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Are You in Control of Your Property Borrowings?

By specialist property accountant **Stephen Fay** ACA

For most investors, their most significant property expense is the cost of their borrowings. But with portfolio investors often having mortgages and other borrowings with different banks, on different terms and rates, gaining a full understanding of the overall debt profile can be challenging.

In the current era of ultra-low interest rates, many investors have benefitted from a massive reduction in finance interest. While this is obviously welcome, many have now spent much of these 'windfall profits' on shoring up their cash reserves and refurbishing properties.

However, as all good things must come to an end, wise investors are analysing their property debt profile to ensure they are able to prosper at 'normal' interest rates. This article looks at how investors can get a better understanding of their property borrowings and the impact of higher interest rates on their property portfolio.

What kind of borrowings do you have?

Residential mortgages have traditionally consisted of an initial fixed term, with a variable follow-on rate or 'revert rate'. Whereas in the past it was the norm to remortgage onto a new fixed term mortgage as each fix ended, in the post-credit-crunch world, many investors are realising the benefit of retaining mortgages with attractive revert rates.

The revert rate for nearly all mortgages will be one of the following three types.

BOE / LIBOR

'BOE' mortgages follow the rate set by the Bank of England (BOE), at a fixed-margin. For example, the mortgage rate may be 2% above the bank rate (currently 0.5%) to give a pay-rate of 2.5%.

LIBOR mortgages follow 'LIBOR' (the 'London Interbank Offered Rate'), which is effectively the rate at which banks lend money to each other. LIBOR is traditionally slightly higher than the BOE rate, often by around a half-percent.

Both BOE and LIBOR tracker mortgages are attractive where bank rates are expected to remain low. Lenders are obliged to peg their mortgage pay-rates to the terms of the mortgage agreement (although, some lenders have been able to break that contract, citing 'unprecedented conditions').

However, it's important to realise that LIBOR can rise quickly and substantially even if the BOE rate remains steady - for example, should a bank liquidity crisis be created as a result of the current Greek financial crisis. Since LIBOR is set within the banking world, not by a central bank, it is more volatile than the BOE rate.

Understanding at what margin your tracker mortgage operates (e.g. +2%), and which index (BOE or LIBOR) it tracks, is vital to understanding how your interest payments will change as BOE and LIBOR change. This means going back to your mortgage offers to check the revert-rate - many lenders favour LIBOR (e.g. Paragon, Kensington), others favour BOE (e.g. Mortgage Express, Bank of Ireland).

SVR

Some lender revert rates do not track BOE or LIBOR, but instead are set by the lender themselves. This has meant that many investors have not benefitted from historically low base rates as lenders such as Accord and DHL have reduced their interest rates very little. These mortgages are often provided by Building Societies and can be less attractive than tracker mortgages as the rate payable is at the lender's sole discretion.

Portfolio analysis

Portfolio investors should perform an analysis of their debt profile to ▶

understand their exposure to changes in interest rates. This can be done by recording the borrowing balance by property and lender, and the mortgage type and margin rate.

Multiplying these figures out, and allowing for different base and LIBOR rates, provides a simple 'stress test' to highlight how the portfolio copes with different interest rate scenarios. Our website has a Portfolio Debt Analyser to enable this exercise to be completed.

Yield on debt

A final key metric to calculate is the portfolio 'yield on debt'. This is the rental income as a % of borrowings. This allows a simple comparison between what the portfolio generates in income, versus what it costs in debt interest. There should be a healthy margin between these two percentage figures, to enable letting costs to be paid, with some 'spare capacity' to fund contingencies.

Using the debt analysis

The purpose of completing this borrowing review is to understand how changes in interest rates affect rental profits. For example, an investor with a portfolio of trackers at 1.75%+BOE will have a very different exposure to an investor with mainly lender-SVR mortgages.

It is often the case that one or two properties skew the figures if there are excessive borrowings on those properties, or the mortgage product is not particularly good.

Having completed the debt analysis, it is then time to 'stress-test' the portfolio using various base rates. For example, you may wish to use a medium-term BOE rate of 3% (to test the next 5 years if you feel base rates will remain below that level, as some commentators do), whereas for the long-term you might use a base rate of 5%.

> **"It is vital for investors to understand how finance interest - usually their largest expense - will change as the interest rate environment changes"**

Taking action

All of this is very interesting - but what action should be taken if the result of the debt analysis is that a portfolio can't survive 'normal' interest rates?

1. Re-mortgage any 'poor' mortgages onto better deals - assuming there is sufficient equity, as the economy returns to normality, the mortgage market should improve, and better mortgages become available. It is vital to remain creditworthy to do this!
2. Sell off any properties with a poor yield and poor mortgage rate. Many investors are able to carry properties with below-par yields if these are financed with a particularly good mortgage. Problems can arise where both the yield and the mortgage are poor - a potentially toxic combination.
3. Sell the property - keep the mortgage. Many mortgages are 'portable' and so can be transferred to another property - this can allow the disposal of a poor property, while retaining a good mortgage - so worth checking the mortgage offer.
4. Raise the income - has the rent kept pace with the market? Can the property be let on a multi-let basis? Could developing the property, or carrying out repairs, allow a higher rent to be charged - which often brings a far greater return than using the refurbishment funds to repay debt?
5. Is there maintenance work that can be done to 'future-proof' the property against future excessive repair bills? Could solar panels or better insulation help to make the property more attractive - and so reduce voids? Get creative to maximise the property's potential.
6. Finally, repay some debt. Many investors have ploughed much of their recent property 'super-profits' back into their portfolios, and may not wish to grow the portfolio size.

   Once an adequate cash reserve has been built up, it may make sense to repay the highest-cost debts over time. With almost 0% interest rates, returns on savings are often so low that earning a post-tax return higher than your highest mortgage interest rate may not be possible.

Summary

Property investing profits are greatly increased by using the leverage effect of debt finance. However, it is vital for investors to understand how finance interest - usually their largest expense - will change as the interest rate environment changes. Fore-warned is fore-armed! PIN

PIN magazine readers can download a FREE 'Property Debt Analyser' from our website (www.fyldetaxaccountants.co.uk) - along with our essential tools and templates to help landlords to manage their property portfolio.