Buy-to-let: What you need to know

Gardner Financial Management

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Buy-to-let: Overview

With interest rates at record lows and house prices rising, you may be considering investing in a buy-to-let property. But before you take the plunge, it's important to understand the costs, risks and rewards involved in becoming a landlord.

Schemes such as the stamp duty holiday can make a buy-to-let investment more attractive in the near-term. But it's important to evaluate all aspects of your proposed investment. The key factor being where you decide to purchase a property.

This guide outlines exactly what you need to know to make your decision.

The basics

A buy-to-let investment offers both income from rent (gross yield) and any difference in the sale price and your purchase price of your property due to a house price increases (capital appreciation). It's also important to remember that gross yield is often different from 'what goes in your pocket.'

Gross Yield

This is the rental income on a buy-to-let property is typically expressed as a gross yield. To calculate the gross yield, divide the annual rent from the property by its purchase price. For example, a property that costs £150,000, on which rent of £6,000 a year could be charged would have a gross yield of 4%.

The average gross yield on a buy-to-let property in England is 3.6%, based on data from the Office for National Statistics.

Lower value properties tend to offer higher gross yields. For example, in the North East, where house prices average £126,945, gross rental yields are around 4.7%, despite average rents of £495 a month being significantly below the average for England of £700.

By picking the right property in the right location, it is possible to find gross yields of more than 7%.

Gross yield vs net yield

Remember that gross yield is often different from 'what goes in your pocket'. Gross yield does not take into account mortgage interest or letting agent fees, nor does it factor in void periods in between tenants and maintenance costs. So instead, when calculating income, you should also look at net yield. For example, your £150,000 property which could be let for £6,000 a year, might be empty for one month and need repairs costing £300. On top of that you have to pay monthly mortgage interest of £235 and letting agent fees of 15% of the monthly rent. As a result, your annual income on the property would be £5,500 for the year, while your outgoings would be £3,954, giving you a profit of £1,555 and a net yield of just 1%.

Capital appreciation

If you keep your buy-to-let property for a number of years, you may also benefit from an increase to its value when you come to sell. For example, if you purchased a property for £150,000 and kept it for five years before selling it for £165,000, you would have made a capital gain of £15,000. But house price inflation can be volatile and property values do go down as well as up.

Making a decision

When picking a buy-to-let investment, you need to decide if your goal is to maximise income generation or maximise capital appreciation.

What's the difference?

If you're maximising income, you're after a property that has the best net income. This means you're focused on a property that may not go up in price right away; but has very good rental potential and is low cost to maintain.

Alternatively, some buy-to-let investors are focused more on capital appreciation; in other words, selling a property for more than you paid for it to make a tidy profit. It may be that you've seen a property that doesn't have a great net yield, but it covers its costs. Instead, you think it's very cheap for a specific area and the price will go up very soon. Even though the net yield might be low, the capital appreciation might still make it an attractive investment.

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What type of property, what type of tenant?

If you decide to go ahead with a buy-to-let investment, a big decision will be deciding where to purchase a property. On the one hand, purchasing something in an area where house prices are lower should give you a higher gross yield. But there is also a lot to be said for buying near where you live, as you're likely to be more knowledgeable about your local market, while you will also be on hand to deal with any problems.

You should also give some thought to the type of property you want to purchase. While your budget will likely play a big role in this decision, it's also worth chatting to a local letting agent to find out what types of home are most in demand in the local area. For example, are renters typically young professionals who want small flats, or students who want larger properties to rent as a group?

So-called houses in multiple occupation (HMOs), defined as being properties let to three or more people who form more than one household, tend to offer higher rental yields, but they also require special licences and have enhanced safety standards, such as requiring fire doors, that you must meet. HMOs also have a different set of lending criteria, so you may have less mortgage choice than if you opt for a regular buy-to-let.

What else should I consider?

Tax changes

Unfortunately, buy-to-let properties have been subject to a number tax changes in the past few years which has impacted the returns you can make.

The good news is that investment properties are included in the current stamp duty holiday on properties costing up to £500,000 which will run until 31 March 2021. Unfortunately, if you already own a home, you will still have to pay the 3% stamp duty surcharge that is imposed on second homes or investment properties.

Another tax change that has impacted the sector is the phasing out of mortgage interest tax relief. Previously, landlords were able to offset their mortgage interest expenses against their rental income to reduce their tax bill. But mortgage interest tax relief has now been phased out and replaced by a tax credit equivalent to 20% of mortgage interest payments. While this does not impact the amount of tax you pay compared with the old system if you're a basic rate taxpayer, it's less generous if you pay income tax at the 40% rate.

The annual 10% 'wear and tear' allowance for furnished properties has also been scrapped, although landlords can still claim for the actual cost of repairing or replacing damaged items.

On the plus side, you can still deduct other costs associated with a buy-to-let property, including letting agents' fees, buildings and contents insurance, council tax and essential maintenance, but not work that could be considered to improve the property, such as building an extension.

Capital gains on sale

When you come to sell, you will be liable for capital gains tax on any increases in your buy-to-let property's value.

The tax is currently charged at different rates depending on the rate at which you pay income tax. Capital gains tax on properties is 18% for basic rate taxpayers and 28% for higher rate taxpayers. For the 2020/2021 tax year, the first £12,300 of profit made on an investment property sale is tax-free. Couples can combine this allowance to £24,600, while you can offset costs such as stamp duty, and solicitors' and estate agents' fees against the amount of tax you have to pay.

Regulation

On top of the tax changes the sector has also been hit by a raft of new regulations, such as a ban on tenants being charged letting agents' fees, while rental properties must have an energy-efficiency rating of at least E. In addition, you must also ensure the property is safe for tenants, deal with any necessary repairs promptly, have annual safety checks carried out on gas and electrical appliances and make sure any furniture provided meets fire safety regulations. All of these requirements add to the cost of being a landlord and should be factored into your calculations when deciding whether to buy an investment property.

Weighing up the pros and cons

Like most investments, buy-to-let can have risks. These include, but are not limited to, interest rate rises that could make the mortgage more expensive, problem tenants who damage the property or default on rental payments and need to be evicted, and high maintenance costs. When you come to exit the investment, you could face problems selling the property, while you could make a loss on it if house prices have fallen.

Despite these risks, buy-to-let properties can still be good investments over the medium to long term. The UK currently faces a mismatch between the supply of rental homes and demand from potential tenants, which is expected to continue to put upward pressure on rents in the coming years. House price growth can be volatile over the short-term, but property values have enjoyed strong gains over the medium and long term, with average prices in England rising by nearly 350% since 2000.

If you're unable to purchase your investment property in cash, you will need to take out a buy-to-let mortgage. Like residential mortgage a minimum deposit is required. The interest rates charged on buy-to-let properties are typically higher than those for residential ones, with best-buy rates for a two-year fixed rate deal for a landlord borrowing 75% of the property's value starting at around 2.5%. Mortgages for investment properties also tend to be interest-only, meaning you only pay interest on the amount you have borrowed each month, and you do not make payments towards reducing the amount you owe.

Remember: an interest-only mortgage may give you more monthly flexibility, but you will need a plan on how you will eventually repay your loan in full.

If you're keen to invest in a rental property but do not want to take out a buy-to-let mortgage, you could consider unlocking capital from your home through remortgaging to fund the purchase.

We can help you understand what may work best for you. Contact us today on 01564 732770 **or click on the image to book a free consultation to talk through your options.**