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This short paper considers the common challenges and emerging trends within the Housing of Multiple Occupancy (HMO) market. It draws on insight, views and opinions from a number of mortgage brokers, conveyancing professionals, valuers and market commentators captured at a round table discussion on this rapidly growing area of property investment and management.

Britain has seen growth in the last 10 years within the HMO market, and while it has been addressed in the Housing Act (2004), more rigour needs to be put in place in regards to the definition of a HMO, how the asset is valued and the licensing and planning requirements for the different types of this asset class.

While historically HMOs have perhaps been seen as a "lower end" accommodation type run by landlords of "questionable" character, there is now a need for a vastly different type of HMO. There is a large volume of professionals now seeking this form of accommodation for financial and social reasons which has been extremely positive for the market. It is pushing landlords to put more thought and effort into their developments, and is making this type of accommodation a more mainstream form of investment and housing.
With social and economic changes emerging within UK society, the HMO market is expanding to cover a new way of living and investing.

Demand from a wide variety of social classes has meant that landlords have been forced to be creative and develop housing that will suit a different type of clientele in order to match their changing social requirements.

There has always been a need and an opportunity for people to take in lodgers or rent out a spare room to make extra money. However, it is societal change that appears to be driving a greater need for HMO living arrangements. Housing has become less and less affordable – figures from Spareroom.co.uk show only 31% of UK adults living in shared accommodation could afford to rent on their own if they wanted, while only 12% could afford to buy a property. Renting in places like London can drain 50% of tenants’ monthly income and with people becoming less agreeable to commuting greater distances or living in smaller flats, sharing in many cases becomes the more attractive option.

So what is pushing the demand for HMOs? While 57% of tenants claim to share for financial reasons, 37% say they share for both social and financial reasons and 3% purely for social. In many cases it is now less about necessity and more about a desire to live in this way. In a time when people are staying single for longer in their 20s and 30s, there is more desire to be mobile, social and have more disposable income and by sharing a house they can save money on rent or a mortgage. Less money on rent means that they can travel more, and spend more on gadgets and experiences – all increasingly relevant across the various age demographics. Karen Bennett from Shawbrook Bank says that “landlords talk about creating a community of young professionals who actually want to co-habitate because it’s more sociable and enjoyable.”

HMOs provide workforce mobility. Rather than relocating the entire family to London for a job, workers who live in other parts of the country will rent a room during the week in London and then return home on the weekend. Relationship breakdowns later in life are driving demand with a spike in people sharing for the first time at a later stage in life.

Spareroom.co.uk survey of 10,000 tenants in shared accommodation
An increase in competition between landlords has meant that there are a growing number going the extra mile to create a product that they think will set them apart from other HMOs. As a result they might create a reception area that is exclusively for the use of one of the rooms, and trying to be more creative with the space. Lucy Hodge from Vantage Finance believes that “people are seeing that there’s money to be made, and saying ok, how do we set ourselves apart?” This is raising the overall standards of HMOs and therefore the reputation that goes with them.

There is now greater visibility and transparency of the process with the inclusion of HMOs on various digital platforms. By becoming more visible it has evolved into a more mainstream housing option; and as a result investors and lenders are seeing the huge potential that it offers over the standard buy-to-let.

The combination of all of these elements has resulted in the emergence of a better quality HMO on the back of changing social patterns, work and migration, quality of product, and basic affordability of people who can’t afford single housing and dwellings.
Lenders tend to split tenants into three categories: professional tenants, social tenants and student tenants.

**Student tenant - traditional tenant group for HMOs**

The student market is actively used by HMOs; however, in some areas this is under threat and changes by councils mean that these may soon be eradicated. For example, according to some intermediaries operating in the area, Manchester City Council has advised that they want to reduce student HMOs and have purpose built student accommodation. In some student cities we are seeing 300-400 bedroom units being built for students and the HMOs that are currently operating there are being pushed out of the market. As demand has decreased it has also reduced the value and desirability of these properties and owners are struggling to sell them.

The area that an investor has chosen to invest in tends to drive the sort of tenants that they subsequently work with. An investor may have become very active in a heavily populated student town, and this will be an area they stick with due to a deep understanding across this local market and the tenant demographic that occupies it. It therefore makes sense to continue to work in this location because they have a high level of experience in this area.

While investors will still mix and match, many student focused operators remain perfectly happy to let their properties out to professionals or post-graduates. This presence of purpose-built stock and high quality accommodation is very attractive to post-graduates and overseas students where social groups may not yet be formed. More investors are becoming sophisticated enough to know their markets and they know their tenant profiles, thereby lending a degree of predictability to their model which allows easy replication according to property type, property finish and location.
Social tenant

Growth in the migrant population is also driving growth in the HMO market which, according to brokers such as Simon Allen from Searchlight, is an area of increasing focus for investors. Population estimates show that net migration was a major contributor to population growth over two decades, setting the scene and supporting the emergence of the UK HMO market. In fact, according to Oxford University’s Migration Observatory, more than half (54%) of the increase of the UK population between 1991 and 2012 was due to the direct contribution of net migration.

Social housing tenants are also a group that would be attracted to HMOs due to their reduced cost. In fact, the falling provision of social housing during the austerity programme as well as schemes such as right to buy has impacted this space, pushing social housing tenants in the direction of HMO landlords. However, according to Simon Allen from Searchlight: "50% of lenders will not accept all types of social tenants and there’s certainly demand to cater for this type of profile, providing a good opportunity for those willing to lend to properties with this tenant profile."

Professional tenant

According to their research figures, Matt Hutchinson from spareroom.co.uk sees a tenant landscape weighted far more heavily (80%) towards young professionals. 70% of this number are young people in their 20’s, 20% in their 30’s, with approximately 10% that are over 45. While their reasons for sharing are different across the market, they all sit within the professional market and are affected by several common drivers including price, location, proximity to transport links, quality etc.

With a generation of young professionals focused more on renting, due in part to house prices but also due to the desirability of higher levels of disposable income, shared accommodation is highly appealing for this demographic for both financial and social reasons.
INVESTOR PROFILE

There are a number of different investor profiles based on the number of different types of HMOs available. However, lenders are seeing three main types of investors that are involved in the different areas that can be classified as HMO.

- **Accidental landlord-** The home owner who rents out a spare room, becoming an accidental HMO as the property would have been originally purchased as a residence rather than an investment.

- **Smash and bash crowd-** Active investors looking for properties that would be suitable for HMO purposes after seeing the growth opportunities, often completely reconfiguring properties to house up to six or seven tenants.

- **Regular BTL-** Investors who have bought a large house for a standard BTL but have used as a HMO as the property lends itself to the model.

There is growing competition between HMO landlords now, with some lenders seeing clients that are really going the extra mile to create a product that they think will set them apart from the other HMO down the road. As Emma Cox from Shawbrook Bank highlights “These enhancements take the shape of very high quality finishes, wireless access, flat screen TVs in communal areas and entrance ways etc - anything that gives them an edge in attracting the desired tenant profile”.

There are also HMOs that are hidden within the wider buy-to-let market. Robert Bryant-Pearson from valuer panel managers, Appraisers UK has reported examples such as where the landlord has a single unit buy-to-let house and that’s what the valuer has seen when inspecting for the mortgage valuation. However, the valuer subsequently mentions "when leaving the property, I saw a transit van parked outside with the back door open. Inside the van there are four dismantled beds and mattresses. Will these be whisked into the dining room and sitting room as soon as I’m out of sight? Are there really 6 or 7 unconnected occupiers rather than the family of 4 which I was anticipating?” While this is less common and by no means a large portion of the market, it still forms a part of the landscape that lenders must be aware of although, from the lender’s risk point of view, the valuation would relate to a 3 bedroom house which would be somewhat less than a 6 person HMO.

**Why HMOs are attractive to investors**

Many types of investors are now being attracted to, or paying close attention to, the HMO market. Lenders are seeing an increase in traditional BTL investors looking at HMOs; they are attracted to the perception of a significantly enhanced yield. However, they are not necessarily experienced in the management of HMOs and may not fully understand the operating costs and management time involved, and therefore overestimate the underlying profitability.

Some savvy investors are using a cookie cutter approach and purchasing more properties close to the one that they already have. This is attractive as they understand that market, and either have a strong relationship with
agents in that area, or they are self-managing the properties and are able to do this more easily if they are concentrated in one area. Building relationships with their tenants helps ensure that rooms are always filled as tenants can recommend friends or colleagues that also need accommodation.

Regular property investors are cashing in on the higher yields where they have bought a large house for a standard buy-to-let and are renting to multiple tenants, because the house lends itself to this model. However, they did not initially seek out this strategy. They have become HMO landlords, but aren’t necessarily equipped to run this sort of operation.

However, there is a question over how sustainable this model is. With an increase in demand and it becoming a more mainstream method for investing, there is risk of oversupply. In fact there is already an oversupply issue in some areas. In some of these areas investors are turning their HMOs back into single lets.
HOW THE ASSET IS VALUED WITHIN THE HMO MARKET

One of the more hotly debated aspects of the HMO market is how to value the property.

The investor has manufactured value because they are receiving a much higher yield than a standard buy-to-let, so the value should increase to reflect the cash the asset now produces. But this is an area that professional chartered surveyors are disagreeing on and is causing much confusion within the industry.

Lenders and investors alike are nervous, because the perceived value of the property affects how much of the equity the bank is prepared to release in order to aid them in future investments. Too much and the bank is at risk, too little and it limits the investor’s potential for expansion.

Chartered surveyors use the RICS Red Book to guide them in valuation. However, the authors of the Red Book have realised that there is no guidance given on HMOs, so work is currently being undertaken to determine if HMOs need to be considered as a separate asset class and how it needs to be approached. Even with pending changes, it is an area that will require training and discussions will need to continue in order to bring the industry closer to having a consistent approach.

The challenge is with little guidance in this area, lenders are approving landlords and houses that are potentially questionable in their quality. There is a risk that without proper guidance there will be a continued drop in quality and that will further increase the risk to lenders.

Another challenge to valuation is the actual definition of a HMO, as there still seems to be some ambiguity in this regard which will affect the ability to value the asset.

While lenders are currently approaching valuation and stress testing differently, they are generally being reasonably cautious. 75% loan-to-value (LTV) should remain the limit of lenders’ exposure. Landlords, on the back of low interest rates and relaxed regulations, are driving up prices. Although speculation remains around when there may be interest rate rises, landlords must be mindful of the impact of this movement.

Should interest rates go up, there is the possibility that some over-leveraged landlords may exit the market and prices/values will fall. By comparison with HMOs, the private dwelling market is reasonably stable; fluctuations are usually pretty small. However, HMO valuations are predicated off a multiple of yields and rents; both are prone to volatility, thus the values of HMOs are vulnerable to very significant fluctuations. It would be worrying if lenders started pushing the boundaries to make higher LTV advances, and some regulation here could be helpful.

Lucy Hodge from Vantage Finance said "While lenders are currently approaching valuation and stress testing differently, they are generally being reasonably cautious. 75% loan-to-value (LTV) should remain the limit of lenders’ exposure. Landlords, on the back of low interest rates and relaxed regulations, are driving up prices. Although
speculation remains around when there may be interest rate rises, landlords must be mindful of the impact of this movement."

Fraser Sinclair from Pure Law raises the issue of value for money commenting: “when does it become a property that can be converted back to residential property or something that somebody’s willing to pay a little bit more for?” While speculative, there is a belief that some investors do not want to undertake the work necessary to convert the property, so will pay a premium for a property already set up as a HMO. However, on the flip side, if it can only be used as a HMO and cannot easily be converted back to a residential property - this affects the value. There is an impact on the volume of buyers interested in the property, which will keep the price on the lower end.

With a lack of a genuine valuation framework in place, work has been done to try and provide some guidance by engaging with valuers across the country and releasing some more clearly defined categories.

As far as we are aware, no real valuation framework currently exists that provides the necessary clarity. With this in mind Shawbrook has endeavored to rectify this by outlining four HMO segments.

**HMO1: Small HMO, no Article 4 or planning exists, fabric of building remains largely un-changed - lending is against value as a Private Dwelling**

If the property is not in an area with an Article 4 Directive in place and the works required to convert into a HMO are minimal, it is logical that the property does not necessarily have an independent value as a HMO. An investor is more likely to purchase a cheaper property in the same street and convert this to a HMO than pay a premium price value based on comparable evidence of private dwelling use.

**HMO2: No Article 4 or planning exists but there is a demand for this property as a HMO, the fabric of the building has changed - lending is against Market Value**

Where the property is not in an area with an Article 4 Directive in place. If specialist/ extensive works are required to convert into a HMO and the security is in an area that supports HMO demand, it is logical that the property will have an independent value as a HMO. As such, any investor is likely to recognise the need to pay a premium, but this is likely to be relatively small. Value will most likely be based upon comparables and cost to convert.

**HMO3: Article 4 is in place - lending is against Market Value**

If the property is in an area that has an Article 4 Directive in place, it is in an area where HMO provision is controlled and will have an independent value as a HMO. As such, any investor wishing to run a HMO in the area understands there is likely to be a premium price to the value and a yield based approach is appropriate.

**HMO4: Sui Generis planning is in place - lending is against Market Value**

Planning is in place to use as a large HMO (7 beds +), and will have very specific structural changes to be utilised as a HMO. Again, a yield based approach is appropriate.
While landlords working in the HMO space currently have a good arrangement, with increased regulation comes potential challenges and threats to their current returns.

As Jim Moulton from Shawbrook Bank has highlighted, “One of the biggest is potential council tax changes in the future. Some of the councils are quite switched on about this and they’re implementing it. They are making changes such as council tax per room rather than for the dwelling as a whole. This will take a huge dent out of landlord’s profits”. Brian Walters from Newsource Commercial Finance adds; “Once all the local government offices get together and start talking about a way to increase revenue, I think more and more will do that”.

One of the areas holding local authorities back from pursuing this more proactively is lack of definition around what constitutes a HMO and the threshold at which a HMO has to be licensed. In certain circumstances the regulatory framework under the Housing Act as it applies to licensing is dissimilar from that which applies to planning, and its application by the local authorities can sometimes appear selective. This can lead to confusion for landlords, tenants and valuers and the different regulations are often hard to follow. A great deal of investigation is required to find out exactly what applies, which can create a barrier to investment, and because the local government does not always enforce these rules, the investor needs to make a call around whether to adhere to them or not.

Once this is defined more clearly, (a target objective for the Shawbrook credit teams), this will provide a trigger for councils to assess individual rooms for tax. Therefore it is advantageous for the local government offices to push the regulation forward. The level at which local authorities are pushing for regulation depends on the local housing policy and supply concentration. For investors this provides different scenarios and messages depending on the jurisdiction that their property falls within. Investors with multiple investments in different locations need to be aware of the different rules that apply.

Staying with planning and licensing, this area – along with valuation, legal issues, and categorisation of the asset itself – is a key consideration at the start of the investment process and on an ongoing basis. The main areas that catch out investors relate to licensing and planning law. These two areas of law are unconnected, and compliance with planning does not mean that licensing requirements have been satisfied and vice versa (i.e. obtaining a HMO licence does not mean that the property benefits from planning permission).
Where licensing for HMOs is concerned we can see several factors in play:

**The Housing Act 2004**

The primary piece of legislation relating to licensing is the Housing Act 2004. For the purposes of the Housing Act 2004, a HMO is broadly defined as follows:

A building or part of a building (i.e. a flat), that:

- is occupied by two or more households, and where more than one household shares – or lacks – an amenity, such as a bathroom, toilet or cooking facilities

- is occupied by two or more households and is a converted building – but not entirely self-contained flats (whether or not some amenities are shared or lacking)

- are converted self-contained flats which have toilet, washing and cooking facilities for the exclusive use of its occupants

For the purposes of the Housing Act, a household is defined widely with each family, each single person living on their own, and each couple being treated as a separate household.

**So which HMOs need to be licensed?**

Local housing authorities are responsible for licensing and not all HMOs are automatically required to be licensed. The Housing Act allows for three different types of licensing:

1) Compulsory (required by law) licensing of HMOs for properties that are three or more storeys high, have five or more people in more than one household, and share amenities such as bathrooms, toilets and cooking facilities.

2) Additional licensing of HMOs. This is a discretionary power that each local authority may decide to apply to a particular type of HMO. For example, an individual local authority may decide to extend licensing to buildings of one or two storeys.

On a practical level this means that if a property falls within the definition of a HMO under the Housing Act but doesn’t fall within the compulsory licensing requirements above, you need to check with the local council to see if an additional licensing scheme applies in your area.

Many student towns have passed such additional licensing requirements and many London boroughs either have additional licensing schemes in place, or are actively considering putting these in place.

3) Selective licensing of other residential accommodation. Properties that are not subject to HMO licensing can be covered under a selective licensing scheme. Any council may declare that certain areas, for example where there is low demand for housing and/or antisocial behavior, are appropriate for selective licensing.

Importantly, this form of licensing can cover all forms of privately rented housing, including but not limited to HMOs. As an example, large parts of the London Borough of Newham have a selective licensing scheme in place, meaning that all privately rented accommodation in those areas needs a selective license.

Therefore it is also important when buying a new investment property to check with the relevant local authority to assess if a selective licensing scheme applies in your area.
Planning

Having examined the various licensing requirements for HMOs, we can now turn our attention to another crucial aspect of this increasingly popular asset class – planning. When investors are looking to maximise yields on residential property by converting an existing residential property into a HMO, the required planning permission is something both investors and their brokers should be aware of. It must be remembered that HMO licensing and planning are not connected. As such, the obtaining of a HMO licence does not mean that the planning system has been complied with.

The planning regime in England and Wales is broadly governed by the Town and Country Planning Act 1990 (TCPA) and associated legislation. In general, the TCPA sets out that any development of property requires planning permission unless it is non-material or permitted by General Permitted Development Orders (GPDO) – in essence this means any change of use of a property or physical work requires planning permission. (Do note, however, that there are other types of statutory consents that may be required for changes of use or physical works to a property and prior professional advice should always be obtained.) It must also be remembered that even if a change of use is permitted without planning permission, any physical works may need planning permission in their own right.

Planning law categorises the different uses of property into what are called ‘use’ classes and other specialist uses which do not fall into any particular ‘use’ class (called Sui Generis uses).

The GPDO includes the following use classes which are relevant to most new HMO conversions from residential dwellings:

1. **C3 Dwellinghouses** – for the purposes of this article this class includes a normal residential house or flat occupied by a single person, couple or a single family (i.e. relatives).

2. **C4 Houses in multiple occupation** – small shared houses occupied by between three and six unrelated individuals, as their only or main residence, who share basic amenities such as a kitchen or bathroom.

3. **Sui Generis HMOs** – essentially this is any other HMO which doesn’t fit into use class C3 or C4. Most commonly this will be any shared house occupied by seven or more people, as their only or main residence, who share basic amenities.

**Do investors need planning permission to change the use of a C3 residential dwelling to a HMO?**

The general answer to this is yes, planning permission is needed unless the GPDO allows ‘permitted development’. In the case of HMOs the following are permitted development:

- Change of use from a C3 (dwellinghouse) to a C4 (HMO)
- Change of use from a C4 (HMO) to a C3 (dwellinghouse)

It is important to note the following in respect of these permitted development rights:

- If the number of occupiers is to be seven or greater then no such permitted development rights exist, as the new use would be considered a Sui Generis HMO as opposed to a C4 HMO.
• Each individual local authority has the ability to remove permitted development rights by what is called an ‘Article IV’ direction.

• Many local authorities have already passed such directions including in many popular student areas. Therefore it is essential that you ask your legal advisor to make enquiries of the relevant authority to determine whether such a direction is in place.

• Planning conditions on previously implemented planning consents can have the effect of removing permitted development rights. If so, planning permission would be required.

As the spotlight continues to shine on the HMO space, it is becoming increasingly important for investors to have a good understanding of these more technical concerns.

The popularity of HMOs has meant that they have become high profile. **Stephen Johnson, MD for Commercial Mortgage Business at Shawbrook Bank** believes that this profile as an emerging asset class requires the risks to be considered independently from standard BTL.

"The HMO segment of the BTL market is an area that the Bank of England is watching carefully, and they expect banks to demonstrate the risks specific to HMOs are thought through. You could see some future regulatory intervention in this area."
Another challenge for investors is the letting and ongoing management of these properties. Many choose to manage the properties themselves, which is time consuming.

For those that have a HMO portfolio that is located a distance from where they live, they need to rely on a letting agent. Finding a proactive and engaged letting agent that understands the unique challenges of the HMO market is important to the ongoing success of the rental property.

For a tenant the main challenge is privacy and security. Tenants are looking for as near to self-contained as possible. In a situation where a landlord is taking in lodgers, there is no security for the tenant as the landlord still has access to the room. Tenants require as much privacy as possible, so ensuite facilities are certainly a big driver for a tenant. A room with a microwave and a basin or sink is an advantage so that they don’t have to use a shared kitchen facility all the time.

Where there is an oversupply in the market, landlords will need to consider how they maintain and increase returns. This is likely to be advantageous for tenants, with landlords looking to improve the conditions of their properties and the offering that they are providing. This may include sectioning up certain parts of the house for exclusive use to some bedrooms and the rest is shared. This would provide something quite different to just renting a standard room.

The message to landlords is that the profits they are seeing currently for the level of work they are doing won’t last. Landlords have seen very favourable conditions in the past few years. Low interest rates, strong yields, plenty of selling demand and undersupply in the market have meant that those that invested early have done well.

David Whittaker of Mortgages for Business said:
Our Complex Buy-to-Let Index has been tracking gross rental yields across a variety of property types for the past five years. In that time HMOs have consistently outperformed both vanilla buy-to-lets and blocks of flats owned on a single freehold title yielding an average of 10% per annum compared to 6% and 7% respectively.
However, are these favourable conditions changing? Increased regulation is on the horizon, higher interest rates, reduced availability of funding - these factors are all set to make the future far more challenging. The market is constantly moving and landlords and lenders will need to learn to move with it.
The most debated aspect of the HMO market is how to value the property. While Chartered Surveyors use the RICS Red Book to guide them in valuation, no guidance is currently given on HMOs.

For a lender they can be an attractive asset because they have strong income and cash flow, provided there is sustainable tenant demand. However, lenders must also be conscious not to overvalue the asset when lending in case the security needs to be realised. There is a need for the industry to work together on this issue of valuation and provide greater guidance for those entering this market - inconsistency and ambiguity is clearly frustrating for investors.

As the HMO market grows and develops there are obstacles that investors, tenants, lenders and local government need to navigate through. Investors and lenders need to work with each other and local government to ensure that this type of housing is available and accessible. While there is a need for regulation to protect tenants, it is important that this is done in such a way that still makes this a viable and attractive investment for landlords.

There is a need for a clear definition of what constitutes a HMO and how to value the property, to ensure that lenders are able to reduce theirs and their landlord’s risk when providing finance for these types of housing. While there have been favourable conditions for the past few years with low interest rates, this will not continue indefinitely and both lenders and investors need to be prepared to manage these properties under stress.

**Shawbrook Bank and HMOs**

Some of the work we have done in this area has been highlighted within this document and according to research carried out in 2015 across the customer and broker space, HMOs remain an attractive new area or an area that warrants expansion for many.

**Is the HMO market an area within which you wish to expand / enter?**

- Yes: 53%
- No: 47%

Investors in increasing numbers are looking at this asset class due to the reasons discussed throughout, and this is backed by trends we can see across the loan book.
Demand for this asset class is on a consistent upward trend, and is strong enough to encourage the development and release of HMO specific products to cater for investor demand.

With the supply/demand challenges across the UK housing landscape and the resulting importance of the Private Rented Sector, HMO property is and will remain an essential and affordable source.