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‘There is a triple whammy for developers: rising build costs, borrowing costs and mortgage rates for buyers’

Since my most recent comment things have gone from bad to worse for the residential development market. We are on our third prime minister, inflation is still rising and the base rate is 2.25% and likely to be 3% by the time you read this article with more increases to come.

There is a triple whammy of issues currently for developers: rising build costs, rising borrowing costs and rising mortgage rates for buyers.

Let’s start with build costs. While things have started to settle, most are of the opinion that they have increased anywhere between 20% and 40% in the past two years, dependant on height and location, with London topping the charts.

On the basis most developers work off a 20% profit on cost, the alarm bells start ringing. On most of our current development appraisals we are working off build costs of in the region of £300 per sq ft on the gross area. Basements and buildings of 12 storeys or more will increase this by anywhere between 10% and 25%. There are many contractors who signed up for fixed-price contracts who are almost certainly under water and sadly a number are likely to go into administration.

Blame game

Borrowing costs were at an all-time low for a number of years and this was the precursor for the boom in the market. Challenger banks and funds backed by private equity, high-net-worths or family offices for first and second-charge debt, mezzanine, bridge, equity and development finance exit sprung up at an alarming rate. Much of the lending was about getting the money raised out of the door as soon as possible with nowhere near as much due diligence on the developer or scheme carried out as there should have been.

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There was money lent on schemes that, in reality, didn’t work where the developer convinced lenders that a cutting-edge brand and control of build costs would allow them to deliver returns significantly ahead of more experienced competition. Most of the valuations I have seen are not worth the paper they are written on, with limited due diligence on build costs or sales values other than the usual cut-and-paste from Rightmove. It would come as no surprise if some lenders try and blame their issues on valuers and, in some cases, they will probably have a point.

On mortgage rates, again the low interest environment allowed many to follow the British edict of “every man’s home is his castle” and as soon as you are able to, you must purchase your first home and stretch yourself with the largest mortgage possible. Add this to help to sell – sorry, Help to Buy – and you can see why the first-time buyer market took off. While it’s a good idea in theory, it inflated prices by somewhere between 20% and 30% and lined the pockets of the national housebuilders and developers alike.

Alarming numbers

We have also been in an environment where large groups of entrepreneurs have made substantial amounts of money from selling businesses and the first place they want to invest is in property. An alarming number tend to think they know everything, so how hard can it be. And if all fails, they will own and take control of the asset where they have backed a developer or lent directly into a scheme with no loan-to-value issues.

We are now starting to see how wrong they have been. We work with a wide network of lenders – and now the receivers they are appointing in an attempt to get their money back – and we are seeing sites purchased without planning; sites purchased with planning that require tweaking or planning conditions to be signed off; part-built schemes where developers or contractors have gone bust and the asset manager may not be able to secure additional funding from their sponsor; and finished blocks built for investment or sale where the developer has not been able to pay back their equity, debt (or both) and have taken an exit loan which has now expired and the loan-to-value is out of kilter.

Worst is still to come

It gives me no pleasure to say what we have seen to date is just the tip of the iceberg. We have a number of clients yet to face reality and I think things are going to get worse before they get better.

The question is: will the market crash? I don’t think so. There’s far too much money around and a strong rental market. An adjustment yes, and this will be dependent on the quality and supply of stock within specific locations. Top end will remain strong first and second-time buyer weak unless the government replace help to buy.

It’s all about being realistic and the old saying “first loss is the best loss” has never been more accurate. It is time to wake up and smell the coffee before it’s too late.