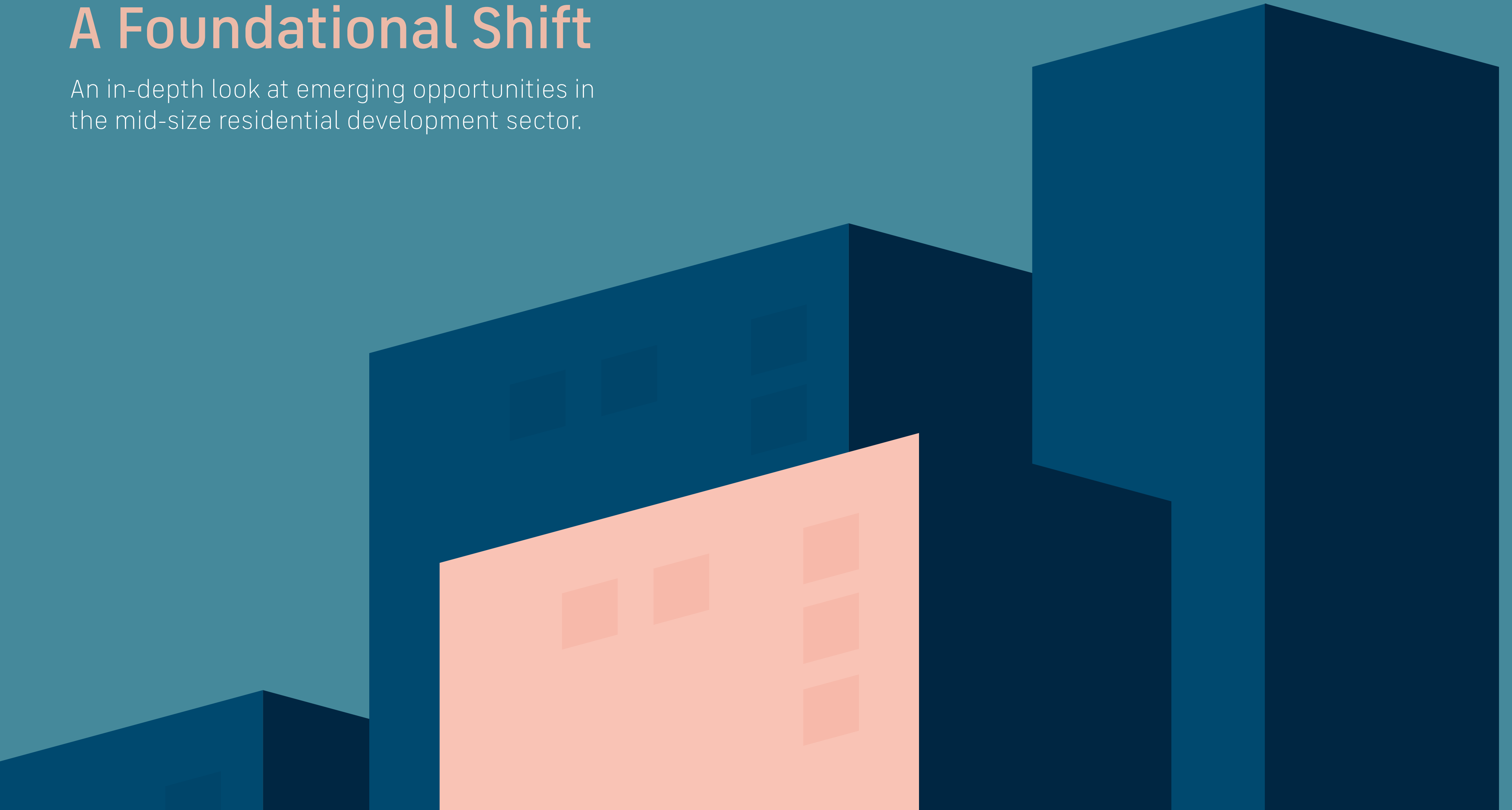
Atelier

# A Foundational Shift

An in-depth look at emerging opportunities in the mid-size residential development sector.



# Contents


Size, context and relevance of the UK residential market 3

Buyer and renter demand 3

Availability of development finance 4

Debt availability 4

Regional differences in the residential development pipeline 5

Land values 6

Sale of assets 6

Challenges and opportunities 7

Finding the right finance solution 7

Conclusion 8

Contact us 8


A Foundational **Shift**

# Introduction

**The development sector rarely stands still. For some, this near constant state of flux is a major barrier to entry, but for us, we see it as a shifting landscape filled with opportunity. As our industry enters another period of uncertainty, Atelier commissioned Dr Nicole Lux, Senior Research Fellow at London's Bayes Business School, to undertake an in-depth analysis of the market at large with the goal of uncovering those opportunities.**

This new period of transition presents an exciting juncture for the mid-size residential development space. Assets are being transferred from unwilling holders to willing holders, and though this process may be lengthy, it offers countless opportunities for nimble, mid-sized operators with customised financing packages to capitalise on a foundational shift in the market.

## The market at a glance

- **The cost of holding an asset** has been minimal for the last 12 years. The increase in interest rates experienced over the last 18 months is creating a large pool of forced sellers.
- **The value of the UK residential property sector** has grown by 6%pa over the last 5 years. For investors, the sector remains a safe haven and a defensive asset class with good income returns.
- **The build-to-rent and student accommodation** sectors have expanded quickly and are recognised as separate asset classes by institutional investors. They also offer significant opportunity as demand is still outpacing supply.
- **In the near-term, short-term** funding costs for development will remain high compared to both past and medium-term expectations. This will make the viability of schemes more challenging in the short term.
- **Development site 'starts'** were down in all regions in 2022, although the Midlands was the best performer. This will result in fewer homes coming to market in 2024 and 2025 which is likely to bolster values and further exacerbate the pressures on rents.
- **There is evidence that land values are falling.** While this is a challenge for landowners, it is essential for the overall health of the market. Borrowing costs and construction costs are up, profits are being squeezed, and the only 'lever' left is land values.
- **With rising interest rates, fewer refinancing options and the general cost of ownership increasing** it is likely that some owners will be forced to sell. This is likely to drive down the prices of block sales and land. For agile SME developers, and investors, this is likely to present a significant opportunity.
- **While financing costs have increased** significantly and are not expected to drop in the short-term, especially for development finance, there are many opportunities to improve interest rates.
- **The fundamentals for residential development remain sound.** An increasing and ageing population is leading to constrained supply, coupled with strong end-user and institutional investor interest. As a result, the market repricing is likely to provide some excellent opportunities from motivated vendors for mid-sized developers with the right financing package to benefit.

# Size, context and relevance of the UK residential market

The UK residential property market is estimated to be worth around **£7.2 trillion** (IPF, 2020), with UK residential property held by institutional investors accounting for one tenth of the market (**£87bn**). Over the last 5 years (2018 – 2022) the sector has grown at **6% p.a.** In comparison, the total commercial property investment market is estimated to be **£918bn**.

Although owner-occupiers account for the majority of the stock, the private rented sector ("PRS") has been growing rapidly, and now accounts for **c.£1.2 trillion**. Of this figure, about **40%** is concentrated around Greater London and the South East. As a sub-sector, the build to rent (BtR) sector has also been expanding quickly, together with the student accommodation sector. Both of these have become firmly established as separate asset classes for institutional investors.

Current institutional ownership in the residential property sector overall is estimated to be **£90bn**. There has been growing investment in further sub-sectors such as social/affordable housing, in addition to market rent investments and development activity for both sale and rent.

UK **residential** property market (est. worth) — £7.2tn

UK **commercial** property market (est. worth) — £918bn

UK **private rented** sector (est. worth) — c.£1.2tn

# Buyer and renter demand

While luxury developments have been struggling with sales, the affordable, mid-market sector has seen continuous interest from buyers and renters, especially in the six big cities in the UK, excluding London.

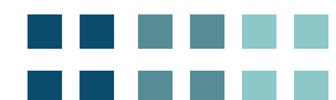
With the closing of the Government's Help to Buy scheme from Oct 2022, first time buyers are now facing more difficulties to apply for a new mortgage. Government statistics show that mortgage approval rates have been the lowest since the pandemic period. During the same period, residential rents have risen sharply, as tenure shifts from home ownership to renting.

First time buyers are now facing difficulties to apply for a new mortgage.

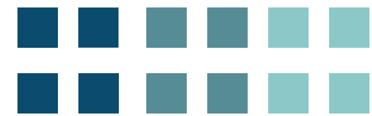
New residential property development is attractive to several groups of investors. Of the residential development schemes sold to investors, 44% is institutionally owned, 27% owned by overseas investors and the remaining 29% owned by other institutional, UK-based operating businesses supported by institutional capital. The sector has been seen as a safe-haven asset class with good income returns and stable exit solutions for investors.

The outlook for the sector as a whole is therefore of crucial importance to both economic activity and buyer and investor demand.

Economic outlook, asset class, scale and location play an important role in the cost and availability of finance and are factors developers should consider when deciding what to build. This is where we believe there are opportunities to provide customised lending solutions to our clients.



# Availability of development finance

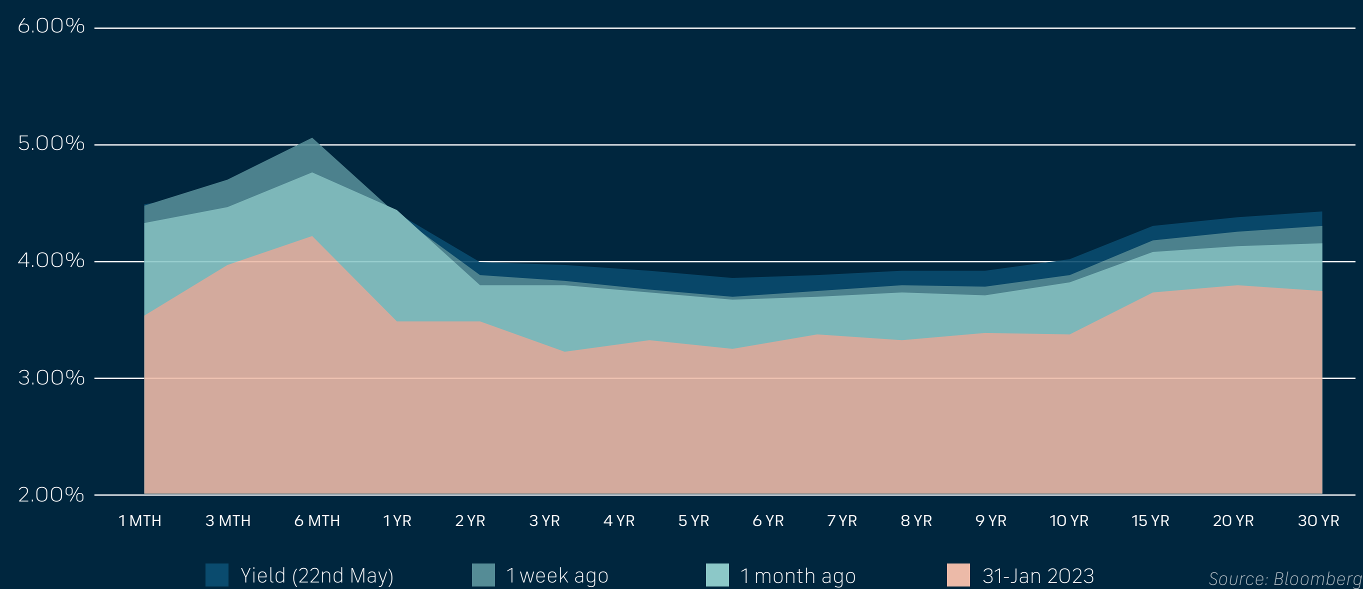


## Leading market indicators

The yield curve below is seen by markets as a good indication for future rates. In Q1 2023, the curve remained inverted, which is historically rare, with a 1% difference between 6 month and 3 year rates. Economists say this implies that **the current upward pressures on inflation and downward pressure on GDP will ease in the next year.**

It also means **for development projects, any short term funding is going to be expensive, relative to recent averages.**

### MARKET INTEREST RATE EXPECTATIONS




*Source: Bloomberg*

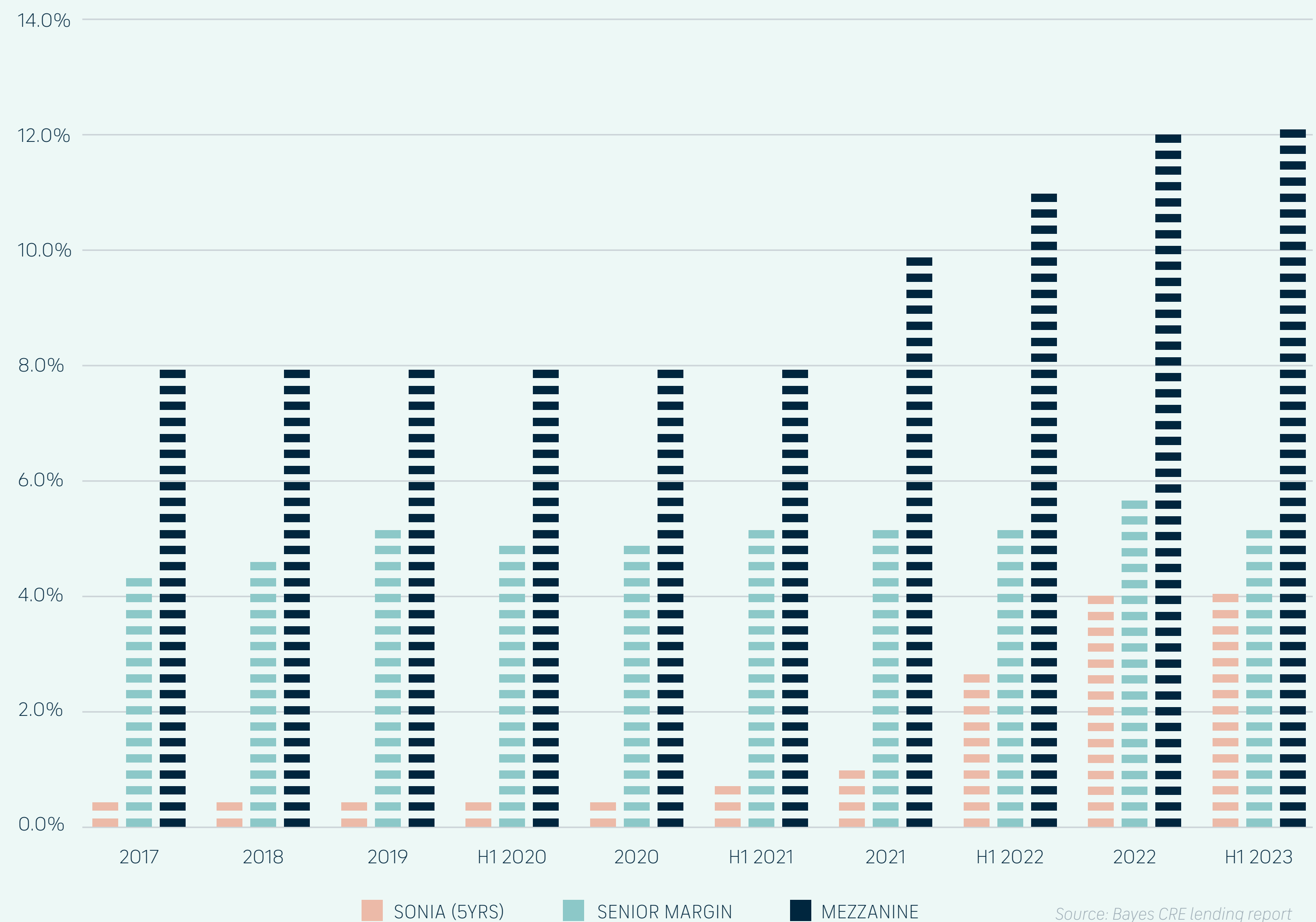
# Debt availability

The residential development finance market has been growing substantially over the last decade. This has been partially due to government incentives, such as Help to Buy, provided to developers and private residential buyers. It is also due to the capital flight-to-safety, where investors have focused on safe assets, which are considered less cyclical and recession proof.

Residential development finance margins for residential property ranged from 2.75% - 5.50%, with upfront and exit fees ranging from 1% - 2%. Of the 76 lenders surveyed by Bayes Business School in their latest lending report, the average preferred loan size for lenders is £30 – 80 million, with larger lenders trying to target schemes of >£40 million GDV. As such, borrowers may have experienced less choice and flexibility for projects less than £40 million GDV.

At Atelier, we offer comparable choice and flexibility to that of larger institutional lenders to SME developers targeting developments under £40 million GDV.

### INTEREST COSTS, RESIDENTIAL DEVELOPMENTS



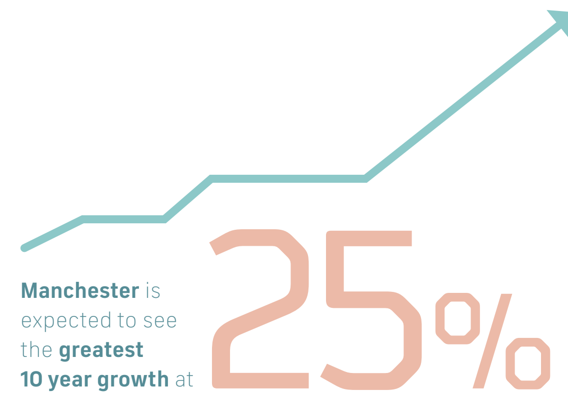

*Source: Bayes CRE lending report*

# Regional differences in the residential development pipeline

In the big six UK cities outside London, economic activity, as measured by Gross Value Added ("GVA") has increased by **22% on average over the past 10 years** and similar growth rates are forecast for the next 10 years. **Manchester is expected to see the greatest 10 year growth at 25%,** with **Bristol and Edinburgh greater than 20%** compared to a national average of 16%*

According to the JLL City Price Index, values for new flats have risen by 4.9% - 17.6%. This explains why new development approval rates and completions are still holding up, while other sectors have slowed down.

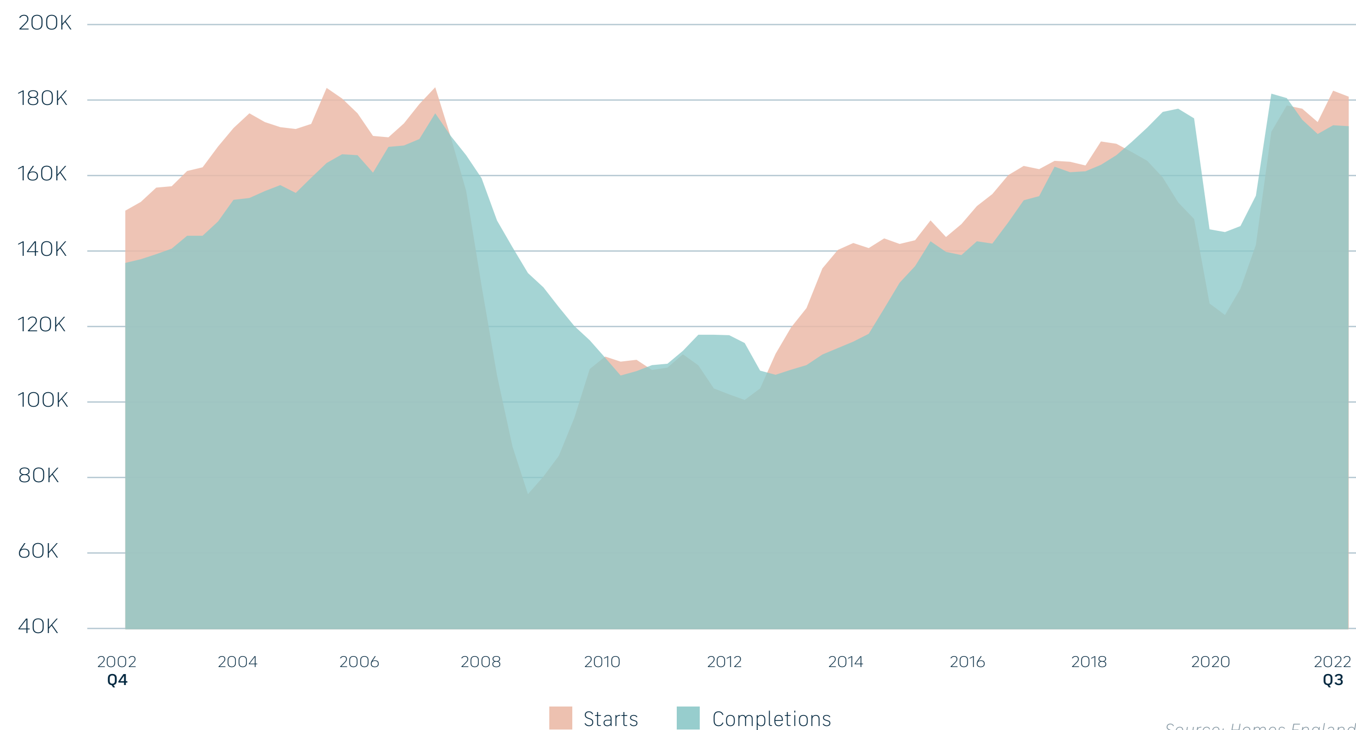
In 2022 the highest amount of starts and completions for residential developments were found in the East Midlands, while in London activity has been stalling.




Year-on-Year (YOY) growth during the last quarter of 2022 was negative across all regions, with the Midlands still being the most active region. Approvals in Scotland were 32% down, and 27% down in North England. This shows the change of sentiment from developers in 2022. They are now facing higher financing costs, and less government support.

** Source (JLL 2022)*

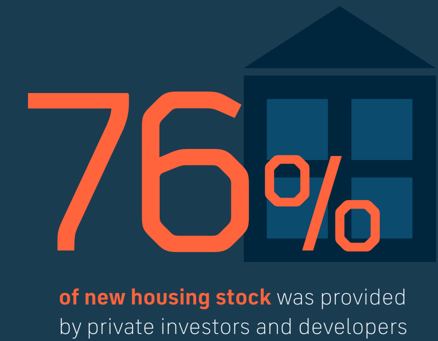
## 12-MONTH ROLLING STARTS/COMPLETIONS, ENGLAND, 2002 TO 2022




*Source: Homes England*

Since **76% of new housing stock** was provided by private investors and developers, the change of the economic conditions immediately led to a reduction in new development projects being started. This has had the effect of balancing supply and demand and regulated any risk of oversupply.

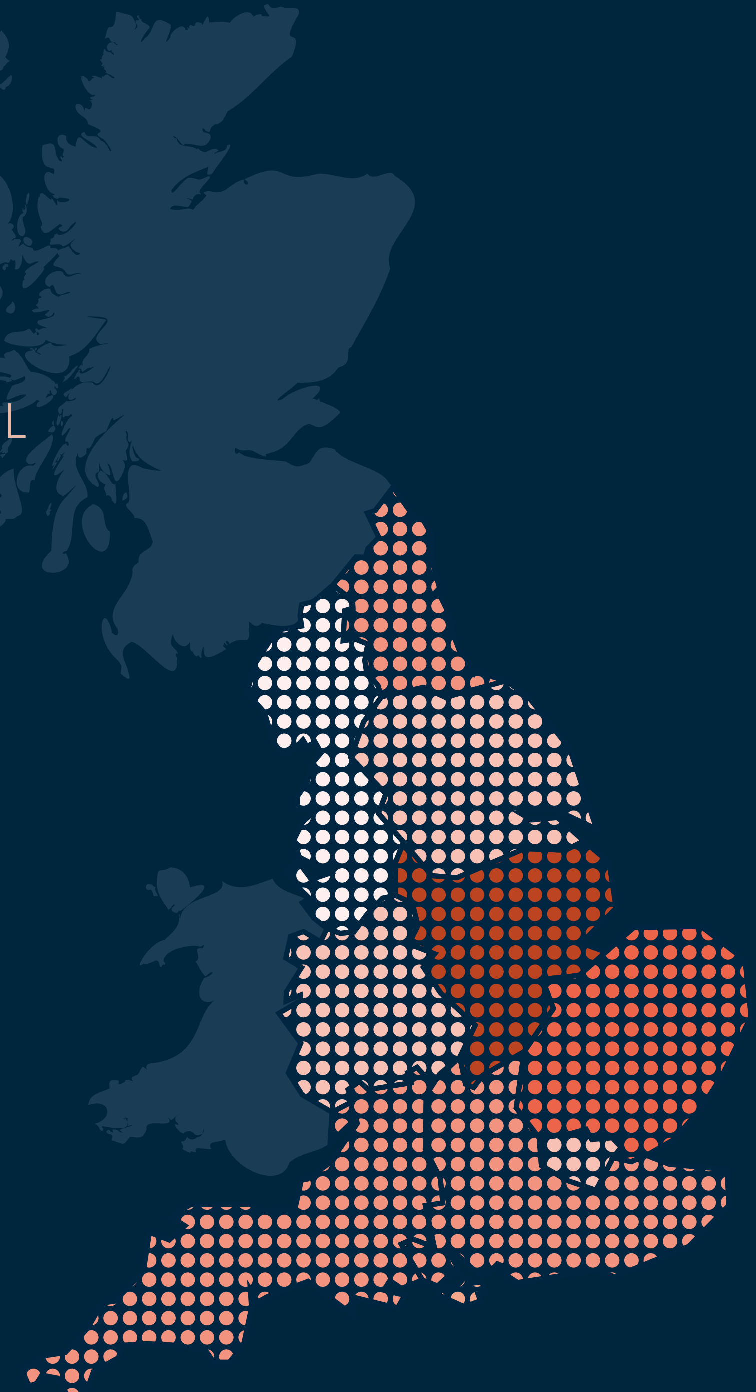
The student housing and BTR markets are expected to show good growth potential in 2023 when compared with other sectors. Student housing development approvals have slowed down significantly since 2020, hence demand is still outpacing supply. This is particularly true for the supply in key student cities, giving opportunities for mid-size developers.




**of new housing stock** was provided by private investors and developers

## NEW RESIDENTIAL COMPLETIONS, REGIONAL

### Completions per 1,000 dwellings



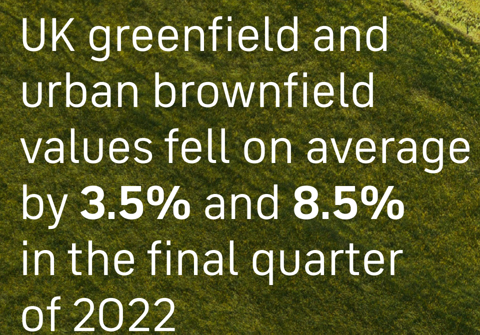

*Source: Homes England*

# Land values

We are starting to see a decline in residential land values following the September hiatus, and according to Knight Frank, UK greenfield and urban brownfield values fell on average by 3.5% and 8.5% in the final quarter of 2022, taking the annual change in 2022 to -1.3% and -9.2% respectively. This decline in land (or residual) values is inevitable given negative headwinds on sale prices, completion delays, mortgage costs and energy bills.

What's more, the interest costs associated with land banking have risen significantly, meaning the cost of holding land assets is significantly less attractive.

We therefore expect opportunities to arise in 2023 for the purchase of land for development at significantly lower values than prevailed in 2021/22 as the market adjusts to a new clearing price.



UK greenfield and urban brownfield values fell on average by **3.5%** and **8.5%** in the final quarter of 2022

# Sale of assets

We believe we are now entering a period of transition, where assets are being transferred from unwilling holders (such as the over-leveraged and over-committed) to willing holders (those that see opportunity and value in a buyer's market). This period of transition may be a lengthy one but will provide many opportunities for nimble, SME developers and investors with access to agile and customised finance.

We also believe that the institutional appetite for the residential sector will remain resilient and attractive, particularly considering the difficulties in the commercial market. In particular, alongside the cyclical fluctuations in value, significant pockets are facing structural obsolescence.

This may be due to one, or a combination of, the following factors:

1) **Environmental obsolescence** – it no longer meets the required criteria (e.g. EPCs) and the cost/ability to retrofit the asset to meet the required standards is uneconomic.

2) **Refinancing** – The debt secured against the asset was fixed at a historically low level and now has to be refinanced at a significantly higher level which would mean breaching the interest rate covenant agreed with the lender(s).

3) **Changing use class/covenant risk** – The existing use class (typically retail but increasingly offices) no longer has sufficient demand to re-let upon expiry of the existing lease and a change of use is required.

4) **Ownership structure** – Rising interest rates, changes in buyer and renter demands, regulation and investor return requirements are putting pressure on many commercial property ownership structures.

# Challenges and opportunities

There are many challenges and opportunities faced in the residential development sector, which SME developers with the right finance solution can take advantage of.

The most noticeable change expected in the next quarter is that upward pressure on labour and material costs is likely to subside.

In broad terms, we therefore believe that, while there is a lot of pain to be felt before the general market reaches equilibrium, there are signs (both from a macro-economic and a sector-wide perspective) that the trough has been reached and passed.

Firstly, for new ground-up developments, land values have peaked and are easing, at the same time demand is still outpacing supply in many regions. Secondly, new opportunities are arising from assets facing structural obsolescence.

These are assets owned for investment purposes by an institution, which are no longer deemed fit for purpose. As it now falls outside traditional long-term institutional investment criteria, it therefore appeals only to a reduced number of buyers, and commands a discount to previous valuation over and above any adjustments for general market movements.

**Challenges:**

- Increased construction and finance costs
- Economic sentiment
- Planning delays

**Opportunities:**

- The peak is in sight for finance and construction costs
- Land values falling
- Demand for 'beds' continues to increase
- Demand switching tenure between ownership and rented, offering significant opportunity in the student and BTR sectors
- Regional resilience

## KEY AREAS OF OPPORTUNITY

| BUILD-TO-RENT (BTR) | RESIDENTIAL DEVELOPMENT COMPLETIONS | STUDENT HOUSING |
|---|---|---|
| With a lack of potential home buyers for flats or houses, the BTR market is expected to grow further with good rental growth prospects. Home buyers will be restricted by high financing costs, higher deposit requirements, and the decline in mortgage approval rates. Many will decide to delay their move to own a home and stay in rental accommodation until the market stabilises. | The appetite from investors and institutions for finished residential based schemes remains high, as they seek to achieve critical mass. This provides the perfect exit for mid-sized developers. Opportunities can be found for new ground-up developments. | The key Russell Group student cities still suffer from an undersupply of student accommodation. Acquire land or conversion and refurbishment opportunities at a discount to previous values (over and above the market decline) and repurpose them to one of the many forms of residential use now in demand – from PRS to student accommodation. |

# Finding the right finance solution

Borrowers have been finding it increasingly difficult to convince lenders to finance projects, raising a couple of questions: which assets and locations are considered financeable in 2023? And how can you future proof your financing?

While financing costs have increased significantly and are not expected to drop (especially for development finance), the following factors are **essential to accessing competitive finance.**

| Project characteristics | |
|---|---|
| Location | Liquid location, with good comparable evidence |
| Experience | Solid experience in delivering similar schemes in the region and asset class |
| Product | Mainstream product suitable for the location and market |
| Recourse | A personal or corporate guarantee supported with demonstrable financial backing |
| Construction | Build costs at market rates, robust procurement route |

### Other considerations

Alongside fundamental project characteristics, it's importance to understand which lenders may be suitable for your project and carry out due diligence on their lending appetite.

- Produce a high quality due-diligence pack, including key risk mitigants. We provide checklists to our borrowers covering the key requirements.
- Where present, promote the project's ESG and sustainable credentials (EPC, Bream, LEED, other standards/certificates). Our Carbonlite challenge is the market-leader in sustainable development finance.
- Consider obtaining pre-let/pre-sales or refinancing agreements. In uncertain markets lenders will take comfort in knowing the exit risk has been reduced.

# Conclusion

We believe that while the overall market appears to be in a period of transition, the fundamentals for residential development remain sound – with strong end-user and institutional investor interest.

As a result, market repricing is likely to provide some excellent opportunities from motivated vendors for mid-sized developers with the right financing package to benefit.

We hope you found this market analysis helpful. See our key takeaway points below:

- Demand in the beds market, continues to outpace supply.
- Although, Interest-rates are now structurally higher, there is now evidence that land values are falling.
- Higher borrowing costs will discourage land-banking and stimulate the sale of sites, creating new opportunities.
- The big six UK cities, outside of London, are forecast to grow fastest as levelling-up gains pace.
- Choosing the right finance partner will be key to maximising opportunities.

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# Ready for your next project?

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