The fall and decline of buy-to-let

Summary

The British continue to be obsessed with buy-to-let property, based on a simple narrative that provided the owner is covering his or her mortgage costs, all will be well, as house prices always rise. There is no doubt that many established buy-to-let landlords have made considerable money, but the past is not prologue. Without due care and attention to the rapidly falling profitability of buy-to-let property – not least due to recent tax reforms – newcomers and those with high loan-to-value mortgages risk getting their fingers burnt. Caveat emptor!

Client Communication

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'Short of attacking them with flame-throwers, or impaling them on stakes, it is hard to know what else the Bank and the government can throw at landlords.'

Daily Telegraph, 31st March 2016

The halcyon days of buy-to-let may well be behind us

The British continue their love affair with being buy-to-let landlords. After all, with bank deposit and mortgage rates so low, and a rapidly rising property market, it all seems so simple: take your cash and make a 20% down payment on a buy-to-let property and borrow the rest at a low rate of interest; then find a tenant – perhaps one of the younger generation who cannot afford to get on the housing ladder - who will pay rent in excess of the mortgage payments; and sit back. In 20 years' time – assuming you take out a repayment mortgage – you will own most, or all, of the property, which will hopefully have gone up in value (although in reality the majority of buy-to-let mortgages are interest only). What could go wrong? In short, a lot.

A perfect storm is brewing in buy-to-let land

The rise in house prices has been driven by a combination of factors including foreign capital inflows, a rising population, a lack of new housing stock, very low borrowing rates, increased competition amongst lenders forcing rates down, and increasingly loose lending terms. Great for those with seasoned buy-to-let portfolios, but bad for newcomers into the game. Unfortunately, for the newcomers – perhaps those taking advantage of the new pension freedoms, or simply exasperated by the paltry, sub-inflation returns from cash deposits - gross rental yields are now low across many parts of the country, at around 3% to 4%, as property prices have risen strongly. The bottom ten postcodes in the UK all have yields less than 2%, with Watford languishing at the bottom with gross rental yields of just 1.3%[1]. That is not a great starting point, and our guess is that many buy-to-renters buy in an area relatively local to them, rather than searching out yield hotspots, such as Bradford city centre, where yields are 9%, for some reason.

A cold wind blows from the Old Lady of Threadneedle Street

Unfortunately for buy-to-let landlords, the Bank of England has a keen eye on the buy-to-let market. In its recent Financial Stability Report[2], it cites a buy-to-let bubble bursting as a major risk to the UK economy. The Bank is concerned about the level and affordability of loans made by commercial banks and other lenders, which, at the end of last year, was creeping towards the pre-crisis peak. In its report, it noted that buy-to-let borrowers are more susceptible to rate rises than owner-occupiers; if mortgage rates rise by 3%, nearly 60% of buy-to-let mortgages taken out recently would be in breach of the 125% interest cover (rent/interest payments) used in 'affordability' tests. In a previous Financial Stability Report, the Bank suggested a more stringent test of 7% interest levels, which is about twice that of the current best rates.

And the Chancellor whips up a maelstrom

The Chancellor too has a particular interest in the buy-to-let market. First, he is very aware of the political consequences and social impact of young adults being unable to get onto the housing ladder, exacerbated by wealthy, middle-aged, multiple home owners afforded significant tax breaks, not least their ability to offset 100% of interest income, at their marginal rate of tax, against rental income. That is a generous perk that someone buying their own home is not afforded. Second, he too is aware of a potential bubble in this market and lower lending standards. Finally, he sees this as a ripe area for extracting greater tax revenues, when so much government spending is ring-fenced from cuts.

As a result, in successive budgets he has instigated a number of tax changes that fundamentally change the profit dynamics - and thus risks - to the buy-to-let investment proposition. The most

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1 '*Cash in on the UK's buy-to-let hotspots*' www.totallymoney.com provides an insightful graphic revealing the low rental yields across the UK, in general.

2 Bank of England Financial Stability Report, December 2015, issue No. 38.

fundamental change is that turnover, not profit, becomes the main focus of the tax regime. These measures include:

- A supplemental 3% duty has been applied to all bands of stamp duty (SDLT). As an example, a £350,000 property purchased before 6th April 2016 would have incurred an SDLT of £7,500. Today it is £18,000.
- Previously, landlords could automatically offset 10% of their rental income as costs. Going forwards, they will only be able to offset actual costs incurred.
- While landlords were previously able to offset all mortgage interest payments against rental income, from 2020/21, they will only be granted tax credit worth 20% of the interest cost to offset against income tax, irrespective of their marginal rate of tax. A transitional, hybrid regime exits in the interim, which is outlined in the worked example below.
- In the latest budget, the Chancellor reduced capital gains tax from 28% to 20% on most assets apart from property, which remains at 28%.

Table 1: The new tax regime will make a big difference

Tax Year	2016/17	2017/18	2018/19	2019/20	2020/21
Purchase costs	Today	Transition	Transition	Transition	New
Property value	£350,000				
Stamp duty (+3% on standard SDLT)	£18,000				
Professional fees + costs	£1,000				
Loan-to-value	80%				
Owner's deposit	£70,000				
Mortgage on property	£280,000				
Mortgage arrangement fee	£500				
Loan interest rate	3.5%	3.5%	3.5%	3.5%	3.5%
Owner's marginal tax rate	40%				
Rental yield %	4%				
Profit & loss					
Gross annual rental income received	£14,000	£14,000	£14,000	£14,000	£14,000
Less maintenance costs (actual)	-£1,400	-£1,400	-£1,400	-£1,400	-£1,400
Net rental income	£12,600	£12,600	£12,600	£12,600	£12,600
Mortgage interest	£9,800	£9,800	£9,800	£9,800	£9,800
Profit before tax	£2,800	£2,800	£2,800	£2,800	£2,800
Interest relief %	100%	75%	50%	25%	0%
Interest not deductible	£0	£2,450	£4,900	£7,350	£9,800
Taxable profit	£2,800	£5,250	£7,700	£10,150	£12,600
Tax chargeable	£1,120	£2,100	£3,080	£4,060	£5,040
Less 20% tax credit	£0	-£490	-£980	-£1,470	-£1,960
Tax owed	£1,120	£1,610	£2,100	£2,590	£3,080
Net profit after tax	£1,680	£1,190	£700	£210	-£280

This example provides insight into a previously profitable venture that becomes loss making, that will need to be bailed out down the line, either by higher rental yields or large property price rises, neither of which are certain. In this case, the difference due to the chancellor's new taxes is almost £2,000. It probably makes sense to model in the upfront costs of acquiring the property in the first place, including the impact of the now materially higher stamp duty. The table below adds a couple of extra lines into the example in the table above. It deducts the upfront costs apportioned (amortised) over 20 years. Over this period, the true maintenance costs (new roof, drive etc.) may well be more than the £1,400 provided for in the example, further exacerbating the challenge to profitability.

Table 2: The impact on profitability of upfront costs

Tax Year	2016/17	2017/18	2018/19	2019/20	2020/21
Net profit after tax (from Table 1)	£1,680	£1,190	£700	£210	-£280
Upfront costs amortised over 20 years	-£975	-£975	-£975	-£975	-£975
True annual profit	£705	£215	-£275	-£765	-£1,255

An icy chill from rising interest rates complete the storm

The 3.5% mortgage rate provided in the example above is realistic in today's market given the size and loan-to-value ratio used. It is likely interest rates will rise at some point, yet the timing and magnitude of these rises is uncertain. In the next table we run a rising interest rate scenario, where interest rates rise by a half of one percent every 2 years. The results are not pretty.

Table 3: The impact of a 0.5% rise in interest every two years

Tax Year	2016/17	2017/18	2018/19	2019/20	2020/21
Mortgage Interest rate	3.5%	3.5%	4.0%	4.0%	4.5%
Net profit after tax	£1,680	£1,190	-£280	-£840	-£2,520

This represents a swing of £4,200 between today and 2020/21. Taking into account the amortised upfront costs, the total true annual loss in 2020 would £3,495.

At this marginally higher level of interest, buy-to-let looks unattractive. For those readers old enough to remember the early 1990s, interest rates rose to above 14% in response to high inflation and property prices crashed. So the Bank of England's 7% test is not as extreme as younger investors might believe, who have only experienced low interest rates since the Credit Crisis.

Somewhat alarmingly, in the Bank of England's report, they refer to recent research that suggests that 15% of buy-to-let investors would sell their properties if the mortgage payments were no longer covered by the rental income. It would be interesting to know if investors begin to think not on an interest cover but on a profitability basis, given the Chancellor's new tax regime. If so, this scenario is probably nearer than one might imagine. According to the report, 45% would be '*inclined to sell*' if house prices fall by 10%.

House prices do go down as well as up. Take a look at the table below, which sets out the five largest falls in house prices since the Halifax Property Index began in January 1983. It makes sobering reading for those under the illusion that never-ending house price rises are the norm.

Table 4: House prices can go down as well as up – after inflation falls

	Peak date	Decline	Trough date	Recovery date	Decline (m)	Recovery (m)
Worst	Aug-07	-26%	Oct-12	Jan-16	63	39
2nd worst	Apr-89	-25%	Aug-95	Jan-00	77	53
3rd worst	Feb-00	-3%	Jun-00	Sep-00	5	3
4th worst	Dec-06	-2%	Dec-06	Jan-07	1	1
5th worst	Dec-02	-2%	Dec-02	Feb-03	1	2

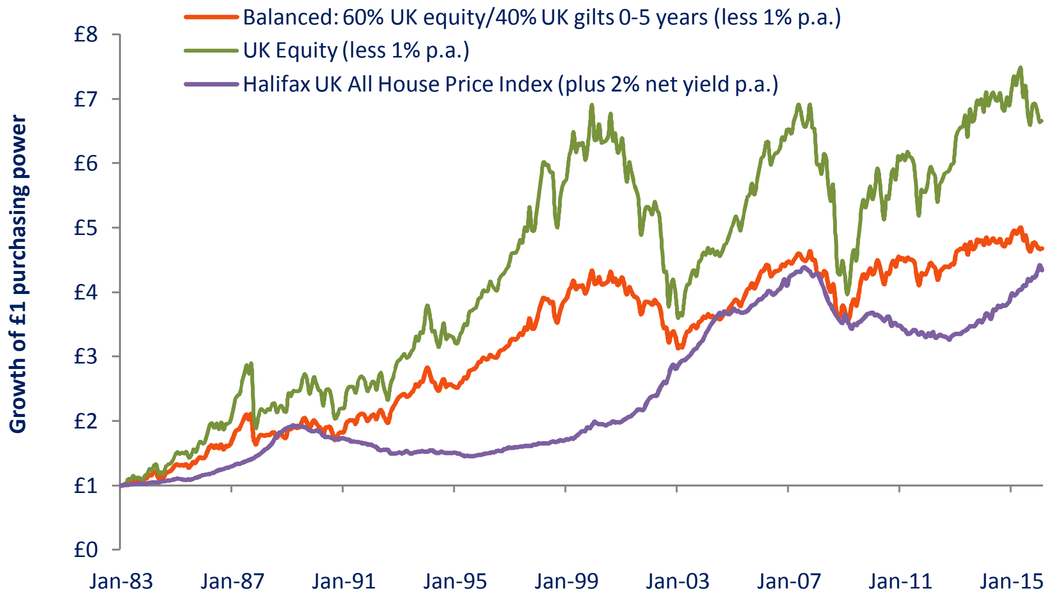
Source: Halifax UK All House Price Index – Jan 1983 to March 2016 from FE Analytics © All rights reserved.

Don't bank on year-on-year price rises.

House price rises are nothing special, it's the borrowing that matters

The reality is that house price rises (with no borrowing) are nothing special, in the broader investment arena. Take a look at the chart below that compares Halifax UK All House Price Index with other asset classes. Even adding in a (generous) net yield of 2% reveals an asset class that fails to beat a basic balanced portfolio combining bonds and equities.

Figure 1: Buy-to-let with no borrowing vs. traditional investment strategies



Data source: Morningstar. All rights reserved 2016. Note: UK equities = FTSE All Share Index (dividends reinvested), Balanced = 60% FTSE All Share, 40% FTSE Government 0-5 Gilts Index. Costs of 1% have been deducted from the traditional portfolios and portfolios were rebalanced back to the original mix once a year.

It is borrowing that has made many buy-to-let owners wealthy in rising markets, but it cuts both ways. Ironically, well-diversified investors who want to borrow against a portfolio would be lucky to be able to borrow 50p in every pound, yet with property one can borrow five to ten times the equity in it. The annual profit buffers that existed in the past have now been stripped away by the Chancellor, which, combined with the potential for rising interest rates at some point, and the risk of falling house prices, add up to a perfect storm, particularly for newer investors who have high levels of borrowing.

A final word

It is worth thinking about what buy-to-let really is. The perception that it is a small step from cash to buy-to-let is extremely naive. In reality, it is leaping from one end of the risk spectrum to the other, particularly if an investor is borrowing heavily to buy the property. When individuals enter the buy-to-let market in this way, they are in fact starting a very highly geared business with all the costs, tax, reporting issues and risks that go with the territory. The numbers provided in Table 1 above highlight a new challenge: zero (or less) net return after tax that demands that house prices must rise to win. A leveraged strategy based on a wing and a prayer is dangerous territory.

Investors who go into the buy-to-let market without anything more than a naïve set of gross yield numbers, basic mortgage cost estimates and the hope of rising house prices, may not get the sort of outcome they are hoping for. Let the buy-to-let landlord beware.

Other notes and risk warnings

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