SPRING 2022

BUILDING A BUY-TO-LET PORTFOLIO

Hamptons

THE HOME EXPERTS

For decades, investing in bricks and mortar has been seen as an attractive and stable way to make money. However, over the last five years or so, regulatory and taxation changes have dampened the appeal of buy-to-let and reversed some of the growth of the private rented sector.

Despite investor purchases rising in 2021, we estimate there are now around 263,000 fewer rental homes in England than there were at the sector's peak in 2017.

These changes have had behavioural effects too – today's average landlord looks a little different to the one five years ago. The tapering of tax relief available on mortgage interest, known as Section 24, has forced investors earning lower yields to sell up while sending new investors in search of higher yielding properties.

The amount of time and research needed to make the sums stack up means investors are more likely than ever to be full-time landlords, many of whom own several properties in a limited company. Last year, a record number of buy-to-let companies were set up in the UK, 20% of which had more than three mortgaged properties on the books – this is what's commonly referred to as the 'professionalisation' of the sector.

As we enter 2022 however, a high inflationary environment is sending investors searching for alternative ways to make money. And, with mortgage rates at historic lows and yields on the rise, many are turning to buy-to-let once again.

In this report we draw on the lessons learnt from the past about how investors have made money. We look at what the future might hold and how this should shape the way new investors begin their buy-to-let journey, or grow an existing portfolio. If history has taught us anything, it's that diversification will be the key to navigating uncertainties in the years to come.

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HOW LANDLORDS HAVE MADE THEIR MONEY.

Rental income vs capital growth
Unlike some other investments, landlords can reap returns from two income streams; regular rental income and on the sale of the property or when it's remortgaged. The average landlord in England and Wales sold their buy-to-let last year for £91,270 more than they paid for it, having owned the property for just under 10 years. Over that period, the average investor earnt around £112,000 in rental income, equating to a total gross income of £203,000 before taxes and costs.

The average lower-rate taxpaying landlord made a total net return of 70% over 10 years

Don't forget taxes & costs
Now, more than ever, it's important to consider the many additional costs and taxes associated with buying and owning a rental home as they will all eat into profits.

Throughout this report, we have assumed that buy-to-let investors borrow as much money as they can to fund a purchase, which typically means taking out a 75% loan-to-value interest-only mortgage. Once we've allowed 10% of gross rental income for other costs and deducted mortgage payments, it means the average higher-rate taxpaying landlord in Great Britain made around £41,000 in profit from rental income on one property over the last 10 years. Meanwhile the average lower-rate taxpayer made a £66,460 profit.

House price growth usually means investors end up paying capital gains tax when they sell. Once capital growth is added, and any stamp duty and capital gains tax deducted, the average higher-rate taxpaying landlord made a total net return of £105,500, or 56%, over 10 years. This represents a 225% return on the initial investment - 39% of this total gain came from rental income, with 61% from capital growth.

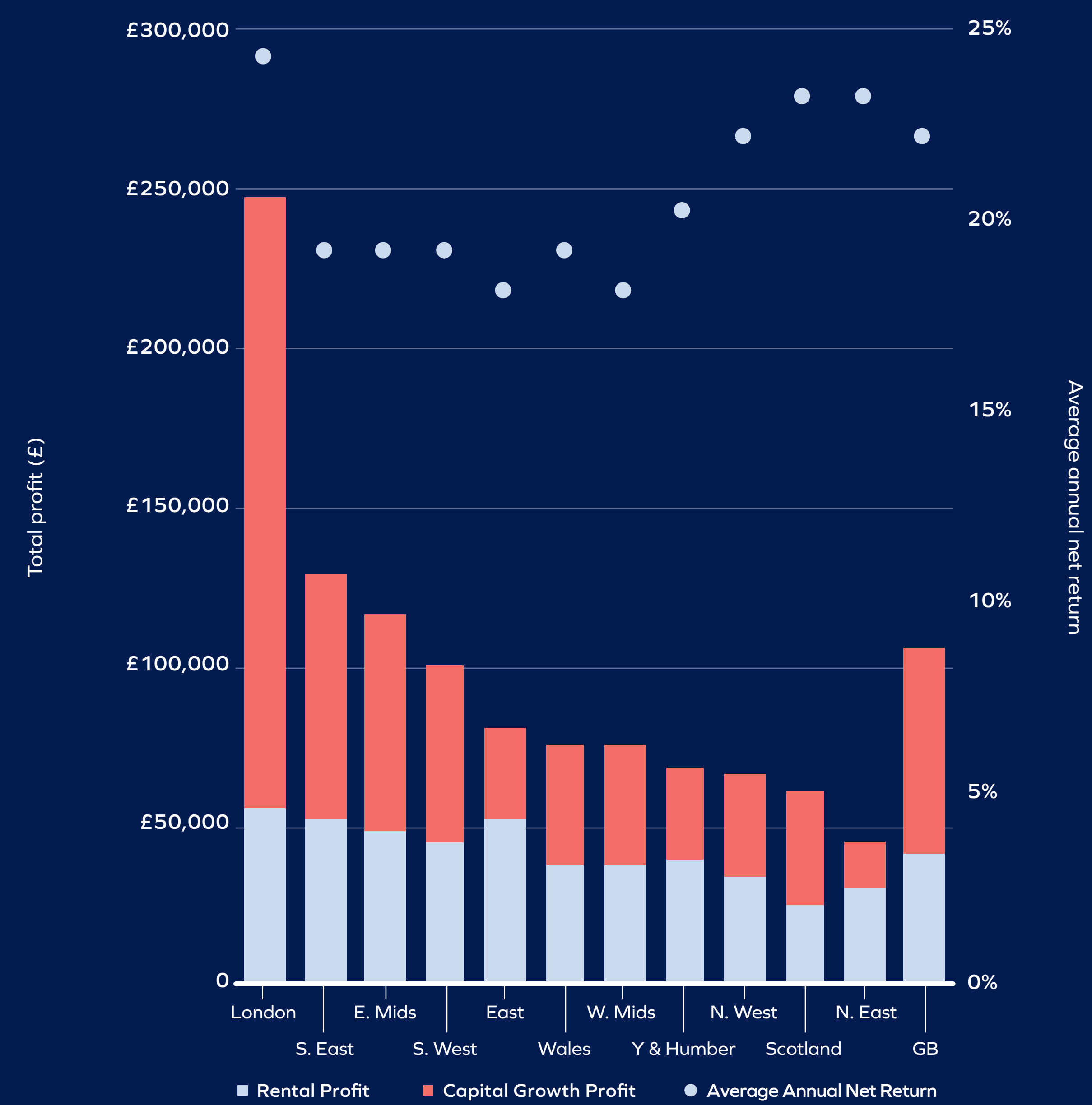
However, if property is a landlord's only source of income, paying an income tax rate of 20% can make a big impact on profit. The average lower-rate taxpaying landlord made a total net return of £130,660 over 10 years, with rental income accounting for 51% of their total return.

The North-South divide
The amount of profit investors have made from buy-to-lets and the way they have earnt their money has varied across the country.

London landlords have seen the biggest returns, both in absolute and percentage terms. The average landlord in the capital who sold up last year made a total profit of £245,900, or a 244% return on their initial investment over a 10-year period, after costs and taxes, which equates to 24% each year. However, because yields are weaker in the capital, most of this gain came from house price growth, with only 23% earnt from rental income.

TOTAL RETURN OVER 10 YEARS *FOR A HIGHER-RATE TAXPAYER*

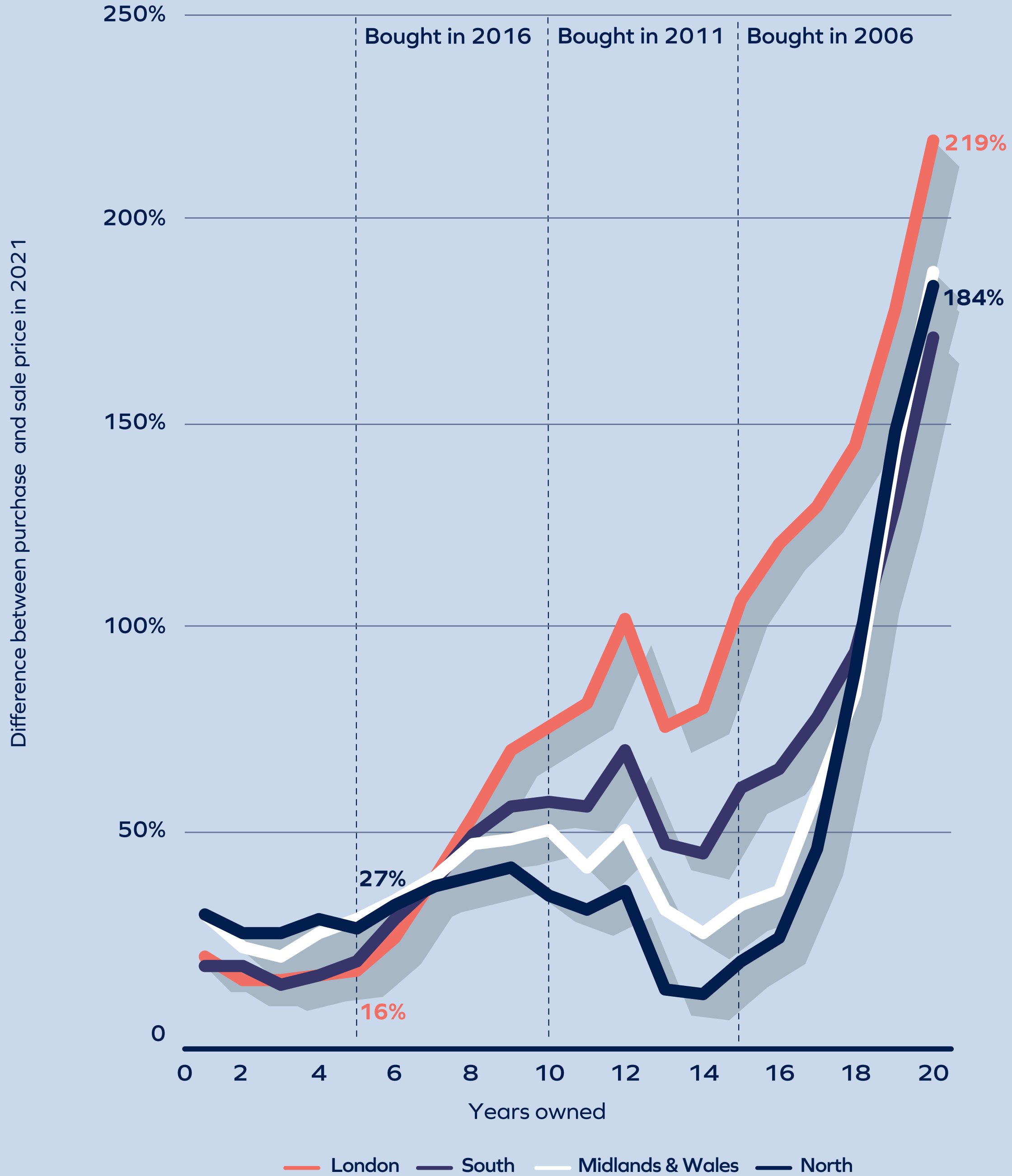
Source: Hamptons & Land Registry

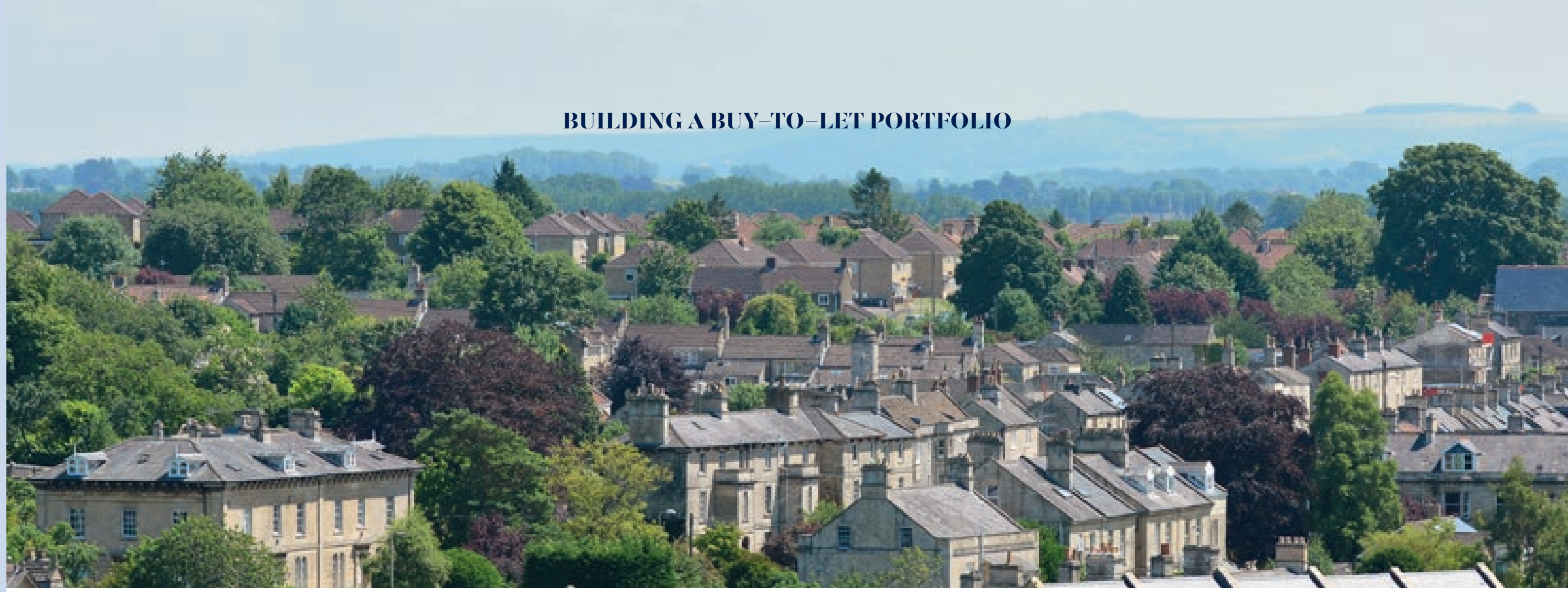


Assumes 75% LTV interest-only mortgage, 10% rental income spent on costs, capital gains tax paid at 28% with SDLT offset.

LANDLORD SELLER GAIN BY LENGTH OF OWNERSHIP

Source: Hamptons & Land Registry





Meanwhile landlords in the North East made the second biggest returns on a percentage basis, but they earnt their money in a very different way. The average landlord who sold up in the North East last year made a total net return of £44,200, or 226% on their initial investment, equating to an average annual net return of 23% over 10 years. However, as the region has seen weaker house price growth than London over the last decade, 68% of this profit came from rental income, with just 32% from capital growth.

The average London landlord who bought near the peak of the market in 2016 sold their home in 2021 for 16% more than they paid for it.

When deciding where to invest, landlords should consider what's important to them: regular rental income or longer term capital growth.

Timing the house price cycle
It's also worth considering the house price cycle when planning on buying a property. House prices have grown by different amounts in different regions at different times and so timing can have a big impact on profitability.

In the past, London has typically seen the strongest price growth at the beginning of a house price cycle, but then values tend to stagnate while the rest of the country catches up. According to the latest data, we're now in a period where house prices in the North West are rising twice as fast as those in London, where price growth peaked in 2014. We think 2024 will mark the beginning of a new cycle when price growth in London is poised to overtake the rest of the country once again.

The chart on the left illustrates what the house price cycle has meant for the amount of capital growth landlords have seen over different periods. For example, the average London landlord who bought near the peak of the market in 2016 sold their home in 2021 for 16% more than they paid for it. Over the same period, an investor in the North made a 27% gain.

Longer-term, however, London investors have benefited most. The average landlord who bought 20 years ago and sold in 2021 made a 219% capital gain in London, versus 184% in the North. However, this gap has closed steadily over recent years.

THE POWER OF PORTFOLIO GROWTH.

Gearing up

Most landlords don't grow a portfolio. And the few that do, typically use rental income and the equity from house price growth to purchase new properties, rather than adding new capital. This can make it a slow burner – developing a portfolio from scratch often amounts to a lifetime's work.

However, for those thinking about expanding their portfolio, we've tracked how reinvesting the profits from rental income and rising house prices can generate a snowball effect to supercharge growth. We look at how a portfolio evolved for someone who invested £50,000 into a limited company in the mid-1990s which was used to purchase buy-to-let property with a 25% deposit.

We check in on the portfolio every five years. We track how the investment would have performed in different regions to see how small differences over one or two years can add up to large variations in returns over a generation. We also look at the impact of reinvesting rental income, the effect of house price growth and how mortgage finance multiplies returns.

But before we start, a brief note on methodology. The investment is made as a limited company in 1996, with all prices adjusted for inflation (£50,000 today is equivalent to around £26,000 in 1996). We assume that all rental income after mortgage interest, maintenance costs and tax is reinvested back into the portfolio. Similarly, equity derived from rising prices is extracted, taxed and then reinvested – this means the loan-to-value of each property in the portfolio never falls below 75%, even if house prices have risen.

The beginning *(1996–2001)*

Every portfolio begins with a single property. For most investors, the first property they buy will be the only one, but for those looking to grow, it's the first piece in the portfolio puzzle. The first few years tend to be a learning curve, dedicated to understanding exactly how the rental market works and their full duties as a landlord.

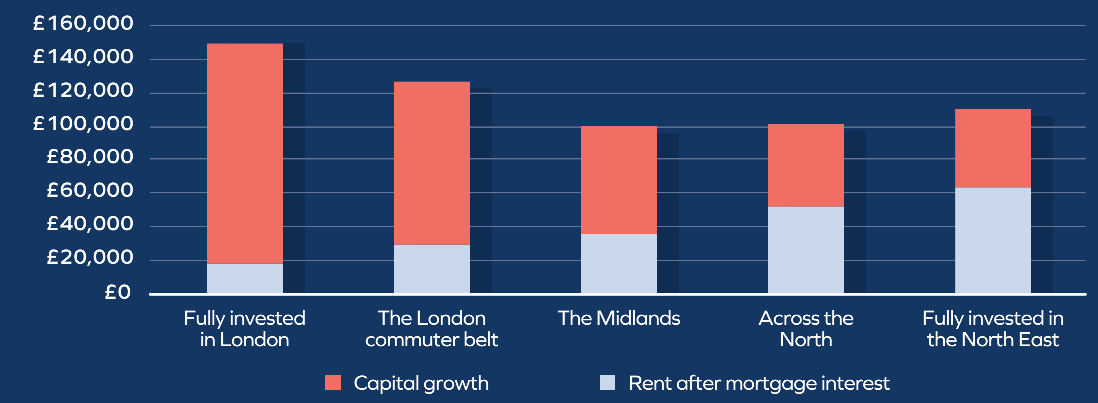
An investor who purchased their first property with a 75% loan to value mortgage in the mid-1990s, not too long after the start of the house price cycle, saw the beginning of their portfolio journey supercharged by house price growth.

After servicing the interest, the initial investment rose in value nationally by an average of 136% through both rental income and capital growth over the first five years. This turned £50,000 into £117,800 with almost three-quarter's of the return coming from house price growth.

Landlords in Southern England saw the strongest returns. Greater capital growth more than offset lower yields and meant a £50,000 investment would, by 2001, have been worth £134,800 in London and £107,300 in the South East. Around 43% of returns in the North came from capital growth, compared to 87% in London.

At the end of this first five-year period, we assume that the profit from rental income (£33,500) and capital growth (£92,000) was reinvested back into the company (after tax and an allowance for maintenance costs). The use of leverage (a 75% LTV mortgage) meant that at the end of the period, investors could remortgage and release an extra £203,600 as a result of rising house prices to reinvest.

Returns from a £50k investment in 1996 (1996-2001)



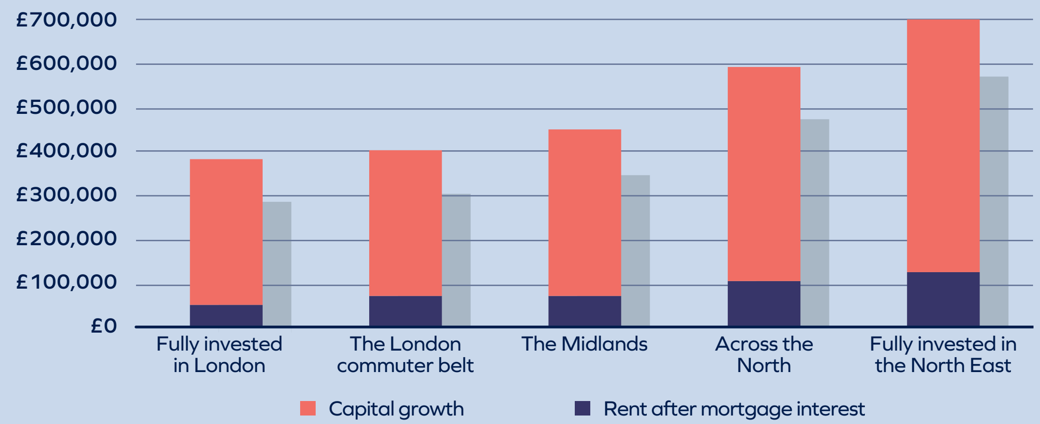
	Share of value growth from rent	Share of value growth from capital appreciation	Average annual return
Fully invested in London	13%	87%	34%
The London commuter belt	23%	77%	27%
The Midlands	36%	64%	20%
Across the North	51%	49%	20%
Fully invested in the North East	57%	43%	23%
GB average	**27%**	**73%**	**27%**

The boom *(2001–2006)*

These next five years also saw significant price growth, boosting the value of both the new and the original investment. The use of leverage means that three-quarters of the house price growth is on property secured by borrowed money rather than the investor's deposit. This amplifies the impact of house price growth fourfold.

By the end of this five-year period and following record-breaking house price growth, nationally the value of the initial investment had increased by 785%. This meant that the £50,000 invested in 1996 was worth £442,000 10 years later (with £79,100 from rental income and £384,600 from capital growth). Capital appreciation accounted for between 82% and 87% of a landlord's return across the country, but, given that the house price cycle was coming to an end, this meant that money invested in the North East saw greater returns than anywhere else in the country with slightly higher price growth coupled with higher yields. The value of a landlord's portfolio in the North East rose 1,101% over a decade compared to an increase of 703% in the capital.

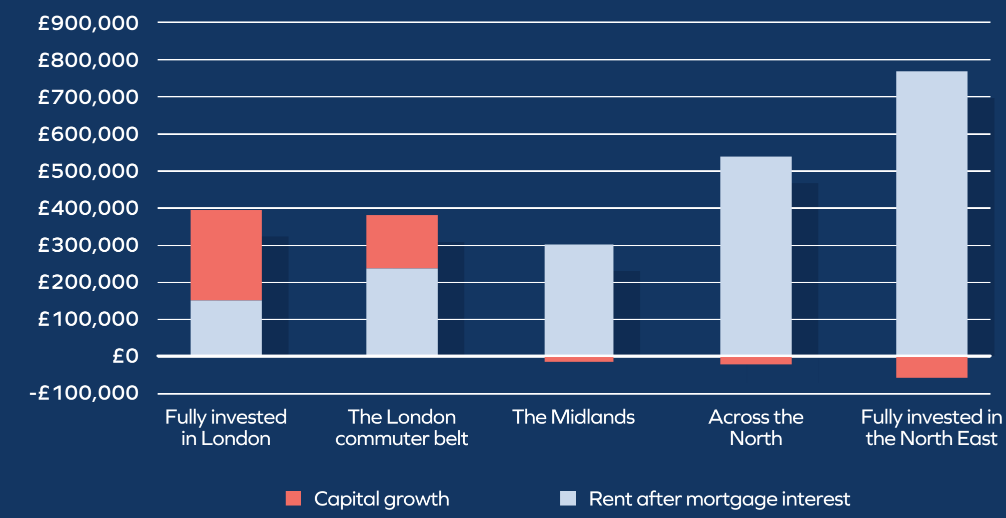
Returns from a £50k investment in 1996 (2001-2006)



	Share of value growth from rent	Share of value growth from capital appreciation	Average annual return
Fully invested in London	13%	87%	40%
The London commuter belt	17%	83%	48%
The Midlands	16%	84%	63%
Across the North	18%	82%	82%
Fully invested in the North East	18%	82%	92%
GB average	**17%**	**83%**	**55%**

The end of the cycle *(2006–2011)*

Returns from a £50k investment in 1996 (2006-2011)



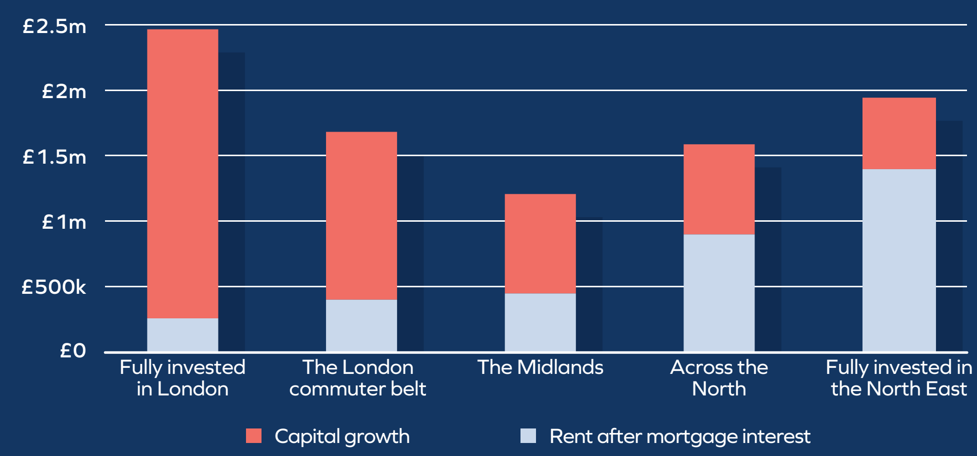
	Share of value growth from rent	Share of value growth from capital appreciation	Average annual return
Fully invested in London	38%	62%	14%
The London commuter belt	62%	38%	13%
The Midlands	103%	-3%	10%
Across the North	104%	-4%	14%
Fully invested in the North East	107%	-7%	17%
GB average	**91%**	**9%**	**10%**

With 2007 heralding a house price correction, this five-year period marked the weakest point for portfolio growth. Investors in the Midlands northwards found themselves dealing with negative returns from house price growth, although strong yields from rental income cushioned the blow. Meanwhile, investors in the capital and surrounding markets saw house prices recover within 18 months, but lower yields dampened their total returns. This meant that rising prices accounted for 62% of returns in London, and 38% in the commuter belt.

By 2011, 15 years after the initial £50,000 was made, putting the money into London would have generated a net portfolio value of £676,900 (1,254% growth), compared to £1,098,000 (2,097%) if it had been put into the North East. Strong yields across the North allowed portfolios to continue growing in value, despite fairly substantial house price falls.

The start of a new cycle *(2011–2016)*

Returns from a £50k investment in 1996 (2011-2016)



	Share of value growth from rent	Share of value growth from capital appreciation	Average annual return
Fully invested in London	10%	90%	51%
The London commuter belt	23%	77%	36%
The Midlands	37%	63%	27%
Across the North	56%	44%	26%
Fully invested in the North East	72%	28%	25%
GB average	**28%**	**72%**	**34%**

This second house price cycle saw the London market explode into life. During this five-year period, Southern house price growth outstripped Northern growth by the largest margin recorded at any point during the 25-year lifetime of the portfolio.

It also marked the point where the total net value of the portfolio passed £1,000,000 in every region of the country. Despite this, the returns from capital growth between 2011 and 2016 were more divided than at any other time over the investment period.

Between 2011 and 2016, 90% of returns across London came from capital growth, compared to just 28% across the North East, where prices were still recovering. By the end of this period, the value of the £50,000 initial investment had reached an average of £1,813,000 (3,527%) nationally. The London portfolio grew to a net value of £2,409,000, almost identical to the North East, but with the growth coming at different times and in different ways.

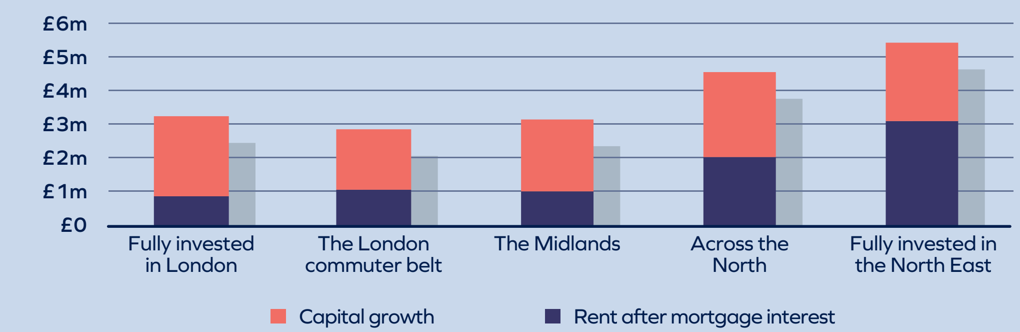
The final five years *(2016–2021)*

The size and value of a property portfolio typically hits its peak after 20-25 years, so an investor who began their journey at 40 years of age would now be pushing 65. While an investor could, of course, carry on growing their portfolio, often for lifestyle reasons they choose to taper growth or begin to downscale and start drawing an income, rather than reinvesting it. The portfolio which started with a £50,000 investment 25 years ago would, in 2021, generate an annual income of £180,900 in London or £624,900 in the North East.

The net value of the average portfolio in England and Wales doubled between 2016 and 2021, buoyed by record levels of rental income and capital growth. Faster house price growth across the North boosted the value of northern-based portfolios, while yields remained relatively resilient. Low yields across the South meant that, despite slower price growth, capital appreciation still accounted for a mammoth 73% of total returns in London.

Portfolio returns varied significantly across the country. A sum of £50,000 invested in the North East in 1996 would be worth the most, at £6,277,000 (12,445% growth) today if all price growth and rental income was reinvested back into the portfolio. This is followed by £5,179,000 (10,259%) for a portfolio spread evenly across Northern England, while London came in third place with a net portfolio value of £4,715,000 (9,332%) over 25 years.

Returns from a £50k investment in 1996 (2016-2021)



	Share of value growth from rent	Share of value growth from capital appreciation	Average annual return
Fully invested in London	27%	73%	19%
The London commuter belt	37%	63%	22%
The Midlands	33%	67%	30%
Across the North	45%	55%	32%
Fully invested in the North East	57%	43%	31%
GB average	**37%**	**63%**	**26%**

IN CONCLUSION.

As the caveat on any investment product will tell you, past performance is no guide to future returns and it's important to point out that we don't anticipate anything like the same level of house price growth over the next 25 years as we've seen in the past 25. However, there are still plenty of lessons we can learn from the experience of growing a portfolio which can help form a strategy for the future.

The stark difference in returns across the country is a product of the house price cycle and the point at which the landlord bought – the results would look different for someone who invested a year earlier or later. An investor who timed the cycle perfectly over the last 25 years, always investing in the fastest growing regions, would see double the average return compared to someone who invested in the slowest areas. In 2016, the values of portfolios in London and the North East were about the same, but, over the last five years faster price growth and higher yields pushed up returns further North.

The scale of returns seen here wouldn't be possible without significant price growth combined with leverage in the form of a mortgage. When prices rise 10%, an investor with a £50,000 deposit and 75% loan-to-value mortgage will see a return of 40% on their initial investment, before the costs of servicing a mortgage.

Nationally, price growth has generated around two thirds (65%) of the increase in value. The average portfolio today, built over 25 years, is 16.6x larger than one built in a market with no price growth at all – it would be valued at just £249,000 compared to £4,146,000. Lower price growth in the future would significantly reduce the rate at which a portfolio could grow.

This 25-year price growth has been magnified by mortgage leverage, meaning the average investor was able to reap the benefits of growth on a value which is around four times the size of their initial cash investment. Without borrowing to boost the value of property they hold, growing a portfolio in cash is much slower. After 25 years, the average cash portfolio would be worth £272,000, compared to £4,146,000 of equity for a landlord who used leverage.

Over the last 25 years, the North East has emerged as the fastest place to grow the most valuable portfolio, despite the region seeing less house price growth than Southern England. This is down to the power of higher rental yields, which accounted for 61% of returns in the North East and 50% across Northern England.

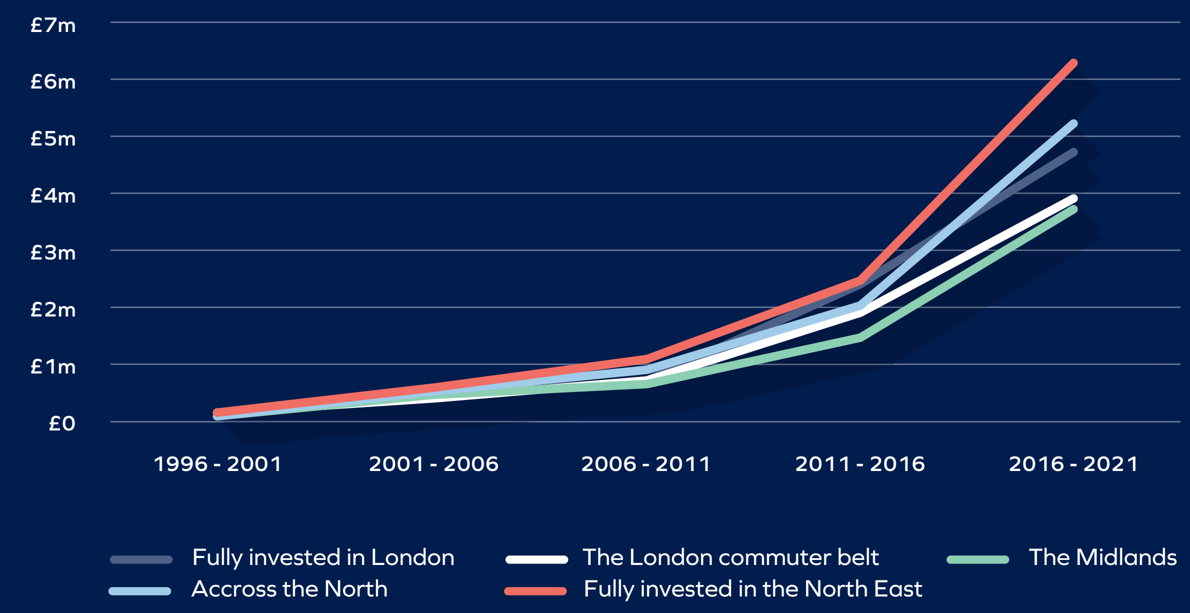
Reinvesting rents back into the portfolio also plays a key role. Nationally, the average portfolio would be 55% smaller after 25 years if rental income was withdrawn each month rather than reinvested.

The decision about where to grow a portfolio will at least partly depend on your future long- term view of what will happen to house prices. We believe Northern areas will see higher price growth up until 2024 when the house price cycle restarts. This means higher yielding areas will also see more house price growth for the next few years. Then from 2024 we're expecting price growth across the South of England to once again begin outpacing the North.

However, just as important are the principles behind why you're building the portfolio. Someone looking to gradually replace PAYE income from a full-time job will likely choose to buy a different (i.e. higher yielding) selection of homes compared to the investor seeking to grow a nest egg for their retirement. In the case of the latter, monthly rental income tends to be less important than ensuring the investment beats inflation so the investor can release a cash sum upon retirement.

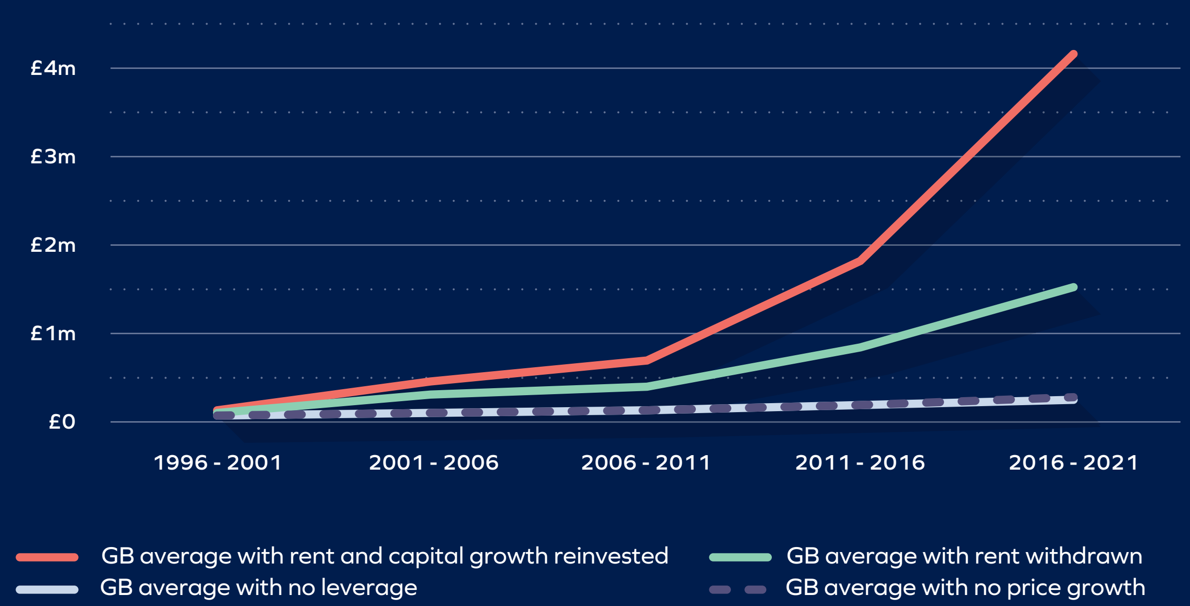
NET PORTFOLIO *VALUE*

Source: Hamptons & Land Registry



NET PORTFOLIO *VALUE*

Source: Hamptons & Land Registry



8 LESSONS LANDLORDS SHOULD LEARN.

BUYING

1 Squeeze up the yield
All investors aim to achieve the highest yield they possibly can. Yet, typically, it's the price they pay for their property rather than the rent it commands which makes the largest difference to their returns. For example, landlords achieving yields that are 50% above the local authority median pay an average of 40% less for their property while achieving rents that are 8% above average.

Price is also the main element behind low-yielding properties, but for very different reasons. Perhaps counter-intuitively, the lowest yielding homes still achieve higher than average rents. These tend to be homes where buyers have paid a large premium and are typically bigger detached or semi-detached family homes. While they achieve higher than average rents, they form a lower-than-average proportion of the purchase price, meaning yields are low.

2 Consider corporate ownership
We estimate that around half of investor purchases last year were put into a limited company structure. The growing preference for company ownership means that around two-thirds of limited buy-to-let companies have been set up since 2016, the year when the then Chancellor George Osborne announced that mortgage interest would soon no longer be tax-deductible for landlords holding investment property in their personal name.

There are now over 270,000 buy-to-let companies in operation, more than ever before. However, despite a corporate structure being advantageous for many, particularly for higher-rate taxpayers, it's likely the number of new incorporations is at or close to its peak. Many of those investors preferring the corporate structure already have it set up, with new purchases going into an existing company, while for lower-rate taxpayers the benefits of incorporation are far more marginal.

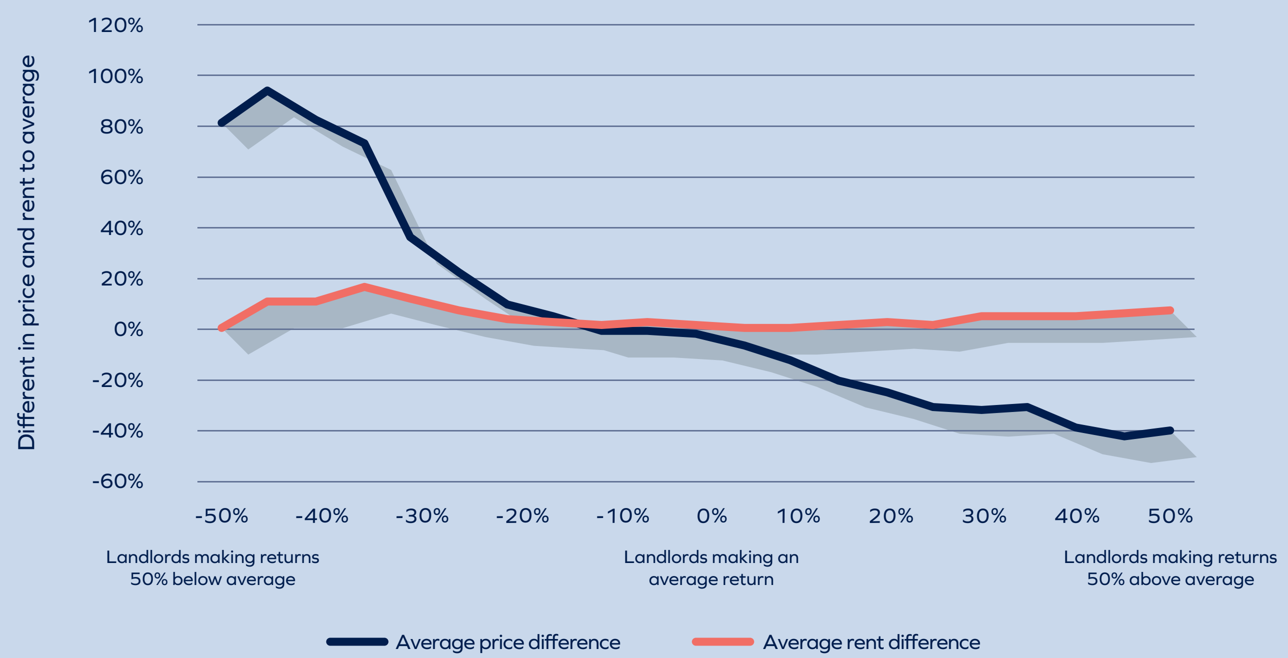
3 Measuring portfolio performance
Tracking and measuring the performance of a single property or even a whole portfolio is central to maximising returns. This typically means investors buy higher-yielding homes and sell those achieving lower yields – last year, the average home bought by an investor achieved a yield that was 1.1% higher than the average home being sold off.

This yield gap has been compounded by a sell-off of larger, lower-yielding homes, partly due to the tapering of mortgage tax relief. These have been replaced by the purchase of smaller properties, which tend to be higher yielding. In practice, this means that two detached homes are sold for each one bought.

4 Don't forget new EPC regulations
Energy-saving regulations introduced in 2018 ban most homes rated F and G from being let out and there are proposals to extend this ban from 2025 by reducing the minimum EPC rating to C. This means

THE COMPONENTS *OF RETURNS*

Source: Hamptons



YIELDS: BUYING HIGH AND SELLING LOW

Source: Hamptons

around 45% of today's rental homes will need to undergo energy improvements, with a cap on costs of £10,000 to £15,000 expected.

While costly for landlords, upgrading a home from an E rating to a C will save tenants an average of £725 a year, although going from a D to a C will save around half of this amount. The drive for sustainability combined with rising household energy bills will likely see tenants put greater emphasis on energy efficiency.

Since Covid, gross yields on flats have fallen by 0.3% on average to 5.5%, while yields on detached properties have seen the biggest increases of +0.2%

RENTING

5 Yield depends on the tenant
Working out who the optimal tenant is will ensure that you can offer them the right sort of space. For example, three friends in their twenties looking for a house to share are more likely to want three double bedrooms, and potentially pay a premium for them. Meanwhile, a family with young children may be happy with a double and a couple of single bedrooms and will likely place less value on three doubles.

6 The pandemic has changed what tenants want – and hence returns
Over the last year or so, larger homes have seen the strongest rental growth as tenants have sought extra space. While smaller properties still tend to earn bigger yields, since Covid, gross yields on flats have fallen by 0.3% on average to 5.5%, while yields on detached properties have seen the biggest increases of +0.2%, meaning they now stand at 4.9%. However, as rental growth in cities catches up this year, we could see this trend reverse once again.

7 Don't be fooled by gross yield figures
Houses in multiple occupation (HMOs) and student lets are widely known to offer stronger yields. But when it comes to evaluating the profitability of these investments, it's important to factor in the many additional costs that landlords must often pay – such as council tax, water, gas & electricity, council licencing fees and furniture. All these costs can soon turn what looked on paper like a promising gross yield into a fairly average net yield. The same can be true for leasehold flats, which often command a service charge and annual ground rent, which can eat into profits.

8 Threat of build-to-rent
In its early stages, build-to-rent was predominantly London focused. However, 2021 marked the point where more new build-to-rent homes were advertised outside the capital than within. And this adjustment is likely to continue over the next few years.

In city centre blocks, the additional services mean build-to-rent operators currently achieve 12% more rent than an average individual landlord who has bought into a similar block. Build-to-rent is also growing in the suburbs with a shift towards single-family homes – this growth is likely to provide more competition to small-time landlords. Further out of cities, with no additional services, the build-to-rent premium shrinks to 7%, meaning rents are likely to be closer to those being charged by individual landlords.

QUICK FACTS

£844,000,000

The total amount saved on utility bills by tenants living in homes with an D-G EPC rating.

ESTABLISHED 1869

THE HOME EXPERTS