RESIDENTIAL RESEARCH

SECOND HOME REVIVAL

New-build second homes report 2010

Knight Frank

NEW-BUILD SECOND HOME REVIVAL 2010

Growing demand for new-build holiday homes in the UK

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Second home developments have been one of the brightest spots in the UK new-build market through the recession and now into the recovery. Liam Bailey, head of residential research at Knight Frank, examines the reasons behind the health of this sector.

The second home market was one of the most resilient sectors of the housing market throughout the recent recession surprisingly so, perhaps. In the property slump of the early 1990s second homes value were hit hard as high interest rates forced owners to sell. This time around there has been no big sell-off of second homes. After a slight decline of 0.4% in 2008, the number of second homes in Britain rose by 2.6% during 2009 to reach a record high of 245,384, we expect to see a further 2% rise in the total to more than 250,000 in 2010 (see figure 1).

There are several reasons for the faster rebound in demand for second homes this time around. Interest rates are much lower than they were in the early 1990s, which has reduced both the cost of acquiring property and the attraction of keeping money in cash. While credit has been severely constrained for homebuyers requiring high loan-to-value ratios, wealthy investors with large amounts of equity have been able to take advantage of low financing costs.

The recovery from the recession has coincided with a trend for taking holidays in the UK – in spite of a succession of three damp summers between 2007 and 2009. The fashion for 'staycations', as holidaying in the UK has been dubbed, has been inspired partly by a weak pound and partly out of environmental concerns. Holidaying in the UK is now widely considered a 'green' option, especially when compared with long-haul destinations.

Equally important for buyers seeking an investment return on second homes, has been the development of a market for year-round holiday-lets. It used to be the case that holiday homes spent much of the off-season lying empty. They were a luxury from which it was hard to derive a significant income. That has changed. Increased demand for self-catering accommodation throughout the year has enabled buyers to look upon a second home as an investment rather than a luxury.

Investing in second homes has been made easier and more attractive by the emergence of managed holiday home developments. Owners do not have to manage lettings personally; this can be organised for them along with cleaning and maintenance. Several weeks' a year of personal use is often included in these arrangements. Such developments continued to sell throughout the recession, some of this demand coming from buyers who would have, until recently, bought a property overseas.

One holiday development in Dorset proved popular with parents of pupils at Sherborne School; they could use the properties when visiting their children, and rent it out during the holidays.

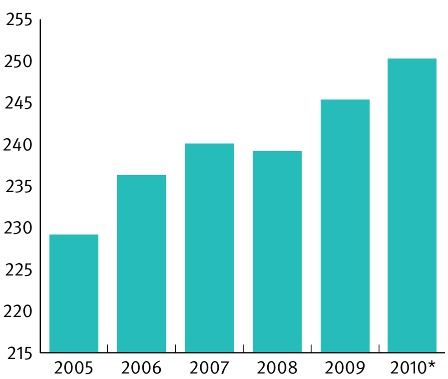
Two main types of managed holiday home investment have emerged in recent years. Holiday lodges are an upmarket reinvention of the traditional caravan or chalet park, with lodges built in contemporary design and with high quality fittings. Buyers usually purchase their homes, but not the land. Included in the price is a licence to occupy the site for a certain number of years. Unlike traditional caravan parks where buyers can find themselves obliged to buy a new caravan after as little as 12 years, holiday lodges typically come with a 125-year licence.

The other type of managed holiday home investment is the leasehold apartment, set in the context of a managed holiday complex or, as is increasingly popular, adjoining a hotel. Residents often enjoy full use of the hotel's facilities, yet have the privacy of a self-contained apartment.

The market for both types of development is likely to grow. The supply of cottages in popular second home locations remains highly constrained. In the popular second home hotspots of the south west, the supply of property in July 2010 was running at 20% below its long-term average.

Meanwhile, the demand for quality holiday accommodation continues to grow. Between now and 2020, the amount of money spent by Britons holidaying in Britain is predicted to grow by 2.6% a year in real terms. The amount of money spent by foreigners holidaying in Britain is predicted to grow even faster, by 4.4% a year. For developers selling holiday homes, and for investors looking to buy and rent out those properties, business is likely to be brisk.

Figure 1
Second home growth
Number of second homes, England (000's)



Source: Knight Frank Residential Research, DCLG
*Estimate

Second home investment economics

Self-catering holiday lets are the fastest-growing sector of an expanding UK tourist industry with a rapid growth in demand for apartments in particular. Changing demographic demand is also a factor shaping demand and influencing where developers should concentrate their efforts.

According to the ONS, in the three years up to the beginning of 2010, the number of nights spent by tourists in catered holiday accommodation in the UK grew by a modest 1.3% from 309m to 313m. However, the growth in nights spent in self-catering apartments rose by 67% to 9.2m and the number of nights in self-catering houses, cottages and lodges grew 20% to 20.8m (see figure 3 for a regional split). The amount of money spent in self-catering apartments also grew by 67% to £528m and that spent on self-catering houses, cottages and lodges grew 22% to £1.13bn.

In terms of age groups, the greatest growth in the tourist industry at present is accounted for by mature people in higher social groups. Spending by 55-64 year olds rose by 17.2% to £2.9bn and that by the over-65s by 26.4% to £2.2bn, in the three years to January 2010. As for social groups, spending by C2s, Ds and Es was fairly flat. Growth in spending by social group C1, on the other hand, rose 8.7% to £5.64bn and spending by groups A and B grew by 7.5% to £6.67bn.

In other words, the trend towards staycations is becoming increasingly concentrated at the upper end of the market. Much of the existing UK tourist infrastructure, however, is concentrated at the lower end of the market. This is especially true in coastal resorts, whose seafronts are still largely dominated by funfairs, chip shops and budget hotels, which are often busy during the summer season but lie vacant for much of the rest of the year.

One of the features of the growth in quality tourism is that it is spread much more evenly throughout the year. The biggest growth in tourism over the past three years has occurred in the late spring and early summer, between April and June. Strong growth has also been seen in September and October, as well as over Christmas and New Year.

Changes in holiday patterns have helped make investing in holiday accommodation much more attractive. Growing demand throughout the year is reducing void periods and boosting yields, with the result that good quality holiday lets in the right locations can now achieve higher yields than properties let on shorthold tenancies.

As might be suspected, for anyone booking a two-bedroom apartment in Cornwall for £1,200 at the height of the summer season, holiday homes can offer enticing rental yields. While few ordinary buy-to-let properties currently offer gross rental yields in excess of 5%, a holiday apartment in the West Country rented out for 32 weeks a year typically offers between 6% and 7% gross rental yield.

On the negative side are higher management charges. While an ordinary rental property might change tenants once a year, a holiday home will change occupier every week or two. Each time the property will need to be cleaned, the sheets replaced and any maintenance quickly undertaken before the next tenants arrive. Even so, the figures can be attractive to investors. The developers of St Moritz, a hotel with private apartments at Daymer Bay in Cornwall, have been able to guarantee investors a net return of 5% per annum for the first two years.

Rental yields on holiday lodges can be even higher than leasehold apartments. At one development, Indio Lake near Bovey Tracey, Devon, where holiday lodges sold for between £165,000 and £210,000, one lodge brought in £25,000 in rent in one year. Once management costs have been deducted, investors can expect a net yield of nearly 8%.

There is a key reason why returns for holiday lodges are higher than for holiday apartments or houses. Lodges are not normally mortgageable, but can be financed through a bank loan as you would get for a car, and so command lower selling prices than alternative properties of a similar size and quality.

Second homes and tax liability

The tax arrangements for holiday homes are in some ways more advantageous than those for other investment properties, and in some ways less so. New holiday homes are liable to VAT in cases where planning restrictions exist to prevent them being used as main homes. From the taxman's point of view a property which is restricted to holiday use is potentially a business asset. Sell the property after three years of ownership, however, and VAT is not chargeable.

The owner of a furnished holiday let is treated as a trader, with several advantages. Capital expenditure on property qualifies for capital allowances which currently include Annual Investment Allowances (AIAs), although the level of expenditure which qualifies for AIAs is being reduced in the latest budget from £100,000 to £25,000 from 1 April 2012. If a property earns less in rent than it costs to run, the deficit can be counted as a trading loss. In order to qualify for these tax advantages a property must be available for commercial letting for at least 140 days a year and must actually be let for 70 days. The property must not normally be occupied for more than 31 days in any seven-month period by the same occupant.

In his 2009 budget the then chancellor Alistair Darling proposed to do away with these advantages and treat furnished holiday lets as any other rented properties. But the change was later postponed.

The new coalition government has said that they will keep the tax advantages of furnished holiday lettings, though investors must not assume that this will last forever. Indeed, the Treasury has recently proposed in its **Furnished Holiday Lettings consultation document** that the rules should be changed. It is proposing that properties should be available for let 210 days a year and actually let for a minimum of 105 days. The final decision is expected after the 22nd October 2010 when the consultation period ends.

Development economics and planning insight

67%

The growth in nights spent in self-catering apartments in the UK between 2007 and 2010.

The most successful developments are those that manage to maximise year-round letting, with occupancies of 30 weeks or more per year. Rental yields need to be sufficiently high in order to offer the investor an attractive yield after management charges – which can account for a third of gross rental income – have been subtracted.

Several coastal locations have become year-round attractions, especially where there are good quality restaurants, coastal walks and scope for watersports with an extended season, such as surfing. Inland locations can attract visitors throughout the year where there is good quality countryside and towns with good cultural life nearby. In both cases, flexible letting out-of-season is essential to maximise occupancy. A favourite tactic is to divide the week into two: a long weekend, Friday to Sunday, and a short midweek break Sunday to Thursday.

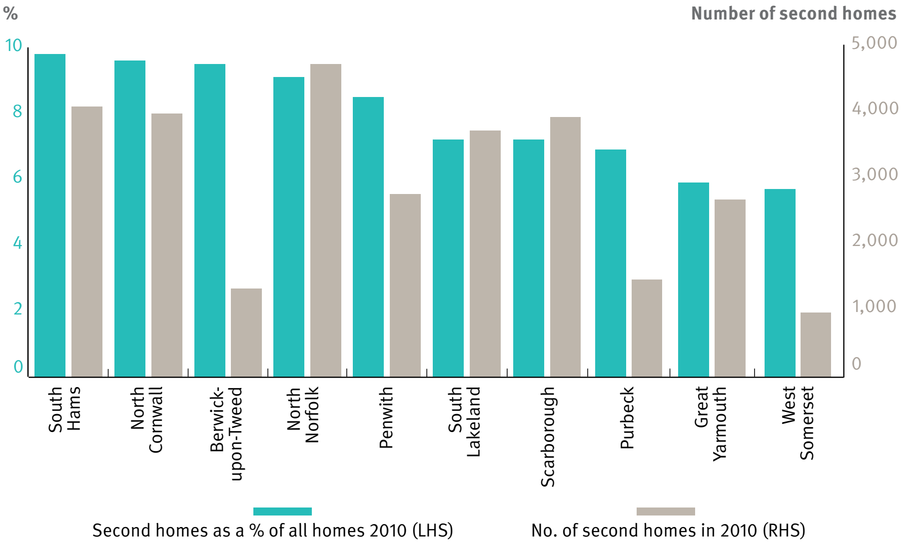
A popular route taken by developers is to buy up and transform faded and under-performing hotels. Such hotels are typically housed in grand Victorian buildings occupying prime seafront sites, for example the development 'At The Beach', which is featured on the front over of this report. Changing fashions are leading to an increase in demand for self-contained accommodation and a reduction in demand for traditional hotel rooms.

In some cases hotels have been entirely replaced with apartments, and in others a hotel-style operation continues but on a reduced scale. The combination of hotel and apartment development can help promote year-round occupancy. In some cases the two types of accommodation have been combined in a flexible format. At St Moritz, Daymer Bay in Cornwall, for example, investors buy a three bedroom self-contained apartment. But when they are not using it, two of the rooms can be closed off and used instead as hotel rooms, maximising rental potential.

There is no shortage of faded hotels around the coast. Upmarket developments are more likely to work, however, in locations that are not compromised by the infrastructure of the traditional 'kiss-me-quick' holiday resort. Newquay is typical of the smaller resorts that have achieved a more upmarket image in recent years. There are lots of other small scale, relatively unsullied resorts around the coast that have the potential for development of upmarket holiday apartments. Among them are Southwold and Aldeburgh in Suffolk, Broadstairs in Kent and Tenby in Pembrokeshire.

Holiday lodge developments tend to be located away from towns, in locations where a large part of the attraction is relative tranquility. These areas by definition lie in open countryside, often in National Parks or Areas of Outstanding Natural Beauty, where planning rules are extremely tight. Realistically, development is only possible on sites that are already developed. Former industrial sites such as quarries and gravel pits can provide an opportunity for offering planners the promise of environmental improvement – as well as providing ready-made lakes for amenity use. The site of the highly-

Figure 2
Second home hotspots
Top 10 rural and coastal second home locations, by local authority



Source: Knight Frank Residential Research, DCLG successful Cotswold Water Park was previously used for gravel extraction.

Another approach is to find an under-performing caravan park and to turn it into a holiday lodge development. The attraction of seeking existing caravan parks is that they have established holiday use. Although the planning designations for caravans and lodges are different, many authorities are willing to consider conversion, even though lodges are a more permanent form of structure than caravans and mobile homes.

Not every caravan park is suitable for conversion, traditional caravan parks that occupy prime seafront locations are often highly profitable, meaning that conversion to lower-density lodge developments does not make financial sense. There tends to be more potential for conversion for sites that lie a little inland, where demand for caravan holidays is lower. Indio Lake, a successful development of lodges near Bovey Tracey, Devon, for example, used to be run as a fishing business with just three caravan holiday lets. The developer won permission to increase this to a total of 12 lodges.

In spite of evidence of a growing market for high-quality dedicated holiday home developments, it is not straightforward at present for developers to take advantage of it. Planning rules, and the implications they have for VAT, at present make it difficult for many schemes to work financially.

Planners in one of the hottest markets, Cornwall, have been reluctant to grant permission for old hotels and caravan sites to be converted into houses and apartments unless the properties are subject to restrictions preventing them from being used as main homes. In many cases there are also restrictions preventing any one person from occupying them for more than six months at a time. The reasoning behind the rules is to protect the tourist industry, on the presumption that holidaymakers tend to spend more money in local restaurants and tourist attractions than do permanent residents.

Properties subject to restrictions limiting them to being used as second homes are viewed by the taxman as business assets – and therefore liable for VAT. Where restrictions are in place it becomes much harder for potential purchasers to obtain mortgages. In 2008 there were a dozen lenders prepared to advance loans on such properties. By the spring of 2010 that had fallen to just one lender.

With few buyers able to obtain finance and prepared to spend the extra 17.5% which must be added to the purchase prices, developers have been struggling to get the figures to add up. In Newquay alone there are 20 sites lying vacant because the planning rules have made development unattractive.

In cases where developers have managed to obtain planning permission without the restrictions, the situation is very different. At Bredon Court in Newquay, where the developer managed to obtain planning permission without holiday home restrictions, all 33 apartments sold quickly in 2009. At a similar development in the town, but with holiday home restrictions, few were sold. Yet the absence of holiday home restrictions at Bredon Court made little difference to the local tourist economy. The vast majority were in any case bought in order to be rented out.

In Newquay, several developers are negotiating with planners in order to try to get holiday restrictions lifted. This involves agreeing to fund off-site affordable homes in return for redesignating homes for year-round use. The holiday properties would then no longer be liable for VAT and investors would find mortgage finance more readily available.

At present, high-quality holiday home developments are concentrated in the south west. We believe that this trend is likely to spread. Developments are more likely to succeed if they offer year round accessibility. Sites within 90 minutes of large cities are most popular and have an advantage in this respect. The locations where developments are likely to succeed are those that already have high numbers of second homes – places where existing second homeowners might be tempted to swap a drafty and expensive-to-maintain cottage for a stylish well-built lodge or apartment with a regular income stream (see figure 2).

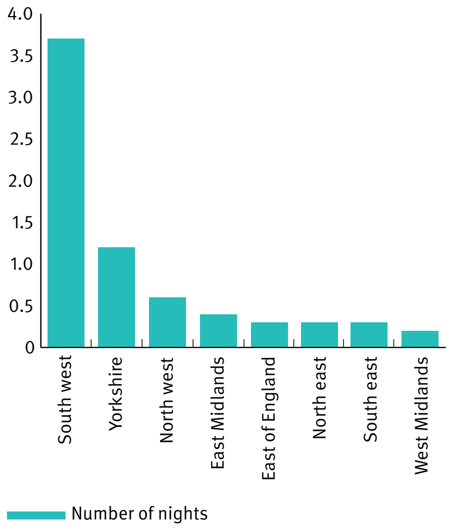
In addition to the already popular west country, which has become more accessible as a result of flights to Plymouth and Newquay and the upgrade of the A30, other locations which fall into this bracket include north Norfolk, the east Suffolk coast, Pembrokeshire, North Yorkshire, the Northumbrian coast, Cumbria, Herefordshire and Shropshire. The success of the Cotswold Water Park has shown that schemes can work away from the coast.

Obtaining planning permission in attractive countryside and coastal locations is not going to get easier, but dedicated holiday home developments can be popular with planners where they bring environmental improvements at the same time as maintaining employment. Worked-out quarries and gravel pits are particularly enticing opportunities. Existing but under-performing caravan and chalet parks also provide potential for development, so long as developers can make the case for replacing temporary structures with more permanent dwellings.

Figure 3

Accomodation in demand

Growth in self-catering accommodation demand, by region, 2006 to 2009 (m)



Source: Knight Frank Residential Research, Visit England

Case Studies

Pearl
Newquay, Cornwall

2 bed apartment
£385,000-£455,000

3 bed apartment
£725,000

The newly built Pearl development comprises 14 two and three-bedroom apartments and penthouses in an enviable position on Headland Road in Newquay with views across the Atlantic. The development was completed in 2009 and has attracted considerable interest with only five apartments now remaining. Key to this demand has been both the scheme's contemporary design and its views across Fistral Beach, widely considered the best beach for surfing and watersport enthusiasts in the UK.

As a second home investment the apartments attract rental interest from a wide range of holidaymakers. Not only is Newquay widely considered a playground for all ages and a superb base for keen surfers, but it boasts 11 magnificent beaches, stretching from Watergate Bay to Crantock Beach. Newquay has also undergone a gourmet revival in recent years. Jamie Oliver's Fifteen Cornwall at Watergate Bay and Rick Stein's celebrated restaurants in nearby Padstow are driving visitor numbers upwards.

Year-round demand is also being boosted by the trend for out-of-season 'staycations'. The nearby Gannel Estuary is perfect for a whole range of outdoor activities from canoeing, walking, fishing and bird watching to horse riding.

The Village
Watergate Bay, Cornwall

2 bed villa
£465,000-£520,000

The Hotel, Watergate Bay, is an Edwardian hotel that has been transformed in recent years. Once only open seven months of the year, it now opens year-round and runs in tandem with the Extreme Academy, which offers surfing, kite-surfing and a variety of other beach sports. The Hotel has sought to widen the range of accommodation available by obtaining planning permission to build 24 self-contained two storey houses on the site of an old sports hall to the rear of the hotel. Each will have two bedrooms and two bathrooms. The Hotel plans to retain 14 of the units and to sell the other 10 on 999-year leases for prices between £465,000 and £520,000 plus VAT.

The proximity to Newquay Airport has been a factor in the scheme's success. By the spring of 2010 four had already been sold. Buyers have the choice of letting their properties through the Hotel's own agency. For the first three years investors will be guaranteed a gross rental return of around £35,000. After the service charges and lettings fees have been taken into account this equates to a net yield of around 4.5% per annum. The scheme's position as part of a successful hotel and sporting complex enables it to command high prices. Planners were co-operative given the extensive efforts made to blend the properties into the landscape in what is a sensitive clifftop location.

The properties may only be used as second homes. Buyers must have a primary residence elsewhere in the UK, a restriction that makes the properties liable for VAT.

St Moritz
Daymer Bay, Cornwall

3 bed apartment
£499,000

St Moritz is a newly built hotel at Daymer Bay on the very popular westward-facing coast between Rock and Polzeath in Cornwall. The area has become well-known for its beaches and its surfing, and also lies a short ferry ride from Padstow, with its famous restaurants. The hotel incorporates 31 three-bedroom apartments that are being sold on 999-year leases for £499,000 – including a furniture package. The hotel offers a full lettings service, which for the first two years offers investors a guaranteed net rental return of 5% a year. This includes eight weeks' personal use. In 16 of the apartments, two of the bedrooms can be parted off and let as individual hotel rooms.

Part of the success of the scheme has been down to marrying the extensive facilities of the hotel with the privacy offered by private apartments. The facilities, which occupants of the apartments are free to use, include two swimming pools, health club and have access to the famous Cowshed Spa.

Indio Lake
Bovey Tracey, Devon

Lodges
£165,000-£210,000

Cottages
£225,000-£250,000

Indio Lake was dug in order to supply fish for an 11th century monastery, which was dissolved by Henry VIII. The three-acre wooded site stands on the edge of Dartmoor, but is also close to the coast at Torbay, and is easily accessible from the A38. More recently, it was run as a fishing business. In 2008 developer Charteroak Estates won planning permission to upgrade three existing cottages and build a further nine lodges. All are subject to a planning restriction preventing them from being used as main homes and restricting occupation to a maximum of six months in a year for any one occupant. The lodges are sold with a 125-year licence to occupy the site and the cottages have been sold on 125-year leases.

In spite of a sluggish housing market at the time of their launch in the autumn of 2008, the lodges all sold within 18 months at prices between £165,000 and £210,000. The three cottages have also sold, for prices between £225,000 and £250,000. Part of the attraction for buyers is being able to combine personal use with a high investment yield. The lodges must be let through the developer, which offers a full rental service. For the first two years buyers are guaranteed a 6% net yield – a deal that allows buyers five weeks' personal occupancy a year.

Part of the success of the scheme has been its appeal to buyers put off by the terms and conditions on other lodge developments. In contrast to many lodge and caravan parks, owners of the lodges can re-sell the properties on the open market without paying any commission to the site-owner.

Staverton Mill
Totnes, Devon

2 bed home
£299,000

3 bed penthouse
£359,000

Staverton Mill, built around 1790, was originally a water-driven corn mill and stands on the north bank of the River Dart, south west of the village of Staverton. Grade II listed, the mill has recently been converted into eight dwellings that overlook the River Dart and Staverton Bridge, providing an alternative waterfront location to the more established holiday destinations in the popular South Hams.

Its location suggests Staverton Mill will appeal to a wide range of second home owners and holidaymakers alike. The South Devon Railway runs through Staverton Railway station offering an ideal location for train enthusiasts and an unusual holiday rental angle, along with fishing there are also canoeing and water pursuits available on the river. The nearby Dartington Hall and Arts Centre will also appeal to those with a literal and cultural interest.

Converted into only eight homes laid out over two or three storeys, the accommodation is adaptable with a utility and versatile studio room on the ground floor, ideal for storing sports equipment, bikes, dog/boot room. This storage space is a particularly welcome asset for owners who want to store personal belongings for their own use while letting the property to obtain income from short hold or holiday lettings. Prices range from £325,000 for a two-bedroom property laid out over four levels, to £370,000 for a three-bedroom penthouse.

The Bay
Talland, near Polperro, Cornwall

3 bed home
£370,000-£385,000

The Bay was an old caravan site, granted planning permission for a gated development of 43 three-bedroom holiday homes, subject to a restriction that they may not be used as main homes. The properties are being sold for prices between £370,000 and £385,000, on 999- year leases. There is a full letting service available that, taking all costs into account, should provide investors with a yield of around 5%. There is no hotel on site, but there is a concierge. The development includes an indoor and outdoor swimming pool and a health club, use of which is included within the £1,750 a year service charge.

Many existing caravan parks are too profitable for it to make financial sense to convert them into holiday home developments. What made the difference in this case was that the existing caravan park was relatively small and the caravans were nearing the end of their lives, so major investment would have been required in any case.

Obtaining planning permission was not easy; it took the developer three and a half years to win consent.

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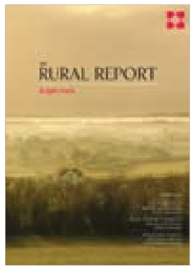

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Front Cover: ‘At The Beach’, Torcross, Devon

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