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Savills Research
UK Development and Investment

Spotlight
Where Best to Develop and Invest in Residential Property

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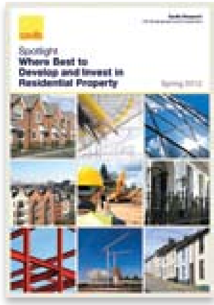


Although there has been a shift in development towards the strongest locations, there are opportunities to be found across all markets

These are uncertain times. This creates opportunities to take positions in the UK residential market, based on its sound fundamentals, underpinned by a scarcity of housing relative to demand. This report summarises our view on the outlook for residential development and investment and how that varies across different markets.

We focus on England, but the principles are equally applicable in Scotland and Wales. For instance, Edinburgh is a hotspot of market strength in Scotland.

Strength and scarcity

Both development and investment performance are driven by the strength of local market, alongside property specifics and acquisition price. The key is to buy well then unlock latent potential to attract demand from other micro-markets.

The strongest markets, as measured by the recovery in both prices and transaction volumes, tend to be the highest value markets (see Graph 1 below). Purchasers in these markets have more equity fuelled purchasing power, with less reliance on mortgage finance.

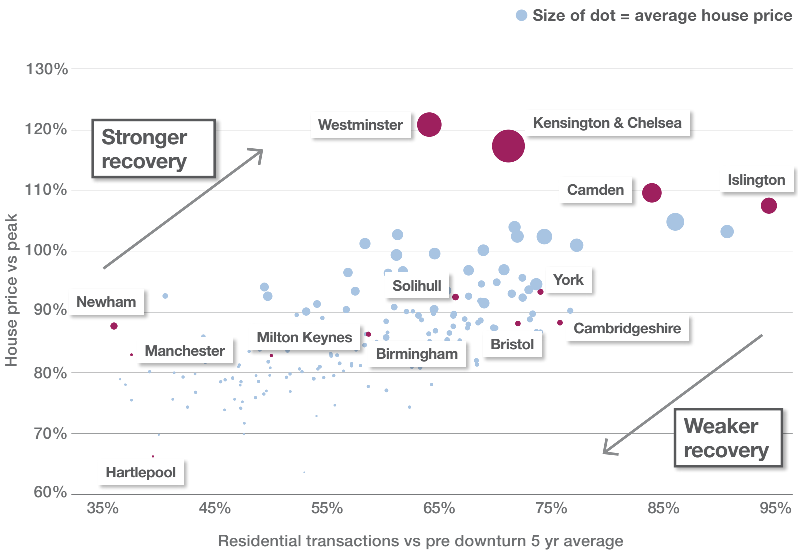
Development locations

A high proportion of development of new homes is in mid to lower strength markets, as a simple consequence of the larger markets (including Birmingham, Manchester and Leeds) that are in these categories.

However, there has been a shift in development towards the stronger markets; 42% of new homes were delivered in markets in the right hand half of the chart in 2010/11, compared with 36% in the three years to 2007/08.

GRAPH 1

Strength of Market Recovery



Graph source: Savills Research, HM Land Registry

SUMMARY

Finding performance

■ The uneven pace of market recovery across the UK has led to a 6% shift in residential development towards the stronger and more active markets. However, there are development and investment opportunities in all markets. The key is often to buy well then unlock latent potential to attract demand from other micro-markets.

■ Delivery of new homes on larger sites is crucial to meeting housing requirements and unlocking development opportunity. Under the new National Planning Policy Framework, the focus will now be on maintaining a deliverable and financially viable five year land supply and the power of the New Homes Bonus incentive. This is already offsetting some 20% of funding cuts within the higher delivery local authorities.

■ Markets with recent scarcity of new housing supply include Oxford, Solihull and Wokingham, despite strong market recovery. Scarcity of deliverable land with consent is a constraint in these markets, so development prospects are good for those who can get land with consent to the point of delivery.

■ There are many other markets with strong market recovery but below par levels of delivery, including Mid Sussex, Guildford and York. In London, boroughs such as Islington, Hackney and Wandsworth have delivered less than might have been expected given their market strength.

■ Finding future investment performance is a matter of acquiring stock at relatively high yield, where growth prospects are not priced into the market. Taking London as an example, gross yields on vacant possession values are above 5.5% in predominantly Zone 2 locations in Camden, Islington, Hackney, Tower Hamlets, Lewisham, Southwark and Lambeth. These boroughs contain large development sites where there is likely to be funding scarcity and opportunities to acquire at higher yields. They also contain large swathes of hidden value that can be unlocked, some of which will be accelerated by regeneration and investment.

Housing Scarcity

High levels of household formation are predicted to continue

The scarcity of housing in the UK is a well established theme that has underpinned market performance and Government policy. Past household formation in England has fallen short of projections, limited by the availability and affordability of housing.

Nevertheless, the household projections indicate that potentially realisable new housing requirements are likely to be in excess of past rates of household formation which have been around 195,000 per annum during the last five years.

Even the low migration projections produced by ONS indicate additional household numbers of around 245,000 per annum.

Housing supply consists of more than new build homes, as it also comprises conversions of houses into flats, change of use from commercial property and the return to use of long term empty homes, after refurbishment.

These sources have added an average of 37,000 homes per annum to England's housing during the last 10 years.

More than new build

Looking forward, we expect new housing completions to rise to 125,000 per annum in 2016, as market transaction levels improve slowly and the Government's Housing Strategy measures take effect, offset by the reduced levels of affordable housing that can be expected within the new funding programme.

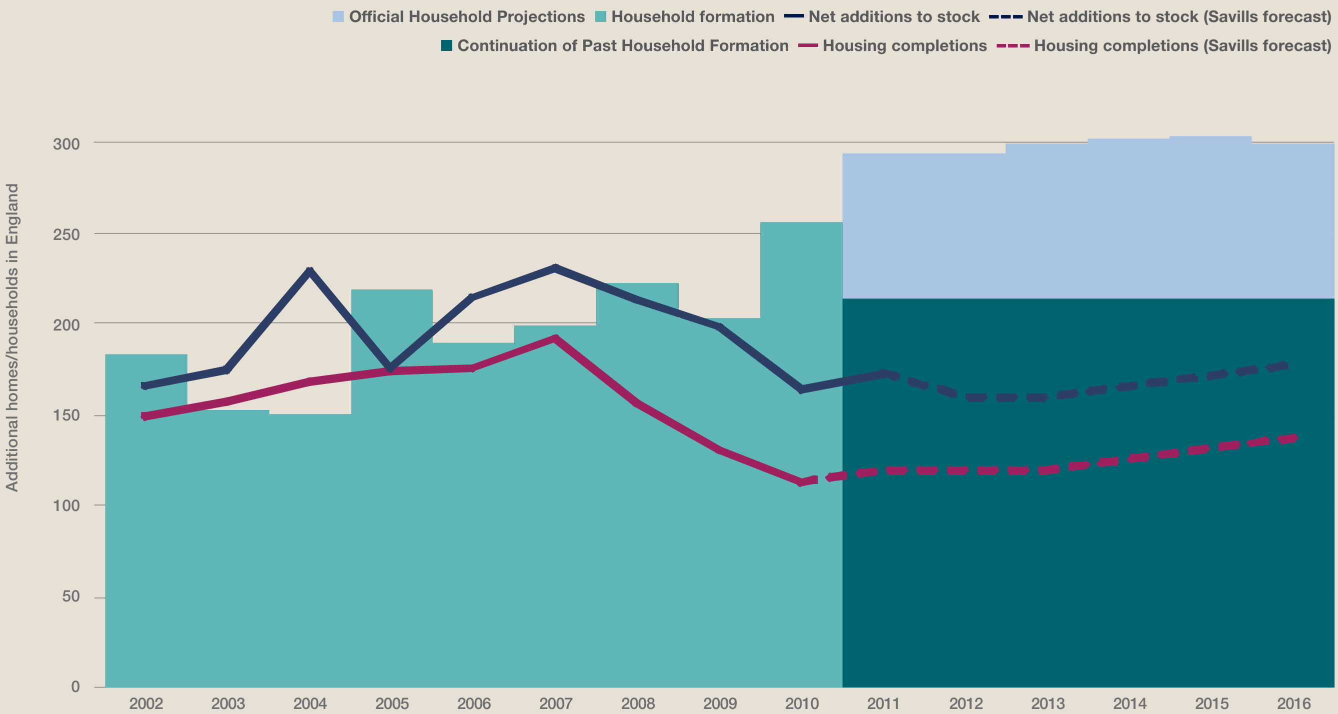
We have pencilled in an extra 20,000 new homes from the recently launched NewBuy mortgage indemnity programme, offset by the end of FirstBuy equity loans which are set to deliver 10,000 homes in 2011/12.

Adding in conversions and refurbishments takes supply to an annual average of 152,000 homes over the next five years. This leaves an annual shortfall of at least 43,000 homes plus the pent up demand that has been constrained by the availability and pricing of housing.

The vacancy rate of long term homes is an indicator of how this overall housing scarcity plays out at a local level. It varies from less than 0.75% of housing stock in parts of London and the south to more than 1.75% of stock in parts of the north.

GRAPH 2

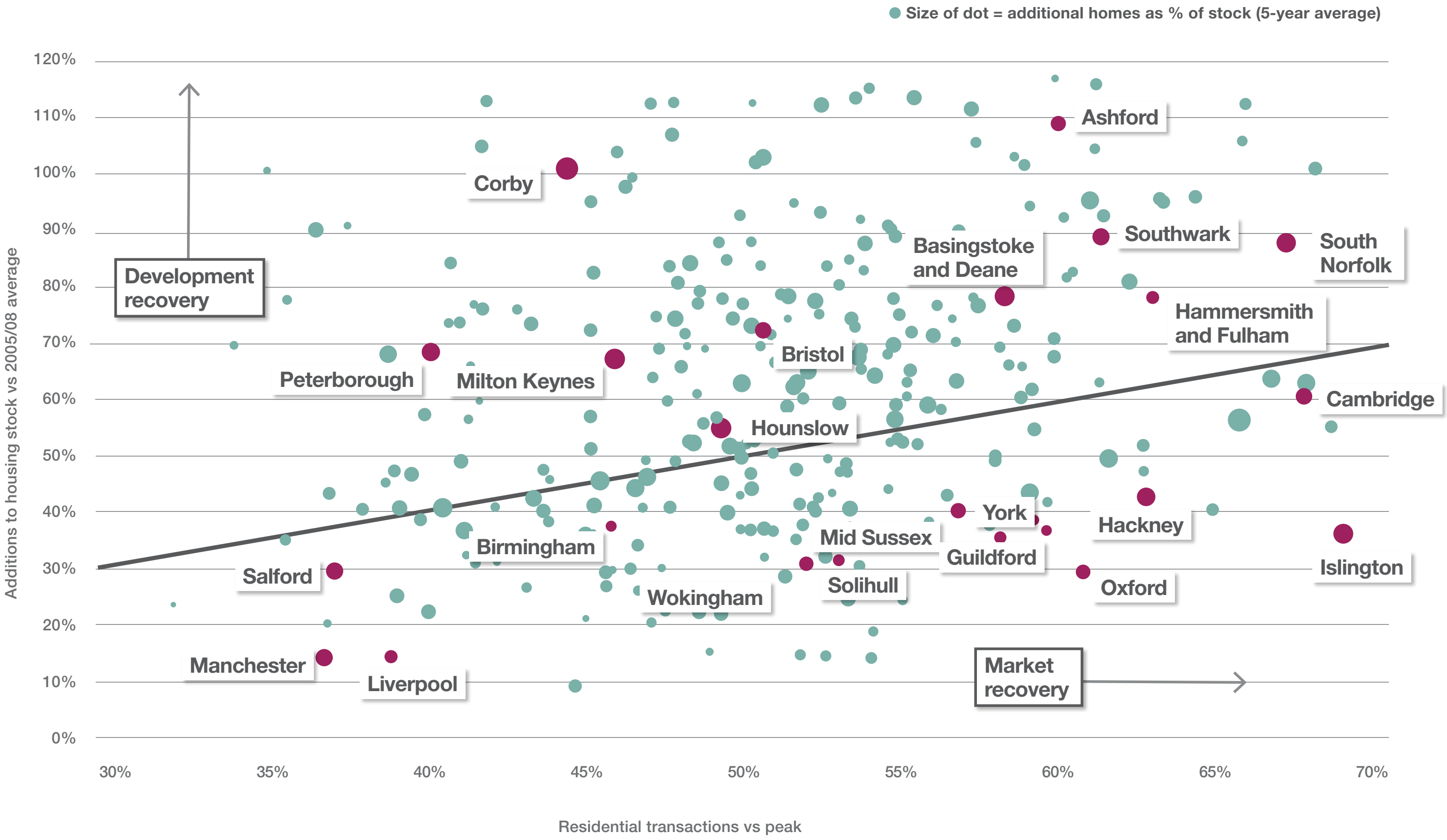
Housing Scarcity



Graph source: Savills Research, DCLG, ONS

GRAPH 3

Recovery in House Building and Market Activity



Graph source: Savills Research, DCLG

Volume sales of new homes is inherently easier in markets in which a high proportion of housing stock changes hands each year. Levels of market activity in the stronger and faster recovering markets are now significantly higher than in the weaker markets. Where transactions are within 40% of peak levels, 4.1% of privately held stock changed hands in 2011, whereas only 2.7% of stock transacted in markets that are more than 60% off peak levels.

Graph 3 shows which markets have seen the greatest recovery in development, relative to the upturn in residential market activity. There are development opportunities in all of these markets, but they vary in nature across the chart. The most straightforward opportunities are likely to be in the strongest markets, provided that land can be acquired at a competitive price.

Relatively strong recovery in high delivery markets such as Cambridge has underpinned an upturn in delivery of similar scale. Issues here include how new infrastructure is funded and obtaining serviced land at a competitive price.

Development volumes have bounced back sharply in Ashford, South Norfolk (including development on the fringe of Norwich) and Cornwall, underpinned by a robust recovery in market activity and the availability of deliverable land.

Equity loans, including FirstBuy and Homebuy, have been an important part of delivery rates in these markets, so developers that offer these products are well placed to compete. NewBuy mortgage indemnity has the potential to extend the positive impact.

Delivery in markets such as Oxford, Solihull and Wokingham have stayed relatively low, despite strong market recovery. Scarcity of deliverable land with consent is a constraint in these markets, so development prospects are good for those who can get land with consent to the point of delivery.

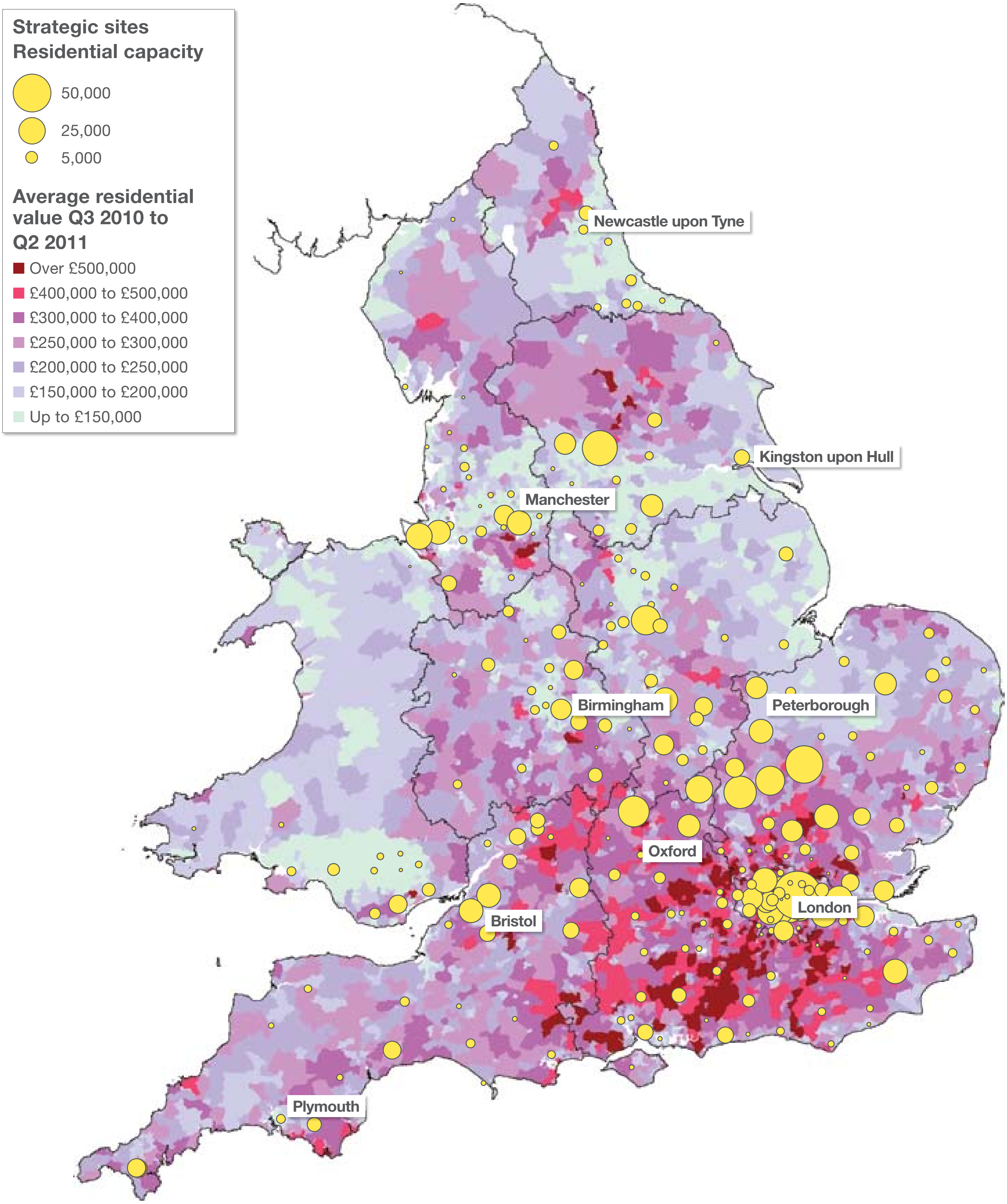
There are many other markets with strong market recovery but below par levels of delivery, including Mid Sussex, Guildford and York. In London, Islington, Hackney and Wandsworth have delivered less than might have been expected given their market strength.

Some of the ‘above the line’ stronger markets have the potential to deliver

> “The most straightforward opportunities are likely to be in the strongest markets, provided that land can be acquired at a competitive price”
> Jim Ward, Savills Research

MAP 1

Strategic sites for Residential Development



Graph source: Savills Research, HM Land Registry

"Delivery is falling short of housing requirements. A significant proportion of local authorities do not have a deliverable five year supply of land" Jim Ward, Savills Research

significantly more. Regeneration in both Southwark and Hammersmith & Fulham will be supported by these boroughs' proximity to central London markets.

The 'below' the line' weaker markets are more difficult. Markets such as Manchester, Salford and Liverpool are heavily reliant on urban regeneration schemes which are capital intensive and depend on capturing excess demand from neighbouring markets with scarcity of supply. Success here typically involves long term investment, with both capital and land, on sites that offer the best long term uplift in value, alongside investment in infrastructure and transport links.

Delivery in below par markets will be enhanced during the next two years by significant allocations of Get Britain Building funding in Manchester, Liverpool, Salford and Birmingham. Above par markets in receipt of significant allocations include Milton Keynes, Bristol and Hounslow.

The opportunities

Much of the development opportunity is in strategic sites of more than 250 unit capacity, which provide a total development capacity of 1.5 million new homes. These sites account for some 45% of the five year land supply pipeline identified by local authorities, where specific sites have been identified in Annual Monitoring Reports. Some 53% of their capacity is in stronger markets and, as shown in the map, many are close to higher value markets, such that provision of affordably priced homes will attract demand from higher value markets.

These sites have been difficult to bring forward since the 2007/08 downturn, because of their greater requirements for both scarce development finance and costly infrastructure.

As the steady pace of refinancing of banks and developers continues during the next five years and market recovery ensues in due course, balanced against higher build costs, a growing proportion of sites will become deliverable, providing land for the higher number of new homes completions that we are projecting. Whether this materialises will be a central test of the new National Planning Policy Framework and how it balances growth with sustainable development.

Surplus public sector land is part of the land opportunity, albeit much of it is in mid to lower strength markets. Of the land identified by Government as having a development capacity of 100,000 new homes, 65% lies in the local authorities with below average market strength, so structuring the right land deal and planning consent will be crucial.

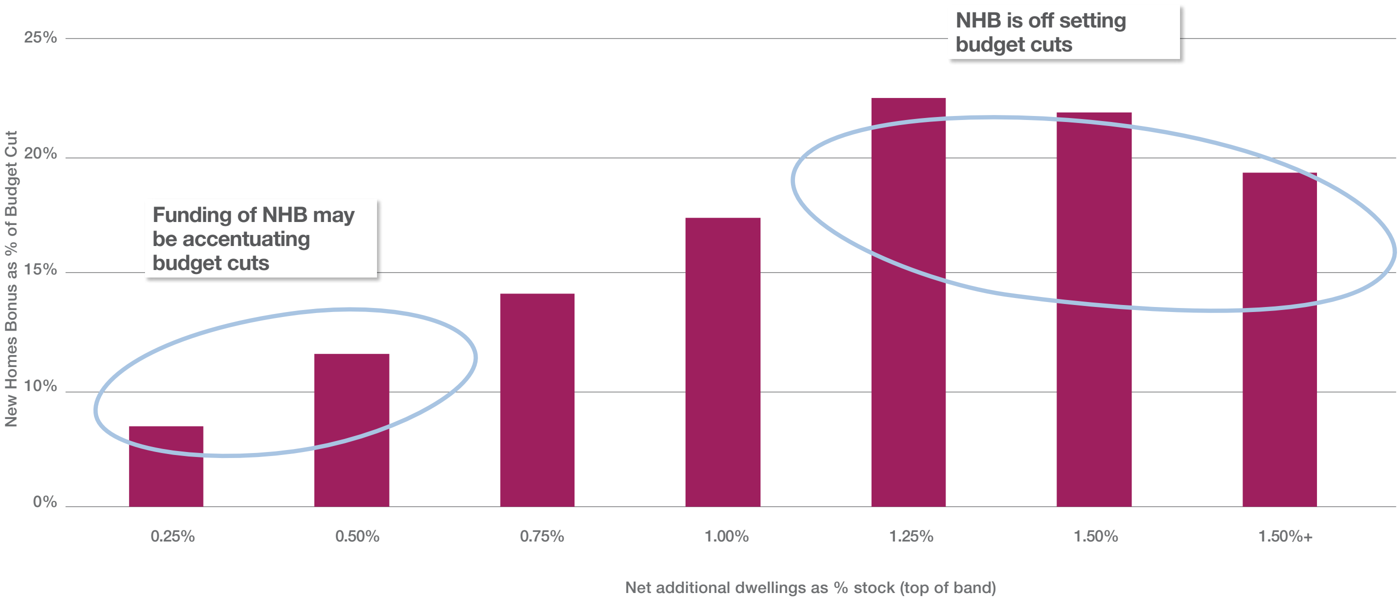
Planning opportunities?

Delivery is falling short of housing requirements in most markets. A significant proportion of local authorities do not have a deliverable five year supply of land. As an example, Savills analysis in November 2011 indicated that, in an area of central southern England centred on Oxford, only 13 out of 24 local authorities had identified a deliverable five year land supply.

In these markets there is an opportunity to obtain consent to provide for those five year requirements. The opportunity is bolstered in those markets that are demonstrably below par on delivery, as outlined above.

GRAPH 4

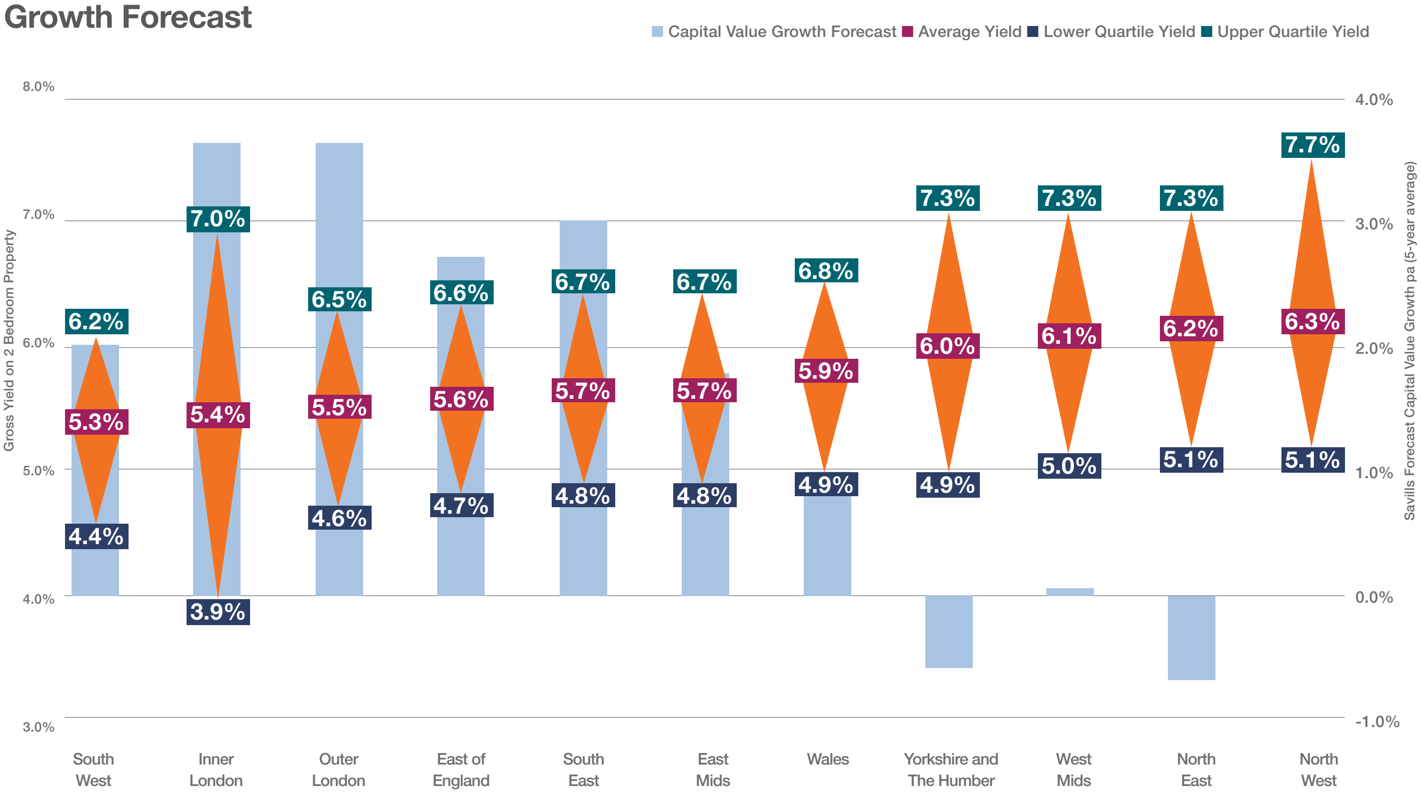
New Home Bonus as a % of Local Authority Spending Cuts



Graph source: Savills Research

GRAPH 5

Gross Yield on Vacant Possession Value vs Capital Value Growth Forecast



Graph source: Rightmove/Savills Research

Delivery of new housing to meet requirements is in the interest of local authorities, not only to deliver the economic and social objectives of the Local Plan. The money now flowing from central to local government via the New Homes Bonus is substantial. In 2012/13 this will amount to £432 million, equivalent to 9% of the £4.8 billion of centrally imposed cuts in local government spending budgets since 2010/11.

These amounts of cash bonus will increase threefold during the next four years, even if there is no change in levels of housebuilding. The power of the incentive goes further, as central funding of payments in excess of £250 million per annum is clawed back from formula grant. This means those authorities that are building fewer homes than the average are already seeing deeper cuts in funding from central government.

The extent to which New Homes Bonus can support services and investment that would otherwise be cut is a powerful incentive that can and should be part of the discussion with communities.

The local authorities that are delivering most housing are already offsetting 20% of budget cuts with New Homes Bonus, compared with an offset of 5% where little housing is being delivered. Are people living in these low delivery authorities really content to be missing out?

A good investment

Residential property has been the standout investment over the last two decades, outperforming equities, gilts and commercial property over both 10 and 20 years. We have a positive view on the outlook for residential investment as the rental market sector expands, as outlined in our recent special report with Rightmove, Rental Britain (see page 11).

Yield/growth prospects?

Finding future investment performance is a matter of acquiring stock at the right price (and income yield), relative to future prospects for rental and capital growth. As a general rule, property in stronger markets with better growth prospects is priced at a level that generates a lower income yield.

These averages hide a wide range of yields, as shown in Graph 5. This shows gross yields on capital values with vacant possession, so where stock can be acquired at lower 'investment values' which can be up to 30% lower, then the yield is significantly more competitive.

The trick is to find opportunities to buy at relatively high yield, where growth

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Jim Ward, Savills Research

"The most common opportunity is to buy lower grade property in a strong market"
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prospects are not priced into the market. These acquisition opportunities can occur for a variety of reasons, related to distressed debt and the lack of finance for development, as discussed in the table.

A typical good growth orientated investment proposition is where stock can be acquired in a market with strong growth prospects at a net initial yield of 5.5%, giving the opportunity for meaningful gearing with debt.

Factoring in forecast for rental growth and capital growth over a 10 year period gives a prospective ungeared investment return in excess of 10% per annum and a higher geared return.

Investment opportunities

There are opportunities across the country to buy at high yield but benefit from capital growth in line with lower yielding markets. The most common opportunity is to buy lower grade property in a strong market, or to find micro-markets of different strength in close proximity. Both opportunities are most common in the strongest markets.

Taking London as an example, gross yields on vacant possession values tend to be less than 5% in central London but they move out to above 5.5% in predominantly Zone 2 locations in Camden, Islington, Hackney, Tower Hamlets, Lewisham, and Lambeth.

Furthermore, these boroughs contain large development sites where the funding opportunities in the table opposite are highly relevant. They also contain large swathes of hidden value that can be unlocked by regeneration and investment, as shown in Map 2.

The regeneration of Elephant and Castle in Southwark is a classic example that brings together all of these themes on a grand scale, but there are many others offering more bite-sized opportunities.

Yield Opportunities

Fund development to acquire at high yield

Distressed Stock	Lenders are having to deleverage their balance sheets to keep within regulated maximum capital ratios. Offloading distressed residential loans and the underlying sock will be part of that process.
Build to Let Development Joint Venture	Many of the larger strategic sites identified in Map 1 are in urban markets where there is strong and expanding demand for market rented accommodation. The finance to develop these sites can be provided by equity investment via a development joint venture with the landowner. The JV investment partner takes a yield on development cost, holding the built stock for investment return. Flexibility on how and when returns to land are received can be part of the JV deal.
Off-Plan Bulk Acquisitions	A simpler variation of the above is that the investor provides certainty of development funding at an early point by acquiring stock off plan, at a discount to vacant possession value. Stock can also be acquired at the end of the development period, to allow the developer to move on to new development with cash in hand.
Management at scale	Net income yield can be improved by efficient management at scale, undercutting the average overhead recorded by Investment Property Databank of 29% of gross rental income, excluding voids. Scale also offers the opportunity for provision of added value services that attract a premium rent. Selection of the right property in strong and active rental markets will minimise voids. However, it should be noted that markets with a high proportion of tenants in receipt of Housing Benefit are exposed to recent cuts in Local Housing Allowance.

Unlocking Hidden Value

Finding extra uplift in London

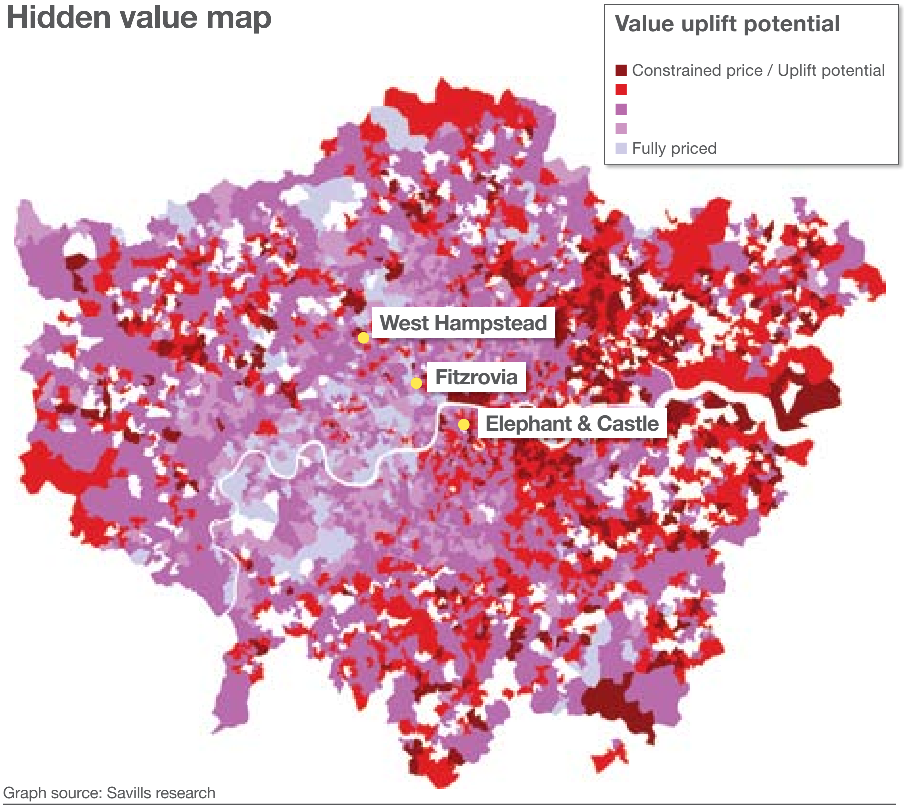
If stock can be acquired at relatively high yield and the stock is located close to a stronger market with scarcity of stock, then future growth prospects can be driven by the stronger dynamics of the neighbouring market as demand spills out. This is a question of judgment on the strength of the neighbouring market.

It can also depend on whether investment in transport or place are likely to improve the attraction of the lower value market. As an example, the map shows our analysis of places in London that are underpriced relative to their transport links and their quality of neighbourhood, measured by indicators such as health and crime.

Value gaps of 20% are commonplace and, where the barriers are significant, the upside is higher if regeneration can lift those barriers.

MAP 2

Hidden value map



Graph source: Savills research

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