Past performance, points to future potential

SME property developers should act now to capitalise on market opportunities.

Contents

Introduction 2

Past performance points to future potential - developer opportunities 3

House prices 5

The pressure of interest rates 10

Supply factors 13

Demand for residential property 15

Conclusion 19

Past performance, points to future **potential**

Introduction

Welcome to *'Past performance, points to future potential'* – the latest research from Atelier.

Once again, we've teamed up with Dr Nicole Lux, Senior Research Fellow at London's Bayes Business School, to provide data and insight for SME property developers to help them plan for the medium and long-term. With this piece of research, we started with a simple question: can we use past property market data to predict the future?

In answer, we have worked with Dr Lux to compile detailed analysis on property prices, inflation, interest rates, demand, supply, mortgage rates, unemployment and population growth. It's our view that this data can be used to understand the market conditions we can expect to see in the short to medium term.

The data indicates that we are close to the trough, which will be followed by a sustained period of recovery. The analysis points to a recovery in house prices, stabilisation in interest rates, and positive demand.

For developers, the take-out message is act now for the best chance to capitalise on the coming upswing. This might seem like a counter-intuitive sentiment, given the volatility experienced over the last few years. Developers have been forced to contend with pressures on supply chains and current levels of pressure on disposable income, as well as the impact of high interest rates. In conditions like these, confidence can be in short supply.

Given our analysis of the long term data and trends, we are positive about the future, and we are here to provide finance solutions to professional property developers ready to act.

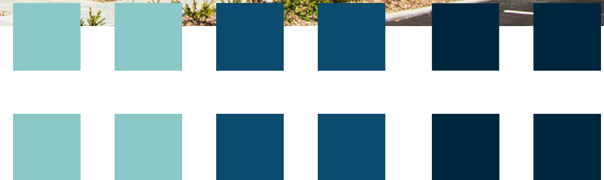
With pipelines likely to take 12-18 months to restock and planning, as ever, a drag factor, it's important for developers to take an opportunistic position and begin bidding, so they are where they need to be when the market turns.

In the UK, private enterprise delivers 60% of new housing – precisely because these developers are agile and can respond quickly to shifts in the marketplace. It's the developers who best play to these strengths who will put themselves in a winning position.

We hope you enjoy this research and please get in touch if we can help. We'll be here, ready to support you.

Chris Gardner, Chief Executive Officer, Atelier

of new housing in the UK is delivered by private enterprise.



Past performance points to future potential - developer opportunities

It is often said that the best prophet for the future is the past. Given the current headwinds facing SME developers including higher borrowing costs, reduced consumer spending power, and higher material costs, can we learn anything about the likely trends over the next 3-5 years by examining long-term historic trends?

We certainly think so and, in this document, we examine the long-term historic trends and medium-term outlook for the drivers of SME residential developer profitability. The key contributing factors that shape the lifecycle of the market include house prices, land prices, interest rates, and of course, all-important demand and supply.

The following research dissects each of these factors and their influence on the market as a means to discern our current position in the cycle.

To set the context, our starting point is an examination of the stages of the cycle from 1982 to now. This perspective is useful to build an understanding of the undulations of the market over the long term, and to get a sense of what point of the cycle we are in now, and what stage we are approaching.

DEFINING THE STAGES OF THE CYCLE SINCE 1982*

1982-1989
Sustained period of house price growth aided by political will shown by Right to Buy and MIRAS initiatives.

1989-1995
House price falls in real and nominal terms due to double digit mortgage interest rates and increasing percentage of disposable income absorbed by mortgage payments.

1995-2007
Prolonged and unprecedented upswing in values fuelled by a rise in the average loan to income ratio and mortgage availability.

2007-2013
Declines in nominal terms due to the Global Financial Crisis, and post Quantitative Easing. Small falls in absolute terms exacerbated in real terms by inflation.

2013-2016
Sustained period of recovery in values particularly in London and the South East fuelled by low interest rates and a recovery in consumer sentiment. Concerns over affordability and deposit requirements led to introduction of Help to Buy in 2013.

2016-2019
Slow, gradual erosion of real house prices due to declining sentiment following a period of growth.

2019-2022
Pandemic induced reassessment of household requirements, a stamp duty holiday and low fixed term rates leads to a post GFC peak in transaction volumes. In real terms house prices back to 2007 level.

Source: Savills

2023 onwards
Developers felt the full force of the fallout of the war in Ukraine, the subsequent energy crisis and 'mini-Budget' in 2023. Yet, in 2024 we have seen the return of market conditions that have historically preceded an upswing. Whilst we currently sit at the bottom of the cycle, history tells us we are heading for recovery.

House prices

To help us understand our current position in the cycle, we start at the obvious and arguably most zealously tracked statistic in the UK: house prices.

The value of UK residential property stock was estimated at £7.2tn at the end of 2020. Over the two years from 2021 to 2023, residential property increased in value by 15% whilst the value of commercial property stock is estimated to have fallen by 9%.

Looking at historic data, we can evaluate how often residential house prices have had a prolonged downturn and how severe and lengthy that downturn was. ONS statistics go back to 1969. In that year Manchester City won a domestic and European double. 53 years later they repeated the feat. That is what we call a long-term cycle.

It was also just three years after England won the World Cup. A one off, not repeated since. That is what we call a structural shift. So, how many times during that 55-year period do you think house prices fell or grew on an annualised basis?

Currently, per the data tracked in Figure 1, we are at the end of the sixth period of decelerating growth, and, it appears, we're now entering a third phase of decline, which is defined when house prices fall for more than two months on an annualised basis. This commenced after a 3.96% decrease was recorded by the ONS between July 2023 – August 2023. As this analysis illustrates, this decline will likely be brief, and followed by a sharp and prolonged period of recovery.

FIGURE: 1 UK HOUSE PRICE ANNUAL CHANGE 1968-2023

There have only been two periods of decline in absolute terms: **1992-93 and 2008-09.** These periods were brief and were followed by sharp and prolonged recovery. In the above graph, **the green arrow charts periods of accelerating growth, and the red arrow charts periods of decelerating growth.**

EXAMINING THE DATA IN MORE DETAIL WE CAN SEE THAT....

1) Firstly, in a 55-year period, house prices experienced significant deceleration of growth six times (we are currently in the sixth phase) and this was followed by significant recovery on four occasions. The general cycle shows that periods of price decline have generally been shorter, with an average of 16 months.

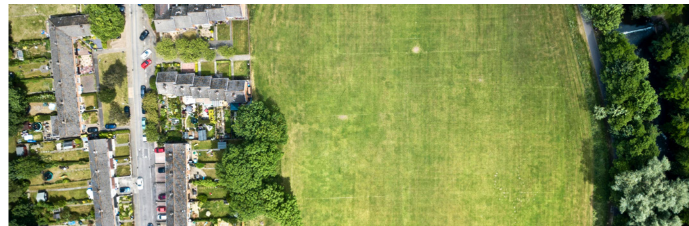
2) Secondly, in only two of those periods was the fall significant (>5%). The UK recession of the early 1990s and the Global Financial Crisis.

3) Thirdly, following each fall there was either stability or a significant and typically prolonged recovery period.

4) The growth after a period of price decline is also much larger in magnitude.

Overall, the total value of UK property has grown at an annual average rate of **6.1%** over 30 years, close to double the rate of inflation – though most of that overall rate is driven by residential property, which accounts for nearly three-quarters of the total.

Moreover, residential values have seen the fastest growth rate, at **6.8%** per year since 1987. Underlying land makes up **72%** of the stock value for residential. Therefore, residential property development is the most profitable sector over the long-term.



The total value of UK property has grown by **6.1%** per annum (av) over 30 years.

6.1%

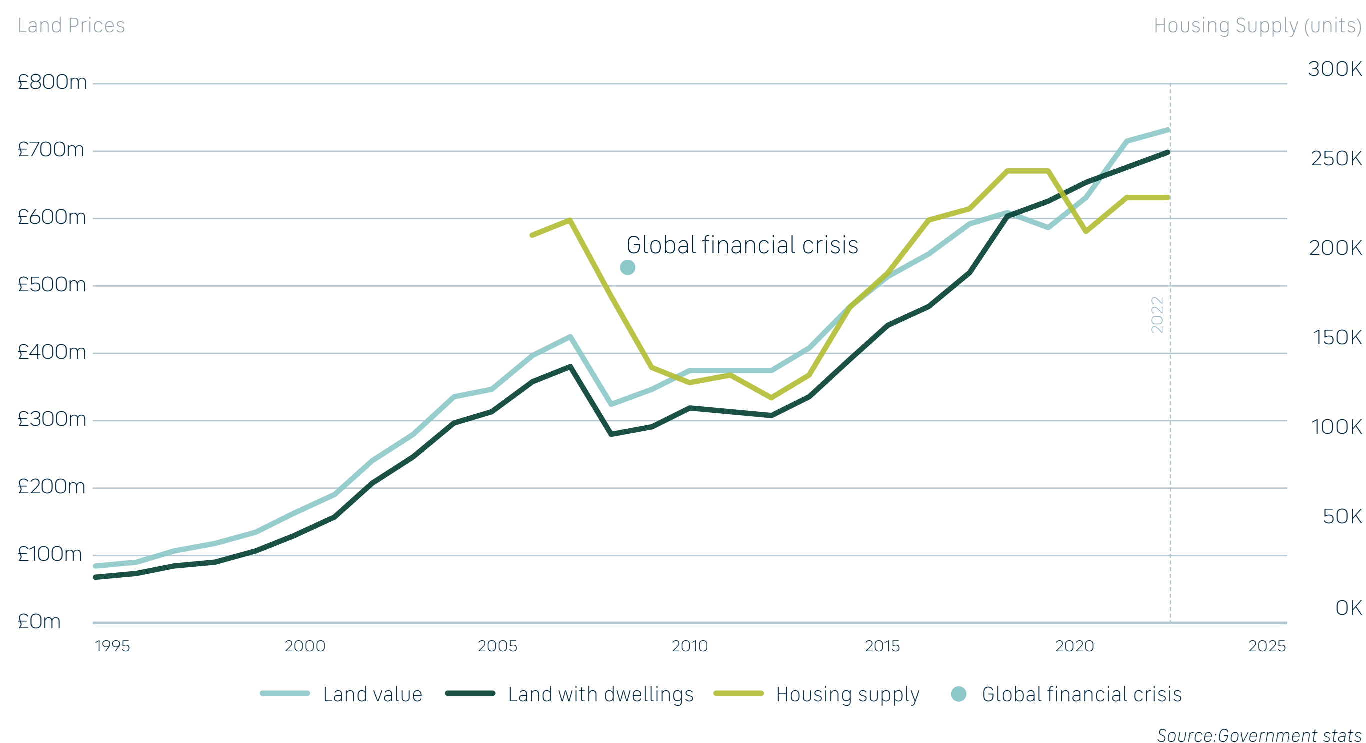
6.8%

growth rate of residential values per year since 1987.

Underlying land makes up 72% of the stock value for residential.

72%

FIGURE 2: LAND VALUE PRICES



Source:Government stats

KEY TAKEAWAYS

1) Historic land price growth has been a prime driver for house price growth in the UK
2) The slowdown in new residential supply in the recent period has led to supply shortage in the current market
3) Although housing supply has risen, it remains well below the annual volume needed to balance supply and demand. As a result, land values have continued an inexorable rise

Positivity is a superpower in business – and it's amazing how often entrepreneurial success correlates with an optimistic outlook. Of course, it's not enough on its own. Fortune often favours the brave – but developers are dealing with many variables and it's key to combine bold decision-making with rigorous analysis, to be sure you're making the right call, at the right time, based on the best available data.

The research sets out a clear case that there is no structural shift. The residential property market is, as it ever has been, a profitable sector over the long term. This is consistent with our own reading of the current cycle.

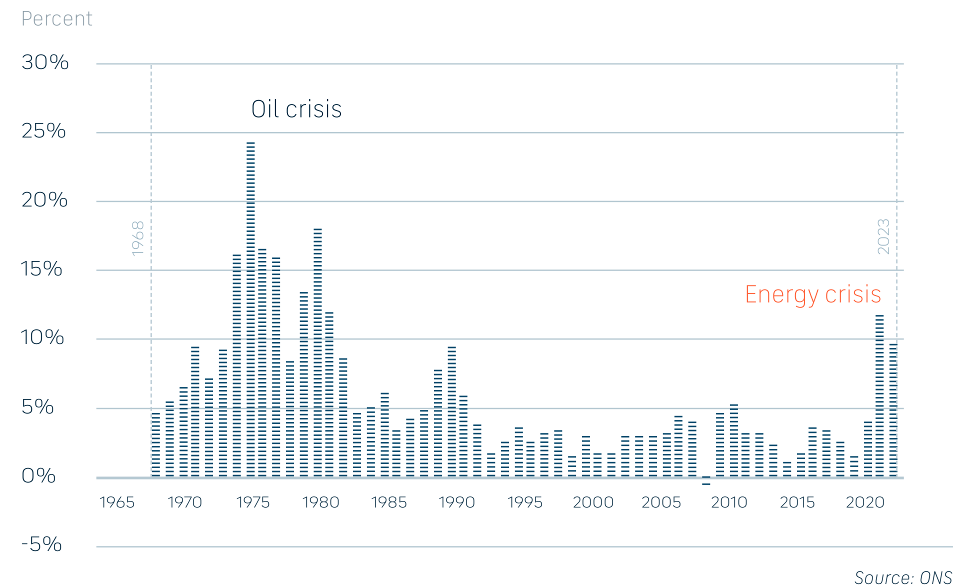
An upturn is coming – that said, it's still first-time buyers that drive the market and they are not getting anything like the support they need. The good news is that with an election looming, our political class will be working hard to set out their stalls and, we expect, trailing plans for meaningful measures, which in turn, will add momentum to the shift towards stability and price recovery that has been charted here.

Chris Gardner CEO, Atelier

House prices and inflation

Thus far we have only looked at house prices in absolute or nominal terms. However, it is very important to look at them in real terms i.e. adjusted for inflation. **So, what has the long-term inflation experience been in the UK?**

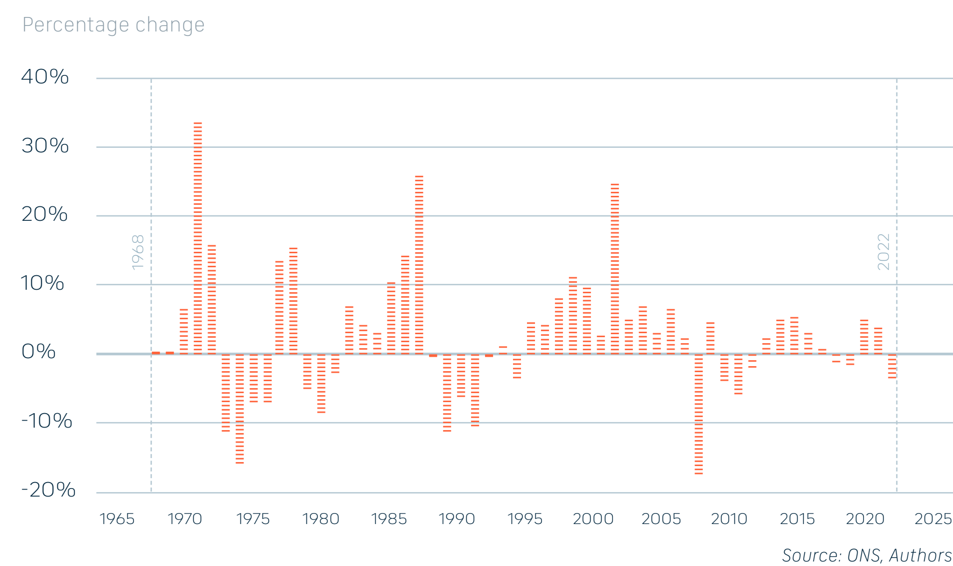
FIGURE 3: UK INFLATION 1968 – 2023



Source: ONS

And what does the house price annual change look like when we adjust for inflation?

FIGURE 4: REAL HOUSE PRICE CHANGE



Source: ONS, Authors

Under normalised market conditions average house prices have continued to outstrip domestic inflation

History would therefore suggest that, other things being equal, the current downturn in pricing is likely to be shallow and followed by a period of stability and recovery. On a three-year view, therefore, now looks an opportune time for SME developers to enter the market.

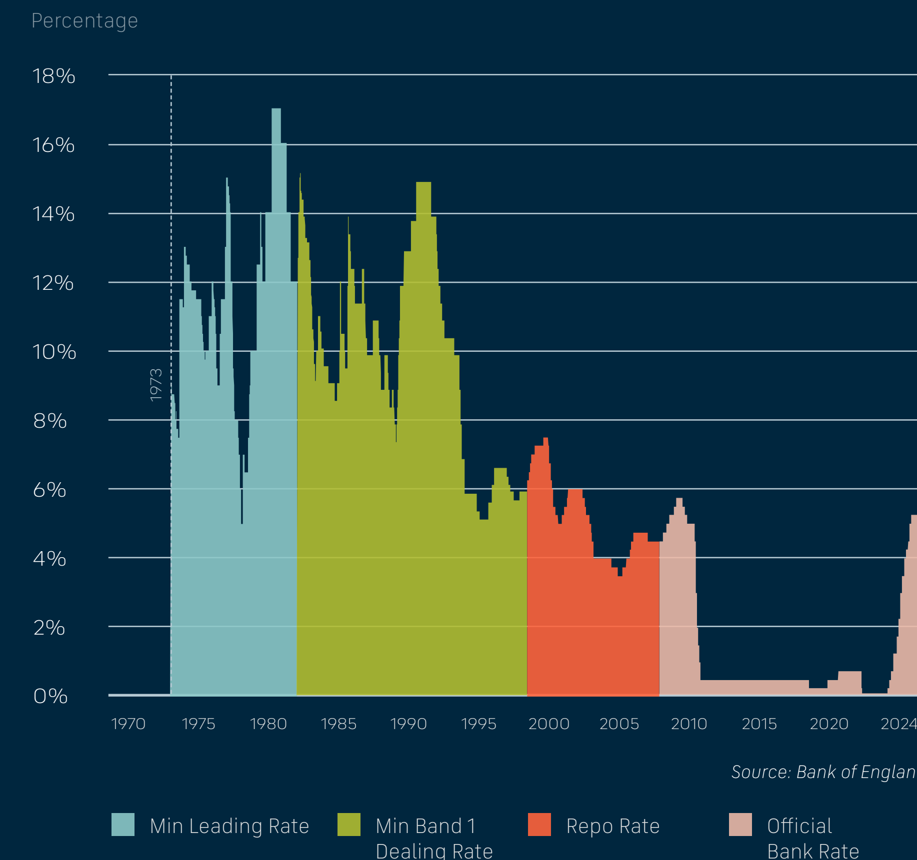
The pressure of interest rates

Now let us turn to the second most looked at statistic, interest rates. Developers, investors and private households were hit by higher interest rates throughout 2023. For many this is a big change from a 10-year cycle of extremely low interest rates. However, when compared with historic rates prior to 2009 and going back to 1694 when the Bank of England was formed, today's rates are put into perspective. For our purposes, let us start at the oil crisis of 1973.

...when compared with historic rates prior to **2009** and going back to **1694** when the Bank of England was formed, today's rates are put into perspective.

FIGURE 5: UK SHORT TERM INTEREST RATES 1973-2023

Changes in Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate 1,2,3,4



Source: Bank of England

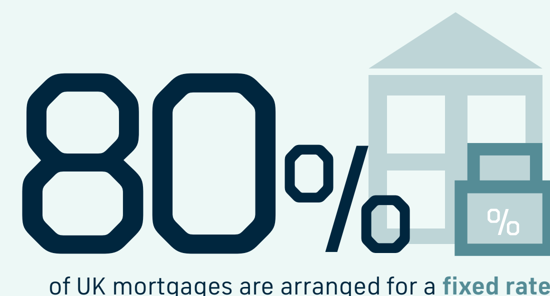
1. Bank Rate, Minimum Lending Rate, Repo Rate and Official Bank Rate are interest rates. The Minimum Band 1 Dealing Rate are discount rates.
2. Data refers to the miminum published rate the Bank discounted bills to relieve money market shortages (excludes late assistance and repurchase and sale agreements).
3. 16 Sept 92, UK leaves the European Exchange Rate Mechanism. MLR set at 12%, raised to 15% (with effect from 17.9.92; never implemented).
4. The official Bank Rate paid on commercial bank reserves.

On a 15-year view the recent crisis is clearly bad news in terms of short-term borrowing costs, and it would be unwise to underestimate the strong negative lagged effect over the next two years as borrowers are forced to refinance at higher rates. However, looking at *Figure 6* it would appear that interest rates are likely to stabilise for a prolonged period at close to their lowest market determined level (i.e. ignoring the artificial respiration of Quantitative Easing).

When overlaying interest rates with new housing; supply grew in the years of lower interest rates, but supply was also strong during 2004 – 2008, when interest rates were high.

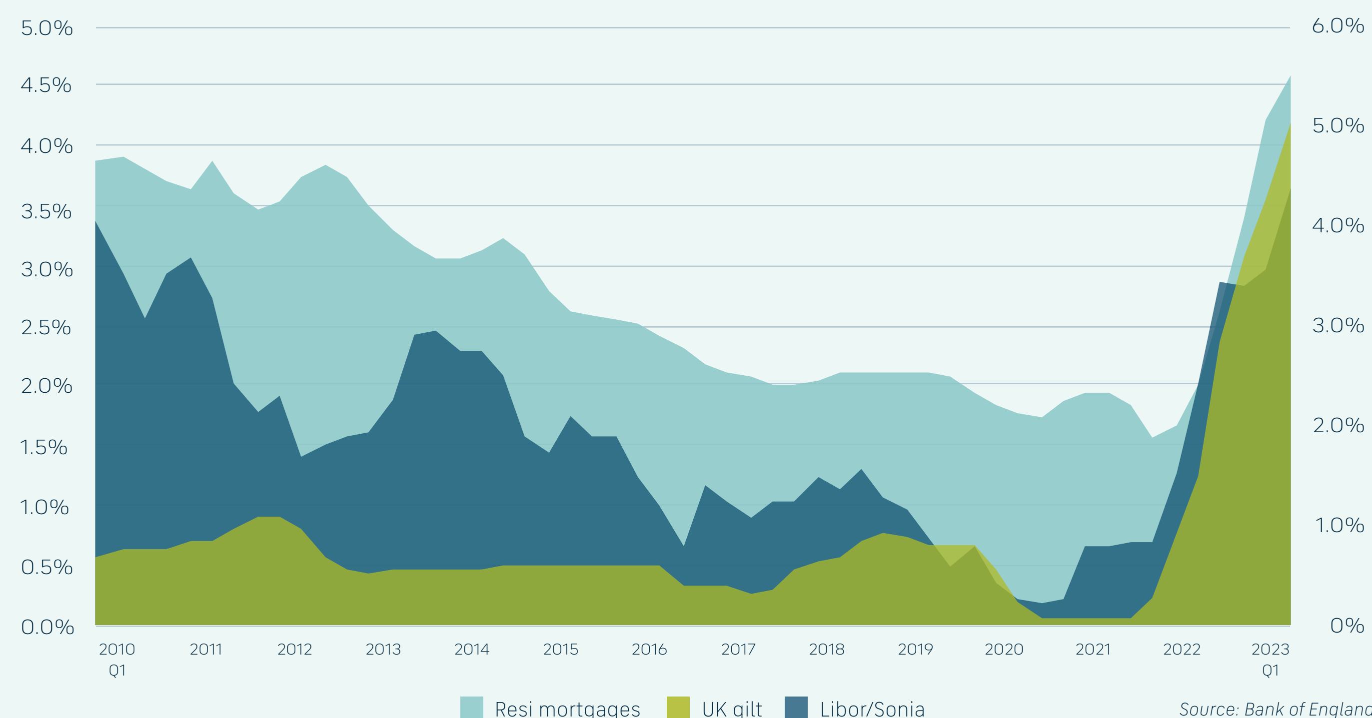
Residential mortgage rates are typically closely related to the Libor/Sonia variable rate, although over **80%** of UK mortgages are arranged for a fixed rate.

On average the residential mortgage rate is 50 – 70bps over Libor/Sonia. A period of readjustment should therefore be expected following the recent rate hikes, but the higher rates pre-dating 2009 should also provide some relief that house prices are not solely dependent on interest rates.



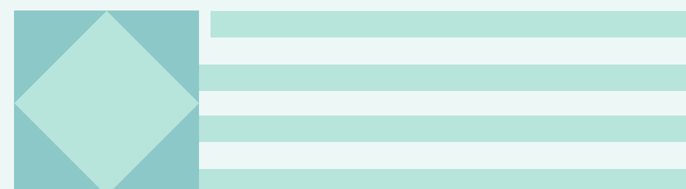
of UK mortgages are arranged for a **fixed rate**.

FIGURE 6: RESIDENTIAL MORTGAGE RATES V BANK RATES 2010 – 2023



Source: Bank of England

A period of readjustment should be expected following the recent rate hikes, but the high rates pre-dating 2009 should also provide some relief that house prices and demand are not solely dependent on interest rates.



We've recently observed a decrease in inflation which has eased pressure on build costs. In addition, interest rate volatility has subsided with markets projecting a continued, gradual fall in rates over the medium-term. It's likely when the first rate cut does materialise, it will be greeted with optimism, increasing confidence amongst investors and borrowers.

In terms of what happens next, following the success of our fixed-rate loan offering, it's interesting to now see that 90% of our borrowers are choosing a base-rate tracker option. This is a trend we're witnessing across the market. It would appear borrowers now believe (rightly or wrongly) that rates have peaked.

We believe that property is a long-term asset class. It's important for developers, in particular, to be agile enough to overcome short-term market volatility whilst progressing forward with a clear, long-term strategy.

As such, we always look at scheme fundamentals to evaluate credibility from front-to-back. Our chief considerations are: the right product in the right location; sensible build costs and an experienced team; 'skin-in-the-game' equity alignment (including personal or corporate guarantees); and importantly, a realistic exit strategy supported by the presence of a liquid and robust local market. If we get comfortable on these key areas we are usually confident we'll achieve a positive outcome - even if there is another significant macro event, such as the rate volatility we've seen over the preceding 18 months.

Paul Silva, Chief Financial Officer, Atelier

Supply factors

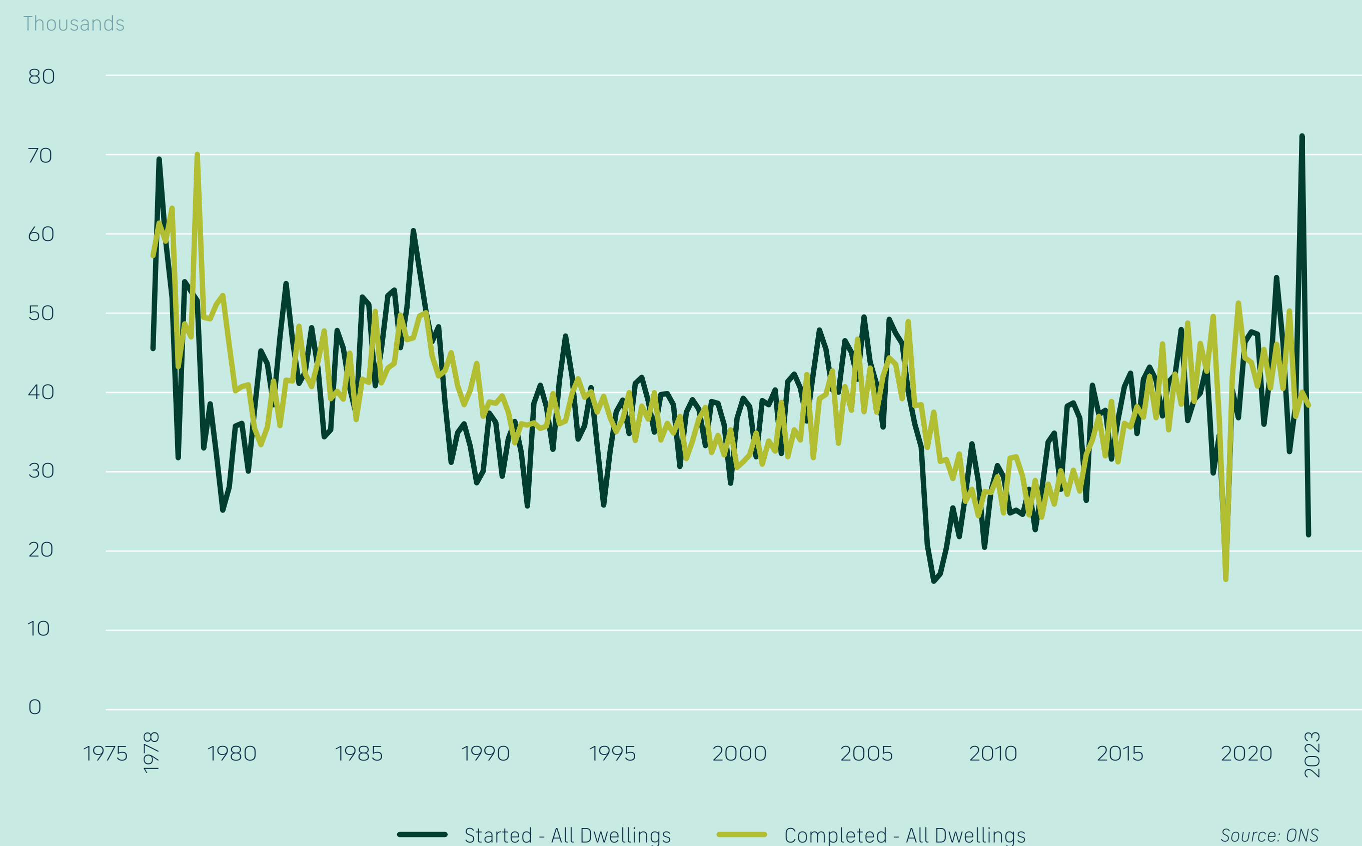
Despite ambitions to deliver **300,000** new residential units a year, the actual figure has been closer to circa **200,000** per annum and the current Government has now abandoned formal targets, which is a mixed blessing for developers.

Quarterly housing statistics shown in *Figure 7* are well under the **75,000** per quarter estimate required by the Government as a target in their 2019 manifesto.

Despite efforts to increase supply, completions were higher during 1975 – 1989 than they are today. Completions have never completely recovered despite low interest rates.

The structural disparity between supply and demand is not going to be resolved in the short to medium term. This supply constrained market presents opportunities for SME developers, as values will be underpinned and demand upheld.

FIGURE 7: QUARTERLY UK HOUSING STARTS AND COMPLETIONS



Source: ONS

One of the biggest blocks to supply is the UK's planning and regulatory system. With extended planning timescales, SME developers should look to acquire sites now, so they are ready when a turn in market conditions arrives.

Planning is a juggernaut of a challenge which, it seems, no Government is willing to try and steer back on track. The UK has a well intentioned, but over-regulated system where the costs associated with planning inhibit developers from delivering more affordable homes, instead making high-end, high-density homes a more viable option. Regulation is extremely difficult to roll back, so this issue is not going to go away any time soon. It's also a real unfairness that those who are building the majority of new homes – the SME developers – are the ones most affected.

However, with an election looming this year, housing could become a political priority, and only recently we saw a positive step forward with the changes to Permitted Development Rights. With PDR, SME developers now have a real opportunity and should be looking to secure funding early so that they are best placed ahead of the coming cyclical upswing.

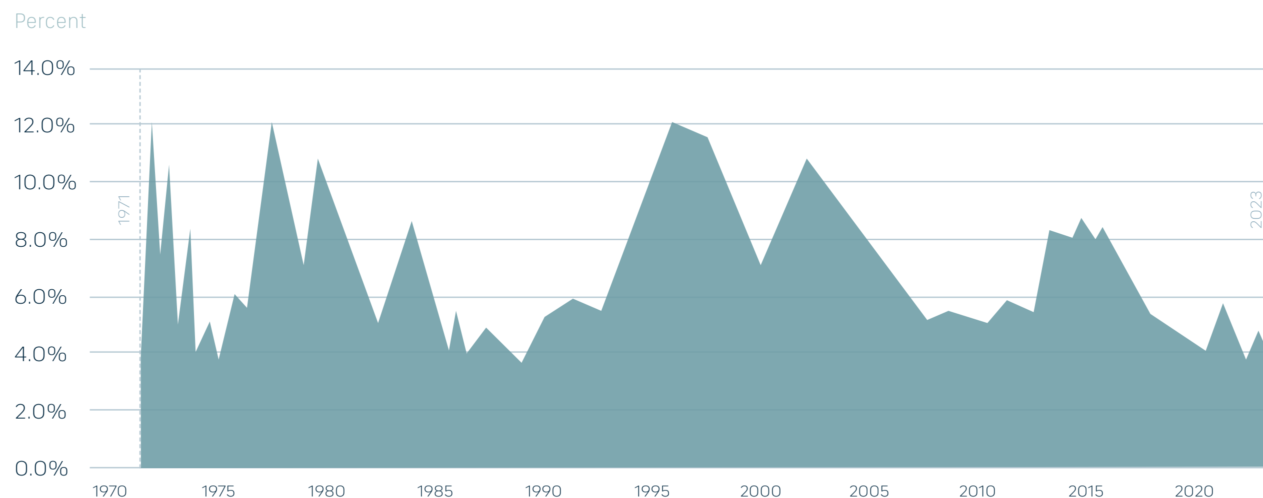
Chris Gardner, CEO, Atelier

Demand for residential property

To better understand longer term structural demand trends, we have chosen to highlight unemployment rates and population growth. For unemployment, we appear to be stable at circa **4%**, which is typically the trough level for the last 55 years.

1) When interest rates were high in 2007, unemployment was much higher than today
2) Unemployment is at a historic trough, meaning household resistance to higher costs is greater
3) UK unemployment is at close to historic lows, leading to strong structural demand for acquiring residential property

FIGURE 8: UK UNEMPLOYMENT 1971 – 2023



Source: ONS

For population, it is true that growth is levelling off after a sustained increase from the early 1980s. UK population growth has very little influence on the overall pressure on land pricing and housing supply.

UK population growth is at its lowest since 2001, representing a fall in a recent trend of high growth, between **0.5** and **0.8%**, from mid-2004 to mid-2019. Despite the decline in the rate of population change, it was still higher than in any year between mid-1972 and mid-2001. Aggregate demand for housing will therefore be driven more by changing household formations.

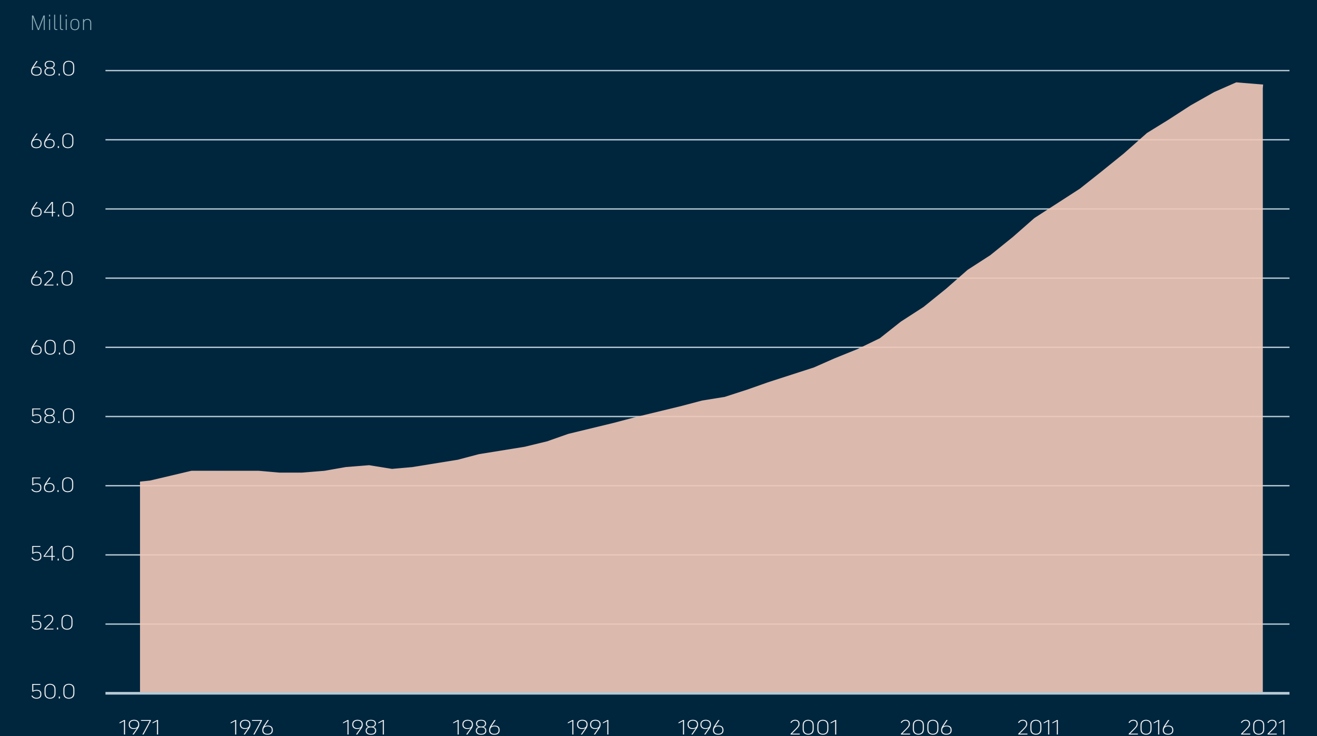
Historically, domestic household formation was relatively stable, with couples marrying, buying a home, and quite possibly staying in that home until the mortgage was paid off. Over the last 50 years there has been a far greater level of fluidity and volume due to an increasing divorce rate and an increase in older households without dependent children, particularly those where the household reference person is aged 75 years and over.

The ONS predicts that between 2018 and 2028, the number of households in England is projected to grow from **23.2 million** to **24.8 million**, an increase of **7.1% (1.6 million)**. This equates to an average of **164,000** additional households per year. For the same period in the 2016-based projections, they projected an average of **165,000** additional households per year.

Over the entire 25-year projection period, the number of households is projected to increase by **16.2%** to **27.0 million** in 2043.

UK population growth has very little influence on the overall pressure on land pricing and housing supply.

FIGURE 9: UK POPULATION 1971-2021



Source: ONS

We agree that demand is likely to remain strong. In fact, based on our conversations with developers around the country, we would go further and say that there is always demand for the right product. Success is more achievable for developers who can deliver what their local market needs and at affordable price points.

Though this data points to a levelling off in population, it's important to think about how that plays out on the ground. For the long-term foreseeable future, housing demand is not going to be met.

Let's also think about the breakdown of the demographics we're dealing with. The UK has an ageing population. Figures published in 2021 estimated that in the next 25 years the number of people older than 85 will double to 2.6 million. A more recent Savills report indicated that an additional 144,000 care beds would be required over the next 10 years to cater for an ageing population yet there are only 30,000 beds in the pipeline. It's certain that we're going to see an increasing demand for later life accommodation. Alongside this, at the other end of the age spectrum, we're sure that the build-to-rent sector will remain robust.

Rebecca Nutt, Director of Portfolio Management

To conclude...

So, what has this brief history lesson taught us about the outlook for the next three years? Having situated ourselves in the historic context of the property cycle, it is clear that we are currently sitting at the bottom of the cycle. Market conditions are beginning to recover, and we find ourselves close to the trough, which will to be followed by a sustained period of recovery.

1. It is reasonable to assume that falling house prices will trough soon and then recover
2. Interest rates are likely to stabilise at lower-than-average historic levels
3. The strong tailwinds that drive demand persist
4. Supply constraints in terms of new builds are likely to have a positive impact on pricing.

At Atelier, we are an agile lender primed and ready for the cycle to bounce back. History tells us that the bounce back will be significant, and Atelier is here to offer competitive, bespoke finance solutions. Now is the time for SME developers to build up their pipeline and we are here to lend a hand.

Contact us

Chris Gardner
CEO
chris.gardner@atelierfinance.co.uk
020 7846 8239

Rebecca Nutt
Director of Portfolio Management
rebecca.nutt@atelierfinance.co.uk
020 7846 8245

Paul Silva
Chief Financial Officer
paul.silva@atelierfinance.co.uk
020 7846 8234

Ready for your next project?

We'd love to help, please get in touch

enquiries@atelierfinance.co.uk
020 7846 0000

3-5 Rathbone Place, London, W1T 1HJ
atelierfinance.co.uk

Atelier