RESIDENTIAL RESEARCH

2009
SOUTH EAST
Residential development review

Knight Frank

HIGHLIGHTS

- A new mood of cautious optimism is emerging among homebuyers and developers alike, with increased sales volumes driving revived interest in land acquisition and construction, particularly with regard to family homes.
- Record low levels of new build suggest that 2010 could see unprecedented supply shortages – developers delivering into this market could reap substantial rewards.
- The new South East Plan earmarks 654,000 new homes for the region over the next two decades, but there is a contradiction between the locations and type of development in the plan and the new strategies of housebuilders.
- The virtual moratorium on development near the Thames Basin Heaths is likely to be broken as a result of the publication of the delivery framework which allows schemes to proceed if new open space is provided.

DEVELOPERS WHO PROCEED WITH NEW OR MOTHBALLED SCHEMES WILL BE SELLING INTO A MARKET THAT IS STARVED OF STOCK.

Pricing and supply

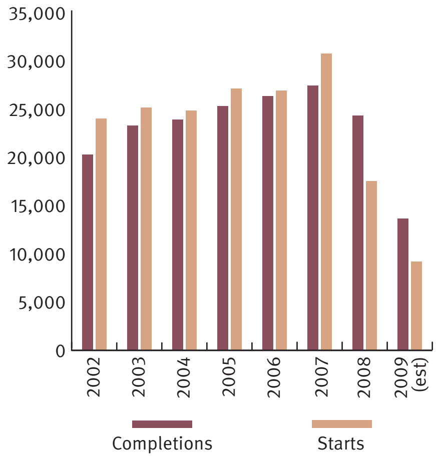
The events of the past year have painted a bleak picture for the residential development industry, with large falls in sale prices and land values and a steep drop in market activity. However, the South East has been among the most resilient regions – according to the major house price indices, prices dropped by between 15% and 20% in the year to the end of March 2009. In prime locations such as Guildford or Sevenoaks, the price falls have been less pronounced although transaction volumes are still markedly lower.

However, the past few months have seen a new mood emerge among developers and homebuyers alike. The Royal Institution of Chartered Surveyors (RICS) reports falling stock levels and rising buyer interest, while mortgage volumes have reached levels not seen for almost 18 months. First-time buyers also appear to be returning to the market, although all these measures remain well below historic averages.

This new optimism is particularly pronounced in the new build market. Sale volumes are supported here by the fact that developers have to be realistic about prices and discount accordingly to achieve a sale. The resales market is more 'sticky', particularly as the low interest rate environment means that many people do not feel forced to sell. Consequently, those seeking properties often find that new build homes offer the best value in the market. For investors also, the yields available on some new build properties can be as high as 7-8%, far in excess of the returns landlords have come to expect over recent years. Cash buyers are a notable presence in the market, particularly those from abroad as weak sterling makes the UK look particularly good value.

More importantly, new build levels have reached unprecedented lows across the region. Work started on just 17,980 private units in 2008, a 36% fall on 2007 figures and the lowest since the Second World War. This slowdown in development has yet to feed into completions, which, at 22,540 for 2008, have only fallen by 12%. With new stock in 2009 likely to amount to only around 10,000 units (unless conditions improve), a severe shortage of new stock will emerge as we move into 2010. This will be particularly pronounced in locations where new supply has always been constrained, such as Guildford and Sevenoaks.

Figure 2
Housing completions and starts, South East
2002 - 2009

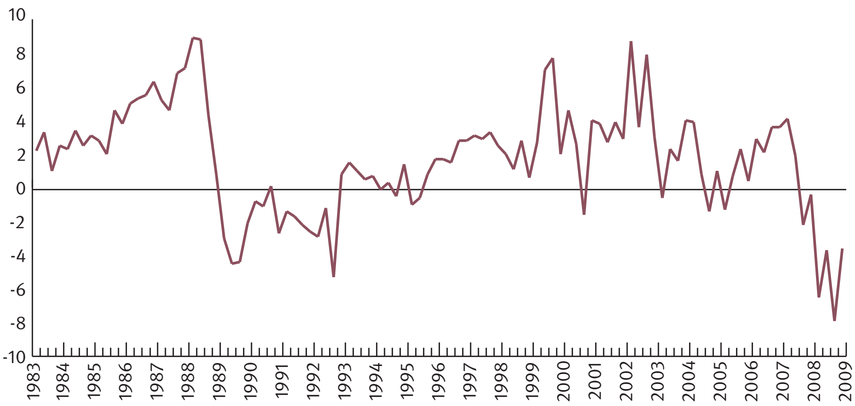


Source: NHBC

Consequently, developers who proceed with new or mothballed schemes now are likely to benefit from selling into a market that is starved of stock. This strategy does require some caution: repossessions and unemployment are unlikely to peak before the middle of 2010. However, the resulting increase in supply in the resales market is likely to be concentrated in locations where the economic picture is weakest. Elsewhere, in more stable and affluent areas, low interest rates will mean that many people will choose to wait before selling their home, restricting the choice available to buyers.

It is unsurprising that many developers and housebuilders are, after a period of virtual hibernation, starting to build again and even acquire land. They are admittedly being highly selective in the types of product and location they will consider. Family homes in leafy areas are the preferred option, while high-density flats are likely to be avoided except in very high-demand areas.

Figure 1
House price inflation, South East
Q1 1983 - Q1 2009 (Quarterly % change)



Source: HBOS

The investment market is likely to remain strong for discounted stock, but developers are likely to pay far more attention to owner-occupiers when considering their options. Nevertheless, volumes, both in terms of construction and sales, will increase from this point onwards.

Many developments remain unviable because of onerous Section 106 agreements signed at the height of the boom. Many councils recognise this and are willing to renegotiate, particularly if they are concerned about a drop in housing supply. For similar reasons, it is also a good time to apply for planning consent for new developments – the process may well be quicker than in the past, partly because many departments are working under capacity.

Developers return to the marketplace

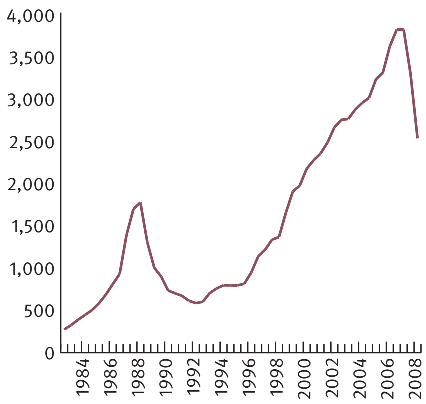
Over the past two years, developers have found it increasingly difficult to obtain funding for land purchase – effectively reducing demand. This has been intensified by the slowdown in the sales market and price deflation, with many opting to roll back their acquisition programme. Meanwhile, supply has increased, partly as a result of the financial stress on developers. However, there are now signs that conditions are improving markedly.

WE BELIEVE PRICING IS APPROACHING THE BOTTOM. PRICES, DEMAND, SUPPLY AND ACTIVITY SHOULD IMPROVE SLOWLY OVER THE NEXT 12 MONTHS.

Figure 3

Average land values, South East

1984 - 2008, £ per hectare (000's)



Source: VOA

According to the Knight Frank Residential Development Land Index, values in the South East have fallen by 56% and 51% for prime urban and greenfield sites respectively, marginally higher than the UK average. The Valuation Office Agency (VOA), which examines a more mainstream selection of sites, reports a 33% fall, compared to 39% for the country as a whole. It reports Portsmouth as the worst hit location (-54%) and Wokingham as the most resilient (-21%).

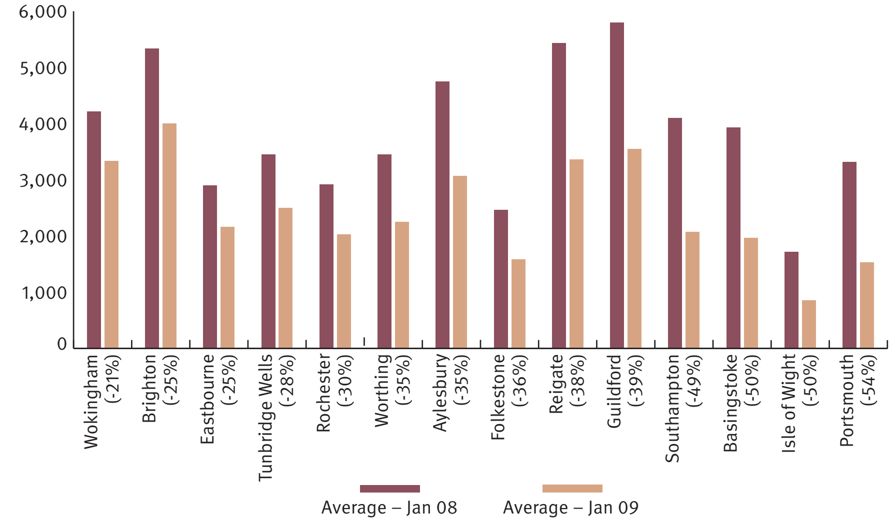
Clearly, opportunities are being offered in the land market although supply is extremely limited. Buyers tend to view sites that are explicitly marketed as 'stressed sales', and, while some land is being quietly sold, most that can hold assets are choosing to do so, waiting for a recovery. However, there are now signs that developers are returning to the market, albeit selectively and are still looking for value. Recent stock market announcements from some of the volume housebuilders indicate that they are becoming more acquisitive. With the sales market improving, and their own stock levels low, they clearly perceive that the time is right to begin their purchase strategies.

This new mood should bring more vendors openly into the market. In the future, there is likely to be a wide variation in price and demand for different types of land. Smaller sites with consent for larger houses may achieve prices not far below boom levels, while larger, more complex urban sites may actually have negative land value as a result of the reclamation and planning costs involved. However, we believe pricing is approaching the bottom. Prices, demand, supply and activity should improve slowly over the next 12 months.

Figure 4

Change in land values Jan 2008 – Jan 2009

£ per hectare (000's)



Source: VOA/Knight Frank

According to the Knight Frank Development Land Index, the largest presence in the land market is still the public sector – either in the form of Housing Associations (29% the largest single group) or government (16%). There is no real evidence that the public sector has become more acquisitive – instead, its activity has remained constant in an otherwise shrinking market. Many Registered Social Landlords, have had to cut back activity as a result of faltering private sales and reduced revenue from Section 106 agreements, which are funded by open market activity. However, the sector remains more resilient than the residential development industry as a whole, and now represents almost 50% of new starts – compared to a historic average of around 10%.

The public sector remains one of the biggest sources of new land supply in the South East, mainly in the form of the disposal of former military installations and hospitals. By contrast, there are few indications that the South East will be swamped by distressed land sales.

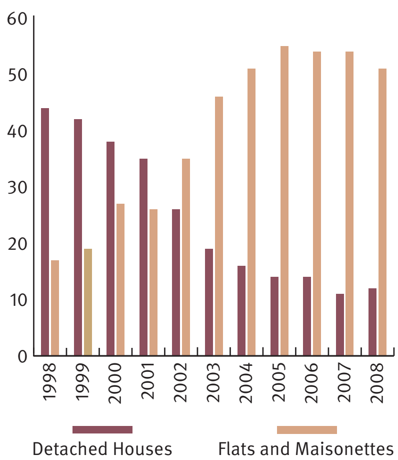
Planning for the future

Improving conditions in the marketplace are not the only reason why more developers are keen to acquire land and bring schemes forward. The longer-term demographic picture clearly demonstrates the need and demand for new homes in the South East. According to Communities and Local Government (CLG), there will be 808,000 additional households in the region in 2029, an average increase of 40,400 each year – much higher than any other part of the country, including London. As both starts and completions averaged around 25,000 per annum between 2001 and 2007, it is clear that more development is needed to cater for this additional demand – particularly given the level of current construction.

Figure 5

Types of properties built, South East

% as a total of completions



Source: NHBC

The final South East Plan was published in May, and outlines how the region will cope with the housing need expected over the next 20 years. It envisages that some 654,000 new homes will be built by 2020 – 32,700 per year. Despite adding almost 6% to the total housing stock this new supply will fail to cater for projected household growth. It is not clear that the plan is compatible with the aspirations of the mainstream housebuilders.

Much of this new demand will come in the form of single-person households: the forecast suggests that the period 2006-2026 will see a 23% increase in household numbers in the South East, but a 54% increase in those living alone. However, while the number of married households will decrease, there will also be 59% more cohabiting couples. Demand for new family housing will continue – something that has been ignored in recent years as developers have concentrated on building smaller flats at the expense of houses. This recent concentration on flats means most developers are now focussed on larger homes – detached if possible.

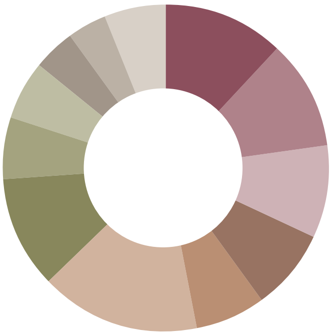
The plan does admit that "an adequate range of larger properties, suitable for family occupation, will also be required." However, it adds that "with suitable attention to design and layout these can be provided at higher densities than hitherto." Indeed, the emphasis on density is retained throughout the document, adding that "within many urban and suburban areas across the South East there are significant opportunities for development in excess of 50 dwellings per hectare net." This is clearly in conflict with the strategic direction of the volume housebuilders – leaving open the question of who will build this type of housing and enable the region to meet its plan target.

Developers may be more pleased by the fact that the plan calls for a review of the green belt to the north east of Guildford, the south of Woking and around Redhill and Reigate. This may lead to the release of more greenfield land suitable for family housing on the edge of these settlements. The plan also identifies several strategic development areas for major mixed-use development schemes: Fareham, north of Hedge End and Whitehill/Bordon, all in Hampshire, and Shoreham in West Sussex.

Figure 6

The South East Plan

Housing provision 2006-2026 (%)



South Hampshire	12%
Sussex Coast	11%
East Kent & Ashford	9%
Kent Thames Gateway	8%
London Fringe	7%
W.Corridor Blackwater Valley	16%
M.Keynes/Aylesbury Vale	11%
Central Oxfordshire	6%
Gatwick	6%
Rest of Hampshire	4%
Rest of Kent	6%
Rest of South East	6%

Source: South East England Partnership Board

However, more than 40% of new homes will be provided in two counties alone – Hampshire and Kent – with the majority of development occurring in a number of 'sub-regional strategy areas' (in fact only 14% of new homes in the region will be built outside these areas). The Western Corridor and Blackwater Valley will provide the single largest slice of homes, 102,100 by 2026. The next largest will be the South Hampshire area, the Portsmouth/Southampton conurbation, where a further 80,000 will be built. The two Kent regions – East Kent and Ashford and the Thames Gateway – are together allocated over 100,000, while a further 70,300 are planned along the Sussex coast. Certain towns, including Maidstone, Redhill and Basingstoke, have been designated 'growth points' and will see particular concentrations of development (see map on page 7).

MOST COUNTIES FAILED TO KEEP PACE WITH DEMAND, EVEN DURING THE BOOM, WITH THE POSSIBLE EXCEPTION OF SUSSEX. OVER THE NEXT FEW YEARS, STARTS IN THE REGION ARE LIKELY TO REMAIN LOW BY HISTORICAL LEVELS.

The tension between the decrees of planners and the strategy of housebuilders is just one challenge faced by the South East England Partnership Board, the body which now has responsibility for regional planning matters in the wake of the dissolution of the South East England Partnership Board in March this year. As Figure 7 below shows, most counties failed to keep pace with demand, even during the boom, with the possible exception of Sussex. Over the next few years, starts in the region are likely to remain low by historical levels. The task will be to introduce measures to ensure that delivery continues – and for all types of home. Social housing delivery is particularly problematic as it has been dependent on the construction of market properties via Section 106 agreements, a process that is now unaffordable.

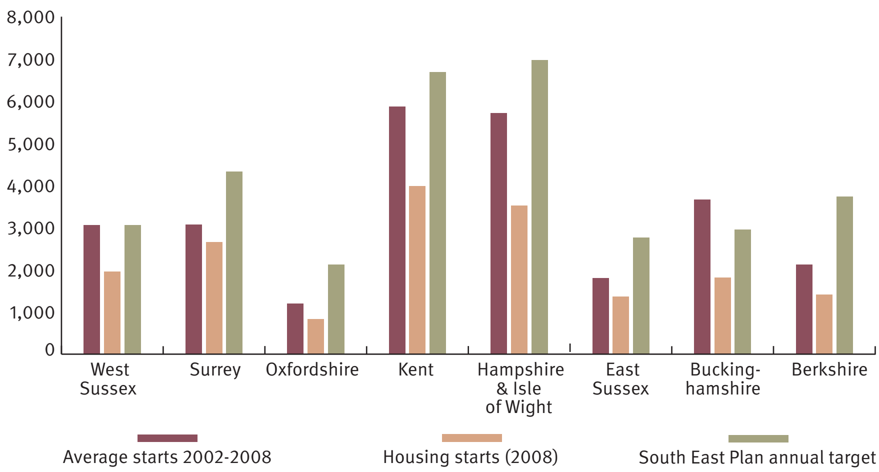
The Homes and Communities Agency (HCA), formed at the beginning of the year from the merger of English Partnerships and the Housing Corporation, will be working with the board to ensure that this happens. Its £400m 'kickstart' scheme will also help a handful of developments which have become unviable as a result of the slowdown. The quango will provide up to 30% equity or debt – or possibly 15% gap funding – to help schemes that could plausibly make a big difference to housing supply with minimum intervention. The qualifying schemes will have to demonstrate high design quality and provide reasonable levels of affordable housing.

The HCA is also setting up a joint fund with Legal and General to help stimulate the embryonic build-to-let market – i.e. developers building properties specifically

Figure 7

Starts and annual targets, South East

No of housing units



Source: CLG, South East England Partnership Board

for the private rental market. This is already a successful sector of the market in countries such as the US and Germany, but it has failed to take off in the UK as yields have remained stubbornly low. However, a growing population unable to access mortgage finance, combined with low land costs, relatively stable rents and declining build costs, suggests that it may become a more viable option, at least in the short-term.

Indeed, with land at historically low prices, there is a big opportunity for investors or developers with funding. There are signs that some institutions are taking an interest in the long-term potential for taking strategic land through the planning and development process, perhaps with a view to selling parcels of land to housebuilders or developers in the future when the market has recovered.

Kent, seems to be a particular target. Canterbury, which will be much more accessible from London as a result of the new high-speed rail service, may see values rise substantially: its high quality housing stock and historic setting should attract new residents.

With restricted access to the mortgage market and both existing and new housing supply at historic lows, many potential new households will not form and people will opt instead to share accommodation or stay with parents or ex-partners. This backlog of demand will only increase over the next few years, potentially adding to the number of new households looking for homes as we move into the next decade. This pent-up demand is likely to be most pronounced in the South East compared to other regions, and will provide a significant support for pricing from 2011 onwards as the economy returns to health. With supply likely to remain constrained by the planning process, the long-term picture for pricing and values looks healthy.

The Thames Basin Heaths Special Protection Area

One of the most significant barriers to development in the region has been the virtual moratorium placed by Natural England, the government's environment quango, on new housing within 5km of the internationally important Thames Basin Heaths. This has prevented consent being given for over 40,000 new homes in the wider area.

This Special Protection Area (SPA) is noted for the presence of the Dartford Warbler, alongside other rare animal life. Natural England is concerned that the increased use of the heaths for recreation, resulting from the higher population levels, could adversely affect these species – particularly if they are used by pets.

The SPA is situated around the Berkshire, Surrey and Hampshire borders – which also happens to be one of the most affluent areas in the UK with some of the greatest pressure for new housing. As it is dotted around the area, there has, until now, been a virtual ban on new consents in Woking, Surrey Heath and Rushmoor, with Natural England effectively vetoing any scheme in the districts.

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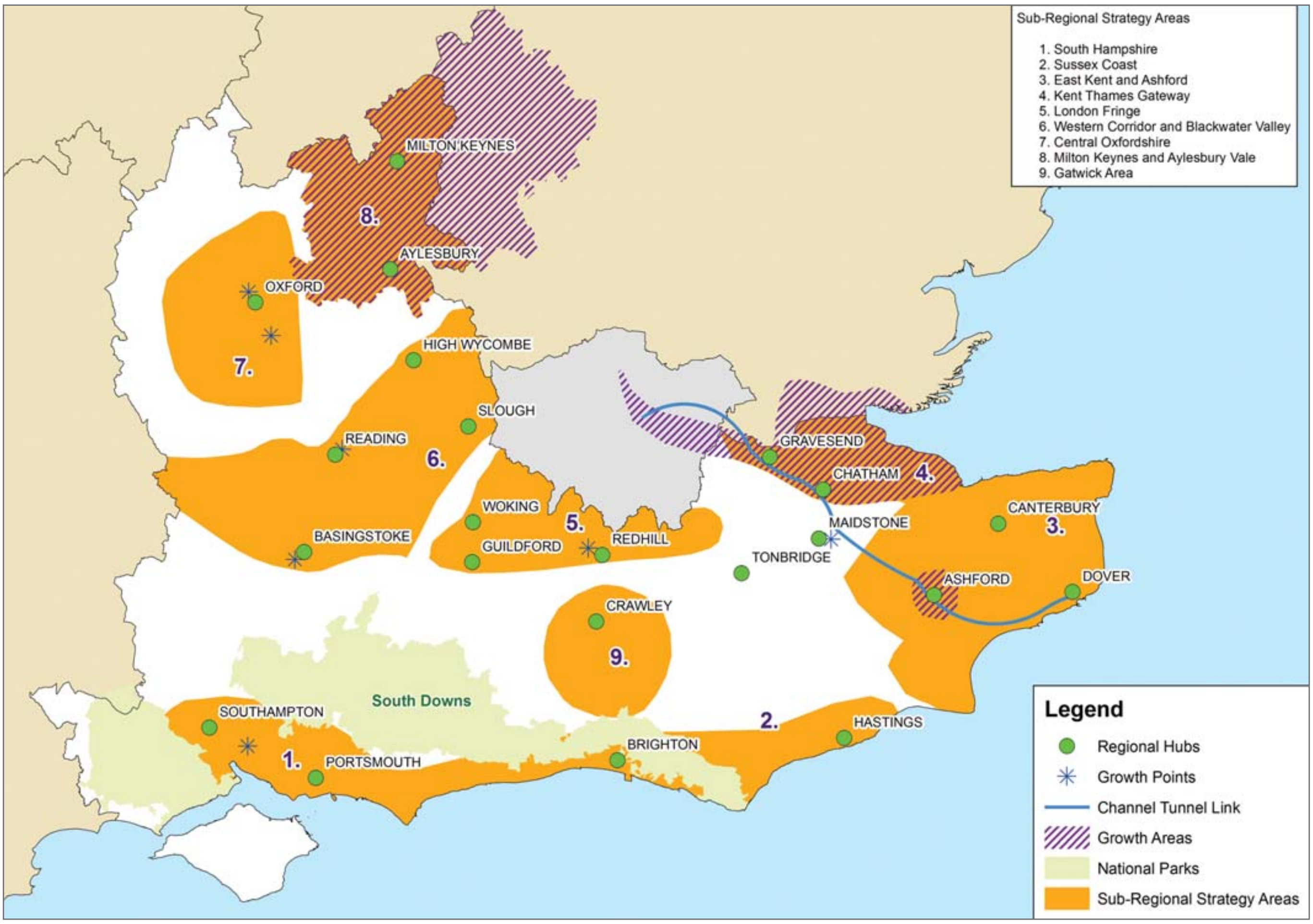
The moratorium also covers much of Guildford, Hart, Runnymede, Bracknell Forest, Waverley, Wokingham, Basingstoke and Dean, parts of East Hampshire, Mole Valley, West Berkshire and Windsor and Maidenhead as well as a significant portion of Elmbridge. Some developers have achieved consent through negotiation with the quango and local planning authorities, but measures such as preventing residents from owning pets have proved difficult to administer and even more difficult to sell to homebuyers.

The Thames Basin Heaths Joint Strategic Partnership Board was set up to examine how viable development could proceed without damaging the delicate habitat of the heaths. It includes members of each of the affected councils as well as the now-defunct

The South East Plan – strategic map



Source: South East England Partnership Board

assembly, and was advised by several local stakeholders and nature organisations.

It has now published a formal delivery framework that will allow schemes to come forward with Natural England's consent – although development within 400m of the SPA boundaries will remain impossible.

At the heart of the document is the use of what it calls SANG – Suitable Alternative Natural Greenspace – as a way to alleviate the use of the heaths for recreation. If sufficient new public space is provided before dwellings are completed, the theory is that, the damage to the delicate heathland habitat will be minimised. The space provided does not have to be new, but existing patterns of use need to be taken into account.

According to the framework, developers need to make financial contributions to create and maintain SANG on the basis of at least 8 hectares per 1,000 population, with the average occupancy rate per unit taken as 2.4 per household. The 'catchment' of each area of open space also needs to be taken into account, ranging from 2km for that of between 2 and 12 hectares in size to 5km for that of more than 20 hectares. The full details are available on the Partnership's website.

The mediation measures have already been described by an inspector as disproportionate, adding that the plan should have allowed alternative mitigation measures such as access management.

Whether it will work in practice remains to be seen. At the moment, when so much development has been made unviable by falling land values and Section 106 costs, the measures may have the effect of further dampening development volumes in the near term. However, given the demand for housing in this desirable area, it seems likely that some well-located, high-value schemes will now proceed and contribute to their own patch of SANG.

Whether the measures will prove effective is debatable. For many in the industry, they will be one more barrier to supply, further preventing the region from reaching its housing targets – pushing prices higher and reducing affordability.

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