THE NEW RULES OF PROPERTY INVESTMENT

Your definitive guide to thriving in the new era of buy-to-let

By Rob Dix
propertygeek.net
Introduction

It’s been a funny few years.

When I started writing about property in 2012, the memory of the 2008 crash was extremely fresh. Prices were flatlining, and although people were very still interested in property, they needed a lot of encouragement that it would continue to perform in future.

Over the next few years, prices steadily rose – and investor confidence increased along with them. In London, prices didn’t just recover – they passed their previous peak. Across the UK, rising rents and the continuing imbalance between supply and demand reassured investors that property was still a good long-term bet – and they flooded back into the market. It seemed like the last four or five years had just been a blip, and we were right back to the familiar story of property prices marching relentlessly upwards and investors happily cashing in.

Then… plot twist! In 2015, the new Conservative government announced their first budget – including a measure that spelled disaster for a certain type of landlord, and showed that property investors were squarely in their crosshairs. As it turned out, that was just the beginning of a series of events and policies that would cast doubt on the viability of buy-to-let – events that we’ll run through in a moment.

As a result, my inbox in 2016 became a very different place. The enthusiasm from investors was still there, but tempered with doubt and caution. Among all the other questions, one that I’d never previously been asked became one of the most common: **is property investment still a good idea?**

So, is it?

Well, clearly I don’t think it’s total doom and gloom or I’d have shut down Property Geek and started up Gold Geek or Under The Mattress Geek by now. But, in 2017, it feels like we’re at an inflection point – almost the end of an era and the start of a new one. Not all current investors will stick it out, and not all those who were preparing to enter the market will (or should) still do so. But for those who are prepared, the opportunities will be there. What’s more, I think the next couple of years will create the conditions to give us more opportunity than ever.

In this short guide, we’ll run through the following:

- All the recent changes that have thrown the property market into a tailspin.
- What, added together, it all means for where we are now and what comes next.
- How investors can prepare themselves to avoid the traps, and position themselves to take advantage of the opportunities in today’s market.

Let’s get started…
What’s been happening?

Stamp duty increase

In their 2015 Autumn Statement the government announced that “additional properties” would be subject to 3% extra Stamp Duty. In other words, if you own a property already (whether it’s the one you live in, or an investment property), you’ll be paying 3% extra for every subsequent property you buy.

Knight Frank has a useful Stamp Duty calculator here.

In many parts of the country, this isn’t a deal breaker: if you’re buying a £150,000 investment property (for which you could get a decent flat or house in many areas), the Stamp Duty you pay will have increased from £500 to £5,000. Clearly that’s a huge percentage increase, but in cash terms it’s not going to make or break most deals: you can offset it by negotiating a small discount, or accepting a slight dent in your ROI.

But in pricier areas, this has the effect of making a property significantly more expensive to buy. For example, the Stamp Duty on a £500,000 property in London jumps from £15,000 to £30,000. It means you’ll need to invest more to get the same return, making the figures less attractive.

Mortgage interest relief removed

This is the big one. And it’s a bit mind-bending if you haven’t encountered it before, so try to stick with me...

In the past, interest you paid on your mortgage was considered a cost of doing business – which means it was tax-deductible. So you’d take your rental income, deduct the cost of interest, deduct your other costs (like maintenance), and be left with your profit. Then, naturally, you’d pay tax on that profit.

No more! Now, the interest is not a cost you can deduct before arriving at your profit – so you take your rental income, deduct any costs except your mortgage interest, and are left with your “profit”. Before paying tax on this “profit”, you can then write off 20% of your interest costs as an allowance.

(I put “profit” in quotation marks because it stretches to breaking point the definition of “profit” that’s used in any other business. That’s what makes this new system so hard for many people to understand.)

Following me? Quite possibly not, so it’s easier to understand when you run it through with some sample numbers. That’s what I do in this blog post.

For the purposes of this brief guide, though, I’ll skip straight to the consequences.

If all your income is taxed at the basic rate (for example, you earn £20,000 from a job and make £10,000 profit from property, putting you below the current higher rate threshold), you end up paying the same amount of tax as you would have done previously. That’s because the 20% allowance you can claim at the end has exactly the same effect as deducting the interest as a cost in the first place.
But if you have income that’s taxed at the higher or additional rate (for example, you earn £50,000 from a job alongside your £10,000 profit from property) you end up paying more tax – because the 20% allowance doesn’t fully cancel out the loss of your ability to deduct interest as a cost. The higher your mortgage interest payments as a proportion of your rental income (i.e. the more highly leveraged you are), the larger the adverse effect.

There’s one other insidious effect too. As “profit” is now calculated before deducting mortgage interest, everyone’s “profit” magically gets higher overnight. That means if you’d previously been ducking just under the higher rate band, you might now be pushed into it.

The takeaway from all this is: if you use mortgages and your income exceeds the basic rate threshold, you’ll pay more tax. And the more highly leveraged you are, the bigger the impact.

Two final notes, and then we can move on to the far more exciting (erm...) topic of mortgage underwriting criteria.

Firstly, this all applies to properties that are owned by an individual. Companies that own property continue to play by the old (more favourable) rules instead – the implications of which we’ll cover later.

And secondly, just to make the whole thing a bit more mind-bending, this is being phased in between April 2017 and April 2020. In the first year, 25% of your income will be treated under the new system and 75% under the old system. In the second year it’ll be 50/50, and the balance will continue to shift until 100% of your income is under the new system by April 2020.

Got it? Good – onwards.

**Tougher mortgage rules**

Back before the last crash, you could borrow up to 100% of the money you needed to buy a property – and if you didn’t have enough income to support the borrowing, you could just make up any numbers you wanted and nobody would really bat an eyelid.

As you’ll have noticed, this didn’t end well. In an attempt to avoid a repeat performance, the Bank of England has stepped in to impose minimum standards on buy-to-let lenders.

The first of these measures came into effect in January 2017. The full set of rules is a bit complicated, but the gist is that the expected rental income from the property must be at least 125% of the mortgage payment when the interest rate is at least 5.5%.

Let’s plug some numbers into this. Say you’re buying a house for £100,000, and want to borrow what’s typically the maximum currently allowed: 75%, or £75,000.

Your monthly (interest only) mortgage payment based on borrowing £75,000 at an annual interest rate of 5.5% would be £344. (Remember, the calculation is always based on a 5.5% interest rate – even if the actual interest rate you’re paying is lower.) So if your monthly rent were £500, you’d be fine: £500 is more than 125% of £344.
However, if your monthly rent were only £400, you wouldn't be able to borrow the full amount you wanted – because £400 is less than 125% of £344. You would be restricted to borrowing a maximum of £70,000 rather than the full £75,000.

125% is the minimum, but in practice many lenders are increasing their “rental cover” test from 125% to either 135% or 145% because of other rules too complicated to go into here. Which – of course – has the effect of reducing the maximum you can borrow still further.

OK, that was a lot of numbers – but what it boils down to is this: **if the rent as a proportion of the property’s value is relatively low, you might not be able to borrow as much as before.**

In September 2017 there’s a deadline for lenders to impose another set of recommendations, largely relating to “portfolio landlords” – defined as landlords who own four or more mortgaged buy-to-let properties. The gist of these rules is that lenders must consider the total assets and liabilities across the borrower’s whole portfolio, rather than just the property being mortgaged – which seems likely to mean that portfolio landlords will have to answer a lot more questions (and encounter more delays) when applying for mortgages.

Some mortgages will escape all of these new regulations. The rules don’t apply to certain “specialist” lending such as bridging, commercial or semi-commercial property and holiday lets, and also don’t apply to any lending with a fixed-term of five years or longer. Also exempt are existing properties that are being remortgaged – as long as no additional funds are being raised. So if you’re moving an existing property from one lender to another to get a better rate (without increasing the amount you’re borrowing), you don’t have to worry about any of this.

Again, shortly we’ll look at what all this means in terms of what you should be doing as a property investor in 2017.

**Crazy high prices**

Since I started writing about property in 2012, prices in many parts of the country have rocketed – recovering from their lows after the last blow-up to eclipse their historic highs in many areas.

I’m pretty sure the timing is just a coincidence: I don’t think the property boom is my fault.

One person might be encouraged by this – thinking that now’s the time to get into the market because property prices seem to be rising fast. Another person might be nervous about getting in now because they think prices have grown to such an extent that they’re unsustainable.

Who’s right? Both of them.

What frequently gets overlooked is the huge variation in prices between different parts of the UK. This graph shows what’s happened to prices in Greater London (blue line) compared to the rest of the UK (brown line) since 2002:
And this graph shows the change in affordability of property (expressed as the multiple of house prices to average earnings) in different cities since 2002:

(Source: Hometrack)

Over the long-term, on average, property prices have been equal to 4.8 times average annual earnings. In many parts of the UK (such as Glasgow in the graph above), prices are currently lower than this long-run average.

(Source: Hometrack)
In London though, they’re 14 times earnings – ridiculously higher than the average. It means that assuming a mortgage lender would lend a maximum of five times annual earnings, an average-earning couple would still need to have four years of earnings in the bank to put down as a deposit.

London prices have always been higher than elsewhere in the country, because earnings in London are higher. But in both graphs, you can see a clear divergence starting in 2011/2012: although prices are getting higher everywhere, they’re growing faster in London and therefore becoming less affordable.

My belief is that over the next few years, prices in London and the rest of the country will start to converge again – with London dipping and the rest of the country starting to grow faster. Recent data bears this out, but whether it’s true or not is almost irrelevant: because buy-to-let in London and expensive areas of the South East just doesn’t add up.

Why? Because of the combined effect of everything we’ve talked about: crazy prices, tougher mortgage restrictions, and higher taxes – both Stamp Duty and the restriction on mortgage interest relief.

While rents in London are crazy high too, they’re not crazy high enough to produce a decent yield. With tougher mortgage criteria, you won’t be able to borrow as much – meaning you need to put in more cash and therefore suffer a reduced return on investment.

Can prices climb further still? Possibly – but at this point it’s difficult to do any better than break even month-to-month, so your returns will be dictated purely by speculative capital growth.

It’s not just London – there are other cities (like Bristol, Cambridge, Oxford and Brighton just off the top of my head) where prices seem totally bonkers. And yes, there will be the odd spot within any of those places where the numbers do add up.

But the general point is: yes, UK property as a whole does appear to be expensive when you compare current affordability to historic affordability. But as the graphs above show, this is largely driven by particular cities and regions. If you dig down a bit, there are plenty of areas where there’s value to be found.

**Brexit**

I include Brexit because I get questions about it all the time, but I don’t think it’s actually going to make much difference to property in general: immigration is unlikely to fall that much, I don’t see foreign investment being deterred, and nobody (currently) knows what form Brexit will take in any case. There are certain markets where it could have an impact in the future (such as HMOs for blue collar overseas workers), but in general I don’t think it’s a big factor.

One thing that does seem likely is that the whole process will be dragged out – and that creates uncertainty. That uncertainty won’t stop Mr and Mrs Jones in Rhyl from moving out of their flat and into a three-bed semi, but there are institutions and large-scale investors who will delay making buying decisions until there’s a bit more clarity. This seems likely to suppress the transaction volume in the market, and probably apply a brake to prices in certain areas too.
What does it all mean?

So the government is out to destroy property investors, prices are historically high, mortgages are getting tougher and uncertainty is going to be a feature of our economic life for the next couple of years at least. Does this mean that it’s time to give up plans to buy any more property, hand back the keys to the existing portfolio and cry in bed while looking at the £0.06 interest your money accumulated in the bank last month?

To many people, it will look like the party’s over. For some (like those who are very highly leveraged), it actually will be: some research suggests that 25% of landlords are considering leaving the market.

But to a student of the property cycle, this just looks like the “mid-cycle dip” – bang on time.

The property cycle comes from the observation that going back hundreds of years, property prices have followed a repeating pattern of boom and bust – with one complete cycle lasting roughly 18 years. It looks like this:

![Property Cycle Graph](propertygeek.net)

From the 2008 blow-up, we had about four years of falling then consistently low prices. Then from 2012, property went on a bullish run (the “recovery phase”) – aggressively in the South East, less so elsewhere.

Now, we’re due a mid-cycle dip. We’ve already seen the multiple factors that are bringing the dip about, and price data coming out of central London suggests that it’s already starting to happen. The interesting thing is that this dip will be widely misinterpreted as a crash. As soon as prices start to fall (or even just stop growing), the media will jump all over it and call the peak of the property market. Properties will sit on the market longer, and transaction volumes will drop.

Prices will fall slightly... but this isn’t the crash. If you follow the media and sell out now, you’ll miss the explosive growth in the second half of the cycle.
What will drive this aggressive growth? Booms are always caused by sentiment and by financial stimulus – and there’s plenty of evidence that we’ll see plenty of both in the years ahead. Growth will be driven by the continuation of low interest rates, overseas investment, more quantitative easing to keep the economy alive, confidence returning as uncertainty diminishes, and probably the government acting to pump up house prices to make everyone feel good ahead of a general election in 2020.

But despite my belief that the outlook is good for property prices over the next seven years or so, all the anti-investor measures we’ve already talked about are still in place. This means that the days of easy gains are over: no more can you just buy any old property at any old price, do very little, watch the price fly up and keep remortgaging to release your new equity.

There are great wins to be had in the coming years, but they won’t be had by everyone. Lazy investors, reckless investors, and investors who don’t bother to look beyond the mainstream media to see what’s going on will be pushed out of the market – exactly as the government wants to happen.

They’ll be forced to sell out to the investors who are willing to professionalise, educate themselves and move with the times – and who will therefore avoid the risks and threats we’ve already talked about.

If you’re up for putting in the work to become one of these latter type of investors, what should you do? That’s what we’ll turn to in the next section.

What should you do?

Consider investing as a company

Incorporation is not a silver bullet – but more and more landlords are deciding to buy properties within a limited company rather than in individual ownership. One mortgage broker I spoke to recently said that 50% of the mortgages he arranges are now for companies, up from 10% just a year ago.

Why is company ownership on the rise? The big reason is the changes to mortgage interest relief – which don’t apply to companies. In other words, companies can continue to deduct their mortgage interest as a cost of business before arriving at their profit figure – just like individuals could before.

Another reason is the consequence of the new “profit” definition I talked about earlier – meaning that more people will be pushed up into the higher rate tax bracket. Previously, as a basic rate taxpayer, you would have paid 20% income tax. Corporation tax is also 20% – so there’s no saving from being in a company. But if you’re now pushed into the higher tax bracket because of the way profit is defined, more of your income will be taxed at the higher rate of 40% – which means paying corporation tax of 20% (and falling over the next few years) becomes more of an attractive option.

Incorporating isn’t as scary as many people think. You can start a company online in ten minutes for a cost of about £20, and you don’t need any trading history in order to get a mortgage. In the context of property investment, the company is effectively just a wrapper for the property: the lending decision will be based on you as an individual.
Mortgage availability for limited companies is improving rapidly too. Rates and fees are still higher than they are for individuals, but they’re falling fast: there are far more products available than a year ago, and in another year’s time it will be better again.

But it’s not going to be right for everyone. The main issue is getting money out of the company: if you pay tax at the higher rate, you’ll pay dividend tax of 32.5% on any money you want to withdraw for your own use. As a result – as a very general rule of thumb – incorporation will work well for someone who’s happy for the rental income to build up in the company for future purchases, but not very well for someone who wants to get at the income as well as have another source of income from a job.

There are other factors too – like companies not having a capital gains tax allowance, and the higher accountancy costs that come along with company ownership. But the main one is the issue of getting money out.

Just to be clear, none of this is tax advice in any way – just very broad-strokes general information. You should speak to an accountant before making any big decisions – and research your options further yourself too, because many accountants have a tendency to process what they’re given rather than come up with proactive suggestions.

In general, though, incorporation is something that has come from almost nowhere to being on most investors’ radars – and it’s something you should at least consider too.

Avoid the South East

We’ve already seen how, by pretty much any measure you can pick, property in the South East is historically expensive – but other areas of the country seem to represent good value.

You could argue that because prices in the South East have been so strong, there must be underlying factors in place that mean the growth will continue. But even if that’s the case, the factors we’ve discussed (like tougher mortgage regulations) will make it very challenging to buy anyway.

So I’d say it’s time to start looking where the value is. For the most part that means away from the South East, although there are still some pockets of value to be found. Head north of Birmingham and prices are largely affordable for investors and owner-occupiers alike: investors can pocket a healthy yield, and owner-occupiers can buy with a reasonable deposit and with a loan based on a sensible multiple of their salary.

You can also look to benefit from the “ripple effect”: the idea that when prices in one area go up, some people are priced out and move to the next area along – pushing up prices there too. We’ve seen this with prices in London rippling out to the outlying suburbs, then even further afield to the commuter belt towns. This means that as Manchester starts to do well, nearby well-connected towns like Stockport and Sale are likely to benefit from the ripple. As Leeds booms, the ripple could extend to places like Bradford and Pudsey.

OK, it’s easy to casually talk about the prospects of different areas – but if you live in an area where buy-to-let doesn’t currently make sense (like London, Brighton, Cambridge, Bristol etc.), it’s logistically challenging and emotionally scary to invest away from where you live. I’m not saying it’s easy, but if you’re motivated enough it can be done. I’ve done it, and so have many other people I know.
Really, it’s just another form of professionalising. Rather than being the amateur investor who buys on the next street along from where he lives, be the professional who looks at the whole range of opportunities and deploys capital where the investment case is strongest. It means taking a different approach to property investing (embracing the “investor” rather than “landlord” mindset and developing new skills accordingly), but that’s where the opportunities lie.

Of course, if you live in an area that still makes sense for investment, go for it. And if you don’t but you’re really not comfortable investing anywhere else, you might want to look at opportunities away from buy-to-let...

Look at alternatives to buy-to-let

There are two sources of profit from property investment: the month-to-month rental income, and the benefits of capital growth over time.

As a result of the tax changes in particular, rental income is being squeezed. This has led to investors turning to other types of property investment that produce higher yields – such as a HMOs, serviced accommodation and holiday lets. All of these have their complications and challenges, but what they have in common is that the same amount of capital outlay (on buying a property) will generate higher rental income than if that same property were rented on a single long-term tenancy.

(Furnished holiday lets have the added benefit of escaping the mortgage interest changes, even if owned by an individual.)

These types of investment all require more specialist knowledge than normal buy-to-let, and are more hands-on too. But if your main aim from property is to generate a monthly income and your ability to do that has been compromised by recent events, it’s something to look at.

There’s also a potential squeeze on the other form of profit from property: capital growth. As I said earlier, I expect growth to be slow in areas where prices have already skyrocketed – and I also expect growth to be generally slow across the board for the next year or two while we’re in the mid-cycle dip.

So if you’re looking to benefit from capital growth over the short term, you’re less likely than before to get it by just buying and waiting. Instead, more investors are looking at “flipping” property (buying it, refurbishing it and selling it for a profit) and conducting development projects – like commercial-to-residential conversions or building new dwellings on a plot of land.

Really, it all comes down to your goals. If buy-to-let is still going to get you to where you want to be (and it is still a great vehicle for the long term), then stick with it and don’t get distracted by any trendy or exciting-sounding alternatives. But if it looks like you’ll need to do something different to achieve what you want (perhaps because your goal involves creating more income or capital in the short term), these are all options worth exploring.

Insist on bargains, and add value

Even if do decide to stick with straightforward buy-to-let, there’ll be opportunities in the next couple of years to grab bargains and add value.
I mentioned earlier that one study found that 25% of landlords were considering selling up (source: RLA). This figure sounds far too high to me, but even if it's only 10%, it means a lot of previously-rented properties will be coming onto the market in the coming years. And – because of would-be investors being scared off by the factors we’ve already discussed – some of those properties could end up sitting on the market without selling.

That spells opportunity. A lot of the rental stock coming onto the market will be tired (the type of landlords who’ll be selling up are likely to be those who haven’t invested in their properties in years), and won’t appeal to owner-occupiers. If it sits on the market for a long time without finding a buyer, that means there’s the opportunity to make a low offer and snap it up for a bargain price. You can then add value by investing in bringing it back up to standard.

With buy-to-let getting tougher in general, it makes sense that returns will have to be earned: instead of just buying any old property for the asking price and waiting for time to work its magic, you’ll need to make your money when you buy by bagging a bargain. That’s always easier said than done, but market conditions should create the opportunity to make it happen if you’re willing to put in the work.

Get educated and get prepared

Most importantly of all, you should keep educating yourself about what’s going on. I reckon most property investors don’t even know about the major tax changes that are taking place – and they’ll probably get a nasty surprise when they next come to take out a mortgage, too.

“Keep educating yourself” doesn’t mean relying on the mainstream media for your information: if you do that, you can pretty much guarantee being misled. They’ll tell you the market’s crashing when it’s just a wobble, then they’ll be full of stories about how brilliantly the property market is doing just as the next crash is around the corner.

Because another crash will come – and given the amount of money that’s been pumped into the economy just to keep it limping along, I think it will be a big one. According to the property cycle, it should be along in about 2023 – but the length of the cycle is a historical average rather than anything you can set your watch by.

By staying educated and looking for indicators in the real world (not the mass media), you’ll be able to see it coming – so you can avoid buying at the peak, make sure you’ve got strong cash reserves and good cashflow, and maybe even sell off any poorly performing properties in your portfolio while you can.

A new era

It’s now been 20 years since the buy-to-let mortgage was introduced. Despite a couple of property crashes along the way, the years have been incredibly kind to property investors: if you’d bought pretty much anything in 1997 and held it until today, you would have done very well indeed.

I’m not one for drama, but as I said at the start, it feels like we’re at an inflection point: the end of the era of the amateur landlord, and the start of the era of the professional investor.

By “professional”, I don’t mean that only corporates and full-time investors will survive – although I do think more large-scale investment in the rental market is inevitable. By “professional”, I mean in attitude.
The investors who will survive and thrive over the next 20 years will:

- Take the time to structure themselves appropriately for their long-term plans
- Acquire properties in the areas with the best investment case, not wherever is most convenient
- Make better purchases than amateur investors would be satisfied with – always at a discount to the retail price
- Constantly review their business model and adjust as market conditions change
- Always be improving their skills and knowledge, and staying on the cutting edge so they can be prepared for whatever lies ahead

That’s what successful companies do, and it’s what individuals will need to do too in order to compete. These are the exact things I’ve just discussed how to do in the previous section.

I can’t stress this enough: landlords hoping for a rerun of 1997 to 2016 won’t just be disappointed: they could suffer major financial losses as a result. If you buy any old property without doing any preparation or research you might be OK, but you’re putting yourself at big risk too.

If you’re not up for the challenge, that’s fine – there are plenty of non-property investments you could make instead.

But if you’re willing to professionalise, I think the next couple of years in particular will be full of opportunity:

- With long-term landlords (who’ve been coasting for the last 20 years) leaving the market, there will be tired properties that can be snapped up at great prices.
- With new entrants put off from entering the market, there will be less competition for stock.
- With still nowhere near enough houses being built, rents will continue to be robust and demand for quality rental properties will be stiff.

It’s not going to be as easy as it has been in the past – but the fact that it’s harder is good news, because the majority of your potential competitors will take one glance at the newspaper headlines and decide not to bother.

It’s up to you. You can either give up on the idea of property investment, or you can commit to developing your knowledge and skills, build the right team, have fun taking advantage of the opportunities the next few years will offer, and build some serious long-term wealth.

I know what I’ll be doing.

**Buy my book: The Complete Guide to Property Investment**

*Fully revised and updated for 2017*

Over the last 20 years, more than a million Brits have made life-changing profits from buy-to-let. But as prices keep rising and the tax landscape changes, investors need to get smarter in order to succeed.
It’s far from “game over”, but the game is changing... for the better. The unwary and under-prepared will be squeezed from the market – leaving educated, strategic investors to have their best decade yet.

*The Complete Guide To Property Investment* gives you the insight, information and action plan you need to navigate this new property landscape and come out on top.

It starts by demonstrating – with real-life examples – a range of strategies suited to achieving different investment goals. Only then does it take you step by step through every aspect of researching, financing, buying and managing investment properties.

You’ll learn:

- How to formulate a strategy suited to achieving your investment goals
- Everything you need to know about financing your investments
- An exact step-by-step research process you can use to decide what to invest in
- How to manage your investments
- What the property cycle is, and how you can use it to your advantage
- How to build a profitable portfolio for the long term – including scaling up, surviving recessions, and exit strategies

Whether you’re turning to property to secure your retirement, start a new career or generate a stream of passive income, this book will be the most valuable investment you make.

[Click here to buy The Complete Guide To Property Investment on Amazon](propertygeek.net)