UK HOUSING OUTPUT
SOLVING THE DELIVERY CAPACITY CONUNDRUM

8 STEPS TO ADDRESSING THE CAPACITY CHALLENGE
The UK’s housing supply has never been higher up the daily political agenda, with constant debate and commentary on the apparent dysfunctional nature of our housing market mostly focused on the supply and demand imbalance which continues to prevail. The recovery in the UK residential market is increasingly being characterised as an asset bubble with short to mid-term house price inflation driven by under-supply.

The accepted wisdom is that UK housing supply is being constrained by a lack of land supply and difficulties of navigating the planning process. However, it is clear there are other, much more fundamental limiting factors in play that would prevent any large scale increases in housing output if land and planning barriers were removed - namely construction industry structural capacity limitations.

This paper sets out our views on how the Government, needs to address Britain’s housing demand challenge which mirrors the UK wide deficit in required delivery. UK historic house building data does not bode well for determining the future. At the peak of the last cycle in 2007, national house building rose to circa 180,000 units per annum - still significantly less than where we need to be as an industry according to current political targets. This is doubly concerning as a statistic because, not only does it give an indication of the potential maximum likely construction capacity available to build more homes, the years leading up to 2007 also represented one of the greatest periods of financial leveraging into the property development market that the UK has seen through freely available development debt finance. It therefore also begs the question as to where the money will come from in the future that will enable the required level of additional homes to be delivered.

UK housing supply patterns are dictated by long term structural factors and macro-economic conditions. The traditionally cyclical nature of the housing market has led to repeated failures in terms of investment and training. In addition there has been a long term and continuous withdrawal of the public sector from the house building market, particularly since the 1970s. The role played by the public sector historically has not been replaced through either registered providers or local authorities so there is now a real gap in delivery capacity, biased towards the affordable housing end of the spectrum.

The above situation is fast becoming one of the greatest real barriers to this country being able to deliver housing at the level required to meet demographic pressures and household formation increases. We are now faced with an unprecedented industry challenge in increasing production and output that not only meets demand but is also in the right locations and represents the optimum tenure that the market requires.

It is well reported that the UK needs to be building somewhere between 240,000-300,000 units per annum to keep pace with demand yet we are currently only building circa 120,000 per annum. This generates the need for a step change in the level of house building in this country. In London, the specific requirement identified by the Greater London Authority is for 42,000 new units per annum compared to the current level of circa 25,000 - again a substantial scale increases in housing output if land and planning barriers were removed - namely construction industry structural capacity limitations.

Labour capacity in the market must be increased at all levels from on-site tradesmen through to the property and construction professional sector and the scale of the problem cannot be underestimated.

The forecasts from CITB are that an additional 180,000 people will enter the construction industry over the next 5 years. This amounts to less than a 10% total (or just over 2% per annum) increase in the existing available workforce of just over 2 million (before associated further employment within the wider construction supply chain). It is worth noting that this total work force is not just employed in house building and has to be shared with the commercial sector as well as social and physical infrastructure sectors. In addition, this increase is before the natural attrition of people leaving the industry. It is therefore possible that on current trends we may end up with a net static employment position after taking account of the fact that we have an increasingly ageing workforce.

Financial capacity in the housing sector must be increased simultaneously. Ultimately, additional housing output needs to be funded, either through the short term financing of land acquisition and construction in the open market sale segment or on a longer term asset retention on basis in the affordable and private rented segments.

The shape of the house building industry has become much more polarised at the larger scale of delivery, with the top 20 house builders now delivering over 50% of the total delivery in the UK. This compares to historic norms where there was much more diversification of delivery with less reliance on the largest national developers. This change has created an additional need for the major players to play a role in increasing production to achieve UK Governmental housing policy targets. The hard reality is that there are a multitude of legitimate reasons why this will not happen at the rate and scale that any Government would want. In the wake of the last downturn, the cash and risk management disciplines employed by the largest house builders, many of which are public listed companies, have strengthened from the previous cycle and the likelihood is that caution will remain despite current buoyant conditions. This therefore creates a working capital limit on the physical land acquisition and construction finance that the UK has seen through debt finance rather than being balance sheet funded. Despite Government initiatives such as ‘Get Britain Building’, ‘Building Fund’ and ‘Funding for Lending’, the sector clearly continues to struggle to secure debt finance to underpin the current planned levels of production, even before consideration of increasing levels by 50-100% begins.

Outside of the open market sale segment, the affordable housing model is now largely reliant on cross subsidy rather than grant. Despite Government further committing to the latest National Affordable Housing Programme, the reality is that this will not even scratch the surface of what were the historical norms of grant subsidy and public sector direct development works programmes.

In the Private Rented Sector, we still await the arrival of the much vaunted flood of institutional money that is looking to invest into a residential asset class. This is perhaps the single biggest avenue to generating additional finance capacity in UK house building which ultimately will fund new development, alongside more traditional and capital constrained models. This sector however is currently hindered by serious viability and valuation challenges created by the transactional interface that sits between a front end development proposition and a long term yield driven asset investment proposition, as discussed in the Arcadis report ‘Pushing the Boundaries’.
HOW DO WE GET BRITAIN BUILDING MORE HOMES?

A series of coordinated actions are required from Government and industry that play to a long term agenda of structural change in UK housing delivery.

1. Create an incentivised mechanism to encourage major house builders to increase delivery

Although this will be politically sensitive, with an industry that is so private sector reliant, the Government should be maximising the tools it can use to influence private sector output. The caution over increasing work in progress and over extending against limited financial reserves is a direct result of the last downturn, where many of the large house builders were massively affected by unsold stock when the sales value market reversed. The only way of overcoming this natural conservatism is to create a large scale form of ‘buyer of last resort’ system whereby, if the private sector sales market falls away, then the Government step in to purchase units at an agreed price linked to adequate safeguards around the location of schemes, relative to demand. The release of those units into the market and the tenure allocation would then be the Government’s decision, based on true local housing need and demand. Such an interventionist policy might be seen as radical but it is the only way, alongside concerted measures on labour and production capacity, the private sector house building industry will create a step change in its current work in progress levels.

2. Enable Local Authorities to directly deliver housing through Local Housing Companies or Housing Investment Funds

This revolution is starting in isolated pockets across the UK but, although the mechanisms exist, the take up of the direct development route in public sector is minimal. This suggestion is not about advocating a wholesale return to local authority led housing programmes – the level of delivery capability within local authorities does not make this viable, even in the longer term. However, what it can do is play a supplementary role beyond the private and registered provider segments to ensure needs driven housing of the right affordability is delivered in accordance with local plans. Innovation in the use of municipal pension funds, combined with appropriate partnerships with private sector delivery expertise, is an obvious target area. This will create real additional finance that is required rather than distribute more thinly existing private sector money. Public sector attitude to development and sales / rental risk is crucial here and this is where the private sector has a key role to play in helping create the propositions that create a de-risked development and investment business case for Local Authorities and public sector funders.

3. Provide better access to development finance for SMEs

The ability of the smaller developers to actively look at the nationwide proliferation of infill site opportunities, with efficient regeneration of small lot size plots in areas of existing maturity, with infrastructure already in place, is crucial in the overall housing delivery picture. Many of these schemes will be below the radar of the larger players but the ability to create quick to market, low exit risk housing schemes which are not constrained by risks of selling

4. Better enable institutional investors considering long term PRS assets to take a more positive view on development risk

5. Incentivise large scale adoption of Modern Methods of Construction aimed at efficiency and reducing labour requirements

6. Facilitate the sharing of planning resource from private into public sector helping shape local plans, development orders and processing applications

7. Create Government sponsored training and recruitment drive into property and construction industries

8. Further facilitate residential product innovation as an extension to the current Housing Standards Review

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8 STEPS TO ADDRESSING THE CAPACITY CHALLENGE

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Better enable institutional investors considering long term PPA assets to take a more positive view on development risk

The current impasse which is fundamentally inhibiting the growth of large scale deployment of funds into residential is largely driven by the unwillingness of long term investors to take development risk, and the lack of desire by developers to buy land and build product at a lower level of return than is commensurate with other options such as open market sale. Other than the combined developer / investor / operator models that are starting their own roll out programmes, the institutional funds are having mixed success in unlocking this. A potential policy development that would go a long way to solving this is creating more certainty in the planning process by which PRS can benefit from an equalised playing field relative to open market sale. This requires further enhancement to the current Planning Practice Guidance Note that loosely references taking cognizance of the different viability model of PRS when setting Section 106 obligations. This is currently being interpreted by authorities in a multitude of different ways and therefore, central leadership in the issuing of a viability testing framework (not the creation of a separate planning use class) could help push more sites into the PRS market. Central and Local Government’s role in de-risking what is currently perceived as a highly risk (laden planning) and construction process will be important in creating a more integrated asset creation and ownership model in this country.

The subject of Modern Methods of Construction (MMC) is again in focus but will continue to be faced with the same challenges unless a different approach is taken which de-risks investment in the long term and enables prospective investors to have a safety net if open market demand fails. This will require Government underpinning of investment and, similarly to the proposed house builder incentivisation scheme, a ‘buyer of last resort’ fall back initiative to reallocate any real risk rather than another raft of cyclical insolencies that has so plagued this sector.

Incentivise large scale investment into Modern Methods of Construction aimed at efficiency and reducing labour requirements

The worrying statistics relating to the construction workforce and ability to respond to increasing output pressures put further emphasis on the need to explore a more diverse range of design and construction delivery models, less reliant on high-intensity on-site labour. Traditional site based construction still dominates in an industry notorious for resistance to change and innovation. Much of that outlook has been driven by the ‘boom and bust’ nature of the construction industry, relative to economic cycles and, in particular, the housing market. The desire to invest large sums in industrialising production akin to the manufacturing sectors has been limited. It is also a debate that appears to come and go relative to the recurring realisation of a problem in improving capacity in an upturn. The investment needs to be long term and, similarly to construction materials supply, there is a lag between perceived market demand and the ability to deliver industrialised output.

Although the planning system is not the subject of this paper, the related recruting challenges facing the industry has never been greater and the need to attract top talent at all levels is increasingly difficult when set against the competing employment sectors that school leavers or graduates are faced with. The changing social and cultural make up of ‘Generation Y’ means that there is potentially much more attraction to other sectors rather than what is often perceived as an unglamorous sector. It is for the industry and Government in concert to curtail this myth if the UK is to meet the housing targets. We need the bricklayers, surveyors and engineers who will be building our housing stock in 10 years’ time to be making the decision to enter the construction industry now. The training and experience lag makes labour the critical vulnerable, and without it, construction cost inflation could easily be making output rather than increasing it.

The recent Housing Standards Review consultation process has been a very positive step by the Government to follow through on promises made several years ago around cutting through the red tape and regulatory burden. Whilst still recognising that we need clear quality benchmarks in this country, the assertion is that this should be more market driven than centrally defined. Hopefully this will enable innovation in the development of products for all tenures which maximise viability; hence more output per pound spent, thus relieving the pressure on sector capitalisation. The obvious example of this is bespoke build to Rent product, where design / cost / value optimisation is currently constrained by certain aspects of planning and building control governance. The opportunity then is for a streamlined planning and building control framework that does not stifles creativity around layouts, spatial standards, amenity, car parking, circulation efficiency and the like.

The focus of political and public attention should perhaps be long term issues of planning and land supply but should in reality be on the way in which a step change increase in additional development can be adequately funded and most importantly, physically delivered. What is clear is that land availability can be increased and planning frameworks can be modified. However, finding the additional finance and the actual people that are going to construct the new homes we need is potentially the greatest latent barrier to balanced economic growth and housing market maturity we face in the UK. It is also one that cannot be turned on like a tap and requires much longer term cross party consistency of political policy.

CONCLUSION

“The likely projected increase in the workforce set out above frankly does not support achieving, via current delivery models, the 50-100% increases in housing output that are being quoted as political targets.”
To discuss the challenges we are facing as an industry and understand how Arcadis can help safeguard your residential development and investment plans please contact:

**CONTACT**

Mark Farmer  
Head of Residential  
T 07831 244 646  
E mark.farmer@arcadis.com

[www.arcadis.com/residential](http://www.arcadis.com/residential)