SPOTLIGHT

Savills Research

UK Development – Autumn 2019

Disruption in development

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The impact of political, financial and environmental disruption on the development industry

Disruption in development

Talk about disruption and people typically think of a new product or manufacturing method that transforms an industry. Housebuilding appears ripe for such change.

There have been repeated calls for the industry to diversify to meet housing demand. With government and private investment in modern methods of construction, housebuilding appears to be on the verge of a tech-driven revolution.

However, focusing solely on technology would be to miss the wider financial, political and social changes that will shape demand for housing.

In this low interest rate global environment, institutional investors are after steady income streams. Residential will be an attractive asset, particularly if it can provide a long-term, index-linked income, such as affordable housing. For this to happen, developers must understand the priorities of large investors and adjust their product accordingly. Politically, there are increasingly interventionist policy debates around how to meet the UK's housing needs. Coming to the fore are the issues of land value capture and the provision of social housing. Both could have a big impact on financial models, putting pressure on developer margins and land value. Finally, the development industry can't ignore the challenges posed by environmental change. Meeting carbon emission goals will require radical change in how we plan and deliver housing.

This report investigates how these forces will interact, and identifies the methods developers can adopt to deliver resilient and sustainable housing in an ever-more unpredictable market.

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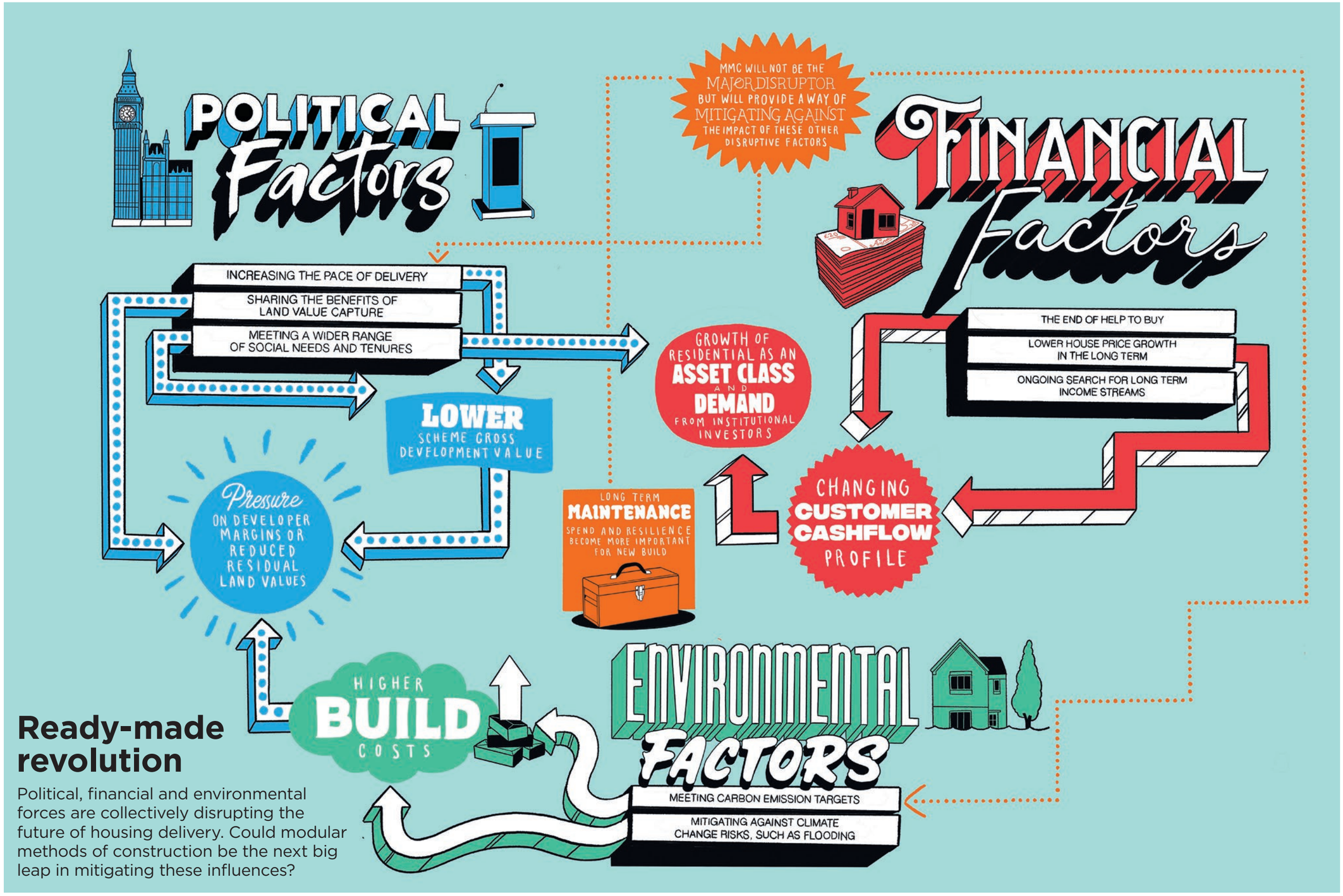

Ready-made revolution

Political, financial and environmental forces are collectively disrupting the future of housing delivery. Could modular methods of construction be the next big leap in mitigating these influences?

Technological disruption

About 10% of new build homes are delivered using MMC, equating to around 20,000 homes each year. We estimate that capacity is up to 27,000 homes a year

Most houses are still built utilising the same materials and techniques that have been used for at least a century. There is a perception among policymakers that this needs to change, and there have been several initiatives to boost the adoption of Modern Methods of Construction (MMC). But the industry has remained largely resistant.

Perhaps that is because these traditional homes have primarily been built for sale to individual owner-occupiers or small-scale landlords. If that were to change towards a greater share of new homes being built for institutional owners, then the spotlight would switch to consistency of product, ease of management and fast delivery, as well as longer-term savings through energy efficiencies – things that MMC is well placed to deliver.

Increased regulation is also likely to focus on energy efficiency and a push for more sustainable construction techniques.

Cross-party support

The Communities & Local Government select committee report on MMC, published in 2019, showed that there is strong cross-party support for a paradigm shift in how we deliver housing, and made the case for wider adoption of MMC. As long ago as 2005, a National Audit Office report suggested that using MMC for housebuilding could cut on-site construction time by more than half.

Homes England uses adoption of MMC as a key scoring criteria for the sale of public land. This has already been seen at Northstowe, Cambridgeshire, where Urban Splash, which will build homes using MMC, was selected as delivery partner ahead of a number of well-known housebuilders.

The Greater London Authority (GLA) published *Designed, Sealed, Delivered* in 2017, which called for the use of offsite construction to meet the capital's housing needs. Mayor Sadiq Khan has since launched Prism, a free web-based tool that aims to accelerate the design process for precision-manufactured housing in London. It combines London's spatial planning rules with data from manufacturers to quickly test a site's suitability for MMC.

Long-term thinking

To fully realise the potential of MMC requires a change of mindset from housebuilders and a widespread adoption of Design for Manufacture and Assembly (DfMA). This aims to simplify design and increase the efficiency of constructing houses.

Full adoption and integration of digital technology into housebuilding, for example using Building Information Modelling (BIM), makes it possible to create a database that would store and track all data about the built environment. This will allow the full lifecycle costing and management of homes to be undertaken with much-increased accuracy – especially important for institutions and housing associations that will be owning and managing properties for the long term in relation to their returns and valuations.

This is of huge value to investors in Build to Rent and housing associations, who are looking for greater consistency of product, lower and more predictable operating costs, and ease of management.

MMC is well placed for fast delivery, ease of management and consistency of product

Piece by piece

If MMC is to replace traditional housebuilding, attitudes towards the new technology need to change – from banks, buyers and housebuilders

Image: Laing O'Rourke

Why not build modular?

The most obvious deterrent to offsite construction is that it costs on average 10% more than building in the traditional method. Incurring this cost is unlikely to result in higher sales values to individual buyers. Many remember the post-Second World War prefabs, highlighted by a YouGov poll for Home Group that found 52% of respondents would be unlikely to want to live in a modular home. This perception is being countered by a range of accreditations, assurances and warranties set up to thoroughly test the manufacturing quality of MMCs.

In contrast to traditional contract terms where payment is due after products arrive on site, MMC requires advanced payment, prior to the fabrication of offsite components. This increases not only manufacturer insolvency risk and the delivery of components but also the cash-flow burden for developers.

For institutional investors and housing associations, there may be advantages if the additional cost of construction results in lower ongoing maintenance costs. But housing associations often have a limit on the proportion of their loan security that can be of non-traditional build. Currently, most banks have a cap of around 10% of stock being built using MMC. This isn't yet a major barrier as so few MMC homes have been built: only 14% of housing associations build more than 25% of their new homes using MMC. But 50% expect to be doing so in five years' time.

When will the balance tip?

At present, only about 10% of new build homes are delivered using some form of MMC, equating to around 20,000 homes each year. We currently estimate that manufacturing capacity is between 25,000 and 27,000 homes a year. And it's growing; Savills has identified more than 75 companies seeking to use MMC to deliver housing at volume.

There are new entrants to the housebuilding sector, including Goldman Sachs, which invested £75 million in TopHat, a modular manufacturer, and Boklok, which already has a successful track record in Scandinavia. Japan's largest housebuilder, Sekisui House, signed a £90 million deal with Urban Splash and Homes England to enter the UK market.

Traditional housebuilders are also changing their approach. Berkeley Group set up its own modular factory in Kent in 2018; Barratt delivered 20% of its completions in 2019 using MMC, and aims to reach 25% by 2025. Timber-framed housing accounted for 45% of all its MMC completions in 2018 and roof cassettes a further 37%.

Housing associations are looking for ways to increase delivery beyond the capacity of the traditional construction sector. Swan set up its own modular factory in Basildon to deliver homes at its Beechwood development. Places for People struck a £100 million deal with ilke Homes to deliver a total of 750 new homes across multiple sites.

The signs are that outlooks are changing. We could be on the cusp of a revolution in how we deliver housing.

"Some 50% of housing associations expect to be using MMC to build new homes in five years' time"

House rules

All political parties will have to adopt increasingly innovative solutions to tackle the housing shortage and address the issue of land value

Ongoing political turbulence has been causing short-term disruption to the housing market, but it is longer-term ideological shifts that will shape housebuilding over the next five to 10 years. We anticipate that pressure to build more quickly and meet a growing range of needs will shape government policy towards the development industry.

Housing has become increasingly politically important in recent years. The 2018 Kantar Public Opinion Monitor ranked provision of affordable housing as the second-highest priority for voters, with only investment in healthcare scoring higher. Within housing policy, the survey revealed three key areas the public think the government should prioritise: increasing the overall supply of affordable housing, tackling homelessness, and increasing the amount of social housing. This shift in attitudes is now inevitably feeding into new policy debates.

Political differences

While they approach the issue from different perspectives, both of the traditional main political parties believe there needs to be a greater diversity of homes built to increase absorption levels, and have mooted changes to the planning system to ensure delivery.

The Conservatives remain focused on supporting home ownership, an attitude reinforced by Esther McVey, the latest Housing Minster, but acknowledge the need for a more diverse product. The final recommendations of the 2018 *Letwin Review* included proposals requiring sites of more than 1,500 units to offer a range of tenures, including private rental stock and more affordable tenures. It also included incentives to diversify such sites by making future government support conditional upon developers accepting a Section 106 agreement, which conformed with the new planning policy for those sites.

In contrast, Labour's *Housing for the Many* policy document tackled the provision of affordable housing, particularly homes for social rent. Their proposals include greater transparency in viability assessments and increasing the existing powers of local government to include clawback mechanisms in Section 106 agreements.

Reduced profits and values

Either way, it appears likely that if housing supply does not continue to rise beyond the current annual level of 222,000 homes per year, government may need to intervene further in the planning system to force a greater diversity of product, which should result in higher market absorption.

This would have two main consequences for the development industry. First, it would accelerate the trend outlined in the finance article (see page 8) of the end customer shifting from individual homeowners buying open market sale homes to institutional investors and registered providers seeking bulk purchases of rental homes.

The second impact would be a reduction in scheme gross development value, as increased levels of either rental or affordable homes would generate lower values than open market sale properties. This would feed through into either squeezed developer margins, or lower residual land values.

This could be offset by shorter building programmes, as build out would not be limited by sales rates. Shortening the time on site, and earlier cash receipts for developers, could result in access to cheaper finance.

Fair shares

Linked to the debate on increasing delivery has been the emergence of land-value capture as a prominent issue around solving the housing crisis. There have been calls across the political spectrum for more attention to be paid to increasing land-value capture within the development process.

The *Letwin Review* called for local authorities to use developer contributions via Section 106 agreements to effectively cap residual land value at 10 times existing use value on greenfield land. Proposals in the June 2019 *Land for the Many* report commissioned by Labour included a Land Value Tax as 'a means for recovering the unearned windfalls from collective development for the state and wider community', and reforms to compulsory purchase to enable the state to purchase land at existing use value, enabling more of the uplift generated by development to be captured by the public purse.

At the end of 2018, the House of Commons Housing, Communities and Local Government Select Committee called for a significant proportion of the uplift in land values after planning permission to be available to the state to invest in new infrastructure and public services. Transport for London has gone a step further, commissioning research in 2017 into the effectiveness of a variety of mechanisms to capture land value uplift generated by public investment in infrastructure. We could see the public sector adopting a master-planning and developer role, anticipating a proportional share in the eventual profits.

Although none of these proposals have become mainstream policy, it is likely that the question of how land value uplift should be captured and shared will continue to be a contentious topic, with repercussions for the development industry should mechanisms for more land value capture be introduced.

> "Government may need to intervene in the planning system to force a greater diversity of product"

Provision of affordable housing was cited as the second-highest priority for voters in 2018

Groundbreaking solutions are needed from all sides to solve the housing crisis

SOCIAL AWARENESS

Alongside the desire for increased delivery of new homes, is growing demand for homes that meet specific social needs. With increasingly stretched housing affordability, the need for more affordable housing, particularly social rent, is chronic. MHCLG's 2018 figures showed more than 1.1m households on local authority waiting lists and 83,700 in temporary accommodation. With 47,000 new affordable homes built in 2017/18, meeting this need would require a disruptive step change in the delivery of social housing.

Demographic shifts will likely result in further policy intervention to deliver more varied housing. For example, the All-Party Parliamentary Group on Housing and Care for Older People recently published a report predicting there will be an additional 1.5 million people over 65 in the private rented sector in 20 years' time. On average, pensioner households have a median net income before housing costs of £344 per week. This means that the median private rented property would cost almost 46% of the median pensioner's income nationally: well above the widely used affordability benchmarks of 30 to 40%. For low-income pensioners, private renting would be simply unaffordable in areas with higher rents. As recognition of these issues increases, we can expect policy responses to become more urgent and disruptive.

Financial disruption

From 1997 to 2018, average wages in the UK grew 71%. House prices increased by 242% in the same period

Balancing the books

In a world of slowing sales and house price inflation, housebuilders need to consider new sources to finance future developments

If individual households cannot afford new build homes, housebuilders must look for buyers who can. In our opinion, in 10 years, their customer lists will see pension funds and life insurers alongside first-time buyers and second steppers. The specification and design of new homes must change to match, as must the way housebuilders secure land.

The rise of institutional investors

There is strong demand from institutional investors, such as pension funds, to invest in homes for the rental market. The long-term, inflation-linked income from rental properties is a strong match for funds with similarly structured liabilities. These long-term landlords have different requirements from individual investors, however, which will affect the design and specification they demand from the homes they buy.

Operating over long timescales with a relatively low cost of capital, these institutions are willing to pay extra for a more durable fit-out, as they save on their maintenance spend in the long term. Reduction of management costs is a key goal, so building homes with high energy efficiency and to a consistent design – perhaps using modular construction – will help attract these investors.

The value of a discount

As well as differences in specification, housebuilders must also consider the different cash-flow profile when selling homes in bulk to investors. Inevitably, these large-scale investors will expect a bulk discount relative to individual home buyers. However, by securing funding for many tens or hundreds of homes in advance, housebuilders can cut their costs on marketing, sales, procurement and finance. These cost savings, as well as the reduction in sales risk, mean accepting a discount can often be worthwhile.

In March 2019, Telford Homes announced a deal with Invesco and M&G which gives those investors first refusal on its new developments. That guarantees a pipeline of new homes for Invesco and M&G to operate for rent, but it also gives Telford greater certainty. While Telford's profit margins have decreased, this deal means the housebuilder can spend less time and cash on marketing, sales costs, and development finance, while reducing its exposure to risk.

Changing role of housebuilders

Build to Rent made up 7.1% of housing projects started in the year to Q1 2019. As bulk sales to investors grow their share of housing delivery, the role of the housebuilder will change. Rather than shouldering the full burden of risk, housebuilders will act as master contractors, forging long-term partnerships with landowners and investors. In the future, their profits may be smaller, but they will also be more resilient and sustainable.

Discounted bulk sales to investors are a relatively new phenomenon. Until recently, housebuilders have had no need to accept a discount, with ample demand from owner-occupiers fuelled by the availability of mortgage finance.

Falling interest rates and tightening lenders' margins have driven house price inflation far higher than wage growth. Between 1997 and 2018, average wages in the UK rose 71%. House prices grew 242% over the same period.

Now the stress tests introduced in the Mortgage Market Review in 2014 are starting to bite. Mortgage affordability is increasingly constrained and residential transactions have slowed. However, with government support, new home sales have continued to rise.

The end of Help to Buy

The Help to Buy equity loan has helped new home sales stand up while the rest of the market slows. Housing delivery grew 90% from 134,000 in 2012/13, when the scheme was introduced, to 255,000 new homes in the year to June 2019. The number of households entering home ownership for the first time has increased, too, with 150,000 using Help to Buy to take their first step on to the ladder. However, this support may not be around much longer.

From April 2021, Help to Buy will face restrictions, limiting the scheme to first-time buyers and imposing lower property value caps in regions outside London. Our analysis of Help to Buy loans granted in the year to June 2018 suggests that 17,000 sales, 34% of the total, would have been prevented by these restrictions. Housebuilders may be able to mitigate these impacts by building more modest, lower-value homes that are more affordable for first-time buyers and fall under the new value caps.

However, government has also announced it intends to end Help to Buy entirely in March 2023. Whether we see this delayed or adjusted, Help to Buy cannot reasonably support more than a third of all private new home sales forever. If individual households cannot afford new homes, developers must look to institutional investors as part of the solution to fill the gap in demand.

Shifting paradigm

Falling yields and interest rates have helped support capital value growth across a range of asset classes, not just housing. Now, with global gilt yields hovering around zero, the paradigm has shifted. House price growth over the coming years will be slower than we have seen previously, constrained by affordability. Our last forecast for UK annual house price growth was 2.7% on average over the next five years, compared with 6.5% over the past 10 years on average.

This increases risks when buying land. Before, if a housebuilder paid too much for its land, it could count on house price inflation to help bail it out. With house price growth slowing, this safety net has fallen away. In turn, this makes development debt riskier, pushing up finance costs and making it even harder to sell new homes profitably.

The government may help sustain values and support households buying new build for now. In the longer term, housebuilders will have to consider the institutions which have the money to buy their homes when securing land and designing their product.

Future profits for housebuilders may be smaller, but less exposed to market cycles

> **"By securing funding for 10s or 100s of homes in advance, housebuilders can cut their costs on marketing, sales, procurement and finances"**

> Some 20% to 30% less energy is required to heat homes built using MMC compared with traditionally built new homes

Flooding is widely considered as the greatest environmental risk to the built environment

Zeroing in on carbon

Climate change, sustainability, plus the future of the high street and transport, will all affect how and where we build residential developments in the future

Before the end of her tenure as prime minister, Theresa May announced a commitment for the UK to become carbon neutral by 2050. Some local authorities have already declared more ambitious targets; Bristol Council announced in November 2018 that the city aims to be carbon neutral by 2030, which will be reflected in its new local plan. Although there is little detail around how this will be achieved, it could require developers to adopt higher eco build standards, deliver an increased level of onsite renewable energy generation and offset the carbon emissions generated in the construction process.

Catalysts for change

This could prove to be a catalyst for more widespread use of Modern Methods of Construction (MMC). According to the Parliamentary Housing Select Committee, half the total waste produced in UK comes from construction, with around 20% of construction materials wasted. But in offsite construction, factories can be optimised to minimise material waste to below 1% of the total. MMC can also help properties meet carbon emission targets. Keepmoat Homes has reported that 20% to 30% less energy is required to heat MMC homes in comparison with traditionally built new homes.

The carbon-neutral agenda could also disrupt current thinking around where to locate future residential development. Transport was the largest emitting sector of greenhouse gases in the UK in 2017, and 56% of all transport emissions were from private car use. If the UK is aiming to be carbon neutral, will local authorities be required to give greater preference to densifying urban centre sites, or consider releasing greenbelt land close to existing settlements to minimise commute times?

In the longer term, environmental and climate change will also affect how we plan for new homes. The ONS 2018 Climate Projections show an increased chance of milder, wetter winters and hotter summers, along with an increase in the frequency and intensity of extremes. Sea levels are also projected to rise across the UK, although the impact will be varied. The greatest impact will be in the south, with London projected to see sea level rises under a high emissions scenario of 0.5 to 1.15 metres by the end of the 21st century. The 2018 Climate Change Risk Assessment identifies flooding as the greatest environmental risk to the built environment, encompassing risk from fluvial, coastal, groundwater and surface water flooding.

Assessing the risks

The impact could be to alter perceptions of where it is suitable to develop. More than one in 10 of the new homes built in England in 2016-17 were in areas the Environment Agency deems at risk of flooding. The Agency projects that climate change and population growth will cause the number of properties built on flood plains to double over the next 50 years, but this could be limited by greater restrictions on development. The Department for Environment, Food & Rural Affairs' National Adaptation Programme proposes that decisions on land use, including development, should reflect current and future levels of flood risk.

An awareness of climate risk is already influencing the commercial property sector. In July 2019, ratings agency Moody's bought Four Twenty Seven, a firm that analyses physical climate change, and has assessed the risk for more than 300 real estate investment trusts. A September 2019 report from the UN-supported Principles for Responsible Investment, predicts a real estate market response by 2025 that will be forceful, abrupt and disorderly.

As institutional investment becomes an increasing part of the residential sector, the resilience of new development will grow in importance, as investors seek to ensure their assets will perform, even during extreme weather events driven by climate change.

FRESH OPPORTUNITIES

Disruption in other sectors is presenting opportunities for residential development. The growth in online retail has resulted in significant volumes of vacant retail space. Savills estimates that the retail sector will be over-spaced by 35% in the next 10 years. [See *Re:imagining Retail*, 2019]. This could be a chance to intensify or repurpose to residential.

However, fragmented ownership remains a problem, particularly in areas of marginalised high street. The greatest opportunities are likely to arise from partnerships with local authorities, using vacant retail space as part of wider regeneration.

Similarly, transport disruption will create new opportunities in designing residential development. Car ownership levels are declining, but analysis by the Organisation for Economic Cooperation and Development shows that if we shift to using fleets of shared autonomous vehicles, the need for on-street parking will be largely eliminated. This will release city space for potential redevelopment. It also poses a challenge for developers, to design garages that will serve the existing short-term need but can be converted for new purposes in the future.

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