Cumulative impacts of regulations on house builders and landowners

Research paper

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Chris Hill, Turner Morum

Department for Communities and Local Government

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Department for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU
Telephone: 030 3444 0000
Website: www.communities.gov.uk

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1. Background to study

Turner Morum was appointed by the Department for Communities and Local Government in late June 2008 to undertake case study and expertise research to support internal analysis of the cumulative impacts of regulations on house builders and landowners.

This report summarises our conclusions and comprises a brief commentary and various supporting case studies or viability assessments.

2. Current market overview

The current state of the UK housing market is well publicised, although the longer term prognosis is not yet entirely understood. Our view is that the downturn has not been evident for long enough for an accurate assessment to be made of how much further, if at all, the market will fall and for how long current negative market conditions will remain. While house prices are said to have fallen generally with average prices down 6.3 per cent compared with this time last year (Source: Nationwide), there appear to be significant regional and local variations. It is also self evident that economic conditions, while not being positive, do not reflect the raft of problems that directly affected the market in late 1989. Although inflation is becoming a concern, the only new negative factor that has and still is directly affecting the housing market at this point is the prevailing crisis in the financial markets. It seems fair to conclude that the current housing market decline has been brought about almost entirely as a result of this problem. Affordability in the first time buyer sector is a problem, but this has been the case for a long time without it causing a reverse in the previous upward trend in the market. In short, it seems reasonable to conclude that the current market strongly favours neither sellers nor buyers, since, whilst prices and sales rates are under pressure, many potential sellers are holding back from marketing property until conditions start to improve. Most, if not all, of this is a direct result of lack of availability of credit – i.e., if anything it seems to be a “lenders’ market”. Once financial markets have recaptured something approaching stability, it seems quite possible that, unless other problems such as far greater fears over unemployment emerge, the UK house buying public could be back in force. This seems especially so given that the factors that created underlying levels of excess demand (demographics, consistently low new-build rates etc) appear to be unchanged and are to some extent being exacerbated by the current crisis. Conversely, there are always plenty of economists ready to predict a far deeper crisis in the UK housing market, on this occasion it appears, largely because this is what has already happened in certain other parts of the world, such as USA and Spain. In fact, we already seem to have entered the ‘second phase’, namely, “who can predict the worst and most extreme outcome?”. Whatever the medium/longer term prognosis, the short

term effects of the financial crisis are similar to those arising in any sudden housing market downturn, for example:

- Non-availability of mortgages to buyers with little equity, even at prices that are genuinely affordable.
- House builders fearing further falls in value increase require profit margins to reflect greater risk.
- Lenders instruct surveyors to value at cautious levels and especially to avoid the usual premium for new build compared with second hand stock.
- Surveyors valuing at lower levels for fear of being sued.
- Incredibly slow sales rates that erode Return on Capital Employed levels to a point where interest on the funds employed is greater than the revenues being produced.
- The need for house builders (eventually) to supplement their (minimal) sales revenue by selling land if they can, often at “distressed” prices.

What is clear by now, however, is the effect that small falls in house prices can have, and indeed once again have had, on the market for residential development land. Our experience is that few transactions are taking place, especially in respect of larger projects/tranches, and that where they do proceed, achievable prices appear to have fallen by up to around 40 per cent. This apparent imbalance between house and land prices is because, while developers buying land do not overtly build house price inflation into their land acquisition models, they are certainly prepared to take higher risks in a rising market, mainly because they can rely upon inflation helping to ‘cover up’ any mistakes that eventually emerge in their land bid assumptions. Once house prices flatten (let alone fall), this dynamic shifts dramatically resulting in a far more cautious approach to most inputs such as costs and values, but also in an attempt to protect further against market risks, profit (gross margin) hurdle rates tend to rise from previous averages of circa 20 per cent to current required levels that we are often now seeing in the 25 per cent - 30 per cent range.

It is only fair to mention that bearing the cost of increasing regulatory measures is difficult enough when the market is buoyant (as is demonstrated by Appendix 5), but these difficulties are significantly increased by current levels of market turmoil when developers in particular are often having their work cut out simply to survive.

3. Typical incentives required to bring land forward for development

i) Brownfield land or redevelopment

The method we have normally adopted to assess the likelihood of land being brought forward for redevelopment is a residual form of valuation that identifies the net sum available for land purchase after all development costs and a reasonable level of developer’s profit have been deducted. We have

then tested if it is financially viable for a site to come forward for redevelopment by comparing the site's residual land value for development with its value for Existing Use – or Current Use Value.
In a situation where a property is occupied and used for a particular purpose, for it then to be realised as a new development its residual development value must exceed it's Current Use Value by a certain margin. This "Surplus of Value" must be of sufficient magnitude to induce the current owner to, for example, shut the business or relocate. Either way, substantial relocation/close down costs and/or tax implications are likely to arise hence there needs to be a significant enhanced value over and above Current Use Value to make it feasible and worthwhile for an owner occupier to sell/relocate. In previous analyses our experience is that a surplus residual development value of at least 20 per cent over Current Use Value is required. We are of the opinion that such a surplus comprises the minimum amount for which an owner such as this would be prepared to sell up or relocate and this guide minimum appears broadly to apply in respect of existing commercial or residential uses.

In arriving at these conclusions in certain cases we have compared the situation to a claim in compensation including disturbance. The compensation code recognises that the payment of market value for land in its Existing Use will not adequately compensate a landowner and this is referred to as the principle of 'equivalence'. It is difficult to put an exact figure on the disturbance and other costs a landowner is likely to face, but we have listed below some of the more obvious costs an operational business is likely to face if it decides to stop trading completely or to reopen elsewhere.

- Capital gains tax.
- Stamp duty on replacement property.
- Redundancy costs.
- Relocation costs including losses on stock.
- Legal and other professional fees.
- Double overheads (during relocation).
- Marketing material including client change of location notifications.

We believe it would not be reasonable to assume that a landowner would willingly close a business or relocate unless the surplus, before tax, was an absolute minimum of 20 per cent higher than the value of the property for Existing Use. In the attached case example (Appendix 1), the Council accepted the principle of at least a 20 per cent uplift in existing use value as a necessary incentive to the landowner in the original valuation exercise, however, our experience shows that the required uplift is more likely to be around 25 per cent. See Appendix 1 – Viability Exercise on Sandy Lane, Teddington.

This approach has also been upheld by the Planning Inspectorate; see Appendix 2 - Appeal Decision notice in respect of land at Gordon Court, Hampton Hill. We refer, in particular, to points 7 to 22 on pages 3,4 and 5, where it will be noted that the inspector upholds the appellants view, which is

supported by financial viability evidence, that a premium of 25 per cent over current use value is required in order to persuade the existing owners to sell their properties. Note also Appendix 3, extract from the Royal Borough of Windsor and Maidenhead Local Development Framework Core Strategy, comments in paragraph 4.2.

In summary, we would recommend that a premium hurdle rate uplift of 25 per cent on Current Use Value is assumed to realise redevelopment of 'brown' land. It should also be borne in mind that, while the examples of Valuation Office Agency data provided to us for Richmond and Windsor and Maidenhead seem not unreasonable for clean serviced land in late 2007, current market conditions will render such land value assumptions effectively meaningless.

ii) Greenfield, or previously undeveloped, sites

Under these circumstances, rather different factors apply. One is most often dealing with agricultural land with a low base existing use value, but the costs normally associated with realising new development on such unserviced 'greenfield' land tend to be considerable. These include both high costs of infrastructure and servicing and a level of s106/planning gain costs that will at least need to reflect the impact of major new development on the local community and its services and amenity. In many cases, we also find that such developments are expected to bear a disproportionately high planning gain burden simply because the base land cost is assumed to be low, perhaps forgetting the high cost of bringing such land into the desired use. See Appendix 4 – Schedule of Typical Infrastructure/s106 Costs on (a sample of 5) Major Projects.

Despite low base values, landowners still need to be enticed to bring their land forward for development and similar principles to those in 3.i above will still apply. In this case, however, required levels of premium are routinely protected by way of minimum land price provisions, usually contained within option or collaboration agreements and long-term conditional contracts.

We are regularly involved in matters relating to such agreements and in our experience it is now usual to find such protection by way of a minimum price threshold for landowners. Levels vary, but typically, we expect to see figures of circa £100,000 to £150,000 per gross acre. Note that this usually applies per gross acre and referring to the schedule in Appendix 3, it will be noted that the average net to gross percentage across the five fairly typical examples used is 56 per cent. By applying the above minimum prices to net areas, it can be seen that development proposals will normally need to support land values of £200,000 to £300,000 per net developable acre if the land is to come forward for development. We should emphasise that this 'gross to net' figure tends only to apply to larger more strategic 'greenfield' sites, whereas for smaller sites, say within urban areas the difference between gross and net can be minimal.

Additionally, most option style agreements also provide for promoters/developers to receive a discount, typically 10 per cent to 20 per cent, to Open Market Value and the above minimum land prices are after the application of such discounts (and other deductible promotional costs).

Consequently, we would recommend that minimum land value requirements of at least £200,000 per gross, and £400,000 per net, acre are assumed for release of 'greenfield' land.

Note that all land value figures within the appendices are net and therefore take account of all abnormals, s106 costs, affordable provision etc. They are also in most cases based upon values being achieved before the effects of the current financial crisis were being felt.

4. Likely costs and effects of increasing environmental regulation

In many cases the industry still does not have an accurate feel for just how much various measures, such as zero carbon, Code for Sustainable Homes, levels 3 to 6 etc., will cost, therefore quantity surveyors and house builders are having to make forecasts that tend to err on the cautious side and assume the worst case in order to identify and attempt to minimise their risks.

Some work has, however, been done on this and in Appendix 5 we provide an example of a case study in respect of one large site where we have applied a build up of the various Code levels, each from their anticipated introduction dates, (in tab 1) in order to measure the cumulative effect upon current net land value (in tab 2).

For this example, it should be noted that the main 'value-determining' factors (house price levels, infrastructure costs etc) are reasonably typical for this type/size of project and we do have examples of infrastructure costs per acre being considerably higher, particularly on projects that are rather smaller, say 1000 to 3000 dwellings (note again the schedule in Appendix 4).

In short, the result of applying this test in this case is a significantly negative land value, implying that, unless considerable mitigation can be found, the owner of this site will clearly not be induced to make his land available for development.

5. Potential for costs 'trade-off' to avoid adverse land value impact of regulations

The trade-off potential for reducing (other) costs elsewhere so as to enable cost of new measures/regulations to be affordable is, in our view, limited. The whole business of developing and selling homes (as with any other product) is a trade off between cost and value. It is crucial, therefore, to avoid trying to make savings in any areas that will, as a result, adversely affect achievable

revenues, such as specification reduction (e.g. "less bathrooms"), where such value reductions are likely to more than offset any savings. Some pundits suggest that house buyers may be prepared to pay a supplement for a dwelling that has been built with sustainability in mind, but in our experience this is not the case. Most buyers shop around in their location or locations of choice and then, in simple terms, purchase the largest dwelling they can afford at the lowest possible price.

Examples of where costs trade-off may be effective should be limited to expenditure that does not affect end sales, either rates or prices, such as lower/less costly (flexible affordable tenure etc) affordable provision, reduced s106 contributions/costs/tariff levels. It is worth noting that where this issue has arisen before, such as in the proposed London Thames Gateway tariff, the Development Corporation has openly stated that the affordable housing provision is seen as the "pressure release valve".

6. Mitigating the impact of regulatory and taxation changes

Most urban extensions are on farmland and most farmers own such land as a "business asset". Until recently, a sale of such business assets would have attracted business taper relief at a rate of 75 per cent. This would mean a farmer would pay Capital Gains Tax at a rate of 40 per cent less 75 per cent, i.e., 10 per cent. The Chancellor recently changed Capital Gains Tax rates to a uniform figure of 18 per cent, which resulted in the tax payable by most farmers selling land for development rising by 80 per cent. This, along with the effects that Stamp Duty Land Tax has on net achievable land price, can provide a significant disincentive to the release of potential development land, unless high net payable values can be achieved.

Opportunities for possible mitigation need to be focussed on the combined effects of taxation and of s106/planning gain/tariff levels with possible relief for 'difficult' sites. This could include reduced Stamp Duty Land Tax, mitigation of the negative effects of other taxation measures, such as the removal of taper relief, and lower tariff/s106 burdens for land that is costly to being forward.

7. How can the house building industry cope and adapt?

Whilst we might hope for some element of adaptation as a result of improving business efficiencies within the house building sector, effective adaptation (i.e. maintained long term profit capability as demanded by the city and resultant increased new housing production) is likely to be limited to either i) reducing effective land prices (with the consequential effects in terms of land release discussed here) or ii) through reduced planning/s106 costs, taxation etc. Some sites/areas with high abnormal or infrastructure costs will not cope as sites are barely viable even under current regulations, let alone once further measures are cumulatively imposed (see 4. above).