

UK buy-to-let market report

Executive summary

The buy to let market has become a significant part of the private rental market over the past ten years. The outlook for the sector remains positive, with signs that the market will continue to expand as demand for private rental accommodation remains strong.

Key trends

- **The buy to let sector has been a key source of overall growth in the private housing stock.** The buy to let sector has grown rapidly since the late 1990s and now accounts for 7% of the total volume of mortgages outstanding.

- **Growth in average capital asset value of rented houses remains strong.** Although the rate of growth has eased over the last few years, robust growth in house prices has underpinned solid growth in the average capital asset value of rented houses

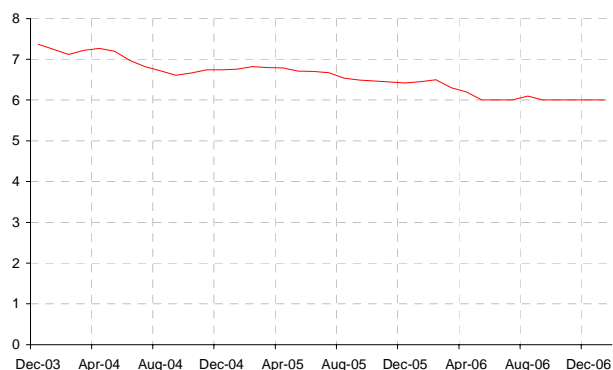
- **Recent increases in interest rates place downward pressure on rental yields.** Data collected by Paragon shows that rental yields have remained relatively static over the past 18 months. The RICS survey suggests that while average rental growth has moderated, it remains more than double the survey's long-run average

- **Demand for rental properties by tenants remains strong.** Both the RICS and ARLA surveys indicate that tenant demand for rental properties remains strong, with demand outstripping supply.

- **Mortgage possessions remain low.** The level of arrears and possessions in the buy to let market remain low, in keeping with trends across the rest of the housing market.

- **A positive outlook for the buy to let market.** The combination of demographic changes, lifestyle choices, government policy, rising house prices and higher interest rates suggest that the market will continue to expand.

Paragon rental yield average for England and Wales (percent)



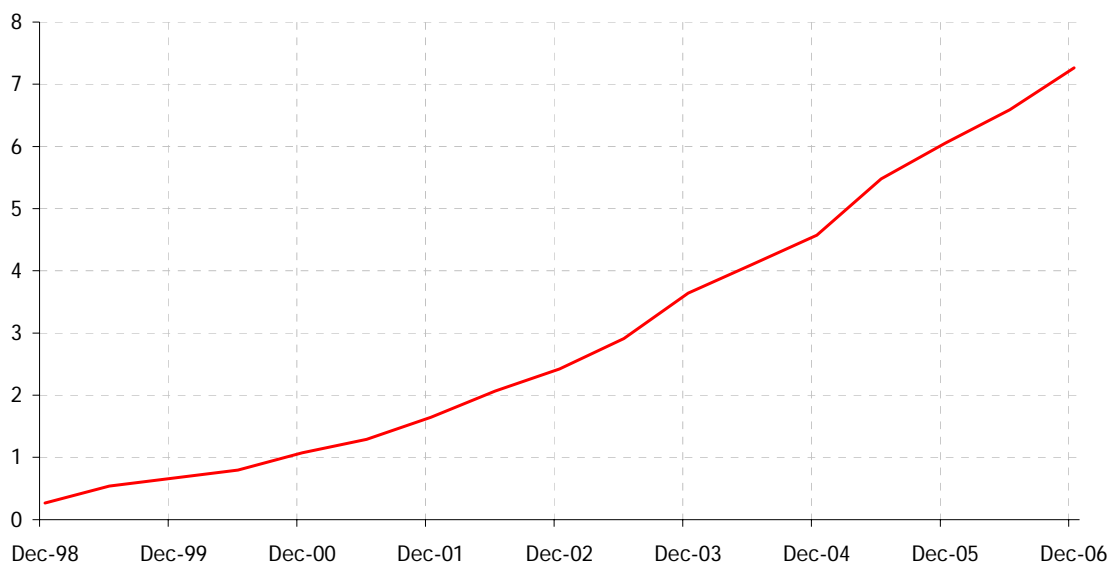
Rapid growth of private rented sector

The buy to let sector has grown rapidly since the late 1990s. From 28,700 at the end of 1998, the number of buy-to-let mortgages outstanding had risen to 849,900 by the end of 2006. By the end of 2006, buy-to-let advances accounted for 7.3% of the total number of mortgages, up from less than 1% in the late 1990s. By value, buy-to-let advances accounted for 8.8% of outstanding mortgages by the end of 2006. In 2006 alone, the volume of outstanding buy-to-let mortgages increased by 21%, or 108,000. During 2006, however, the number of gross buy-to-let advances advanced totaled 330,300, indicating that more than half of the buy-to-let mortgages drawn down during the year were re-mortgages, rather than advances on new rental properties.

Growth driven by policy, lifestyle and demographics

The 1988 Housing Act was a significant turning point in the recent revival of the sector. The Act brought about changes to the landlord-tenant relationship, giving landlords an absolute right of possession at the end of the tenancy. Another boost to the sector came when the Association of Residential Letting Agents (ARLA) introduced a mortgage scheme, called buy-to-let, to stimulate the sector. Under the scheme, several mortgage lenders brought their interest rates closer to those offered to owner-occupiers, rather than forcing landlords to borrow at commercial rates when buying a property. Over the past decade the number of financial institutions offering attractive terms to landlords has increased, with the resulting increase in competition leading to improved loan terms for landlords.

Buy-to-let mortgages as a % of total outstanding mortgages



While changes in government policy have played a large role in the growth of the private rented sector, changing lifestyles and demographic factors have also been important influences. Changes in family structures, demographics, work patterns and lifestyles have demanded greater flexibility and mobility in housing accommodation. Not only does rented accommodation offer people flexible housing tenures, it also allows people to live in areas in which they may not necessarily be able to buy. Research has also found that home ownership is now a lower priority for young people than it was some 20 years ago, leading to young people entering home ownership at a later date.

Financial appeal of renting

Financial factors also play an important part in the decision to rent rather than buy a house or flat. Data from the Survey of English Housing shows that as a percentage of their income, average gross rental expenditure by renters in the private sector, as a percentage of their gross income, has remained relatively stable over the past five to six years, ranging between 24 and 26%. Over the same period, data from the Council of Mortgage Lending shows that average interest repayments (excluding principal repayments) on a new mortgage as a percentage of the borrower's income have risen from 13½% at the beginning of 2000 to 16.3% by the end of 2006. Thus relative to income, the financial cost of renting has remained largely unchanged over the period while the cost of servicing a mortgage has increased.

Rent expenditure by private tenancies

	Gross annual income (£)	Annual rental expenditure (£)	Rental expenditure as % of income
1999/00	19448	4836	24.9
2000/01	19604	5052	25.8
2001/02	21892	5520	25.2
2002/03	22880	6024	26.3
2003/04	23998	6216	25.9
2004/05	25480	6204	24.3

Tenant demand is strong

The January 2007 RICS residential lettings survey reported very strong tenant demand for residential property in the 3 months to January 2007, with demand rising at its fastest pace in nine years. Demand was strong for both flats and houses, with the latter recording the biggest rise during the quarter. The acceleration in demand was underpinned by stronger economic activity and employment, as well as migration from EU countries. Rising tenant demand was reported across most of the UK, with the biggest upturns in the North of England and London.

The ARLA Members Survey of the Buy to Let sector also reported strong demand for rental properties across the UK, with demand outstripping supply in the March 2007 quarter. In particular, over half of the London letting agents reported more prospective tenants than properties available for rent.

Capital asset values still increasing

According to Paragon the rate of growth in the total rate of return on a buy-to-let property, while still robust, has eased over the last few years. The average total return on a property purchased 12 months ago (rental income plus capital gain) was 8% in January 2007, down from nearly 12% in January 2006 and 31% in January 2005. The CML's 2004 survey (The profile and intentions of buy-to-let investors) found that over 40% of landlords owned property in London and the South East, and nearly two-thirds owned property in the south of the UK. The Paragon mortgages data shows that in the year to January 2007, the total average returns on property purchased in the south of the UK 12 months ago are above the UK average. The South East recorded a total return on a property of 16% in the 12 months to January 2007, with the South West returning 11% and Greater London 9.4%.

The ARLA Member survey of the Buy to Let sector also showed that growth in the overall average capital asset value of rented houses remains strong, rising by 10.7% during the March 2007 quarter. The increase was driven by rises of 12.4% in Prime Central London and 15.5% in the Rest of the South East. The average value of rented houses for the remainder of the UK, however, fell by 0.6%. A similar trend was observed for the average value of rented flats, with an increase of 5.8% in Prime Central London and increase of 11.3% in the Rest of the South East underpinning an average increase of 6.6% for the UK. Survey respondents also reported that the average weighted rental return for

houses was 5% in the first quarter of 2007, compared with 5.1% for flats.

Recent RICS surveys, on the other hand, have pointed to falls in gross yields on investment property. An acceleration in house price inflation together with a moderation in rental growth had led to the second consecutive quarter of declining residential gross yields in January 2007. RICS surveyors reported that gross yields for both houses and flats declined, with falls across all areas of the UK. Given the prospect of another 25 bps increase in interest rates by mid-2007, yields will remain under downward pressure in the near term.

Rental yields dampened by higher rates

Data collected by Paragon shows that rental yields on buy-to-let property have remained relatively static over the past 18 months, despite robust growth in house prices and rising interest rates. Rental yields averaged between 6 and 7% since mid-2004. That said, rental yields have eased from an average of between 7 and 8% between 2003 and mid-2004.

The RICS surveyors reported a firm increase in rents in the three months to January 2007, with tenant demand for property exceeding new supply for the eleventh consecutive quarter. While growth in average rent was down from its peak in mid-2006, it remained more than double the survey's long-run average. Despite the current strength of demand, surveyors expect rental growth to ease further during

the coming quarter as a backlog of properties on the market dampens rental levels.

Repossessions low

By the end of 2006, 0.59% of buy-to-let mortgages were in arrears by three months or more, down from 0.65% at the end of 2005. The level of possessions in the buy-to-let market was 0.6% of all loans at the end of 2006, with an additional 0.3% having a receiver of rent appointed.

Overall, the levels of arrears and possessions in the buy-to-let market are similar to the rest of the housing market. The main reasons why a buy-to-let mortgage may fall into arrears are:

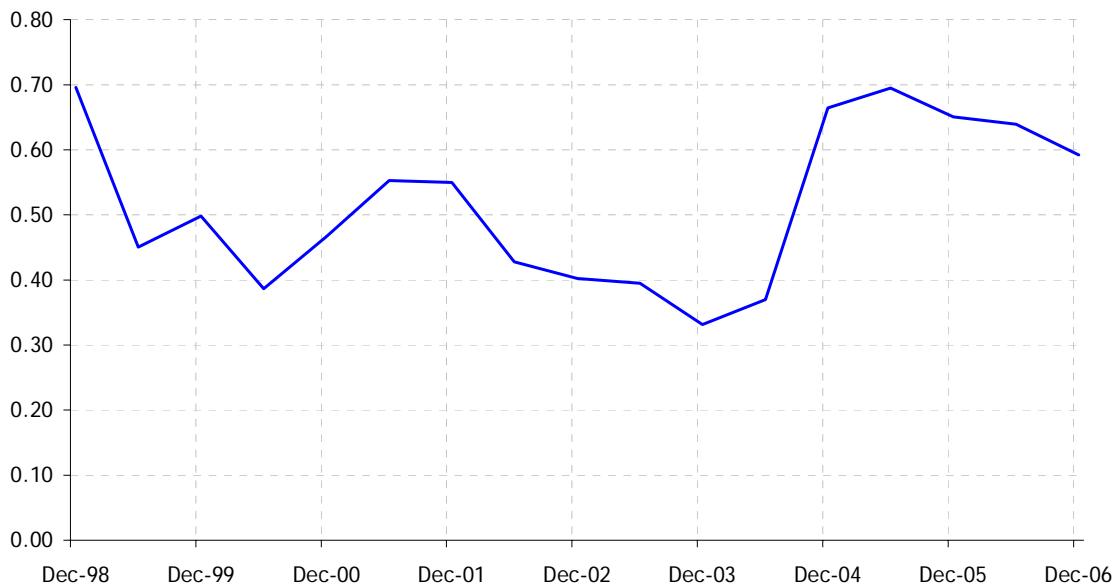
- The tenant fails to pay rent;
- A property is left vacant for an extended period of time; and
- The rent does not cover the mortgage payments.

The relatively low level of repossessions most likely reflects the financial composition of the buy-to-let sector. The CML's 2004 survey (The profile and intentions of buy-to-let investors) found that at least half of landlords had mortgages on all their properties with loan-to-value ratios of between 26 and 75%. Less than one per cent had a loan-to-value ratio of over 90%. Alliance & Leicester reported that over two-thirds of all the buy-to-let applications they received in December 2006 were for mortgage products under 75% loan-to-value ratios. This suggests that the majority of landlords are in a position to withstand an adverse change in interest rates and/or house prices.

Positive outlook for buy-to-let market

The outlook for the buy-to-let market remains positive. Demographic changes, lifestyle choices and government policy suggest that demand for rental accommodation will remain strong. In particular, with the affordability of first-time home buyers expected to remain stretched in an environment of

Buy to let mortgages - 3 months in arrears (percent)



rising house prices and higher interest rates, demand in the rental market should hold up well.

Research undertaken by the CML showed that over 60% of landlords expected to remain in the residential rental market for at least the next 10 years. This suggests they invested for the longer term. That said, given recent increases in interest rates and the prospect of another rate rise by mid-2007, there is the potential for mortgage payments to rise above rental income for some landlords, pushing-up the levels of possessions in the sector.

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