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Who is going to grow the private rented sector?

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The case for a larger private rented sector which will provide more flexibility and increased choice for young working households is slowly being made. The challenge now facing policy makers is how to stimulate the supply of rented homes by professional landlords while at the same time putting pressure on the unprofessional ones to raise their game.

An analysis of the facts would suggest that the negative perceptions surrounding the rental sector are largely mis-placed. While the house price boom of the last decade has led to some localised problems, these do not reflect trends across the whole market. The policy challenges we're facing now are how to grow the rented sector and who will drive its expansion. What the sector needs are professional landlords focused on delivering decent housing – the reality is that the majority are, and will continue to be, private individuals.

The good news for the housing market overall is that the supply of rented housing - driven by the availability of affordable mortgage finance and strong house price appreciation - has been growing over recent years. The open market rented sector has grown in the last 20 years from almost nothing to 2.03m dwellings – a 54% occurring since buy to let finance first became available in 1996. Most of this growth has been driven by private individual landlords who now own around two thirds of all rented housing, a trend that has been rising over the last decade.

Meanwhile, levels of corporate ownership have been shrinking and are unlikely to grow significantly despite the recent introduction of Real Estate Investment Trusts (REITs). Here the rules may work for commercial property but challenges remain in making them work for the residential sector. All of which leads us to believe that the private rented sector will be dominated by private individuals for the foreseeable future. The key policy challenge is how to ensure that the professional landlords are encouraged to stay in the market while the unprofessional landlords are forced to either raise their game or exit altogether.

Differentiating between good and bad landlords is hard but the underlying motives of landlords probably reveals most about the way they view their investments. There is certainly confusion between 1) normal investment activity by professional landlords committed to their tenants and the sector, and; 2) pure speculative activity where investors use residential assets to try and make a quick buck on the back of a rising market with little, if any, commitment to tenant demand or the community in

which they are investing.

Over the last two years there has been an increasing amount of speculative investment as a result of falling yields and rising finance costs. This has meant that it has become increasingly expensive for a normal investor to access the market. For example, the equity required to buy an average two bed flat with a typical buy to let mortgage in a British city today, averages around £35,000. The rising cost of sustainable investment has resulted in new activity being focused on riskier markets such as those in renewal areas where values are low but where there is the prospect of high returns on the back of market intervention. Put simply the housing benefit market provides investors with an ability to secure a cashflow from their properties while they wait for a point in the future where compulsory purchase at a higher price is highly likely.

Parts of the new build sector attracted a growing amount of speculative demand whereby a 10% deposit on a property meant that they could benefit from house price inflation as the scheme was built out. Such has been the uptake from investment buyers looking at their property as an asset rather than a home that pricing in some new build markets has become distorted and problems and further negative headlines lie ahead. That said, pricing in other new build markets appears more sustainable.

While there are some very real and on-going problems in these speculative investor driven markets it cannot be said they are not representative of the private rented sector as a whole. Indeed, it is hard to see how policy could control some of these recent excesses that were inevitable after a decade long bull market in housing. The danger is that we spend too long trying to influence problems where the horse has already bolted and market forces are now starting to unwind through higher finance costs and lower house price inflation.

Contrary to some press speculation a mass exit of private investors from the sector seems highly unlikely and it is important to differentiate between amateur investors with small portfolios and larger more established investors. Analysing data from the English House Condition Survey shows that over 80% of rented property owned by private individuals is in the hands of the largest 16% of landlords, typically those with portfolios of more than 10 properties. The credit squeeze will impact on the smaller players with little equity, while the larger players may sell some assets. But a mass exit is highly unlikely and not what the housing market needs from either a stability or improving choice perspective. The focus must be on growing a sector of the market that adds to flexibility and provides additional choice, especially for young working households.