Research report

Development Outlook

Summer 2011

Executive summary

This bulletin examines development viability and activity. It reviews changes in the market over the last twelve months and examines how emerging government policy and forecast economic performance are likely to affect viability, and thus development activity, over the coming years.

- On a national basis development activity remains somewhat constrained, largely due to capital values remaining depressed and the lack of availability of development finance. There are however some signs of a small upturn, with the recent rise in values stimulating activity. New construction orders were up in most sectors at the end of 2010, by 12-14% in the retail and office sectors and 66% in the residential sector, but from a very low base. In contrast, new orders in the industrial sector continue to fall.
- The outlook for the economy shows weak growth in the short term, reflecting public spending cuts, higher taxes and relatively high inflation. This will affect occupier demand, and national forecasts for rental value and capital value growth in the commercial and residential sectors show no growth in 2011, and marginal growth in 2012. With development finance remaining constrained, a strong upturn in development activity is unlikely.
- The London development market proves to be the exception. London offices are performing well with healthy occupier demand, limited new supply and stronger growth in rents and capital values. Development activity is notably stronger than in 2010, which is set to continue with demand outstripping supply. Likewise residential development activity remains strong.
- Overall building costs rose by 4.4% in the year to Q1 2011 (BCIS General Index), slightly lower than inflation. While material costs have risen by more, labour costs have risen by significantly less and are likely to remain subdued. Significantly tender prices have been falling since 2008, with a high number of projects stalled and subsequent fierce competition for those projects able to proceed. Tender prices are currently c.13% below their peak in Q4 2007 but are now no longer falling. Again London bucks the trend with more resilient tender prices as a result of a more active marketplace.
- Viability has become an increasingly important consideration in town planning decisions over recent years, with the delivery of new developments being threatened during the economic downturn. To promote development, local authorities have been more flexible in negotiating Section 106 agreements.
- Securing funding remains one of the principle hurdles to development, with bank finance likely to remain restricted for some time. In this environment new methods of funding need to be explored. The establishment of debt funds by institutional investors , interest from private equity houses and contractors taking equity stakes in developments are all emerging trends in the market. Forward funding or forward purchasing of developments are also options.
- Recent changes in development viability and land values have varied between places and sectors. While in much of the UK changes in capital values and tender prices over the last 12 months have been small, resulting in little change in viability or land values, central London has seen development viability and residual land values improve significantly over the last year. Looking ahead a slow improvement in development viability outside London is forecast over the next few years.

Development activity

Private sector development activity has picked up from its low of 18 months ago. In the commercial and residential sectors the upturn is very moderate outside London, but in London it is strong.

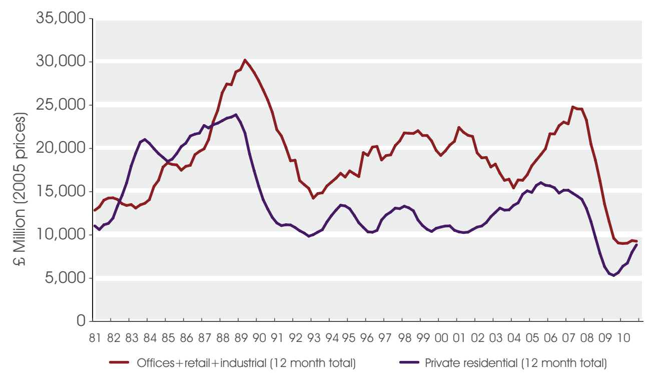
Key drivers

Key drivers for development activity are occupier demand, investor demand and the availability of development finance. Over the last 12 months there has been some improvement in each category, although this varies by sector and location.

The first chart clearly shows the volatility in the private sector development market over the last five years, in marked contrast to the preceding ten years. It also shows that in constant price terms development activity as measured by new construction orders, was lower, (18 months ago and still is), than each of the previous major downturns in the early 1990s and early 1980s recessions.

The key driver for the current weak level of development activity has been the fall in capital values in the residential sector and the larger fall in the commercial sectors over the last three years, although admittedly there has been recent improvement. In the commercial sectors capital values are now, on average nationally, about 15% above their recent low point and in the residential sector about 10% above. However, these levels are still well below their 2007 peak.

Chart 1 – New construction orders



Source: ONS, GVA

Cyclical upturn

The recent rise in values has stimulated an increase in development activity, mainly in London. In the office sector the 12 month total of new construction orders in Q4 2010 was 14% higher than at its low point a year before. In the retail sector it was 12% higher but in the industrial sector new orders are still falling.

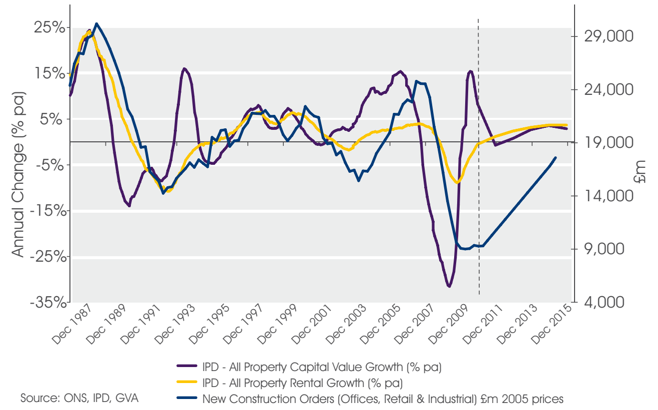
The private residential sector saw a much greater increase of 66%, but from a very low level in 2009, when it was half what it was during the early 1980s and 1990s recessions.

Is this development upturn about to accelerate or will concerns about the economic outlook, occupier demand and the lack of development finance stifle it? In the commercial sector outside London rental values are still falling on average, albeit marginally. Capital values, which were increasing strongly a year ago, are now increasing at less than 5% pa. In the residential sector the picture is similar.

From a regional perspective it is clear that a strong upturn in capital values and new development activity is unlikely in 2011 or 2012. The economic outlook is for below trend output growth in both years as a result of the public spending cuts and tax increases and the relatively high levels of inflation.

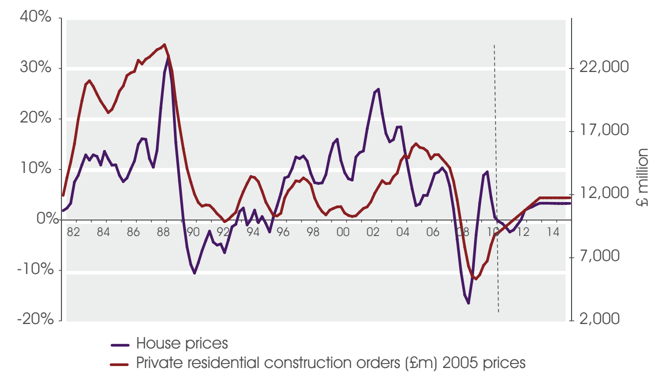
The development market in London provides a welcome antidote to this picture. Occupier demand is healthy, new supply is limited, rents and capital values have risen strongly and development activity is markedly stronger than a year ago. This looks set to continue as the demand supply imbalance is likely to cause prime commercial and residential values to continue increasing strongly.

Chart 2 – Commercial new construction orders and IPD all property rental and capital value growth



Source: ONS, IPD, GVA

Chart 3 – House prices and house buidling



Source: Nationwide, ONS, GVA

Development viability

Over the last year capital values have risen slowly in some areas, but tender prices have changed little, leaving viability worse in some areas, but better in others, particularly in London. This uncertainty is compounded by changing planning policies and constrained finance.

A year ago, economic growth was accelerating, prime capital values were rising strongly and development costs were falling. Viability had improved and development activity was slowly beginning to increase. Much of this optimism was down to the then government's fiscal stimulus. Once this was withdrawn and replaced by the CSR and a stringent plan to reduce the deficit quickly by cutting public sector spending and increasing taxes, confidence has fallen, economic output has slowed and capital value growth has all but evaporated in the commercial and residential sectors.

Development income – Regional View

Although on average capital value growth has all but evaporated, this hides significant differences at the sector levels. Capital values fell slightly in the provincial office markets and in the retail sector as a whole. However, out-of-centre retail warehousing saw some positive rental growth, whereas shopping centres and standard shops saw rental values fall. In 2011, there will be a similar divergence but with mildly positive rental value growth in most sectors and areas, except the retail sector outside London where rental values are likely to continue falling marginally.

Due to a fall in yields in 2010, capital values in all sectors in most areas saw positive growth of varying amounts. Little change is expected in 2011 however, as yields hold steady and performance is driven by rental value growth/decline. There is also an increasing difference between prime and secondary locations, which also affects development viability. There is good investor demand for prime locations but not for secondary locations.

In the residential sector there has been a pattern of flat capital value growth over the last 12 months, although there were pockets of stronger growth. A similar pattern is likely in 2011.

Development income – London View

In the office and retail sectors rents have increased strongly in central London. In the central London office market last year, prime rental values increased by 20 – 25% in headline terms and by even more once reducing rent free periods were taken into account. Falling yields due to strong investor demand, particularly from overseas investors, meant that capital value growth was over 50% in some parts of central London. As downward yield movement has now probably run its course, capital values will increase much less in 2011 and beyond.

With regard to the residential sector, London (particularly central London) and the south saw positive house price increases. This was most marked at the upper end of the market.

Development income – Affordable Housing

The ongoing changes to the funding of affordable housing in England are creating significant uncertainty in this element of the residential development market. The government has instigated a switch in the funding regime for social housing from capital grant to revenue funding through rental income; enabled by introducing a new Affordable Rent for social housing at up to 80% of market rent. This has created significant uncertainty in the market as Registered Providers (RPs) assess the new risk profile of investing in houses with rents related to the market and which they will have to fund 100% in the absence of grant.

Initial indications from the current Affordable Housing Programme bidding round are that RPs are taking a cautious approach to the new model. This is being compounded by uncertainty over how individual local authorities will look to apply the new Affordable Rent model, with many stating that they will not accept it as affordable housing.

These changes are happening at the same time as funders in the RP market are looking to negotiate shorter term finance and the cost of funds is increasing; a trend which will only increase with the additional uncertainty around the Affordable Rent model.

Together these trends are creating uncertainty over the value of affordable housing in developments and higher planning risk due to the differing interpretation of the new regime by individual local authorities.

Building costs and tender prices

According to BCIS, the General Building Cost Index rose by 4.4% in the year to Q1 2011, while material costs rose by 7.6% and labour costs by 1.3%. This compares to general inflation of 5.3% (RPI).

While material price increases slowed towards the end of last year, increasing by just 0.5% in the final quarter, prices are forecast to continue rising at rates above inflation this year. The steep rises in the cost of some materials over 2010, such as copper and iron ore was due to the voracious demand from China and India. The fit-out market has been badly affected by rising material prices – house building less so because it is less reliant on the steel industry. Sterling remains relatively weak and so imported materials will also be more expensive. Adding to the cost demands, oil prices rose over the last 12 months. Material prices should settle down to inflationary growth towards the end of the year and into 2012.

While material prices have shown above inflation growth over the past year, labour cost rises have been below inflation. Unsurprisingly, labour costs are expected to remain subdued over the next two years, as the level of work remains considerably below pre-recession levels. Of more significance to overall costs, tender prices have generally been falling since the beginning of 2008, with increased competition for less work. However, in line with other construction data, they rose surprisingly in Q2 2010, but since then, have stabilised and are still 13% below their peak in Q4 2007.

Tender prices in London have proved more resilient compared to the rest of England and Wales, driven particularly by commercial offices. Despite a fall in new work output expected in 2011 and 2012, it is anticipated that tender prices will continue on a slow upward trend over the next two years, driven by increases in input costs, with London and the South East leading the recovery.

Construction

While the economic stimulus of the last government boosted construction last year, the comprehensive spending review and budget cuts are beginning to take effect on the industry. While the latest CIPS construction surveys have been positive, the economic recovery and consumer spending are likely to be subdued in the short term. The prospects for growth in private sector construction are good in the medium term to 2015 but it is unlikely that this will compensate for cutbacks in the public sector this year and next. Consequently the Construction Products Association forecasts construction output to fall 0.8% this year, 2% next year and return to growth in 2013. This will limit the increase in tender prices.

Planning policy and planning obligations

Viability has become an increasingly important consideration in town planning because scheme viability is inherently linked to delivery of planning policy, regeneration objectives and development. The tests for planning obligations are set out in Circular 05/2005 in England and financial viability is a key consideration, particularly in determining whether a planning obligation is 'fairly related in scale and kind to the proposed development' and 'reasonable in all other respects'.

This importance has increased over the last few years because of the economic downturn when the delivery of new development has been threatened and the relative burden on developers of planning obligations and policy requirements has increased. With the advent of localism, planning policies at the local level will become even more relevant to development viability.

To ensure development remains attractive and deliverable, local authorities have had to be more flexible in negotiating Section 106 contributions/obligations in England (S75 in Scotland), including affordable housing, or in setting reasonable levels for community infrastructure levies or tariffs. Where this has not happened, development risk and uncertainty has increased, which has deterred development coming forward.

Finance

The traditional development finance market remains very restricted. Developers are struggling to obtain debt finance on anything but the best commercial and residential sites and for commercial schemes where there is a pre-let in place. Even on low risk schemes such as these the cost of funds is likely to be in excess of 6% and Loan to Value (LTV) in the region of 70%.

Moving away from these prime schemes, development finance is very difficult to obtain and, where it is available is likely to require a LTV of 50-65% and cost of funds upwards of 7%. Compounding this, arrangement fees on debt have risen significantly to double their pre-credit crunch levels and terms have shortened.

The availability and the cost of development finance will only be made more restrictive by Basel 3 regulations which are determining the quantum of capital that banks must hold and the risks they can take. This will make it more expensive for them to lend longer term and will also limit lending on relatively high risk property development.

In the ongoing environment of restricted development funding from the traditional sources alternative approaches are emerging. Two key trends are the willingness of contractors to invest equity into schemes and take on development risk, and the establishment of debt funds by major institutional investors. Even allowing for these new entrants into the market the ability to secure debt finance will remain one of the main challenges in securing development.

Development appraisals and land values

Over the last 12 months residual land values have improved dramatically in central London, but elsewhere the changes in capital values and tender prices have been small, so there has been little change in viability or land values. A slowly improving outlook is forecast.

The following charts illustrate the effect that changing market conditions have had and will have on development viability and residual land values. Theoretical development appraisals between Q4 2006 and Q4 2015 are shown, covering office schemes in the City of London, central Birmingham and central Glasgow, a medium density, small brownfield residential scheme in east London and greenfield residential schemes in the South East and Scotland (central belt), near Edinburgh.

All appraisals are based on moderately sized developments, with consistent assumptions about any existing buildings on the site that would be redeveloped. Where existing buildings are assumed to exist, assumptions about their size and condition have been made, and a broad indication of value is shown to reflect how the size (and hence value) might change at the site level. The main development variables that have been altered as market conditions have changed, and are anticipated to change over the time periods, include:

- Income from sales, as a result of changing capital values. Valuations have been taken from the top of the market in 2006/2007 to a trough in 2009 - 2010 and recovery thereafter, using our latest market forecasts. A similar approach has been applied to existing buildings on each site and the calculation of their existing values.
- Tender prices. While tender prices showed above inflation increases in 2006 and early 2007, greatly reduced development activity and increased competition for work drove down tender prices in 2008, 2009 and early 2010. The latest (end April 2011) BCIS forecasts, have been used.
- Finance. While the reduction in interest rates in 2009 theoretically reduced finance costs, the availability and terms of finance remain severely restricted and the actual cost of finance has changed little.
- Return for risk and profit. The developer's allowance has been increased for all appraisals in 2008, 2009, 2010 and 2011 to reflect the increased risks and uncertainties of development.

The assumptions for all other development variables remain unchanged to simplify the calculations and to draw out the main issues. These include purchaser's costs, professional fees, planning obligations, contingencies, development and finance periods, sales and letting fees and marketing, although in reality some of these have and will change to reflect the economic climate and its effect on development viability.

Chart 4 – City of London offices site value

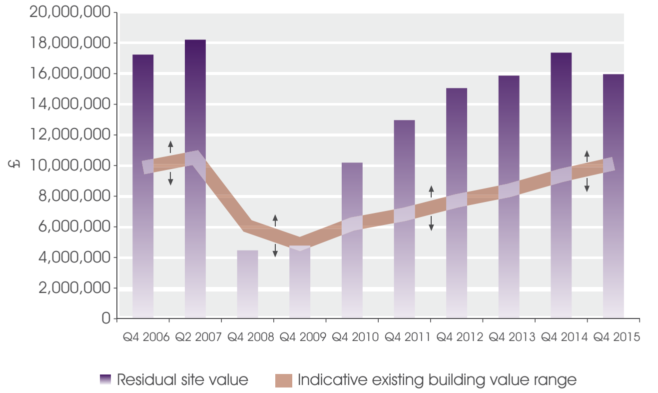


Chart 5 – Central Birmingham offices site value

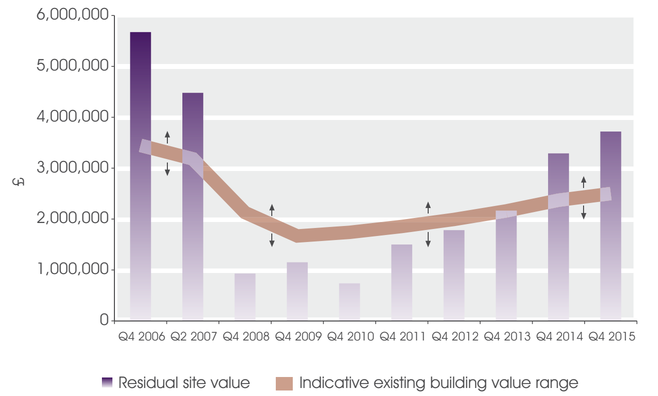
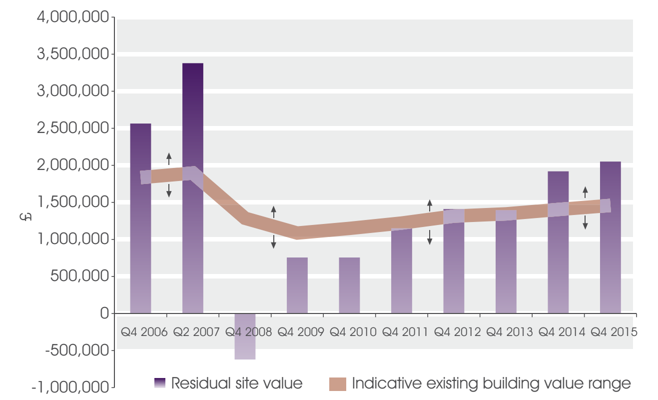


Chart 6 – Central Glasgow offices site value



The resultant residual land values give an indicative figure that the developer could theoretically afford to pay for a cleared site for each specific scheme compared to a broad indication of the existing value of buildings currently on the site. In reality, where the residual land values are very low for a specific development, alternative uses would be considered (e.g. residential or hotel uses in central office locations) or if existing use values are higher than residual site values (as shown on some of the charts), existing uses would remain until development viability improved.

The charts show the dramatic decline in the viability of schemes and fall in residual land values that occurred in 2008, reversing the increase in land values that occurred in the strong property market of the mid 2000s. It is also noticeable how the change in viability has affected land values differently depending on the sector and location, and how in some locations viability has improved more quickly than was expected 12 or 24 months ago at the peak of the recession. This is particularly true in central London where prime office rental values have greatly increased, yields have fallen significantly and tender costs are noticeably lower than they were a few years ago.

For residential development, site values are now very location, size and density specific. Small sites in attractive locations, suitable for houses rather than flats, have seen relatively small price falls from the market peak and some significant increases over the last 18 months due to strong demand and limited supply. For these schemes early house sales mean less risk, less onerous cash flows and less need for debt financing. Large schemes, comprising high density flats with delayed sales until whole blocks of flats are completed, and with large negative cash flows early on requiring high and expensive debt financing, have fared worse, with large falls in site values and little increase over the last 18 months.

In many cases commercial and residential residual land values fell 50% - 75% from their peak in the recession, but with some improvement over the last 18 months. These percentage reductions in residual land values are for specific schemes and do not take account of alternative schemes that could be developed or the existing use value of sites where clearance has not occurred. For some sites, residual land values are still theoretically negative, but in reality this would not happen as someone would always pay the existing use value as a minimum (although this value has also fallen significantly from its peak).

These charts also highlight the problems developers are experiencing if sites were purchased some years ago at the top of the market, far in excess of what sites are now worth.

Chart 7 – East London residential site value

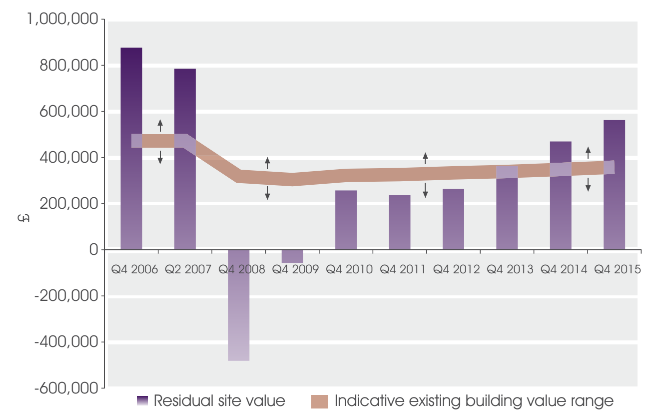


Chart 8 – South East Greenfield residential site value

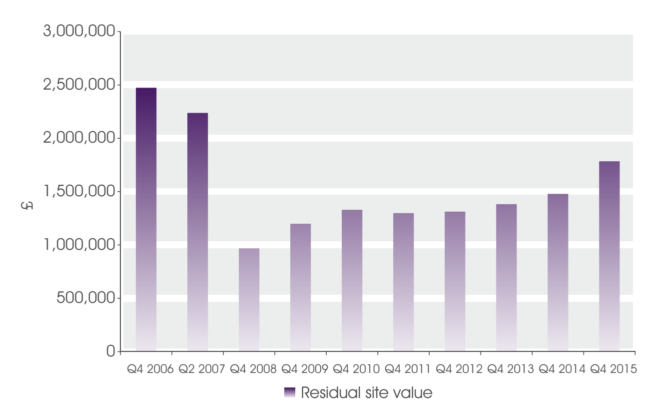
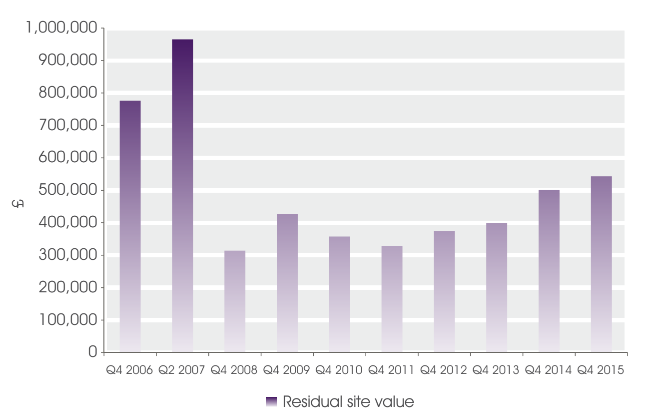


Chart 9 – Scotland Central Belt Greenfield residential site value



Development outlook

Key uncertainties revolve around the strength of the economic upturn, the effects of public spending cuts at the local level, localism and changes to the planning system and the availability of development finance.

A year ago the recession was over and there was a strong bounce back in economic activity in Q2 and Q3, stimulated by high government spending and very low interest rates. Occupier demand in the residential and commercial sectors was improving and prime investment yields were falling. The prospects for development in terms of viability were better, but restricted bank finance was a major problem.

One year later the short term economic situation has, if anything, worsened as the coalition government has instigated severe public sector spending cuts and tax increases to reduce the ballooning budget deficit. The outlook for economic growth and occupier demand is rather gloomy in 2011 with a slight improvement expected in 2012, and stronger growth expected thereafter.

In London capital values increased noticeably in 2010. The lack of new development pointed towards a constrained supply side for both the commercial and residential markets over the medium term. However, there has been a significant increase in both residential and commercial development starts, with the larger property companies using internal finance and/or forming JVs with institutional investors in order to implement their planning permissions.

On a regional basis, development activity, having increased in 2010, has now stabilised due to an uncertain short term occupier outlook. Rental and capital values have not generally increased much over the last 12 months and are unlikely to do so over the next 12 months. This and the limited availability of finance in the regions means that a high percentage of schemes remain economically unviable at the present time. On top of this the new localism agenda may well make new development more, not less, difficult despite the financial incentives proposed by central government.

However, the Localism Bill may be much changed by the time it becomes an Act, businesses as well as residents may have a say in development proposals, Local Enterprise Partnership (LEPs), where adjacent local authority and local businesses join together to proactively plan defined areas may help drive local economic growth. Enterprise zones may assist in this with concessions on rates and fewer planning restrictions. This is unlikely to have much effect in the short term though.

Development finance availability remains a stumbling block and is likely to be so for years to come, so alternatives need to be pursued. Developers will have to consider issuing bonds or shares to bring in money from investors to finance new development. Insurance companies will have to seriously consider providing investors and developers with short term loans (ie debt finance) to replace bank loans, as well as providing equity finance through forming JVs with investors and developers and forward funding or forward purchasing commercial developments, as occurred in previous post recession upturns.

When disposing of sites, local authorities are now considering the deferral of land payments in order to enhance values. These may be made either upon a conditional "subject to planning" basis or even by the formation of a joint venture ("JV") with a developer whereby the local authority "invests" the land into the JV vehicle. This benefits developers as up-front costs are lessened, development cash flows are improved, the amount of borrowing is, therefore, much lower, and overall risks are reduced. For residential development, grants from the HCA for social rented housing are no longer generally available, but as higher rents can now be charged (closer to market levels, but subject to local authority approval) viability may not be so adversely affected.

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