

Spotlight The Future of Sub-Market Housing

Autumn 2015



SUMMARY

70,000 new households are excluded from the market every year. How will they be housed?

The Government now has a housing 'target' of 200,000 homes per annum in England over the lifetime of this parliament. Will the range of policy announcements, particularly as they affect providers of sub-market housing, help hit the target and provide homes for those households in housing need?

■ **Right to Buy and high value council homes sales.** Our analysis indicates that at least 24,000 new households per annum could exercise the Right to Buy. Full compensation to housing associations for the discount would

cost circa £1.5 billion per year. Viable replacement is only likely to be possible with shared ownership units in most areas. This will lead to a depletion in the stock of sub-market rented homes. p2/3.

■ **A clear role for sub-market housing.** Reduced development of sub-market rental housing will leave a gap of at least 70,000 potential new households each year being unable to access the housing market. That's 350,000 over the term of a parliament. This shows a clear and continuing role for sub-market housing. p4/5

■ **Capacity for cross-subsidy.**

In order to provide sub-market housing, cross-subsidy from development for market sale will be required. In some areas it will be needed at substantial levels to put the new homes within reach of those in housing need. p6/7

■ **Market risk.** Housing associations will need to make best use of their competitive advantages in the market and be aware of both cyclical risks and limits to market absorption. p8

Issues

IMPACTS OF POLICY CHANGES

New policies are raising clear challenges for housing associations and local authorities in providing sub-market housing

The Conservative Government has made housing in England a key issue for this parliament.

They are particularly intent on reversing the decline in owner occupation seen over the last two decades. To do this the Government is moving ahead with a range of policies and reforms that are focussed on increasing the supply of market housing. It remains to be seen how successful this approach will be given the number of outstanding questions.

The policies are likely to have a long lasting effect on the sub-market housing sector and the ability to provide enough homes across the spectrum of housing need. The future role of housing associations is clearly up for debate and the Government wants to see them acting more 'efficiently', delivering more market and sub-market homes for ownership rather than social or affordable rent.

Right to Buy

The original Right to Buy for local authority tenants has helped almost 1.9 million households buy their home since its introduction in the early 1980s. Following the 2008/09 downturn, there had been low numbers of purchases given the affordability constraints in the market. However, the recent changes to eligibility and discounts combined with a buoyant market have helped increase the number of local authority homes sold and we expect further small increases in coming years.

The Government is keen to replicate the success of the original Right to Buy with its extension to housing association tenants. Based on the evidence available we have calculated that around 20% of existing housing association tenants would be both eligible for the first time and able to buy their own home.

Our analysis indicates that around 24,000 households could exercise their Right to Buy per annum although activity is likely to be higher at launch given the widespread attention on the scheme. Full compensation for housing associations for the discount would require in the order of £1.5 billion per year.

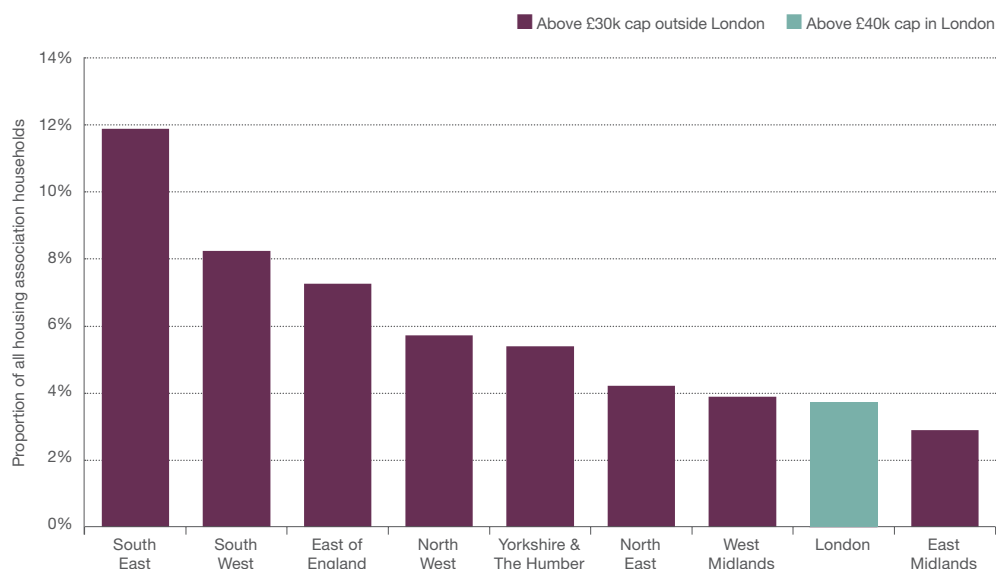
High value council homes

Local authorities will be expected to raise revenue for Government through the sale of high value council homes as they fall vacant. This is intended to compensate housing associations for the discounts given on homes sold through Right to Buy. The Housing Bill states that the amount of payment to Government will be determined by a formula, but the definition of 'high value' remains in question. Whether councils actually sell homes to raise this revenue is likely to be left for the local authority to decide.

Replacement

The high value homes sold, and those homes sold under Right to Buy, will need to be replaced, but the funding for this is uncertain and largely in the hands of the Secretary of State. Figure 2 shows the number of possible shared ownership units that could be provided to replace each home sold under the extended Right to Buy, taking account of build costs and likely first tranche sales but disregarding land costs. This shows that across 90% of local authority areas, at least 1:1 replacement may be possible

FIGURE 1
Housing association tenants above Pay to Stay income caps



Source: Savills Research using English Housing Survey

with shared ownership. In reality, the probable requirement for a land value will reduce this in many cases and there may not be demand for shared ownership in all areas. Replacement at 1:1 with new affordable rented homes is likely to be impossible in all but a handful of areas.

If replacement homes are provided in addition to existing development volumes, this would require a 70% increase in new affordable homes delivery from 2013/14 levels. This demonstrates the potential of the policy to boost new housing supply, but also highlights the challenge in making it work.

Rent reduction

The reduction in social rents over the next four years will drive housing associations and local authorities to manage their assets and associated costs more efficiently. However, the cuts may also reduce some associations' capacity for development given the lower headroom for borrowing and the uncertainty over the longer term future once the four year period expires. This policy has already disrupted Section 106 deals across the country, harming site viability and hampering development activity.

'Pay to Stay'

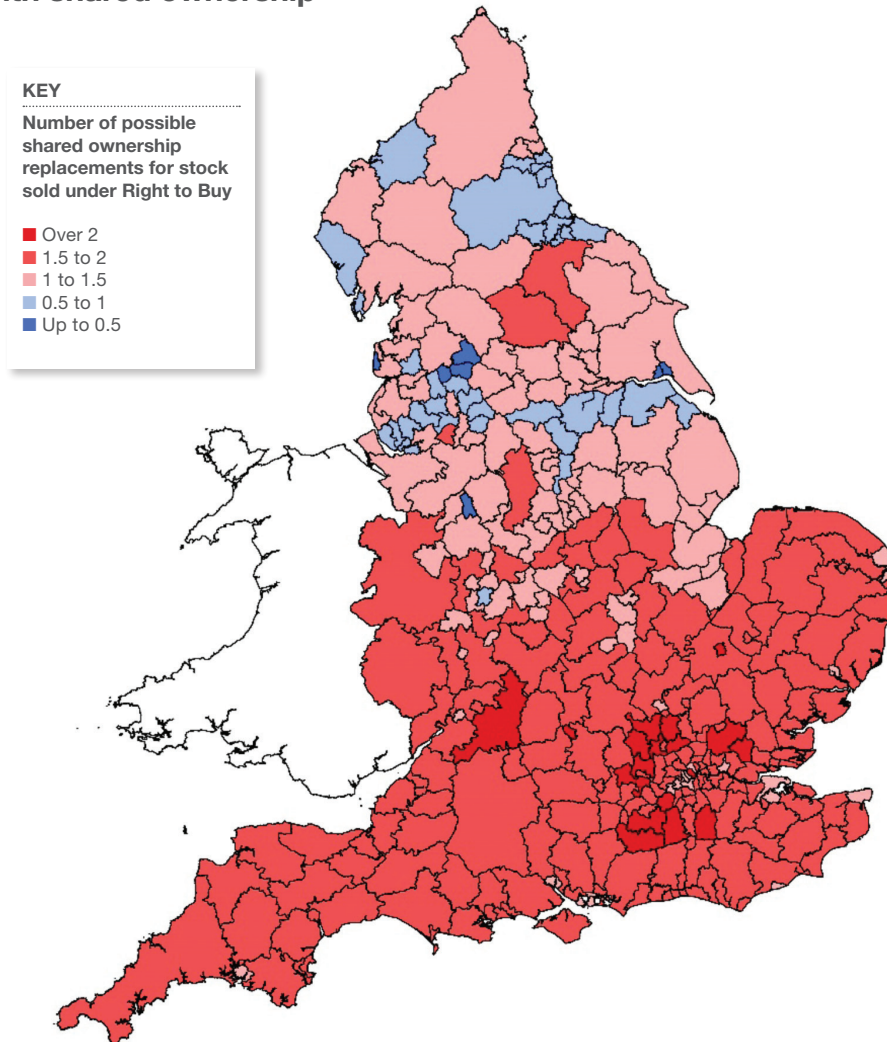
Under 'Pay to Stay', referred to as "High Income Social Tenants: Mandatory Rents" in the Housing Bill, social housing tenants will have to move towards paying a market rent if their incomes exceed £30,000 per annum or £40,000 in London. This may help offset some of the rent reductions for housing associations in the short term. Our analysis suggests around 6% of social rented tenants will be affected by the new caps, but this rises to 12% in the South East.

The blunt use of the GLA boundary for the change in cap is likely to cause hardship for many households in the districts surrounding London, where £30,000 income is insufficient to afford a market rent. These households will probably have to look for cheaper housing options elsewhere. This will reduce the potential additional receipts for housing associations from tenants paying market rents.

In contrast, many of the affected households in the midlands and north of England, where the cap is also £30,000, will be able to afford market rents and Right to Buy.

FIGURE 2

Scope to provide replacement of homes sold under Right to Buy with shared ownership



Source: Savills Research (assuming nil land value)

Reclassification

On 30th October, the Office for National Statistics reclassified English housing associations as 'public non-financial corporations'. This was a consequence of changes that pre-date the policy announcements made over the last year. In response, the Department for Communities and Local Government said it would bring forward proposals for deregulation of the housing sector, seeking 'to allow housing associations to become private sector bodies again as soon as possible'.

This has further increased the uncertainty in the housing sector, particularly for financial institutions lending to housing associations. Being part of the public sector would improve the credit worthiness of housing associations, whilst deregulation could

have an adverse effect. The move also raised questions over control associations have over their debt.

To reverse the reclassification, deregulation would need to include two changes. Firstly, giving housing associations control over the decision to dispose of assets, releasing restrictions on asset management and potentially helping associations become more efficient.

Secondly, amending the Government powers to intervene in the event of the failure of an association. When the further education sector faced similar circumstances Government substituted reserve powers for direct control. Alternatively the sector might create a guarantee fund to underwrite debt and hence retain credit quality. ■

Excluded households

THE NEED FOR SUB-MARKET HOUSING

With 70,000 households per annum unable to access the market, there is a clear role for sub-market housing

Anual housing need in England is for nearly 250,000 new homes and the Government has recently adopted a ‘target’ of 200,000 new homes per annum over the course of this parliament. Even if we were building this number of homes, current pricing means that 70,000 of these households would not be able to access the market unassisted every year. That’s 350,000 over the term of a parliament.

In 2013 (Bridging the Gap in Housing), we showed that reduced market turnover and the low levels of new housing supply were preventing 500,000 households per annum from moving onto and up the housing ladder. Transaction levels remain suppressed and housing supply continues to fall short of need, so this problem has not gone away.

The erosion of Government support for sub-market rented housing focusses attention on development at the lower end of the market. Is there a need for additional sub-market housing and, if so, what are the incomes of those households excluded from the market?

Our analysis looks at the ongoing cost of buying or renting a home in the current market and, assuming 30% of gross household income is spent on these costs, assesses which households can afford to live in market housing.

This leaves a gap comprising low-middle income households who cannot afford the ongoing costs of living in market housing. The analysis shows that there is clearly a continuing need for the development of sub-market housing.

Sub-market need

No new development of sub-market rental housing could leave a gap of at least 70,000 potential new

households each year being unable to access the housing market without other forms of assistance or severe compromise on living standards.

This number excludes any backlog of unmet need and the effect of falling stock levels due to Right to Buy and the sale of high value council homes.

The gap is 26% of all housing need in England, but this ranges from 17% in the north to 46% in London.

In reality, many of these households will pay much more of their income on housing costs or plug the gap with benefit payments, some will live in shared households and the remainder will become ‘concealed’ households: adult children continuing to live with parents, for example.

The greatest problem is in London, where housing demand is greatest, housing costs are highest and supply consistently fails to meet need. Here we estimate that there are 26,000 excluded households per annum, compared to just 1,500 in the North East.

Excluded households

The nature of households in need of sub-market housing varies around the country and therefore different solutions are needed in different places to fill the gap left by the market. In London, their household incomes reach up to £60,000 per annum, although the median is £20,000 per annum.

In contrast, the median income of these households in the north is only £8,000 per annum. There are also substantial variations in the income of these households within regions, at local authority level (see Figure 4).

The advent of the National Living Wage (£9 per hour by 2020) will not solve a large part of the problem in London and parts of the south of the country, where many households beyond this level of pay are excluded from the market. Failure to provide

FIGURE 3
Annual number of households in need of sub-market housing, by region

	New households in need of sub-market housing per annum
London	26,000
South East	11,500
East of England	8,000
South West	6,500
West Midlands	4,500
East Midlands	4,000
Yorkshire & The Humber	4,000
North West	3,500
North East	1,500
Total	69,500

Source: Savills using CACI, HM Land Registry, Rightmove, 2011 Census and Holmans for TCPA

additional sub-market housing will increase reliance on a shrinking pot of benefits and tax credits.

Development of affordable housing in 2013/14 filled 68% of the gap across England, but this national figure includes a range of outcomes. In the North East, the gap was filled 1.8 times and much of this new housing provides a better quality alternative to the unregulated private rented sector.

In London, only 36% of the gap was filled, suppressing household formation and exacerbating the supply-demand imbalance.

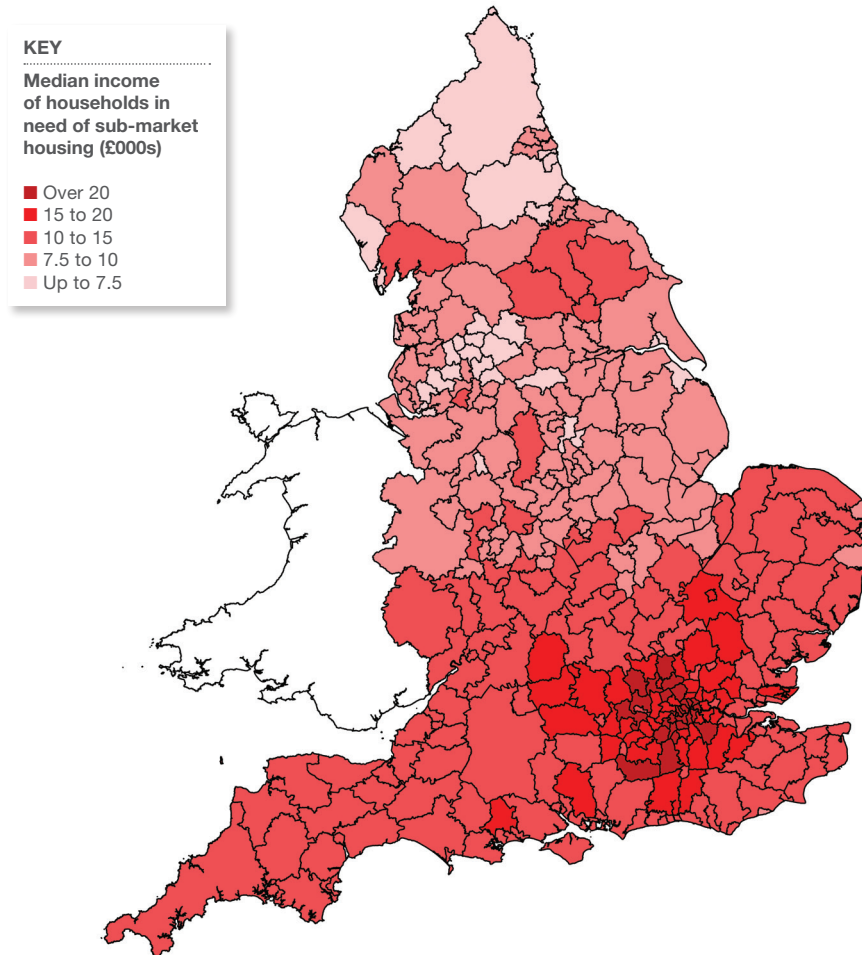
This analysis (and the details on page 6) provides a framework within which affordable housing providers can work out how best to fulfil their charitable objectives in the new policy environment. New sub-market products for rent as well as sale, that make best use of cross-subsidy funding, will be needed to fill the gap. ■

£60K

Maximum income of households needing sub-market housing in London

FIGURE 4

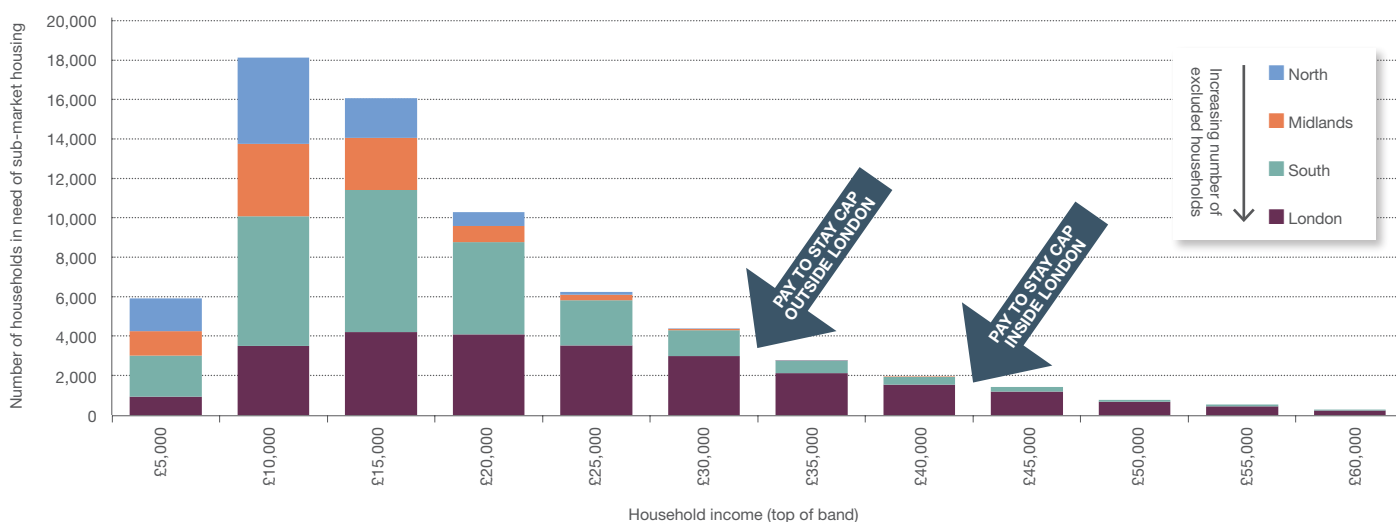
The nature of households in need of sub-market housing varies between markets



Source: Savills using CACI, HM Land Registry, Rightmove, 2011 Census and Holmans for TCPA

FIGURE 5

The range of incomes for households in need of sub-market housing



Source: Savills using CACI, HM Land Registry, Rightmove, 2011 Census and Holmans for TCPA

Sub-market solutions

CAPACITY FOR CROSS-SUBSIDY

Is there capacity to deliver the cross-subsidy needed for sub-market housing?

Ask a minister what the Government is doing about the housing crisis and the response is likely to include a long list of past and future policies. Shared ownership, Help to Buy and Starter Homes are all sure to be mentioned. Having identified 70,000 emerging households per year whose needs are not met by market housing, we have assessed the working of the current schemes, the impact of the new policies and what is needed to fill the gaps.

Our analysis indicates that the number of households unable to access the market, unsurprisingly, is particularly large in parts of inner London and house price to income ratios have reached double digits in

some boroughs. Efforts to improve the affordability of homeownership are welcome, particularly where deposit affordability is the key barrier.

Need for cross-subsidy

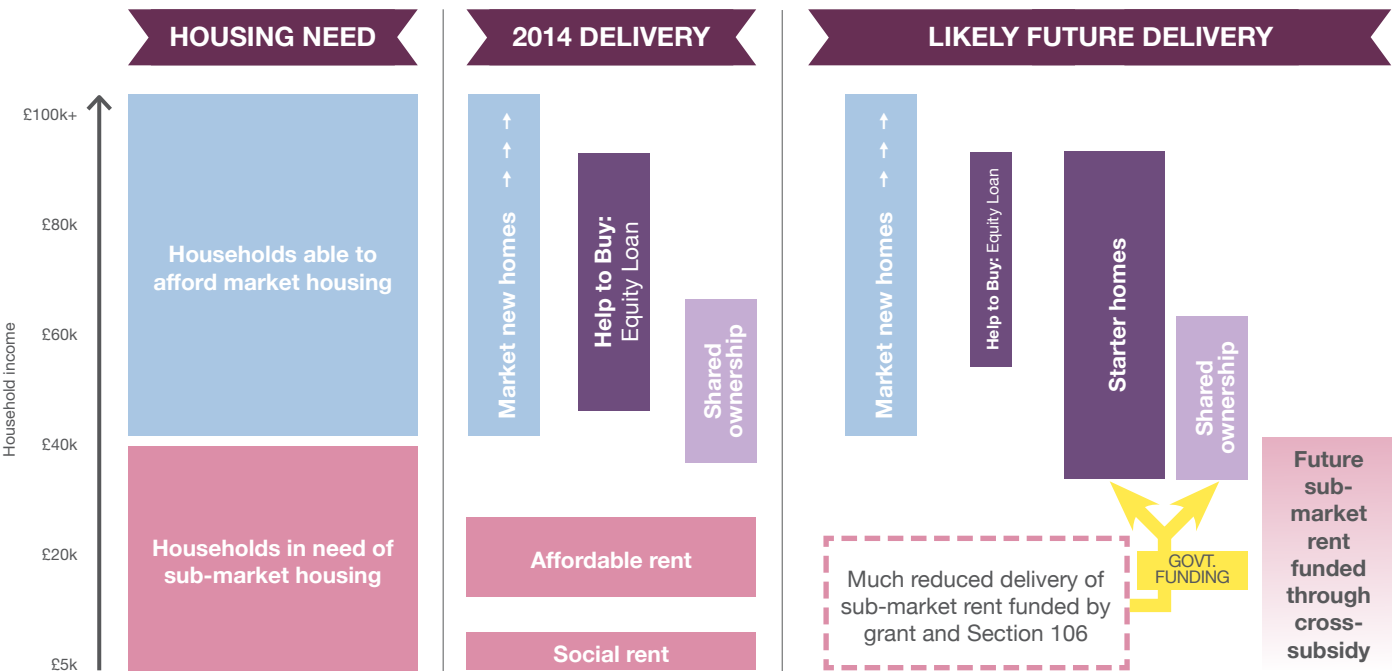
Looking at the incomes required to access homes under the various schemes, it is clear that they overlap, as illustrated in Figure 6, which is based on a typical inner London borough.

The combination of Starter Homes, shared ownership and Help to Buy all help households with £45,000 to £90,000 annual income. The emerging policy focus on these overlapping schemes introduces a new risk that total take-up of new homes and therefore housing delivery will be limited.

In 2014 the affordable rent element of delivery was well priced to help households excluded from the market, albeit that some relied on benefit to pay the rent. However, the policy changes will cause a shift away from government funded sub-market rental products towards shared ownership and probably Starter Homes.

This will happen despite many housing associations wanting to continue provision of sub-market rental products (two thirds according to

FIGURE 6
Affordability of housing tenures in a typical inner London borough



Source: Savills Research

Inside Housing), because the capacity to support this activity through cross-subsidy from other activities will act as a constraint.

In our typical London borough, market rent levels would need to be reduced by at least half to make them affordable to the excluded households. This would require a substantial level of cross-subsidy. Lower levels of discount will be sufficient in more affordable parts of the country.

Cross-subsidy capacity

The challenge for housing associations is to find enough cross-subsidy to continue their sub-market rental development programmes in the absence of support from Government. Many are looking to expand their market sale and rent development activity, but this brings the sector into competition with the major housebuilders and emerging institutional PRS investors.

So housing associations need to use their competitive advantages, namely large balance sheets, access to low cost capital and a business model that spreads the product across a wide range of pricing and tenures.

Access to patient capital allows housing associations to take a leading role in delivery of large strategic housing sites, through early funding of infrastructure and the potential to increase absorption rates (the speed at which new homes are sold or let) through investment in place, delivery of a range of tenures and ongoing management of the retained estate.

This is likely to include selling land parcels or granting long leases to housebuilders as well as development of market rented housing, sub-market rented housing, shared ownership and Starter Homes.

This potential to maximise absorption rates, though providing homes across a wide range of tenures and price points, makes housing associations good partners where speed of delivery is a high priority for the planning authority, a public sector landowner or a private sector landowner looking to establish a sense of place on a large site. This requires additional construction capacity, with off-site construction technologies likely to be part of the answer.

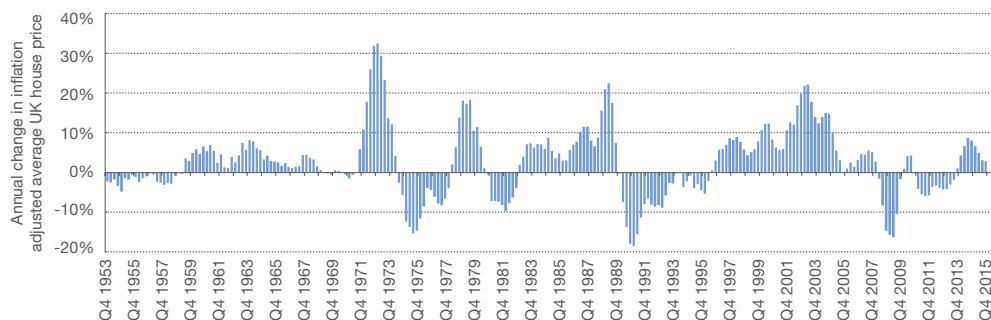
All of this exposes housing associations to additional risks and the volatility of the housing market. ■

FIGURE 7
Vulnerability of development land value to a downturn



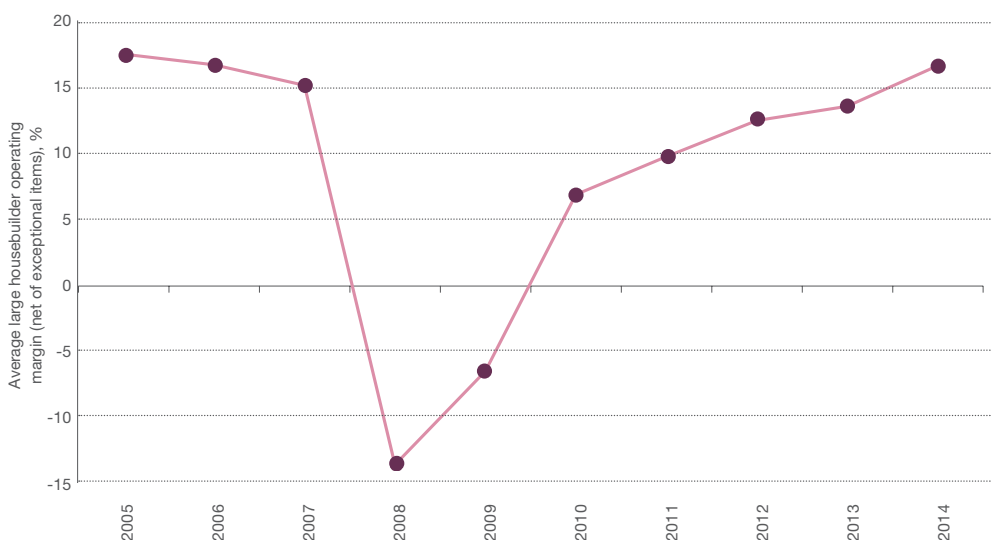
Source: Savills Research

FIGURE 8
House prices are cyclical



Source: Nationwide, ONS

FIGURE 9
The effect of market cycles on housebuilder margin



Source: Thomson Reuters

MARKET RISK

The most important consideration in the delivery of housing into the market is absorption rates and control of the amount of development in progress to avoid having large amounts of unsold stock. Understanding absorption rates is fundamental to successful development for market sale and rent, with wide variations amongst markets in the speed at which homes can be sold or let at any price point. One way of increasing absorption is diversification of tenures, which housing associations are well placed to do.

In the sales market, appropriate pricing is essential to optimise the size of the target market and thereby optimise sales rate. When buying a house, key considerations for consumers include

how many bedrooms it has and how much it costs. Size in square feet and value per square foot are less crucial for the buyer, although they are important for the developer.

In order to deal with this, many private housebuilders target the unit prices that secure the greatest volume of demand, whilst maximising value per square foot. Often this means reducing unit sizes, but maintaining a number of bedrooms appropriate to the unit value. Housing associations will need to adapt their product to suit the market, subject to local space standards where they apply, if they are successfully to deliver new homes at volume into the private sale market and be competitive in the land market.

The most significant risk to private housing developers is being caught out by a downturn, following significant land acquisition or with large amounts of development in progress. One advantage housing associations have, compared to private housebuilders, is the flexibility to switch new homes between tenures if, in a downturn, the sales market contracts.

Nevertheless, housing association boards will need to take a view on the appropriate risk adjusted margin to build into their business plans, compared with the typical housebuilder target of 15-20% operating margin over the cycle. They will also need to be looking for early warning signs of turning points in the market.

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NB: This analysis was completed before publication of the TCPA paper "New estimates of housing requirements in England, 2012 to 2037" on 4th November.

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