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Buying HMO Property Using a 'Low/no Money Left in' Strategy

Is it possible to buy an investment property and recycle your deposit within 2-4 months, avoiding the 6 month ownership rule imposed by many lenders? For some investors the answer is to buy an HMO property...and be creative! **Richard Bowser** talked with Rory O'Mara of Closed Bridging Finance to learn how they are currently working with investors

Investing in an HMO (House in Multiple Occupancy) tends to be more about cashflow than relying on future capital growth. Many investors can make decent money in property by having HMO units in their portfolio. The resulting cashflow can often be quite significant and yields typically are double digit. Cash on cash returns are significantly higher when compared to those gained from investing in a traditional single let 2/3 bed property.

According to Rory O'Mara if you do it correctly then you can expect to earn at least £500 per month positive cash flow per unit after your mortgage payments, voids, and maintenance and management fees. This is far more than the typical returns from many traditional buy to let investments.

What is an HMO?

An HMO as defined in section 254 onwards of The Housing Act 2004,

The new definition is detailed and complex but the underlying principal is that there must be 'material sharing'.

In summary:

- A house split into bedsits where the tenant has exclusive use of their room but shares a kitchen or a bathroom and WC;
- A house or flat share with three or more tenants who are not related to each other;
- Students living in shared accommodation where they have exclusive use of the whole house;
- An owner-occupier with more than 2 lodgers who have a licence to occupy their accommodation;

Two unrelated people sharing are excluded from the term HMO.

There are very strict rules relating to planning and licensing of property that could be an HMO. Licensing is a mandatory requirement for all HMO's that:

- Are three storeys or more in height (including basements and HMO's above shops);
- Have five or more occupiers;
- Some or all of the occupiers share a facility (bath, WC or kitchen).

If you can answer yes to all three parts then you do need a HMO licence. Each local council will have its own interpretation of their rules, so you need to speak with them about becoming an HMO landlord. It is a serious offence to operate an HMO without a licence; fines of up to £20,000 can be handed down on conviction. The licence will last for five years. More information on HMO licensing can be found at the Communities and Local Government web site at: www.communities.gov.uk/publications/housing/hmolicensingguide

Facilities
The number and location of shared kitchens and bathrooms is important with minimum ratios set out as follows; 1:4 for shared bathroom/WC, 1:5 if the WC is separate and 1:5 for shared kitchens.

Do I have an HMO?
In April 2010 a new planning class of HMO property was enacted, called C4 (three or more people sharing as opposed to a minimum of six previously). As this has been a political football of late do speak with your local authority about these changes and if they will have an impact on any HMO you wish to set up. From October 2010 local authorities were required to focus their efforts only on specific locations where it might be deemed appropriate to limit the spread of more property let to students.

As an example of how councils are using 'article 4 directions', Nottingham City Council is proposing changes to planning rules relating to Houses in Multiple Occupation (HMO's) so that from 11th March 2012, it will become necessary to obtain planning permission to convert a family dwelling (Use Class C3) to a HMO with between 3 and 6 unrelated people sharing (Use Class C4) throughout the whole of the Nottingham City Council area. Planning permission is already required for properties shared by more than 6 unrelated people.

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What is the strategy to buy for low/no money left in with HMO property?
According to Rory O'Mara the approach they are taking with their investor clients on HMO's is a refinancing strategy via a draw-down of commercial funds.

"Investors do need funds up front, typically £60k+ depending on the original purchase price to fund the deposit, all fees and cost of works. You buy with cash and bridging finance, make the ▶

HMO Case Study:

An investor purchased a 5-bed ex-local authority home in Southern England for £165,000. He refurbished it to a very high standard, converting the lounge into a 6th extra bedroom. The target average weekly rent was £92 per room but the actual achieved was £102 per room, generating gross annual rents of £31,824 per annum.

The works included adding a stud wall to divide the lounge, redecoration of the entire house, re-carpet the first floor and the 6th bedroom. Supply and fit a BS rated fire alarm, emergency lighting and fit FDS30 fire doors with locks. Furnishings included new beds, mattresses; table lamps etc, new white goods, kitchen appliances, TV, sofa, chairs, blinds for all windows, garden furniture and BBQ. The investor had approx £82,000 funds up front to cover all fees and the cost of works. Bridging funds of £123,420 were supplied and all works were completed in less than 2 months with the commercial lender providing a net advance of £174,000. The cost of finance was 5.90% interest only. Gross annual profits were £21,558 before voids, utilities, insurance, council tax and maintenance. The investor left approx £30,881 in the deal. Using a traditional CML lender, he would have left approx £75,000 in the deal and would have to wait 6 months before he could refinance. He has saved at least £44,119, which can be recycled into the next project.

Summary Numbers:

Gross Annual Income	£31,824
Cost of Mortgage	£10,266
Gross Profit	£21,558/£1,796 per month
Purchase Price	£165,000
Market Value at Purchase	£175,000
Commercial Value after Works	£290,000
Commercial Mortgage	£174,000
Cost of Works/Furnishings	£20,000
Finance/Lender/Legals etc	£18,231
SDLT	£1,650
Investor cash left in Deal	£25,881

improvements and then exit with commercial finance. The approach is to use a combination of bridging funds to cover up to 70% of the purchase price coupled with the investors' cash. The expected turnaround time is 2-4 months," says O Mara.

He adds: "The first step is to identify a property that can be converted into an HMO - an existing HMO will qualify - in either case you will have to make substantial improvements (at least £15,000 cost of works) to the property, enabling the commercial surveyor to value the property based on its potential rental income. Valuations are subject to comparables on rents, brick and mortar value and the value of HMOs in the area. The client then receives the commercial mortgage offer prior to the project starting and at this stage the clients risk is the valuation fee. This is subject to all works being completed as per schedule of works, AST's signed and re-inspection by surveyor."

A current live project in the Midlands illustrates the concept, where the investor is buying a five bed property for £110,000 - the cost of works is estimated to be £18,000 and rental income will be £90 per room per week. The commercial valuer has valued the property at £240,000 after works are completed and AST's signed. Loan to Value @ 60%, will provide a maximum drawdown of £140,000. After all fees including legals, bridging costs, refurb costs, the client will leave approx £1,661 in the deal. After 3-4 months positive cash flow @ £500 per month, the investor has an infinite return with no money then left in the deal.

> **"The approach is to use a combination of bridging funds to cover up to 70% of the purchase price coupled with the investors' cash"**

The pay rate on the commercial loan is calculated at approx 5.90%. Gross rents of £23,400 less mortgage of £8,260 leave a gross annual profit of £15,140 (£1,261 per month). This excludes costs for voids, maintenance and management charges. The expectation is approx £500+ per month positive cash flow.

The commercial lender will only consider experienced investors; however O'Mara says they can group a maximum of 4 investors together for a project. However the lender will then want bank statements, profit & loss and asset & liability statements for each applicant. All properties must meet all HMO rules and regulations.

If the concept of sourcing, managing the refurbishment, obtaining the necessary HMO licences and then finding tenants leaves some investors cold, then O'Mara's team can arrange to do all this for a fixed fee of circa £7,000 per property. Annual management fees are then 10% of the monthly rent.

If you want to know more: email Rory O'Mara on pinmag@closedbridgingfinance.com for a copy of the HMO Strategy Report and an illustration.