example, experience of an antipathy to buying amongst potential first-time buyers has not been that different from previous downswings.[6] In any case, loan supply has improved since the worst of the crash and is clearly going to recover further over time. Similarly, interest by younger people in owning will bounce back as the housing market improves.

In many respects, it is more informative to treat renting and owning as complementary rather than being locked in a competitive battle for market share. There are some important features of this complementary relationship which help to explain the future of private renting. It is important to recognise that renting and owning are different in some important ways. It may be the case that they are both about providing housing. Yet, in reality, the two ways of living offer distinct accommodation-related bundles of services, cash-flows and risks for consumers over time. Unsurprisingly, therefore, renting and owning tend to serve different types of housing consumer, because costs and user benefits vary substantially between the two tenures. The cost-benefit mixes are attractive to different types of people and they vary across the housing market cycle. In addition, home owning is significantly favoured by the tax system.

One enduring problem in the UK is a general lack of housing supply. Housing costs are high because there is the general shortage of housing, caused by a combination of rising demand and a chronic lack of land on which to build new supply. This affects people in all housing tenures but especially so in areas where demand is high - exactly the places where private renting is concentrated.

Supply problems

Amidst current commentary about private renting, one key in element is often missing: recognition that landlord returns presently are generally poor. This situation is partly hidden by the existence of general price inflation which is running at over 5% a year; the poor returns currently offered on savings accounts; and by stock market volatility. Yet, even though the general investment horizon is bleak, it remains that case that many current residential investors would have been better-off if they had invested their money elsewhere.

Capital values have been sinking as real house prices have been fallen since their peak four years ago. So have real rents, though to a smaller extent. It is hard to predict the likely situation over the next couple of years. However, modest revivals in real rents in summer 2011 do not necessarily imply that a sustained increase is yet underway. Even the London market where rental markets have been strongest does not look as promising as some in the media have suggested while the economy remains weak. Much has been made of a flood of foreign investment into the London market, though its scale is hard to estimate accurately. But if it is large and increases the supply of rented property that depresses rental yields rather than raises them.

Therefore, all does not look good on the supply-side at present. Gross rental yields will have to rise in order to make investing in rental property more attractive. That can be achieved by rents rising or through house prices falling, or a combination of the two. While further house price falls cannot be ruled out, the most likely prospect is for a general rise in rents relative to house prices. Marked increases in rents are however difficult to sustain in a weak economic environment, so the

[6] 'Problems for first-time buyers', *CML news & views*, Feb, 2011.

adjustment may take some time. Nonetheless, until yields firm sufficiently, investment by landlords is going to be weak.

Landlords' non-interest costs determine the mark-up they need to charge in rents to make a worthwhile return. These costs are associated with management, the physical deterioration of properties, housing standards and tenant turnover. They are substantial and are not fully incorporated in the estimates of net and gross yields published by a number of estate agency chains and organisations. The research underlying this report has been able to access in more detail the costs faced by landlords. These have been incorporated into a specially designed landlord investment model. So, it is now possible to highlight the impact of these costs more deeply and accurately. Private renting is also not a risk-free investment, so landlords face risks that have to be compensated for in returns.

Collectively landlords are never going to elicit popular sympathy when their investments do not make them the money they expected. Nevertheless, the consequences of their actions in the face of poor investment returns will rebound on millions of current and prospective tenants. Although hard-pressed tenants may not appreciate it, rent levels in Britain relative to house prices are currently unsustainably cheap and the choice of accommodation wider than it would be under normal market conditions. So, over the next few years the market situation is likely to worsen significantly for tenants. They will either have to pay notably more or get less than they have become used to.

Without a significant improvement in landlord returns, there is a risk of a flood of disinvestment as disillusioned landlords put their properties up for sale, when given the opportunity as the housing market picks up and when other investment options become more attractive. It will be argued here that poor landlord returns are partly due to the current state of the market but they also result from important structural factors with respect to the private rented sector. They point to a need to re-examine of both taxation and regulation.

A high and growing tax burden

It is widely recognised that housing in general is lightly taxed, but that situation refers only to owner occupation and social housing. It is not the case with the private rented sector. In contrast to other housing, the tax burden on the private rented sector is rising fast. This has been caused by both a widening and a deepening of the tax take. The tax net has widened because of the expansion of renting and the growth of nominal rents. But it is also deepened in the sense that tax rates have risen in recent years in response to deteriorating public finances and this has significantly affected the private rented sector in a number of ways: through VAT rises and the increases in capital gains and income taxes. Many landlords are in the top half of the income distribution and, so, the income taxes they pay on their net rental incomes have been rising fast following government measures in recent years.

The increasingly adverse tax situation of the private rented sector is unique amongst the various housing tenures and contrasts with experience regarding many competing forms of savings and investment. For example, although there has been a reining back of the tax breaks offered to investments in pensions, the restrictions were mainly targeted at those on the very highest incomes. So, even after recent reforms, for most people the tax efficiency of pension investments are still substantial and have grown with higher income taxation. Similarly, ISA savings vehicles' maximum permitted annual volumes have risen considerably and other tax-break investment schemes have

been introduced. At present, the Treasury in a number of respects takes a dim view of utilising direct ownership of rental housing as an investment medium and, as a result, it is explicitly excluded from pensions and savings tax breaks.

The relative attractiveness of private rental investment has been notably diminished as a virtually unseen but adverse consequence of the ways in which governments over the past four years have altered and raised taxes. It is now more tax efficient for many landlords to utilise pension and other savings vehicles rather than to continue putting money into rental property.

It is important to recognise that taxation is not simply an extra burden on landlords and as such can be politically justified on grounds of 'fairness' and 'equity'. As will be explained later, much of these growing levels of taxation are passed onto tenants in the form of higher rents. Meanwhile, higher income and capital gains taxation make owner occupation even more attractive as a tax haven. So, the contrast with private renting is stark. People now have even greater incentives than before to buy housing for themselves but less incentive to buy to let.

It is difficult to come to firm figures about the tax burden on rents as it depends on assumptions made about rents, marginal tax rates, whether landlords are UK-based, the way they organise their businesses, mortgage levels and other costs. However, calculations by the author suggest that the annual tax on rental income paid by England's 3.4 million market tenancies may be of the order of £3.5bn.[7] The actual tax take is higher once renters in the rest of the UK are taken into account. If that tax-take was averaged out over all rented accommodation, it represents roughly £1,000 per tenancy yearly, equivalent to 17% of tenants' average annual rent costs. Although these taxes are charged to landlords not tenants, much of burden will feed through to the level of rent that tenants pay.

These calculations are obviously highly sensitive to the assumptions made but they are based on information that is currently available. The details of the assumptions can be debated but firmer estimates cannot be made, given the paucity of the available information. However, the general point that the private rented sector pays large amounts of tax still holds in any reasonable assessment.

Neither owner occupiers nor social tenants have tax obligations in this way. Quite the opposite: it is estimated that owner occupiers save £11bn in tax annually on the (imputed) rental values of their properties.[8] A future £8.8bn is saved in capital gains tax on the disposal of main residences.[9]

On top of rental taxes, capital gains tax (CGT) is payable by landlords, typically at the rate of 28% at the time of sale. In 2007-8, over 100,000 sales of residential land and buildings netted the Inland Revenue £5.7bn, many of which would have been of rental housing.[10] There is a further large liability

[7] The figure is derived by assuming all tenants on average pay the VoA estimated average 2010/11 rent; that there is 6% non-payment of rent; that landlords' annual non-interest tax deductible costs are £1,000pa; that the median value of a rented property is the same as the median England house price; that 50% of landlord properties have 60% LTV mortgages charged at 5% interest a year and the rest have none; and to simplify that all landlords pay UK income tax with half of landlords' marginal tax rates at 25% and the other half at 40%.

[8] S. Wilcox & H. Pawson, *UK Housing Review 2009/2010*, University of York.

[9] Inland Revenue Statistics, 2010-11. Note, if the taxes were charged, the revenue would be lower because people would change their behaviour.

[10] *Inland Revenue Statistics*. NB: Rental properties cannot be separately identified; CGT rates were also higher then than they are now.

embodied in unsold properties, as well. By contrast, owner occupiers incur no CGT liability at all. Further tax revenue comes from the 20% VAT charged on the market services that landlords buy, such as those on estate agents' fees or on repairs, which they cannot directly claim back because rents are not subject to VAT. Landlords are also double taxed on building improvements as they have to pay 20% VAT on them and, then, are taxed on the higher rents that the improvements generate. Owner occupiers admittedly have to pay VAT on the market services they use as well, but they do not incur so many costs as landlords do because they are not in the business of supplying tenant services. Landlords can deduct interest on mortgage payments which owner occupiers cannot but, even so, huge tax bias remains in favour of owner occupation and social housing.

The tax burden is also rising as rents increase, as the private rented sector expands, and it has grown with rises in income tax rates. Every increase that occurs in rents not offset by higher landlord costs pushes up the tax burden commensurately. The growth of private renting has benefitted government income considerably over the past two decades, because it has progressively drawn more of the housing stock into the tax fold. Renting will continue to increase tax revenues further over the coming years, in the absence of reform.

There is a real political paradox here. On the one hand, governments of all political persuasions bemoan the plights of those who cannot find affordable accommodation and they publicly fret over those who are trying to save up to buy a home. On the other hand, governments indirectly tax the same people substantially for the housing they consume when they are private tenants. These taxation effects, moreover, are regressive as tenants on average have lower incomes and less wealth than do owner occupiers.

The outlook for investment in renting

The investment outlook for private renting has changed in the past few years. In the decade up to 2007, the prime motivation of many when contemplating buy-to-let was to be able to profit from substantial rises in house prices. So, the prime driver was capital gain rather than rental income returns, which were widely recognised to be modest at best. However, since the advent of the financial crisis house price rises have been muted and, so, rental income returns have come into greater prominence.

Some currently think that now is a good time to buy, because house prices have bottomed out and will now continue to rise as a recovery gathers pace, with perhaps some initial sluggishness. However, forecasting house price change is a hazardous business. Looking backwards, it may be easy to see when was a good time to buy and to sell, but housing market cycles are highly irregular. Even when they do increase after a period of falls, prices tend to be volatile and slow to accelerate. In the last upswing, during the relatively easier recovery from the early 1990s recession, it took 12 years for real house prices to reach their late 1980s peak again. Currently, real house prices continue to fall in many parts of the UK, after brief periods of recovery in 2009/10. Parts of London may now be exceeding previous peak prices but there is no guarantee they will remain that way. Looking forward, house price changes and cycles in them are difficult to assess. But, for housing investors, the risks of further falls in capital values are now very real, whereas they were generally ignored in the earlier boom years. House price growth will remain a risky prospect in the future.

This raises a series of questions about the financial viability of the private rented sector that were muted in the booms years when supply expanded dramatically on the back of rising house prices and the buy-to-let boom.

- Have rents and house prices adjusted to the extent that reasonable returns can now be made in an era of modest house price growth?
- What is the minimum level of house price inflation or the ratio of annual rent to house price that can offer landlords a risk-weighted return comparable to that on offer by investing in other assets?
- Do current rent market conditions offer the prospect of such returns?
- What will happen to demand?
- What is the tax burden on landlords and how does it affect their returns?
- What costs in housing investment have to be considered and to which of them are returns most sensitive?

This report addresses these issues in several ways. First, Chapter 2 looks at who are the prime customers of private landlords, how they are changing and how the demand for renting is likely to develop in the future. Chapter 3 presents an overview of the characteristics of residential investment and examines the main drivers of returns and risks. This analysis is reinforced in Chapter 4, which presents the results of a survey of landlords and the costs and revenues from investment properties specifically undertaken for this report. The data from the latter survey are then utilised in a specially designed landlord investment model, which is used to investigate returns and the factors that influence them. The model further enables investigation of the benefits and costs of different residential investment strategies and also taxation issues. The final chapter, Chapter 6, then draws together the conclusions of the analysis and reviews some potential policy reforms to improve the supply of rented accommodation.

Chapter 2: Who rents and how is it changing?

Introduction

Living in rental housing is not for everyone but is attractive for significant parts of the population. Its benefits for tenants are its relative affordability in terms of cash outgoings; the freedom and flexibility of easy and cheap moving; and the opportunities it offers to deal with certain economic risk that households may face. Those people that value such benefits are most likely to rent, so lifestyles are of key importance and because of that the desire to rent tends to happen at particular times in people's lives.

The ability to live in the other two main tenures, owner and social renting, are key factors in people's choices. These choices are often posed as sharp negative constraints – i.e. 'I'm renting because I can't get a mortgage' or because 'I'm on a waiting list but can't move into social housing' – but, in practice, most private renters opt for their choice based on a comparison of the relative costs and opportunities they face, give their income, wealth and personal constraints. Relative costs over long periods of time come into play in that comparative framework, especially in relation to the main alternative to renting of owner occupation. More immediate finances will come into the calculation as well for the many that face cash flow constraints; in which context the monthly cash cost of owning versus renting will be a central comparison.

A desire for mobility often favours the choice of renting. The costs of moving as a renter are low and there is no need to wait until another occupier comes along. Under usual tenancy agreements, tenants can quit at short-notice if another property is found that is more desirable to them on cost or quality grounds or suits their changing requirements, such as when a job is found in a new location. Finding someone else to live in the properties previous tenants leave are problems for landlords, not tenants. By contrast, homeowners when they want to move have to find someone who is willing to buy their properties at mutually agreeable prices. This process can take many months and typically involves estate agency and legal fees and, usually, the need to link up in chains of other buyers and sellers in which the risk of a sale or purchase falling through can be quite high.

Those on variable incomes or who face the risk of losing their jobs also benefit from renting, because home ownership funded by a mortgage requires regular monthly payments and defaulting is costly.[11] Low-income households can more easily crowd up in lower market rental accommodation and are more likely to be able to move subsequently to social housing. Other renters may be concerned about the risk of falling house prices at particular times and, so, opt for renting until market conditions improve.

The rules of the welfare state have a role to play as well. Housing benefit, though currently under reform, remains an important supplement to rental costs for many; in fact, around a quarter of private tenants are in receipt of housing benefit. Even though they do not receive it now, housing benefit also represents a social insurance cover for a much wider group of renters because it is there when they lose their jobs or when they experience a sudden loss of income for some other reason. However, such support for housing costs does not extend to owner occupiers. Although when they get into arrears, various support systems and lender forbearance may come into operation.

[11] *Tackling housing market volatility in the UK*, M. Stephens, JRF, 2011.

All of these aspects of the desirability of being a tenant have played parts in encouraging the demand for private renting. Some of them have grown in importance over the past four years since the advent of the world financial crisis and the economic downturn. However, the extent to which the framework of demand has changed permanently is less certain but probably is relatively small, as will be argued below.

Who rents and what do they rent?

Younger and more mobile people in work are the main clients of the modern UK private rented sector. The young age profile of renters is illustrated by the fact that a progressively smaller proportion of each older age group rents. Almost two-thirds of those aged under 25 years old are renters; while a substantial 36% of those between 25 and 34 also live in the tenure, but only a tenth of those aged between 45 and 54 rents privately. Overall, half of tenants are aged below 35, a further fifth are in their late 30s and early 40s and only 8% are aged over 65, with many of the older renters living in the remaining controlled tenancies (Figure 2.1).

Most tenants stay in the tenure as long as they value one of its attributes. One of the most significant is mobility. However, the benefit to tenants of much lower transaction costs when moving as a renter than in homeownership gradually wains for many people. This occurs as people age and move less, while their savings simultaneously rise, because in combination those factors make owner occupation increasingly attractive and feasible.

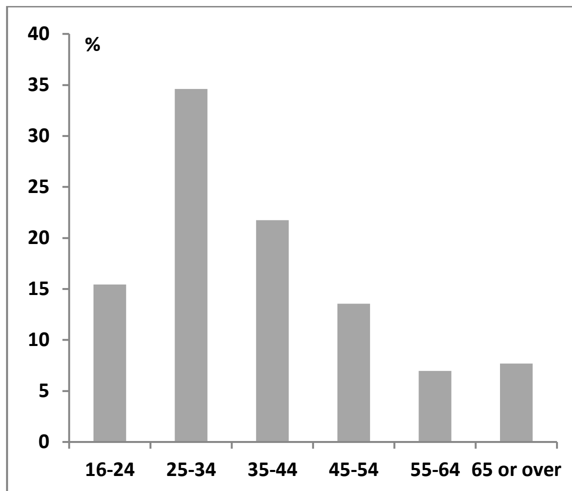
Household sizes are typically small in the private rented sector. Two-thirds of renter households are singles and couples (Figure 2.2). This partly reflects the age profile of tenants and their life styles and the fact that families with children are less likely to rent. Smaller-sized households are likely to be looking for relatively modest types of property, so unsurprisingly these types of home predominate in the private renting stock, with a relatively high share of flats and smaller houses in the tenure. However, it should not be thought that there is a fixed and easily identifiable stock of rental properties. Rather, they are spread throughout the housing stock and there is a considerable churn over time in the properties being offered for rent in any town or city. Ownership of individual dwellings may shift between landlords and between them and homeowners as properties are bought and sold.

Most rentals are existing dwellings rather than new build (for which there is only a relatively small demand, given its typical premium cost). Given the requirements of potential tenants, there is also a tendency of rental properties to cluster into specific neighbourhoods in some localities, but the location of rental housing generally reflects the locational and affordability needs of typical renters. So, unsurprisingly, the bulk of the private rental stock is found amongst the older parts of the housing stock especially in inner city and older suburban areas, where investors have purchased and often improved existing properties.[12]

Private renting predominately houses those in work. Over four-fifths of private tenants are in employment or in higher education. Almost three-quarters of renter households have at least one person working and there are two or more working in 35% of cases (Figures 2.3 and 2.4). Taken

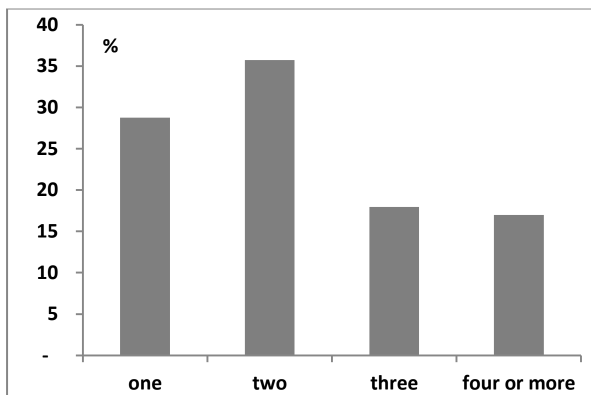
[12] M.Ball *Buy to Let. The revolution 10 years on. Assessment and Prospects,* Association of Residential Letting Agents, Amersham, Bucks, 2006.

Figure 2.1: Ages of private tenants, England, 2009-10



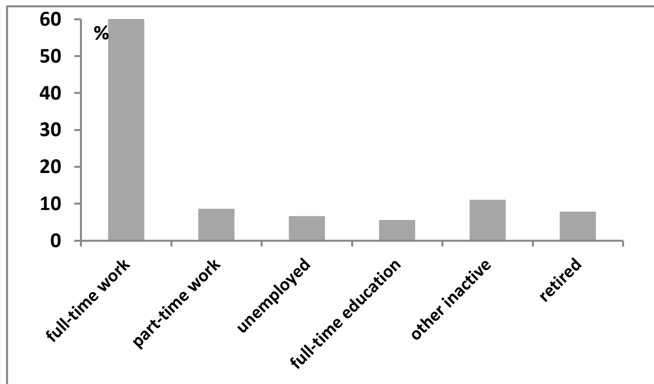
Note: Household reference person.
Source: EHS

Figure 2.2: Household size in the private rented sector, England, 2009-10



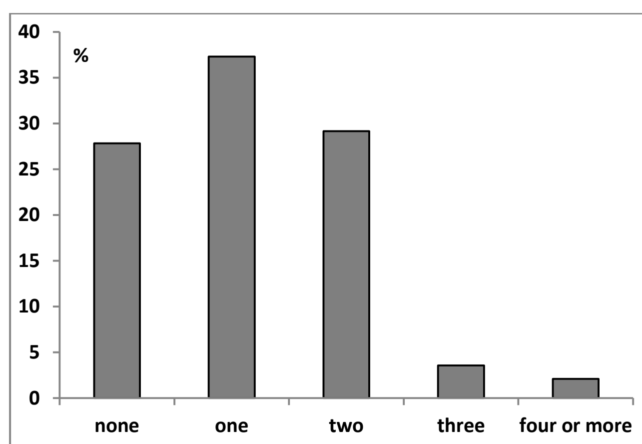
Source: EHS

Figure 2.3: Economic status private tenants, England, 2009-10



Note: Household reference person.
Source: EHS

Figure 2.4: Number working in renter households, 2009-10, % of all tenancies



Source: EHS

together, private tenants have a broadly similar distribution of income to the population as a whole, with a somewhat higher share of middle and lower income groups and a somewhat smaller share of those with the highest incomes.[13] The share of low incomes is influenced by the fact that around 6% of tenants are students. Just under a quarter of private tenants receive housing benefit, i.e. public assistance with their rents, and they mainly are found amongst renters with children or amongst the elderly. Approximately a fifth of renting couples with children and two-fifths of renters over 60 receive housing benefit.[14]

A high mobility tenure

The significance of mobility for private tenants can be seen in data on moves. When surveyed, a third of renters say they have lived in their current home for less than a year, and another fifth have been there for between one and two years only (Figure 2.5). Renter movers also typically switch to other rental accommodation rather than go to another tenure. The extent of the greater propensity to move in the private rented sector can be seen in the median length of a private tenancy, which is just 1.7 years, whereas it is almost 8 years for social tenants while owner occupiers on average move only every 12 years.[15] Those tenants staying in their accommodation for lengthy periods of time include those still living in a rump of rent-controlled, secure tenancies or in long-term, work-linked or non-market accommodation, so that the number of long tenancies in the free market is small; which means that the length of average tenancies is even shorter there than for the private rented sector as a whole. Most of this high mobility is driven by tenant choice rather than landlord push: the English Housing Survey in 2009-10 found that only 8% of private tenants were asked to leave by their landlord or an agent.

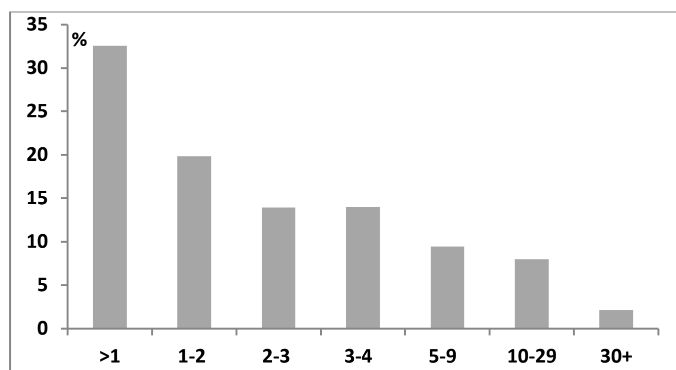
The extent of moves in the private rented sector and the collapse in house purchase in recent years now means that there are three times as many moves by renters each year than by owner occupiers, whereas prior to 2007 the numbers were fairly even (Figure 2.6). This scale of renter transactions exists even though there are over four times as many owner occupiers in England as there are renters.

[13] DWP Family Resources Survey 2007-8.
[14] EHS, 2009-10.
[15] EHS.

Moves and private renting

Private renting offers specific benefits that are more or less attractive to people depending on their lifestyles and their current stage in life, as has already been noted, and it particularly suits younger people, either through choice or because they need to save up a deposit in order to buy a home. Eventually, they tend to become owner occupiers or, less commonly, social housing renters; joining others from their age group that are already in those tenures. However, there are also large numbers of existing home owners that move into renting in any one year. The English Housing Survey estimates that almost 900,000 previous renters moved into owner occupation between 2008 and 2010 but, at the same time, another 600,000 households who had previously been owners moved into renting. Those moving into renting from owning were typically older than those moving in the opposite direction; with the majority aged 35 to 54, while the majority moving to owner occupation were less than 35 years old. Moreover, the number of moves into owning has been depressed since the on-set of the crisis while the number of moves from owning to renting has been enhanced.

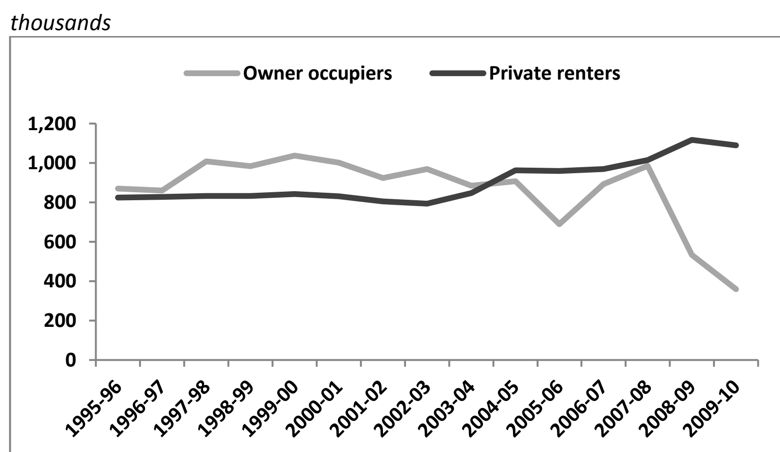
Figure 2.5: Length of time in tenancy (years), England, 2009-10



Source: EHS

Figure 2.6: Owner occupier and private renter moves in a year, England, 1995/6-2009/10

thousands



Source: EHS

Some of the ex-owner new private tenants had been in relationships that have broken down and have moved into rented property in consequence - at least, for a while. Many will eventually move back into owner occupation, or less frequently to social housing, once their lives have settled down

again. They may well eventually share in the proceeds of a previous owner occupied home and, so, have fewer constraints over deposits than potential first-time-buyers.

A further group of private tenants are those who have moved out of owner occupation for financial or job-related reasons. For example, those moving to jobs in high-priced Southern England from elsewhere in the country may be unable to find sufficiently large deposits to purchase or, alternatively, they may wish to settle into a new area and explore the options before buying.

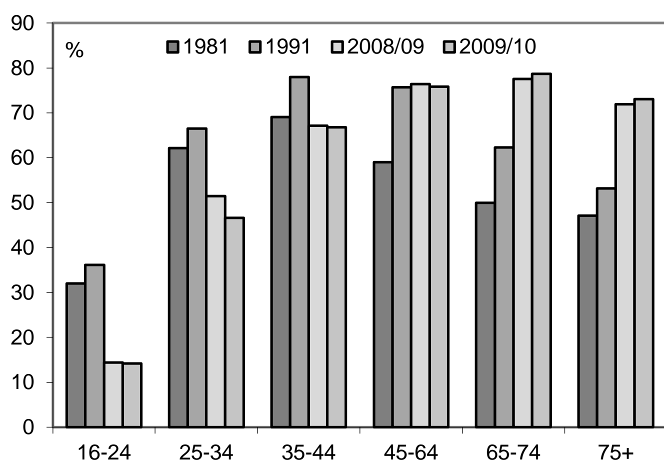
Others moving from owning to renting may be encouraged to do so by the relative cash-flow cost of renting versus owning and their own forecasts of house price developments. Renting because it is affordable and through fear of purchasing an asset soon to fall in price. Such groups' moves are going to be particularly affected by the state of the housing market and they will be more likely to opt for owning during upswings in the market and more likely to rent near to price peaks and during downturns. In this and in other ways to be explored later, the relationship between owning and renting varies across housing market cycles.

Demographic factors influencing the growth in renting

Much of the growth of private renting in recent decades has been associated with two interrelated demographic factors: i) the share of younger adult age groups buying homes and ii) the share of those younger adult age groups in total household numbers. Both in the past two decades have had positive effects on the expansion of the private rented sector.

With respect to the share of specific age groups living in rented accommodation, there have been opposing developments over time. Younger households are increasingly opting for renting, while older households rent less. This can be seen in data on the share of homeownership by age group. The youngest households aged below 25 now have homeownership shares that are only a third of the level they were 20 years ago. A similar though less marked decline can be seen amongst the 25 to 34 year old group where homeownership rates have fallen from nearly 70% to around 50%, with indications that the rate is currently being further squeezed. In contrast, the homeownership rates for those aged between 45 and 64 have remained steady and high, while shares amongst those aged over 60 have grown substantially over the past 20 years (Figure 2.7).

Figure 2.7: Percentage of owner occupiers by age cohort, England, 1981-2009/10



Source: CLG

With regard to the second demographic factor, the share of younger households in the overall population, the situation is changing as the population ages. As a result, the increase in younger households is forecast to be far less than for older households over the next two decades or so. Over the forecast time frame, 2008 to 2033, those aged 35 and under will rise by only 0.6 million, whereas those 65 and over will increase by 5.8 million. This means that the share of younger age groups in total households will decline (Table 2.1). So, age demographics play an important part in understanding the future size of the private rented sector. The ageing of the population is likely to constrain the demand for private rental accommodation in the years to come, because renting is increasingly less attractive to people as they grow older.

Table 2.1: Projected increases and share of English households by selected age groups

	2008	2033	Increase millions
Under 35	18%	16%	0.6
Under 45	39%	35%	1.3
65 and older	26%	33%	5.8

Source: CLG

Another reason for the expansion of the private rented sector has been that standards of living in general have increased substantially over the past two decades. Generally higher incomes manifest themselves in a higher demand for housing. In fact, studies show the relationship is broadly a proportionate one with, say, a 20% increase in average real incomes raising housing demand by 20% as well. This income effect is apparent in the heightened housing requirements of those aged 35 or less, compared with their forebears. With greater affluence has come a desire by progressively more young adults to live in comfortable, self-contained, well-located accommodation by themselves, as part of a couple, or less frequently in larger household groups. But, along with that liking for freedom and space, has also come a desire to have the flexibility to move when required. Accommodation offering such benefits and flexibilities can now be widely found in the private rented sector.

Recent migrants also tend to rent rather than buy, although after some time their tenure patterns more closely match those of existing nationals. The surge in immigration during the 2000s consequently proved an important stimulus to renter demand. However, this is likely to be less of a force in the future for two reasons: some recent immigrants will become owners, as with the rest of the same age-group in their newly adopted country, and, second, the rate of economic immigration is likely to slow with the relatively weak growth forecast for the UK economy for some time and a greater convergence in earnings across the EU.

Benefits of ownership

Why do many people prefer to be owners rather than renters? In some way, the desire is psychological and related to preferences for ownership, control and perceived personal freedoms and community engagement. These features are often emphasised in political debate, though they hard to measure with any degree of accuracy. There is greater security in comparison to the typical short-lease, as long as mortgage payments are kept up. However, in many respects, the choice

between renting and owning is a straightforward financial one in which there are trade-offs in costs and benefits that vary across time and for different people.[16]

Homeownership generates costs in terms of mortgage repayments, deposits and tied up equity, buying and selling, and property management and repairs. It also poses risks connected to unexpectedly high mortgage interest rates, loss of employment and other sources of income, to mortgage default, and to a lack of liquidity because it may not be easy to sell when required. Capital values are also at risk because house prices fluctuate over long time periods and may fall. The evidence shows that, although UK house prices are rising on a trend basis, cyclical peak real house prices typically do not recover for a decade or more, so that some purchasers may find the real value of their asset is less than they had hoped for extended periods of time. There are additional price risks connected to specific dwellings or locations.

However, despite all these costs and risks, homeownership enables the accumulation of wealth in the form of growing, untaxed, equity. It also protects purchasers from the risks of rising prices/rents because they buy into a level of housing costs. This aspect is important in the UK, where long-run real increases in house prices have historically been amongst the highest in the advanced economies of the world.[17]

Furthermore, owners do not have to bear some of the costs that landlords do. They include the costs of high tenant turnover and vacancy risks. Furthermore, as mentioned earlier, the tax burden on owner occupation is far less than on renting.

These pluses and minuses clearly vary across age and income groups. For example, those on higher incomes are more likely to be owner occupiers. Younger people are not only more mobile but have less accumulated savings and often face greater risks of job loss. The risks of mortgage default are also lower the more of a mortgage has been paid off, which clearly has a link to age. Furthermore, many of the benefits of ownership only accrue over time, including wealth accumulation and the associated tax breaks so, once again, age matters. Therefore, whether to own or rent at the time of potential first entry is a distinctive choice from that of a long-term established homeowner.

Housing market cycles add further factors, especially for those undertaking or contemplating a move. If movers expect house prices to fall, their preference for renting over owning is going to be higher than if they expect to make capital gains. Potential first-time-buyers will similarly hold-off when prices are falling and buy when they are rising. The evidence suggests that purchasers put great weight on recent market experience when formulating their views on likely house price developments and the longer a price downswing (or upturn lasts) the more entrenched views become.

Price expectations are influencing current attitudes to home ownership. In nominal terms, prices are gradually sliding and in real terms, given relatively high rates of inflation, prices are falling quite fast. They are now around 30% below their 2007 peak nationally and some regions are experiencing greater declines than others (Figure 2.8). Economic prospects are also currently weakening. Fears of capital losses from purchase are therefore encouraging people to rent rather than buy.

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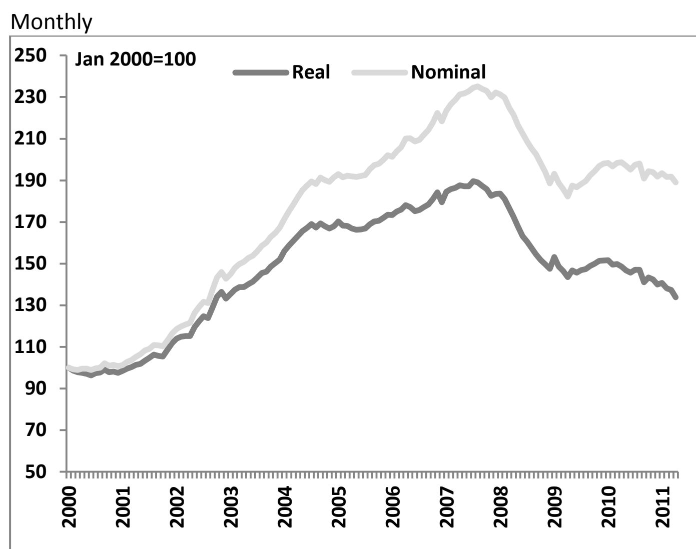
[16] Andrew, M. and G. Meen, "Housing transactions and the changing decisions of young households in Britain: the microeconomic evidence", *Real Estate Economics*, 2003;
[17] *Barker Review of Housing Supply*, HM Treasury, 2004.

Figure 2.8: UK house prices, 2000-2011

Monthly



Source: Lloyds Bank, Halifax

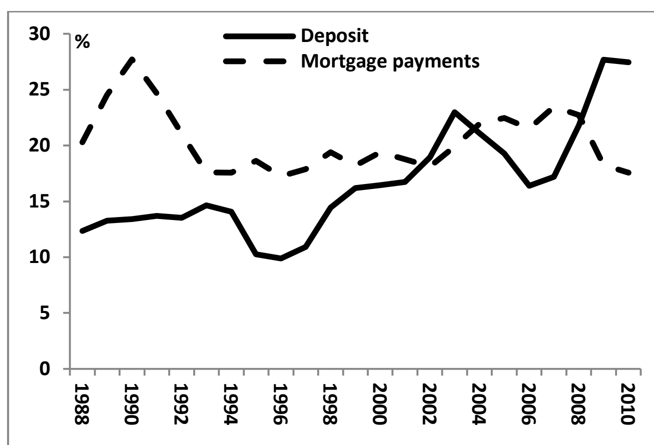
This rent to avoid capital losses phenomenon was also observable in the last early 1990s downswing, even though the private rented sector was then much smaller. But after several years as the housing market picked up, the numbers of first-time-buyers grew quickly and the growth in renting slowed sharply. However, by the 2000s, the pendulum swung again as rising house prices then began to price many potential first-time-buyers out of the market, especially because of growing deposit costs, raising worries amongst some about the timing of the next dip in house prices.

These cyclical patterns suggest that part of the current growth in renting is cyclical and directly due to the problems of the owner occupied housing market. As house prices stabilise in real terms, it is to be expected that the demand for renting will weaken and that for owning will rise. However, the housing market is likely to remain weak for some time to come, so this negative effect on renter demand may be delayed. Whether house prices subsequently rise fast enough to push people away from owning again is hard to forecast, although experience suggests that future surges in house prices cannot be ruled out.

In this analysis, a major unknown factor is the future size of entry barrier for first-time buyers caused by the need for deposits. Nowadays, typical first-time buyer down payment ratios are of the order of 25% rather than the 15+% seen at the end of the last boom. Such ratios may improve somewhat when mortgage markets free up from their currently highly constrained states and, say, fall back to a 20% own equity ratio. Even so, loan terms are likely to remain more stringent than in the years immediately prior to the crisis, though not necessarily much different from those in the early part of the 2000s and earlier.[18] However, interest payments as a share of income have come down to levels as low as those at the start of the 1990s upswing (Figure 2.9). This makes the cash outgoings comparison with rents increasing attractive for purchase. House prices to first-time-buyers' income ratios still remain historically high but they have come down significantly from their peaks, especially outside southern England (Figures 2.10 and 2.11). Fears of sudden rises in interest rates are also currently low, also diminishing the risk of owning.

[18] *Mortgage Market Review*, DP09/3, 2009 & *Mortgage Market Review: Feedback on DP09/3*, 2010, Financial Services Authority.

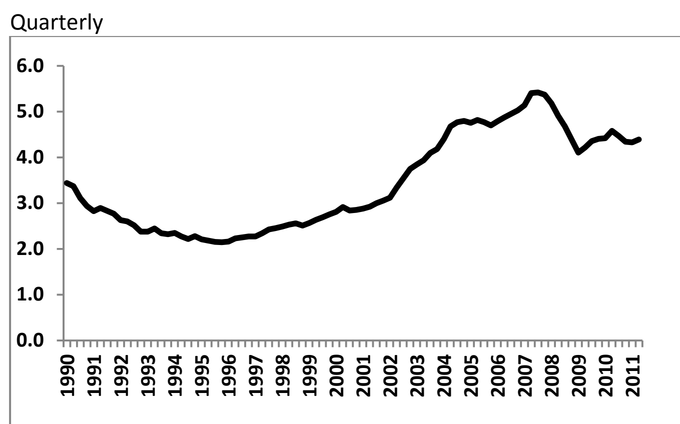
Figure 2.9: First-time buyer deposits and mortgage interest payments as a share of income



Note: Deposit as % purchase price; mortgage payments as % gross income
Source: CLG

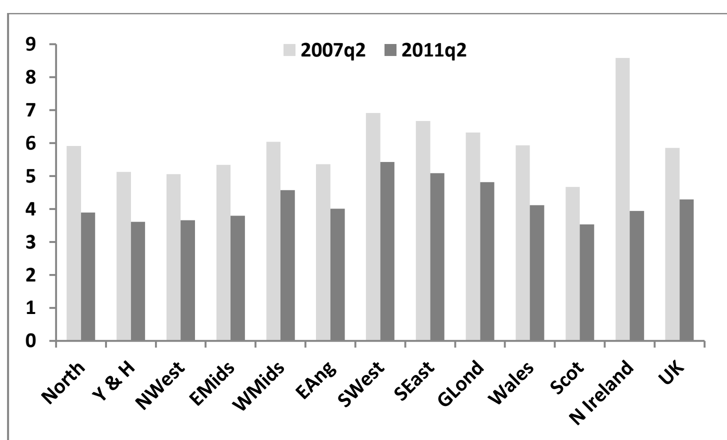
Figure 2.10: Ratio of first-time buyer house prices to gross earnings

Quarterly



Source: Nationwide BS

Figure 2.11: Regional house price to earnings ratios, UK, 2007 & 2011



Source: Halifax

Conclusions

This chapter has explored the demand side of the private rented sector. Renting has specific attributes that appeal to certain sections of the population, although most move onto other tenures

after a period of time. The ability to move frequently at minimal cost is one important attribute. Being able to pay rent directly out of income with no capital commitment or need to build up savings are others. Younger people and those on modest incomes benefit most from these attributes, especially if they are in work or eligible for housing benefit.

Unsurprisingly, most of the growth in the tenure over the last two decades has result from higher shares of younger adults renting instead of owning as they might previously have done. However, this feature of renting puts a cap on its growth. Although the number of younger households will increase over the next two decades, older households will grow at a much faster rate. Experience of the past two decades is older people are renting less and owning more. So, the ageing of British society will limit further expansion of the private rented sector.

A key feature of the demand for private renting is its complementarity with owner occupation. Most renters will eventually become owner occupiers. When depends on lifestyles, access to wealth and borrowing, and also on the state of the housing market. The state of the housing market is key here. At times when house prices are rising fast, more potential first-time buyers will stay longer as renters because they need higher deposits. When prices are falling, potential first-time buyers might also delay purchase in order to avoid the threat of capital losses.

The flexibility inherent in renting enables such purchase strategies to be adopted. These cyclical patterns suggest that part of the current growth in renting is cyclical and directly due to the problems of the owner occupied housing market. The flexibility inherent in renting enables such purchase strategies to be adopted.

Chapter 3: Supply after the boom

Introduction

This chapter starts to explore the supply-side in the residential lettings market. It introduces and outlines the model of total returns as the basic driver of investment and examines the consequences for supply. Following this, developments in supply and rents are then examined: both during the boom years and subsequently following the world financial crisis.

The chapter also explores who owns residential investments and why small-scale landlords are so important in providing supply. Reluctant landlords seem also to have become significant providers in recent years as well. When total returns crashed in 2008, it might be thought that supply should have started to decline as well but, in fact, it grew fast. So, this apparent paradox is investigated.

Becoming a landlord is a major step and property's investment characteristics are unique. So, it is useful to consider briefly what distinguishes private rental investment from the many other investment opportunities open to private individuals and a final section does this.

The dynamics of rental supply

The supply of rental homes depends on the risk-weighted returns that can be achieved by landlords relative to those they could earn in other investments. As a rule of thumb, if total yields rise, either because of rent or house price increases, extra investment is induced from both existing and new landlords thus generating more supply. Conversely, when yields fall, dis-investment is likely to take place. Expectations of future rent and house price changes are obviously important in this context. For example, if house prices are expected to fall only temporarily, any drop in house prices may actually encourage investors to search for property bargains rather than disinvest. The longer market conditions remain in rising, falling or static states, progressively more investors are likely to expect them to remain that way.[19]

The timing of many sales and purchases will be influenced by individual circumstances. For instance, some landlords may be selling up properties because they wish to exit the sector altogether and had planned to for a long time. Others may be buying because they have had a recent inflow of capital, say, from a legacy. Investment fluctuations occur therefore within persistent property churn, as buying and selling goes on all the time.

It takes time to buy and sell properties and long lead times are important in understanding market supply dynamics. When buying, there will also be a period of time between purchase and letting, because repairs and improvements are likely to be required and tenants then have to be found. When selling, a purchaser has to be identified and sellers' expectations may encourage them to hold off the market until prices firm.

In general, it is to be expected that investment comes on stream quicker than disinvestment does when the market softens and yields fall. This is because many landlords are likely to delay quitting

[19] Housing market studies commonly find the existence of such adaptive expectations amongst market participants e.g. Gatzlaff, D. H. (1994), Excess Returns, Inflation and the Efficiency of the Housing Market. *Real Estate Economics,* 22: 553–581; Muellbauer, J. and Murphy, A. (2008) Housing Markets and the Economy: the assessment, *Oxford Review of Economic Policy*, Vol. 24, (1): 1-33.

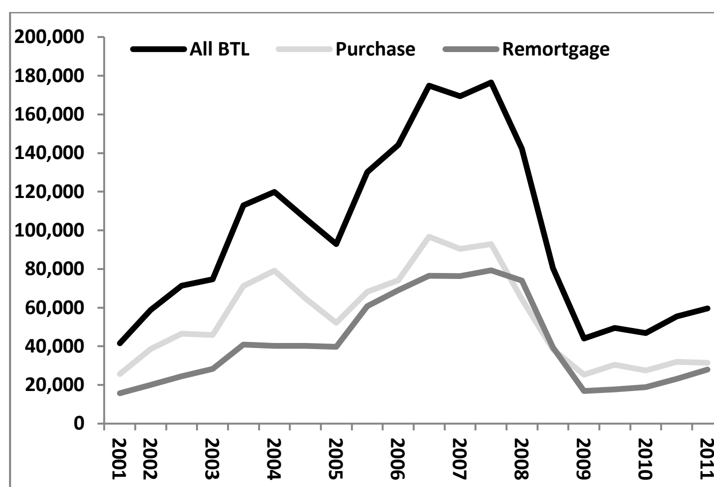
for as long as they have some hope that better rental market conditions or improved selling prices will return. Even so, supply is highly responsive to changes in property returns; though lags mean that it is far more elastic in the long-term. It is unnecessary for all landlords to be profit maximisers for such investment dynamics to have a significant impact on rental supply.

As the transactions costs of buying and selling are high, few investors will set up rental operations on a temporary basis but, instead, understand the need to commit to the investment for some time. Landlord surveys highlighting long-term investment attitudes provide empirical backing to this conclusion.[20] However, there will always be some investors who are interested in trading profits rather than making returns from holding property for periods of time. Especially at times of booming prices, the risky prospect of capital gains may outweigh any concerns about transactions costs and encourage some investors to ‘flip’ purchased properties. However, speculative property flippers are more likely to hold properties empty than become landlords, because vacant properties typically command higher sales values and involve less effort.

Rental supply in the UK

During the years of rapid house price boom up to 2007, investing in rental property generated substantial returns through capital gains. Supply boomed with many new entrants while some landlords built up large portfolios of properties. The buy-to-let mortgage market acts as a good indicator of overall activity in the private rented sector. From 2003 to 2007, the number of buy-to-let mortgages grew rapidly, both in re-mortgaging and new purchase (Figure 3.1). House purchase using buy-to-let mortgages peaked at 183,000 in 2007, three times the level of five years earlier. Unfortunately, as so many purchases were made in the years leading up to end of the boom, a lot of them have since turned out to be poor investments.

Figure 3.1: New BTL UK Mortgage Lending 2001 H1 – 2011 H1



Source: CML

The scale of the capital losses landlords have made in recent years should not be underplayed. The 30% average fall in real house prices since the peak has resulted in substantial capital losses, although often they are paper ones because investors have not sold their properties. Moreover, price falls have been greatest for the more moderate types of property that landlords specialise in. London has bucked the price decline to some extent.

[20] See Private Landlords Survey, 2010, CLG.

In weak market conditions, some landlords struggled and arrears grew to just over 3% of all buy-to-let mortgages by 2009. Arrears have since declined markedly (Figure 3.2). So, the once feared meltdown of the buy-to-let market never occurred.

There has been a very modest recovery in buy-to-let mortgages for purchase since 2009. But in mid-2011 the volume remained at less than a third of its peak five years earlier in 2006. There have been suggestions that cash purchases have become more important, so that buy-to-let mortgage data do not show the full picture, but the consequence is likely to be modest. So, the residential investment market can hardly be said to have recovered yet.

Figure 3.2: Buy-To-Let mortgages 3+months in arrears in UK, 2007 q1 to 2011 q2

Source: CML

Where has the new supply in recent years come from?

During the past three full years, covering 2008 to 2010, the stock of rented properties has been estimated to have risen by nearly half a million, as discussed in Chapter 1. However, buy-to-let lending generated less than 220,000 new purchases during the same period. Moreover, that lending figure overstates net additions, because market churn would have continued with dwellings being sold as landlords ran down their holdings or quit the sector. So, the net addition would have been less and well below 200,000 dwellings. So, where did the extra supply of 300,000+ rented dwellings come from, assuming the government's estimates of the stock increase are right?

One possibility is that purchases were financed in other ways, as buy-to-let mortgages do not cover all sources of funding. Yet, it is unlikely that such alternative sources led to hundreds of thousands of purchases when the market was so weak and uncertain.

The other alternative is that there has been a surge of ‘reluctant landlords’ since the downturn. There are two sorts of reluctant landlord:

1. Previous owner occupiers unable to sell their properties at desired prices in the downturn have become landlords themselves instead. A large mortgage or negative equity may have encouraged them in this choice. By becoming a landlord, with the mortgage lender’s tacit acquiescence, those with negative equity do not have to realise a loss that might mean they could not repay their mortgage in full. Alternatively, renting out properties rather than living

in them may enable those with large mortgages to keep up mortgage payments and avoid default.

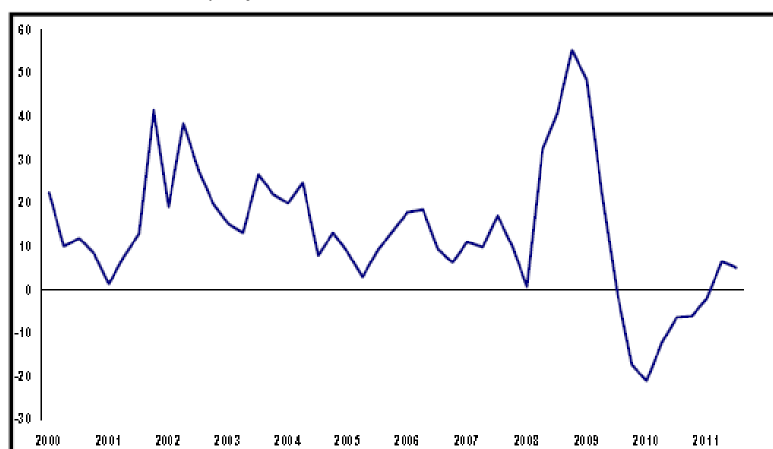
2. Existing landlords with low returns or losses, who cannot currently sell at attractive enough prices but will do so as soon as prices reach target levels. Their inability to sell has lowered the rate of property churn in the private rented sector.

It is impossible to measure the true scale of these phenomena but they may be large with important effects. If significant numbers have become reluctant landlords that would help to make the supply figures add up.

Reluctant homeowner landlords were certainly believed to have caused a major peak in new lettings during 2008-9, which can be seen in Figure 6.1. Once again, new recalcitrant may now be being added to the fold because of the renewed housing market slowdown in 2011. Some of these new landlords may acquire a taste for private rental investment but the majority are likely to sell up when the housing market picks up again. If that happens, the negative impact on rental supply could be large.

Figure 3.3: Change in new instructions in RICS Lettings Survey, GB, 2000-2011

% balance, seasonally adjusted



Source: RICS

Rents

Unfortunately, there is no long-run rent index and so it is difficult to derive an accurate picture of rent changes. The basic principle, of course, is that rents vary in line with changes in the balance between supply and demand.

For some years, there was an experimental rental index produced by the Department for Communities and Local Government but this ended in 2007. It suggested that rents on average rose by around 30% between 2000 and 2007. However, this represents only a 9% real rise – i.e. around 1% a year - while house prices grew by 132% in nominal terms over the same period.[21] The result was that rental yields deteriorated markedly because of the much slower rise in rents than house prices.

[21] CLG, Halifax.

Since 2008, two estate agency groups/websites have been producing their own indices. FindaProperty.com produces a mixed-adjusted index of asking rents for Britain and its regions, while LSL Property Services produces an index based on average let rents for England and Wales and the English regions. Their comprehensiveness and accuracy remains uncertain but they do provide information on recent developments. The detailed movements of rents in the two indices vary but the broad pattern of change since 2008 is similar. Overall, when the FindaProperty.com rent index is adjusted for general price inflation (CPI), it suggests that real rents fell in Britain by over a tenth in value between Spring 2008 and Spring 2011 (by -11%).

Both indices suggest that rents fell quite significantly during 2008 and 2009 but rose again from the summer of 2010. Yet the increases in rents have been relatively modest and in many parts of the country have not even kept pace with general price inflation. Even in London, real rent increases have not been particularly high. The LSL July 2011 index reported rent rises of 7.1% over the year but RPI was also up 5% over the same period.

Poor economic growth, rising unemployment and continuing pressure on disposable earnings have dampened prospects on the demand-side for substantial real increases in rents in the near future, outside of a few hotspots. Until earnings start to rise again in a revived economy, rental growth is likely to be subdued. However, volatility and seasonal variations may still provide headlines and contribute to uncertainty about the future of rents.

Landlords

The private rented sector is predominantly a small individual investor sphere of activity around the globe, especially in free market contexts.[22] The principal reasons for this are economic, related to the nature of the rental business and the investment characteristics of the asset. In particular, residential renting offers flexible leverage and labour-oriented opportunities to small-scale investors.[23]

Small to medium sized landlords seem to be cost competitive relative to larger ones over wide portions of the rental housing stock.[24] They can flexibly invest their own time; do not have high overheads; can move fast in response to market signals; and the relatively larger ones can easily scatter their investments over a variety of local markets and thereby spread their risks. Small and medium sized enterprises can compete effectively with larger ones within the diverse and scattered stock of properties that constitutes most of the private rental stock; whereas large enterprises need more concentrated holdings.[25] Current survey evidence in England does not suggest that larger private landlords or social housing institutions have more satisfied tenants than small ones.[26]

Almost 90% of English landlords are private individuals and couples; about 5% are property companies and the rest a mix of other organisations.[27] This small-scale characteristic has been reasserting itself over the past two decades as residential renting has once again become an

[22] M. Ball, *The UK private rented sector as a source of affordable accommodation*, Joseph Rowntree Foundation, 2010.
[23] J. Glascock and G. Turnbull, “On the supply of landlord labor in small real estate rental firms”, *Journal of Real Estate Finance and Economics*, 8.1, 1994, 21-33.
[24] There are no detailed studies of scale economies in the private rented sector.
[25] Ball, *ibid*.
[26] English House Condition Survey 2006 Private Landlords Survey, CLG; J. Rugg and D. Rhodes, *Review of Private Rented Sector Housing*, Centre for Housing Policy, York, 2008.
[27] English House Condition Survey Private Landlords Survey 2010, CLG.

attractive investment. In the mid-1990s, less than half of landlords were individuals but the long housing boom saw many firms sell up or run down their property holdings, while the advent of Buy-to-Let mortgages and rapidly rising house prices encouraged many thousands of new investors to become landlords.

In the UK, private landlords have come to be associated with Buy-to-Let mortgages, yet the roughly 1.3 million Buy-to-Let mortgages in existence account for only around a third of private tenancies. Larger landlords typically take out other types of residential or commercial mortgages, on which there is far less information. In addition, it is likely is that much of the private rented sector is held by individuals with no mortgage debt on some or all of their properties. However, many own multiple properties and have mortgages on some of them.

Given high house prices, the values of investor portfolios can be substantial. Lower quartile (i.e. the price of a dwelling at the 25% point in the house price hierarchy) house prices are likely to reflect typical landlord investments. In the South East in 2008 it was £162,000, according to CLG, so that a landlord portfolio of 10 dwellings at that price would be worth £1.6m and a portfolio of a 100 would be worth £16m.

The majority of rental housing is spread around neighbourhoods of quite old, terraced and semi-detached houses and flat conversions within this house type.[28] New properties in blocks of flats - though often thought to be typical landlord territory - are, in fact, comparatively rare within the private rental stock. New rental properties are often derived from renovations and conversions of previously single-family properties into flats. Such conversions and modest upgrades are often found in neighbourhoods of relatively moderately priced properties.

Some characteristics of residential property investment

Large, lumpy, leveraged, illiquid and 'hands-on' are all features that characterise property investment. This distinguishes being a landlord from many other investment opportunities open to private individuals.

Housing is expensive, so becoming a landlord or increasing an already existing property portfolio is a major investment decision involving a significant part of most people's wealth. The investment is a lumpy one because a whole dwelling has to be bought. Borrowing has to be considered as well when contemplating purchase, in order to facilitate the acquisition and to leverage the return on the landlord's own capital. Illiquidity arises because the exit from the investment, when the property is sold, is lengthy and uncertain. It will be influenced by contemporary housing market conditions, by how long it takes to find a buyer, the time taken for negotiations over price and the legal process of exchange.

These features of property investment highlight important differences from the characteristics of many of the other savings and investment options open to individuals. In the general market for personal savings, there is a myriad of financial assets to buy and investment, savings and pensions plans on offer. Unlike housing, they do not involve owning anything tangible nor do they require dealings with people in the form of tenants and agents. Typically, financially based options are also

[28] Ball, M. *The Modern Housing Market - Origins and Prospects*, NFOPP, 2009.

far more liquid than housing, because securities can be bought and sold at will and savings and investment accounts opened and closed.

None of this, in principle, should deter anyone from becoming a landlord, if they are contemplating doing so. Yet, it does influence the relative return that should be expected from such an activity to compensate the investor for the potential costs and downsides of property investment. It also influences the dynamics of rental market. For one thing, supply cannot quickly adjust to changes in returns: it can only do so fully over a long drawn-out period.

One of the most important features of renting is that it is a hands-on investment. Participants therefore have to make a subjective decision as to whether they want a purely passive asset mix or the active engagement that comes with letting residential property. Such assessments can only be made by individuals themselves and a major change in the UK over the past two decades has been that increasing number of investors are willing to become landlords.

Conclusions

Returns drive private rental investment and small landlords predominate. Hundreds of thousands of people have become landlords over the past two decades and the returns they earned during the boom years were often exceedingly good. Since the downturn the picture has changed dramatically. Substantial capital losses replaced capital gains in many cases. Buy-to-let mortgage arrears rose and then somewhat declined, helped in part by low interest rates and continuing demand.

Rents failed overwhelmingly to keep up with house prices during the boom years, leading to a considerable squeeze on rent margins. Though the data are poor, it seems that in recent years since the world financial crisis, rent growth has been generally weak. Once general inflation is stripped out, it is hard to find the rapid rises in rents often talked about in the media. In fact, since 2007, rents seem to be down by around a tenth in real terms. Furthermore, prospects for significant real rent growth in the near future do not look strong, given the state of the economy, strains on disposable incomes and the buoyancy in supply added by reluctant landlords letting out their properties - and possibly renting themselves - while waiting to sell their homes.

The statements in Chapter 1 about weaknesses on the supply-side have therefore been borne out by the evidence presented in this chapter. However, the characteristics of residential property as an asset mean that lags can be long, which complicates an already complex situation.

Chapter 4: Rental property portfolios and landlord finances

RLA Landlords' Surveys

Two online surveys of landlord characteristics and finances were undertaken in summer 2011 as part of the research that underlies this report.

In the first of them, Residential Landlords Association (RLA) members were asked to submit some information about the numbers and types of properties they own. Altogether 627 landlords from across Britain agreed to participate. Although not a random survey, its results give an interesting insight into the characteristics of landlord property holdings. This survey can be seen as reflecting the characteristics of 'professional' landlords, signalled by the fact that they made the effort to, and incur the expense of, joining a professional body.

In the second survey, a smaller group of around 200 RLA members itemised the costs and revenues associated with recently bought and let dwellings with standard characteristics. These related predominantly to 1 bedroom flats, the most common type of rented dwelling. They enabled a picture to be built up of landlords' costs and revenues, making it possible to dig deeper into landlord finances than is the case with the gross and net returns published by organisations such as ARLA.[29]

Portfolio sizes and market segments

The results of the survey of landlord portfolios show that there is a wide range of property portfolio sizes (Figure 4.1). The most common portfolio is one with between two and five properties but around that size there is a wide range of holdings from just one property to hundreds. As is usual in these types of survey, most landlords have quite small holdings of property, with over 60% owning five or less dwellings. Larger landlords were relatively few in number: only 16% of respondents have portfolios in excess of 10 dwellings. However, these relative few own 68% of the almost 7,000 properties in the sample; whereas 1 dwelling only landlords own just 17% of them. Landlords with more than 50 properties in their portfolios alone owned 37% of all the recorded properties.

This result is at variance with the findings of the most recent CLG *Landlords' Survey* 2010, which found that over 60% of properties were owned by those renting 4 or less properties (Table 3.1). However, there may be sampling issues with that survey with regard to this issue. This is because around a 1,000 landlords were interviewed and there is a population that is highly skewed towards smaller landlords but with a long-tailed distribution of ones with larger holdings. Under such circumstances, an under-representation of larger landlords could easily arise. In contrast, in the landlords' survey here, there may be some over-representation of larger landlords because members of a professional body are being sampled. So, the true figure may lie somewhere in between the two estimates, though the author's hunch is that there are considerably more larger landlords in existence than the CLG study estimates.

[29] I should like to express my thanks to all who participated in these RLA surveys and to the RLA for their help in setting up and managing them. Confidentiality commitments were given, so no individual can be identified in this analysis and no personal information was passed onto the research by the RLA.

Table 3.1: Size of property portfolios (% of all dwellings)

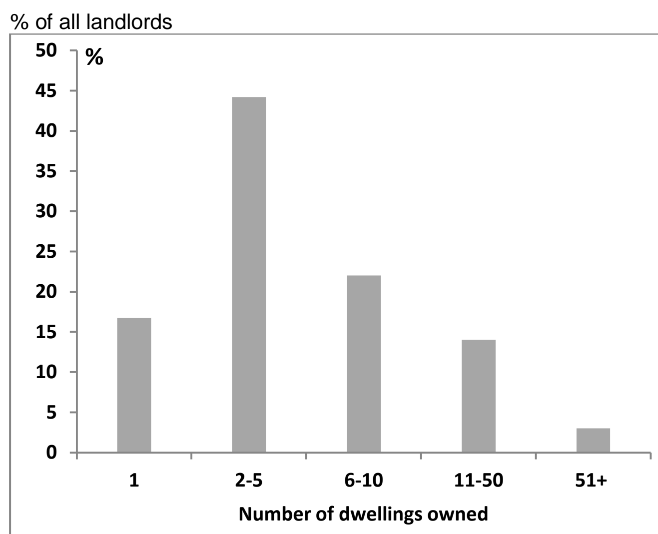
1	40
2-4	21
5-9	8
10-24	9
25-100	10
More than 100	11
Total	**100**

Source: CLG

Studies of landlords can give a misleading picture of the extent of the 'cottage' nature of the industry if they focus primarily on the smallest landlords. An investment holding of 10 properties would give a portfolio typically worth far in excess of £1 million and 100 dwellings would be worth well in excess of £10 million, so there can be substantial capital in the business. Of course, even large landlords' market shares are tiny, with, say, a holding of 350 dwellings being a miniscule percentage of the 3.9m privately rented dwellings in England.

This pattern of ownership holdings amongst respondent RLA members is likely to be reproduced throughout the private rented sector. Although the available data are poor on this issue, this and other evidence from the English House Condition Survey suggests that the majority of rented dwellings are parts of significant (i.e. 10 or more) holdings of properties. So, there exists a rented housing industry in the UK that has large numbers of small landlords but also, simultaneously, investors with sizable portfolios of properties.

*Figure 4.1: Size of landlords' holding*s

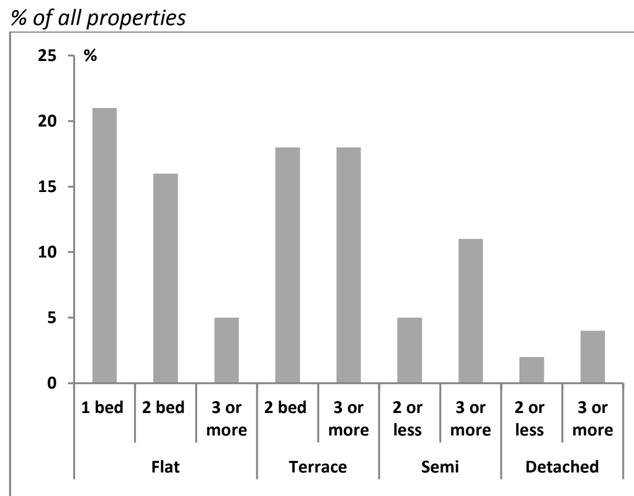


Source: RLA landlords' survey

With regard to the types of properties owned, the majority are the smaller types of property, because that is what their customers want. The property holdings in the sample are concentrated within the one and two bedroom-room flat markets and in terraced houses (Figure 4.2). Landlords with larger stocks hold quite a wide range of property types; which suggests that landlords like to diversify the markets and localities in which they operate.

Figure 4.2: Types of properties owned

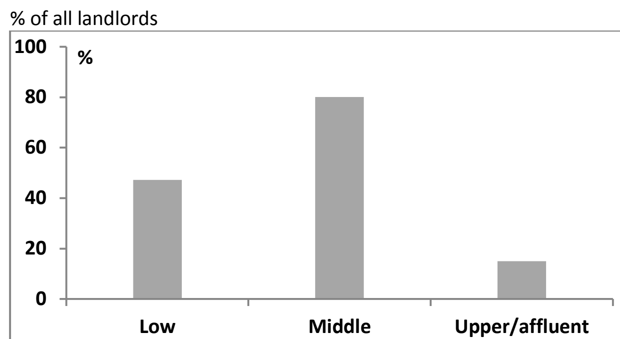
% of all properties



Source: RLA landlords' survey

Figure 4.3: Market segments targeted by landlords

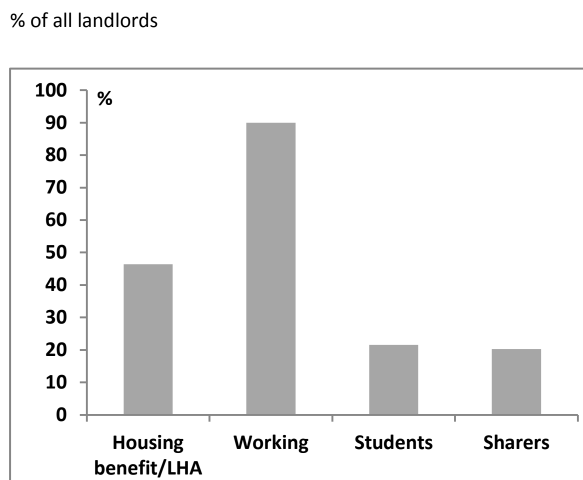
% of all landlords



Note: Respondents were allowed to use their own market definitions and to identify as many market segments as they wished. Percentages refer to the proportion of respondents indicating that segment and sum to more than 100% in total across all segments.
Source: RLA landlords' survey

Figure 4.3: Type of tenant targeted

% of all landlords



Note: Respondents were allowed to identify as many market segments as they wished, so percentages refer to the proportion of respondents indicating that segment and sum to more than 100% in total across all segments.
Source: RLA landlords' survey

Many landlords are also prepared to operate in a variety of market segments. In the survey, landlords were asked which type of market segment and tenant they were aiming to rent to and they were allowed to indicate multiple sectors (Figure 4.3). Mid-range markets were the most popular but 45% were also prepared to operate at the lower end as well, though few were active in the sparser, more affluent market. In terms of types of tenant, working tenants were the most popular – after all, they are the most common type of person looking for rental property - but almost 45% of landlords were prepared to rent to people in receipt of housing benefit.

Landlord finances survey

In the second survey, RLA members were asked to itemise the costs and revenues associated with recently bought and let standard-sized properties. The information collected was then analysed and used as inputs into a landlord investment model, designed specifically for this research, which is described in the following chapter.

Altogether, two hundred landlords co-operated with the research. Three sub-samples were identified in order to improve the comparability of the data in the samples. There were one bedroom flats valued at over £100,000; one bedroom flats valued under £100,000; and two bedroom flats. The sample sizes were approximately equal. The information gathered is listed in Table 4.1. It covers most financial aspects of landlords' activities: purchase, refurbishment, preparation for letting, managing a letting, rent levels, potential arrears, and overheads.

Convergence in gross rental yields

One potential problem with undertaking a comparative cost and return exercise is that rents vary considerably between locations and also between individual properties within them. In principle, this could make comparison difficult because each property may have a unique cost and revenue profile as a result. However, theory would suggest that the market does much of this comparison of quality and location and expresses it as graded differences in rents and house prices.

Many thousands of transactions of residential properties by homeowners and investors continuously take place throughout the UK on a monthly basis. As a result, house prices closely match differences in the attributes of the dwellings being bought and sold and the same happens with rents. Hence, properties are being continuously valued and re-valued on the basis of their age, location, internal design and other features. Within these trades, any bargains are quickly snapped up. By contrast, over-priced properties languish on the market until their values are adjusted downwards.

As a result, in a competitive rental market, such as the UK's, differences in gross rental yields between properties tend to be limited. However, this convergence of rent to house price ratios is less likely with rents and house prices themselves, which vary across regions and localities quite markedly over time.

The suggestion here is that within the broad '1 bedroom flat', 'middle-market' type of properties being examined here, tenants search out best-value rents and landlords the best returns, thereby equalising gross yields across a wide variety of properties and locations. In plain English, 'you get what you pay for' and higher value properties yield higher value rents.

Table 4.1: RLA landlord finances survey: information gathered

ACTIVITY	COST/REVENUE
Investment Purchase	Purchase price Current market value Date of purchase Borrowing amount, including set up costs Stamp duty Other costs Own time
If refurbishment	Building works & decoration Equipment & furnishings Planning & other permissions Surveyors & other professional fees Own time
Preparation for letting	Certificates Agency fees (tenant find) Advertising costs Credit checking & tenant references Legal, including lease cost Cleaning, redecoration Own time
Letting	Own or agency managed Agency fees (management and rent collection) Typical time from purchase (for initial letting only) Typical time from advertising property to rent Time spent on viewings Time spent when tenant check in Time spent on collecting rents and tenancy management whilst let Other costs
Rent	Monthly rent
Background	Postcode Cost of repairs How long expect a tenancy to last?
Arrears	Time spent recovering arrears Cost of recovering arrears Experienced of arrears in last 12 months
Overheads	Share of costs of running business, not already taken account of Share of annual vehicle mileage

Investigation of gross yields in the survey sub-samples revealed that such competitive processes did seem to be at work. There is a close relationship between rents and current house prices in the data, with correlations of 0.8 in two of the samples, and 0.7 in the other. Common gross rental yields

suggest that the results of an investment return model are likely to have general applicability, which would have not been the case with wide variations in gross returns between properties.

However, capital gains exhibit no such convergence. Looking backwards, it is easy to see when is a good time to buy and to sell. Housing market cycles are highly irregular and, so, hard to predict, as are local and property-specific variations in price and rent changes.

Costs

Apart from gross rent yields, the other main influences on returns are the costs of renting out a property. Some of those costs directly vary with the value of rents, whereas others are fixed.

Costs that vary with rents reduce net yields. Letting agents' fees associated with finding tenants and managing properties are set in this way. Typically, agents charge a month's rent for finding tenants and 10% of the annual rental for managing the property and collecting rents. This was confirmed in the landlord finances survey; although there is a wide range of charges around this median. Arrears and void costs similarly vary with rent levels.

Other costs are more likely to be task-specific in nature, including acquisition of energy and safety certificates, many repairs, legal costs and other such items. They vary extensively neither with property price nor location. Fixing a boiler, for example, involves pretty much the same costs across the value ranges of properties; although some landlords may better at negotiating with service providers than others. Some costs differ between large and small properties because of the scale of the work involved but such influences are unlikely to be relevant within the size ranges under consideration here. Analysis of the survey data confirmed the broadly fixed nature of many costs and, unsurprisingly, there was a low correlation between them and rent levels.

Task-specific costs that do not vary with dwelling size or value are going to represent a higher share of gross rental income for lower value properties than for higher value ones. This is also the case with regard to the cost impact of regulatory requirements, which are also discrete in nature.

The overall conclusions about costs further highlight the feasibility of generalising investment models and assuming that they reflect common experiences of landlords.

Choosing whether to use an agent

Landlord may choose to use letting agents either to find tenants or to manage properties fully or partly as well. Using an agent raises landlords' costs but reduces their own workload, so deciding whether to use one and for what represents different investment strategies that they could adopt. Which strategy investors choose depends on their relative cost, overall expected returns, how engaged they wished to be with the face-to-face aspects of being a landlord, the scale of their rental business, and the distance that they live from their properties. Letting agents' fees also incur VAT, which is not the case with the do-it-yourself option.

The cost of using a letting agent is quite high. Typically, using them both to find tenants and manage properties reduces landlord net rental income by around 15% a year, when new tenants have to be found every year. However, the figure is lower if tenancies last longer, because tenant-finding fees occur less frequently, and when landlords are successful in bargaining for fee reductions.

Though most lettings agents perform their services well, there are also risks involved with using them, as they may manage properties poorly or fail to pass through finances. Most agents are members of professional bodies but landlords tend to be price sensitive and may not search them out in particular.[30] Unscrupulous or financially pressed agents do misappropriate client funds and the tenant deposits they hold. There is a variety of compensation schemes and codes of practice to minimise the occurrence of such events but they are neither fool-proof nor cost-free. Only between 50 and 80% of lettings agents are believed to participate in them.[31]

An important element of any landlords' investment strategy concerns whether to use letting agents. Amongst the RLA member landlords involved in the finances survey, just under a half (49%) used letting agents to find tenants and just over a quarter (26%) used them to manage properties. These figures are lower than those reported in the latest 2006 English House Condition Survey (EHCS) but are in line with earlier ECHS 2001 and 2003 results.[32]

Depreciation and property renovation

Buildings wear out with use and age, so that part of the initial capital value of a property is being used up on a continuous basis. Depreciation is widely recognised as relevant in assessing returns with regard to commercial property. However, many published measures of residential landlords' returns do not include a depreciation expense. If that omission goes unrecognised, an exaggerated impression of true returns is given.

The consequences of depreciation are abundantly clear in the housing market, even if they are not recognised as such. For example, if a comparison is made of the value of two adjacent, identical dwellings, one of which had recently been renovated and the other not, it is clear that the current market value of the refurbished one is going to be greater. The difference in the price of the two would approximate to the total cost of bringing the un-renovated one up to the same standard. That cost is a measure of the depreciation rate, when adjusted for time.

The extent of depreciation may vary depending on the amount of continual maintenance and repair undertaken. Even so, the latter should not be confused with depreciation because even the best looked after things still suffer from wear that requires major re-investments of capital at periodic times, either in the form of renovation or replacement.

As it is difficult to measure wear-and-tear for individual properties precisely, depreciation is often measured in a rule of thumb way with different rates for equipment, furnishings and the built structure. Straight-line depreciation assumes constant wearing out over a number of years of use, which can then be converted to an annual percentage depreciation rate of initial values.

One option for investors, of course, is to purchase a property in need of work (i.e. that has depreciated) at its discounted market rate and then renovate it before letting, thereby making a capital gain on the renovation. This is a common strategy and has helped to raise standards within the private rented sector and the country's housing stock as a whole.

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[30] EHCS *Landlords' Survey 2006*, CLG, found 71% belonged to a professional body. C. Jones, *Government review of regulation and redress in the UK housing market,* 2009, discusses issues with respect to lettings agents.
[31] Rugg, J. and Rhodes, D. (2008) *The Private Rented Sector: its contribution and potential*, York: Centre for Housing Policy.
[32] Rugg and Rhodes, ibid, Table 3.8.

In the landlord finance survey, substantial expenditure on renovation and equipment and furnishings was reported to have been undertaken in many cases before initial lettings. Almost a quarter of landlords (23%) reported spending £4,000 or more on building works and around a fifth (18%) stated they had spent £2,000 or more on equipment and furnishings.

Landlords' costs in comparison to those of owner occupiers

Some of the costs landlords have in letting properties are the same as those of owner occupiers. The prices landlords and homeowners pay for dwellings are the same and that goes for items like building refurbishment and equipment renewal as well. Both may also borrow to fund purchase and the costs of doing so nowadays are quite similar between the two tenures, and the same is the case with legal costs and stamp duty. However, there are a number of costs that landlords face which are the greater than those of owner occupiers for equivalent activities or that are not incurred by owner occupiers at all.

1. *Higher repairs and maintenance*

Repairs and maintenance are inevitable parts of living in a dwelling, but their frequency and cost is likely to be higher for landlords than for owners of equivalent properties. The general activity of tenants in the property, even when careful, is likely to lead to more wear and tear and higher repair costs than homeowners may experience. If some minor event occurs, for example, tenants may avoid sorting it out themselves for fear of incurring any liability. Furthermore, landlords will have to repair, redecorate at least in part, and extensively clean their properties after every tenant leaves before making it available for the new ones.

2. *Additional transactions, management and void costs*

Transactions costs are big items in housing. The most obvious areas of extra costs for landlords when compared to occupiers are associated with the need to find tenants. The greater the frequency of tenant moves, the higher is the cost.

Furthermore, void periods are likely to arise when the property is empty between one tenant moving out and another moving in. In part, such voids are an inevitable consequence of tenant turnover, but their length is also likely to vary with general market conditions. Seasonality factors will be important as well, with voids longer at quieter times of the year, and also when the market as a whole is depressed or over-supplied. Every week when no rent is being paid reduces annual rental income by almost 2%, so that the loss of income from several void weeks soon mounts up. By contrast, as homeowners live in their properties themselves they do not face such void issues.

3. *Different risks*

Property ownership is a risky business. For example, there are risks of higher maintenance and repair costs and there are price risks resulting from fluctuations in the housing market. Some risks are common to investor and owner occupier alike. However, some are specific to landlords. For example, tenants may damage property or fail to pay rent. Many landlords may never experience such problems but the rational landlord will recognise that there is always a risk of such events occurring. The same is the case with arrears. In the landlord survey, one in six commented that they had experience of arrears. Obviously, arrears can vary considerably scale and from late to non-payment. Further costs are incurred in chasing arrears. Several landlords in the survey were of the

view that it was not cost-effective to pursue arrears through the courts and, so, wrote-off debts instead. Tenant deposits partly insure against such events and are common but may be insufficient.

The expected length of tenancies

The typical length of tenancies expected by landlords in the landlord finances survey is quite low, with the mode being 12 months, which is less than that reported in national surveys. However, quite a few landlords expected tenancies to last much longer, with some experiencing tenancy lengths of three years or more. As tenancy length is unpredictable, it is another risk faced by landlords.

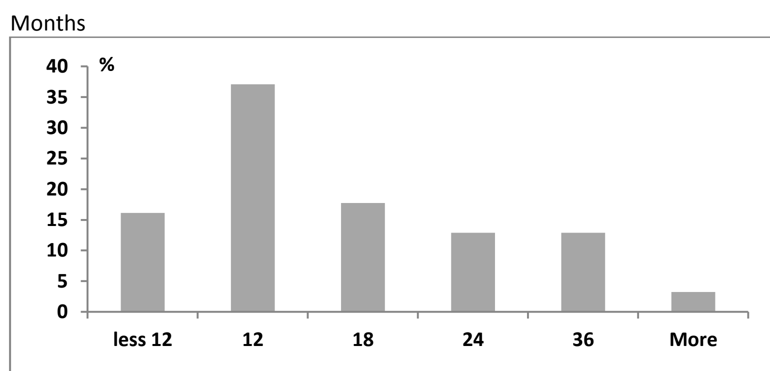
The cost of a tenant leaving is high for three main reasons:

1. The property will require cleaning and often decorating to be brought up to re-letting standards.
2. There is a loss of rent during the void period between the previous tenant leaving and new one arriving. FindaProperty.com surveys were quoting average periods when properties were advertised on their sites of 7 weeks before letting in summer, 2011. However, properties are typically advertised before previous tenants leave, so that voids are shorter. ARLA reported void periods of 20 days in 3q, 2011, which is similar to the 21 days average report in the landlord finances survey.
3. Finally, there is the cost of finding new tenants.

So, overall, the equivalent of roughly two months' rent of a year's potential rent (i.e. 15%) can easily be lost whenever a tenant leaves.

Figure 4.4: **Landlords' views on expected tenancy length**

Months



Source: RLA Landlords' Survey

This brief discussion highlights that the mobility tenants enjoy in the private rented sector comes at the price of extra landlord costs. These costs are passed on in higher rents, so that tenants in effect pay a premium for the flexibility associated with renting that they may not wish to use, especially if presented with a potential trade-off between high mobility and a lower rent.

If the costs of tenancy change are high, landlords should offer discounts to those prepared to stay longer. There is evidence to suggest this does actually occur. For example, the most recent English Housing Survey reports that market renting tenants who have lived in a property for between three and ten years, pay on average 10% less than those in residence for less time. Theory would suggest that the rent discount will be less than the cost of quitting for a landlord, because the risk remains that even a long-term tenant could quit at short notice.

Additional evidence that landlords do cost tenant turnover (and arrears and voids risks) into rent levels comes from the use by local authorities of private landlords' property to meet their housing obligations. One of the reasons why local authorities can obtain significant discounts from private landlords is that they offer long- term contracts with guaranteed payments and no voids.

Landlords may also offer lower rents to longer-term tenants for added reasons. In particular, they benefit from knowing tenant behaviour and may be willing to offer existing tenants attractive rents as result. With new tenants, there is always a risk that they will be 'lemons' by causing damage and through being social nuisances or poor payers.

In negotiations between landlords with new tenants, in the absence of long fixed-term contracts, it is difficult for either party to negotiate a lower rent at the initial fixing of a tenancy for longer periods of occupation because it is hard to signal credible lower offers for longer periods of staying. Tenants rarely see themselves as going to live in a place for a long period of time and have limited knowledge of the landlords' behaviour, so, they are likely to be reluctant to commit; while, from past experience, landlords may be wary of tenant quality and, in any case, do not expect them to stay either.

Conclusions

This chapter has covered a wide series of issues related to residential lettings and the results of two landlords' surveys have been used in the analysis.

The first set of themes examined landlord operations and market strategies. Many landlords have small operations, owning one or just a few dwellings, but there are also a relatively small number of landlords that own quite large numbers of properties. The evidence suggests that those larger investors disproportionately own the property available to rent, although each of them has only a small share of the stock overall. This finding contrasts with that of the CLG's *Landlords' Survey 2010*. However, there may be 'long-tail' sampling issues with that survey.

The survey evidence also suggests that landlords seem to be aware of market risks and the benefits of diversifying across a variety of properties in order to lower them. This was evident in the survey results, both in terms of the properties owned and the market segments targeted.

The surveys provided further evidence that competitive market processes tend to narrow the spread of gross rent yields, with a convergence of gross rental returns across different local markets. However, capital gains may still differ widely across local housing markets at specific points in time and, so, total landlord returns vary with them over time.

The second set of themes in the chapter examined the constituents of landlords' operating costs. Two types of cost were highlighted: those that vary in proportion with rent levels, including agents' fees, voids and arrears; and those that are task-specific, including repairs and regulatory compliance. Task-specific costs bear more heavily on cheaper properties.

Depreciation is another important consideration in landlord costs, although it is often neglected. Failure to take account of it leads to exaggerated returns, with used-up capital being treated inappropriately as profits. The wearing out of equipment, furnishings and buildings occurs at different speeds, so that distinct depreciation rates are needed for each of these elements of landlords' initial capital investments.

Landlords' operating costs are generally higher than those of owner occupiers. This result arises from the fact they face higher repairs and maintenance costs; additional transactions, management and void costs; and higher operating risks. In reality, like is not being compared with like in the comparison, because landlords are offering a specific package of tenant services rather than simply providing accommodation and, so, their operations differ from those of an owner occupier. These higher costs are reflected in the rents charged.

A key influence on landlords' operating costs is the cost of tenant moves. The mobility tenants enjoy in the private rented sector comes at the price of extra costs for landlords. These costs are passed on in higher rents, so that tenants in effect pay a premium for the flexibility associated with renting.

There is also evidence that landlords and tenants are able to negotiate over longer than average tenancy length; even within the framework of the standard UK short lease. Landlord costs are reduced by longer tenancies and the data suggest that in such situations rents are typically lower as well, so that the cost savings are shared between landlord and tenant.

Chapter 5: Investment returns in residential property

Introduction

Most general discussion regarding landlord returns is couched in terms of gross and net yields at single points of time for hypothetical fresh investments. They are also based only on a partial set of costs. In order to look more deeply into returns from residential investment, it is useful to look at the flows of costs and returns over time for a specific dwelling investment and, within that approach, to incorporate a full range of costs. With that in mind, this chapter outlines a landlord investment model formulated as part of this research.

As an initial exercise, costs and rents derived from the RLA landlord finances survey are inputted into the model to examine the levels of returns landlords can currently expect from their investments in residential property. Unsurprisingly, they are significantly lower than those often reported in the media and raise doubts about the viability of investing in the sector in existing circumstances. Rents are simply too low relative to house prices to make investment returns worthwhile. In the absence of rent rises, only substantial capital gains can improve these poor rental returns, but high house price inflation is neither likely in the near future nor desirable for the housing market or for the wider economy.

Sensitivity analyses are then undertaken to explore which factors are the most important in influencing the level of returns.

The landlord investment model

An evaluation of landlord returns is made here using a cash flow model of revenues and costs over time to derive an internal rate of return (IRR).[33] Specification of the items in the model takes a similar form to the costs and revenues identified earlier as part of the analysis of the landlords' survey presented in Chapter 4. Obviously, the estimated IRR is of interest in itself but can also be used for comparisons. For example, it can be related to landlords' target rates of return, to potential risk-premiums, and to returns from alternative investments.

Specification of the model is based on post-tax rental income, capital gains from house price changes, and costs. It assumes that the holding period for the property is 10 years, after which it is sold, although that can be adjusted to longer or shorter time spans if required.

In order to project values into the future, assumptions are made regarding future general, house price and rent inflation. However, the levels of each of them can be varied within the model to explore the sensitivity of returns to changes in these assumptions. Furthermore, the model is set up so that estimates of returns can be made depending on specific investment strategies and outcomes: for example, whether a letting agent is employed; the average length of tenancies and resultant turnover in them; and investors' marginal tax rates.

Summary of the content of the model

The model is based on the following factors that influence the returns achieved from an individual investment property:

[33] This approach is the standard one in modern property investment appraisal. See *Property Investment Appraisal, A.* Baum & N. Crosby, 2007; and *The Economics of Commercial Property Markets,* M. Ball, C. Lizieri & B. McGregor, 1998.

1. The value of the investment made, which consists of:
    a. The purchase price of the dwelling
    b. The associated transaction costs and taxes: including legal fees, stamp duty, the value of the time spent by the landlord in searching for and buying the property, and other incidental costs
    c. Refurbishment costs: including building works, professional fees, equipment and furnishings purchase, and time costs. It is assumed that these costs are reflected in the current value of the dwelling, so that current property values are used in the model following on from refurbishment works rather than including them directly in the estimates. (However, the model is set up so that refurbishment costs can be identified separately, if required.)
    d. The holding costs incurred between the time of purchase and when rents start being paid;
2. The size of the mortgage loan taken out and the mortgage costs incurred. Those costs include the interest rate charged and the set up fees incurred, as they are now a common initial charge. Repayment terms are either based on regular payments of interest only with the loan repaid in full at term, which is most common in buy-to-let, or they can be regular payments of interest and principal until the full value of the loan is paid off by the end of the term. The model is calibrated for the interest-only type of mortgage, although it can easily be adjusted to the repayment form;
3. The costs of preparing to let the property, which include either using an agent to find a tenant and set up a tenancy agreement or, alternatively, advertising, arranging and undertaking viewings in person, drawing up the contract after the appropriate credit searches, and the processing and holding of tenant deposits;
4. The rent charged, minus any expected events that lower annual rental income: such as the void times between tenancies when no income is earned; or any expected arrears and associated legal costs;
5. The costs of managing a tenancy: such as rent collecting; dealing with tenant requests; undertaking maintenance and repairs; travel to and from the property; taking out insurance; plus the value of the landlords' time taken up in these tasks. Time costs are valued at the average national hourly earnings rate.[34] In this item, costs will vary depending on whether an agent is used;
6. The depreciation assumptions made with respect to the physical structure of the building, the equipment for heating, cooking, sanitary ware and the like, and the furnishings, which typically in an unfurnished property will relate to floor and window coverings only. The simplest rules of thumb here are to make property deprecation an annual proportion of the dwelling's initial value and, with respect to equipment and furnishings, to make depreciation a percentage of their initial values, such that they are fully written off after a fixed period of time, as discussed in Chapter 4;
7. The overhead costs assigned to the property, including the appropriate share of the landlord's overall costs of running the renting business, submitting financial returns, and paying accountancy fees and other necessary charges;

[34] Source: ONS

8. The appreciation in the value of the property over time. On annual basis, such valuations are entirely notional and are excluded from the model, which instead incorporates only the net cash realised at the time of sale. Selling itself incurs estate agency, capital gains tax (CGT), legal and other costs, which need to be deducted from the sale price to derive net proceeds;
9. The taxes paid by investors on their properties. It is assumed that taxes are taken from rent revenues annually at the person's marginal rate of income tax but, simultaneously, offset by reliefs on the allowable costs of running a property, including interest charges on loans and on-going expenses. Under current UK rules, tax relief exists only for recurrent expenses on a cash-paid basis. This means that they do not encompass capital costs, apart from deductions for improvement. Losses in one year can be rolled over to subsequent years but they cannot be offset against a person's general tax bill in that year (so-called 'negative gearing');[35]
10. The cash flow over time and the specified investment horizon at the end of which the property is sold; and, finally,
11. In the context of investment returns, general inflation and risk should both be taken into account. The approach to adopt here is that they can be examined in relation to the estimated IRRs from data calibrated in nominal terms. Therefore, future values are recorded in nominal terms with an assumed rate of inflation, whilst risk is not explicitly taken into account within the model.

For any run of the model and calculation of an IRR, a series of assumptions have to be made about several of the items listed above, while others can be directly derived from the cost and revenue data provided by the landlords' survey. The list of assumptions is shown in Table 5.1. The values used in initial runs of the model are shown in Table 5.2. Further costs and revenue inputs are shown in Table 5.3. In all of this, other values can be inputted, for modelling purposes, if desired.

Setting up the model

As has been outlined earlier, landlord returns depend on a variety of variables in relation to rent income, capital gains and costs. Unfortunately, such complexity means that that reporting of any in-depth empirical analysis of those landlord returns is itself going to be complex. The approach used here is to provide a base-case scenario and, then, to report on how returns alter when a variety of factors are changed in relation to that base-case scenario.

A wide range of scenarios can be inputted into the model, depending on assumptions made about costs and revenues. Therefore, in order to make the results comprehensible, some assumptions regarding the base-case have to be made.

An obvious base-case is to take the results from the landlord finances survey and take the averages (medians) as being representative of typical property investments. This is what is done in the base-case referred to in Table 5.4. That information provides useful data on average costs for one bedroom flats, rents, arrears, voids, loan-to-value ratios (LTVs) and how long tenancies can be expected to last. However, several additional assumptions still need to be made regarding the tax position of investors, their investment strategies with respect to using an agent and mortgage interest rates over time. In the base-case, it is assumed that the landlord is a basic rate (25%) taxpayer who uses the full services of a lettings and managing agents.

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[35] *Buy-to-let Tax Guide*, Paragon Mortgages. Being able to use annual rental tax losses to offset tax on other income is called 'negative gearing' in Australia, where it exists in the tax code.

Table 5.1: Assumptions incorporated into the investment model

Assumption	
Expected general inflation	
Expected house price inflation	
Expected rent inflation	
Marginal tax rate of investor	
Mortgage interest rate	
Expected tenancy length	
Letting Agency used for:	
	Tenant find
	Property manage
	Tenant deposit
Agency fees at sale	
Agency fees for tenant find	
Agency fees for management	
Voids:	
	Purchase to first letting
	Time between tenants
Arrears:	
	Expected lost rent
	Legal & other costs
Value of equipment	
Value of furnishings	
Depreciation rate:	
	Property
	Equipment
	Furnishings

Table 5.2: Initial run assumption values

Assumptions: which can be varied within the structure of the model

Items marked * are derived from the survey and those marked + cannot be changed

	%
Expected general inflation (pa)	3
Expected house price inflation (pa)	3
Expected rent inflation (pa)	3
Marginal tax rate (pa)	40
Stamp Duty rate	1
Loan-to- value ratio	55*
Mortgage interest rate (pa)	5
Monthly initial rent £	**700***
Use Letting Agency for:	
Tenant find? (Yes, 1; No, 0)	1
Property management? (Yes, 1; No, 0)	1
Tenant deposit? (Yes, 1; No, 0)	1
Agency fees at sale (% sales price)	1.5
Agency fees tenant find (% ann. rent)	6*
Agency fees man. & deposit (% ann. rent)	9*

Voids (weeks)	
Time from purchase to first let	6*
Time between tenants	3*
Arrears	
Expected average no. of week's lost	1
Average legal & other costs (£)	80*
Estimated value of existing & new	
Value of equipment	4,500
Value of furnishings	500
Depreciation assumptions	% pa
Property	1.5
Equipment	12.5
Furnishings	20
Travel (miles pa on this property)	100*
Refurbishment Y=1, No=0	1
Planned holding period (years)	10+
Tenancy length (1 or 2 years)	1*
Share of business overhead (£pa)	250*

Note:

1. Own hours multiplied by £10 (= av. UK earnings)
2. Borrowing costs assumed to be mortgage rate
3. Travel costs at 40p per mile
4. Assumed CGT exemption used up, & CGT rate is 28%
5. With refurbishment, assumed in enhanced value of current property price
6. Mortgage set up fees are not included in mortgage value

Table 5.3: Model inputs from survey results

	£ (or hours)	
Purchase of investment		
Purchase price/current value	**145,000**	
Mortgage set up fees	1,000	
Legal fees	800	
Own time in purchase (hours)	30	
Other costs	750	
TOTAL PURCHASE COST	**147,850**	
Refurbishment		
Building works & decor.	5,000	
Equip/furnishings	500	
Planning & other perms	250	
Prof. fees	300	
Own time in refurbishment (hrs)	30	
TOTAL REFURBISH COSTS	**6,350**	
Preparation for letting		
Annual certificates	150	
Advertising costs	80	*
Credit check/tenant ref.	75	*
Legal cost incl. lease	200	
Prof. clean, redecoration, new locks	250	*
Own time man., etc. (hrs)	15	*
Tenancy costs		
Maintenance/repairs (£pa)	360	
Insurance, etc (£pa)	250	
Time collecting rents & management (pa)	10	*
Arrears		
Own time (hrs pa)	15	

* only comes into force when letting agent not used

Table 5.4: Model results using different assumptions

Mortgage LTV		Gross yield %			Agent tenant find		Agent manage		House price inflation			Marg. tax rate		Arrears weeks		Void weeks		Tenant turnover		IRR	MODEL CHANGES (FROM 1ST ROW BASE)
55%	*75%*	*Survey = 5.4%*	*8%*	*10%*	*Yes*	*No*	*Yes*	*No*	*3%*	*5%*	*10%*	*25%*	*40%*	*1*	*3*	*1*	*3*	*Annual*	*Every 2yrs*		
X		X			X		X		X			X		X			X	X		0.4%	BASE SCENARIO
X		X			X		X		X			X		X			X		X	0.8%	TENANCY LENGTH & AGENT FIND & MANAGE
X		X			X			X	X			X		X			X		X	1.3%	
X		X				X		X	X			X		X			X		X	1.3%	
X		X			X			X	X			X		X			X	X		0.9%	
X		X				X		X	X			X		X			X	X		1.0%	
X			X		X		X		X			X		X			X			2.3%	HIGHER INITIAL RENT
X				X	X		X		X			X		X			X			4.4%	
X		X			X		X		X				X	X			X	X		1.8%	HIGHER INCOME TAX +LTV +GROSS YIELD
	X	X			X		X		X				X	X			X	X		1.7%	
	X			X	X		X		X				X	X			X	X		3.6%	
	X	X			X		X			X		X		X			X	X		2.8%	HIGHER HOUSE PRICE INFLATION @DIFFERENT TAX RATES &75% LTV
	X	X			X		X			X			X	X			X	X		3.3%	
	X	X			X		X				X	X		X			X	X		10.3%	
	X	X			X		X				X		X	X			X	X		10.7%	
X		X			X		X		X			X			X		X	X		0.0%	MORE ARREARS
X		X			X			X	X			X		X		X		X		1.5%	LESS VOID

Further assumptions have to be made about the future: with respect to changes in house prices, inflation, rents and interest rates. With respect to future inflation values, general inflation is assumed to be 3% annually and, also, for there to be zero real increases in the other two items (i.e. they also increase at 3% in nominal terms yearly).

In the base-case, furthermore, mortgage interest rates are assumed to be constant at 5% throughout the 10 year investment period. The annual payments are interest only, with the capital sum redeemed from the proceeds of the sale after 10 years.

The base case may seem overly pessimistic in terms of expected returns over a 10 year horizon, as it does not include any real increases in rents and house prices. It also has low gearing, which is set at 55% LTV because that was the average leverage recorded in the landlords' survey. However, that pessimism is deliberate. The reported variations in the scenarios then concentrate on the impact of items which would be expect to improve returns, in order to explore how sensitive actual returns are to them.

Results

Table 5.4 presents the results for a range of scenarios. Space and complexity has meant that many other potential variations are not reported. However, the variations in the table identify some important results.

First, it can be seen that the base-case returns are very low with an IRR of only 0.4%. With such low returns, high gearing is a hindrance rather than a help. Flat house prices are assumed but, at the time of writing, the prospect was for further declines in house prices, so the current estimated returns could be even worse.

Second, the scenarios identify what factors matter the most in raising returns. Looking across the scenarios, it can be seen that returns only marginally improve in most scenarios. Reductions in costs help to raise returns, as does a higher marginal rate of tax, but neither do so by substantial amounts. The only contexts in which returns rise significantly are when gross yields are higher (i.e. when rents rise significantly relative to house prices) and, most notably, when house price inflation is high. The best returns are achieved when house price inflation reaches 10% annually. Yet, even those larger nominal returns do not seem that high once inflation and risk are taken into account.

House prices have really to boom to create substantial returns and that clearly is neither a desirable nor a sustainable state of affairs, because house prices cannot rise at a fast rate forever. However, this conclusion backs up the views of many investors that capital gains are where the big returns can be made. This is partly a result of poor rental yields but also of a tax system that helps to keep total returns down in the absence of a house price boom. It is also a situation that encourages high gearing to take the greatest advantage of capital gains when then occur.

One of the reasons why the model results lead to low IRRs is due to the depreciation charges. Remove those and returns rise by around 2% across the board. However, the case for including depreciation was made above and it strongly points to depreciation charges being an integral part of landlords' costs. Arguments could be raised about the rate of depreciation but the ones used here are not particularly high. For example, the assumed depreciation rate for buildings assumes they have a 67 year life. Using initial property value does imply that a certain land element is included.

But the data are for average values from a national survey and, so, does not relate to localities specifically with high land values. If the complexity of stripping out land values was undertaken, that might question the long assumed building life. If the assumed building life was lowered, that in itself would raise depreciation charges.

Interpreting the results

The returns cited here highlight the current weak incentives to invest in the private rented sector. Properly estimated returns imply that many landlords should sell up at the earliest opportunity. They should not if they think there is going to be a substantial house price boom at some time over the next decade. But this report has argued that this is unlikely.

That statement should not be interpreted as actual investment advice but rather a demonstration that something is going to have to change to improve those returns if large-scale disinvestment is to be avoided. The change could come about through substantial increases in rents relative to house prices or through a renewed bout of house price inflation. Neither of those options is attractive for tenants, the economy or society as a whole. An option would be an improved tax system.

These results reinforce the comment made in Chapter 1 that the private rented sector to a great extent has expanded as much as it has in recent years because of the buy-to-let investment boom. Then, there was much additional investment in the private rented sector. It was undertaken by literally millions of investors on the expectation that house prices would continue to rise fast on a trend basis. That corresponds precisely to the 'high return' model scenario shown in Table 5.4. Yet such high returns did not last forever and the reality of the downside of housing market cycles returned with a vengeance after 2007.

Of course, buy-to-let investors were not the only people caught up in the over-optimism of the credit boom. Many investors in other spheres suffered high losses as well. Yet there remains a long-lasting supply legacy from the buy-to-let boom; arising partly because of the lengthy lag structures existing in the private rented sector. Rents relative to house prices were pushed well below their equilibrium values during the boom years, because supply expanded so rapidly, and they have yet to return to sustainable levels nationally. As emphasised earlier in this report, it is the ratio between rents and house prices that is key, rather the levels of either, when examining rental returns.

What this argument is suggesting is that during the 2000s both demand and supply for renting grew but that supply grew faster than was warranted by the impact on rents of extra tenant demand. Instead, extra supply was driven in expectation of continuing rapid house price rises. Since the 2007/8 downturn, both house prices and rents have fallen in real terms, with prices declining faster than in rents. This has helped to improve gross yields but by an insufficient amount to make residential investment more of a rental income than a capital gain strategy, as the model results show.

A revival in rent yields would be in line with recent history. For example, in the late 1990s and early 2000s gross rental yields were significantly higher than they are now and of the order of 8% to 10%, according to historical ARLA, Paragon and other estimates.[36] Yields at that time are more likely to reflect long-term equilibrium values than current ones, because they pre-date the dual house price

[36] Ball, *ibid*; Crook, A. *et al*, *Investment returns in the private rented housing sector,* British Property Federation, 2002.

and buy-to-let booms of the 2000s. The modelling results also point to the need for gross rental yields to be of somewhere around that level for landlords to earn a decent return. Unfortunately, recent tax increases have push up required gross yields to even higher levels than in the past, because taxes are now much greater than they were a decade ago.

Comparing the model results to quoted gross and net yields

The low returns identified in the cash flow modelling analysis might surprise those used to seeing the much higher yields quoted by agency organisations such as ARLA and others. The differences occur because those sorts of yields are not calculated full appraisal models and do not include many costs faced by landlords. They are designed to give broad and quick indicators of market developments but their specifications are insufficient for a full investment appraisal.

Importance differences arise because the cash flow investment model estimates:

1. Discount a time flow of returns rather than a single time point figure
2. Take account of net taxation
3. Incorporate tenant turnover and property management costs
4. Use forward-looking rather than backward-looking house price changes
5. Incorporate depreciation, and
6. Have flexibility in assumptions

These and other factors give a truer reflection of investment returns.

The returns quoted here are similarly different from the residential yields reported by the Investment Property Databank (IPD). Those yields form a mid-way point between the estimates here and those of lettings agencies because they incorporate a wider range of costs than the latter.

Rent yields in UK private residential investment empirically tend to be notably lower than those in commercial offices, according to IPD data. This is paradoxical, given that commercial leases are typically long ones lasting five years or more, and that commercial tenants have many repair and maintenance obligations while residential tenants have none. As a result, commercial office landlords face relatively lower operating costs than those in residential investment.

Conclusion: explaining current supply-side problems and how they have developed

This chapter has examined landlord returns using a post-tax cash flow investment model specially designed to take account of true landlord revenues and costs over time. The results highlight that landlord returns are poor, even in nominal terms with no account taken of investment risks. Returns are somewhat better, but still poor, if depreciation is ignored. However, to ignore depreciation is to mistake a rundown in the value of the capital invested for annual profits.

Moreover, the results suggest that returns are sensitive to costs, to how often tenants move, and to a variety of other factors. However, the big drivers of higher landlord returns are sharp increases in rents relative to house prices and, above all, rapid rates of house price inflation.

The problem is not a physical lack of demand. Rather, there has been a long-term increase in the demand to rent. In addition, the current problems of the housing market and the extra barriers faced by first-time buyers have further added to that demand. These returns data instead suggest that supply has been running ahead of demand for some time now: firstly because of the buy-to-let

boom and, then, through a growth in reluctant landlords in the downturn. However, that era is coming to an end as several years of poor returns and the prospect of more dampen the appetite for private rental investment.

Present rent levels do not cover landlords' costs and, simultaneously, enable them to earn a risk-weighted return competitive to those available in other investment options. Moreover, capital gains are currently insufficient to make up the difference, and are unlikely to do so in the future on a sustainable basis. In the short-term, the situation is particularly bad, because many landlords have experienced sharp real falls in the value of their properties over the past four years, which has pushed total annual returns in to negative territory, and the declines are not over yet.

An important implication of these results is that rents need to rise quickly in order to raise rental returns to more feasible higher levels to avoid a potentially large amount of disinvestment by landlords. This may prove difficult to achieve when household finances are as badly stretched as they are now. If rents do rise, this will tip the balance between owing and renting for some tenants and stimulate first-time buyer demand.

An alternative, of course, is that house prices fall, with rents staying relatively stable. This would also increase gross rental yields. To an extent, this dynamic has been occurring, because real house prices during the downswing have so far fallen by 30% while rents have dropped by only around 10%. However, the prospect of house price declines of the scale required to push up yields sufficiently over the next few years does not seem high.

General price inflation points to upward pressure on nominal rents in order to maintain their real value. Again that process has already been happening to a degree.

The stimulus to landlord investment of the past two decades essentially relied on the existence of marked house price inflation and plentiful credit in the years up to 2007. That investment approach is never going to be feasible for the sector as a whole over the long-term, as house prices cannot continue to rise forever and credit booms end in crisis.

A lack of awareness of the current supply-side problems of the private rented sector has been encouraged by the experience of the past 20 years when supply grew so strongly, but they were unique years. The investment model in the private rented sector of relying on rising house prices to generate landlord returns had an exceptionally long life during the 1990s and 2000s. It was sustained because, fortuitously, that particular house price upswing was unusually long. However, its rationale ended when the boom burst in 2007.

The UK is still in a price downswing, which is being partly obscured by general price inflation, as in past downturns in the period from the 1970s to the 1990s. The point at which real house prices will rise again and the extent to which they will do so remain uncertain. The current economic and financial situation does not point to an earlier revival. Moreover, once revival is in place, interest rates will begin to rise from their current low levels. This will put added pressure on both homeowners and landlords and, again, dampen prospects for house price growth.

Both trends and cycles matter. It may have been the case that the past trend of UK house prices has been for real increases of around 3%, but it has been associated with long price cycles. Prices go up for many years but they fall for some time as well and, then, do not reach their previous peak for

many years afterwards. With the benefit of hindsight, more are aware of the cyclical nature of house prices than was apparent during the boom years. Yet, recourse to the strong underlying price trend should also be sparingly used to reassure the property investor. It is unclear what the future trend of house prices may be. Though unlikely at present, such factors as major changes in credit conditions or increases in residential land availability may alter it.

Despite the existence of well-worn phrases like ‘prices may go down’, the notion that housing is always a good investment is hard to dispel. The estate agents’ cry is always ‘location, location, location’ but ‘timing, timing, timing’ may be more appropriate from an investment perspective.

Chapter 6: Policy reforms to improve the supply of rented accommodation

Introduction

This report has examined the current state of the private rented sector. It has identified a worrying weakness on the supply-side. Investor returns are too low at present and prospects do not look too good.

What this final chapter aims to do is to present some options and suggestions of ways to improve landlord returns, through adjustment to regulation and the tax system. The first part summarises the likely effects of doing nothing. Subsequent sections argue that governments can improve the supply of rental accommodation and help keep down rents in four ways:

i) by trying to lower the cost base of renting and to encourage investors through reducing regulatory impacts
ii) by making taxation fairer and more efficient
iii) through specific inducements with respect to new buildings
iv) by limiting the constraints on including privately rented housing investment in pensions wrappers.

The 'do-nothing' policy option and its consequences

Whatever governments do market forces will 'solve' the problem of poor investment returns to residential property but in ways that will have unpalatable effects. Without policy changes, the outcomes will neither satisfy the desired social goal of a large and affordable private rented sector; nor will they be economically efficient or fair to millions of private tenants. Renting will continue to bear an unfair burden of taxation, at a higher rate even than now.

This is because adjustment will take place through an increase in gross rental yields, that is the ratio of market rents to house prices. As argued earlier, much of the adjustment is likely to take place through higher rents than through lower house prices. However, even with higher rents, rental supply is likely to be less. So, market equilibrium will be restored through less supply and higher rents.

The long-term knock-on effects in terms of a smaller private rented sector, disinvestment in the housing stock, urban decay, higher inflation, and reduced labour mobility could be substantial. Unfortunately, with current data, it is not possible to estimate the precise effects but they are likely to include some or all of the following:

- Higher rents will choke off demand and lead to greater housing distress and over-crowding
- The high levels of investment in the housing stock untaken by landlords over the past decade is likely to be compromised, with a lack of supply increasingly apparent
- More landlords will be tempted to disinvest by allowing property quality to rundown, while simultaneously trying to maintain rent levels in order to boost yields
- The prized mobility benefits of private renting and the resultant positive labour market effects would be reduced. Prospective tenants will face less housing choice and higher rents and that may put quite a number off from moving to new locations to work

- Higher private sector rents will feed into general inflation as they are a disproportionately key housing element in the estimation of the CPI (from which owner occupied housing costs are currently excluded)
- Higher private sector rents could also derail attempts to make social housing rents more market-related by making the transition for steeper.

These sorts of adjustments are already beginning to take place, but are currently being obscured or delayed by a series of factors:

1. Rental growth over the next few years being likely to be modest, because of the current strains on households' incomes and the weak economy
2. An overhang of landlords with weak returns but who are unwilling to quit the sector
3. The consequences of the surge of 'reluctant landlords' since the downturn.
4. Alternative investment opportunities currently often having poor returns or high risks, as seen in the recent volatility of equity markets.

However, contemporary circumstances point only to delayed and drawn-out adjustment. They do not resolve the underlying issue that, over time, the ratio between rents and house prices needs to rise to improve the attractiveness of residential rental investment.

Reforms to private rented sector regulation

Landlords complain strongly about the difficulty of running their businesses because of the regulatory environment. Housing in general and landlord-tenant relations specifically are subject to a wide-variety of housing, health and safety, planning, social policy, and environmental legislation. This has all developed in a haphazard, uncoordinated manner over many decades. Once in place, repeal is rare. Moreover, the cost-effectiveness of many requirements was never assessed when the measures were implemented nor have recent ones been reassessed after several years in place.

This report has not focused on the detail of regulation but it inevitably:

- Raises landlord costs
- Increases landlord administrative time
- Heightens risks because of the liabilities associated with regulations
- Elevates the 'hassle-factor' of being a landlord

What is more, there is a wide variety of regulatory bodies, often with overlapping responsibilities. Many have risk-minimising, rather than optimal risk strategies, and do not bear the costs of their own actions. Responsibilities are spread between quangos, central, national and local government with limited or no coordination and potential negative overlap.

A particular worry regarding current policy trends is that additional localism is adding to an already confusing diversity of local authority performance, rules and regulations. Local authorities interpret and pursue powers given to them in variable ways with differing degrees of effort and success. Landlords with properties in more than one local authority area are particularly disadvantaged by a lack of common standards and approvals. A recent study in Scotland went so far as to conclude

from focus group discussions that landlords felt that "the primary barriers to running their business lay in the poor performance of their local councils and Sheriff Courts."[37]

The Coalition Government has focused on cutting red tape with its 'Red Tape Challenge' programme. In the planning sphere, its current planning proposals for England aim to reduce planning legislation from over a thousand to around fifty pages.[38] Similar exercises are needed with respect to the private rented sector by the Coalition Government and governments in Scotland, Northern Ireland and Wales. Much simplification could be done without legislation, through encouraging common and overlapping positive practices amongst local authorities and through the setting up of websites dedicated to simplifying the burden of compliance. As important as less bureaucracy is improving the performance of regulatory agents in achieving commonly agreed goals.

Making taxation fairer and more efficient

The much higher taxation on private renting than on other tenures is both unfair and inefficient. It is also a tax on savings that differs from the more favourable treatment given to other investment options.

However, to argue to bring private rented sector taxation fully into line with present owner occupation tax arrangements may be unwise. This is because the tax system is now so heavily biased towards favouring owner occupied housing. On the one hand, the overall availability of housing is tightly constrained in the UK by highly restrictive land policy but, on the other hand, the tax system simultaneously encourages investment by people in owner occupied housing. The former helps to generate the high house prices that make the tax breaks so beneficial. There is then a feedback loop: the tax attractiveness of home buying further stimulates housing demand, which exacerbates the supply shortage, which raises house prices more. Moreover, as income and wealth taxes escalate, owner occupation becomes an increasingly effective tax shelter.

Neither the 'little new housing land' nor the 'no taxes on owner occupied housing' policies make economic sense. Yet, they are hard to budge. Given that they exist, to extend the tax anomaly completely into the only tenure that is currently significantly taxed might be stretching 'second-best' arguments too far. Similarly, proposals for an all-encompassing tax approach to housing may be an ideal option, with the introduction of a universal property tax across all housing in all tenures, but it is unlikely to be politically palatable for some time, as proponents recognise.[39]

However, the disadvantageous tax position of private renting is so glaring and so unfair to millions of younger people that the case for doing something soon is strong. Narrowing the tax gap on the private rented sector can be justified on both efficiency and equity grounds. Reductions in the tax on landlords' revenues would lower their required gross rental yield. This would lead to more rental housing supply, with the sector exhibiting a high responsiveness of investment to increases in expected returns. That supply stimulus would lead to lower rents to the benefit of housing consumers. Moreover, given that the elasticity of supply is high in the 'market' rented sector, while

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[37] *Review of the Private Rented Sector: Volume 3: Views and experiences of landlords in the private rented sector*, Scottish Government, 2009, para 11.60

[38] *Draft National Planning Policy Framework*, CLG, July 2011.

[39] *Mirrlees Review of the Tax System*, IFS, September, 2011.

the price elasticity of demand is far lower, much of any tax reduction would be passed onto tenants in lower rents.[40]

It could be argued that there is no chance of government lowering taxes in the foreseeable future, because of the delicate state of public finances. But there is never a good time to implement tax change and the threats to investment in the private rented sector are currently great. If large scale disinvestment did occur, moreover, there would be serious negative knock-on effects on the economy, damaging any growth agenda.

In any case, there is room for change even within current fiscal strictures, because taxes on the private rented sector are at present rising. It is a classic 'unintended policy consequence'. No-one has said that private tenants should have to pay more for their housing to help pay for the deficit. That outcome cannot be counted as fair or sensible. So, simply committing to keeping the volume of taxation of the private rented sector at its current level is likely to offer considerable scope for change. Further measures could then be introduced as the fiscal situation improves.

In contrast to owner occupiers, landlords can offset mortgage interest payments against their tax liabilities through Mortgage Interest Tax Relief (MITR). So, the tax break advantages are not all one-way, although the tax-benefit gap remains highly in favour of owner occupation. However, to load landlord tax breaks primarily onto borrowings is to encourage higher LTVs in the private rented sector and, therefore, to raise landlord default risk. Thus, to widen the tax reliefs available for private rental investment is also to lessen the leverage incentive to borrow as high a LTV as possible.

Taxation of rental income

a. A tax-free net rent yield

The simplest tax reform would be to exempt a fixed percentage of net rent yields from taxation, so that only returns in excess of that level would be subject to tax. Accordingly, when submitting their tax returns landlords would calculate their net rental income and divide it by the current value of their properties and pay tax only on incomes above the tax exempt level. To ensure fair reporting, such calculations would be randomly checked by the Inland Revenue, when they could require independent valuations if personal assessments seemed questionable.

The net rental income in this approach could be calculated as being either before or after mortgage interest deductions. If it is before interest charges, a preferable route, the tax free yield would be set higher to compensate for the loss of MITR. This is similar in principle to a suggestion by the recent IFS Tax Commission, although they did not consider landlord costs in any detail in their discussion.[41]

The tax-free rate should be set at a level that took account of landlords' costs, depreciation, the impact of inflation, risks, and minimum viable returns. It should also be held relatively steady to enable forward planning by investors. A yield of 4 to 5% might be a plausible figure when MITR is not given in addition, though detailed analysis would be required to fix the percentage yield precisely. When yields rose above that level, taxes on the excess net rental income would come into effect, so that extraordinary gains arising from sharp upswings in rents would be subject to tax.

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[40] The pass-through incidence of a tax cut depends on relative elasticities of supply and demand. If the price elasticity of demand is less than that of supply, tenants will bear the more of tax rises and gain more from falls, S.Connolly & A. Munro *Economics of the Public Sector*, 2009.

[41] *Mirrlees Review of the Tax System*, IFS, September, 2011.

This approach has the advantage of simplicity, is neutral in relation to marginal income taxes, discourages off-shore holdings, limits herd behaviour in rent booms, and does not cause landlords to distort their business models in search of tax breaks.

Unfortunately, the thought of 'tax free' yields for landlords might raise political emotions. Pass-through incidence effects are unfortunately often forgotten in such debates. If that is so, it may be politically more palatable to offer greater tax deductions directly related to landlords' costs, such as by introducing capital allowances.

b. Capital allowances

The importance of depreciation in calculating returns has been highlighted in this report. Without its inclusion, investors are essentially misallocating what is in effect a loss of capital to income. They artificially boost their apparent returns in consequence, which then get taxed. In fact, at present landlords have no choice but to engage in such financial folly because of the tax treatment of their returns.

What the tax system does at present is to tax the cost of the physical wearing out of capital, precisely because the tax rules wrongly treat depreciation as contributing to income rather than to costs. This is unfortunate, especially with regard to the ageing properties that landlords typically invest in. As the discussion regarding depreciation noted in Chapter 4, there may be scope for arguing about the scale of depreciation but not about its existence.

In most other countries with significant private rented sectors, a depreciation allowance on rental housing is permitted within their tax codes.[42] For example, in the USA, the straight line depreciation of building structures is allowed over a 27.5 year period, with building value calculated by subtracting land values from house prices.

There is an important principle here, because the UK differs from most countries in not having explicit depreciation provisions in its tax code. Instead, specific investment goods have 'capital allowances', which can be entered as deductions into businesses' tax calculations. In general, buildings do not feature in these capital allowances but capped expenditures on the 'integral fixtures' of buildings are allowable. This arrangement does not favour residential renting, though it is of great benefit in commercial property where equipment (lift systems, air conditioning, etc.) forms much higher shares of building values. So, within the spirit of the UK approach, the suggestion here is that additional capital allowances are explicitly made available for rental housing. These capital allowances would then be used to offset taxes on rents.

The size of such allowances is a matter for future evaluation. However, in principle, they should cover the real costs of building wear-and-tear with ageing and use. Claw-backs that were tapered over time would ensure that the allowances were not misused but associated with rental properties only.

[42] M. Oxley at al., Promoting *investment in private rented housing supply. International policy comparisons*, CLG, 2010.

c. *Special capital allowances*

Once capital allowances are introduced, differential amounts can be set in order to encourage specific types of investment within the private rented sector or to focus on certain features of property market behaviour. For example, extra or accelerated (i.e. front loaded to earlier years) allowances could be offered to encourage investment in building improvements, urban regeneration areas or in energy saving. (At present, capital expenditure on a dwelling can only be offset against CGT liabilities.)

Investment in newly built properties faces particular dynamics. Newly build properties, once occupied, tend to suffer a marked fall in value for several years afterwards. The market rapidly discounts their value once they are no longer ‘new’ in the sense of being never used. [43] This obviously deters investment, because there is a high expectation of a capital loss shortly after purchase. Recognition of this negative investment effect within a capital allowances regime would limit this effect and encourage more landlords to invest in new building.

New building highlights an area of the housing market where recent UK governments may have missed a key opportunity to stimulate the demand by investors for new housing. Instead, emphasis has been solely put on short-term subsidies to encourage first-time buyers e.g. ‘FirstBuy’ and low cost home ownership schemes.

Fiscal encouragement of investor spending on new housing is likely to leverage significant amounts of private expenditure: both because landlords do not generally face constraints of having to save for a deposit when they borrow in contrast to first-time buyers and, also, because they can more easily mobilise their own cash resources to buy when a good opportunity arises.

Incentives to landlords avoid long lead times in building projects. In general, the lag before building projects get underway can weaken their usefulness as means of rapidly stimulating domestic demand. However, the responsiveness of private rental investors is rapid. They just want to buy properties, possibly off-plan, and rent them out as quickly as possible, because that maximises their returns.

Such incentives to landlords were tried in France following the 2007 downturn with spectacular results. The share of investors in total new build purchases rose dramatically during the period of the temporary subsidies. This greatly contributed to the only modest fall in French housebuilding in contrast to the collapse that took place after 2007 in the UK.[44]

The current lacklustre state of the housing market would suggest that such a time-dependent scheme could still have a significant impact in UK in raising the current low demand for housebuilding. Moreover, it would have an impact in an area of the new housing market that is currently particular depressed outside of certain parts of London, apartment building in inner-city areas. Temporary diversion of some of the funds for the New Homes Bonus from local authorities in order to fund such schemes would limit additional Exchequer expenditure. Justification for this is

[43] M. Ball, *Large-Scale Investor Opportunities in Residential Property: An Overview.* Investment Property Forum, Research Findings, 2007.
[44] M. Ball, *RICS European Housing Review 2011.*

that it is not a lack of planning approvals that is holding back this type of brownfield housebuilding at present but a lack of demand.

As policy instruments, it would be possible to target residential capital allowances in both spatially and temporally. The inducement could be offered in short time windows. Spatially, it could be varied regionally or within city districts. For example, it could be used to kick-start housebuilding in hard pressed regional economies in northern England or the Midlands. To make such a programme work, local authorities would have to be sensible with regard to s106 and Community Infrastructure Levy demands.

d. VAT

Residential investors face the anomaly not experienced by most businesses that they bear the financial burden of VAT on their purchases because their product, rental housing services, is not VAT eligible. A simple solution to this tax conundrum would be to allow landlords to offset tax already paid through VAT against their annual tax liabilities.

Capital gains tax

Capital gains taxes on residential investments are now 18% within the basic rate band, and 28% for taxable incomes higher than £37,400 (including realised capital gains), above an annual allowable tax free amount. The tax free amount can be rolled over if it is not used up in any year. Unlike landlords, owner occupiers are exempt from CGT.

CGT is payable at the time of sale, so that there is currently a substantial, though hard to quantify, CGT liability locked up in the private rented sector. Its large size is influenced by the fact that most of the present rental stock was bought during or before the years of rapidly rising house prices up to 2007.

Capital gains taxes on UK rental housing are now the highest amongst those developed countries with large private rented sectors.[45] Many other countries have tapered arrangements that penalise quick sales but offer reduced rates for longer holding periods, which may go down to a zero liability after a specified number of years of ownership. The UK abandoned such a tapered approach itself. Some countries impose no CGT at all.

Apart from the fact that there is an imbalance between the treatment of residential investors and owner occupiers, there are a number of other issues related to CGT on residential investment property. Three of the most important are:

- *It raises the tax burden on rental housing* Part of the overall tax burden on private renting takes the form of CGT and, indirectly, this raises equilibrium rents and, so helps to make renting less attractive than owning.
- *Inflation* Capital gains are taxed in nominal rather than real terms. Therefore, as residential investments are typically held for long periods of time, a significant part of any capital gain may be due to general price inflation alone. In other words, part of the investors' original capital when revalued at today's prices is being wrongly treated as a 'capital gain' and taxed.

[45] Oxley, *ibid*.

- *Inflexibility* The need to pay CGT on sale incentivises landlords to hold onto properties longer than they would otherwise have done. This creates a series of difficulties. For example, potential management inefficiencies arise, because new owners may be more entrepreneurial with their recently acquired assets than ones still holding onto to them simply for tax reasons.

Furthermore, there is substantial churn of properties within the rental housing stock which is essential for the efficient functioning of the market. This churn is held back by CGT liabilities for two reasons: i) a desire to hold off of paying tax and ii) the inability to buy a like-for-like property because of the loss of capital through CGT, meaning that additional funds have to be added into the new purchase.

So, the responsiveness of landlords to changes in supply and demand is diminished by CGT. The extra rigidity spills over into the wider housing stock, given the existence of extensive trades between those in other tenures and private landlords. In turn, this compromises flexibility in residential renting. Because of that it lowers one of the key characteristics of a large and successful private rented sector, flexibility; a characteristic that generates substantial wider economic and social benefits.

Paradoxically, the design of CGT may even limit the short-term tax take, because of the reduction in stock turnover encouraged by it.

Options for CGT reform

1. *Abolition* This would bring the private rented sector into line with owner occupation. But it would be expensive.
2. *Introduction of tapered relief* The effectiveness of this approach depends on the rates at which the taper takes place. Its impact moreover varies depending on the overall scale of the tax, ranging from only imposing substantial CGT burdens on properties that are held for short times to a more general burden.
3. *Raise exemptions i)* Exemptions for the impact of general price inflation and ii) inflation plus a percentage of real house price change. Having higher exemptions levels would have the added benefit of raising the tax rate during house price booms to dampen herd-like behaviour.
4. *Rollover tax relief* Under this approach, CGT liabilities would be rolled over to new rental properties, so that liability would only occur when capital is withdrawn from private renting altogether.

Which tax reforms to choose?

There are a variety of pluses and minuses with regard to each of these proposals. The idea of a tax free net rental yield is most appealing for its simplicity and lack of distortionary effects. Capital allowances are a less attractive substitute, but could overcome the glaring inconsistency in tax practice.

With respect to CGT, reform needs to focus on its distortionary effects. Again, a higher exemption level with rollover relief would be the most appealing package.

Inclusion of private rental investment in tax efficient wrappers

Currently, residential property cannot be included in self invested pension plans (SIPPs). The justification for the exclusion is weak. Private rental investment is a savings option, as much as are financial assets. Moreover, the risk profile of residential investment is typically better than that of either equities or commercial property. Individuals should be able to search out the best returns across the whole range of potential assets. Inclusion of private rental investment in SIPPs on this criterion seems justified. It would also bring capital into the private rented sector with the concomitant spillover benefits to supply discussed above.

Conclusions

This chapter has explored some potential tax reforms with respect to the private rented sector.

Reform is needed for five reasons:

1. Without it, disinvestment in the private rented sector is likely to grow. The old flawed investment model of 'become a landlord to profit from continual house price rises' survived for a remarkably long-time but is now bust. A refocus of investment strategies onto rental yields requires reforms in regulation and taxes to make investment viable.
2. There are inconsistencies in taxation that lead to the taxing landlords' capital as well as the returns to their capital.
3. The UK is unique in taxing its private rented sector so highly. The burden of tax is especially unfair given the low tax treatment of other housing tenures and the social characteristics of tenants. The burden is also rising.
4. Lower taxes on landlords rapidly pass through to more housing supply and lower rents.
5. Useful micro and macroeconomic fiscal instruments are lost, especially as the evidence suggests that landlords react quickly to improved returns.

The proposals for reform highlight regulation in a general way and specific elements of the tax system. A series of options are suggested and to a degree the ones to adopt depend on detailed evaluations and political circumstances.

The preferred options are a non-taxed element of net rental yields and reforms to CGT that lessen anomalies and enable rollover in order to minimise distortions and encourage investment. Explicit recognition of depreciation through capital allowances is another option. Others are also discussed.

In the present economic and political circumstances, recommending tax reductions in general and specific tax breaks to landlords in particular does not seem like feasible policy analysis. However, the tax inefficiencies are so glaring and unfair. Moreover, simply to commit to stopping the tax burden rising further would be a good first step though more than that is required.

The analysis of this report suggests that behind all the hype there are serious worries about the future volumes of private rental investment. The revival of the private rented sector has been one of the great policy success stories of the past two decades and the resultant benefits have been varied and widespread. To jeopardise that through neglect seems a poor policy stance indeed.