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THE HMO REPORT

Houses in Multiple Occupation are evolving, moving up the value chain and attracting a new type of tenant.

A word from *Paragon Bank Managing Director of Mortgages*

Richard Rowntree

The HMO market has existed for decades but the past three years have seen a marked departure from the traditional perception of this type of shared accommodation. Properties are moving up the quality scale as tenants demand more space, better services and access to private facilities.

Partly this shift to high quality has been accelerated by the pandemic and tenants' desire to have self-contained accommodation that offers increased flexibility at lower cost than a typical house share. It is also a reflection of altered dynamics in the landlord mix across the market. The removal of buy-to-let tax reliefs in 2020 has driven demand for higher yielding properties to maintain profit margins. Limited company purchase has risen and landlords previously in the market with just one property are reducing.

The private rented sector is attractive to institutional investors and professional landlords with larger portfolios. Not only have capital values held up - and in many areas soared - rents continue to rise, supporting yields. Complex buy-to-let, including HMOs, will net investors returns averaging at least 6% to 7% and in some cases more than 10%.

With global stock markets experiencing severe volatility as economic and geopolitical tensions exacerbate both public and private finances post-pandemic, investors have few stable capital and income-bearing asset options. Residential property remains resilient, with long-term supply shortages underpinning demand and valuations in the coming years.

More rigorous regulation of safety and living conditions is now commonplace across the entire private rented sector – and expected to toughen - and accommodation quality has seen rapid improvement in recent years.

We examine some of the trends in this report, capturing who HMO landlords are, how they are feeling, the challenges they face and what they are seeing from tenants.

The changing face of HMOs

HMOs are moving upmarket as tenants demand better facilities and professional landlords grow their presence in the sector

HMOs offer tenants more affordable and flexible rental accommodation than traditional buy-to-lets, freeing individuals up from longer-term commitments and reliance on fellow tenants. The pandemic saw demand slow, but marginally and temporarily. Momentum in the market is still very high, even with the rising cost of living.

There has been a marked change in tenants' expectations of quality accommodation, which is driving stronger landlord demand for good quality HMOs. Demand for mod cons is noticeable among both the young professional market and, increasingly, within student markets.

Overseas students, in particular, are prepared to pay a premium on rents where accommodation is high spec and self-contained. En suites are becoming more of a priority for tenants, with some demanding hotel-like standards from their landlords.

As workers returned to offices following the end of social restrictions and the worst of the covid pandemic, demand for HMO accommodation in commutable areas has strengthened considerably.

The valuation of HMOs is becoming increasingly specialised given the complexity of local markets. The type of tenant demand is much more nuanced and important, while rental prices are more sensitive to property condition in HMOs. There are many different varieties of HMO property type as well as tenant profile.

Location is also more nuanced for the HMO market than for traditional buy-to-let. New and extended licensing requirements vary by local authority, as does councils' enforcement of minimum standards and planning permission thresholds. Some local authorities are noted for their strict adherence to the rules, while others are less assiduous at checking compliance for properties that do not meet minimum regulatory requirements on condition, fire safety and room sizes.

Resale demand is more complex to assess for HMOs than residential or single tenancy buy-to-lets, minimising the buyer pool and adding cost for buyers wishing to convert post purchase. Location is also critical in understanding values. The same property in a fringe location is likely to be valued at a higher price if sold as an owner occupier property than an HMO. In areas of high tenant demand, it's likely that the property would be valued higher as an HMO than as a single unit.

With minimum EPC band ratings on new tenancy agreements expected to become mandatory for landlords in England from 2025, properties' energy efficiency is now front of mind for many landlords, particularly those seeking to purchase additional properties and for those planning retrofits on existing properties between tenancies.

While some estimates put the cost of upgrading stock to the incoming band C thresholds in excess of £30,000 per property – more in some cases – there is no evidence that this extra spending requirement is being factored into asking prices or mortgage valuations. Demand for property remains so strong compared to supply, valuations are reflective of current market conditions and do not account for future expenditure needs.

We surveyed HMO specialist landlords to examine the key trends in the sector, how HMOs are changing, the challenges and the opportunities.

At a glance...

Source: Paragon Banking Group research, April 2022

"Demand for HMO finance has been turbocharged over the past couple of years and it's really pushing up standards. At Paragon we consider the condition of properties as central to responsible lending practices, and where we don't think properties are up to scratch, there will be a dialogue with the borrower and adviser to make the necessary improvements. It's in the whole market's interests to protect the tenants and shed that dingy bedsit image of the past.

Jason Wilde, National Sales Manager, Paragon Banking Group

TIME IN PROFESSION

79%
of landlords with HMOs have been letting properties for more than 11 years

39%
have been in the game for more than 20 years

MANAGEMENT

50%
of HMO landlords run their business in partnership with immediate family members

37%
let and manage their portfolio themselves

36%
of professional landlords with HMOs run their business solo

READY-MADE OR CONVERSION

54%
converted their property into an HMO after purchase

27%
bought or inherited their HMO already established

PROPERTY TYPE

43%
of HMO-owning landlords have individual units in a block with a further...

22%
...owning the whole block

62%
of HMO landlords own terraced houses

48%
own semi-detached houses

9%
have short-term holiday lets

PORTFOLIO SIZE

74%
of HMO landlords own up to 12 rentals

4 out of **5**
landlords owning HMOs said they had up to six within their portfolios

An evolving stock profile as tenants demand more

What is the profile of HMO stock and what are tenants demanding?

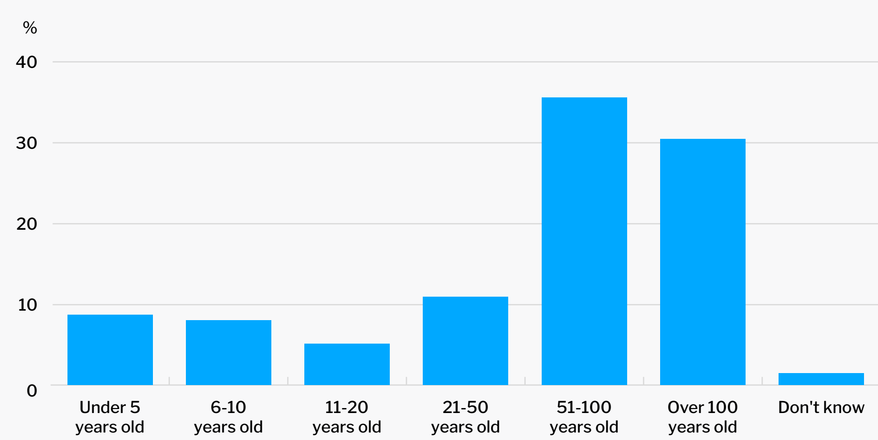
HMOs were plagued with a poor reputation and deemed to be low quality housing, but that perception is changing.

HMO landlords identify a flight to quality as a trend characterising the past year, with 48% saying they'd seen growing demand for high end HMOs and 45% saying demand from young professionals was up over the past year. Just under a quarter, 23%, of landlords also said HMOs were appealing to older, affluent tenants.

The majority of landlords said demand for higher speed broadband had increased over the past year, while a significant proportion of tenants were seeking larger rooms (39%), ensuite bathrooms (52%), and better quality furnishings (39%).

Four out of five HMO landlords said they had a strict no pets policy, though 12% of those questioned said they'd seen more enquiries for pet-friendly accommodation over the past 12 months.

WHAT IS THE TYPICAL AGE OF HMO PROPERTIES IN YOUR PORTFOLIO?



Despite this move up the value scale, HMOs still typically have an older stock profile. A considerable 82% of landlords with HMOs said the typical age of HMOs in their existing portfolio was 11 years or older. Some 36% of HMOs were reported as being between 51 and 100 years old, while three in 10 are more than 100 years old.

Over half of landlords, 54%, have converted a property into an HMO after purchase, with 27% purchasing a ready-made HMO into their portfolio.

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WHAT TENANTS WANT FROM AN HMO

55.8%
High speed broadband

52.8%
Rooms with ensuite bathrooms

39.1%
Large rooms

39.1%
Quality furnishings

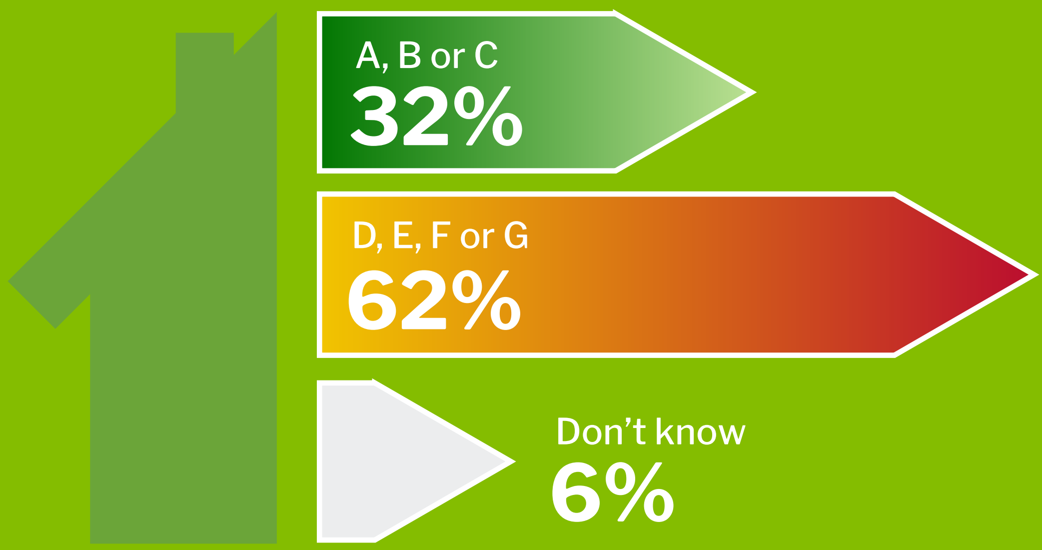
34.8%
Office furnishings for home working

30.4%
Communal space

27.7%
Garden/ outdoor space

12.4%
Allowing pets

WHAT IS THE MOST COMMON EPC RATING OF YOUR HMO PROPERTIES?



The *burning issue* for HMOs

HMOs are typically older properties and tenants pay an 'all-in' fee. Landlords are therefore, paying close attention to proposed new energy efficiency rules

The Heat and Buildings Strategy published in October 2021 outlines government's proposed ambition that all residential properties – owner occupied as well as landlord owned and social housing - should be EPC band C or above from 2028 "and beyond".

The private rented sector is leading the way, with rules expected to pass into law requiring that all new tenancies from 1 April 2025 and all existing tenancies by 1 April 2028 meet EPC band C or higher.

Almost two thirds, 62%, of HMO landlords said the most common EPC ratings across their portfolios were D, E, F, G, suggesting there will be significant demand for finance to fund renovations.

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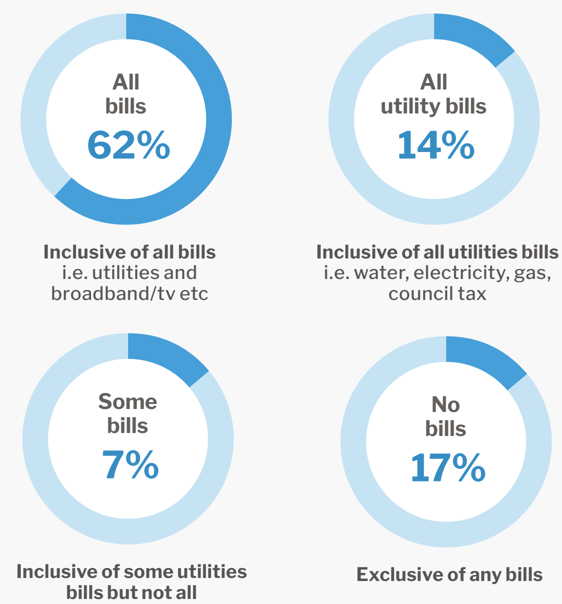
Some 71% of landlords planning to expand portfolios with the purchase of an HMO in the next 12 months said the property's EPC rating was an important factor when assessing whether to invest. More than one in three said energy efficiency was now either a "very important" or "extremely important".

The high cost of converting older properties to improve energy efficiency was a frequent reason given by landlords now opting to purchase properties with high existing EPC ratings.

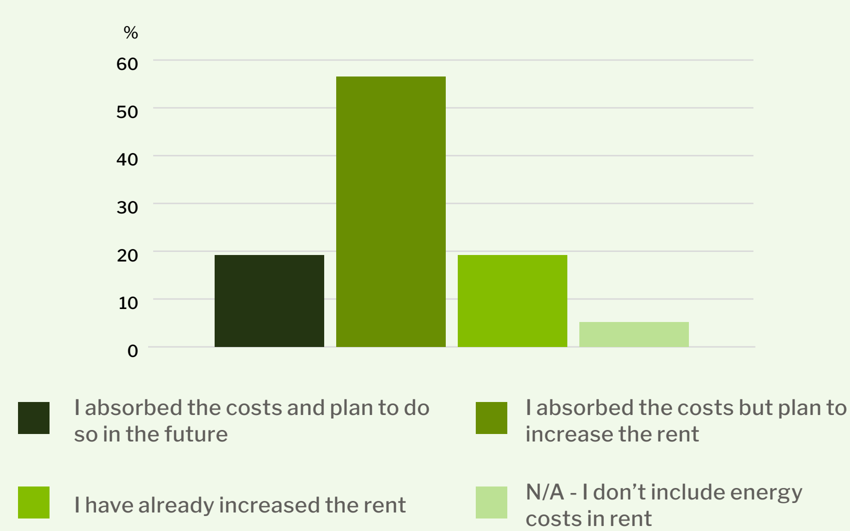
AND HOW DO YOU USUALLY RENT YOUR HMO PROPERTIES?



Rapidly rising energy costs stood out as the frontrunner when HMO landlords were asked what their biggest challenge had been over the past 12 months. Some 64% of those surveyed said higher energy bills had been a concern, reflecting the fact that 62% of tenancies in HMOs are inclusive of all bills including energy, broadband and council tax. A further 14% include utilities bills only – gas, electricity, water and council tax.

While one in five landlords said they had no plans to pass higher energy bills to their tenants, more than half do plan to increase rents to cover the higher cost of living. Some 19% have already raised their tenants' rents.

MANAGING INCREASED COSTS



The growth of HMO lending

HMO loans have increased since the low of the pandemic, but remain a specialist part of the buy-to-let market

The HMO market remains a niche section of the overall buy-to-let market. UK Finance data shows that HMOs represented only 3.6% of all buy-to-let new purchase lending in 2021

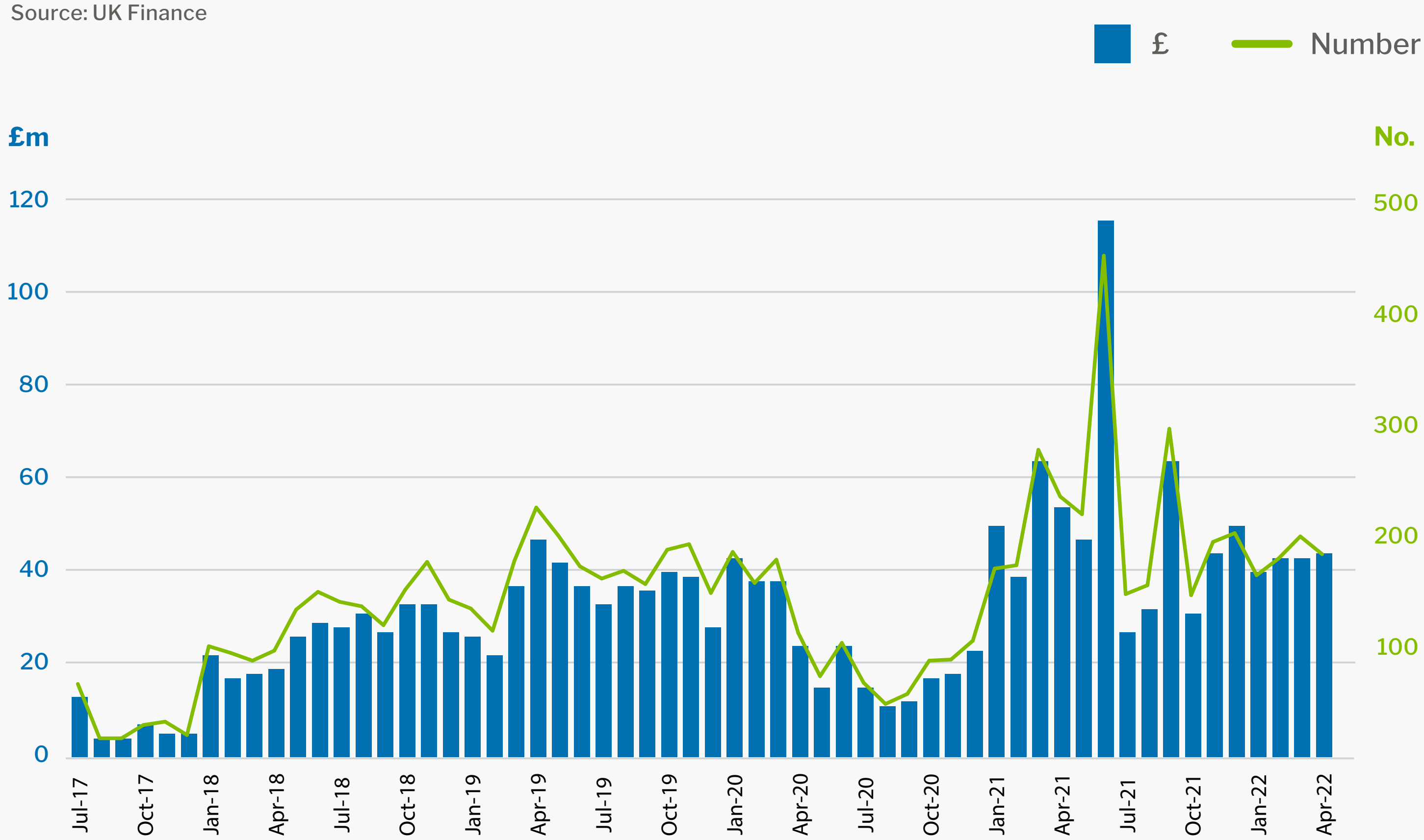
The value and number of loans for HMO purchase has seen strong growth over the past five years. Lending grew from £310 million in 2018 to £424 million in 2019, the full year before the pandemic.

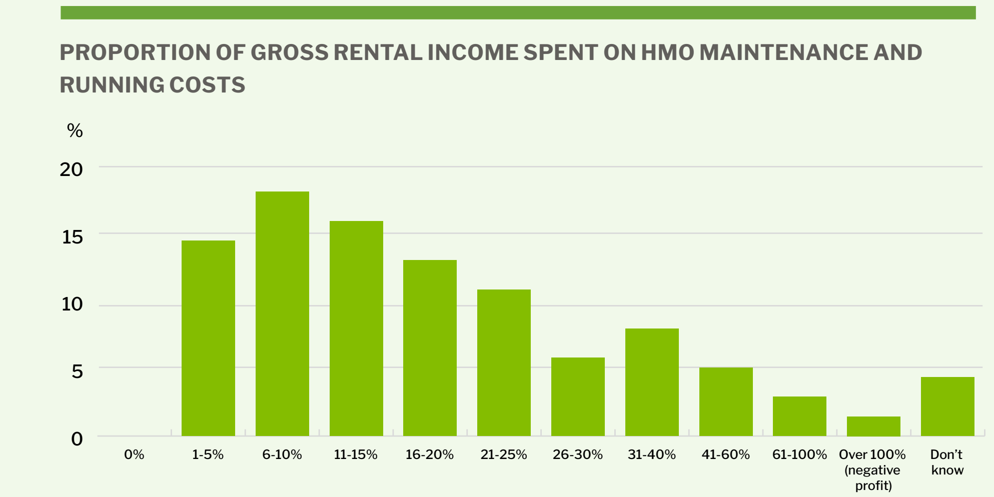
Last year, buy-to-let lending on HMO property totalled £618 million, which was clearly bolstered by the Stamp Duty holiday offered by the Government. Figures for January to February this year show that £170 million has been lent so far for HMOs. Extrapolated out, that would bring lending for 2022 in line with 2019 numbers.

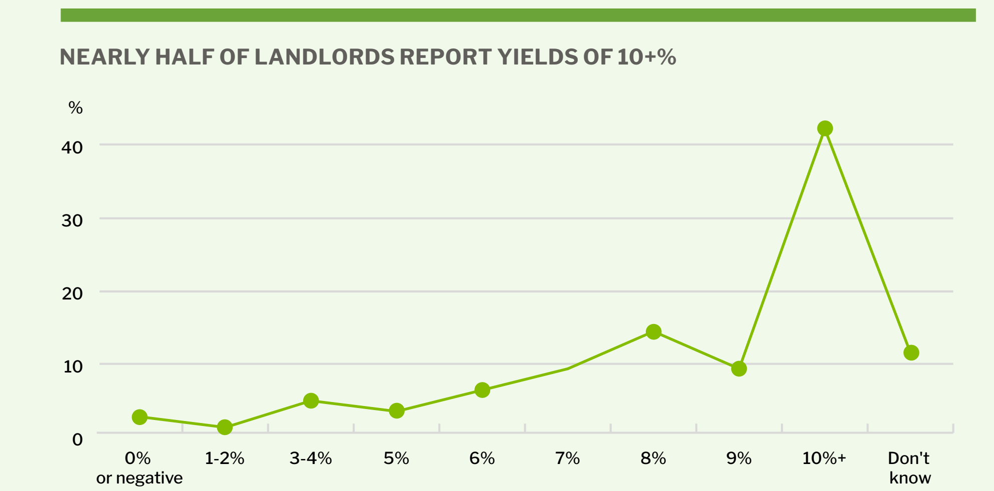
However, the market remains a niche section of the overall buy-to-let market. UK Finance data shows that HMOs represented only 3.6% of all buy-to-let new purchase lending in 2021, reflecting its specialist status.

HMO LENDING DATA

Source: UK Finance







HMOs offer a yield premium, but also incur high costs

HMOs have typically generated a better yield that other types of rental property, but that comes with a price

The investment case for HMOs is compelling, with 47% of landlords with an HMO agreeing that they offered better rental yields than other residential rental property.

Some 40% said HMOs offered better financial protection from voids, while 53% said there was no material difference in capital gain between single units and HMOs, making income the deciding factor.

The largest proportion of HMO landlords, 42%, reported net yields of over 10%, while 64% reported yields of 8% or over.

At 72%, the majority said maintenance, insurance and utilities accounted for less than 25% of their gross rental income across their portfolios.

However, landlords also spend a high proportion of their rental income on the maintenance of the HMO. Nearly two thirds, 63%, of landlords spend over 10% of rental income on annual property maintenance.

Buy, sell or hold?

What are landlords planning for their HMO properties

NEXT 12 MONTHS

53%	**I don't plan on making changes to my residential letting portfolio**
22%	**I plan to purchase more already converted HMO properties**
20%	**I plan to purchase more properties to convert into HMOs**
8%	**I plan to sell some of my HMO properties**
4%	**I plan to sell all my HMO properties**

Given shifts in tenant demand and the higher yields on offer, HMO landlords are more likely to purchase additional stock than sell.

Over four in 10 HMO landlords, 43%, said they planned to buy an additional HMO property in the next six months. There is roughly an equal split (22% vs 21%) in the proportion of landlords who plan to buy an existing HMO against those that will buy another type of property and convert.

In terms of those looking to trim properties, 4% said they planned to sell all of their HMOs and exit the sector, with 8% intending to reduce their HMO holdings in the next 12 months.

The remaining 53% of HMO landlords said they weren't planning to make any changes to their existing portfolios.

Who lives in HMOs?

The profile of tenants who live in HMOs is changing, with a growing proportion of young professionals

Nearly half, 46%, of tenants fell into the young single bracket, with 47% students and 41% white collar, clerical or professional workers.

One in five tenancies were in place for two years but by far the most tenancies were for one year. Just 2% of tenancies lasted longer than five years. There is some anecdotal evidence to suggest that longer-term tenancies could become more common.

This would most likely be driven by housing associations and councils agreeing five-year fixed tenancy agreements with registered social landlords for social tenants. An increasing number of deals like this are emerging, particularly because short-term economic uncertainty makes medium-term risk minimisation much more attractive, even at a slightly reduced market rent.

HMO TENANT TYPE

47%	Students
46%	Young singles
41%	Professional workers
27%	Manual workers
15%	Older singles
10%	Young couples
9%	Universal Credit claimants
6%	Families with children
6%	Migrant workers
4%	Retired
4%	Local Housing Allowance (LHA) claimants
3%	Older couples
3%	Other benefit claimants
2%	Executive / company lets

AVERAGE LENGTH OF TENANCY FOR YOUR HMO PROPERTIES?

12% Less than a year

54% 1 year

2 years	22%
3 years	5%
4 years	3%
5 years	2%
6 years	1%
7 years	1%
8 years	1%
9 years +	0%

Challenges facing the HMO sector

HMOs are more complex propositions than standard rental properties, which is reflected in some of the challenges landlords in this sector face

By far the most commonly cited challenge facing HMO landlords over the past 12 months was rising energy bills, with 64% stating this as a concern. Two in three said changing government legislation in the private rented sector and complex licensing rules were increasingly difficult to manage.

A rather high 22% said tenants falling behind on rent had been a big challenge during the past 12 months, though this likely reflects a drop in income for those on furlough during lockdowns, as well as those not eligible for government support during the pandemic. A third of landlords with HMOs (34%) said they'd experienced one or more tenants getting behind on their rental payments over the past 12 months, with 38% of landlords reporting some voids over the same period.

Rising inflation has also been problematic for portfolio landlords, as have supply chain blockages and higher import costs in the aftermath of Britain leaving the European Union. Two in five HMO landlords said rising building material costs were a concern, leading to higher maintenance costs.

Landlords said the coming year's challenges would include higher energy bills, rising interest rates and mortgage costs

Several referred to a shortage of quality tradespeople to carry out maintenance, with some landlords commenting on the higher cost of paying tradespeople.

Landlords said the coming year's challenges would include higher energy bills, rising interest rates and mortgage costs. The threat of higher energy costs was present in nearly all responses, with many landlords worrying about the implication of this on rental arrears.

A significant number of landlords interviewed said increasing red tape was deterring them from investing further, and some said they were considering exiting from HMOs because of the administration made necessary by the recent expansion of local authority licensing and planning rules.

In terms of arrears and voids, 38% of landlords said they had experienced arrears and 34% had experienced voids in the past 12 months.

Who are the HMO landlords?

HMO landlords are typically experienced individuals who own a mix of properties

Unsurprisingly, the HMO market is dominated by more experienced landlords, with 51% of HMO landlords aged 55 or over and 79% having let property for over 11 years. They also own a mix of property in their portfolio, with 62% of landlords also owning a terraced rental property and 48% owning a semi-detached home.

Most reported buy-to-let as supplementary to other sources of income, with just 23% earning a living by being a full-time landlord. Additionally 17% recorded their employment status as retired. A quarter of HMO landlords said they were self-employed.

Gender diversity in the private rented sector remains in need of improvement. Three quarters, 74%, of HMO landlords are male and just 24% women.

OTHER PROPERTIES OWNED

62% House – Terraced

48% House – Semi-detached

43% Flats – individual units in a block

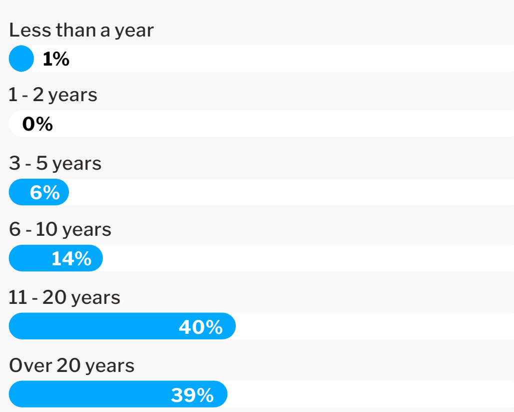
20% House – Detached

10% Short term holiday let

9% Bungalow

HOW LONG HAVE YOU BEEN LETTING RENTAL PROPERTIES?

80% of landlords have been letting out rental properties for over 10 years



The Intermediary view

Jeni Browne, New Business Director at Mortgages for Business, discusses the role of the intermediary in HMOs

"HMOs are usually more profitable than vanilla properties, usually producing higher rental yields than standard buy-to-let. But the gulf between average gross yields has narrowed recently. Our research into HMO trends shows that in the first half of 2022, gross yields on HMOs were 7.6% - compared to 5.4% on vanilla buy-to-lets.

As recently as Q2 2021, HMOs were generating 9.1% compared to 5.7% for mainstream buy-to-let investments. That might not be quite as high as it was back in 2016 when it hit 10.5%, but it compares well to Q4 2018 when average gross rental yields dropped to 7.7%.

Why the gap? Firstly, HMOs take more time to manage and more commitment than vanilla buy-to-lets, which puts off some potential landlords. Secondly, HMOs require a licence from the local council: someone must be deemed as 'Fit and Proper' for the role of managing the HMO. Those with a criminal record or in breach of landlord codes of practice won't get a look in. Thirdly, they incur higher running costs. By way of example, some councils will charge a fixed fee of over a thousand pounds for an HMO licence. That makes some lenders nervous and means they prefer to lend to more experienced landlords, limiting the pool of potential investors yet further.

HMOs are usually more profitable than vanilla properties, usually producing higher rental yields than standard buy-to-let

Lastly, risk-averse buy-to-let lenders won't be willing to lend against HMOs at all. At the end of Q1 2022 there were 27 lenders offering HMO mortgages to individual applicants and 23 to limited companies. Most lenders accept a maximum of five or six bedrooms for one property although the specialist lenders are comfortable with up to 20 bedrooms for one HMO.

While HMO mortgage rates are still higher, some lenders are bringing down loading on rates and the market is more competitive than it was."

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