

Bradford & Bingley[▲]

Myths about the Buy-to-Let market

mortgage express

Myths about the Buy-to-Let market

Executive summary

The phenomenal growth of the Buy-to-Let market has been well documented. The first Buy-to-Let mortgage was offered in 1996, and now, only a decade later, there are more than three quarters of a million Buy-to-Let mortgages in the UK, worth over £90bn.

This revolution has brought with it vast benefits for the housing market and for the economy. There has been a huge improvement in the quality and availability of rented accommodation. And the ownership of this property, previously the province of companies, institutions and specialist investors, has spread to a huge range of people from all walks of life. At a time when people are being urged to save more, hundreds of thousands of people are investing for their futures through Buy-to-Let.

This should be celebrated as a resounding success story. And yet the public perception of Buy-to-Let is not always positive. The Buy-to-Let market and its wider impact are widely misunderstood.

At Bradford and Bingley we have unparalleled experience of the Buy-to-Let market. Through Mortgage Express, our specialist lending arm, we were pioneers of Buy-to-Let in 1996. And we remain the leading Buy-to-Let lender in the UK. This report seeks to address and rebuff, with evidence, a number of commonly held misperceptions about Buy-to-Let.

The benefits of Buy-to-Let to the housing market and the economy over the last ten years have been enormous:

- ▷ Increased competition among landlords has greatly improved the quality of rental accommodation.
- ▷ The economy has benefited from increased efficiency and liquidity in the housing market.
- ▷ Social and demographic factors have increased demand for rental accommodation. Buy-to-Let has addressed this demand in the most flexible and efficient way possible.
- ▷ Buy-to-Let offers a secure investment with favourable long-term returns. Many people are using it to provide for their retirement.

Myth 1 “The Buy-to-Let market is a bubble waiting to burst.”

As long ago as 2001, when the market was a small fraction of its current size, commentators were describing Buy-to-Let as a bubble. The evidence suggests, by contrast, that the market is stable and robust, and that there is considerable room for growth in the future.

Demand for private rental property is strong and will remain so

- ▷ Immigration has been rising [See Figure 1] and the combined effects of globalisation and further EU expansion means that this is likely to continue. This will continue to contribute to demand for rented accommodation.
- ▷ The student population, which traditionally provides a significant pool of potential tenants, is growing [See Figure 2]. The Government’s strategic target for students in tertiary education is 50% by 2010, which has led to an increase of 25% in student numbers since 1998, to 2.5 million.
- ▷ The number of households is increasing, as average household size gets smaller, due to lifestyle changes, divorce, later marriage and other factors. Figure 3 shows the decline in average household size from 2.65 in 1981 to 2.30 today. This decline is expected to continue (to 2.10 in 2026).

The growth of Buy-to-Let is really just a shift in the ownership and financing of the private rental sector, which is still under-mortgaged

- ▷ The private rental sector has only grown marginally as a proportion of UK housing, mainly as a result of a shift from the social rented sector [See Figure 4].
- ▷ Buy-to-Let still only represents a minority of the private rental sector. According to a study by Professor Michael Ball of the University of Reading, only 30% of private rented accommodation has Buy-to-Let borrowing secured against it.
- ▷ The overall loan-to-value ratio (outstanding mortgage as a percentage of property value) of the entire private rental sector is only 24%.
- ▷ Buy-to-Let investors have taken up the slack from large property companies and institutions which have been selling their assets and leaving the sector.

Buy-to-Let investors are motivated by the desire for long term capital gain. In a downturn, they would be unlikely to abandon the market

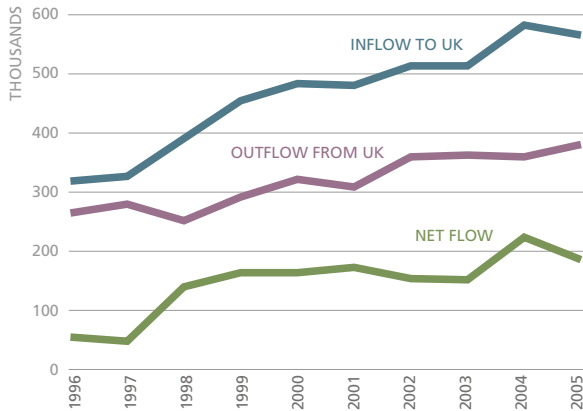
- ▷ The majority of Buy-to-Let investors are motivated by long term objectives [See Figure 5 on page 4].
- ▷ They are therefore likely to ride out cyclical fluctuation in house prices, with a view to realising their capital gain at a time when they can maximise their return.
- ▷ It is highly unlikely that demand for rental accommodation would reduce in a downturn, so landlords would be able to earn income to cover mortgage payments while waiting for house prices to recover.
- ▷ Only 1.5% of investors said they would sell if property prices fall, according to a recent survey by ARLA (the Association of Residential Lending Agents).

Where an excess of rental properties develops in a particular area, this is corrected at a local level

- ▷ As with any market, there are instances of local over-supply, where there are more properties than available tenants.
- ▷ But, even after the significant growth in Buy-to-Let, tenant demand is up and void periods, where landlords cannot let out properties, are down (see page 5).
- ▷ The market corrects over-supply at a local level: Buy-to-Let landlords sell up, and buy elsewhere. It would be extremely difficult for a widespread, national over-supply to develop.

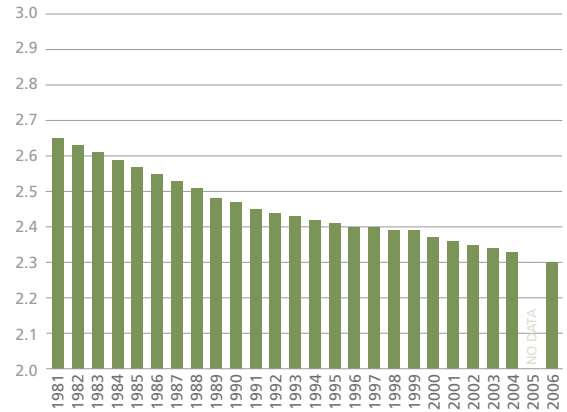
Myths about the Buy-to-Let market

Figure 1:
International migration



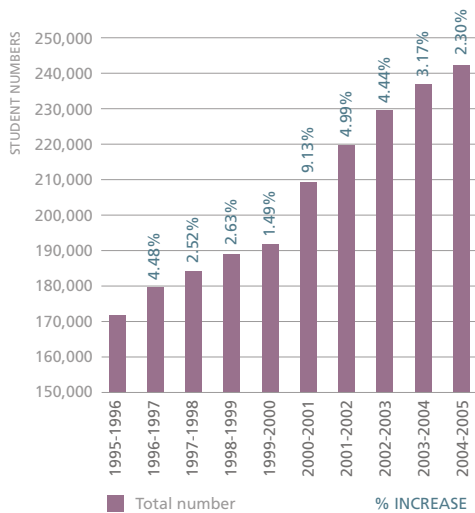
Source: Office of National Statistics, 2006.

Figure 3:
Average UK household size



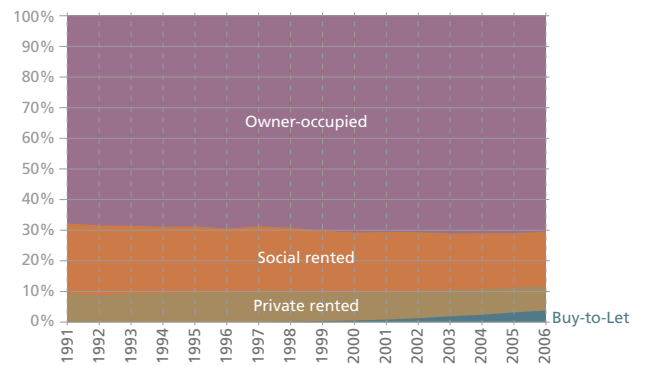
Source: Communities and Local Government, 2006.

Figure 2:
Number of students in higher education.



Source: Higher Education Statistics Agency.

Figure 4:
UK housing by tenure



Source: Communities and Local Government, CML, 2006.

Myth 2 “Buy-to-Let investors are mostly speculators looking to make a quick return by buying up city-centre new build apartments.”

The exceptional growth in Buy-to-Let over the last decade has prompted some critics to assert that investors are piling into the market to benefit from quick returns. In fact, Buy-to-Let landlords overwhelmingly declare that their involvement is for the long term.

Investors are committed for the long term

- ▷ According to our recent survey, 38% of investors buy investment properties as a pension nest egg and 34% are looking for long-term capital growth [See Figure 5].
- ▷ More than half of Buy-to-Let landlords have been in the market for five years or more [See Figure 6].
- ▷ Buy-to-Let lenders usually experience better mortgage retention on Buy-to-Let than on standard residential loans.

The economics of property investment favour a long-term approach

- ▷ Ever-increasing transaction costs (stamp duty, legal fees, estate agency fees etc.) make it very difficult for speculators to realise short-term returns.
- ▷ There are tax benefits to holding assets for the longer term (non-business taper relief on Capital Gains Tax applies).

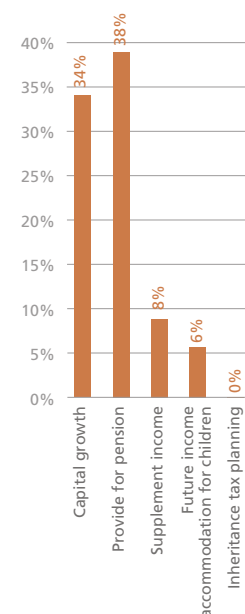
Buy-to-Let landlords cannot be stereotyped. They are a diverse group from all walks of life, investing in their future through property

- ▷ Only 8% of landlords surveyed are full-time professional landlords. The rest are either employed by somebody else (49%), self-employed (31%) or retired (7%).
- ▷ Of these, just 26% describe themselves as working in higher managerial or professional jobs, and 18% work in clerical or administrative jobs, or are manual workers.
- ▷ Landlords who are employed work in all kinds of sectors, including 11% in the public sector, and 11% in service industries, such as electricians, plumbers, carpenters, hairdressers and cleaners.

New build city-centre apartments represent only a tiny fraction of the Buy-to-Let market

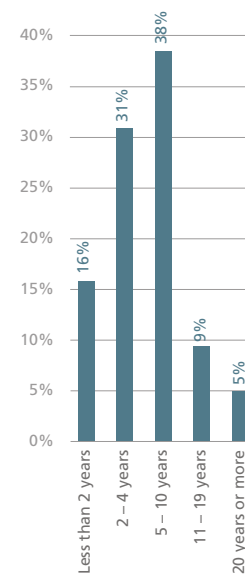
- ▷ Most Buy-to-Let properties are houses in residential, suburban and rural areas.
- ▷ Around 60% of our Buy-to-Let lending is on houses (mostly terraced or semi-detached).
- ▷ Of the 40% that are flats, apartments or maisonettes, only a small proportion are new builds, and an even smaller proportion in city centres.
- ▷ Professor Michael Ball of the University of Reading estimated in 2006 that as little as 1% of the Buy-to-Let market was in city-centre new builds.

Figure 5: Reasons for investing in Buy-to-Let



Source: Mortgage Express BTL Survey, 2006.

Figure 6: Length of time in Buy-to-Let market



Source: Mortgage Express BTL Survey, 2006.

Myth 3 “There are no longer adequate returns to be made from Buy-to-Let.”

Rental yields in the UK have fallen over the last few years. This has led some commentators to argue that Buy-to-Let investors can no longer get a decent return. In reality, the decline in yields is just a reflection of the increasing efficiency of the market. Buy-to-Let investors are more interested in capital growth than they are in net income. Experienced landlords, who understand the returns they can get, are coming back for more.

Landlords are primarily interested in capital gains, not in income

- ▷ Only 8% of landlords say they invest in property to supplement their income [See Figure 5 on page 4]. Most landlords are happy so long as there is enough rental income to cover the mortgage payments and any other costs.

Even with declining rental yields, there are still plenty of properties available with yields that are more than enough to cover mortgage payments

- ▷ According to specialist lender Paragon, the average gross rental yield in the UK in December 06 was 6%. With discounted mortgages available below 5.5%, there is still surplus rental income available. Note that investors only pay interest on the amount they borrow (usually 85% or less), not the full value of the property.

Experienced landlords want to grow their portfolios

- ▷ The people who know the most about the returns available from Buy-to-Let are existing landlords, who are increasingly experienced (see page 4).
- ▷ These landlords are more confident than ever in their ability to get a good return. In our latest survey [See Figure 7], 55% of landlords expressed an intention to increase their portfolio in the next 6 months, 40% intended to maintain their portfolio, and only 3% to decrease it.

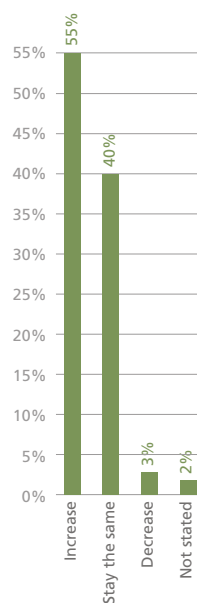
Borrowing enhances the returns available to investors

- ▷ A landlord with, for example, £25,000 to invest can use the funds for a deposit on a Buy-to-Let property worth £150,000.
- ▷ If the value of the property increases, this gearing significantly enhances the landlord's return on his or her initial £25,000 investment.
- ▷ A landlord with good local knowledge is well equipped to identify the right property, buy at the right price, and keep costs down to deliver an excellent return.

The growth of Buy-to-Let has not led to a surplus of rental properties: the rental sector is in excellent health

- ▷ ARLA reports that the proportion of letting agents saying that there were more tenants than properties at the end of 2006 was at its highest level since they launched their survey in 2002 [See Figure 8].
- ▷ The average annual void period (where landlords are unable to let a property) has fallen steadily over the last three years, according to ARLA, from 4.4 weeks in 2003 to 3.6 weeks at the end of 2006.

Figure 7: Plans for portfolio in next six months



Source: Mortgage Express BTL Survey, 2006.

Figure 8: Tenant demand



Source: ARLA, 2006.

Myth 4 “Buy-to-Let is fuelling house price growth and squeezing first-time buyers out of the market.”

The most commonly heard complaint about Buy-to-Let is that investors are keeping first-time buyers out of the market. This view is fuelled mainly by the general difficulty first-time buyers are facing in getting onto the property ladder. The real underlying issue is high house prices, which have been caused by other factors: an excess of demand for housing over supply and historically low interest rates.

The number of households is growing much faster than new houses are being built

- ▷ According to the 2001 census, the formation of new households in 2001 was 179,000, yet only 134,000 new homes were built – the lowest level since the Second World War.
- ▷ The government has acknowledged that this is a problem, and the Barker review of housing supply, commissioned by the Chancellor and the Deputy Prime Minister, highlighted a chronic shortfall in new house building in the UK.
- ▷ The number of households has been increasing (see page 3), driving further demand for housing.

House price inflation has also been driven by historically low interest rates

- ▷ For the last decade or more we have been in an environment of structurally low interest rates [See Figure 9].
- ▷ The low interest rates, leading to low mortgage rates, have enabled people to borrow more, and therefore spend more on property.

Prices are driven by supply and demand

- ▷ If demand for houses exceeds supply, and if all types of potential buyer are able to borrow more, house prices will rise. Tenure is irrelevant – it does not matter who owns the property, or whether the owner lives there.
- ▷ In fact, Buy-to-Let investors provide a very useful service to potential first-time buyers who cannot yet afford to buy, by providing high quality, good value rental accommodation.

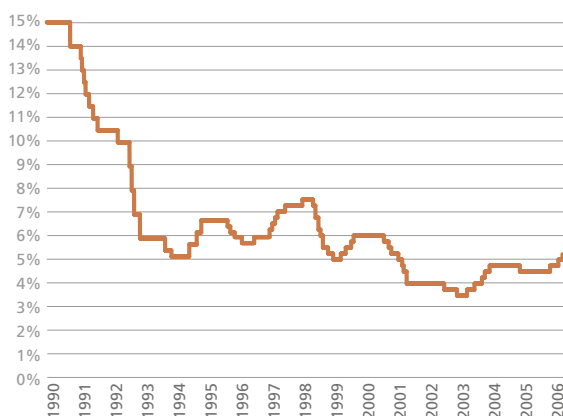
Buy-to-Let investors are just one set of buyers among many in the market. They cannot afford to overpay for a property

- ▷ Buy-to-Let only represents around 10% of new lending in the mortgage market.
- ▷ Buy-to-Let investors are constrained in how much they can pay for a property, first by the need to generate sufficient rental income to cover the mortgage payments...
- ▷ ...and second by their need for a good capital gain. 66% of landlords in our survey cited purchase price as the main factor when choosing a property.

However, it could be argued that Buy-to-Let has acted as a stabilising influence on the housing market

- ▷ Investors see opportunities to buy at times when the housing market is soft.
- ▷ Their focus on the longer term, and the relative stability of the rental market, means that their behaviour may be less volatile than that of owner-occupiers.
- ▷ Therefore, if Buy-to-Let has had an impact on house prices, it is in preventing a significant fall rather than backing excessive house price inflation.

Figure 9:
UK bank base rate



Source: Bank of England, January 2006.

Buy-to-Let is here to stay

The rise of Buy-to-Let has had a profound effect on the UK housing and mortgage market. It has contributed to the private rental sector's regeneration, raising the standard of living conditions and providing a realistic alternative to home ownership for those who want flexibility when it comes to choosing accommodation.

It has provided a means of long-term investment for a wide range of people from all walks of life. At a time when many are not saving enough for their retirement and have lost faith in more traditional forms of investment, this should be celebrated.

And there is still plenty of room for growth. Demand for rental accommodation will continue to increase. The private rental sector will continue its shift towards Buy-to-Let financing. And investors will continue to see property as a good long-term bet.

Despite misperceptions about the market, the evidence suggests that the Buy-to-Let sector is stable, robust and in very healthy shape.

Gus Park

Head of Buy-to-Let
Bradford & Bingley Group

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