RESIDENTIAL RESEARCH

Knight Frank

NEW FOUNDATIONS

Housebuilding Report 2013

FUNDING

DEVELOPMENT

PLANNING

OUTLOOK

Overview

Housebuilding is a key component of the UK economy. The wider construction sector accounts for nearly 7% of the UK's annual economic output, and its effect on the UK economy has been amplified in recent years given the slowdown in Government spending.

"The report findings are largely informed by our wide-ranging survey, with most major UK housebuilders represented among the respondents."

Gráinne Gilmore, Head of UK Residential Research

The performance of the construction sector can also have a strong bearing on consumers' sense of economic "wellbeing", from the confidence engendered when a major infrastructure project is completed to the "wealth effect" felt by households when property prices rise.

This report gives a snapshot of the housebuilding sector, examining the current and emerging trends. There are certainly signs of recovery from the worst of the fall-out from the financial crisis, but the sector faces continuing challenges ranging from funding to planning.

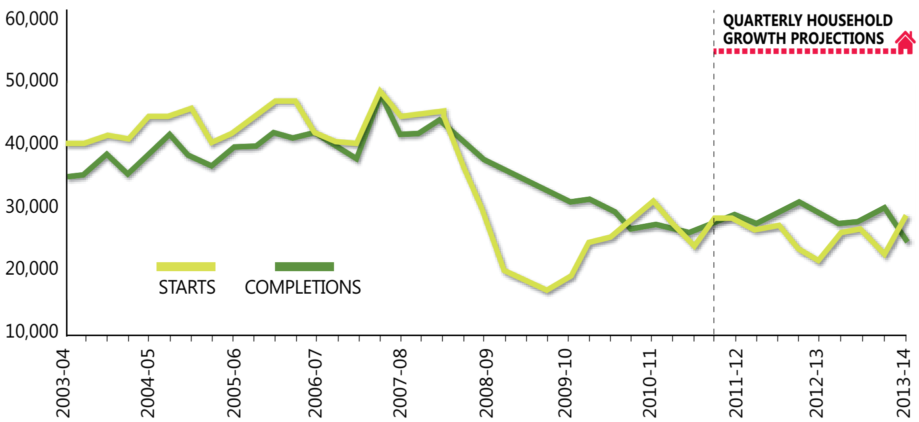
Housebuilders have had a solid start to the year in terms of their own performance, with the successful return to stock market by Crest Nicholson marking the first major market floatation on the London Stock Exchange of a company from any sector in 2013.

The strong belief in the strength of the sector has also been amply demonstrated by a significant step up in private equity and institutional activity, with Patron Capital and Legal & General buying Cala Homes, and Oaktree Capital Management buying Countryside Properties in the year to date. The Government's Help to Buy scheme, examined on page 4, has also boosted activity since March.

The findings in this report are largely informed by our wide-ranging annual survey of housebuilders, with most major UK housebuilders represented among the respondents. In light of the Budget on March 20th, in which the Chancellor announced the introduction of 'Help to Buy', we asked some respondents for their reaction afterwards, and these results are also included throughout this report.

Housing starts rose slightly in the first quarter of this year, according to the most recent official data. But as figure 1 shows, housing starts and completions are still much lower than they need to be to meet the UK's growing housing demand. The imbalance between demand and supply was underlined by new household growth projections recently published by the

Figure 1
Development volumes, quarterly
Housing starts and completions, England



Source: Knight Frank Residential Research/DCLG

Department for Communities and Local Government, also shown on figure 1.

Despite the structural demand for housing in the UK, the dynamics of the market at a regional and local level are more nuanced, influenced by economic and employment activity in each area. This is reflected in our survey responses which show that housebuilding activity is weighted towards the south of England, particularly the South East, where demand is highest.

"With over 300 housebuilders now signed up to Help to Buy, I'm confident that over the coming months we'll see many thousands more achieve their dream of owning a home."

Mark Prisk, Minister of State for Housing and Local Government

Local economic factors also have an impact on local planning policies, and these policies have come much more to the fore under the new National Planning Policy Framework (NPPF), which is still effectively being rolled out across the country. We examine the impact this, and additional development legislation and charges, such as the Community Infrastructure Levy (CIL), are having on the industry.

Housing demand from those with the ability to raise finance is key in the current market conditions. The constraints of the mortgage market since the financial crisis have been well documented, but we examine what effect the Government and Bank of England's efforts to unblock funding have had so far, and are likely to have in the years to come. We also analyse the relationship between funding and shifting demand for different types of housing.

Development finance is also a key issue for housebuilders, and we examine the emergence of new types of funding, and it is this issue to which we turn first.

Funding

The lack of development finance is still a major risk facing the housebuilding sector, according to our survey.

The constraints on the banking sector since the financial crisis have been felt in most corners of the economy, but particularly in the property sector, both in terms of development finance and mortgage lending.

There are signs that the funding market for developers and housebuilders is adapting, with fund managers becoming increasingly active and looking to help fill the funding gap left by the banks. There are new types of 'blended' finance on offer, combining senior debt and mezzanine finance. Private equity firms are also becoming much more involved in the market, a move seen by many as a vote of confidence in the sector.

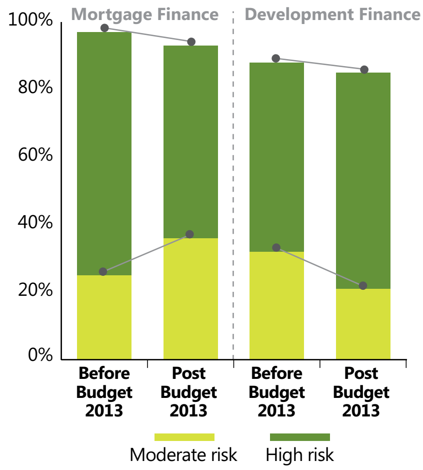
Our survey respondents were clear that development funding remains a significant issue for the industry however, **with more than four out of five identifying a lack of funding as a moderate or high risk to the sector.**

Drilling down into the data a little more, it emerges that more than two-thirds of respondents expect some rise in the availability of private equity finance (figure 3) this year compared to last. In contrast, no respondents at all expect a significant pick-up in bank funding, despite the fiscal measures (quantitative easing, Funding for Lending) designed to try and boost bank lending to businesses.

One respondent suggested that the Government should do more to "pressurise banking institutions to increase lending levels", while another said it should "force government supported banks to fund development". When asked if the Government had done enough to make finance available, another developer said no. "Funding is not available at all to small developers on a viable basis," he added.

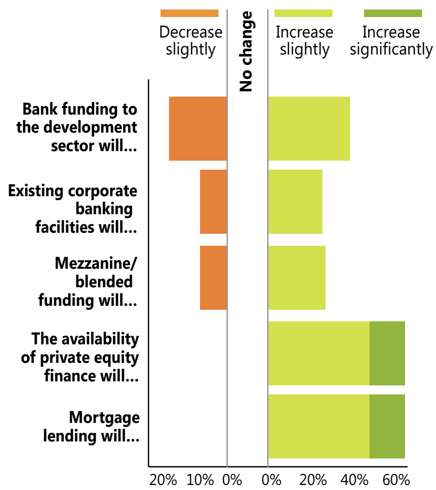
Mortgage funding is also flagged up as an on-going issue for the industry, but there is initial evidence that the Government's 'Help to Buy' scheme (see box, page 4) has already boosted buyer interest and sales rates.

Figure 2
Risks to market
% of respondents identifying these issues as moderate or high risk to sector



Source: Knight Frank Residential Research

Figure 3
Funding outlook
Funding remains a key issue for developers. In 2013, % of respondents who expect that...



Source: Knight Frank Residential Research

More than half of respondents (57%) from our survey still singled out a lack of mortgage finance as a risk factor for the industry, just days after the Chancellor's Budget announcement (although this was down from more than 70% before the Budget). Indeed, only one in ten respondents said that a lack of mortgage finance did not pose a moderate or significant risk to the sector in the year ahead.

But there is also an **expectation among housebuilders and developers that mortgage lending will rise this year**, with the proportion of respondents expecting a significant rise in lending jumping from 5% before the Budget to 15% afterwards. This is supported by recent data showing a step up in mortgage approvals in April.

Help to Buy

The Chancellor announced the multi-billion pound Help to Buy scheme in March 2013. The first part of the scheme launched at the start of April, offering a 20% equity loan from the Government for those who only have a 5% deposit to buy a new-build home worth up to £600,000. The loan is interest-free for five years and will be repaid when the house is sold, if not before.

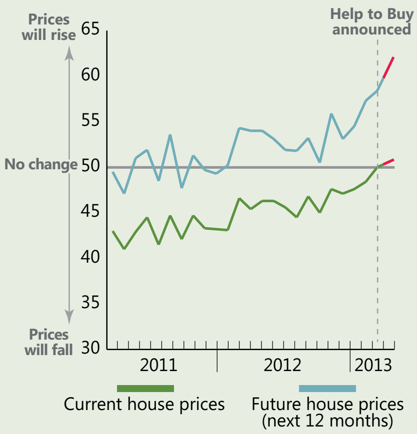
The scheme is expected to **help 74,000 buyers** over three years. The first buyers have already taken possession of their home under the scheme and several major housebuilders have reported that reservation levels have jumped since the scheme started. Opening the equity loan scheme to home movers as well as first-time buyers has boosted interest further.

The second part of Help to Buy, the mortgage guarantee, will be launched in January. It **could help around 500,000 buyers** purchase a new-build or existing home. If the take-up was split evenly over the three year duration of the scheme, it would result in an 18% uplift in annual transactions based on current levels. However, there is, as yet, little detail on how the scheme will work, with the Treasury Select Committee calling it "very much a work in progress". There are signs that despite this, the scheme has boosted confidence among homeowners and prospective buyers, as shown in April's Knight Frank House Price Sentiment Index (figure 4). The index is based on a survey of 1,500 households across the UK who are asked what they believe has happened to the value of their home over the last month, and what they expect to happen to its value over the next year. A reading of 50 means no change, while any figure above this indicates that prices have risen or will rise. The higher the figure, the bigger the rise. As can be seen in the table, both the perception of current house prices and future house prices ticked up noticeably in April in the wake of the Help to Buy announcement in the Budget.

Supporting confidence in the market will help underpin prices and activity, but there will be much attention paid to the levels of take-up for the schemes. The take-up of NewBuy, one of the pre-cursors to Help to Buy, was relatively modest in the first year.

In the short to medium term, if lenders and buyers engage with both the Help to Buy "equity loan" and "mortgage guarantee", the scheme is likely to aid price growth, and may also boost development volumes. However it cannot be overlooked that there are concerns over the sustainability of pricing once Help to Buy is unwound, and the resulting impact this could have on development economics.

Figure 4
House Price Sentiment Index



Source: Knight Frank Residential Research

Legislation

Planning

A year on from the introduction of the National Planning Policy Framework, or NPPF, the true impact on development is still becoming clear. The industry is spilt on its opinion of the new rules, with nearly half identifying the new regime as a moderate risk, while 40% say it presents only a negligible risk to the sector. Some view the NPPF as a positive development, as shown in one respondent's answer below.

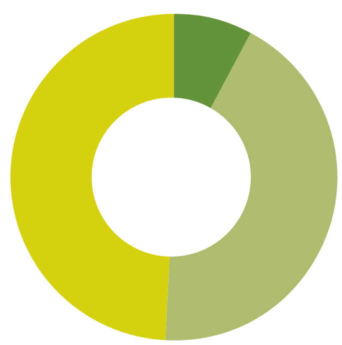
"Best thing in 20 years to assist planning delivery."

"The prevailing need to go to appeal to get it [the NPPF] enforced is a major obstacle to the industry."

Survey respondents

Some notable trends have emerged in the housebuilding sector since the NPPF was introduced, not least a tendency for 'planning by appeal'. This is clearly shown in our survey, with 40% of respondents saying the number of planning appeals had risen over the last 12 months. **Nearly half of respondents reported that the number of schemes granted planning after appeal had risen (figure 5).**

Figure 5
The number of schemes granted planning after appeal
(over last 12 months)



Fallen	8%
Remained the same	43%
Risen	49%

Source: Knight Frank Residential Research

Under the NPPF, local authorities are required to produce a local plan, and identify (and update annually) specific deliverable sites available to provide five years' worth of housing against their housing requirements. But recent data suggests that half of local authorities have yet to submit a local plan, and of those that have, less than 7% of the local plans have been fully approved by inspectors. This is despite the fact that the deadline set by the DCLG for producing a local plan was in March this year.

Where a local plan is not available, the NPPF states that 'presumption in favour of development' should be adopted if other criteria are met, such as schemes which don't have a high environmental impact and are sustainable.

This factor is no doubt playing a part in some of the planning permissions initially turned down by local planners but then later approved by an inspector after an appeal is lodged.

Sometimes this is not the end of the process however, as exemplified by a recent case where a planning appeal was recovered by the Secretary of State for Communities and Local Government for his determination. The Secretary of State ruled in favour of development, but this decision was then challenged by the local authority and the case was referred to the High Court. The High Court ruled in favour of the Secretary of State's decision. The judgement made clear that the new localism agenda did not remove the obligation on Councils to maintain either a five year supply of housing or indeed an up to date Local Plan or prevent the Secretary of State from making decisions in favour of development where neither existed. As the NPPF beds in, it opens the way for sustained appeals processes, yet decision by appeal is at odds with the Government's localism agenda. In addition, it slows down the planning process, and makes it more expensive for all parties.

However, there are some positive signs emerging along the way. For example, Mark Clare, CEO of Barratt Developments, recently indicated that local communities were recognising the need for housing when the schemes were well thought-out. "Nimbyism is thawing", he said.

CIL

Another relatively new piece of legislation, the Community Infrastructure Levy (CIL), is also causing some disquiet in the sector. Our survey shows that 77% of respondents think it poses a risk to the industry in the

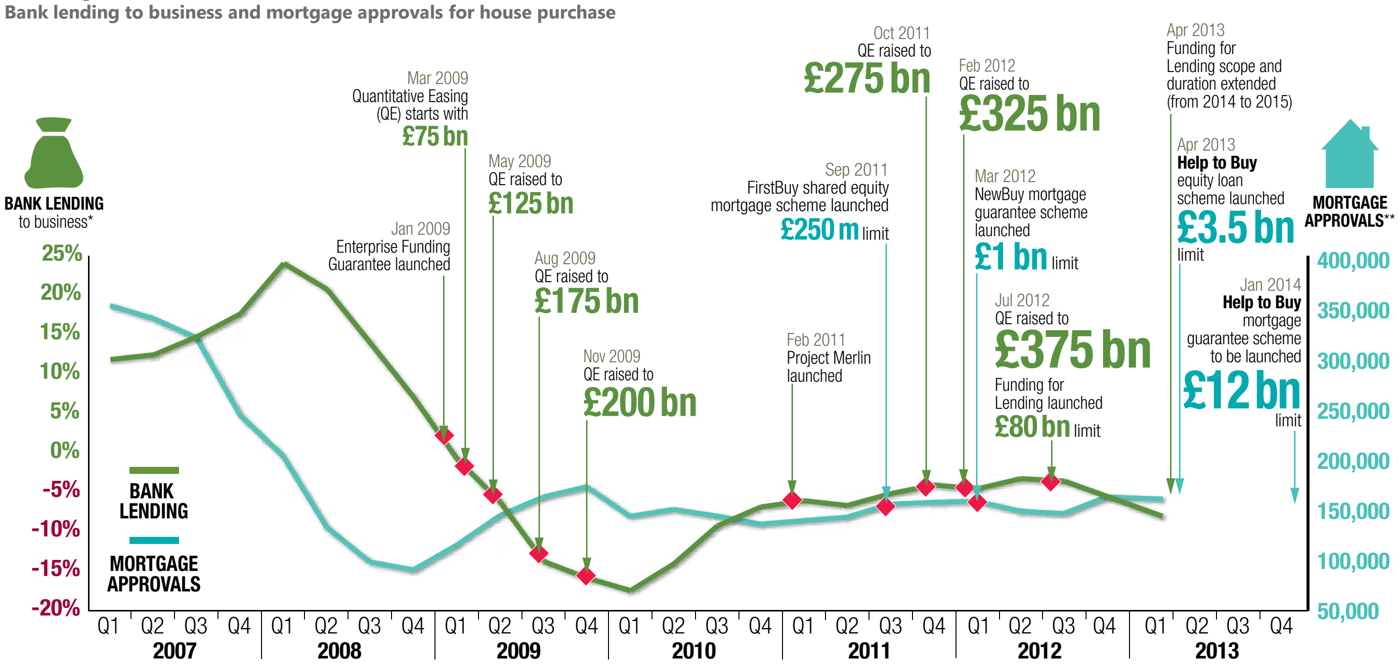
54%

Proportion of the estimated 61,920 hectares of brownfield land in England which is derelict or vacant

Figure 6

Lending trends

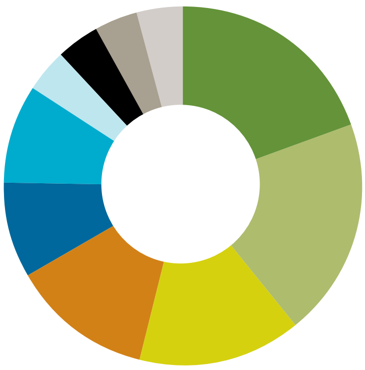
Bank lending to business and mortgage approvals for house purchase



Source: Knight Frank Residential Research/Bank of England *Growth in stock of lending to UK businesses (annual change) **quarterly

Figure 7

What positive steps could be taken to encourage development volumes?



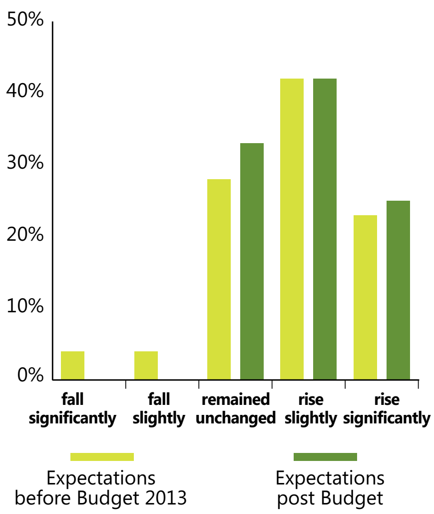
Increase mortgage availability	20%
Ease development funding	20%
Reduce red tape	14%
Scrap CIL	13%
Remove Stamp Duty	9%
Ease planning regulations	9%
Refund application fees	4%
Reduce affordable housing requirements	4%
Grant for affordable housing	4%
Scrap any plans for mansion tax	4%

Source: Knight Frank Residential Research

Figure 8

Housebuilding activity: housing starts

% of respondents who expect start volumes to...



Source: Knight Frank Residential Research

coming year. Around 90 of England's 326 local authorities have published their planned CIL charges, with around nine already levying the charge.

There is concern that some local authorities are setting CIL charges too high, adding a hefty additional charge to those levies developers are already expected to pay. While CIL is designed to replace Section 106 in some respects, there is, thanks to some wiggle room in the interpretation of the rules, a risk that developers are asked to pay twice for infrastructure, through CIL and Section 106. This problem is addressed in a current Government consultation but has yet to be fully resolved. CIL is seen by some developers simply as an additional tax, scaling up the cost of development, pushing some developments to the limits of viability or beyond and putting real pressure on the delivery of affordable houses. This comes at a time when more building is sorely needed, and funding is scarce.

"From our point of view, the relatively high level of CIL requirement on smaller schemes [2-10 units] will make these sites less likely to come forward as they will not be commercially viable."

"Defer the introduction of CIL. This will be the largest threat coming forward."

Survey respondents

From April 2014, the CIL charge will apply in all local authorities (where the authority decides to implement the charge). A recent consultation suggested that the Government may push this date back by a year – and this is significant, as it also marks the time when Section 106 requirements for infrastructure contributions will be scaled back. The same consultation also suggests that councils should make it easier for developers to pay the levy in phases, as well as making it simpler to apply for exceptional relief, ideas mooted by the British Property Federation.

Outlook

Land prices

Knight Frank's Residential Development Land Index shows that land prices across England and Wales have remained broadly static over the last 18 months. The exception is prime central London, where prices climbed by nearly 5% in the year to the end of March and which have risen by 8% since September 2011.

Our survey respondents expect land values will rise across the board in the coming year, with 59% expecting prices to rise for greenfield land, and 63% predicting a rise in values of urban land. Certainly the increased buyer interest reported by housebuilders since the Help to Buy announcement opens the way for price rises. More active buyers signal a quicker turnaround on sites, cutting the cost of capital and allowing more room for land prices to grow.

Land acquisitions are expected to rise across the board, although the pick-up in purchases of strategic land and land subject to planning is set to outstrip the increase in purchases of oven-ready sites.

It is also interesting to note that around a third of respondents said they would buy no greenfield land at all over the next year, and a further 25% said greenfield land would make up less than a quarter of their purchases. In contrast, a third said that brownfield acquisitions would make up 75% or more of their total land purchases over the next 12 months.

Brownfield land can be more complicated and expensive to develop than greenfield, but the increase in interest in this type of land is notable. This may well be due to the increased levels of brownfield land being brought forward under the accelerated land release programme, under which the Government has pledged to release enough public sector land to enable the construction of an extra 100,000 homes. Much of the public sector land is brownfield. In addition, under the NPPF, development of brownfield land is prioritised.

Housing supply

Around half of housebuilders and developers expect a moderate rise in the number of units completed this year, according to our survey, with a further 15% expecting a significant rise in housing completions. It is interesting to note that the **overall proportion expecting a slight or significant rise in housing completions climbed from 69% before the Budget to**

75% afterwards, a signal of the potential impact of Help to Buy. Expectations for housing starts, a more forward-looking indicator for the sector, are also largely positive. Around 65% of respondents expect that the number of new homes started will rise this year – with 25% expecting a significant uplift. This is reflected in recent official data showing an 18% uplift in housing starts in the first three months of this year, compared to Q1 2012.

New-build house prices

The growth in the average values of new-build homes across England and Wales has outperformed that in the wider mainstream market over the past five years, according to recent data from Halifax. New-build property climbed in value by 12% between 2007 and 2012, compared to 9% growth in new-build and secondary stock. But the regional breakdown in price movements during this period shows a highly localised picture, with new-build values in the South East rising by 17% while prices in the North of England slid by 10%, reflecting the trend seen in the wider housing market.

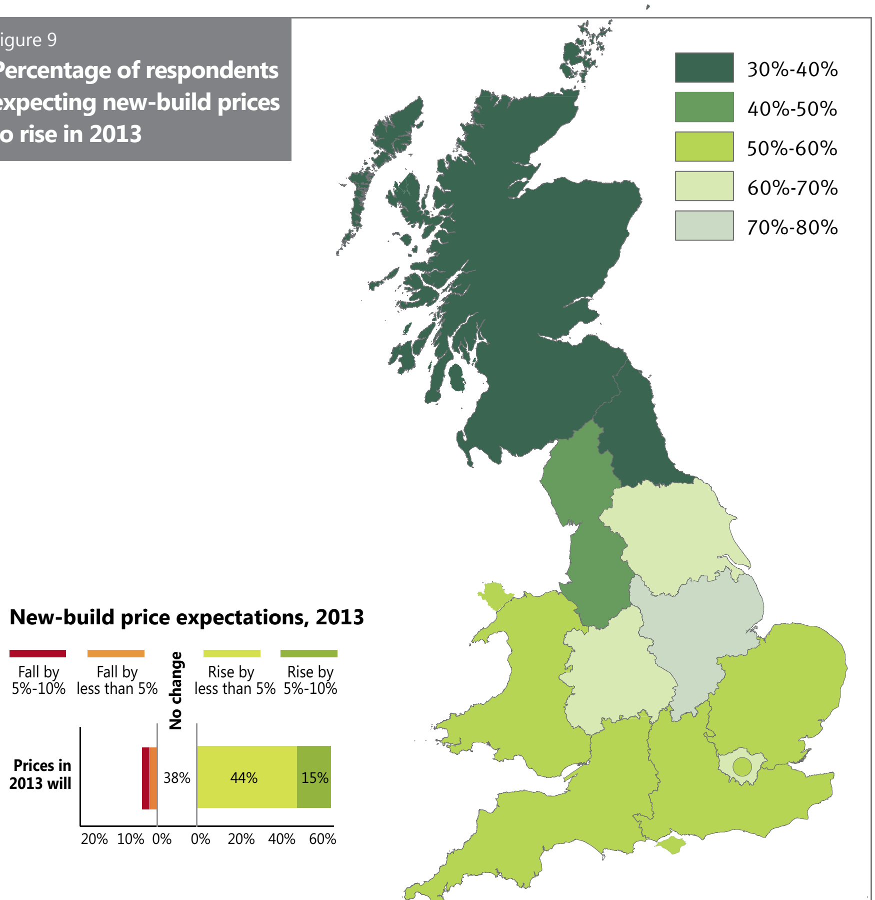
There is modest optimism around house price movements over the next year, with 44% of respondents expecting prices to rise by up to 5%, and a further 15% expecting a rise of between 5% and 10% (figure 9).

But as the heatmap shows, expectations for price rises differ across the regions, with the highest proportion of respondents active in the East Midlands expecting prices to rise.

Type of housing

Last year's Housebuilding report showed that the appetite for large family homes rose sharply compared to 2011. This displayed the relatively strong position of buyers who had built up equity in their existing home, making it easier to source mortgage finance.

Figure 9
Percentage of respondents expecting new-build prices to rise in 2013



Source: Knight Frank Residential Research

What steps can Government take to encourage more development?

Our survey respondents said:

"Penalise planning departments when a decision is not given in the prescribed time. If that decision is a refusal and reversed on appeal make the authority liable for all the developer's abortive costs."

"Introduce another Stamp Duty holiday."

"Make LPA's more accountable for ignoring their five year supply shortfalls and refusals of applications that are later won on appeal, e.g. refund of application fees."

"Speed up processes and reduce unrealistic Section 106 agreements."

"Remove 7% stamp duty."

"Take the threat of mansion tax off the table."

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This year, the survey indicates that the biggest overall demand is still for three bedroom houses, with 95% of respondents reporting moderate or high demand. The highest level of demand for this type of property is in the South East of England and the East Midlands, our survey shows. It is worth noting that the new 'bedroom tax' for those in the social rented sector has, in some cases, already started to have a negative impact on Housing Associations' appetite to build larger four or five bedroom family homes.

But as figure 10 shows, there has been a noticeable pick-up in demand for apartments. The highest levels of demand are in the South of England, with London and the South East at the forefront. But nearly two-thirds of respondents indicated that there was moderate or high demand for two-bedroom apartments in the East and West Midlands.

This can be seen as a positive development for the housing market, indicating that buyer demand for city centre developments in some key cities across the UK may be returning. Certainly the Help to Buy scheme should help boost demand among buyers for new-build apartments and houses alike, tapping into a sector of the buying market that has been sluggish in the wake of the financial crisis – specifically the 'first' or 'second-steppers' who do not have a sizeable deposit at their disposal.

The new scheme to make office to residential conversions exempt from the need for planning permission, coming into force at the end of May 2013 could further boost the delivery of new apartments in and around some UK cities. However there will be exceptions; local authorities in most of central London as well as in Manchester, Kent and East Hampshire have been granted exemptions from the new rules.

The demand for larger flats is also interesting to note, with 45% of respondents reporting moderate or strong demand for flats with three or more bedrooms, up from 29% in 2012 and 30% in 2011. This certainly reflects a trend emerging in central London, where some buyers' tastes, especially overseas buyers, veer towards large lateral spaces rather than narrower townhouses.

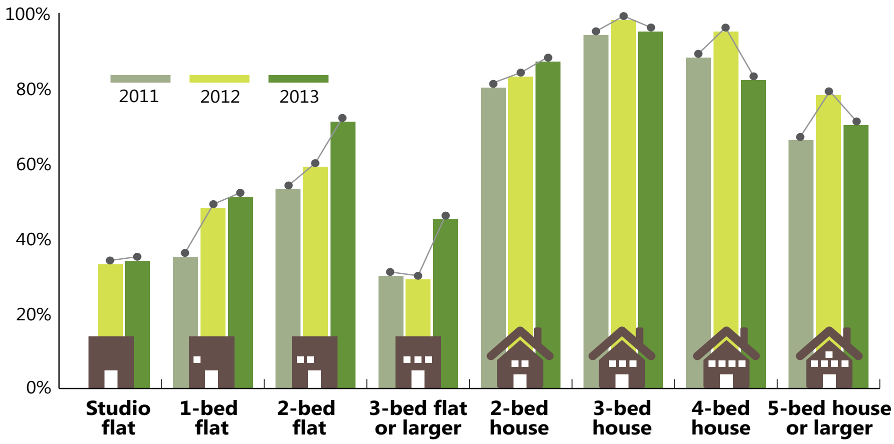
While there is optimism among housebuilders about the year ahead, especially in terms of construction and buyer activity levels, our survey highlighted that there are still significant headwinds facing the sector, not least new regulations being rolled out across the country.

In such difficult economic times, support for buyers who have been prevented from climbing onto the housing ladder will boost activity, and housebuilders expect this will translate into a rise in construction over the coming years, although this increase is unlikely to bridge the current housing shortfall across England and Wales.

Figure 10

Buyer demand

% of respondents reporting moderate or high demand for types of housing



Source: Knight Frank Residential Research

Front cover image courtesy of Taylor Wimpey UK

Knight Frank Residential Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

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