THE MOST IMPORTANT HMO QUESTION … … AND SOMEONE ASKS ABOUT IT EVERY DAY

By Arsh Ellahi

This month, I want to answer one of the most burning questions that people ask me.

Let's get straight into it …

IS IT STILL POSSIBLE TO GET COMMERCIAL VALUATIONS ON HMOS?

Every day, I get a call, text or email from someone saying that they have not received the valuation they thought they were going to get.

In an ideal world, every property investor would love to purchase a two-storey property, turn it into a compliant four/five-bedroom HMO and rent it out quickly. Yes, that would make more cash flow than if it was rented out as a single let, but it doesn't necessarily mean it will be valued as a commercial entity. From my experience of dealing with HMOs, commercial lenders and the dreaded valuers, here is what is required to get a commercial valuation:

Significant works – This does not mean simply changing a few doors to fire doors and putting in a fire alarm system. To get a commercial valuation, a valuer must be able to comment that the property has undergone a major refurb to make it fit for purpose and uplift the value. However, even then a commercial valuation is not guaranteed.

Goes above and beyond – To achieve a commercial valuation, the property must stand out as one that can no longer be valued on its bricks-and-mortar merits.

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A valuer will look at it on the basis that if the borrower were repossessed, could the bank easily turn this property back into a family dwelling? If the answer is yes, the chances of getting a commercial valuation are slim to none. On the other hand, if you have put an en-suite and mini-kitchenette into each room, you could argue that due to the nature and amount of work done, it is no longer comparable to other family homes within the vicinity.

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For example: if you take a three-bedroom semi-detached house where the average value is £100k, then spend £50k on the property to create a four/five-bedroom HMO with each bedroom having an en-suite and mini-kitchen facility, should a valuer decided to value it on a bricks-and-mortar basis, you could clearly argue the case by asking how many other properties on this street have …

- **Five bathrooms**
- **Five kitchens/kitchenettes**
- **A full Grade A fire alarm system**
- **Fire doors and associated hardware**

Collectively, these should make for a sufficient argument to get a commercial valuation.

Electric meters - I have taken this one step further. All rooms in my HMOs have separate electric meters supplied directly by the energy providers, ie Npower / British Gas. As soon as a valuer steps into any of my HMOs they can clearly see it is a commercial product, as this property would have, for example, six electric meters (one in each of the five rooms plus one electric meter for the landlord). I also remove the gas supply from my properties.

My HMOs are therefore incomparable to a single dwelling. It would almost be like trying to compare a supermarket to a hospital.

I also like to get each room banded separately for council tax. Now, I know this will not land well with a lot of people reading this, but I actually prefer this method. I ask the VOA to come and band each room separately, so each room will receive its own council tax bill. That removes the liability from me as the landlord and also allows me to generate more cash flow from the property.

People ask all the time whether this restricts my market. I have been following the HMO model for almost 18 years and to this day, we maintain a 98% occupancy rate over a portfolio housing 800+ tenants. So the honest answer is I don't think it has. Maybe I've been ahead of the game as HMOs all over the country are now being banded in this way. I have seen many posts on social media forums from investors who are worried about the separate room banding. My advice is simple – if it happens all over the country, it will become the norm; therefore, tenants will have to live with the fact that this is another cost of living they will have to absorb. The only real difficulty is that if a tenant leaves, most councils do not give a grace period, and the landlord will be charged the council tax for that room from the moment it becomes vacant.

Tenants seem to like this model as they get all their own facilities, and I no longer have to deal with quibbles such as *"Tenant A used my milk"* or *"Tenant B refuses to clean up"*. The only real communal space in my HMOs is the corridor used to enter / exit the building.

It may seem heartless and cold, but I like to think it's as bulletproof and hassle-free a product as I can create. More importantly, this method has allowed me to generate commercial valuations on every HMO. In turn, that enables me to recycle my cash to build a decent-sized portfolio.

Article 4 - If you are in an Article 4 location, getting a commercial valuation would be easier than in non-Article 4 areas. The reason for this is simple – Article 4 was introduced to slow down the number of HMOs popping up all over the town / city. Article 4 has therefore restricted the number of new HMOs and in some cities has completely brought it to a standstill, eg Milton Keynes. As a result, they have become a sought-after asset class, so could also be considered for commercial valuation. If you are setting up an HMO in an Article 4 location after successfully gaining planning permission, you could demonstrate that you have had to go above and beyond to turn that single dwelling into a multi-occupancy property.

If you already had an HMO prior to Article 4 being introduced, you may find your property has shot up in value as a result. As property investors are still keen to invest in HMOs in prime areas such as Milton Keynes, Oxford, Birmingham, etc, but can no longer covert a single dwelling (without applying for planning), an existing and successfully running HMO holds a premium and generally can be sold on its commercial value.

What is a commercial value? – To value a property on a commercial basis, a rough rule of thumb is to take the income and multiply it by 7-10 to get to the commercial value. In most parts of the UK, the most common multiplier is seven times (7x) the income, whereas other areas (predominantly in the south, closer to the capital) might achieve circa 10-12.5x the income.

In Wolverhampton, we achieve circa 8-9x the income. This means I can purchase a property as a single dwelling using cash or bridging finance, renovate it and refinance based on commercial valuation. For example, back in 2010, I purchased a four-bed HMO for £40,000, spent £20,000 on the refurb, and it was valued at £200,000 based on the fact that it was, and still is, producing £20,400 per annum.

The £200,000 valuation enabled me to borrow up to 70%, or £140,000, against that property, which in reality only owed me £60,000. There are two trains of thought here.

1. **You could take all the cash out, recognising that it will cost you a lot more on the monthly mortgage payment and make you more highly geared (70%) on the property. That could prove useful providing you use the additional funds wisely, and invest them in other income generating assets (as opposed to buying flash cars, etc).**

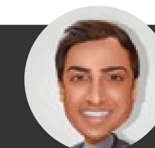
In the above example, I had the option to pull out not only my initial funds, but also an additional £80,000. If I took the whole amount, I could replicate the already tested model on potentially two more similar projects, leaving one unencumbered. If you were to rinse and repeat, by planning it carefully you could create a healthy portfolio in a short space of time.

2. **Take out only as much as you need – I generally take out the amount that I put into the property and leave the remainder in as equity. I like to think that this equity forms a war chest that I could call upon on a rainy day. Banks generally like the fact that I do not take all the equity out from day one. It also means that my payments are quite low and cash flow is high, allowing me to build a portfolio that:**
   - Is sustainable
   - Has a healthy cash flow
   - Is a commercial valuing asset
   - Has none of my own money left in

Debt levels are the most important aspect of your property investment journey, so I would advise everyone reading this to take debt seriously. Understanding the gearing level of your portfolio will also stand you well for the future. The lower your gearing, the greater the equity you have available should you wish to call upon it.

I hope you have enjoyed this month's article.

CONTACT



If you have a question which you would like answered in next month's article, email me on **arsh@arshellahi.com** and I'll aim to answer as many questions as I can over the following months.

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Arsh Ellahi is the author of **"Boom, Bust and Back Again: A Property Investor's Survival Guide"**