As Permitted Development peaks, is Resi Refurb riding to the rescue?

Naismiths White Paper
Has PD peaked?
As the largest team of dedicated independent monitoring surveyors in the UK, we are driven to protecting the investment that the Funder has made and ensure that a suitable exit is always maintained. Our strength comes from our passion to deliver for our clients and the collective experience of the team.

At Naismiths we pride ourselves on the ability to deliver a best in class service to our clients and this is at the heart of our business. We are a company that has been delivering and learning for 55 years, and we have the experience to prove it. Our simple aspiration is to be the best, not the biggest.
Like London 2012, but not in a good way

Has Permitted Development had its time in the sun?

Mexican stand-off

Residential refurbishment rides to the rescue

Double-edged sword

Betting on UK construction
Research from Naismiths has found that Permitted Development schemes have had their day in the sun, while a spike in Residential Refurbishment schemes is filling the gap left by developers.

While Help to Buy is often seen as a turbocharger for housebuilding activity, for years residential developers’ engines have been kept running smoothly by another, more overlooked stimulus — Permitted Development (PD) rights.

First introduced in 2013, and then extended in 2016, PD rights allow developers to carry out certain building works — typically converting a commercial building to residential use — without the need for planning permission.

While the rationale behind the new legislation is a shift in working patterns — the boom in remote working has reduced many employers’ need for office space — PD schemes hold several key attractions for developers.

By allowing them to target a wider range of sites, and bypassing the need for a planning application, PD schemes can offer developers wider choice, lower costs, no planning conditions and a quicker route to market.

Their appeal hasn’t been lost on either developers or lenders, who have queued up to offer finance, powering a boom in PD schemes in cities across the UK.

But data compiled by Naismiths and the Office for National Statistics reveals that the boom peaked in 2017, and PD has since been on a downward trajectory. Yet its decline has been offset by a rise in the popularity of residential refurbishment projects, especially cutting edge refurb work such as air space developments and basement builds.

This white paper looks at how the dynamics of residential development have shifted, what lies behind the change, and what clues this gives us about the course of UK construction in a post-Brexit future.
Like London 2012, but not in a good way

Official ONS data shows that UK construction output grew by just 0.7% in 2018. This measly pace of growth was the slowest recorded since 2012, a year which may have seen London host a triumphant Olympics but also saw Britain’s brittle economy make only a halting recovery from recession.

Last year also saw big swings in construction activity. After a miserable first quarter which saw work on many sites grind to a halt amid freezing weather, quarterly output rocketed to 2.1% in Q3, before slumping to a 0.3% fall in the final three months of the year.

You don’t need a degree in economics to identify the culprit. The confidence-sapping uncertainty of Brexit led many developers to put plans on hold, and any investment decisions that could be delayed were put on ice.

Yet for all tortuous melodrama provided by the Brexit saga, on the residential front line, activity has remained brisk.

Across Naismiths’ national network of offices — and our regional hubs in London, Bristol, Birmingham, Nottingham, Manchester and Leeds — residential demand stayed strong. During the course of 2018, we were instructed on a total of 335 schemes, up 20% on the 280 we began in 2017.

While the central London market has been hit harder than most by Brexit uncertainty and rising labour costs, southern England still remains our busiest market. But last year we also saw strong growth in Birmingham — which accounted for 18% of new instructions in 2018 — and in Manchester, which accounted for 14% of our work.

Residential new build schemes remained the largest single sector, even if they fell as a share — down from 70% in 2017 to 54% in 2018.

But behind those headlines, there has been a shift in the type of residential schemes coming through the pipeline. Our researchers cross-referenced Naismiths’ data with the official statistics compiled by the ONS, and found the number of Permitted Development schemes has dropped off significantly from the heights reached in 2017.

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Our analysis shows that Permitted Development activity suffered a dramatic slowdown after peaking in the second quarter of 2017.

Between Q3 2017 and the same time in 2018, the number of PD schemes recorded across the UK by the ONS plunged by a quarter (21.4%).

By contrast, numbers rose in the first half of 2017, jumping by 5.6% — from 601 to 637 — between Q1 and Q2 that year.

However the Q2 2017 level remains the high water mark, with numbers sliding to 601 in Q3, and then sinking further to 568 in the final three months of 2017.

The decline continued largely unabated in 2018, with the first quarter’s tally of 509 falling to 468 in Q2 and just 472 in Q3.

This national data highlights the significant drop in PD activity. While the boom was arguably unsustainable, the reasons for such a sharp decline are more complex and surprising. Crucially, the shift is being driven by lenders’ attitudes as much as developer demand.
On the frontline, Naismiths has seen several cases of developers who are well into the construction phase of a PD scheme deciding that they would like to extend the scope of works beyond the original, PD-approved project for which they secured funding.

Such a pushing of the envelope — typically by adding additional floors beyond the number allowed by PD rules (typically to create high-margin penthouse units) — necessitates not just additional funds, but also full planning permission for the additional works.

Such ‘eleventh hour’ decisions to extend the project beyond the limits allowed by PD rules are rarely anything of the sort, and lenders have in some cases taken the view that a more likely explanation is sharp practice by the developer.

Whatever the reason, the impact of such a change is three-fold:

- It triggers the need for planning permission for the additional works. Even assuming approval is granted, the possible imposition of planning conditions will impact both the timeframe and funding structure of the development.

- The resulting uncertainty (more than the request for additional funds) is likely to antagonise the lender. Even though construction has begun, there is no guarantee the developer will secure planning permission for the additional works and a revised development valuation will be required.

- The result could be a Mexican stand-off, in which a lender who is already heavily committed to a project may refuse to release additional funds because of the project’s expanded scope and greater risk profile.
While funds are still being made available for PD projects, Naismiths is currently working with a number of lenders to provide enhanced due diligence and monitoring, right from the loan application through to the planning and delivery phases.

As a result, Naismiths’ first hand data mirrors that of the ONS. For us, the high water mark in PD instructions came in July 2017, when we received a record 12 instructions in one month alone — nine in London, two in Birmingham and one in Bristol.

During the course of 2017, PD schemes accounted for 8% of our annual instructions. In 2018 that share slipped significantly, while residential refurb project instructions moved in the opposite direction, jumping from 6% of our instructions in 2017 to 18% in 2018.

Yet despite PD’s rapid fall from favour, in March 2019 the Housing Minister James Brokenshire revealed that the Government remains committed to PD, and even plans to extend its scope with a further easing of planning laws.¹

We believe, that if followed through correctly, this could be the lifeline that PD needs to secure its revival in the current market.

The changing fortunes of residential refurbishment have been thrown into even sharper relief by Naismiths’ data. During 2018, as PD activity was slowing, our residential refurb instructions more than tripled, compared to their 2017 level. In October 2018 alone, we received 12 new instructions for resi refurb projects—a new record for us.

The regional spread of our residential refurb work is also greater than that of our PD schemes, with London accounting for 59%, while Birmingham, Manchester and Bristol all have a decent share of the action too. Strikingly, residential refurbishment accounted for one in six (16%) instructions received by our Birmingham office in 2018, and across the UK, activity in this sector has proved resistant to seasonal fluctuations—we received seven instructions in December 2018 alone.

Sector Update — London Q3 2018
Such a rapid rise in resi refurb activity can only be partly attributed to the waning of PD’s star. A Brexit-inspired flight to safety is likely to be at play as well.

While the purchase cost of an existing, usable building will be higher than that of a vacant lot or a building requiring demolition, refurbishment works should in principle cost less than building from scratch.

Nevertheless this rule of thumb may not apply if asbestos needs to be removed, or extensive upgrades have to be made to bring the building up to current standards.

However refurbishment projects typically carry lower risk than new builds, due in large part to new builds’ potential for unknown risks within the ground.

In addition, refurbishment projects are largely immune to adverse weather delays. Against the backdrop of acute Brexit uncertainty, the appeal of such reduced risk is clear.

Nevertheless there is a trade-off to be made; in return for lower risk, developers have to accept lower margins. Here Brexit is acting as a double-edged sword, as it is widely blamed for driving up input costs — imported materials have been made more expensive by the weak Pound and the supply of EU labour is faltering — and is thus squeezing margins further.

So it’s a measure of just how attractive refurbishment has become, even in the face of compressed margins, that both developer demand and lenders’ willingness to lend on such schemes continue to surge.
Despite all the uncertainty surrounding the construction industry, there are grounds for cautious optimism.

The residential sector as a whole continues to buck the trend of weakness seen in infrastructure and commercial construction. While some of the residential world’s big beasts have opted to defer pulling the trigger on major new build projects, refurbishment and student accommodation projects are holding up well.

Meanwhile Britain’s army of SME residential developers — who lack the deep pockets of their larger rivals — continue to soldier on, and have become the backbone of the residential sector’s resilience.

And with specialist development finance lenders still happy to fund residential projects, there is strong latent demand, both among developers and lenders.

The construction industry has learnt the hard way to absorb shocks. The current issues are relatively modest compared to those unleashed by the Global Financial Crisis of a decade ago.

As Britain’s tortuous Brexit negotiations drag on into the summer, the prospects for a managed exit from the EU are gradually improving. While Brexit will always be a process rather than an event, if a cliff edge ‘no deal’ exit is averted, we should expect pent-up demand to be released like a champagne cork.

That demand is likely to be spread across sectors which have seen the highest level of project deferrals. Residential new build projects are likely to be the first in line, as commercial sector clients may take longer to convince that the Brexit clouds have parted.

Permitted Development schemes are set to be an important part of the residential mix, especially in the wake of the Government’s planned relaxation of the PD rules. Their current waning popularity is unlikely to be the final word.
For now, the industry is doing what it does best — taking volatility in its stride. Residential refurbishment has emerged as a white knight as new build resi and PD development take a back seat.

While forecasting the final nature of Brexit remains a fool’s game, one thing is sure — developers, lenders and the construction industry as a whole will continue to pragmatically adjust their strategy in response to unfolding events.

I’d never bet on Brexit, but I will always bet on UK construction.

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