

RESIDENTIAL
RESEARCH



HOUSEBUILDING 2012

The opportunities and challenges facing the UK
housebuilding industry

Knight Frank



FUNDING

DEVELOPMENT

OUTLOOK

2012 HOUSEBUILDING

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Overview

The housebuilding industry has been near the forefront of the political and economic agenda over the last year, resulting in enhanced government support for homebuyers and an expansion of the national debate on how to provide housing for a growing population.

“The lack of mortgage finance still remains a key challenge for housebuilders.”



Gráinne Gilmore, Head of UK Residential Research

At the same time, the industry continued to build its strength after the damaging fall out from the financial crisis which saw housebuilding slow markedly in 2009. Although housing starts in England were broadly the same in 2011 as in 2010 at around 100,000, this still represented a 25% uplift from the trough of the construction market in 2009. But this falls far short of the number needed to meet the government's target of an extra 200,000 new homes every year. Providing new homes for a growing population is rightly a key priority for the policymakers who also recognise the economic benefits of a healthy construction industry.

To help assess how the industry is set to fare over the next 12 months, we have repeated our comprehensive sentiment survey of the sector, the results of which are analysed in detail throughout this report.

The main themes of the findings highlight continued concern about the lack of mortgage finance, an issue which remains a fundamental challenge for developers and

housebuilders some five years after cracks started to appear in the financial system.

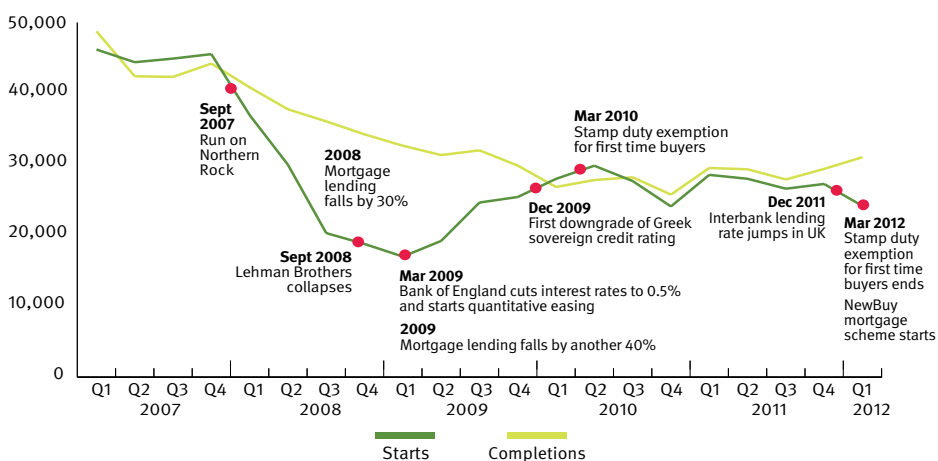
The government has moved to boost the availability of mortgages through the Mortgage Indemnity Guarantee Scheme, or NewBuy. Our survey respondents indicate that while such government intervention might be helpful, it is unlikely to be the ‘silver bullet’ that will boost the flow of money around the sector.

53%

of survey respondents expect development volumes will rise in 2012

The lack of mortgage finance has led to the ‘rise of the renter’, which we examined in detail in our recent [Residential Investment Report](#). This developing trend, and the opportunities it presents for housebuilders, is discussed by Stephan Miles-Brown, head

Figure 1
New-build housing starts and completions, quarterly totals, England



Source: DCLG

of residential development at Knight Frank, on page 5.

The National Planning Policy Framework (NPPF) for England, which was published in April, has been perhaps the biggest topic of discussion over the last year. There is no doubt that the Government has succeeded in its aim to streamline the rules and policies for planning – the NPPF document is 47 pages long, compared to more than 1,000 pages in its previous incarnation. While the content of the framework has been largely welcomed across the industry, there will be some side-effects, not least the confusion and delays that could result from the “bedding down” of the policy over the next year.

Environmental legislation also remains a concern for housebuilders, as does the new Community Infrastructure Levy, or CIL.

Our sector survey also highlights the importance of economic performance, both in the UK and globally, to the decisions being made within the industry. A worsening of the Eurozone crisis could have further implications for development and mortgage funding, which remains a key concern throughout much of the sector.

There are still stiff headwinds facing the housebuilding industry but we expect that development will pick up modestly this year, although in localised areas. This will still leave a large gap between government targets and actual housing completions, but notwithstanding a sharp deterioration in the Eurozone, the sector should continue to build momentum this year.

Funding

The financial crisis has taken a double toll on housebuilders. As bank lending seized up, some companies were starved of commercial funding to get building projects underway. The second hit was at the other end of the business model; mortgage finance became very scarce, resulting in fewer buyers and a sharp reduction in the appetite for homes being built.

Our survey confirms that these factors are still a major concern within the industry.

Worryingly, nearly 30% of developers and housebuilders expect that bank funding could contract further this year, as shown in figure 2. This is balanced somewhat by the 22% who expect it to increase, but it highlights how uncertain the outlook for development funding remains. Cash-rich housebuilders are in a position of strength however.

There is also increasing concern about the effects of the wider global economy on the UK banking system. Our survey showed that a ‘weak global and eurozone economy’ is the third biggest concern for housebuilders (figure 5). Another significant wobble, or even a break up of the Eurozone, could have a dramatic impact on UK banks, leading to another seizure in the credit market and a downturn in funding, as well as mortgage lending. Housebuilders are very alert to this risk.

29%

of survey respondents expect bank funding will decrease in 2012

A lack of funding is also a concern for the wider economy, both in terms of providing new homes, and in keeping activity buoyant in the construction sector, which feeds into the country’s economic growth. The importance of the sector was underlined when the Government stepped in to provide commercial loans via its ‘Get Britain Building’ fund. It recently topped the fund up to £570 million, from the initial tranche of £400 million promised in November last year, in a bid to get stalled building projects back up and running.

The lack of mortgage finance has been well documented, but access to finance for those wishing to buy new-build homes has been particularly constrained.

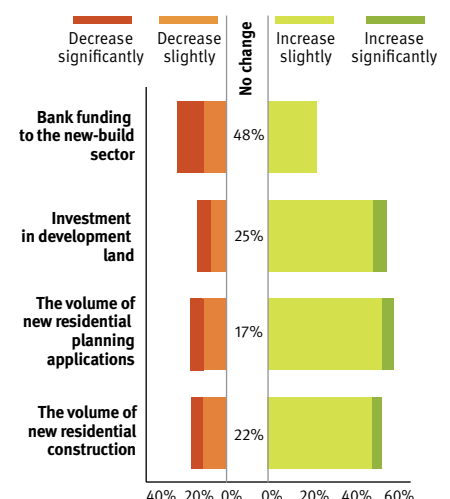
Again, the government has taken action, introducing a NewBuy Mortgage Indemnity Guarantee Scheme. Under the scheme, housebuilders and the government act as a ‘backstop’ for lenders, encouraging them

HOUSEBUILDER SURVEY:

More than 100 respondents took part in our second annual survey, representing a real cross-section of the housebuilding industry. Respondents were fairly evenly split across all price brackets, with just a slight predominance in companies which were active in building properties worth between £250,000 and £500,000, followed by those building units worth £500,000 to £1 million. Geographically, more than 50% of respondents were primarily active in London and the South East, reflecting the rise in development activity in these areas.

Figure 2

Over the next 12 months how do you expect the following to perform?

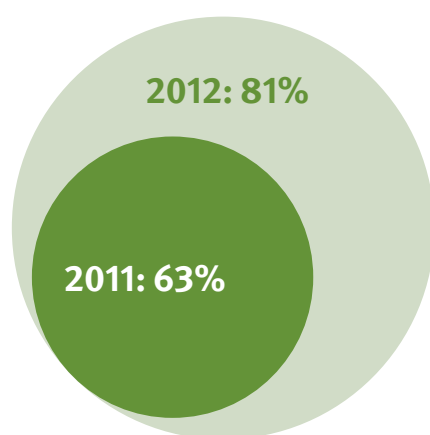


Source: Knight Frank Residential Research

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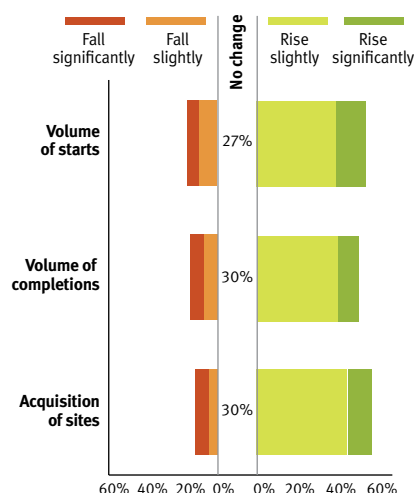
The opportunities and challenges facing the UK housebuilding industry

Figure 3
New Homes Bonus
Proportion of developers who said the 'bonus' would have no effect on development volumes



Source: Knight Frank Residential Research

Figure 4
With regard to your business how do you expect the following to perform over the next 12 months?



Source: Knight Frank Residential Research

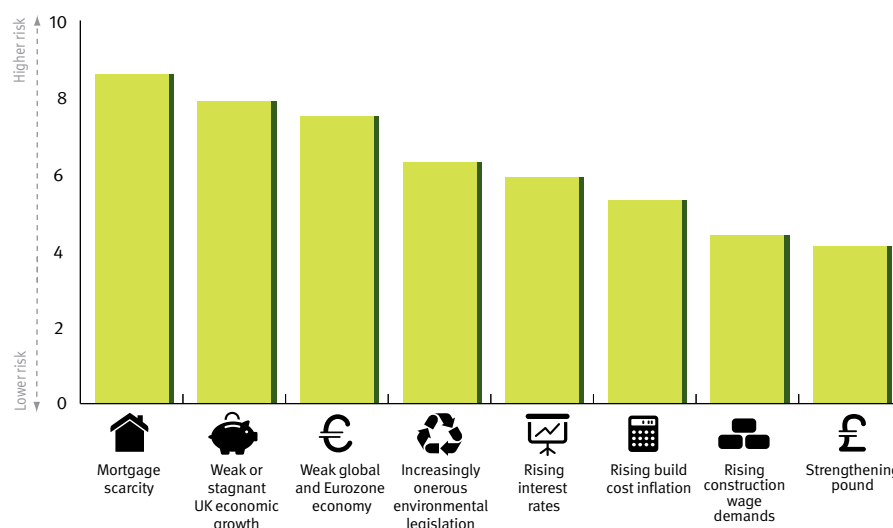
to offer mortgages to buyers who have a 5% deposit. The scheme aims to help 100,000 new home buyers. To put this in context, there are around 60,000 home sales across England and Wales each month.

Our survey showed that housebuilders are quite upbeat about the effects of the NewBuy scheme, with two-thirds saying that the scheme would result in a slight rise in development volumes, and 70% saying that it should result in a modest rise in sales. However the number of respondents who felt that the scheme would have a 'significant' positive effect was modest, with only 3% saying it would result in a large rise in the volume of sales. Some housebuilders have also expressed dismay in recent weeks at the high interest rates on such mortgage loans.

Our survey shows that lack of mortgage finance remains the biggest risk to the performance of the housebuilding sector over the next 12 months, as shown in figure 5. Mortgage approvals for house purchases are still down by around 50% since the peak of the market in 2007.

Add to this the ending of the first-time buyer stamp duty holiday – and it is clear that the barriers to borrowing remain significant.

Figure 5
Risks
How significant will the following risks be to the performance of your sector over the next 12 months?



Source: Knight Frank Residential Research

Development

This has been a key period for policy surrounding planning and development.

The New Homes Bonus was introduced last year in a bid to encourage local councils to approve plans for new homes. In return they receive a payment matching council tax income for each home built or brought back into use, with an additional bonus for affordable housing.

Yet our survey shows that in the second year of the bonus allocation, there has been a notable rise in the number of respondents who think that the scheme will have no impact at all on development volumes. Some 80% of those surveyed said that the bonus would have little effect, as shown in figure 3.

The publication of the National Planning Policy Framework (NPPF) in late March at last provided some certainty over the Government's intention to streamline the planning process in England – its key tenet is presumption in favour of sustainable development. The policies within the NPPF still need to be thrashed out in a local context however – regional spatial strategies were scrapped in 2010. As a result, the development framework has been less than certain for some time (with the exception of

London, where the Mayor's office has retained an overarching handle on development targets). Add to this the wave of appeals on Sector 106 requirements in the wake of the financial crisis to take into account the change in development finances and land values, and the result has been a quagmire of expensive and time-consuming planning negotiations.

The new NPPF will take time to 'bed down' and promises little change to the current situation in the near future. This is strongly

reflected in our survey, with nearly half of respondents saying they thought that the Government's move towards 'localism' would actually slow down the process of securing planning permission. Some 54% said that the plan could result in a fall in development volumes from where they would otherwise have been.

There was also disquiet among respondents about the Community Infrastructure Levy, CIL, which is currently being rolled out across the

country. Respondents said the new charge was already "squeezing margins." There are growing concerns that this levy could also lead to a decline in the supply of residential development land across the UK.

Increasingly onerous environmental legislation is also troubling housebuilders, as shown in figure 5. One housebuilder recently said that the plan to make new homes 'zero carbon' from 2016 could add £30,000 to the cost of building each new home.

INTERVIEW: Stephan Miles-Brown



STEPHAN MILES-BROWN
Head of
Residential Development
Knight Frank

IS THERE A SHORTAGE OF HOUSING IN THE UK?

There is, without question, a shortage of housing in some regions including quite extensive areas in the South East and the Home Counties. This obvious shortage is caused by simple supply and demand imbalances, especially at key price levels.

There isn't however, a shortage in some other areas of the country, especially those which have suffered from a lack of investment and employment opportunities, as people have less reason to live there. Whilst at present, many of these areas are in the North of England, the current housing shortage is fundamentally a reflection of the economic scenario, rather than a simple North-South divide. The North of England has boomed in the past and could do so again, albeit from a lower base.

WHAT DO YOU SEE AS POTENTIAL FUTURE TRENDS IN THE HOUSEBUILDING SECTOR?

A key theme will be the trend to explore different forms of tenure, especially long-term renting. There will always be people who choose to rent in the short term, or who can't buy because they lack the substantial deposit now required. There has been a lot of debate in the last two years, of pension funds and private equity

making investments in some form of build-to-let model, and given the relative positive performance of well located, new-build residential property as an institution-grade asset class, it can only be a matter of time before this happens.

There are obviously some challenges with the dynamics of the investment model, which will need to be overcome, but there is now a real opportunity for housebuilders to start to consider the rental sector, in areas where mixed tenure schemes best address local housing need.

I can envisage situations where institutions and housebuilders agree the pre-sale of an entire development, in the same way offices are pre-let. We may well see housebuilders forming specialist teams or subsidiaries to build to a specific typology, purely for the "build-to-let" sector. As ever, the key ingredient will be a supportive planning regime which allows for smaller units and higher densities.

At the moment, this idea has greater potential for the regions, as in London and the South East, demand from home buyers remains buoyant. However, the larger metropolitan centres elsewhere present real opportunity areas. Personally, I would favour university towns and cities, as these already have a well-established rental market – both stable and transient, with a

good tenant profile, low voids, market rents and consistent rental growth.

WHAT ABOUT CO-INVESTMENT IN SUCH A SCHEME?

That would be a really interesting development in the market. A housebuilder could co-invest with an institution, for example, retaining the freehold whilst offering the investor a 10-year lease. Once the lease expires, there are several options: the investor could renew the lease; the housebuilder could choose to retain the rental income and become a landlord, or sell the let investment; or they could break up, refurbish and sell the units.

There are obviously 'challenges' with this model. Investors and housebuilders would need to come together to agree acceptable margins on each side. In addition, the usual pressure on housebuilders (as current traders) to recoup development costs quickly through sales, would need to be addressed and the financials re-engineered, so clearly more work is required in this area, and the devil will be in the detail.

There are real opportunities to develop different strata of tenure and it would be a logical and timely progression to establish another market to address housing need in particular locations, as well as allowing housebuilders to increase production.

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INTERVIEW: Steve Morgan



STEVE MORGAN
Chairman
Redrow

The stamp duty regime should be reformed.

It is a very unfair tax, and always has been. The 'slab structure' should be changed to a sliding scale so the levy is charged in the same way as income tax. I am concerned about the new 7% stamp duty charge on homes worth £2 million or more and the 15% charge for corporate purchases. It is important that we don't send the wrong message to overseas buyers in light of the money they pump into the UK economy.

The NewBuy scheme is excellent in theory.

It is still early days, but we have had a lot of interest. However it will not be a success unless the interest rates being charged by lenders are reduced. I would also like to see it rolled out to all forms of housing, not just new-build.

The NPPF is a step forward. However there is a lot of room for interpretation and as such I believe it will take a couple of years, and significant use of the appeals process, before it settles down.

Environmental legislation is a ticking time bomb.

The areas that will be hit by the increasing cost of building arising from more onerous rules will be the less affluent areas where the development finances no longer add up. In Wales, for example, by 2016 it will cost £13,000 more to build a 1,000 sq ft house than in England because of the over-zealous interpretation of zero carbon and the introduction of sprinklers.

Development levels will continue to rise in the years to come. New housing starts will rise by 25% over the next three years.

Outlook

Housebuilders are slightly more upbeat about demand and prices over the next 12 months, as shown in figure 6, expecting new-build house prices to rise by 1%.

Construction costs are tipped to rise 3% this year, coming after a 3% increase last year, which will put additional pressure on margins for housebuilders, given the modest expectations for price rises.

Encouragingly, housebuilders and developers report a pick-up in demand across most types of housing, as shown in figure 7.

As in 2011, the market for two-bedroom and three-bedroom houses is dominant. There has been a slight fall in demand for apartments with three or more bedrooms, but this reflects the rather niche nature of developments offering this type of unit.

Perhaps the most interesting trend to note is the rise in demand for large homes. Nearly 80% of respondents said that there was moderate or high demand for family homes with five or more bedrooms, up from 65% last

year. The proportion of respondents reporting demand for four-bedroom houses also rose from 88% to 95%.

This can be seen as a symptom of the mortgage finance issues faced by buyers in this post-credit-crunch market. Equity-rich home movers – families who have built up equity in their existing properties – are more dominant in this new-look market, and larger family homes cater perfectly for their needs. Demand is highest in the South and South East, reflecting the relative economic strength of this part of the country, suggesting that an uplift in development could be localised.

Moving on to land, more than half of respondents expect their acquisition of sites to increase over the next 12 months, with only 14% forecasting that their rate of acquisitions may fall. In addition, 58% of respondents said that investment in development land would rise over the next 12 months. This suggests that there could be more upward pressure on residential development land prices over the next year, especially for the most desirable sites as supply remains tight. This situation will only be exacerbated by the new CIL regime.

Figure 6

Demand, prices and costs

| | New-build prices | Site visits | Construction costs |
|---------------|------------------|-------------|--------------------|
| 2010 | -4% | -3% | 0% |
| 2011 | -1% | 0% | +3% |
| 2012 forecast | +1% | +2% | +3% |

Source: Knight Frank Residential Research

Residential development land prices in prime central London soared by 20% in 2011, according to Knight Frank data, reflecting a huge demand in this market, underpinned by very strong capital price growth in the luxury London market.

78%

of respondents said there was high or moderate demand for homes with five or more bedrooms

In the wider UK market, residential development land values rose more modestly, by 1.3%.

It remains to be seen if the Government can step up its delivery of public sector land. Whitehall departments are reported to have identified enough surplus public land to build 102,000 homes. Our agents report that there has been a rise in sales of residential development land by public sector bodies over the last year, but the next couple of years are crucial. It is estimated that 40% of land suitable for development sits within public sector land banks.

In terms of housing delivery, our survey showed an industry which is expecting to increase its output over the next 12 months. Some 54% of respondents expect to increase their housing completions, with 10% gearing up for a 'significant' increase. Only 15%

said completions would fall compared to the previous 12 months.

More than half of respondents said that housing starts would rise, with 13% saying there would be a large rise in new schemes started over the next year. Some 60% said that the number of planning applications submitted would rise over the coming 12 months, suggesting that this trend will continue.

There is no doubt that the housebuilding and development sector faces challenges in the current climate. Curtailed funding, planning confusion, onerous levies, environmental legislation and wider economic turbulence mean that housebuilders are still navigating perhaps one of the most difficult periods in recent memory, although cash-rich housebuilders are at an advantage. All of this comes against a backdrop of housing shortages, especially in the most economically active areas in the country, placing housebuilders in the policy spotlight.

But there are signs of optimism within the industry. A healthy start to the year – as reflected in robust trading statements – has buoyed confidence, and the green shoots can be clearly seen in our survey results. As a result, we expect development volumes to rise modestly over the coming years, especially the delivery of family homes. But there is evidence that policymakers may have to do more to address some of the current barriers to development to meet their own housing targets in the short or medium term.

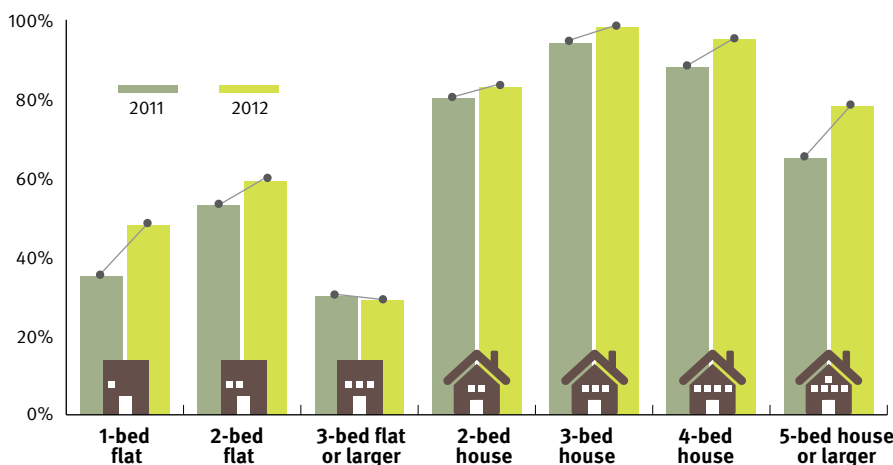
What steps can Government take to encourage more development?

Our survey respondents said:

- “A bonus for planners based on units granted”
- “Reinstate regional building targets”
- “Offset CIL contributions against S106”
- “Increase supply of mortgages”
- “Have a period of consistent policies with no knee-jerk reactions”

Figure 7

Strength of demand, % of respondents stating 'high' or 'moderate' demand



Source: Knight Frank Residential Research



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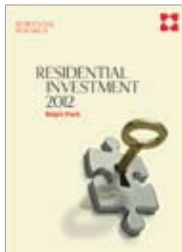
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