

To build or not to build: is financing the question?

DR OTHMAN COLE, ASSISTANT PROFESSOR OF FINANCE AT **ESCP EUROPE BUSINESS SCHOOL**, GIVES A MACRO-ECONOMIC ASSESSMENT OF THE UK HOUSE-BUILDING SECTOR AND THE KEY FACTORS AFFECTING SUPPLY AND DEMAND

House-building activity in July rose at its fastest pace for the last three years. This can be attributed to the government's Help to Buy Scheme which gives first-time buyers a foot on to the property ladder, leading to a greater number of construction companies building more homes. Additionally, the Bank of England and the Treasury are supporting a Funding for Lending Scheme in which cheap credit is offered to banks if they lend more to households and businesses.

But is this boost temporary? How strong are the fundamentals going forward in the medium to long-term? Key factors that influence the demand for new housing include population growth, interest rates, the state of the economy as a whole proxied by GDP growth, unemployment, and especially in the case of London, the influx of foreign buyers. On the supply side, some of the key factors include the availability and affordability of land, labour, materials, access to capital, and success with planning permissions.

According to the Office for National Statistics (ONS), London alone will see an increase in population of 14% within a decade. Projections show that the number of people living in London will increase by more than one million in less than 10 years to reach over nine million people by 2020, making it along with Moscow the only cities in Europe to have more than nine million residents. This growth is mirrored in both the East and Southeast regions, making southern England a prime area for new housing developments.

In addition to a growing population, other factors that influence the sale of new homes are growth in the economy, rise in employment, and availability and cost of mortgages proxied by interest rates. With a second quarter GDP growth rate of 0.7% following 0.3% growth in the first quarter, there is a gathering momentum in the recovery of the UK economy. The unemployment rate is also down by 0.2% to 7.8%.

The situation with interest rates and its effect on new mortgages is less clear. While rates are at unprecedented low levels and expected to stay low for at least the next three years, banks still have funding requirement challenges.

It is therefore unclear to what extent this would impact on the demand for new housing and in turn growth in house-building activity. On a positive note, a factor that is contributing to the demand for new homes, especially in London, is the increased interest from foreign buyers from Singapore, Hong Kong, China, and Malaysia.

On the supply side, the availability and acquisition of suitable land is always a challenge facing developers, particularly in dealing with the planning process. Environmental objections for greenfield projects are only expected to intensify, leaving mostly brownfield sites available, which can incur significant costs before they are ready for use. Labour availability and cost are less of a threat. According to the Construction Skills Network (CSN), employment in the Southeast is expected to rise by 7.7% to a total of 408,140 by 2016, representing a 5% increase from the previous peak in 2008.

However, a key factor that could potentially dampen house-building activity in the UK is access to funding for the developers. Understandably, given the scale of write-downs across banks since the 2007/8 crisis for bad loans to the construction industry, their lack of appetite for funding new developments comes as no surprise. Even if some banks are willing to lend, they may lack the ability to provide such funding, given the stricter capital requirements. Therefore, unless banks are adequately capitalised and they return to their business of lending for viable projects, activity in new housing developments might be stifled.

Perhaps a new model of financing is needed? We are already seeing developers pre-sell off-plan up to 70% of their projects in London to buyers in Asia, even before construction starts. This, they argue, is the only way banks would agree to finance the projects. The practice of buying off-plan is also well established in France, however we have not seen this adopted on a large scale in the UK. Whether this would work in the UK is unknown, but one thing is for certain, if enough new houses are to be built to meet the pent up and forecasted growth in demand, particularly in the Southeast, innovative ways of financing these new developments have to be explored. ■