

Facts & Figures

Investment Property Purchase Guide



By
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Our Guide

This guide has been produced in response to enquiries from clients who are keen to have some background on this opportunity in the property market. It is not intended to be an exhaustive encyclopaedia.

We would be very pleased to receive feedback that we can incorporate into future releases.

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Facts & Figures' Services:

Facts & Figures is a family run business established in 1992 by husband and wife team Simon and Pam Webster.

Facts & Figures acts for a number of businesses as well as for private individuals.

Facts and Figures offers professional consultancy services across the whole range of Financial Services. Of particular benefit to clients are its extensive product databases which compare and contrast the relative merits of the majority of insurance, investment and mortgage related products currently available.

For our personal clients **Facts & Figures** advises on Mortgages, Life & Health Insurance, Pensions, Investments and tax mitigation strategies .

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Please note that not all products and services mentioned are regulated by the FSA.

Facts & Figures operates on both fees and commission and we will be happy to tailor a remuneration package to suit your needs.

Lastly we are obliged to inform you that while the Financial Services Authority regulates most of our activities - Buy to Let Mortgages are not currently regulated by the FSA...

Introduction to the Property Market:

The recent economic downturn has hit all investment classes. However it is important to recognise that *average* prices mask substantial *regional* price variations. So do make sure the area you wish to invest in has good letting and capital appreciation potential. This will mean relying on your own local knowledge or talking to local property professionals. But as an example in “Facts & Figures” own area (Ashford) the newly launched high speed rail link to London has stoked considerable interest in the property market and prices have recently risen quite sharply as a result (August 2009). Ashford now quite possibly represents one of the few potential hotspots in the South East.

Investment property is usually a *leveraged* investment – i.e. purchase is supported by borrowing. If you had invested say £50,000 of your own money into a building society 12 months ago you would have been lucky to achieve a return of 5%; earning you the princely sum of £2,500. If you had used that same money as the deposit on an investment property costing £150,000 and that property had grown in value by the same 5% you would have gained £7,500 or three times as much. The key point however is that property can fall as well as rise in value and a 5% fall in value of the property could see a paper loss of the same amount. You also have to allow for void periods (i.e. those with no rental income) and then there are sale, purchase and management fees; plus maintenance as well as tax to consider.

A recent survey found that most Britain consider pretty to be a good investment, and so do we, but it is important to go in with your eyes open!

It could be that you have no spare cash but you do have equity in your own home. You could borrow against your own home to raise the necessary deposit. Indeed in some circumstances, if you have not changed your mortgage in some time, it may be possible to increase your mortgage, and yet still reduce your total domestic monthly mortgage outgoing!

Nothing in life is guaranteed and just because property has been an attractive investment in the past does not mean it will certainly be so in the future. But none of us can predict the future and there is no way of knowing which asset class will actually perform the best in the years ahead. You could buy a house to let out and:

- Fail to find any tenants.
- Have problem tenants that fail to pay and won't leave.
- Interest rates could rise.
- The bottom could fall out of the housing market and if that happens, you could lose more than the value of your initial investment if you sell.
- The market could become saturated and push rents down.
- The chancellor could amend the tax system to the detriment of investors.

Investment Matters

Any potential investor has to take careful note about what they need to achieve from their investments in terms of income & capital growth in the light of personal circumstances such as age and the investment time frame envisaged.

Is income important? If so, how much is required? If income is not required now is it likely to be required in the future? How protected does capital need to be? How will this investment fit in with any other investments held? How will this investment impact on the investor's overall tax position? Is inheritance tax an issue? If so, what IHT mitigation strategies have been implemented? Whose name or names should the property be in?

All this needs to be very carefully considered before asking questions about what to buy and where. A soundly based investment strategy is crucial before embarking on any decision making process and if you have any doubt, it is vital that you take professional advice.

Emergency Fund

Every investor should hold an emergency fund in cash. It may be that this fund is fed by standing order each month to meet planned purchases. Liquidating investments to meet unexpected contingencies is bad planning; can be very expensive and is to be avoided wherever possible.

Risk: Reward Ratio

It seems that people today want to live in a risk free society. If anything goes wrong the first question often asked is, who is to blame? The sad fact is that bad things happen - for example cars crash every day - but most of us still drive. Markets sometimes crash too - but should that stop us investing?

Statistically one may consider car travel as a low risk activity. But the sad truth is that someone is killed or injured in a car crash every day. The fact that *overall* car travel is still a low risk activity does not reduce individual tragedy. The same is equally true with all areas of human activity, and just because an investment is categorised as 'relatively' low risk does not mean that investors cannot lose money. It just means that losing money is *relatively* less likely than with other types of investment.

The perfect investment returns a high income; capital growth well in excess of inflation and zero risk. The truth is however that no such investment exists. So any investment decision will of necessity be a compromise between potential risk and potential reward. Advisers can only detail the alternatives; it is for the investor to decide whether the risks are acceptable in the light of the potential reward.

Asset Allocation

There is an old saying about not putting all one's eggs in one basket. Every investor has to decide which asset classes are most suitable for their needs and in what proportion. This is usually best decided with the benefit of professional advice. If one only has £22,500 to invest then should it all go into property? On the one hand it would be sensible to have some stock market and bond exposure; on the other if to do so spoils one's chance of a higher, leveraged return in property does that adage still apply?

There is no hard and fast rule, every investor is different and individual circumstances and objectives are paramount. Always take professional advice.

Macro Economic Theory

Key to sound investment decision-making is an understanding of the factors underlying potential risks and rewards. What makes investment property so attractive is the potential an investor has for making capital growth from some one else's money - usually the building society's. This is known as "leveraged" investment.

For property investment to work at least four things need to happen:

- Property prices need to continue to rise
- There needs to be a good supply of reliable tenants
- Interest rates need to stay low
- There should be no major changes in the UK tax system

The first two are determined by the oldest law in the economic book, supply and demand; the third largely by world economic markets and the fourth, while impossible to predict, is at least constrained by electoral forces! We shall examine each in turn.

Demand

The law of supply and demand decrees that where supply is short, prices will rise and where there is over supply prices will fall. The regional planning authority in the South East recently declared that there is an overall shortage of 735,000 dwellings. These homes cannot be built overnight. In 1963 average occupancy was 4.3 people per household today the figure is nearer 2.6 and falling, yet according to Inside Track we are now building slower than at any time since 1924! On that basis alone there is likely to be continuing upwards pressure on prices.

In Ashford property investors have an additional advantage. The new high-speed rail link is now available to domestic passengers for the first time. Commuting to London has become a 37 minute 'hop' rather than an hour and 15 minute odyssey. Shorter London commuting times, coupled with easy access to France and improving local infrastructure could make Ashford an increasingly attractive location. As more businesses and more people move into the area the demand for property in Ashford is likely to increase faster than the national average. Demand is likely to continue to outstrip developers' ability to build. This will impact on future capital values.

In high growth areas there is likely to be a higher than average demand for rental property caused by people moving into the area quickly at the behest of their employers, while taking their time to get a feel for an area (and perhaps the job) before purchasing. Others may only be in town for a short time, making renting a logical accommodation choice. Sadly some just cannot afford to buy and have to rent.

The biggest worry for those considering investment property purchase is future interest rates. If rates shoot up into double digits the whole property market will take a very severe knock. This will impact on cash flows and value. While it is likely that as rates that are now at a 50 year low will rise slightly over time, the key question for any property investor is how likely is a *major* rise in interest rates? The answer to this question can be helped by an examination of what factors really impact on rates.

The recession has led to low bank base rates BUT mortgage rates are high relative to base. In our view while some rate rises are a certainty we do not see a return to double digit borrowing costs in the foreseeable future. But it is essential that you work out how much of an impact interest rate rises would have on you personally if you were to buy and make sure

that any increase would be affordable. So prior to leaping into the market you should consider whether you could support your purchase from your own pocket if the need arose.

Size Matters – So Does Local Geography

The general trend in national property prices is always headlined. However, national statistics mask a whole range of regional and property type / size variations. Certain types of property in certain areas change in value more quickly than others. The strongest demand from families is often for properties that have three or four bedrooms, while young singles just need their own space and prefer only two bedrooms. So if you are buying a three or four bed house what are the local schools and other amenities, such as parks and shops like? If you are buying a two-bed property, how far is it to walk or taxi back from the local pubs and nightclubs? Perhaps surprisingly, such issues are a real consideration for younger people, who tend not to drink and drive.

It is important to assess the likely market in a targeted local area both for rental and ultimate resale. Buying a property in a really good local area will obviously be more expensive than a similar property in a less attractive area, but will the rent it will command offset the additional capital cost? Remember this purchase is for investment so one has to consider what is likely to happen over the next 5 or 10 years.

One option could be a good sized property in a less attractive area with potential. Tenants will be less worried about local areas than they are about cost and if you buy value you can rent out economically. However many might find such a strategy unnecessarily risky, after all the promised area improvement might not materialise, and therefore you may prefer a more established area.

The Purchase Process

Legal

The legal process for the purchase of an investment property is identical to the legal process for buying a property for owner occupation.

- Decide on your target property type and area.
- Check the local plan, as while searches should in theory give you details about any big developments in your area they are often confined to the immediate vicinity only.
- View a selection of appropriate properties
- Decide on one or two you like and make *low* offers – you are looking for a bargain not a dream home.
- As an investor with no dependent sale you are in a strong position to purchase. It is a good idea to try and find a vendor who is keen to sell; you'll get a better deal that way. NB Estate Agents are legally obliged to communicate all offers to vendors so if you think the vendor might accept but the estate agent is baulking, put your offer in writing and ask for written confirmation of rejection.
- If the vendor is willing, consider negotiating directly.
- Agree a price
- Instruct a solicitor who liases with the vendor's solicitor
- Solicitor performs a local search on planning and other issues (basically to check that a railway is not about to built in your garden – but see comments on local plan above.)
- Solicitor inspects the title deed – does the vendor own the property? Who is responsible for which fences? Quite importantly he formally asks the vendor what is included in the sale and also if the vendor knows of any reason why the property should not be bought by you (nuisance neighbours, it's falling down etc)
- Solicitor peruses the contract for sale and purchase and any appropriate lease and advises on any anomalies.
- Solicitor agrees dates to exchange contracts and then collects the purchase deposit of typically 5 or 10% of the purchase price from you, which he holds as stakeholder until completion
- Solicitor exchanges contracts at which time everyone is finally committed to the transaction
- Solicitor completes the purchase at which time the balance of the purchase money must be paid over (mainly by the mortgage lender) and you get the keys.
- Meanwhile you should have been lining up contractors to undertake any decorating or repairs, arranging gas and electrical inspections, as well as advertising the property for rental so that your new tenant can move in as soon as possible.

Space precludes a detailed treatise here so check <http://www.landlordlaw.co.uk/> for further information.

Mortgage

There are so many different types of mortgage it would make this a very long document indeed to go over them all in detail. However some basic principles follow.

If you originally purchased your property with an owner occupier mortgage you will almost certainly be in breach of your mortgage conditions if you then let the property out, without the lender's consent. If you ask for consent the lender may choose to charge additional interest on your loan, or decline. As the lender is often jointly named on your buildings insurance policy the lender is likely to be advised when you change your buildings insurance in any event (see buildings insurance below).

The cost of mortgages and secured loans is generally cheaper than the cost of other borrowing. There is no tax relief available against the interest on a domestic mortgage. There is full tax relief at the highest rate paid on residential investment property mortgages – against rental (but not other) income. It follows that unless you have no residential mortgage and no other debt, you should consider arranging investment mortgages on an interest only basis and applying any spare capital against any non relieved or more expensive unsecured debt.

Traditionally mortgages in the UK were always arranged on a variable interest rate basis. But over the last 10 years fixed rates, typically over three or five year terms, have become more fashionable. Today, with low borrowing costs, fixing may sound an attractive option. But fixed rates are often higher than current variable rates. If rates do rise over the next 2 or 3 years an initially cheaper variable rate loan will become more expensive. So make sure you weigh up all the options in the light of what you believe is likely to happen.

Make sure you can still afford to proceed if what you regard as the worst case scenario occurs instead, and give yourself a safety margin.

There are two other fundamentals that must be factored into the equation. The first is lender fees. While most buy to let mortgage deals carry an arrangement fee of around £1,000, others command fees of up to 1%. While these are often added to the loan they can have a major bearing on the value decision when considering which type of loan and which lender is more attractive. The other key issue is lock-ins or tie-ins, whereby a borrower has to pay to extract himself from a loan within a certain period. These fees can be significant. There is only one rule here – always, always check.

Competitive pressures mean that there often deals available if you shop around. Consult Facts & Figures for the best deals – we do the shopping around for you...

It pays to examine the market for *all* the mortgages that you hold on a regular basis and certainly at the end of every tie in period to see if a third party lender will give you a better deal. Many lenders will offer further discounts to keep existing business, while others may offer deals to attract it – talk to **Facts & Figures** for advice!

With all mortgages there are two issues that are paramount for lenders. These are their security and your ability to repay. With a residential mortgage one can normally borrow up to 90% (although more typically 80-85%) of the lower of purchase price or valuation. Lower maximum advance percentages often apply to higher value properties. These are typically constrained by a maximum loan amount calculated as a multiple of 3.5 times the higher income plus 1 times the lower income; or 2.5 times joint incomes. The lender then looks at job security and the nature of any variable income – less the cost of servicing any other debts that a prospective borrower may have. Individual credit worthiness is also considered. Does

the prospective borrower have any CCJ's, for example? Lenders share information these days and a detailed credit reference can even indicate whether you pay all your loans or credit cards on time. The nature of the system is such that if you normally pay your credit cards a couple of days late some lenders will not offer you a mortgage.

With mortgages for residential investment the lender wants to see a more substantial deposit; usually a minimum of 25%, or as much as 35%. However they then look at ability to repay based on the likely rental income stream – not usually the borrowers' own income. When the property is valued the lender will ask the valuer to give an opinion on likely rental income. The lender will then advance up to 65% / 75%, as long as the prospective rental income covers the cost of the loan by typically 130%. A buy to let lender will not generally care if you earn £20,000 per annum and already have a £70,000 mortgage on your own home. Although they will check to make sure that all your payments are up to date. However some buy to let lenders need to see that borrowers do have a regular income and some stipulate that it be at least a minimum of £20,000 per annum; while others will not lend to first time buyers. The exact formula varies from lender to lender; again it pays to take professional advice so talk to **Facts & Figures**.

The interest rate charged on a residential investment mortgage is often a little higher than that charged on a mortgage on owner occupied property. But there are still some very attractive deals available. As these change almost daily we recommend you either contact our buy to let specialists on 01233 813313 or email ifa@fffp.co.uk

In any event it is always sensible to take professional advice so do contact us for further information.

Other Costs

Purchasing a property carries inherent costs. Due to the nature of the market in the UK, one may enter a transaction in good faith but for whatever reason the vendor or indeed the purchaser may decide to withdraw before exchange of contracts when everyone is committed. Until exchange of contracts the purchaser and the vendor are liable for their own expenses, irrespective of whether or not the purchase completes.

For the average £150,000 transaction the following fees apply. Those marked * are only payable on completion and will not be payable at all if the purchase falls through.

Lender Valuation fee	300
Mortgage broker fee	250
Lender completion fee (range £400 – 1%)	999*
Solicitor fee inc. VAT	500*
Land registry fee	150*
Stamp duty	Nil*

A solicitor may charge a pro rata fee in the event of an abortive transaction.

Stamp duty works on a sliding scale but there is none to pay on purchase prices under £175,000

Tenancy Agreements

It used to be that traditional tenancies gave tenants considerable rights - not least restricting the landlord's right to increase rent in line with market conditions and his right to take back occupancy of his property. While such rules in theory controlled unscrupulous landlords, they also deterred many honest ones from entering the market.

Most properties today are let on assured shorthold tenancies, a relatively new type of tenancy that is typically run for 6 or 12 months but can be extended if both parties agree. There is a clear process for removing non paying tenants, while still providing tenants adequate protection from unscrupulous landlords.

Most letting agents will supply a copy of a tenancy agreement as part their service, although you can get useful information from <http://www.landlordlaw.co.uk/>

Safety: Three golden rules

1. The law states that any furniture supplied by a landlord must comply with relevant fire safety standards. Just any old furniture will not normally do, always check for the fire retardant labels
2. The law also states that properties supplied with gas must have an annual landlord inspection at the landlord's expense.
3. It is good practice but not yet law that an annual electrical inspection be undertaken at the landlord's expense.

Remember that in our increasingly litigious times in the unlikely event of a fire or electrical problem the tenant will be looking for a way to seek damages. If you as landlord have complied with all your legal requirements the tenants' claim is less likely to succeed.

Remember also that if you, as landlord, have failed to comply with a legal requirement your insurance may be invalidated and you may be personally liable.

Letting Agents

When someone wants to rent a property they tend to go to a letting agent rather than the local paper or the internet. Any delay in letting the property will cost you money so we strongly recommend that you always use an agent to find your tenant. The agent will credit check the prospective tenant and show them around - saving you a load of hassle - they really earn their fee; which typically would be around one month's rent with a minimum of £500 plus VAT.

If you self manage you will need to collect rent from the tenants which means you will need to draw up a standing order. You will also need to be prepared to fight if the rent is paid late or not at all and again at this stage a good management agent earns his fee. Agents typically charge 10% plus VAT for management, which includes collecting the rent.

Whether you want to use an agent to manage your property once it is let will depend on your confidence in your DIY and negotiation skills. If you give the property over to an agent to be managed the manager will call in a plumber even to change a tap washer - this will probably cost you £70! You will never know about it until you see the bill - which saves you considerable hassle. Alternatively you could do it yourself in half an hour and save the £70 – but only if you have the know-how, the time and don't mind meeting the tenants in person. Alternatively if you self manage you could choose to retain a local odd job man to do such things more cheaply for you.

What you choose may also depend on the general state of the property. If it's just been extensively modernised or is a new build the chances are nothing much will go wrong in the early days and self management should be a fairly safe bet. If it's older and more run down, handing the problems to an agent might be very good value; as long as you are happy that the bills will not come in too high.

Building and Contents Insurance

If you are the insured and you let a property out without informing the buildings insurance carrier you may be invalidating your buildings insurance, you will almost certainly be invalidating your contents insurance. You must inform your insurers when you let a property and they will may charge an additional premium. Facts & Figures has an arrangement with a Lloyds Carrier for dedicated landlord insurance.

Conclusion

This is an exciting market opportunity and Facts & Figures is ready to help you. Call us now on 01233 813 313 or email ifa@fffp.co.uk