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Market Commentary

Residential Analysts

United Kingdom – March 2023

- **Slowly Speeding Up**
- **Blind Spots & Unknown Risks**
- **High Density Development Sector**

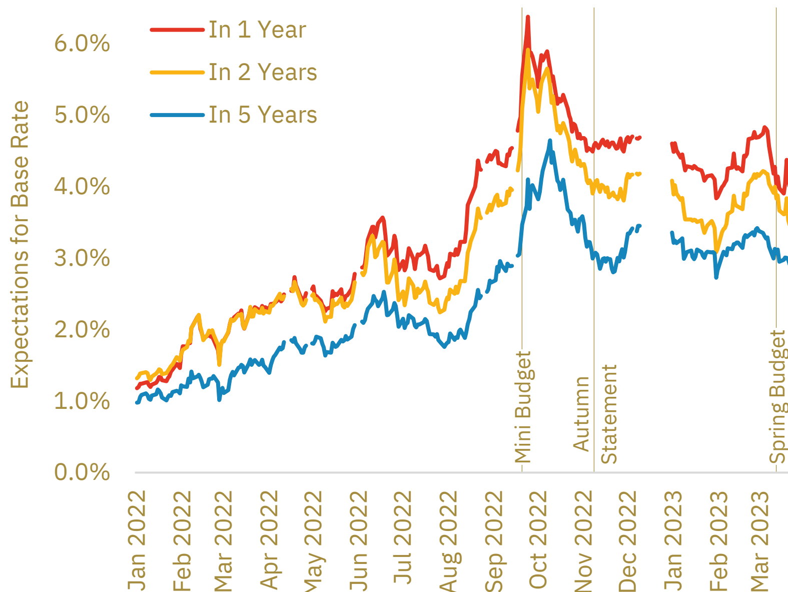
The latest data shows a mixed picture for the state of the UK housing market. The hangover from the Truss turmoil is slowly clearing and some leading indicators for activity are back near pre-pandemic levels. However, the housing market is highly seasonal so the next couple of months could be the best it will get this year. Meanwhile, the rapid exit from record low interest rates may be easing but we are only just beginning to find out what a decade of this has done to the UK's economy, financial system, and housing market. It is far from over.

Slowly Speeding Up

Housing market downturns typically start slowly and this time has been no exception. We spent a large proportion of last year writing some variation of "housing prices are booming despite rising interest rates and the cost of living crisis". It eventually took around 9 months for the boom to end – with a little help from Liz Truss.

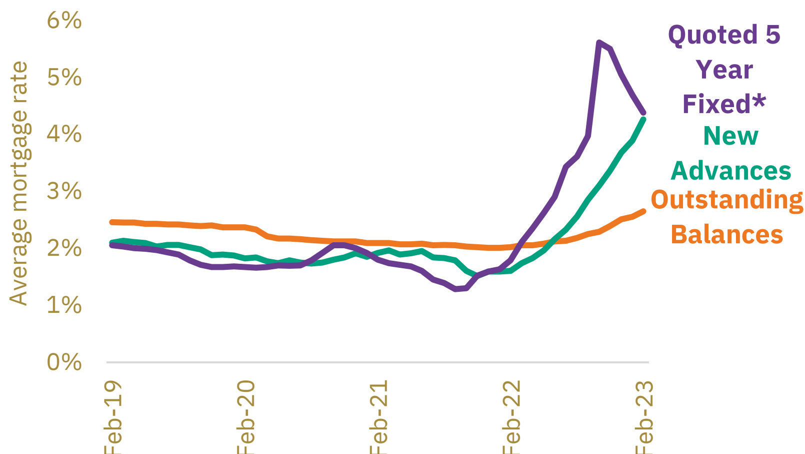
The downturn is now underway with lower activity and falling prices. However, for the time being, consumer demand remains high. There are still plenty of people who want to buy – especially first time buyers desperate to escape renting – but they need to stretch themselves given higher rates. Meanwhile, most vendors are still under no pressure to sell. Asking prices are still high but the deals that are being done are at a significant discount. For many, the decision is much easier – just wait to see what happens next.

Fig 1: Financial Market Expectations for Base Rate
Source: Bank of England



There are some signs that conditions are easing. As Fig 1 shows, financial market expectations for future interest rates have fallen and quoted mortgage rates have too (Fig 2) - though with a wide spread depending on the riskiness of the borrower. Some leading indicators are now suggesting activity is back near pre-pandemic levels with Rightmove reporting sales agreed of "first time buyer type" properties just 4% lower than 2019 levels in early March. However, the housing market is highly seasonal and this tends to be the most robust time of the year for the sales market so the next couple of months could end up being the best that estate agents get this year.

Fig 2: Average Mortgage Rates
*Source: BoE *quoted rate at 75% loan-to-value - UK*



Despite this easing, the impact of higher rates following a decade at record lows is only now starting to emerge. This marks the next stage of the downturn. Capital values across all assets have been inflated by low interest rates and some form of correction looks likely for many real estate asset classes. Commercial property is currently in the spotlight though, much like housing, the actual impact will depend on location, type, and quality. For the housing market it is still not clear how much of the correction will be through nominal price falls or a real correction thanks to rising wages. What is clear is that it will take time, there will be lots of noisy data along the way, and risks – both known and unknown – will emerge.

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Blind Spots & Unknown Risks

It has been clear since early last year that this downturn was going to be different to previous ones. There were few of the usual signs of excessive mortgage lending and loosening criteria in the lead up and homes were priced appropriately given record low mortgage rates. At a headline level, this is simply a repricing event thanks to higher rates – and a quick sharp correction in prices is probably the better option than a long drawn out period of stagnation. Most homeowners facing financial difficulties should be helped by their lenders in the event of stress and repossessions should be lower than previous downturns. What's different this time is that the risks are predominantly at the fringes of the housing market – some obvious but others in blind spots or simply unknown.

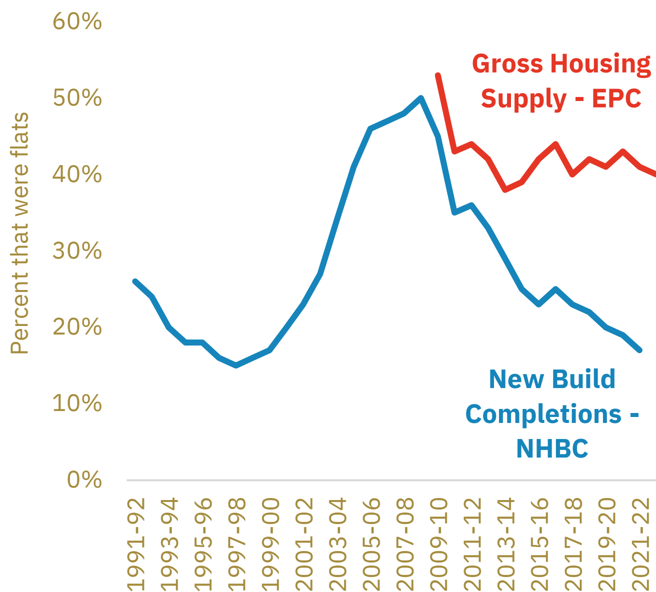
High Density Development Sector

An example of the possible risks in blind spots can be found in the high density development sector. While flats have become less popular amongst the volume housebuilders (e.g. the NHBC line in Fig 3), flats are still an important contributor to overall new housing supply (red line). In recent years high density developers have relied on a three-part financing approach.

The process, typically found in regional cities, usually involves developers using small amounts of their own capital to raise funding from private credit markets to acquire sites. They then gain planning approval and sell around 30% of the flats off-plan - often to overseas individuals or syndicates. These lending facilities are then re-financed for the major construction phase and a further 30% of off-plan sales are made – to domestic and international investors before construction starts. This second phase of lending is then re-financed as later-stage construction funding as the final investor sales are made or, increasingly, when bridge funding is used as the final flats are sold post completion.

Fig 3: Flats As A % of New Delivery

Source: DLUHC, NHBC



This whole process is clearly dependent on rising prices to incentivise the early stage off-plan investors, readily available development funding throughout the process, the supply of buy-to-let (BTL) mortgages to fund completions, and tenant demand for homes in the rental market. That final one appears robust for the time being but the first three are at considerable risk in the current climate. Those risks could affect everyone involved including the developers, development finance lenders, BTL lenders, buyers of BTL mortgage backed securities, and the investors themselves.

Falling house prices and higher mortgage rates will further disincentivise BTL investors after the tax changes of recent years. Conversely, the appetite for offering development finance could actually increase in the short-term – before existing loans go bad - as it becomes more profitable to provide the lending than make the investment. That could lead to a rush into poor quality decisions thanks to more competition from inexperienced lenders. Of particular concern is a further rush into Build-to-Rent (BTR) as it is seen as a potential lifeline by many of these developers – as already seen in London in recent years.

Unfortunately, the BTR markets many of these regional developers are targeting is very different to the ones that the purpose built institutional BTR market has invested in. With a lack of expertise in developing appropriate BTR homes and a lack of experience in managing or selecting operators, many developers and investors heading down this route could find themselves with poor quality blocks that are too expensive to run efficiently. There were already signs back in 2017 that many overseas BTL investors were buying new build flats in London that cost more to own than they made in rental income - owning overseas assets and capital growth were the priority.

This is just one specific area of the residential market that could become a big problem this year but we don't really know how big these risks are, who is involved, and what the fallout will be. For example, there are many developers in this space that don't appear on DLUHC's list of those they want to sign the remediation contact. Unfortunately, there is a lack of public information and the private sector data is not much better.

As the Bank of England FPC warned this week "There remain vulnerabilities in market-based finance. There is an urgent need to increase resilience. We need to work with other regulatory authorities to achieve this, as many firms involved in market-based finance are not regulated by the Bank of England". Those active in this space – lending to both developers and investors - should expect increased attention but it may be too late from the regulators' perspectives and there are undoubtedly other risks in the housing market that will emerge this year.

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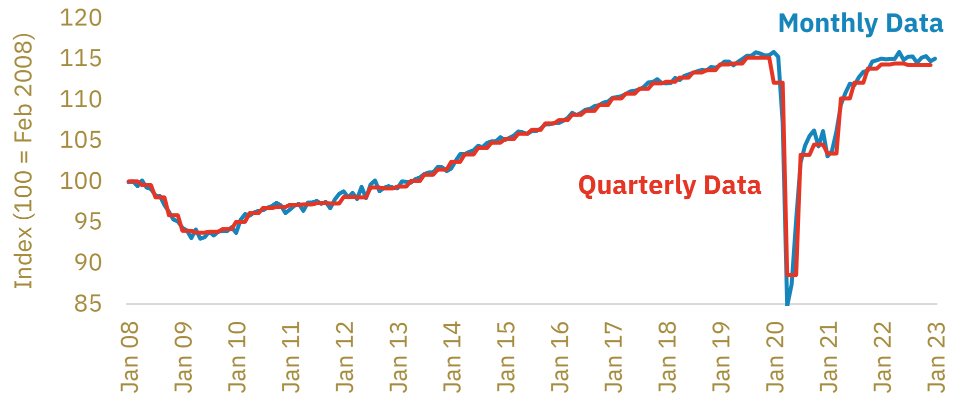
Market At A Glance

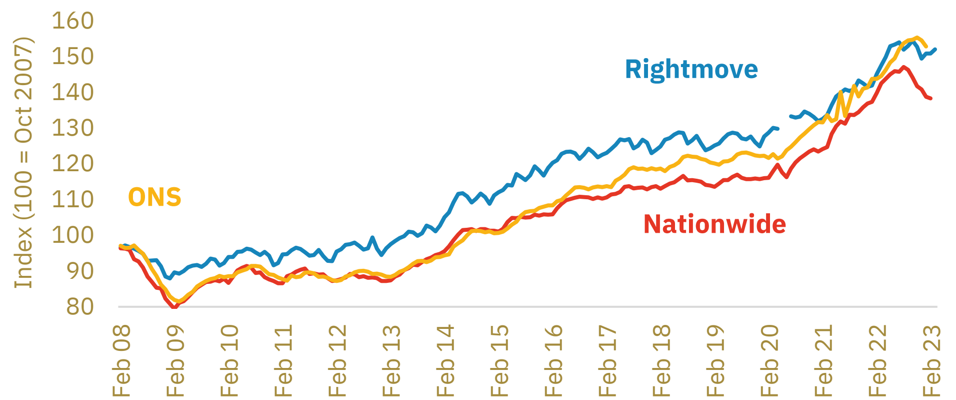
Economy – UK

The ONS monthly estimates reported GDP was unchanged in January 2023 compared to the same month in 2022. This left monthly GDP 0.7% below the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



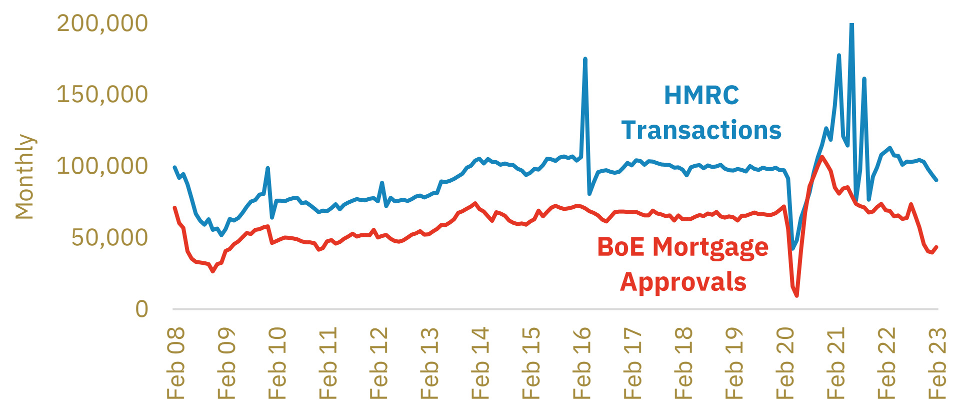
House Prices – UK

Rightmove reported a 3.0% annual rise in asking house prices in March 2023 while Nationwide reported a 1.1% annual fall in their mortgage approval based index in February. Meanwhile, the ONS reported 6.3% annual growth in its sales agreed index for the year to January 2023.



Transactions – UK

HMRC provisionally reported 90,340 residential transactions in February. This was 6.8% lower than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 32% lower in February 2023 than the same month in 2019.



New Supply – England

The latest net additions data for 2021/22 reported 233,000 net new homes in England with 210,000 new build completions. The latest quarterly house-building data suggests there were 222,200 completions in the year to Q4 2022 while there were 252,500 new build Energy Performance Certificates in the year to Q4 2022 – a leading indicator for net housing supply.