

THE UK MAINSTREAM RESIDENTIAL RECOVERY - FROM UNDERWATER TO DRY LAND



All of the messages in the market for the last 12 months have centred on how London's prime housing market has 'decoupled' from the balance of the UK. The wealth of foreign investment which has flooded into the capital on the back of weak Sterling, and the global desirability of a London address (as a home or investment) has fuelled the top end of this market.

Looking at the state of the mainstream housing market across the UK regions however, tells a different story.

Although some UK markets have seen a small recovery since 2009 these are yet to reach 2007 peak sales figures. The UK has been in a largely deflationary sales market in the UK since the fourth quarter of 2007 and by the second quarter of 2008 the same has been true of construction costs.

To gain a better understanding of the correlation between the sales market and construction costs, EC Harris and Savills have conducted specific market research (using real project data) to extrapolate gross margin* positions over an 8 year timeframe, from the peak of the market in late 2007, through to the projected scenarios of schemes completing in 2015. These profiles effectively show the shape of viability and the recovery for the chosen scenarios as follows:

- Inner London (all projects)
- Inner London (high rise)
- Outer London / Home Counties (all projects)
- Outer London / Home Counties (low density)
- Provincial Town / City (all projects).

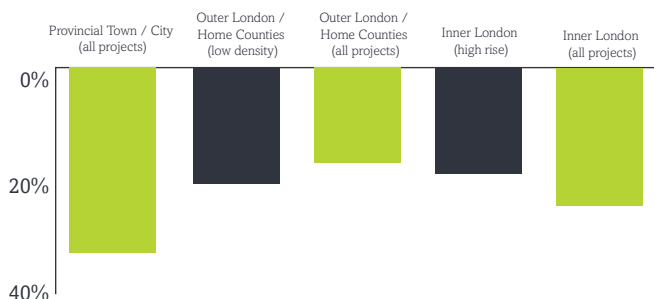
"South East England and Home Counties markets will lead recovery, non prime London is following with provincial UK towns and cities lagging behind."

Mark Farmer - EC Harris

The above profiles represent a fair spectrum of property product and locations. It is not meant to be an exhaustive list but has been selected to specifically observe whether there is any polarisation of viability between London, South East and the rest of the UK as well as the sensitivity of scheme density/type.

As predicted, research shows that there has been marked drops in gross margin on all types of residential schemes studied for completion between third quarter 2007 and third quarter 2009. What is interesting is that the level of drop experienced does vary.

Gross Margin Falls (as % of 2007 peak)



These drops reflect the offsetting of an element of the absolute GDV falls by a reduction in build costs that has occurred over the same period. These figures are therefore weighted to reflect build cost versus sales value and not just absolute sales value drops. The dramatic fall in provincial town/city viability is still telling and shows despite construction cost falls, viability has been seriously impaired in the last three years.

However, what is interesting is the relatively lower level of gross margin attrition for Outer London and Home Counties projects compared to Inner London. This suggests that outside of the prime segment of the market, there was a significant drop in sales values for main stream London product. This could be due to the correction of the over developed areas of East London, including Docklands and the collapse of the buy to let model that was driving a large element of this market. The fallout of this will hopefully be a future market driven by sustainable end user demand and not speculative investment that we have seen in the past.

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The shape of recovery

Our analysis shows that schemes will not return to the absolute levels of gross margin achievable at the peak of the market in 2007 until:

Date of return to 2007 peak Gross Margin (£ total)	
Inner London (all projects)	early 2015 completion
Inner London (high rise)	early 2014 completion
Outer London / Home Counties (all projects)	late 2013 completion
Outer London / Home Counties (low density)	late 2014 completion
Provincial Town / City (all projects)	early 2016 completion

Alternative uses for sites

For those with committed land assets bought at the top of the market and wanting to avoid a write down, there is still a long way to go before they are able to develop at the originally intended levels of return. In the case of provincial towns and cities this might mean deferring commencing development for at least another 3-4 years. In many instances developers will need to be looking hard at alternative uses for such sites, innovative funding or new revenue solutions, to ensure a return on investment.

A changing buyer profile

There has been a shift in buyer profile and ultimately a change in stock. Those buyers that we expect to be most active within the new build sector in the short to medium term are the owner occupiers rather than the investors. Therefore, developers looking to build out stock may find that sales off plan are harder to come by because owner occupiers prefer to buy at, or close to completion. The units proposed pre downturn that were targeted at investment purchasers may be smaller in size and lower in specification than those most desired by the owner occupier. Building the right stock, for the right occupier is vital in this market.

“In the London mainstream market this exercise confirms that percentage return viability has already returned to enable schemes to be actively committed to build for completions in 2012-2013.”

Gross Margin percentage of GDV

We also looked at the Gross Margin as the percentage of GDV and this approach creates a slightly different time profile for return to peak of market viability (see below), which is not linked to historic cash commitment that may have been made on a site.

Date of return to 2007 peak Gross Margin (% of GDV)	
Inner London (all projects)	late 2013 completion
Inner London (high rise)	early 2012 completion
Outer London / Home Counties (all projects)	late 2011 completion
Outer London / Home Counties (low density)	late 2013 completion
Provincial Town / City (all projects)	early 2014 completion

In the London mainstream market this exercise confirms that percentage return viability has already returned to enable schemes to be actively committed to build for completions in 2012-2013.

Viability has returned even quicker for Outer London and South East England, indicating that this market should be active. Provincial town and city markets however still appear to be in a two year period of hibernation before percentage levels of returns on scheme completions will recover to peak market levels.

Those developers looking to take advantage of the forecast lack of new build stock coming to market over the next few years will face a number of challenges including the right product in the right location, rate of sale assumptions, phasing and most importantly the ability to secure debt funding.

Project Funding still dictates the market

This exercise cannot quantitatively factor in the major issue of project funding which is still in many respects dictating the market. The absolute focus on levels of equity now needed to advance schemes and the de-risking expected by lenders can often be the over-riding factor in unlocking real viability**. However this analysis hopefully illustrates some of the market mechanics and fundamentals at work and the relative speed and shape of recovery across a selection of UK residential markets.

The key consideration is the return to development fundamentals that is now required to ensure individual sites are identified based on real demand in terms of location and product. Exercises such as ours, by their nature can paint general trends and broad pictures, but the UK residential purchaser market is likely to be very exacting going forward and this will make the success of every scheme dependent on the diligent matching of local supply and demand. More bespoke research, interaction with potential customers and pushing quality relative to price point will need to be undertaken.

Outer London and Home Counties markets would appear to be in recovery before elements of the mainstream Inner London market, perhaps reflecting the move towards less urban living and the more difficult nature of urban regeneration. It is also true that elements of the mainstream (non prime) London market which involve high rise development, although showing an accelerated return to paper viability according to our analysis, will still struggle to achieve funding due to the lack of phase ability, and the cash flow and sales risk penalties inherent with this kind of development. This has to be a major caveat to all vertical high density development, that does not enable appropriate 'hold points' that respond to sales rates. Consequently developers, in the London and South East market, are now looking for smaller sites in established areas to lower the risk over a short time frame.

For those who have historic land purchase commitments from the peak of the market the journey back to being above water has been, and in some instances is continuing to be, a painful one. Nonetheless there are still options available to unlock viability either through partnerships with Registered Providers, the Public sector or by accessing the remaining housing delivery being promoted by the HCA initiatives in the UK.

The summary

There is clear evidence that when looking at the reality of sales value movement, tempered against the considerable build cost reductions over the last two years, the relative level of viability corrections (18% - 35%) have not necessarily been as dramatic as often headlined but is still significant. It captures the considerable long term adjustment that appears to have taken place especially in the provincial town and city markets.

What is clear is that in addition to location and development fundamentals, timing is crucial, both in terms of establishing and stress testing viability to prove a business plan to funders and also in formulating medium to long term strategies for land acquisition and development.

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*gross margin = gross development value less construction costs

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