

RESIDENTIAL
RESEARCH



HOUSEBUILDING 2011

The opportunities and challenges facing the UK
housebuilding industry

Knight Frank



The New Heritage Collection by Redrow

HOUSEBUILDING 2011

Overview

51%

The increase in new-build volumes since Q2 2009

On the surface, the housebuilding industry has staged a remarkable, if partial, recovery from the depths of the recent recession, with build volumes up by 51% from their nadir. Despite this improvement and the aid for first-time buyers promised in the recent UK budget, economic and regulatory constraints risk this revival stalling in 2011.

To gauge the outlook for the UK's housebuilding sector, we have undertaken a comprehensive industry-wide sentiment survey, the results of which are presented throughout the report.

While our key findings point to several bright spots and some clear opportunities across the sector, we also uncover concerns over low mortgage availability. This has the potential to sap homebuyers' buying power at a time when regulation is conspiring to drive up building costs, and when changes to the planning system threaten to reduce the availability of sites which may help to bolster land values. These issues combined suggest that new home completion volumes are likely to remain low for the foreseeable future.

Over the last two years housebuilders have responded to market conditions by keeping clear of city centre apartment schemes and large regeneration projects, and instead have adopted a 'back to basics' policy of building traditional-style two-storey houses at lower densities in convenient and desirable locations on the edge of existing urban areas.

The opportunity to continue this policy depends on as yet unresolved issues regarding the coalition government's 'localism' agenda. So far the signs, confirmed by our sentiment survey, are that the coalition's legislative changes risk creating an even more hostile planning environment than that which existed before.

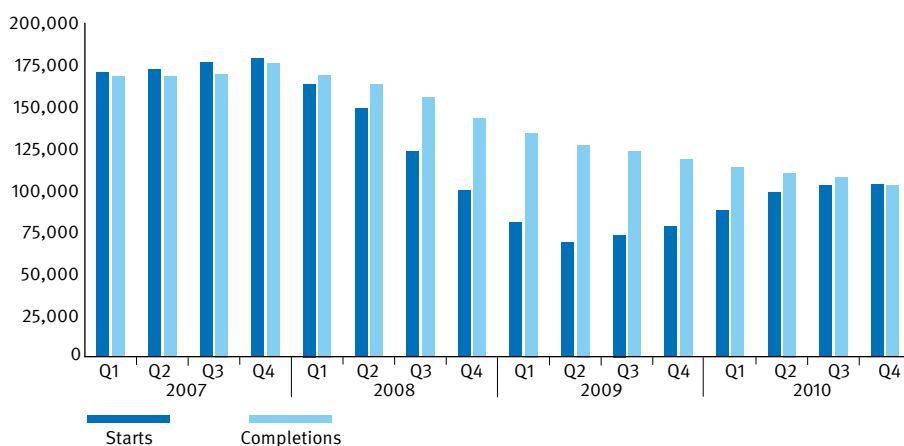
While volumes have recovered, they are still low even by recent standards. A total of 103,000 units were started in 2010, 42% below the number reached in 2007, and little more than a third of the annual housebuilding target set by the previous Labour government, figure 1.

Future prospects

In some ways the coalition government has made life easier for housebuilders. The new government has committed itself to ending the top-down approach favoured by Labour. The abolition of density targets means that developers are no longer being pushed, as they had been for the past decade, into building large numbers of one- and two-bedroom flats.

Figure 1

New-build housing starts and completions, rolling annual totals, England



Source: ONS

While the tiny units built in the decade to 2008 attempted to meet theoretical demand, with The Office of National Statistics (ONS) predicting that the number of single person households would rise from 6.8 million in 2006 to 8.5 million in 2016, they did not in many cases meet real demand.

The outperformance of new-build family homes, down only 6% since Q4 2007 compared to new-build flats, down 15% over the same period, confirms the difference in the demand and supply characteristics of these two property types.

Other changes, enacted or proposed by the coalition, could potentially suppress development. The abolition of Regional Spatial Strategies has done away with regional housebuilding targets. The power to decide how many houses get built has been returned to local authorities who, as elected bodies, are much more likely to be steered by Nimby opposition.

The government hopes that it can overcome Nimbyism by dangling a carrot in front of local authorities: under the New Homes Bonus scheme the government will match the council tax receipts from new homes for six years. But this is unlikely to be enough to counter Nimby attitudes except, perhaps, in poorer areas where there will in any case be less demand for new housing.

Cuts in the Social Housing Grant will impact on the ability of housebuilders to develop sites where a large number of social housing units have been demanded as a planning requirement. These sites are likely to remain undeveloped, unless developers are able to renegotiate the number of social housing units required.

Another source of extra costs is the Community Infrastructure Levy (CIL), which will allow councils to demand a contribution towards new roads, on top of the money developers must already pay under section 106 agreements. Few councils have begun to charge CIL as yet, but the indications are that it will add an extra £2,000 per plot to the cost of development.

Housebuilders have had little option but to turn their attention to sites in affluent areas

concentrated in the South East, on which planning permission already exists for the product they know will sell best: traditional-style, two-storey houses with gardens and space for off-road parking for two vehicles. Where apartments are built they now account for a smaller proportion of each development.

Overall, the new homes market will fail to deliver nearly enough units to meet demand created by a growing population.

The number of households in England is predicted by the ONS to grow from 23 million in 2011 to 24 million in 2016 and 25 million in 2021 – that is an extra 270,000 households per year over the next decade. This growth in demand is set to take place at a time when building volumes are likely to remain for some years at around 100-120,000 units per year.

The low level of housebuilding will exacerbate housing shortages, and while this may be mitigated to some extent by the better matching of location and property type to demand, the medium-term outlook for UK housing is that we will see more overcrowding, especially in the south, and ultimately the creation of accessibility and affordability issues.

Land market

The old adage ‘when the economy sneezes, construction catches a cold’ could be extended with the words ‘...and the land market goes down with pneumonia.’

With the arrival of the credit crunch in the summer of 2007 many housebuilders stopped buying development sites. The need to raise cash during the subsequent recession caused them to go further and begin to sell off some sites, even some with planning permission. The effect on prices was dramatic. Land prices in England, which in the third quarter of 2007 had been rising at 11% a year, underwent a swift reversal.

Between the first quarter of 2008 and the first quarter of 2009 land values plunged by 45%. No region escaped: some of the biggest falls were in the areas which previously had the most buoyant property markets. In London the fall over the same period was 47%, and the South East 41%.

Figure 2
I operate in...
Geographical spread of survey panel activity

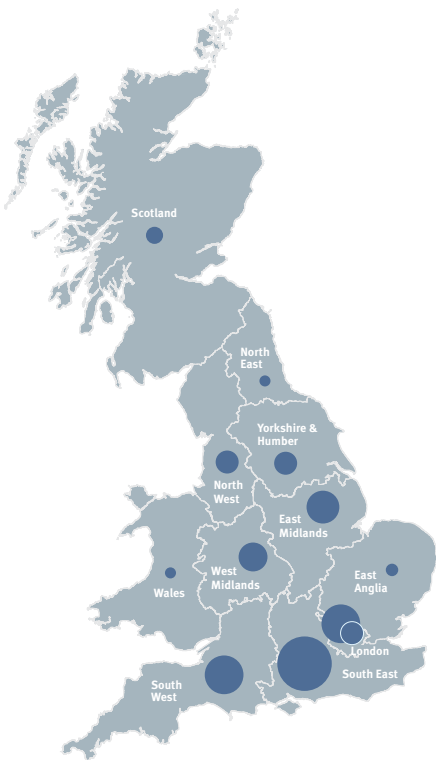
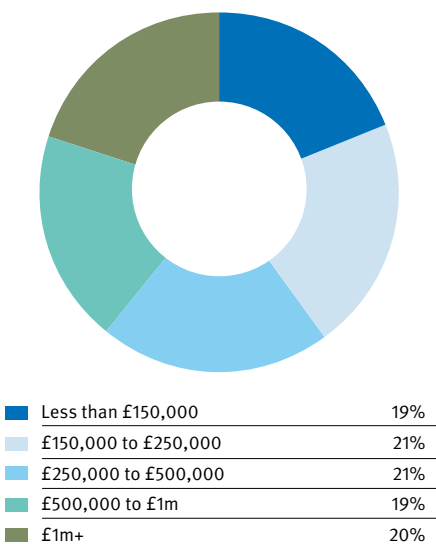


Figure 3
Price Points
Price bands for survey panel's unit sales



Source: Knight Frank Residential Research

The rate of growth in residential development land values slowed rapidly in the final quarter of 2010. While greenfield land still managed a rise of 2% between October and December, English urban land values fell by 1% and in Greater London the fall was more significant at -3%.

The only urban market which avoided price falls was the prime London market which registered no change over the quarter.

The recent slowing in quarterly growth has pulled back annual rates of growth, which had hit 26% in prime London in Q2 2010. Greater London annual price growth ended the year at 4%, down from the 14% hit during the summer.

Despite rising values during 2009 and 2010, average residential development land values as at December 2010 were still 40% below their Q4 2007 peak.

As we move into 2011, gathering problems are emerging, which seem likely to pull back some of this recovery in values.

Funding problems continue to provide difficulties for developers. In most cases

there is no funding available for sites without planning consent, and even for land with consent, loan-to-values of around 50% and possibly up to 60% are the maximum provided.

The few cash buyers in the market, who drove values forward in late 2009 and early 2010, have already spent a significant amount of money on sites over the past 24 months and are running low on funds.

There is a risk for 2011 that bank restructuring will increase the number of properties on the market just as demand is falling back.

Nonetheless, our view is that land values are likely to remain firm in 2011, whilst the supply of land is beginning to rise as receivers begin to push sites into the market, this is likely to be counteracted by the changes to the planning system which may limit the number of sites available.

That said, there are some positive market trends which should support pricing in the more desirable areas of the country – especially greenfield markets in southern England.

Green sickness

Another factor bearing down on housebuilding volumes is the increasing burden of regulation. While the government has made deregulation one of its central themes its only noticeable effort to date has been the watering down of the 2016 zero-carbon target, announced in the spring 2011 budget.

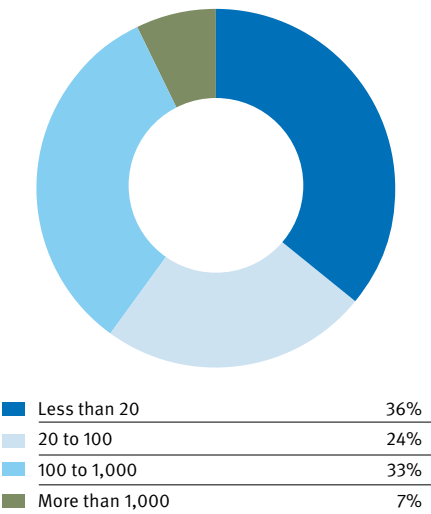
From 2013 all new homes will have to comply with the insulation standards described in level 4 of the Code for Sustainable Homes, which on the government’s own estimates will add £6,030 to the cost of building a four-bedroom detached home, while our own Green Homes report of 2010 pointed to a potential 22% cost uplift.

From 2016 all homes were due to be ‘carbon neutral’, as described in level 6 of the code, which requires micro generation such as photovoltaic panels and was

expected to add £42,770 to the cost of a new four-bedroom property. However, the Treasury’s new ‘Plan for Growth’ announced that energy used by appliances in homes will not have to be generated from renewable sources, and the zero-carbon definition will only cover heating, lighting and water when it comes into force in 2016.

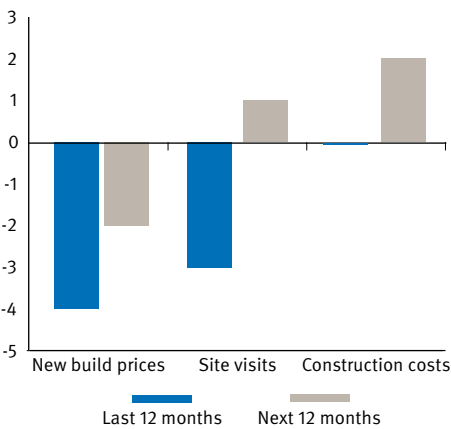
While the costs might be expected to come down as the technology develops there is a widespread view in the housebuilding industry that the standards may need to be relaxed even further if the government is serious about bolstering the volume of new homes. As one comment from our sentiment survey put it: “in current market conditions the sharp uplift in costs would mean there would scarcely be a development in the country which would still be viable.”

Figure 4
Measuring the builders
Approximately how many units does your organisation complete each year?



Source: Knight Frank Residential Research

Figure 5
Prices, demand and costs
Panel response to: In your view to what extent have sales prices, site visits and construction costs changed in the past 12 months and how do you see them changing in the next 12 months? (%)

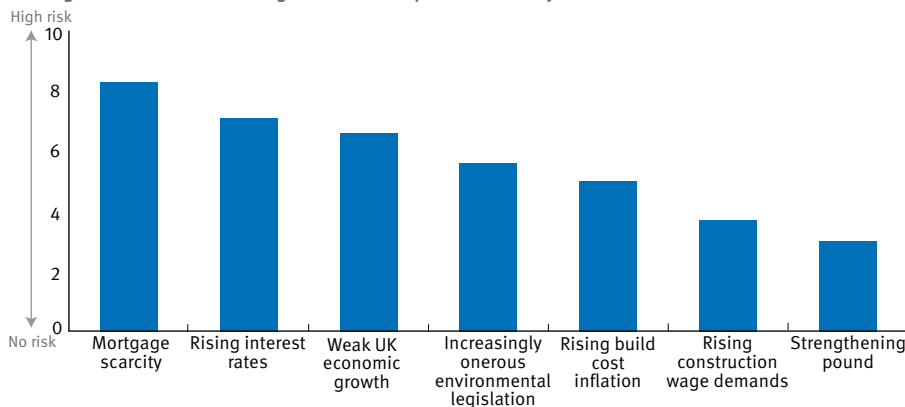


Source: Knight Frank Residential Research

Figure 6

Risks

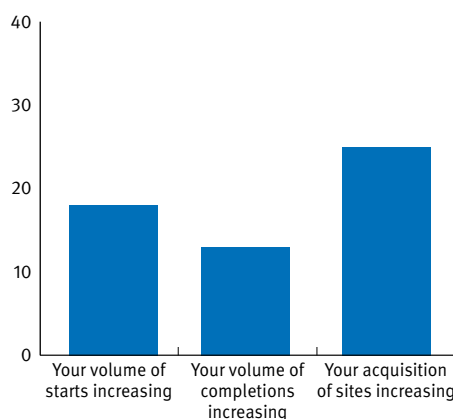
How significant will the following risks be to the performance of your sector over the next 12 months?



Source: Knight Frank Residential Research

Figure 7

With regard to your business do you expect the next 12 months to see...



Source: Knight Frank Residential Research

Housebuilder strategies

Housebuilders are minimising their risk by building homes in better-off areas and on sites with room for 200-300 houses, not the huge sites with room for 5,000+ homes that were common at the height of the property boom.

They are concentrating development in areas south of Birmingham, and in the South East in particular, believing that these areas will be less affected by cuts in public sector jobs.

In 2006-07, 11.2% of new homes started were in the North West and 10.1% in Yorkshire and Humberside. By 2009-10 those percentages had reduced to 8% and 7% respectively. By contrast, London increased its share of housebuilding starts from 11.4% to 14.3% and the South East from 17.8% to 21.5%. This is a trend which housebuilders expect to continue.

But not all sites in the South are currently of interest to developers. Labour, through its Regional Spatial Strategies, attempted to steer the bulk of development towards a few high-growth areas, namely Ashford in Kent, the Thames Gateway, the M11 corridor and central Northamptonshire, between Corby and Wellingborough. But house prices in these areas tend to be relatively low and do not offer attractive margins.

Instead, developers will concentrate their demand on smaller sites on the edge of existing towns and on well-served locations adjacent to large conurbations.

Large apartment developments were a feature of the housing boom in the decade to 2008. In 1997-98, flats made up 12% of all new homes built in England. A decade later that had grown to 45%.

Four-bedroom houses, which had made up 32% of all new homes built in 1997-98, made up just 21% of new homes built in 2007-08. The imbalance has partly been restored already, as housebuilders adopt a 'back-to-basics' approach of building family housing.

In 2010 the proportion of flats fell back to 40% and four-bedroom houses rose slightly to 24%. But this trend has much further to go. The market for city centre apartments outside London looks especially bleak, to the extent that even sites already granted planning permission are likely to remain unbuilt for several years. Regeneration schemes in secondary locations are looking especially unattractive for housebuilders.

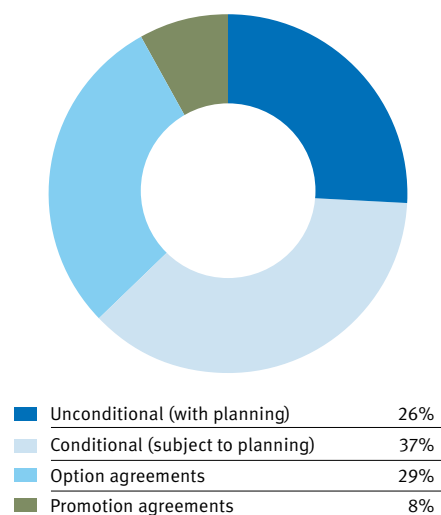
There is a potential that new homes could once again become regarded as a premium product designed to meet the needs of relatively well-off buyers in the South and Midlands.

It is entirely possible that the combination of extra costs and the reduced purchasing power of homebuyers will prevent the housebuilding industry being used, as it was during the Labour years, as an instrument to promote urban regeneration and regional development.

Figure 8

Land buying

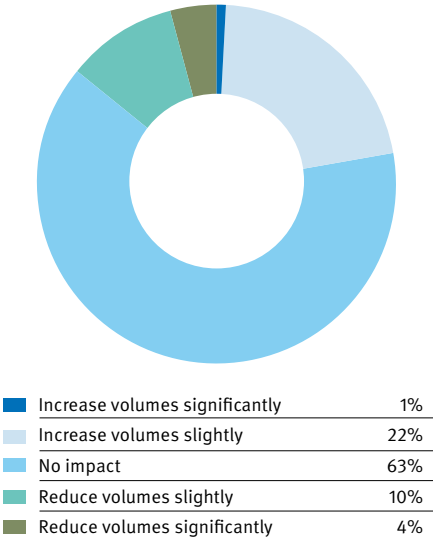
Which are the most popular methods for current land purchases?



Source: Knight Frank Residential Research

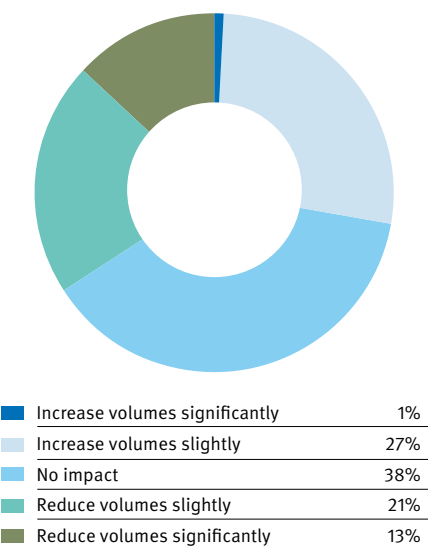
Knight Frank 2011 Housebuilding Survey

Figure 9
Small bonus
What impact will the recently announced New Homes Bonus scheme have on development volumes?



Source: Knight Frank Residential Research

Figure 10
Affordable supply
What impact will the new HCA Funding Framework have on volumes of affordable housing completions?



Source: Knight Frank Residential Research

While the results of Knight Frank’s 2011 Housebuilding Survey point to ongoing strains and risks in the sector, there are some hopeful signs, especially as the industry refocuses on a more economically sustainable product mix.

Our survey panel extended to more than 200 of the UK’s leading housebuilders and residential developers. The panel represents activity across the UK, figure 2, with particularly strong representation in London and the South East – reflective of the current clustering of construction activity. The panel was equally distributed across our five price brackets, figure 3.

Indeed, the average unit delivered by our panel is a good reflection of the make-up of the UK housebuilding sector, with strong representation from the smaller builders, figure 4. However, several builders noted in historical terms they were building far fewer units than they had been only three or four years ago.

Market conditions

The headline results from our survey confirm the picture of an industry in slow recovery.

New home prices slipped by 4% in 2010, with a noticeable north/south divide – with growth of up to 8% noted in London. Looking ahead to 2011, the consensus is that prices will continue their downward trend, but at a slower rate, figure 5.

This slightly more positive view on pricing is backed up by the view that while site visits declined by 3% last year there is an expectation that they will rise, slightly, this year.

While rising inflation has been threatening to become the UK’s defining economic issue, it seems to have passed the building sector by. Huge spare capacity has meant that construction costs were unchanged in 2010 and are expected to rise by 2% this year, a level which would be welcomed by Mervyn King.

While seemingly contained, cost pressures from environmental legislation, insurance, and implicit costs from planning delays are causing concerns, figure 6.

Looking forward, we asked our panel to consider a number of risks to their

performance in 2011. Without doubt the biggest concern relates to the availability and cost of mortgages, figure 6.

Economic concerns are headed by a general nervousness regarding the UK economy. As we note above, concerns over rising costs are subdued at the moment, if not wholly discounted.

Only in London, does the future performance of the pound matter to developers, a growing number of whom are increasingly reliant on investment demand from Asia and to a lesser extent the Middle East.

Future activity

In general there was a mood of optimism regarding the housebuilders’ thoughts on construction starts, estimated to rise by around 18% this year, and with completions, up by 13%, figure 7.

The most positive statistic is that site acquisition is likely to rise by around 25% this year. Respondents acknowledge that this ambition is likely to be tested by the lack of consented schemes in the market. There is still a significant aversion to unconsented land purchases, due to increased planning uncertainty.

For those in the land market, figure 8 confirms that while conditional contracts are the most popular single route to land purchase, nearly two thirds of purchases take place through “with planning” and option or promotion agreements.

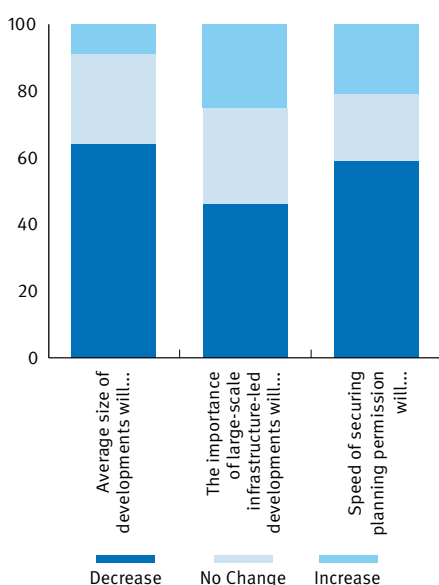
The impact of government schemes is thought to be modest at best. A 23% increase in development volumes was expected from the recently announced New Homes Bonus scheme, which was generally thought to be a poorly-executed policy, figure 9. Even this improvement is likely to be offset by a 34% decline in affordable housing completions following the introduction of the new HCA Funding Framework, figure 10.

Figure 11

Smaller, fewer, faster schemes

Panel response to: What will be the long term impact of localism in the planning arena, including the new Neighbourhood Plans?

(%)

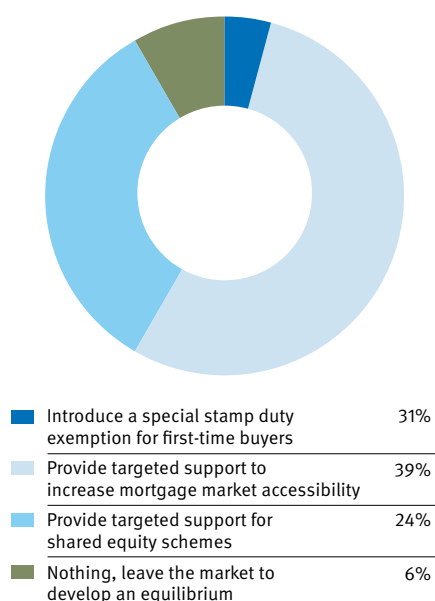


Source: Knight Frank Residential Research

Figure 12

Support needed

Panel response to: First-time buyers are struggling to enter the market in significant volumes, therefore the government should ...



Source: Knight Frank Residential Research

The future of development

It has been well reported that localism in the planning system is likely to lengthen the time it takes to secure planning consent in the future. Another likely change, however, will be the form of development – our panel believes that the average size of developments will shrink and the importance of large-scale infrastructure-led developments will reduce, figure 11.

Most respondents agreed that in the short term localism will lead to uncertainty and more difficult interaction with local authorities. In the long term a more open attitude to potential benefits is expected.

The recent budget contained proposals in favour of sustainable development – the new Enterprise Zones, reform to change-of-use rules, scrapping of brownfield land targets and the potential for land to be sold to local authorities – and all of these are to be welcomed.

However, while the long-term impact of the above proposals depends on the final details, their short and medium-term impact will be stymied by the fact that the Chancellor had absolutely no power to influence the one issue which controls the

fate of the housing market at the current time – the lack of mortgage finance.

Lack of demand for smaller products reflects weaker conditions in the first-time buyer market. We asked our panel to consider what they would do if they held the political power to deal with this issue, figure 12. Unsurprisingly, offered free reign to aid their own industry, few of our panellists elected to pursue a laissez-faire approach, with only 6% suggesting that they would leave the market to develop an equilibrium. Of the interventionist approaches on offer the most popular was to target support at first-time buyers through subsidised mortgages followed by stamp duty exemptions.

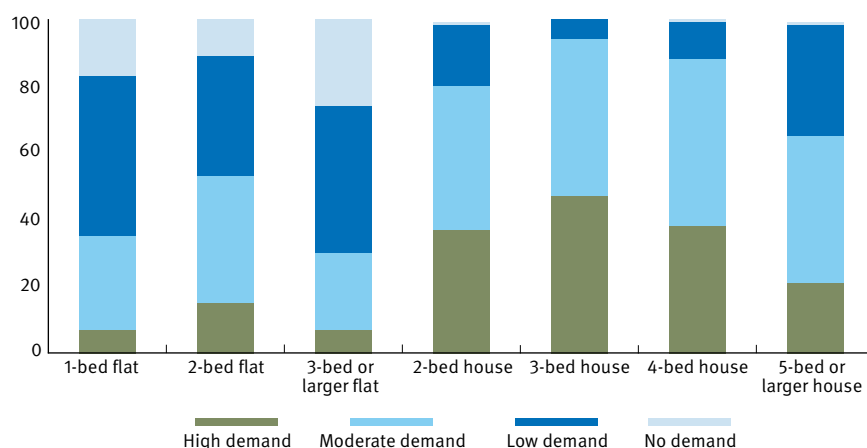
The Chancellor at least listened to the first of these requests with his announcement of the £250m aid for first-time buyers struggling to access the mortgage market.

In terms of product requirements, the general push towards family housing, especially suburban development forms, is confirmed by our survey, with the strongest demand recorded for three- and four-bed houses, figure 13.

Figure 13

In demand

Panel response to: How would you rate demand for the following products?



Source: Knight Frank Residential Research



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