Michael Beaman LIMITED
regeneration

Note

June 17th 2008

For Discussion: Hertfordshire Infrastructure Study - Short Term Outlook for Housing Land Values

In May an estimate was made of the level of S106 contributions that might be obtainable across Hertfordshire on the basis of current house prices. This was a 'snapshot view' of the market. A significant caveat related to the outlook for house prices. Since then new data and anecdotal evidence of house sales during the key spring period has pointed to a significantly deeper downward lurch in the housing market than was expected then. This note (a) reviews that evidence (b) looks at trends in house and land prices during the last recession in the early 1990's to see if there are lessons to be learnt and (c) draws tentative and provisional conclusions for the current study.

The Current Market

It is apparent that:

1. House prices are falling - analysts anticipate a drop of between 5% and 20%
2. The rate of sales has diminished - Spring sales suggest a decline of between 30% and 50%.
3. Housebuilders have cut back investment

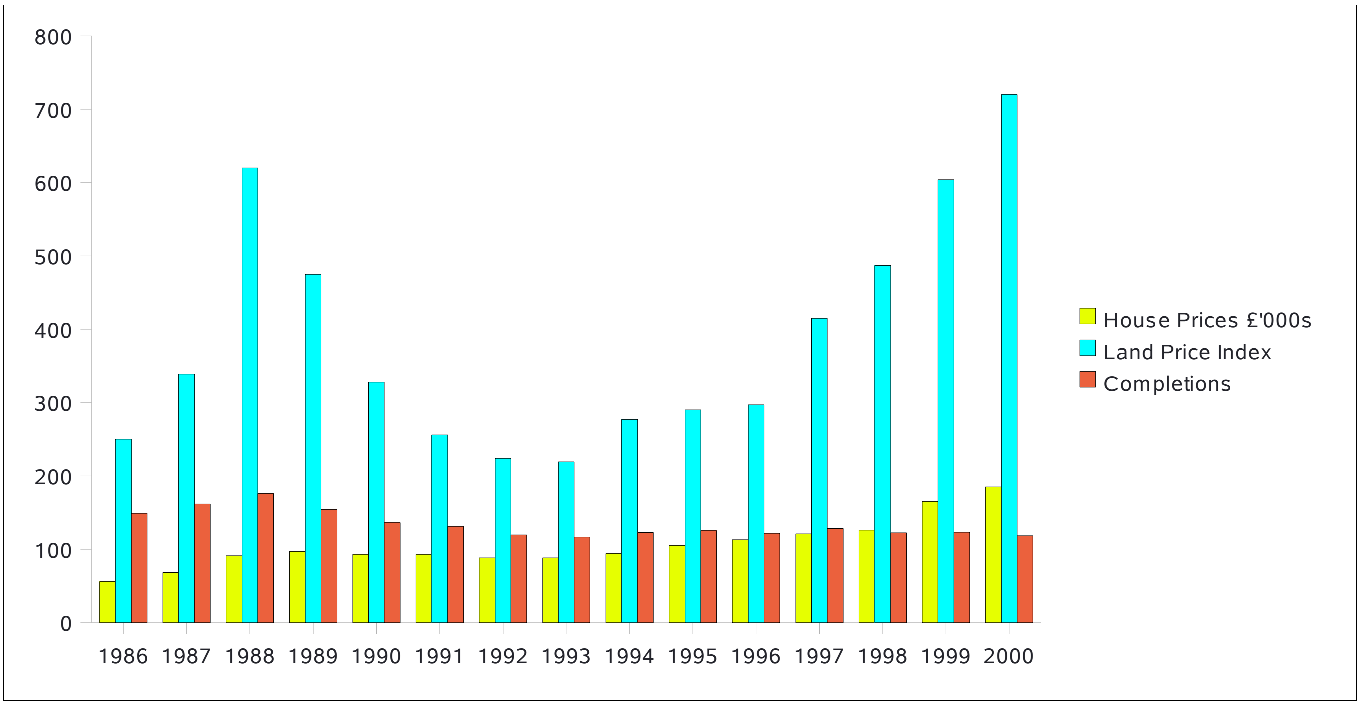
Evidence from 1990's.

We compared for the period 1986-2000, average house prices across the South East using DCLG data and trends in residential land prices across the South East using Valuation Office Agency data. The result is shown in the chart below and the accompanying data. It can clearly be seen that the percentage fall in housing land values (65% from previous high) between 1988 and 1993 greatly exceeded the percentage fall in house prices (9% from previous high) and completions (34% from previous high).

It is not surprising that the any fall in house prices has a disproportionate effect on land values. In theory, land values are the result of subtracting the anticipated costs of development from the anticipated receipts. The industry rule of thumb has been that the price of land absorbs roughly one third of receipts. So if receipts fall and costs stay the same, the value of land might be expected to fall three times as fast as house prices.

What is surprising, is the extent of the fall in land prices, roughly twice what might have been expected on the basis of the rule of thumb, and the time it took for the market in land to return to previous levels . We are not in a position to analyse this further but expect that it is due to the housebuilders practice of withdrawing new investment to preserve cash when the rate of sales is falling which starves the market of land buyers. In effect, the value of land 'undershoots' what might be expected on the basis of house prices in the same way as it can 'overshoot' at other points in the cycle. After the recession it took some time for housebuilders to rebuild their balance sheets and financial probity might well have taken precedence over commercial opportunism. Because most of them maintain a 'land bank' equivalent to around 5 years take up they can survive without buying new sites for several years. A secondary cause would have been the effect on residual land values of a slower rate of sales and consequentially higher financing costs.

Graph : Comparison of Trends in House and Land Prices in South East England 1986-2000



	House Prices £'000s (SE)	Land Price Index (SE)	Completions (England)
1986	56	250	149
1987	68	339	162
1988	91	620	176
1989	97	475	154
1990	93	328	136
1991	93	256	131
1992	88	224	120
1993	88	219	117
1994	94	277	123
1995	105	290	125
1996	113	297	122
1997	121	415	128
1998	126	487	123
1999	165	604	123
2000	185	720	118

Table: House and Land Price Data 1986-2000

There is a good deal of evidence that this sharp curtailing in investment is happening at present. A typical example is analysis from Dresdner Kleinwort quoted in Investors Chronicle on May 20th ""Housebuilders' sales reservations have collapsed by almost two-thirds year-on-year during the critical spring selling season....Prices are sliding, land values are down at least 40 per cent, and company announcements have highlighted the perilous state of the market......virtually all the housebuilders have now stopped buying land."While a decline in house prices hits profitability, a falling rate of sales threatens the housebuilders solvency as they have no other source of income to service costs and interest payments. The house builder's usual reaction is to preserve cash by cutting overheads where possible but also new investment in both land and development.

Implications

The data suggests that the decline in the market will lead to a decline in new development and housing completions in the short term and this in turn must affect the affordability of Section 106 contributions. But the strength of this relationship is unclear. It is important to note that the macro-economic context if different from the early 1990's in crucial respects such as the Bank of England stance on interest rates. So the analogy is imperfect and should be treated with care. Key issues are dealt with below in 'FAQ' style.

How long might a downturn last?

Some commentators have pointed to the possibility of house prices stabilising in 2010. But the data above shows that while the decline in house prices in the early 1990's only lasted a few years, it took over ten years for land prices to recover to previous highs. In the previous note we referred to the calculation in the Barker Report that macro-economic factors should lead to continuing long term increases in house prices in real (i.e. inflation adjusted) terms.

Developers are not only faced with falling values but construction costs are rising steeply due to the requirements of the Code for Sustainable Homes, higher prices for materials, planning gain and affordable housing. The last two were relatively unimportant in the early 1990's. In the longer term a simple extrapolation suggests that even after making an allowance for rising costs in the short and medium term, rising house prices should lead to increases in land prices gross of the cost of meeting planing requirements in the longer term. The problem is that it is difficult to estimate the time scales involved. (By the same token, adjusting a simple extrapolation of values and costs to include both a short term dip in prices and increase in costs, suggests a perfect storm for housebuilders and a medium term decline in land prices at the very severe end of the scale of expectations).

The core scenario might be a steep short term decline in land prices followed by a resumption of growth from a much lower level.

To what extent would S106 charges at the indicative rate of £20k - £30k dwelling affect the viability of development?

The analysis in our note in May was based on average of 4000 sq m per ha selling at around £4000 sq m i.e. around £16m receipts per hectare. A fall of 10% would reduce receipts by £1.6m

At £20k to £30k a house, and allowing for 25% for the additional developer's margin on cost etc. the typical impact of the Section 106 contributions on land values at a typical density of 40 homes per hectare might be £1.0m to £1.5m per hectare.

We suggested a target residual land value net of all planning obligations of around £1.5m ha. This took into S106 contributions of £20k - £30k per home, the impact Code for Sustainable Homes and affordable housing costs.

So:

A fall in land values of the extent that might be anticipated on purely arithmetical grounds (i.e. as a result of house prices falling by 10% and not to the lower lower level that would result from a replay of the trends in the early 1990's) would either (a) wipe out the capacity to pay S106 at the level indicated or (b) if s106 were still required, wipe out residual land values.

In practice it is not quite so straightforward due to the effect of the timing of costs and receipts on the NPV, but the broad pattern is clear.

To what extent would S106 charges at the indicative rate of £20k - £30k dwelling affect the pace of development?

It is the rate of potential sales rather than house prices or overall development costs that determines the pace of investment by housebuilders and that will depend in large part on a return of confidence in the economy and a reduction in mortgage rates. But where there is potential short term demand

and the level of prices and costs are critical to viability, then substantial compromise on the latter insofar as planning requirements are concerned could make a marginal difference in the rate of new housing starts.

What other factors might affect land values in the short and medium term?

The pace at which the government implements higher construction standards for new homes, and changes in the requirement for affordable homes and the availability of grants to offset the cost of creating them. It is is possible that recent changes to CGT might have a marginally beneficial impact on the rate of land release onto the market.

If planning requirements were cut in the short term, how easy would it be to increase them substantially in the future?

Difficult when a scheme already has planning permission. Easier in other instances in higher value areas. From the comments on historic deficits above it is clear that any additional burden burden caused by undercharging short term schemes cannot readily be made up by overcharging long term schemes.

Has there been any Government policy response to the downturn so far?

Housing Minister Caroline Flint has said that the Government intends to stick to its targets but noted the observation in the Barker Report that this would be difficult to achieve in a downturn.

Response

The broad options for a response in the Study are set out in the tabulation on the following page.

Table 1 Advantages & Disadvantages of Potential Policy Response to Low Land Values

Option	Advantages	Disadvantages
Cut planning requirements to the bone	• Maximise the rate of development	• Will new housing have adequate facilities to ensure sustainability? • Rate of development might be unachievable in any event due to perceived lack of demand. • Difficult to 'make up' loss of short term contributions later in the programme.
Require that planning requirements are met in full.	• Ensures that developments are fully serviced and sustainable.	• Lower rate of development. • Possible developer /landowner resistance. • It is possible that the overall amount raised through Section 106 for wider strategic investment might still fall if the rate of development falls.
Minimise need for Section 106 funding to achieve sustainability	• Optimises rate of development in context of the need for sustainability	• Requires active diversion of public sector funding to offset costs arising from housing growth. • Might impact on achievement of other policy targets. • Possible reduction in level of Section 106 requirements might be insignificant in terms of drop in land prices. • If there is a compromise on affordable housing requirements this will have repercussions on affordability.