

THE IMPACT ON RESIDENTIAL DEVELOPMENT

Brexit Briefing



THE LONG VIEW

The housing market remains undersupplied.
We need to build around 300,000 new homes a year



SUMMARY

Brexit will not solve the housing crisis. Policy flexibility and Government support is crucial

■ **Long-term demand:** low levels of house building have resulted in a market that is fundamentally undersupplied. The housing crisis is a long-term structural issue which is not limited to population growth alone. Even with substantial falls in net migration, we will still require around 300,000 new homes a year.

■ **Short-term sentiment:** having a new prime minister quells some uncertainty but sentiment will still fluctuate as negotiations to leave the EU proceed. We expect to see lower transaction volumes and weaker house price growth in the near-term.

■ **London:** we have seen steady sales of prime new homes with some renegotiations of between 5% and 10% off the agreed price. New build sales rates have been slowing for the past 18 months with greater reliance on take up by PRS operators. However, the fall in sterling has prompted more interest from overseas buyers.

■ **Outside London:** since the vote, sales are marginally down but pricing has held firm with little evidence of developers offering discounts.

■ **Development finance:** the availability of development finance

could be at risk. Government must be ready to unlock this potential barrier to maintain momentum in housing delivery.

■ **Government policy:** house building will play a significant part in the new Government's wider economic strategy. To maintain housing delivery, we need: the continuation of schemes such as Help to Buy, help with development finance, more planning consent in areas of high housing demand and policy flexibility surrounding affordable housing tenure.

→ Leaving the EU will not solve the housing crisis

The housing market remains undersupplied and we still require 300,000 new homes a year

Low levels of house building have resulted in a market that is fundamentally undersupplied. The prospect of leaving the EU and projected falls in net migration has not changed this.

The housing crisis is a long-term

structural issue resulting from a range of factors, including but not limited to population growth.

Other contributing factors to the housing shortfall would still remain and may be exacerbated. We require around 300,000 new homes a year in England taking into account the backlog resulting from years of undersupply since the credit crunch.

In the year to March 2015, we delivered 171,000 net additional

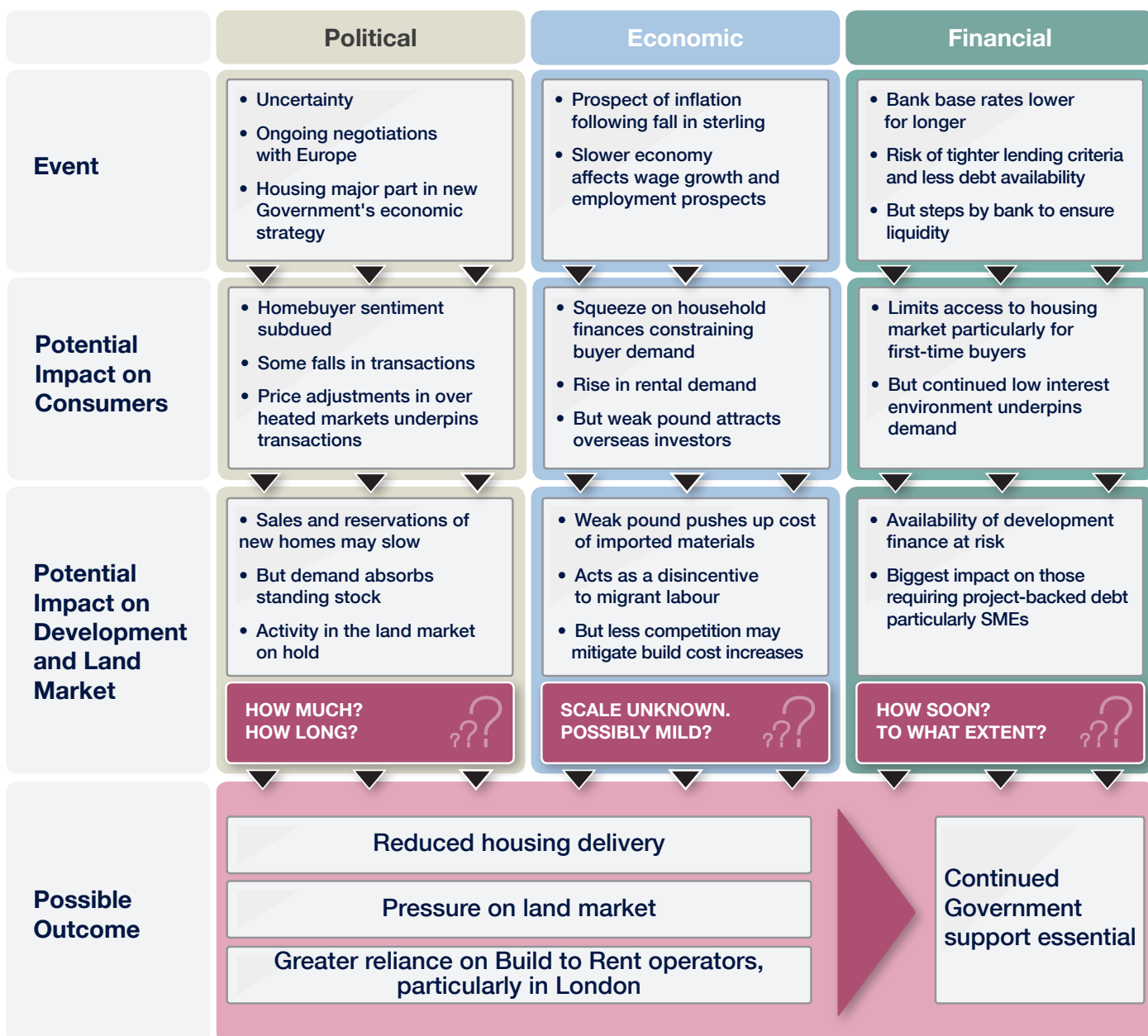
homes. This is a major improvement on the previous year's figure of 137,000. Residential developers had begun to build momentum.

However, there is still a significant shortfall in housing need. It is therefore crucial that the Government and the newly appointed housing minister, Gavin Barwell, take steps to prevent short-term political uncertainty and potential economic slowdown dampening housing delivery.



FIGURE 1

Political, economic and financial effects of Brexit on residential development



Source: Savills Research



→ Short-term sentiment

In the short-term, sentiment is likely to fluctuate as negotiations to leave the EU proceed

The appointment of Theresa May as Prime Minister has helped quell much of the uncertainty that followed the result of the EU referendum. Mrs May has already stated that infrastructure, energy and housing policy will play a major part in her economic strategy to tackle Britain's low productivity.

The fact that housing remains on the political agenda is welcome news in terms of meeting the challenge of delivering homes. Support for construction of infrastructure and housing will also provide employment to mitigate the prospect of slower economic growth.

However, over the coming months we expect sentiment will ebb and flow as negotiations to leave the EU proceed and the implications of the change on different parts of the UK economy become clearer.

Given buyers' reluctance to commit to a major capital purchase in times of uncertainty, we expect transaction levels, which reached a post-credit crunch high of 1.3m over the past year, to fall. Less activity is therefore likely to impact on house price growth, which has already been slowing at national level, according to most indices.

New homes sales

Activity is slower but so far no real impact on pricing outside London

It is still too soon to fully analyse the impact of the vote on the sale of new homes. Early indications reveal a mixed picture. Some house builders have reported strong sales since the referendum.

Savills agents report that the number of sales in the three weeks immediately following the referendum is marginally down compared with the same period last year. But the fact that there were few launches in the aftermath of the referendum partly explains the decline.

Taking the longer view, the number of Savills new build sales in the year to date is 17% higher than the previous year. Outside London, pricing has held firm so far with little evidence of developers offering discounts.

Looking ahead, a slowdown in the property market as a result of a more sluggish economy could potentially slow the rate of new homes sales.

Independent of Brexit, other factors were already expected to impact on the new homes sales market this year. These include the recent stamp duty changes which brought in a surcharge on investor and second home buyers and upcoming changes to the tax deductibility of landlord's expenses.

New build in London

In London, sales of new homes have held up better than expected. Momentum has been maintained with renegotiations of between 5% and 10% off the agreed price

These adjustments must be seen against the backdrop of a London development market moving into the next phase of the cycle.

The number of both new build sales and housebuilding starts have been declining for the past 18 months, whilst the number of completions has gradually increased and has now overtaken sales and starts for the first time since 2012 (see Fig 2).

After a prolonged period of strong house price growth, affordability in the mainstream London market is stretched which is likely to limit future demand and curb further house price growth. →



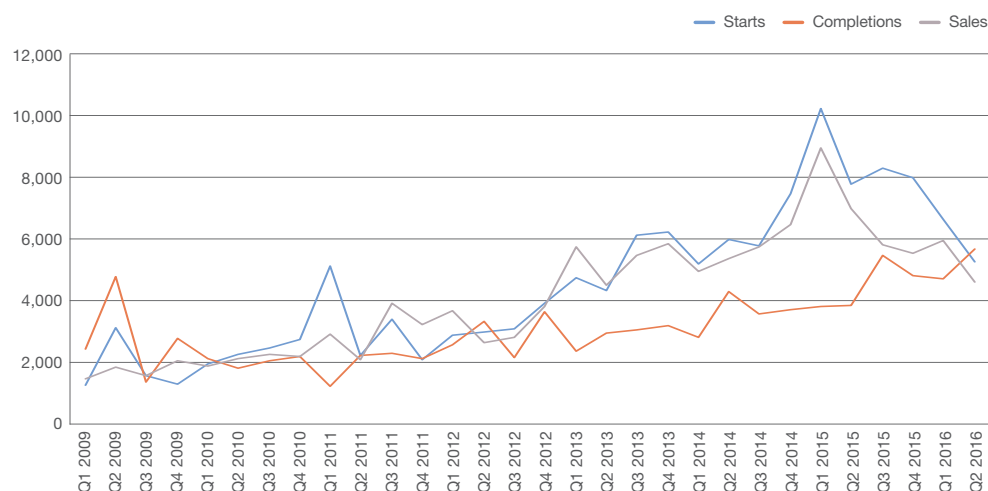
DEMOGRAPHICS AND HOUSING NEED

The 2014-based household projections recently released by the DCLG which anticipate the formation of 210,000 new households a year in England. Based on current rates of vacancy and second home ownership, this is the equivalent to a need of 219,000 new homes.

The household projections are based on the official population projection which already assumed large falls in net migration to England even before the referendum. They anticipate a sharp reduction to 165,000 a year by 2021 from almost 300,000 in 2015.

The housing shortfall since the economic downturn adds up to just over 410,000 new homes. Given this backlog, addressing the housing crisis within this parliament would require a housing target of about 300,000 new homes.

FIGURE 2
Completions are now higher than starts and sales in London



Source: Molior London



➔ Demand in the prime markets has already been affected by the accumulation of a series of tax changes aimed at wealthier and overseas purchasers. These include higher rates of stamp duty, greater exposure to capital gains tax and pending changes in the treatment of non doms.

In central London we have seen a fall in sterling stimulate some new international interest in the new build market. In previous cycles, weak sterling and resulting international interest acted as a catalyst for market recovery. This time round, overseas buyers will have to weigh up currency incentives against a less hospitable tax environment. However, London still remains competitive and attractive on the global stage, which will continue to act in its favour.

Slower sales of new build were already resulting in greater reliance on take up by PRS operators. There is a wave of money looking to enter the UK's private rented sector and the shift in the market represents opportunities. There is also political support. James Murray, Deputy Mayor for Housing, has identified Build to Rent as key to addressing housing shortfall and has been meeting investors following the referendum.

Land market

Uncertainty has subdued sentiment in the land market although good offers are still being made for the best sites. A survey of Savills land agents across the country shows that sentiment shifted from positive to neutral following the vote. Agents report that uncertainty is prompting house builders and promoters to slow their land buying activities.

Many house builders have a strong pipeline of land at present and can afford to wait for a few months to establish where the market is heading. We have seen some early signs of a more risk averse approach to purchases with land buyers increasing their buying profit margins and hurdle rates. We are still receiving a range of offers for development sites. Some developers have a more cautious approach to terms and are increasingly considering deferred payments.

Ahead of the referendum, activity in the land market was steady and values for

urban land were growing at a slightly faster rate than greenfield land.

Savills land index showed that urban development land values increased by 1.3% in the second quarter, up from 1.0% in the first quarter, bringing annual growth to 4.1%. Greenfield values saw little change with values rising by 0.7% over the second quarter compared with 1.0% in the previous quarter. Annual growth stands at 2.2%.

Construction & Labour

The fall in sterling will impact on cost of materials and availability of labour

The depreciation of the pound means that the cost of importing construction materials has increased. For developers with a stockpile of material, there will be no impact in the short term.

However, further down the line pricier replenishments sourced from outside the UK will put pressure on builders' margins and land values.

A weaker pound will also act as a disincentive to migrant labour, even before discussions regarding the free movement of EU nationals and the reduction of migration to the UK take place. With fewer builders around, the cost and availability of labour, which was already an issue pre-referendum will be exacerbated.

However, increases in build costs could be offset by weaker demand for labour and materials should house

building slow as a result of weaker new build sales.

Interest rates & lending

Availability of finance is key to maintaining house building delivery

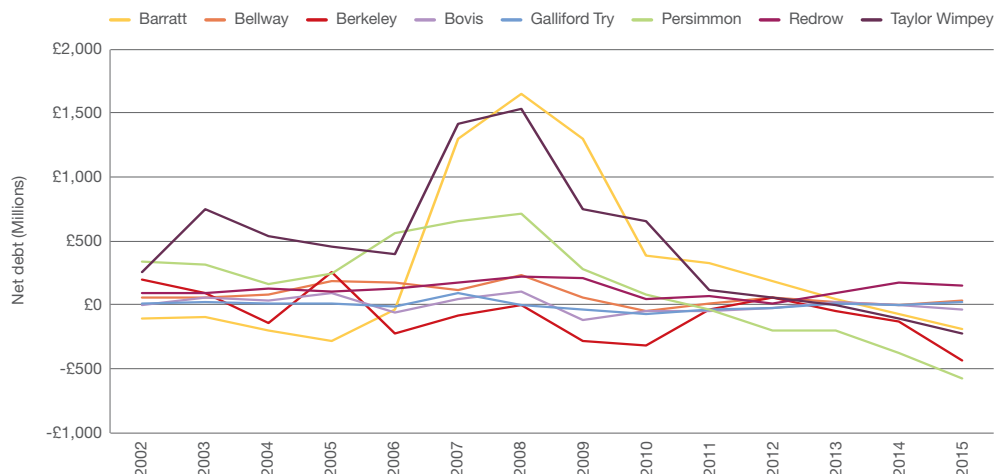
Ensuring liquidity in the lending markets is a key objective for the Bank of England at the moment. It has already taken steps to facilitate lending by easing capital requirements for banks, potentially freeing up £150 billion. There are currently suggestions that the Bank is considering further stimulus measures alongside a rate cut this summer.

In contrast to the 2008 financial crisis, banks are well capitalised after almost a decade of reform and regulation. However, what their appetite for risk will be as Brexit unfolds, is not yet clear.

In the consumer markets, we have seen the launch of mortgages with extremely low rates but these have been accompanied by high loan-to-value requirements. A more cautious approach from lenders aiming to limit riskier deals would affect new borrowers and particularly first time buyers in markets where affordability is stretched. This would act as a drag on demand.

With uncertainty surrounding the property market, development finance could be at risk. Lack of funding would particularly affect small and medium builders that are ➔

FIGURE 3
The quoted house builders have reduced reliance on debt



Source: Thomson Reuters



→ reliant on project-backed debt and result in fewer homes being built.

Less availability of debt to SMEs will therefore put greater pressure on the largest house builders to deliver even more housing. The majors are in a much stronger position than they were in 2008 when high levels of gearing left them exposed to the downturn. Today most have lower levels of net debt, built up a pipeline of land and have access to corporate borrowing facilities (see Fig 3). This enables them to continue delivery assuming demand holds steady.

Conclusion

Support from the Government will be essential to maintaining housing delivery

The Conservative Government's aim to build one million homes in this parliament is ambitious but necessary. The challenges ahead will test that resolve. Given that housing need will not change substantially with Brexit, Government support to ensure the continued delivery of housing is essential.

Support must come in several guises, such as the continuation of schemes such as Help to Buy, help with development finance, more

planning consents in areas of high housing demand and policy flexibility surrounding affordable housing tenure.

The Help to Buy equity loan, which launched in 2013 just before the market picked up, has played an important role in supporting the sales of new build homes. The equity loan has accounted for 27.3% of all private completions since its inception and supports around 40% of sales among the major house builders. It is essential that this successful demand-side measure continues as Brexit negotiations unfold.

On the supply side, the Government needs to be ready to unlock any potential barriers to development finance to ensure that builders reliant on project-backed debt continue to deliver. We also need more land to come forward in areas where housing take-up is greatest.

Lastly, Government policy must allow for greater flexibility of tenure in the planning system to help ease the ebbs and flow of homebuyer demand. Current Government policy aims to deliver 400,000 new homes aimed at affordable home ownership including 200,000 Starter Homes and 135,000 homes for shared ownership.

Although we are still waiting for further details on the mechanics of Starter Homes, the introduction of this product as a form of affordable housing alongside shared ownership, assumes consistent strong demand from individual homebuyers. Post-referendum this is less of a certainty and developers of all types, from the major listed house builders to housing associations must be allowed the flexibility to reposition schemes and provide for the tenures that are needed.

Ultimately, it will be the success of Theresa May's wider economic strategy that will determine the health of the property market and consequently the continued delivery of housing. Support for infrastructure, construction and house building has the potential to play a large part in stimulating the economy by providing jobs, unlocking opportunities for further development and providing much needed homes. ■

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