# The Revival of Private Residential Landlordism in Britain through the Prism of Changing Returns

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# Introduction

- Private landlordism in Britain began a revival from the turn of the millennium.
- This was caused by the removal of regulation of the sector and the arrival of buy to let (BTL) mortgages in 1996.
- The number of BTL landlords expanded dramatically in the property boom of the noughties, supported by high debt gearing and a favourable tax position.
- The dynamic and rapid development of PRS in Britain cannot be understood in isolation to the financial rewards from the sector
- This paper focuses on the financial consequences for PRS sector.

| Year | Number of Mortgage Loans Outstanding | Number of Mortgage Loans for Purchase |
|---|---|---|
| 1998 | 28,700 | |
| 1999 | 73,200 | 44,400 |
| 2000 | 120,300 | 48,400 |
| 2001 | 185,000 | 72,200 |
| 2002 | 275,500 | 85,030 |
| 2003 | 417,500 | 117,120 |
| 2004 | 576,700 | 143,870 |
| 2005 | 699,400 | 120,460 |
| 2006 | 835,900 | 170,830 |
| 2007 | 1,025,500 | 183,300 |
| 2008 | 1,156,200 | 102,810 |
| 2009 | 1,234,800 | 52,740 |
| 2010 | 1,304,400 | 53,650 |
| 2011 | 1,383,900 | 65,500 |

**BTL Mortgages in the UK 1998-2011**
**Source:** Council for Mortgage Lenders

# The Scope

1. Paper looks at the financial underpinnings of how the revival of the PRS occurred by exploring **average landlords' historical return since 1996**.

2. Explores **impact of gearing on landlords' return**. 75% of BTL mortgage loans are ***interest only*** and benefit most from tax relief. ***Outright*** acquisitions have increased in popularity but are they financially rational? Can they provide reasonable returns compared to geared investments.

3. Explores effect of **landlords' tax rates.** Ownership of more than one property in the BTL market has increased over time with tax implications

4. Explores likely impact of **new unfavourable package of tax measures** on viability of the PRS

# Methodology

- Calculate internal rate of return (IRR) using financial model to simulate average landlord investing in every year over the period from 1996 to 2015 in eleven regions in Britain (cases).
- Total financial simulations is 3025
- Model estimates cash initial outlay and produces the stream of net cash flows related to each case over its holding period.
- To calculate the IRR, final net cash flow must account for the proceeds from the sale of property, the repayment of outstanding debt and any transaction costs.
- IRR is calculated as at either 2007 (peak of housing cycle) or 2018.
- To illustrate, if a landlord purchased in 2000, the study calculates the IRR for the periods from 2000 to 2007 and IRR for the period from 2000 to 2018.
- IRRs compared with the equivalent returns obtained from FTSE 250 index

# Financial Simulation: Example

IRR as at 2018 for a landlord who pays basic tax rate and invests in London in 1996 via a 90% - LTV interest-only mortgage

| Year | Initial outlay / proceeds from sale | Mortgage closing payment | Maintenance & insurance costs | Rental income | Letting, management and void costs | Mortgage repayments | Income taxes | Net cash flows |
|---|---|---|---|---|---|---|---|---|
| 1996 | -10,704 | | | | | | | -10,704 |
| 1997 | 0 | 0 | -435 | 8,735 | -1,223 | -4,121 | -680 | 2,276 |
| 1998 | 0 | 0 | -450 | 8,903 | -1,246 | -4,798 | -554 | 1,855 |
| 1999 | 0 | 0 | -456 | 9,074 | -1,270 | -4,615 | -628 | 2,104 |
| 2000 | 0 | 0 | -470 | 9,248 | -1,295 | -4,318 | -696 | 2,469 |
| 2001 | 0 | 0 | -479 | 9,426 | -1,320 | -4,490 | -690 | 2,447 |
| 2002 | 0 | 0 | -487 | 9,607 | -1,345 | -4,074 | -814 | 2,886 |
| 2003 | 0 | 0 | -501 | 9,791 | -1,371 | -3,412 | -992 | 3,516 |
| 2004 | 0 | 0 | -516 | 9,979 | -1,397 | -3,140 | -1,084 | 3,843 |
| 2005 | 0 | 0 | -530 | 10,171 | -1,424 | -3,343 | -1,072 | 3,801 |
| 2006 | 0 | 0 | -547 | 10,366 | -1,451 | -3,459 | -1,080 | 3,828 |
| 2007 | 0 | 0 | -571 | 10,565 | -1,479 | -3,389 | -1,128 | 3,998 |
| 2008 | 0 | 0 | -594 | 10,768 | -1,508 | -3,665 | -1,000 | 4,001 |
| 2009 | 0 | 0 | -591 | 10,975 | -1,536 | -3,609 | -1,048 | 4,191 |
| 2010 | 0 | 0 | -618 | 11,186 | -1,566 | -2,347 | -1,331 | 5,323 |
| 2011 | 0 | 0 | -650 | 11,400 | -1,596 | -2,279 | -1,375 | 5,500 |
| 2012 | 0 | 0 | -650 | 11,619 | -1,627 | -2,172 | -1,434 | 5,737 |
| 2013 | 0 | 0 | -650 | 11,842 | -1,658 | -2,526 | -1,402 | 5,607 |
| 2014 | 0 | 0 | -666 | 12,070 | -1,690 | -1,896 | -1,564 | 6,255 |
| 2015 | 0 | 0 | -672 | 12,302 | -1,722 | -1,732 | -1,635 | 6,540 |
| 2016 | 0 | 0 | -684 | 12,538 | -1,755 | -1,587 | -1,702 | 6,809 |
| 2017 | 0 | 0 | -709 | 12,779 | -1,789 | -1,366 | -1,783 | 7,132 |
| 2018 | 415,606 | -63,301 | -732 | 13,024 | -1,823 | -1,499 | -1,794 | 359,481 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | | | | | | | IRR | 28% |

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# Scenarios

Overall, there are main six actual scenarios based on the **landlords' tax rate** and **type of finance**:

1. **Basic tax and decreasing-balance mortgage (this is the base case scenario -BCS)**
2. Basic tax and interest-only mortgage
3. Basic tax and outright purchase
4. Higher tax and decreasing balance mortgage
5. Higher tax and interest-only mortgage
6. Higher tax and outright purchase

The following scenarios examine the consequences of the new tax regime assessing its impact if had been introduced in 1996 (**backdated scenarios**) for the above six scenarios.

1. Basic tax and decreasing balance mortgage **backdated**
2. Basic tax and interest-only mortgage **backdated**
3. Basic tax and outright purchase **backdated**
4. Higher tax and decreasing balance mortgage **backdated**
5. Higher tax and interest-only mortgagee **backdated**
6. Higher tax and outright purchase **backdated**

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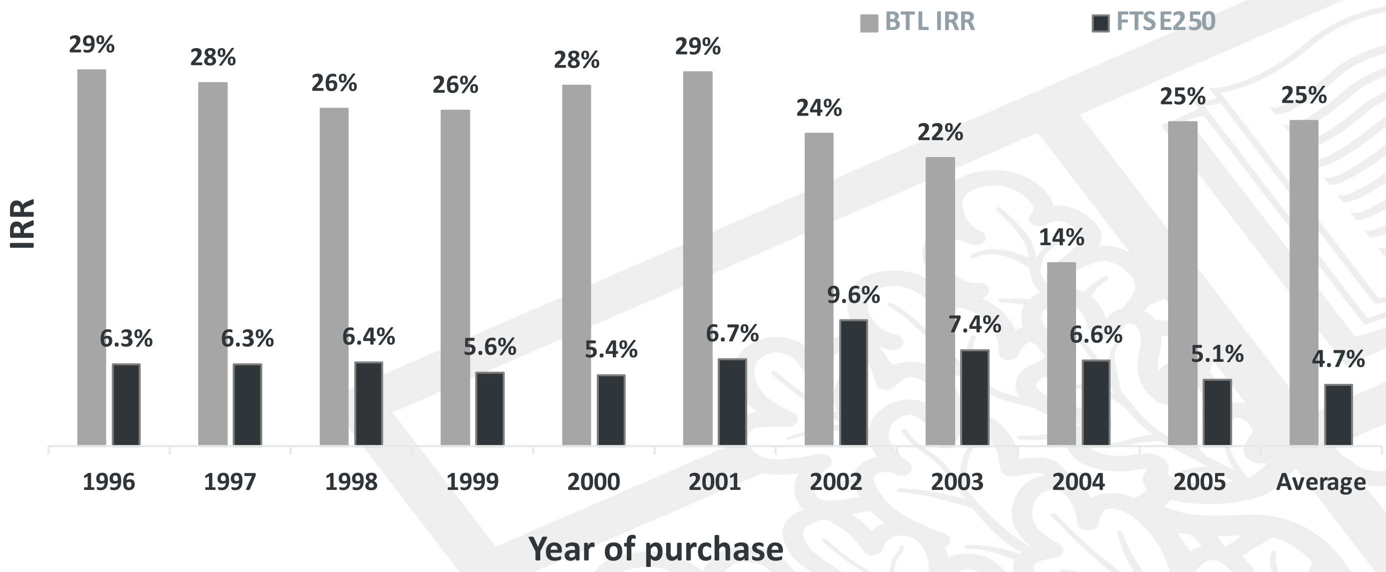
# Results: Early Birds - investing before GFC




IRR as at 2007 for every year of purchase from 1996 to 2005

- Evidence that early strong momentum in BTL market was sustained by extraordinary perceived financial rewards.
- Explains the increase in number of both landlords and properties owned per landlord during this period.

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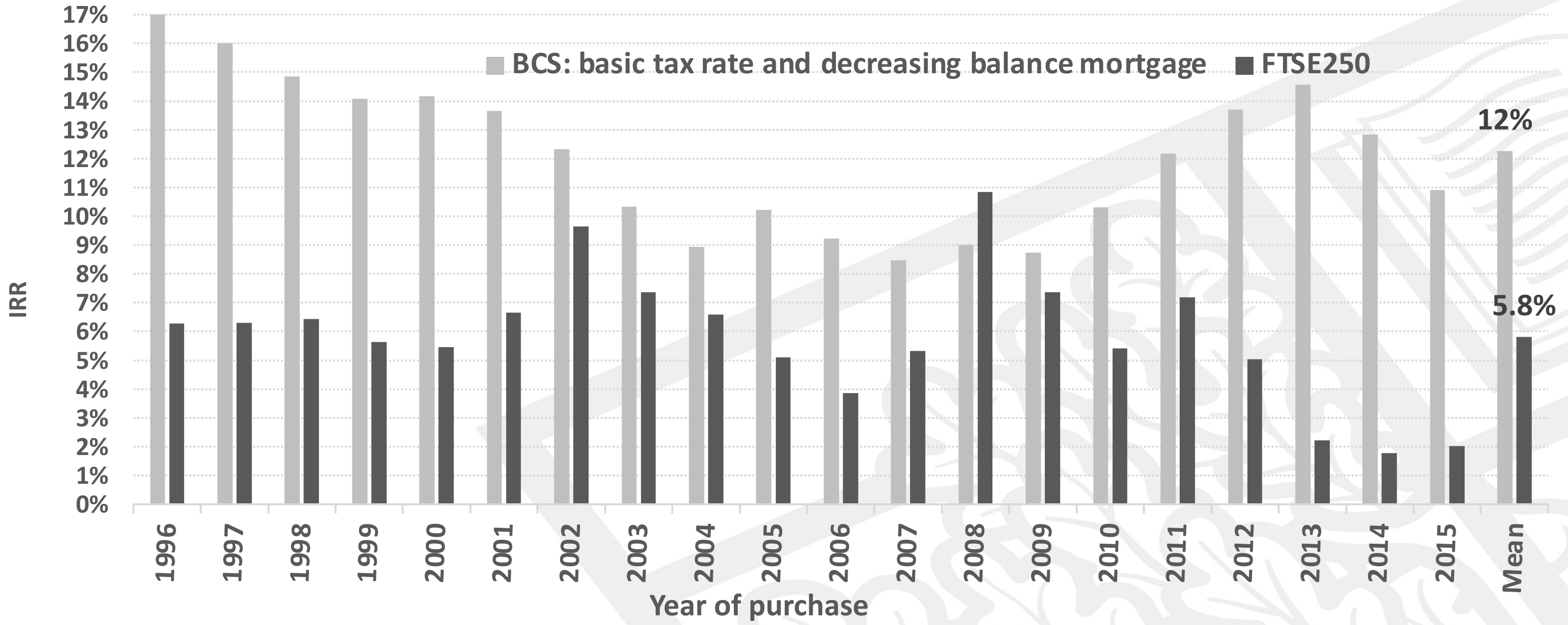
# Results: Base-Case Scenario (BCS)



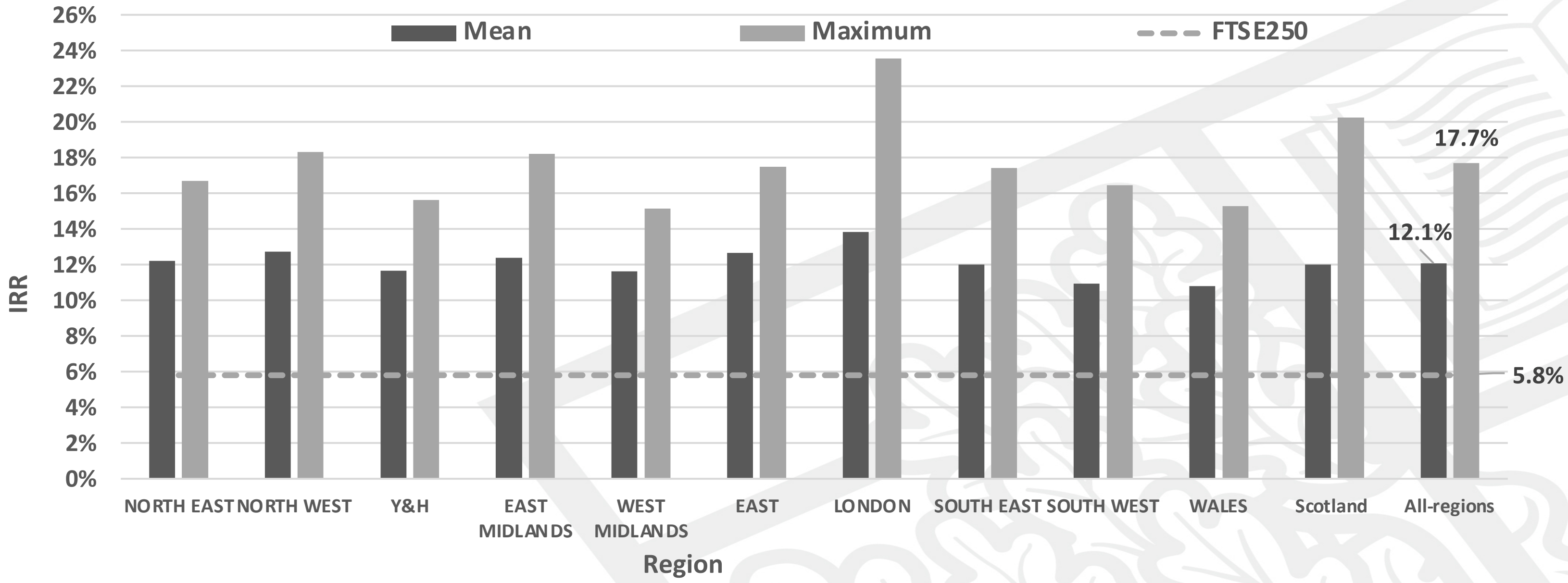

**BCS IRR as at 2018 for every year of purchase 1996-2015 compared with IRR from the FTSE 250**

- Figure shows a general trend of higher returns from investing in the rental market than the equity market except for those who invested in the equity market in 2008, immediately after equity market crash caused by the GFC.

- Average IRR is 12% against 5.8% achieved in the stock market.

- Clear cyclical pattern to returns. Lowest average IRRs (between 8% and 9%) at or shortly before the peak in 2007.

# Results: BCS / Regional Effect




**BCS Average and maximum IRR per region (over the period from 1996 to 2015) compared with FTSE 250**

- London outperformed all other regions in terms of both average and maximum IRR.
- Other regions remained within the average except SW and Wales with 11% and 10.8%, respectively.
- Scotland came second in max IRR (20%) while East and NW came second in average IRR (12.7%).

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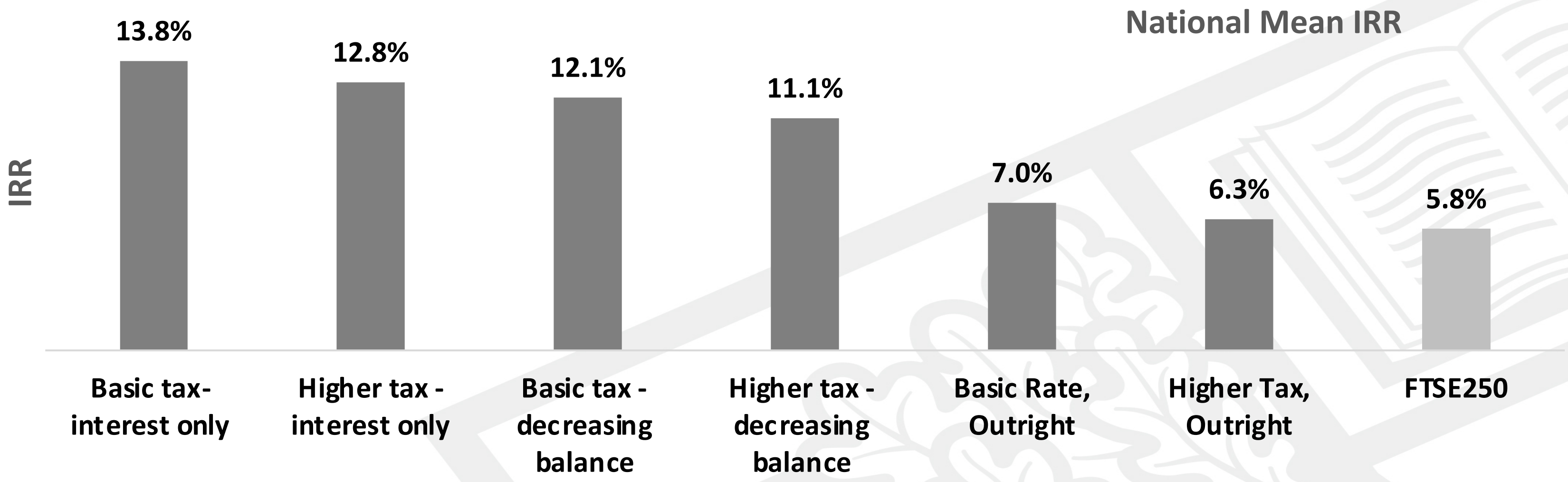
# Results: Other Scenarios




**National mean IRR as at 2018 (the average of 220 cases per scenario) from 1996-2015 compared with IRR from the FTSE 250**

- When **mortgage** is used, the IRRs range between 11.1% and 13.8% against 5.8% for FTSE 250.
- When owning **outright**, the return is slightly higher than FTSE 250's return and remains between 6.3% - 7%.
- **The best scenario:** landlords who pay **basic tax rate** and use **interest-only** mortgages.
- **The worst scenario:** landlords who pay **higher tax rate** and own their properties **outright**.

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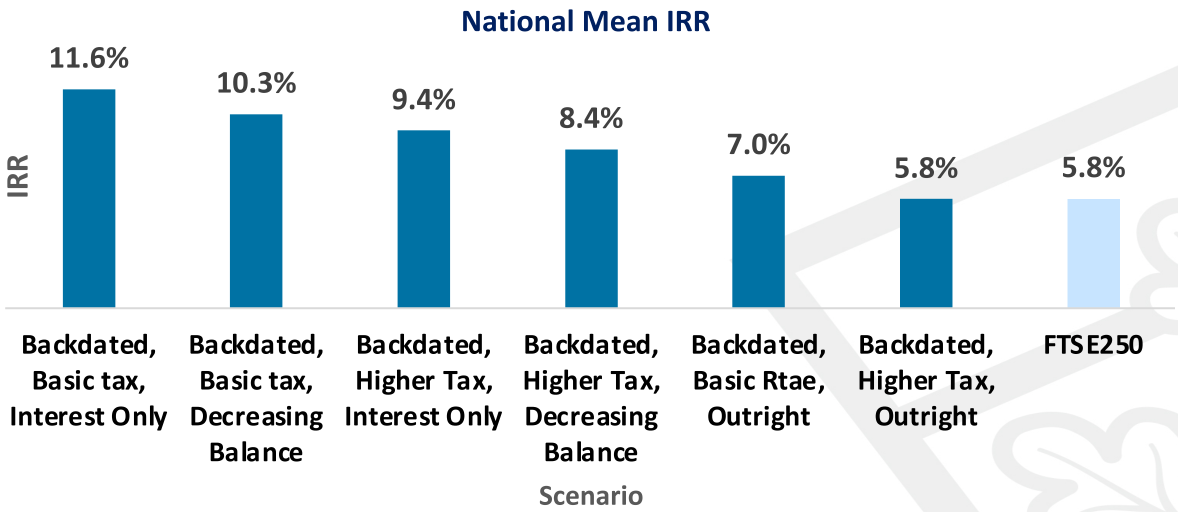
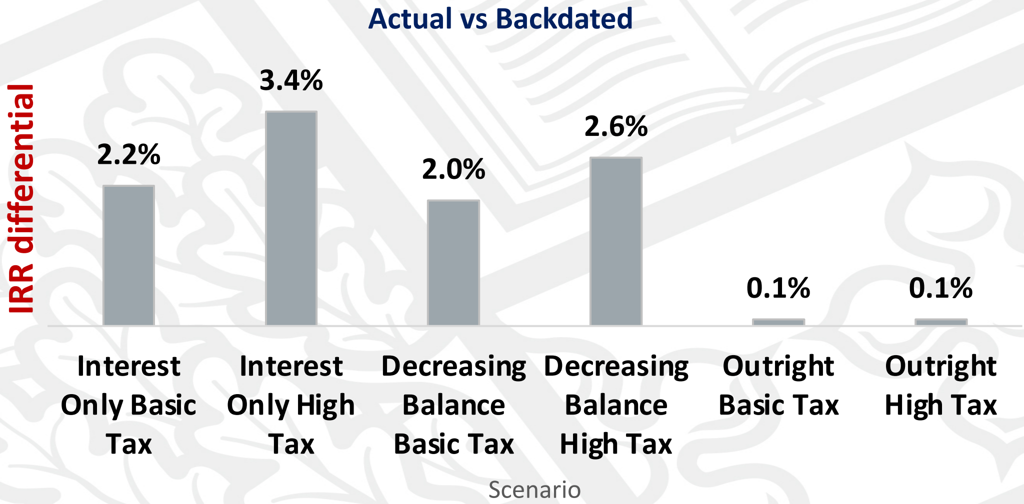
# Effect of Recent Tax Changes (Backdated Scenarios)

The study runs six ‘backdated’ scenarios by assuming all recent restrictive tax changes (interest tax relief in 2017 and stamp duty taxes in 2016), had taken place since the inception of BTL in 1996.




- When **mortgage** is used the IRRs fall by 2.0%-3.4%, still significantly high at **8.4%-11.6%** vs FTSE250
- When buying **outright**, the IRRs remain marginally higher or equal to FTSE 250’s return
- The impact of new tax measures on outright scenarios is almost nil.

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# Conclusions

- The early spectacular growth in the BTL market over the housing boom (1996-2006) was stimulated and sustained by very attractive perceived financial return (with an average IRR of 25%) that substantially exceeded the FTSE 250's average return of 4.7%.
- More than a decade on from the GFC the returns from the sector have fallen away but are still sufficient to ensure continuity of investment, and the PRS is approaching maturity.
- Over the entire study period (1996-2015) the returns have continued to be attractive in every region of Britain. Average IRR stood at 12% versus 5.8% from the FTSE 250, thanks to the tax relief package provided to Landlords.
- Owning vis mortgages maximises wealth while outright owning proved to be irrational financing decision.
- The introduction of recent restrictive tax measures is expected to reduce the landlords' expected returns **BUT** is not likely to change the game in the BTL market.
- It is useful to note that the anatomy of the sector is changing. **Institutions** are beginning to show an interest in the sector and **short-term letting platforms such as AIRNB** are making inroads at the top end and tourist areas.

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