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# Investor costs and returns in the English private rented sector

**Michael Ball**

Real Estate & Planning  
Henley Business School  
University of Reading

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## Abstract

Financial returns in the English private rented sector should be central to examination of its performance but robust estimates are scant. Here, the results of a simulation exercise based on a discounted cash flow investment appraisal are reported. Returns on own capital are estimated for 10-year long residential property investments made in successive years from 1996 to 2015. They suggest that, once costs, taxes and variability are taken into account, landlords' returns are far more modest than is often believed and are worse for those that borrow and who pay higher rates of income tax. Some implications for the sustainability of the current size of the private rented sector are discussed, where it is concluded that investor behavioural motives are important but that the sector may be vulnerable to a sustained market shock.

## Introduction

Analysis of private renting is hampered by a lack of good financial data, especially with respect to private landlords, who rather than corporates own the vast majority of UK rental stock (DCLG, 2010). It is widely believed that landlords make excessive profits (Bentley, 2015). Press reports certainly give that impression, as the quotes in the box indicate. However, robust comprehensive analyses are rare.

“Buy-to-let landlords have hit the investment jackpot by earning returns of almost 1,400% since 1996, leaving the performance of shares, bonds and cash trailing in the wake of Britain’s property boom.” *Guardian*, 11.4.15

“UK landlords make £177bn from rising house prices over 5 years.” *Financial Times*, 12.1.15

“Landlords enjoyed a record £14bn in tax breaks in 2013, according to figures revealing the expansion of the UK’s buy-to-let market in the aftermath of the financial crisis.” *Guardian*, 25.5.15

Information on gross annual investment returns is provided by a growing number of commercial agencies,<sup>1</sup> and widely publicized, but they can give an over-optimistic picture unless their limitations are recognized. Sampling issues apart, they only consider recent market transactions and take little account of the notable costs and risks associated with providing a market-based rented housing service. Furthermore, net rental income and capital gains are subject to taxation, which is ignored.

Unfortunately, it is no easy task to account for actual rents, costs and taxation when examining landlords' returns. Circumstances vary considerably between investors, properties and over time, and there are data limitations. Here, the results of a simulation exercise are reported in the hope of casting some light. A discounted cash flow investment appraisal exercise is undertaken in which returns on own capital are estimated for investments made in the successive years from 1996, when the fabled UK 'Buy-to-Let

Revolution'<sup>2</sup> started, to 2015. In order to do this, assumptions have to be made and some data estimated; the details of which are explained below.

The findings are obviously indicative and subject to potential error rather than accurately reflect investors' experiences. They are mid-point national estimates as well, so some landlords and some localities will have done better and some worse. Nonetheless, they suggest that once costs and taxes are taken into account returns are far more modest than 'headline' data seem to imply. In fact, even in a world of low and risky returns from other asset classes, such returns seem modest and suggest that some landlords may be financially vulnerable to economic shocks or to unexpected events specific to their properties. Moreover, they cast doubt on the long-term sustainability of the current size of the private rented sector.

### **A cash-flow simulation model**

In order to examine landlord returns over the long-term a standard discounted cash flow investment appraisal is undertaken (Baum and Crosby, 2007). Annual net post-tax cash flows are calculated for the purchase of a ready-to-let average rental property, subsequently sold after 10 years. Returns are then evaluated as the IRR (Internal Rate of Return) on the own capital invested. Such returns are calibrated for investments starting in each year from 1996 to 2015 to give an 'annual' IRR in nominal prices.

As there is a ten-year investment horizon in each case, it is assumed that a property is 'typical' in the sense that its annual rental income is equivalent that of average national rent levels while the capital gains accrued are the same as the average house price rises in England over the period in question. Information subsequent to 2016 obviously has to be estimated, so the returns after 2006 increasingly rely on those latter synthetic values.

Clearly within this simulation formation, it is not so much returns from the initial year of the investment that affect overall outcomes but those of the subsequent years of investment. This means that outlier points – in terms of, say, high annual house price rises or falls affect the estimated IRR investment returns over quite a number of years. In this way, some of the real world risks of property investment are incorporated into the analysis, associated with market variations in house prices, rents and interest rates.

This longer horizon approach offers better insights into the reality of residential investment than the more commonly publicized one-year snapshots. It is not possible to move quickly into and out of investment positions, given real estate's high transactions costs and relative illiquidity. So, commitments are far more likely to be for longer periods than is feasible with bonds and equities. During the investment period, moreover, interest rates on loans, house price inflation and rental income growth are likely to vary and investors cannot cherry-pick the best years but have to accept incorporation of poor ones. To adopt an infinite or very long investment horizon would be both implausible and impractical. A clear cut-off date also enables inclusion of capital gains taxation in the calculation, as this is only imposed at sale. So, a fixed period investment horizon long enough to incorporate property market fluctuations and most investors' behaviour, but manageable in terms of analysis, is a preferable research strategy - such as the 10 year one adopted here.

## Estimating annual cash flows

Positive cash flows derive from rental income and the price achieved for the property on sale. Costs come from the variety of sources associated with buying and selling a property and letting it as a rented tenancy.

Table 1 provides a detailed list of the costs. They are: i) initial purchase costs, including purchase price, legal fees, stamp duty and use of own time; ii) borrowing costs, including mortgage interest rate and loan set-up costs iii) letting costs, including finders' fees, occupancy preparation and safety and energy certification; iv) tenancy costs associated with insurance, management and on-going repairs; v) foregone income costs from arrears and vacancies between tenancies; vi) ancillary costs related to general business overheads, own time and travel; vii) repair and replacement costs, associated with equipment (kitchen, boiler, bathroom, etc.), furnishings (even so-called 'unfurnished' flats have floorings, window coverings, etc.), initial and external repairs and modernization (modelled as an annual sinking fund); and, finally, viii) agent and legal sales costs.

*Table 1: Income and costs in residential property investment*

<b>INCOME</b>	
Rents	
Net sale price of property	
<b>COSTS</b>	
<b>Purchase costs</b>	<b>Preparation for letting</b>
House price	Annual certificates
Stamp Duty Land Tax	Agency fees (tenant find)
Legal fees	Legal & set-up costs
<b>Borrowing costs</b>	Cleaning, redecoration, locks
Mortgage interest rate	<b>Other</b>
Mortgage set up fees	Share of investment overheads
<b>Tenancy costs</b>	Value own time
On-going maintenance/repairs (£pa)	Cost of travel
Agency fees (man./rent)	<b>Sinking Fund</b>
Insurance, etc. (£pa)	Replacement of equipment & furnishings
<b>Arrears/Vacancy</b>	Major repairs
Lost rent (£pa)	<b>Sales costs</b>
	Agency & legal fees

### *i) Costs*

Data on costs were derived from official and agency data and discussions with landlords. Some are relatively minor, such as equipment certification and annual insurance, but mount up when added together. Larger items, apart from the cost of the dwelling itself, are purchase and sales transaction costs; annual management costs, which are assumed to be

contracted to an agency for an annual fee of 10% of rents; repairs and replacements; and letting costs.

The property is assumed to be fully ready to let at the point of purchase; thus in a good state of decoration and repair and containing up-to-date equipment and furnishings. So, no additional capital costs need to be included in order to bring the property up to the appropriate standard.

Letting costs are a particularly expensive item and include property preparation and tenant find costs. If an agency is used to find a tenant it is assumed that they charge a typical one month's rent fee. There are also likely to be vacancy costs in the form of several weeks of lost rent. ARLA suggests that these run 3 to 4 weeks a year.<sup>3</sup> However, the estimates here assume that vacancies and other causes of lost rents are limited to 1 week a year only in order to avoid potential over-weighting of costs with voids. It is assumed that letting costs are incurred every second year in line with available evidence (ARLA, 2016). Repair costs were based on SEH (2010). All costs reflect inflation over time as the exercise as a whole is calibrated in nominal terms. Furnishings and equipment were depreciated assuming 8 and 10 years lives respectively and major repairs were assumed to cost the equivalent of a one percent depreciation rate on the house price.

A wide variety of mortgage offers exist and they vary over time. To simplify matters, the interest rate was assumed to be the average prevailing variable mortgage rate, as reported by the Bank of England. Better deals may be on offer but they have to be rolled-over and incur set-up costs every time, which often erodes the attractiveness of apparent lower headline rates. Two scenarios are modelled: i) sole use by investors of their own capital and ii) leveraged investment by borrowing a mortgage of 80% of property value and using own capital for the remainder of the purchase price and set-up costs. This enables exploration of leverage effects on returns.

## *ii) House prices and rents*

There are no specific data on landlord property purchases, so the first-time buyer house price index was used as a proxy. Rents present a problem as there are no time-series data available for the whole period. However, the Office of National Statistics (ONS) produces an index of private housing rental prices (IPHRP), which for England goes back to 2005. Rents prior to 2005 were estimated here from data on the market rents paid by households from 1996 available from the *Survey of English Housing* (SEH).<sup>4</sup> The average monetary rent levels provided in that information were then carried forward using the IPHRP.

Several commercial bodies (e.g. LSL, Countrywide and Homelet) provide actual average rent data through web based reports based on returns from lettings agencies, with the earliest extending back to 2008. Though each uses quality-adjusted approaches, they vary quite significantly from each other and generally indicate higher increases in rents than those in the IPHRP (ONS, May 2016 provides a comparison). The disparities may be due in part to sampling and data quality issues, because none of the providers are able to adopt truly representative sampling techniques. The ONS' sample is by far the largest and is based on rent officer information and voluntary filings by agents and landlords. It includes data for

both existing and new tenancies, whereas most of the other indices are for new lettings alone.

The difference in rents charged on new and existing lettings is likely to be an important influence on measured rent changes. As was noted above, landlords face significant transactions costs when letting their properties. Moreover, the behaviour of a new tenant is an unknown quantity, in contrast to existing ones. Landlords' transactions costs and tenant risks are consequently minimized by holding onto 'good' tenants. So, landlords are incentivized to encourage existing tenants to remain. As part of that strategy, they can limit rent rises, so that over time existing tenants pay less than prevailing new let rates. Behavioural factors may also be relevant with some landlords reluctant to create bad feeling by raising sitting tenants' rents.

The slower rate of change of IPHRP when compared to the indices based on asking-rents on vacant properties can be interpreted as providing evidence of this effect as many in its sample will be of existing tenancies. This is appropriate because the index aims to measure average changes in all private tenants' rents and most of them at any point in time will already be in a tenancy. This view is reinforced by the ONS' own comparison of its index with the existing tenancies index recently introduced by Countrywide, because the two closely follow each other (ONS, 2016).

As most tenants are already living somewhere, this argument suggests that measuring rents via indices that include a large sample of sitting tenants is preferable for use in the investment return simulations. However, a conundrum is created because tenants on average move frequently and at that time landlords will again probably ask the prevailing new tenancy market rents of their new tenants. The best approximation given these issues was decided to be rent estimates based on the SEH/IPHRP approach mentioned above, scaled up by 10% to take account of periodic re-adjustment to market levels. This has a degree of arbitrariness to it but anecdotal evidence suggests that it is a reasonable approximation.

For the post-2015 years that have to be forecast, it is assumed that house prices stagnate for three years, then rise by 5% annually for three more alternately until the end of the investment horizon to given some cyclical variation. Rents are assumed to rise at their previous trend of 3% pa with no cycle, while mortgage interest rates are assumed to rise by 1% after 2016 and stay at that level.

### *iii) Taxation*

Taxation is incurred on rents and capital gains, with the latter chargeable on sale. Allowable deductions include some, though not all, letting, management and repair costs and mortgage interest. Tax rates changes are frequent and are taken into account in the simulation.<sup>5</sup> Tax differences vary between income tax bands. Therefore, estimates were made for both basic and higher rate income tax rate investors. There are also tax-free personal allowances on capital gains tax but these are assumed to have already been used up by the investor rather than incorporated into the calculations.

## Results

Figure 1 shows for the data used here on an annual basis from 1996 to 2015 the typical 'headline' investment returns for private renting: that is the 1-year information provided by agency-based reports on rental yields and total returns (rental yield plus annual capital gain, assuming no leverage and prior to incorporating costs and taxes).

Rental yields fall from around 8% in the mid-1990s to 4% two decades later. Total returns were usually above 15% in the decade prior to 2006 but show a downwards shift from then onwards with a sharp drop in 2008 and 2009 with the recession in the aftermath of the 2008 global financial crisis but notable recovery after that. Driven by renewed post-2009 house price rises, total returns averaged 12% a year in the five years from 2010 to 2015. These results are plausible, given the substantial surge of investors into the private rented sector over 20-year period and the faster growth of house prices relative to rents for most of the time, which together help to explain the decline in headline returns.

The investment return simulation results are shown in Figure 2. Four outcomes are shown for each year in order to take account of varying circumstances, categorized by whether a mortgage was taken out or not and the investor's income tax band.

The results consistently show much lower returns on own capital than those suggested by the headline returns on property price approach. Of course, this is unsurprising as costs and taxation are taken into account by it. Nonetheless, the scale of the difference is marked.

Periods of low returns are also brought forward, as investors in any year commit to the experience of the forthcoming decade. Therefore, returns drop markedly after the turn of the century and revive somewhat during the 2008/9 period, as investors could pick up relative bargains then; only to fall off subsequently to their lowest levels as rental yields declined, taxes increased and (forecast) property price rises slowed. Again, the 1990s are identified as a period when much higher net returns were earned from investments made then than in later years.

Higher rate tax payers consistently earn lower returns than do basic rate ones. This is perhaps unsurprising as they pay higher taxes, which are only partly offset by higher tax deductions. Their tax situation has worsened since Treasury announcements made in 2015, which are incorporated in the analysis. The higher rates of stamp duty on purchases for rent announced then lowered returns for all investors as well.

It should be emphasized that these are nominal returns and, so, will typically be lower in real terms, though less so in recent years as inflation is much reduced. In addition, the estimated returns are not risk-weighted for such events as high levels of vacancies or arrears, unexpected repairs, abnormal tenant turnover, problem tenants and stagnant or falling local rents/house prices. Fully risk-weighted returns would consequently be lower. Furthermore, returns have shrunk on other assets in recent years and risks in alternative investment such as equities have risen (BoE, 2016) but, even so, it remains questionable whether the private rented sector is as such a financially attractive investment option as is often supposed.



Figure 1: Rental yield and total returns

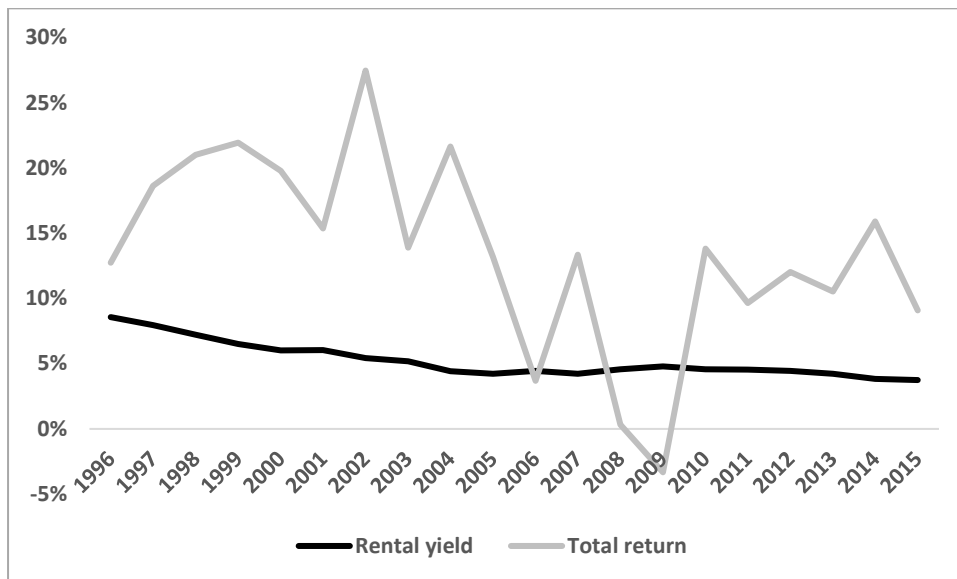
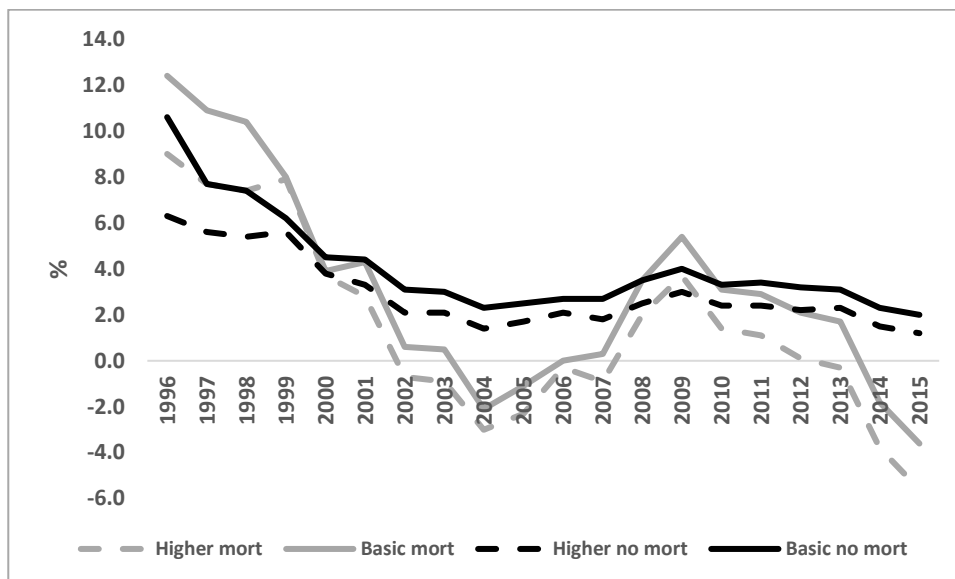


Figure 2: Investment return simulation results



NB: Higher/basic refers to the income tax band of the investor and mort/no mort relates to the use of mortgage borrowing.

A further consequence of the relatively low returns estimated in the simulations here is that leveraging often is a poor investment strategy. Returns can be leveraged upwards if borrowing costs are expected to be less than the returns generated by the asset in question. However, for residential investments made in English residential property since 2000, these results suggest that this has often not been the case with those using their own capital earning better returns than borrowers, despite tax relief on mortgage interest. Borrowers'

returns are also noticeably more volatile, because they are additionally subject to mortgage interest rate volatility.

In terms of cash flows, the biggest positive flow occurs at the end of the investment period when the property is sold. In previous years, cash flows may be negative, especially when net mortgage and transaction costs outstrip net rents. In general, the cash flow analysis shows the greatest likelihood of negative cash flows is in the earlier years of the investment. This pattern of cash flows highlights that for most of the investment period liquidity is limited. This means that there is little spare cash to deal with unexpected events, especially if sinking funds are inadequately accumulated. This adds to potential investment risks.

### **Raising income flows**

#### *1. More labour input*

Landlords can limit costs by undertaking all management themselves and save on agent charges by doing so. This is less possible with tenant find as agents have advantages in terms of property listings that cannot easily be replicated. As Ball and Glascock (2006) argue for many smaller landlords, renting is a 'small-business' involving labour input as well as pure investment. Of course, this supplements rather than raises investment returns as effort has to be expended, which in itself should be rewarded. The effort is also taxed in so far as it raises net rental income which is then subject to tax at landlords' marginal rates.

#### *2. Avoiding repairs*

Apparent returns can be raised by skimping on repairs and the replacement of worn out equipment. Neglecting to put aside funds to cover those contingencies artificially raises annual cash flows. However, a price is paid in the devaluation of the sales value of the property, as purchasers are likely to discount offers accordingly. So, in effect, capital is being misguidedly withdrawn as apparent annual income. If extensively practiced, moreover, tenants might be less willing to pay an equivalent rent, thereby cutting into income as well.

### **Behavioural biases?**

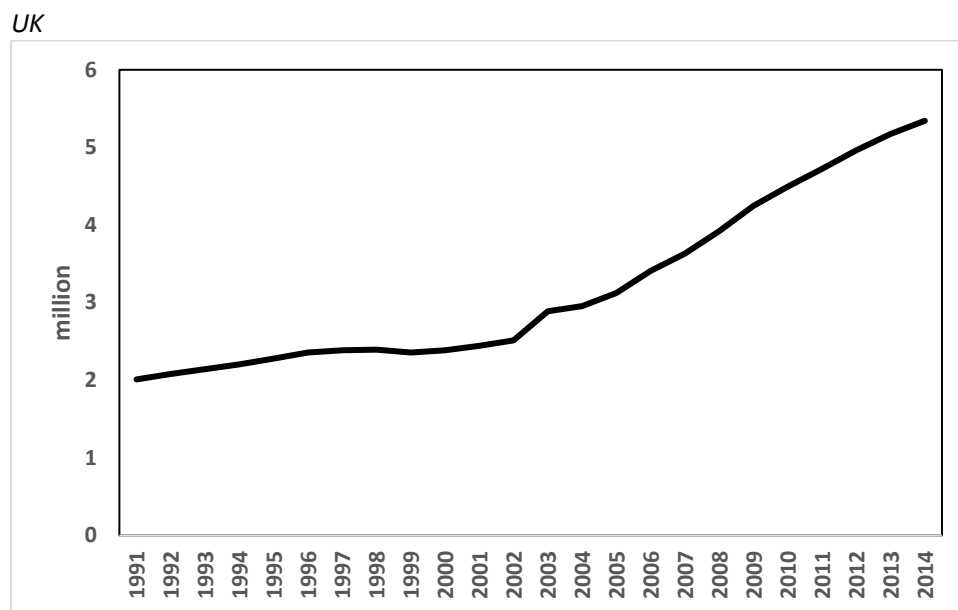
The simulation exercise reported here suggests that the returns for the private rented sector for individual investors are not particularly large. This raises questions about whether investors are adequately aware of the likely profile of net post-tax returns when they make decisions to invest in residential property. There is evidence that many landlords do not make detailed examinations of the viability of their residential investments and nor do lenders when they offer mortgage loans to them. Simple rules of thumb, such as rent cover, often suffice (BoE, 2016). As outlined below, there is evidence that many landlords are not financial return maximizers but operate on entrenched beliefs, such the long-term benefits of investing in housing. The question therefore arises of whether such behavioural patterns indicate a bias towards housing that makes low, risky returns acceptable? Moreover, no matter what investors believe are those perceptions credible and the returns viable?

It is difficult to come to any firm conclusion. Expectations are known to have substantial effects in housing markets and can switch dramatically, amplifying market volatility. They are influenced by recent events, are subject to shifts in sentiment and may be unrealistic. The housing market boom in the USA in the 2000s, for example, has led to a series of

studies identifying such influences on price dynamics (Lambertini et al., 2013; Ling et al, 2015; Towbin and Weber, 2015). They also suggest marked switches in price expectations when events prove previous ones to be false. So, if such behaviour exists amongst residential investors in England, as it is likely to, many could have made unwise investments which they may come to regret. This is especially the case when widespread beliefs regarding high investment returns and over-optimistic forecasts of house price rises fail to come to fruition.

Such expectations driven behaviour would suggest high rental stock volatility and a pro-cyclical pattern in investment property ownership. However, to date this does not seem to have been the case in aggregate. Instead, there has been a steady expansion in the size of the private rented sector (Figure 3); combined with relatively modest and steady rent rises, as was noted earlier.

*Figure 3: Number of privately rented properties 1991-2014*



Source: NSO.

Some researchers emphasize the diverse motives of residential investors and an acceptance of long-term holdings irrespective of returns (Crook and Kemp, 2011; DCLG, 2010). Many investors are financially unsophisticated and may be of modest means; a feature found in other rental markets as well as the UK's (Beer, 1999). Investors, in particular, may emphasize long-run house price change and discount the adverse effects of short-run cash flows and taxation. The idea of property being a 'safe' investment has a long, if somewhat misplaced, pedigree. Property surveys by agencies and banks involved in the marketplace, such as those of ARLA and Paragon, consistently indicate that landlords view their investments as long-term. However, Scanlon and Whitehead (2006) in a careful reading of evidence from their landlord attitude survey conclude that residential investors are sensitive to market conditions, although they may not articulate that in a straightforward way.

It could be argued that market conditions in England have fortuitously been comparatively benign for residential investors over the past 20 years, so that the resilience of landlords to severe market shocks has yet to be fully tested. A tipping point temporarily, or even permanently, affecting underlying investor expectations with regard to the private rented sector may come at some future date during a market shock that actually severely affects the private rented sector. At such a time, adverse circumstances may lead to the negative cash flows that the simulations here suggest often occur for several years while investing in residential property, even in good times. If landlords do not have access to alternative liquid financial resources, their investments may then fold.

Nonetheless, landlord behavioural factors make it hard to predict the impact of net investment returns on the overall size of the private rented sector. Returns may be limited but sufficient, in the absence of severe shocks, to allow many investors to justify their views on why they invest there. For example, the ability to run a modest business combining capital and labour input may be attractive to modest-income investors on a sustained basis. However, circumstances may equally arise that rapidly diminish the sector's attractiveness. So, it must be concluded that an inability to forecast investor behaviour in response to specific levels of returns leads to uncertainty about the future relative sizes of housing tenures in the UK but that some floor still exists, because even the most ardent non-maximizing investor can go bust. Future marked investment volatility cannot be ruled out.

## **Conclusions**

The results of a cash-flow simulation exercise related to investor returns in the English private rented sector since 1996 have been reported here. Caveats have to be made regarding the assumptions, data adjustments and forecasts made as part of the exercise and its national average nature. Therefore, it may not fully reflect actual investor experience. Yet, the simulations do provide plausible estimates. The approach is also a truer reflection of typical investor experience than one-year total gross return snapshots prevalent in general discussion of investor returns, because the simulation exercise incorporates market and cost fluctuations over time and takes into account tax effects.

Costs obviously depress apparent returns and are often substantial. Having periodically to find new tenants imposes a significant cost burden on landlords. There is growing evidence that existing tenants pay lower rents than new market offers, so market rents as measured by recent new tenancies may be a poor guide to actual rent incomes.

The estimated total net returns turn out to be significantly lower than the snapshot approach would suggest. They have declined over time and are now low, even when taking the current limited earnings in other asset classes into account. Furthermore, all residential investors' returns are susceptible to further investment specific risks. They are associated with i) the attributes of the properties invested in, as they could have unforeseen expensive repairs or turn out to be harder to let than hoped for; ii) unexpected periods of vacancy or iii) costly problems with tenants. If any of them occur, returns are reduced further and may lead to significant losses. Higher rate tax payers consistently achieved lower returns than basic rate ones, because they pay more tax.

Apart from the 'golden years' of the 1990s returns are such that investors would typically be better-off using their own capital rather than borrowing. So, with hindsight, for most of the time-period leveraging would not have been a preferable investment strategy for those with sufficient resources to purchase outright. The analysis also highlights how vulnerable to market shocks heavily indebted investors may be.

If investors are only sensitive to reasonable estimates of risk-weighted returns over the long-run, it is unlikely that the levels estimated here are sufficient to maintain, let alone expand, investor interest in the sector. Low returns alone would suggest that the private rented sector is over-extended.

Yet, conclusions about a potential decline in investor interest cannot be made with any degree of confidence because of widespread evidence regarding the 'irrational' investment motives of many landlords. Landlords may continue to accept low average returns; gain compensating personal satisfaction from running a small business of providing housing services for rent; be lucky and consistently beat the average; or fool themselves into thinking they are making more money than they actually are. They may ignore poor short-term cash flows and underlying tax liabilities, thinking only of gross longer-term capital appreciation. On such speculations about private landlord behaviour rest forecasts of the relative sizes of housing tenures in England. Yet, however significant such behaviour may be in influencing investment choices and tenure mixes, studies of expectations formation in housing markets show how sudden change can be. Past perceptions may radically change, particularly in the face of severe market shocks, and investor behaviour with them.

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<sup>1</sup> ARLA and Paragon have been the longest providers of information but more recently organisations like LSL and Countrywide have begun to produce quarterly rent indices.

<sup>2</sup> Ball (2005).

<sup>3</sup> ARLA *Private Rented Sector Report* April 2016 found an average void period of three weeks; 5 viewings per property before it was let; and an average tenancy length of 19 months.

<sup>4</sup> DCLG (2009) *Survey of English Housing*.

<sup>5</sup> The Institute of Fiscal Studies provides a record of tax changes for the period in question on its website *Fiscal facts: tax and benefits*, [ifs.org.uk](http://ifs.org.uk).