# HMOs: valuations in a cocked hat

**Robert Bryant-Pearson,** CEO of the Allied Surveyors Group and MD of specialist panel managers, Appraisers UK, considers HMO valuation methodology

As more lenders buckle up to enter the HMO part of the buy-to-let arena, the necessity for prudent valuing and careful underwriting becomes particularly important.

Local planning authorities have powers, via Article 4 Directions, to intervene in markets by restricting change of use between private dwellings and houses in multiple occupation. In many instances councils wish to restrict the creation of new HMOs but some may equally be concerned about the loss of rented accommodation in conversion back to single dwellings.

## Planning consent categories

Once such Article 4 Directions have been introduced, HMOs become crystallised into defined planning consent categories (C4 or a special 'Sui Generis' consent for larger properties) and these are separate from that of private dwellings (C3).

Therefore, chartered surveyors valuing such property must consider such HMOs in their own right with their C4/Sui Generis HMO use: quite simply they can no longer be treated as single dwellings. Usually, an Article 4 Directions confers scarcity value on the existing HMOs.

The market for C4/Sui Generis HMOs is not mature and comparability between sales evidence in the sector is subject to a far greater number of variable factors and contains more inconsistencies than in other asset classes.

Purchasing investors should consider the net income to be derived and this informs the amount they are prepared to pay. Therefore, analysis of comparable evidence revolves around the rent and how rental income translates into capital value by way of expected return, i.e. yield.

## Yields and rents

These bases of yield and rental value are prone to significant fluctuation in themselves but the variability of the resultant valuation figure is compounded by the calculation methodology which is the multiplication of one factor by the other.

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Rents and yields are subject to much more volatility than the capital value of single dwellings. An HMO valued in a benign market will have a low yield applied to a high rent: when macro-economic conditions turn for the worse, however, rents may decline and yields lengthen. The combination of the two can wipe out the owners' equity before they have an opportunity to even get the property onto the market for sale.

Moreover, the degree of accuracy of the original valuation is subject to more uncertainty than the comparable sales data gathered for a private house valuation. There may be evidence to support rents achieved on new Assured Shorthold Tenancies but are those rents sustainable in the long term? Should the valuer be prepared to fly in the face of recent rental evidence and alienate the lender and the introducer by adopting a significantly lower rental value than a recently agreed passing rent?

The difference between £27,000 per annum and £30,000 per annum does not seem massive and neither does the view of a yield being 9.5% instead of 10.5%. On the face of it, perhaps not unreasonable margins of accuracy, especially as yield evidence often varies by considerably more than this; and rarely is there reliable detailed analysis available to valuers for yield evidence gleaned from third parties. This is an imperfect market.

Thus, a 'pessimistic' valuer applying a 10.5% yield to the £27,000 per annum rent will produce a valuation of £255,000 in comparison to the 'optimistic' valuer who applies 9.5% to £30,000 per annum whose valuation comes out at £333,000. The introducer will assure the lender that the latter is the correct figure.

However, in a market downturn, the pessimistic valuation will be 'proved' to be correct and cries of negligence will be levelled against the optimist whose valuation was 30% higher.

Yields and rents, therefore, are not enough.

## Triangle of values

As my colleague Gordon Loughran puts it, sailors cannot plot a course off just one coordinate: you have to take three bearings and these produce the 'cocked hat' triangle wherein you will be found.

Therefore, the valuer should have more than a weather eye on the prevailing value of similar houses as single dwellings, as well as considering the cost and ease of acquiring a single dwelling and converting it into an HMO. The true value lies within this triangle of values and is rarely at any one of the vertices. It would be a false assumption to believe the value as a single dwelling would always be a safe fall-back position. Exactly where the value lies within this triangle is subjective: it's a judgement based view of the market at the time.

Sensibly, the Bank of England's "Underwriting standards for buy-to-let mortgage contracts" consultation paper has erred away from LTV in favour of stress testing on Interest Coverage Ratio (ICR). A further caution is necessary here. In arriving at the valuation figure, many valuers' evidence will be based on gross rents and not the net income which the lender should consider within the context of ICR.

The gross rent figures frequently create a fool's paradise of expectation for investors and, for HMOs especially, the deductions from market rent to deduce true net income are many and considerable. ■