UK Development – Autumn 2018

SPOTLIGHT
Savills Research

What next for housebuilding?

Boosting build-out rates • Land value capture • Housebuilding forecasts

> Variety of product will help with market absorption, but we also identify the roles of competition and pricing, alongside a greater variation of tenures

The housebuilding industry has once again been under scrutiny this year, with another government review tasked with looking at the challenge of increasing delivery rates.

Encouragingly, the Letwin Review has concluded that landbanking is not an issue affecting housing delivery, instead focusing on the lack of product diversity in the industry.

Certainly, more variety of product will help with market absorption, but it is not the only answer; our research also identifies the roles of competition and pricing, alongside a greater variation of tenures.

The conclusions of the Review also have potential to impact land value uplift, at a time when land value capture is becoming a hotly debated topic.

The Review has been a welcome addition to the discussion around boosting delivery, but ongoing policy support and funding for smaller developers, affordable tenures and infrastructure requirements will be needed to make its aspirations a reality.

We await Sir Oliver's final recommendations this autumn with great interest.

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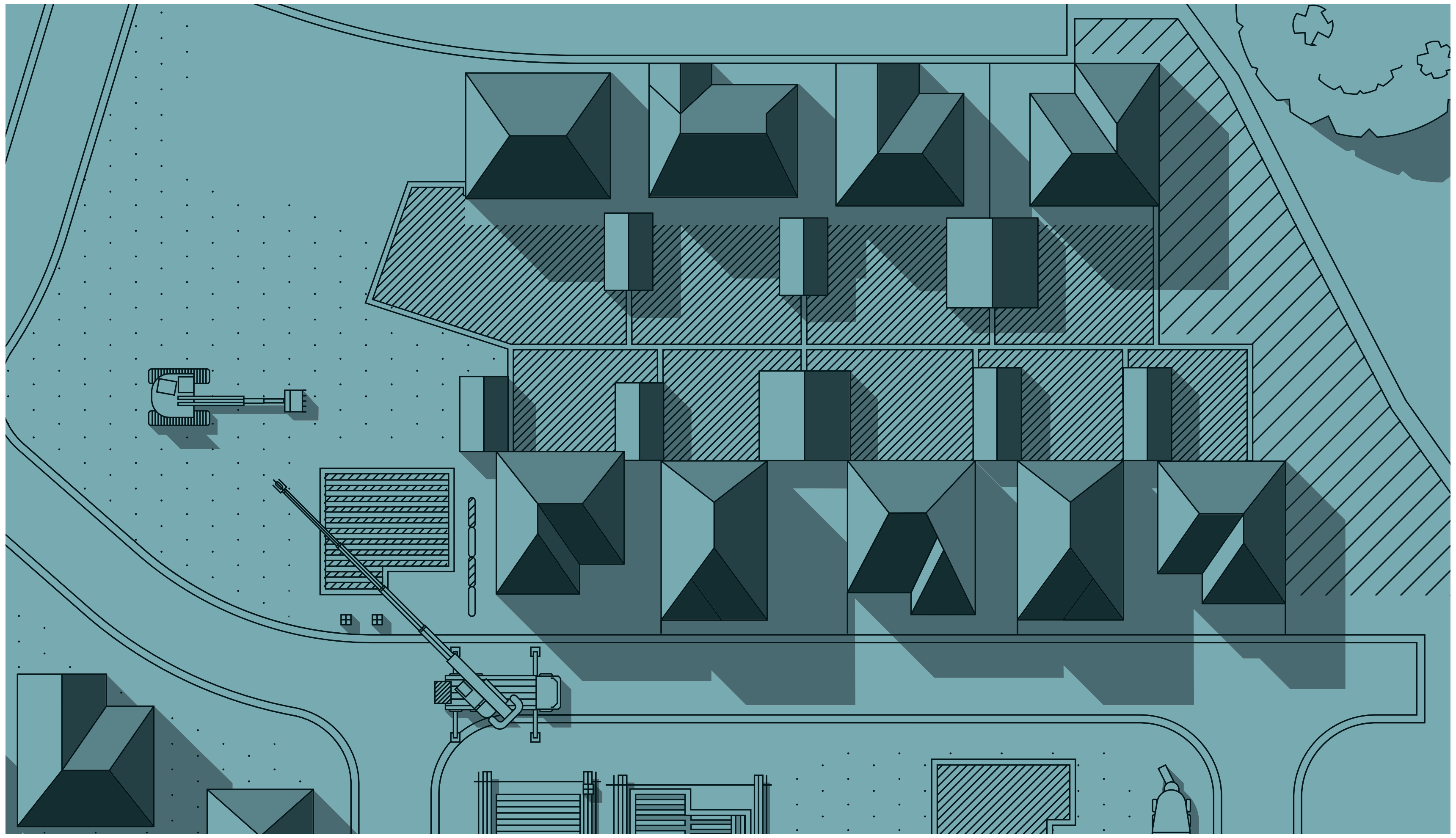


Is the lack of variety in new build the issue?

The Letwin Review believes so. But our research of new build sales rates suggests there are many other factors at play

Housing continues to be a key political issue, as the government searches for ways to boost delivery by building 300,000 new homes per year in England.

In 2016, annual planning consents granted reached 300,000 and have continued to climb. However, despite rapid increases in output, the 217,000 net additional dwellings for the year to March 2017 leaves a big shortfall. Lead indicators, including energy performance certificates for new dwellings, suggest that the figure for the year to June 2018 will be slightly higher, but with lower growth than in previous years.

Sir Oliver Letwin MP has been investigating the causes of this gap, with particular focus on the build-out rates of large sites. After assessing 15 sites across England, his key conclusion was that build-out rates on very large sites are limited by the homogeneity of product. Major housebuilders should offer more variety in product type, tenure and design, which could result in more variation in pricing. This would make the new build market accessible to a greater number of people, thus increasing market capacity for open market sales and absorption via other tenures.

How important is product diversity?
We have tested Sir Oliver's conclusion against our own data of 30 sites across the country, each with capacity for more than 1,000 homes. We assessed sales rates against the mix of house types (detached, semi-detached and terraced and flats) on each site. While there is a correlation between more diversified sites and a higher sales rate, this is an inconsistent relationship. Our analysis shows that there are many other factors in play.

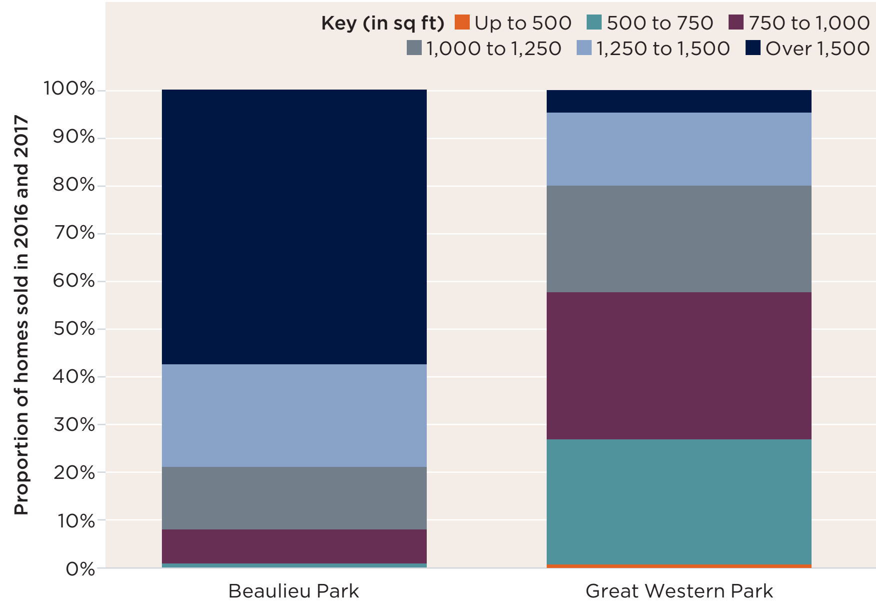
The sites achieving the highest sales rates of at least 50 homes per quarter all provide a wide range of house types. At the Western Expansion Area in Milton Keynes, which had the highest sales rate of the sites in our study, the most prevalent house type accounted for 36% of units sold. The least prevalent type accounted for 18%. The sites achieving lower sales rates tend to have one product type dominating delivery, accounting for more than 50% of all sales.

The effect of product diversity can be seen in the difference in build-out rate between Great Western Park in Didcot and Beaulieu Park in Chelmsford. These sites are of similar size, with capacity for 3,300 and 3,600 homes respectively, yet private sales have averaged at least 195 per year at Great Western Park (between Q1 2015 and Q4 2017) compared with 120 homes per year at Beaulieu Park (between Q3 2016 and Q3 2017). At Great Western Park, a wide mix of house types and sizes have been delivered, whereas the focus at Beaulieu Park has been on larger homes. >

Delivery

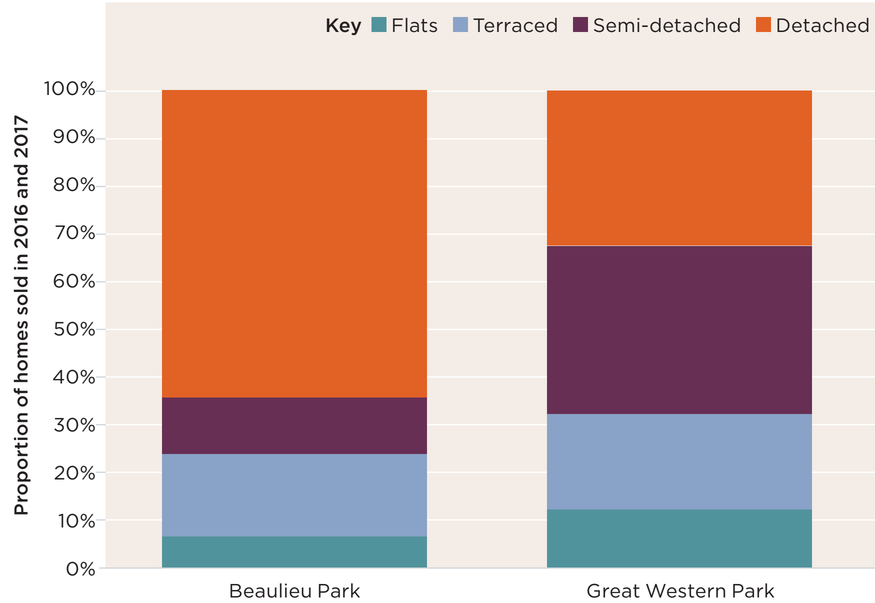
Tale of two sites At Great Western Park (sales rate 195 homes per year), a wide mix of sizes and homes have been delivered, whereas the focus at Beaulieu Park (sales rate 120 homes per year) has been on larger homes

Size distribution of new homes sold in 2016 and 2017



Source Savills Research using HM Land Registry and MHCLG

Distribution of type of new homes sold in 2016 and 2017



Source HM Land Registry

The correlation between sales rates and share of the local new build market is more than 2.5 times stronger than that between sales rates and product variation

The importance of competition
However, a variety of home types doesn't guarantee a high sales rate. The sites in our study that had the highest variation in product all had peak sales of fewer than 30 homes per quarter, less than half the rate of the fastest-selling sites. Clearly, building less homogenous developments isn't the sole solution to the challenge of increasing delivery.

Instead, our analysis shows that the broader market context for each site is the main influence on sales rate. Competition among sites is a key limiting factor on the pace of sales. All of the sites that achieved a sales rate of more than 30 units per quarter were supplying over 50% of new build homes within a two-mile radius of the site. The correlation between sales rates and share of the local new build market is more than 2.5 times stronger than that between sales rates and product variation.

Pricing relative to the local market is also a factor on sales rates. Where large sites are successfully selling high numbers of new homes, particularly in less affordable areas, the homes tend to be priced in line with or below the local market.

Great Western Park and the Western Expansion Area in Milton Keynes have average sales values 2% below the average for the local new build market. North West Bicester, Ledsham and Ashford, however, were selling at between 2 and 12% above the local market averages, and achieving much lower sales rates. To maximise absorption, new homes need to be accessible to the mass market. In unaffordable locations with competing supply, this requires new homes to be priced below local market averages.

Beyond sales rates
Looking at sales rates should not be the only focus for boosting housebuilding. There were 1.2 million residential transactions in the year to June 2018, half a million few than before the global financial crisis. New build transactions have historically tended to follow overall market activity, amounting to around 10% of all residential transactions. In recent years, new build has climbed to 12% of all transactions, largely thanks to Help to Buy, but it is questionable how much further that relationship can be pushed, even with increased product diversity.

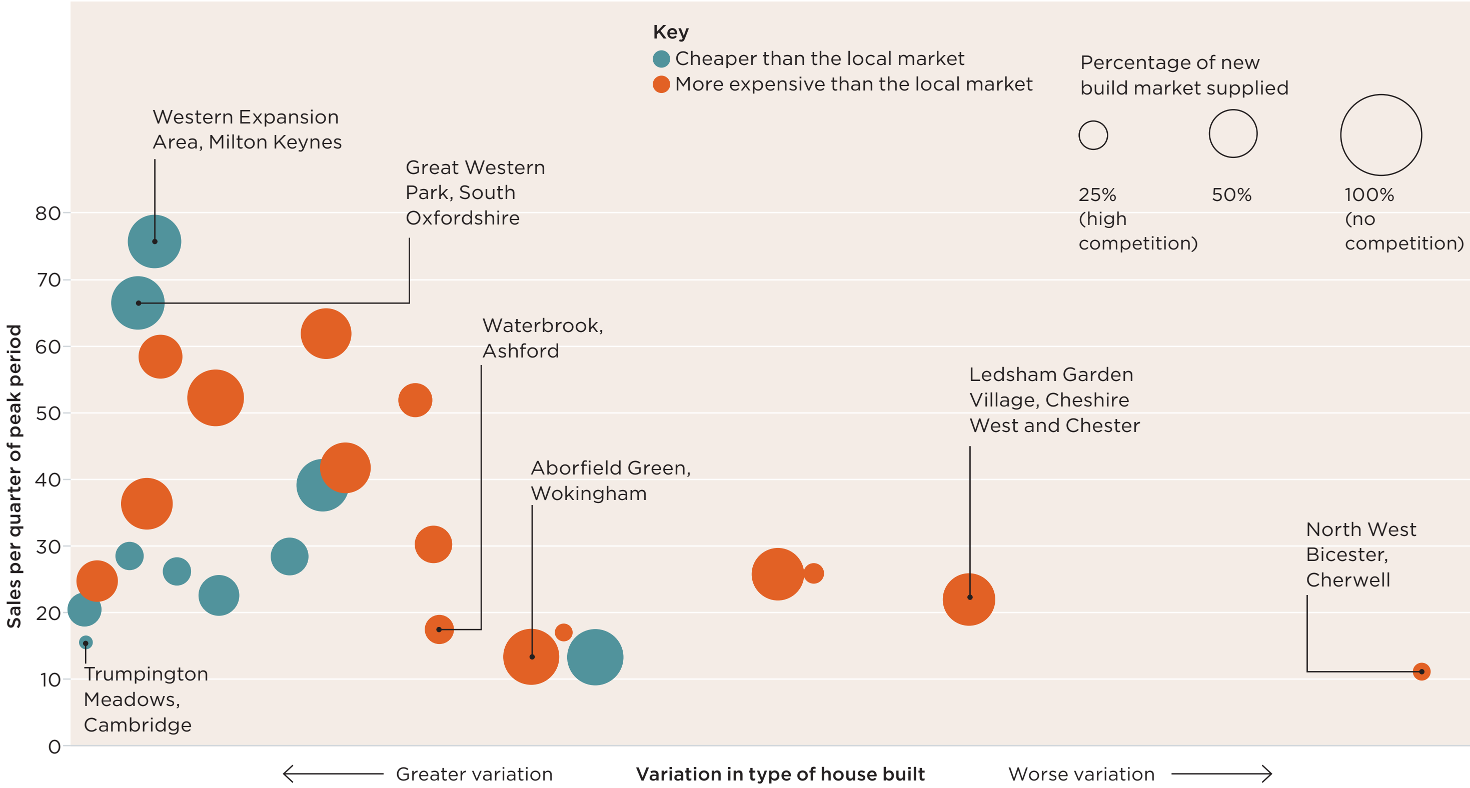
Therefore, if overall numbers of transactions do not increase, it is hard to see how new build sales will. Instead, developers need to tap into demand in other parts of the housing market. This will require more diversity of tenure, namely private rented homes and affordable housing, both of which are underserved by new housing development.

BOOSTING BUILD-OUT RATES

Price
Where large sites with significant competing supply are selling high numbers of new homes, they tend to be priced in line with, or below, the local market. Our research revealed lower sales rates where properties were sold at margins that were as little as 2% above the local market average.

Local competition
The correlation between sales rates and share of the local new build market is more than 2.5 times stronger than that between sales rates and product variation. Our research of 30 sites across the UK showed that those with a sales rate of more than 30 units per quarter were supplying the majority of new build homes within a two-mile radius of the site.

Factors affecting sales rates
Product diversity, pricing and competing supply in the local market against sales rate per site



Source Savills Research

“We estimated that around 50% of land value uplift is captured via developer contributions, accounting for site remediation and enabling”

How far can land value capture be pushed?

Delivering the Letwin Review's proposals may reduce GDV and limit land value uplift. How can the government and stakeholders balance competing priorities?

Increasing housing supply will not only be achieved by diversifying the types of homes available for open market sale. The greatest untapped potential is in delivering alternative tenures. Indeed, the Letwin Review notes the demand for affordable housing is "virtually limitless".

It is tempting to see the provision of this type of housing as the easiest way to increase build-out rates. However, doing so within current development models poses challenges.

Housing developments with more affordable housing and build to rent will generate a lower gross development value (GDV), although this will be offset by the earlier cash receipt, as build-out is accelerated.

The Review acknowledges that it is not realistic to require housebuilders to lower the selling price of their current product, but this wider tenure mix will restrict GDV and the uplift from existing-use value.

The current rate of affordable housing delivery on most sites is limited by the need for subsidy from open market sales on the rest of the site. Government funding for affordable housing is £9 billion for 2016-2021, with a further £2 billion recently announced to be available after 2021. This is the first time government has pledged funding beyond the current spending review period, and will provide more certainty to support the delivery of affordable housing. However, there is not enough money to fund the volume of affordable housing that is required.

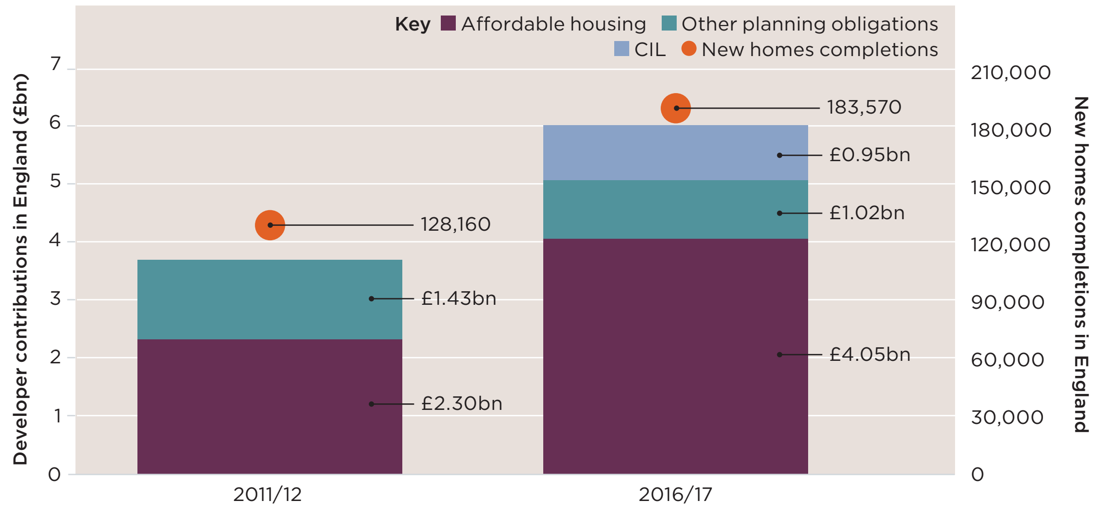
So, expanding delivery will have to be done either through increased developer contributions, or the housing association cross subsidy model, both of which eat into the available land value uplift. There is, therefore, a need to balance the tension between increasing current rates of land value capture and ensuring that the returns from developing homes are enough to incentivise landowners and developers.

Crucially, to maintain the expansion of housebuilding, developers also need to be able to maintain margins which are high enough to cushion the business in the event of a market downturn.

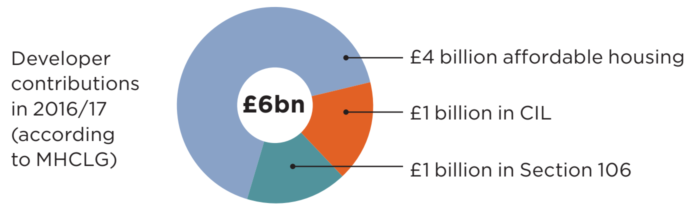
Potential for land value capture
The potential to capture land value uplift varies significantly across the country, in line with the sales values of the new homes.

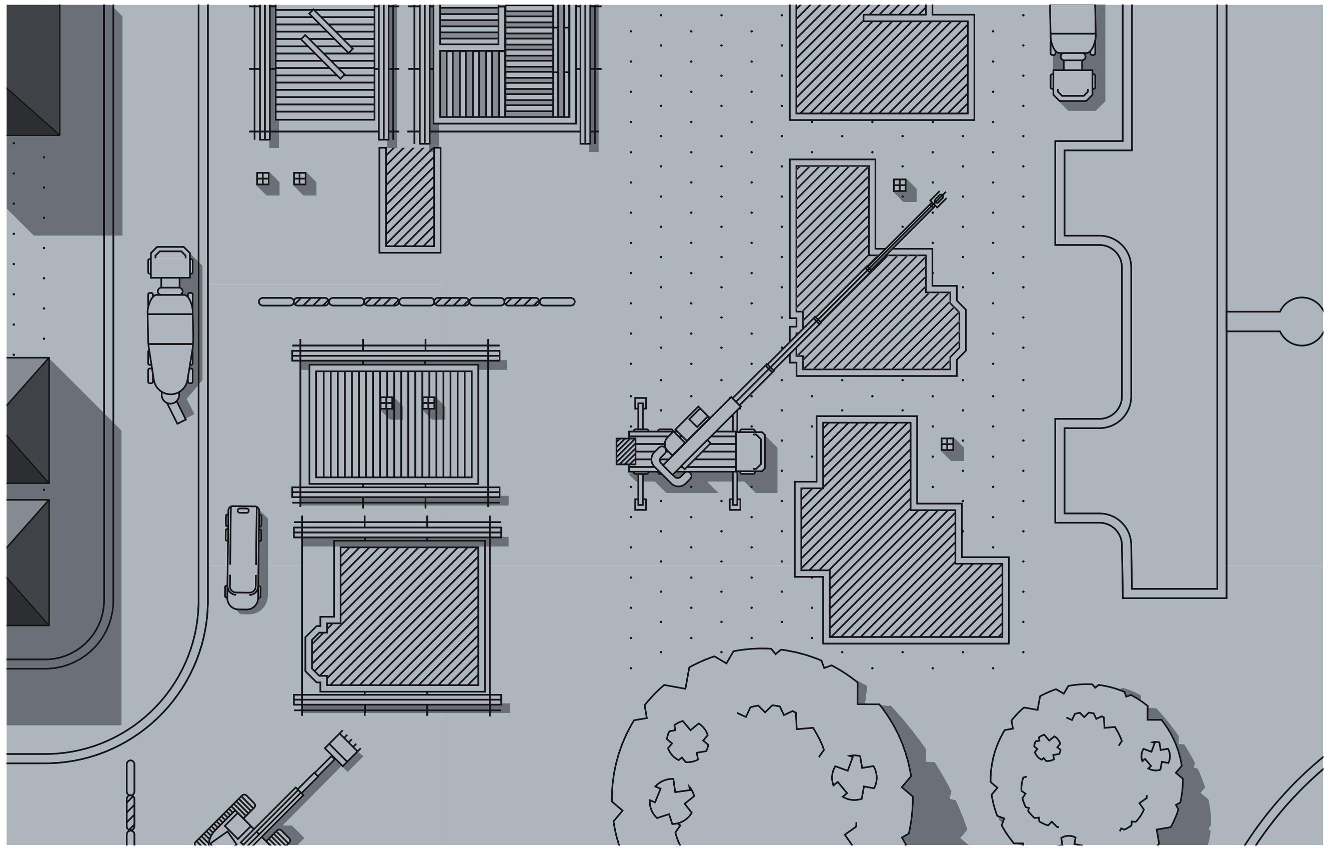
In 2012, we calculated that delivering 30% affordable housing alongside at least £3,000 per plot in Community Infrastructure Levy (CIL) and Section 106 was viable in only 38% of English local authorities outside London, although the proportion has increased significantly since then. ›

Land value capture Since 2011/12 there has been a 43% increase in completions, but a 60% increase in developer contributions



Source MHCLG





According to MHCLG research, developer contributions in 2016/17 amounted to £6 billion. This was made up of £4 billion in affordable housing, £1 billion in CIL, and a further £1 billion in Section 106 agreements.

This is a 60% increase from 2011/12, partly supported by national average house price growth of 30%, while build costs have only increased by 16% since 2012. Consequently, affordable housing, CIL and Section 106 can be delivered by more sites in more markets in 2018 compared with 2012, while still providing a reasonable return to the landowner and profit for the developer.

We have estimated that around 50% of land value uplift is captured via developer contributions, once the costs of site remediation and enabling are factored in. By this measure, developer contributions are working.

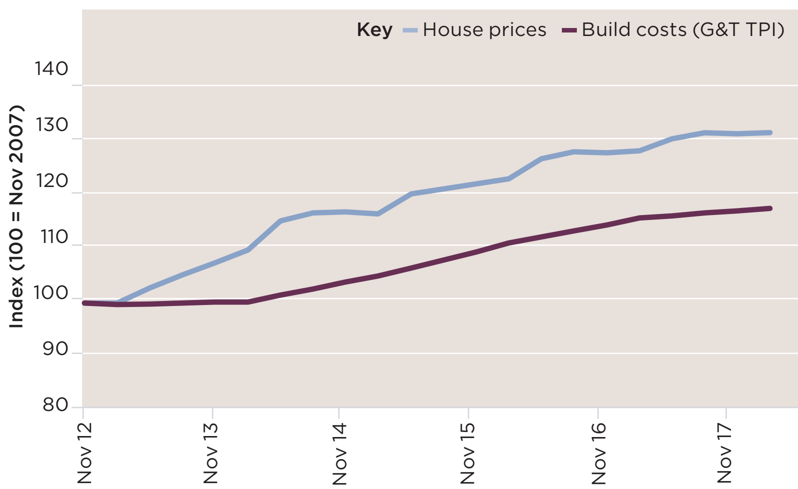
Crucially, the rest of the value uplift is usually not all received by the landowner. Much of it funds the complex and lengthy business of masterplanning and enabling sites, with all of the market and planning risk that entails.

The trend of an expanding pool of land value uplift is unlikely to continue over the next five years. We are forecasting much lower house price growth of only 14% during the next five years, meaning the amount of uplift available for land value capture will not expand as rapidly as it has since 2012.

Balancing priorities
To deliver the ambitions outlined in the Letwin Review and ultimately work towards solving the housing crisis, there has to be a way to capture the optimum share of a limited pool of land value uplift. But there is a limit to how much further land value capture can be pushed before landowners are unwilling to bring their sites forward for development. A willing landowner will require a reasonable receipt that compensates for loss of the land and any income it generates.

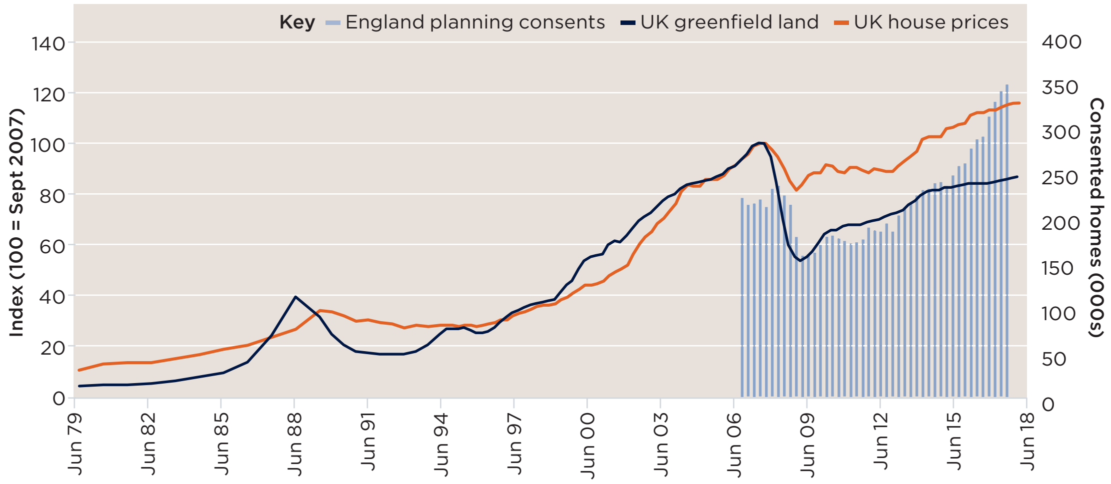
The question is, what can the government do to balance these competing priorities and ensure that developers deliver more diversified schemes?

House price growth Affordable housing and CIL/S106 can be delivered by more sites in more markets in 2018



Source Nationwide, Gardiner and Theobald

Land value growth
Increased supply of consented sites has helped moderate land values



Source Savills Research, Nationwide, HBF

Government action
The most important thing is to increase land supply, particularly in the highest demand areas.

At a national level, higher land supply has already been seen to moderate development land value growth which allows developer contributions to be made viably. Between 2007 and 2017, the number of residential consents granted increased by 58% from 222,000 to 350,000 plots, with the growth following the introduction of the NPPF in 2012 (see above).

Over the same period, UK greenfield development land value growth has been muted, remaining 13% below its former peak level in 2007. In contrast, UK house prices are now 15% above their 2007 peak.

The exceptions are the most land-constrained and highest demand markets: predominantly those in and around London. Planning restrictions, including Green Belt, have limited the supply of development land, alongside a rapidly declining stock of previously developed land.

This has led to high levels of competition for sites, and competitive bidding has resulted in higher land prices. Our greenfield land index is 13% below its former peak nationally, but in the South East values are only 3% below 2007 levels. Without substantive change to Green Belt policy, a significant increase in land supply in these areas is unlikely. This is where an alternative approach is required.

Policy clarity
In areas where land supply is limited, the key to delivering the ambitions of the Letwin Review is to give clear and explicit requirements for development contributions, particularly in very competitive land markets.

This means having an up-to-date local plan in place, which sets a realistically ambitious but achievable requirement for affordable housing provision alongside other developer contributions.

If the local plan policies are clear to all parties from the start, land will be priced by developers on that basis. This prevents landowners from forming unrealistic expectations of land values, removing barriers to delivery.

However, local authorities need to set requirements that are ambitious but will still produce reasonable returns for landowner and developer. In urban locations, this becomes more complex. Sites may already have an existing-use value that is higher than the residual land value for housebuilding, or a sale for an alternative use such as distribution would give the landowner a better return.

If government is too aggressive in using affordable housing without providing any additional grant funding to boost build-out rates and seeking other developer contributions, the unintended consequence may be to remove the incentive for land to come forward for housing at all.

> “Higher land supply has been seen to moderate development land value growth”

AFFORDABLE HOUSING
We estimate sub-market housing need at 100,000 homes per year in England. Since 2013, delivery rates have averaged 45,000 homes per year, with the majority of the shortfall in London and the South East.
It would take at least £7 billion of grant funding each year to provide social rented homes to all of those in need of sub-market housing.
Current funding is £9 billion for the 2016-2021 period.
We await the final policy recommendations of the Letwin Review to see if there are any proposals to fill this funding gap. There have already been positive signals with the recent announcement of a further £2 billion of funding after 2021.

IS COMPULSORY PURCHASE THE ANSWER?
It has been suggested that using a lower basis of compensation payable under compulsory purchase powers, or the threat of it, would be enough for landowners to accept significantly lower land values. However, the scale of housing development required to meet need (300,000 homes each year in England, 14,000 in Wales and 25,000 in Scotland) means that using compulsory purchase would be expensive, time-consuming and it is doubtful that local authorities and Homes England would have enough resource to do so.

63%
The 13 largest housebuilders built 63% of new homes completed last year

How do we reach 300,000 homes? And who will build them?

Housebuilding levels have increased, but are still below the government's target to build 300,000 additional homes in England per year by the mid-2020s

We estimate that 218,000 net additional dwellings have been delivered in England in 2017/18 – similar to the previous year when 217,000 homes were added.

The number of new homes built in England in 2016/17 was 184,000, which, given the plateauing net additional dwellings, is likely to be similar for 2017/18. In the year to March 2018, 6,700 new homes were built in Wales and 17,000 were built in Scotland.

Large housebuilders

The large housebuilders build the majority of new homes in Great Britain. Those building over 2,000 homes per year built 63% of the new homes built by housebuilders in 2017 according to NHBC. Their output has grown considerably since 2009, exceeding their 2007 levels by 4%. Since 2008, output from this group has grown at an average rate of 9% per year. During the past year, growth has been slightly moderated, averaging 6.1%.

We expect controlled growth, at the current rate of 6% per year on average, to continue for the next three years. We base this on the latest trading updates and annual reports issued by housebuilders.

Medium housebuilders

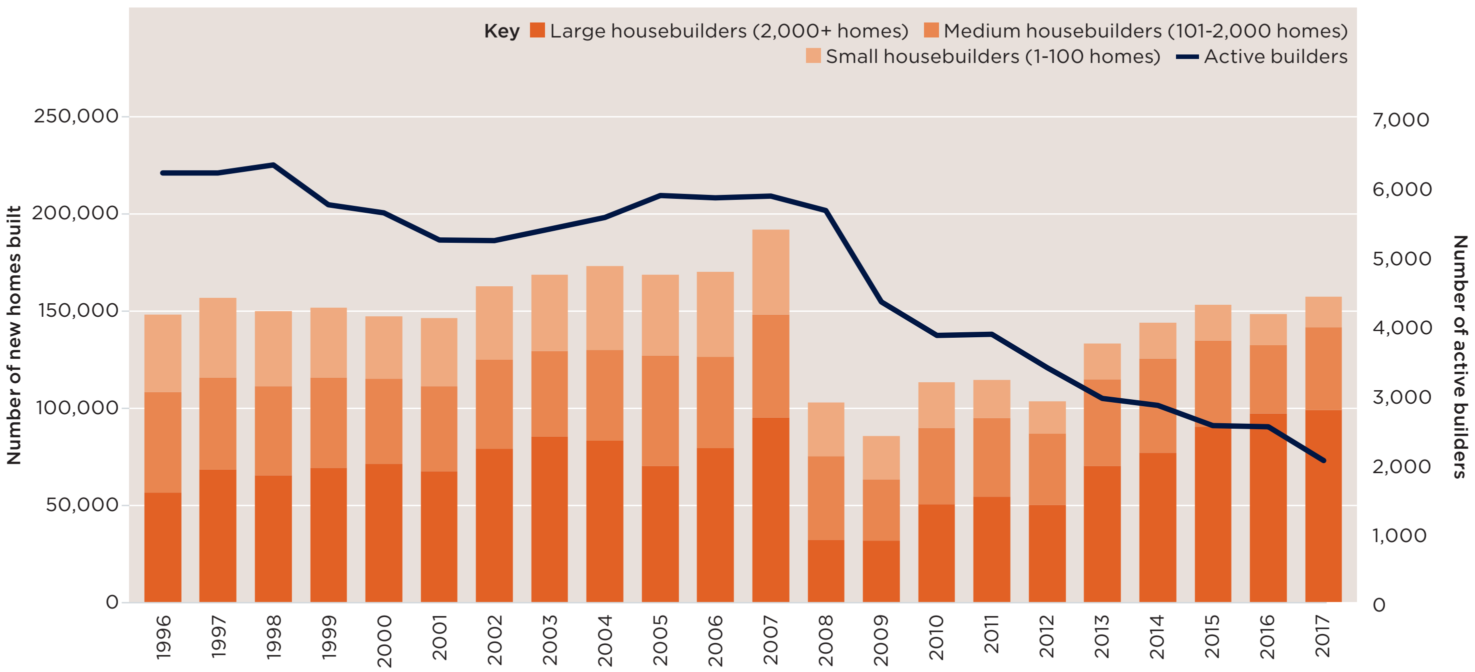
Medium-sized housebuilders have recovered more slowly than the large housebuilders and output from this group is still 20% below its 2007 peak. However, they have been building more homes, increasing by 4% per year on average, since 2009, and have also become more active in the land market, suggesting ambition to continue expanding. In 2017, medium-sized housebuilders bought 54% more plots through Savills than in 2015.

While some medium-sized housebuilders may merge or be bought by larger companies, others have been showing significant growth. The smaller ones, in particular, are able to benefit from the Home Building Fund. Therefore, we estimate that their output will continue to grow in line with larger housebuilders at the rate of 6% per year for the next three years.

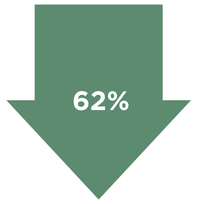
Small housebuilders

The number of smaller housebuilders has reduced significantly since the global financial crisis. There are 72% fewer of them registered with NHBC and collectively they are building 62% fewer homes

Homes and builders The number of new homes and active builders since 1996 (GB)

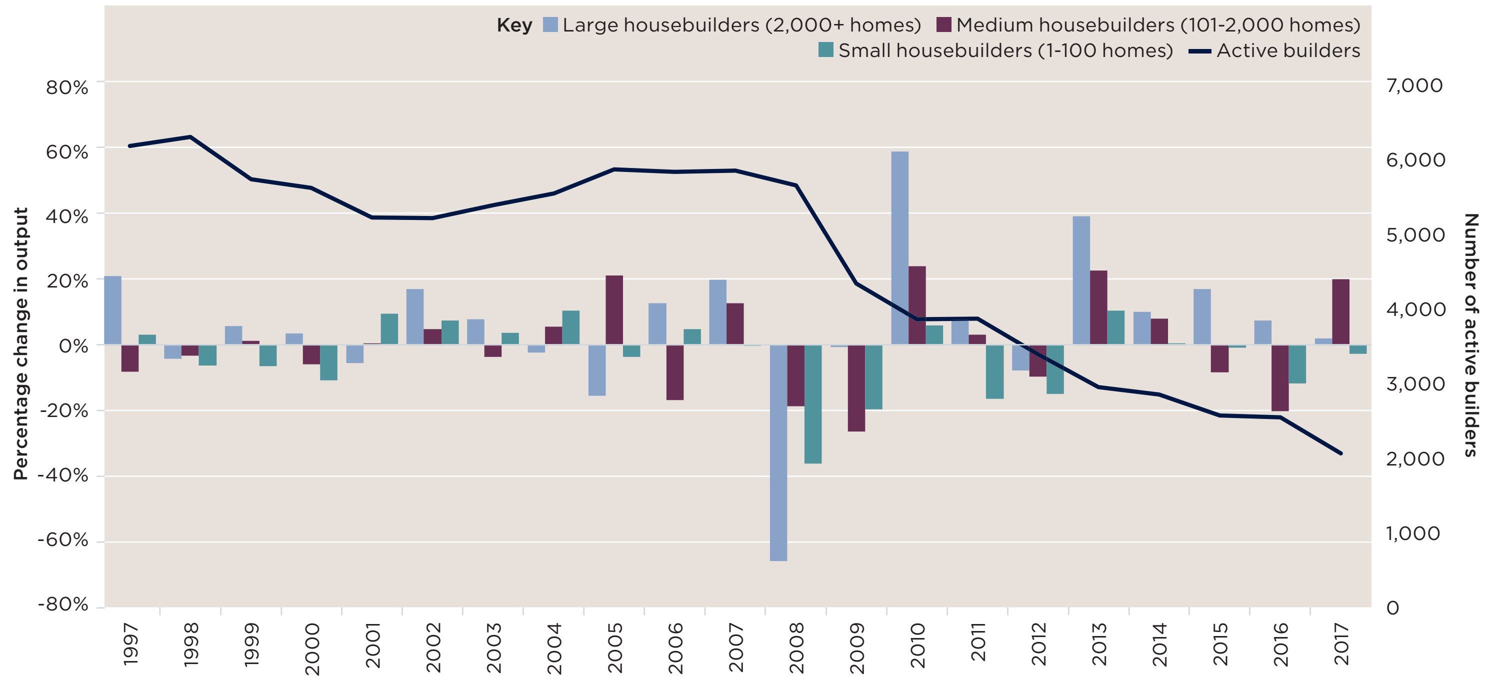


Source NHBC



Since 2007, the output from small housebuilders has fallen 62%

The impact of the GFC The percentage change in output for housebuilder type (GB)



Source Savills Research

than in 2007. Access to finance and relatively higher costs for planning and materials due to a lack of economies of scale have been particular challenges for small housebuilders.

However, the £3 billion Home Building Fund is intended to benefit smaller housebuilders who would otherwise be unable to progress quickly, if at all. The fund has been heavily oversubscribed, however the majority of these funds, as of December 2017, had not yet been fed into the market.

We expect smaller housebuilders to draw down this funding over the next three years, supporting growth over the period of 10% per year. Further support is being directed at this sector with the recent announcement of a £1 billion loan financing fund from Barclays and Homes England.

In 2017, just 13 housebuilders built over 60% of new homes in England. With the Letwin Review calling for a greater number of builders on development sites to help create natural variation in product, we need to see continued support for smaller housebuilders to partner with larger housebuilders on sites.

Housing associations

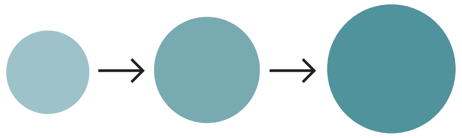
Nationally, housing associations built 17% of new homes and have ambitions to increase output. With limited grant, they need to cross subsidise affordable product with development of homes for private sale.

The top 50 housing associations plan to build 43% more homes per year in 2020/21 than they did in 2016/17, reaching 50,000 per year. The eight Strategic Partnerships announced so far by Homes England, with a second wave to come, will help achieve this. The associated increase in scale and flexibility of funding will help this sector meet the demand for affordable housing as well as delivering private homes to cross subsidise the affordable.

Build to rent

The build to rent sector is growing fast, with completions increasing by 50% per year over the last three years. As the sector becomes more established this trend should continue. Around 7,000 new build to rent homes were completed last year and we expect that completions could reach 15,000 by 2021.

> "The top 50 housing associations plan to build 43% more homes per year in 2020/21 than in 2016/17 – reaching 50,000 per year"



50%
Supply from the build to rent sector has grown by 50% per year over the last three years

Local authorities
Local authorities built 3,450 new homes in Great Britain last year. In England, the 1,870 new homes built last year by local authorities represented just 1% of supply and has remained at similar levels in the last eight years according to MHCLG. However, in Scotland and Wales, 41% more homes were built by local authorities in 2017/18 than the previous year.

The removal of the HRA borrowing cap in England will enable local authorities to deliver more homes. With prudent long-term planning, we estimate that authorities could release between £10bn and £15bn of extra borrowing capacity. However, many will need to establish a land pipeline and build up construction capacity. We expect local authorities could deliver up to 5,000 homes a year in England by 2021.

Other additions
The total number of homes added to stock each year includes conversions and change of use as well as new build. This other supply has increased by 33% per year over the last three years. Since permitted development rights (PDR) came in, this supply has been equivalent to 24% of the number of new build completions.

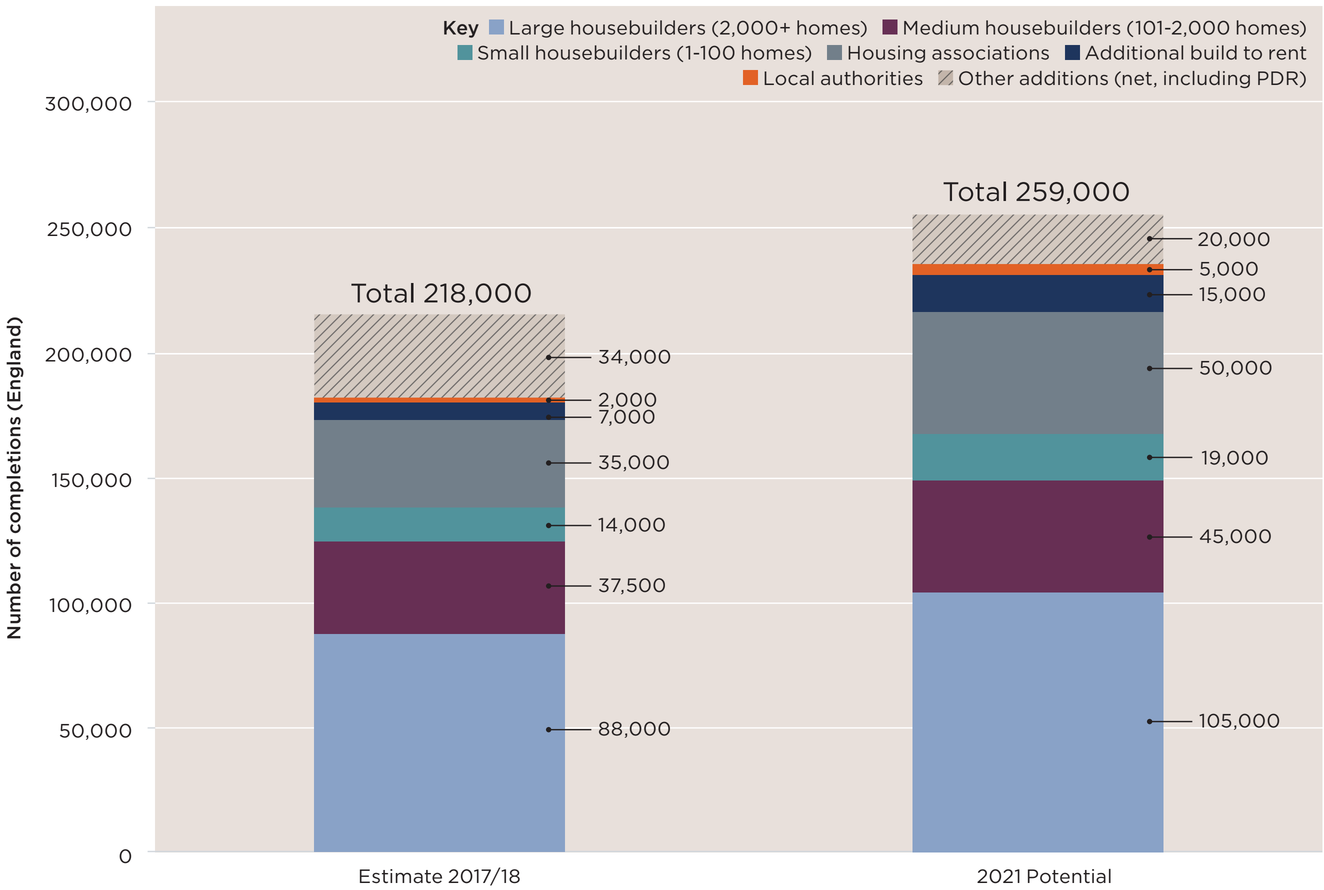
Change of use has increased significantly since PDR allowed the conversion of office buildings to residential. However, the supply of this type of home is not unlimited and in many key cities the majority of viable conversions have been made.

Applications for prior approval for permitted development of office to residential in the year to March 2018 have fallen to 60% of what they were three years ago. We expect the decline to feed through in the number of homes completed through change of use over the next three years.

On track to reach 300,000?
In 2017/18, the number of additional homes built in England plateaued, after five years of strong growth since 2013. However, we think that housebuilding will increase to 260,000 a year by 2021, progressing towards the 300,000 goal.

The target should be achievable by the mid-2020s. However, it will require ongoing government support and collaboration to bring together public land and capital and private sector expertise to boost delivery.

How completions stack up New home completions in 2018 against the potential for 2021



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