BUILDING FIRM FOUNDATIONS: ESG RISKS IN THE HOUSEBUILDING SECTOR.

2019

Northern LGPS

SUMMARY

There is now broad consensus that the UK faces a severe housing crisis. Housing is now viewed by the public as one of the most important issues facing the country. This focus brings with it huge opportunities for the housebuilding industry. However, it also has led to growing scrutiny of the way that housebuilders operate. For example, support of housebuilding through Help to Buy has not only led to its stated objective of increasing output but also criticism that housebuilders have unduly profited from state support at a time of acute housing affordability problems. Equally there have also been questions about the way looser planning regulations to deliver more new houses has also reduced contributions by housebuilders to local communities.

At the same time the sector has also been singled out for not doing enough to address climate risks. And due to the high levels of self-employment, the sector finds itself at the forefront of concerns about precarious work.

These issues carry with them reputational, environmental and social risks, all financially material factors for the Northern LGPS as investors. Furthermore, Northern LGPS beneficiaries live in a society that is affected by the behaviour of investee companies within the local authorities of the pension funds and beyond. Ensuring high environmental, social and governance standards within the housebuilding sector is therefore financially and socially critical for the North and Northern LGPS.

Set against this backdrop, in December 2018 Northern LGPS agreed to undertake an engagement project to examine these risks and engage with companies where it was felt risks were not being address.

The following report is the first stage of this work. The report does not name individual companies. Instead, it looks at the whole sector by examining the publically available material on how companies are addressing the risks outlined.

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This report was produced by PIRC on behalf of Northern LGPS

You can contact Northern LGPS at:

**Guardsman Tony Downes House,
5 Manchester Road,
Droylsden
M43 6SF
Tel: 0161 301 7000
Email: info@northernlgps.org**

@northernlgps

MAIN FINDINGS

CUSTOMER SATISFACTION

The long-term sustainability of companies will depend on their reputation, and an important component of this will be how they are viewed by customers. Housebuilders generally provide information on customer satisfaction but provide little information or commentary that goes beyond headline survey results.

BUILD QUALITY

Customer satisfaction is likely to also include the build quality of new homes. However, companies provide few details about warranties or the levels of claims to enable investors to understand the quality of products and potential financial and reputational risks.

ENVIRONMENT

Emissions from domestic buildings is a major contributor to national carbon emissions and housebuilders have been singled out for not doing enough. Companies generally provide information on carbon emissions. However, only a few have plans for capturing Scope 3 emissions – emissions that flow from homes sold and in use. As such, only a few have plans to set science-based targets to be in line with Paris Climate Agreement.

LEASEHOLDS

Despite the reputational damage to some housebuilders caused by their leasehold provisions few companies provide details for investors to understand whether this is a risk for the company.

EMPLOYMENT RIGHTS

Listed housebuilders disclose employment policies and most companies regularly conduct employment satisfaction surveys. However, despite most companies being heavily reliant on sub-contractors there is little or no detail about the extent to which companies use umbrella companies or agency workers or how they ensure workers are legally self-employed and not employees.

HEALTH AND SAFETY

By the nature of the industry employees face specific health and safety risks at work. All companies disclose that they have a health and safety policy and most disclose the number of accidents and injuries. However, less detail is provided on whether rates include sub-contracted workers, the level of major injuries, or if external audits on health and safety are undertaken.

SKILLS

The housebuilding sector faces specific skills issues, not least because productivity growth within the wider construction industry has been weak over the last two decades. Most companies disclose whether they have an apprenticeship scheme in place but very few provide information on how the company's skills policy relates to the company's approach to employment contracts and sub-contracting or the obligations of sub-contractors on training.

DIVERSITY

Making the most of the skills available in the workforce and ensuring strong governance will depend on ensuring diversity throughout the company. The vast majority of housebuilders have disclosed equal employment policies, in half of the companies 30% or more of board positions are occupied by women but few set targets to increase diversity.

PLANNING

Gaining planning consents and maintaining a good reputation depends on how housebuilders engage local planning authorities and local communities. All companies provide information about how their activities benefit local communities. In the main they also disclose the value of the company's planning obligation (the developer's legal obligations and contributions entered into with planning authority to mitigate the impacts of a development proposal). However, they provide little information to contextualise that information. A fair proportion also do not provide information about their approach to managing relationships with local planning authorities that go beyond boiler plate mentions of working with local communities.

EXECUTIVE PAY

Some companies within the industry have faced specific criticism for the level of executive pay. Few companies disclose executive remuneration as a proportion of average employee pay or, indeed, the industry average given the sector's reliance on contracting. Most companies include metrics for executive pay based on customer satisfaction but a minority do on health and safety and none appear to do so on carbon emissions.

LANDBANKING

Housebuilders have been criticised for the size of their landbanks and slow build out rates. Most companies provide information on the size of a company's land banks. However, few disclose the average buildout out rate and no information is provided on the number of plots not being developed by planning status or the value appreciation (or impairment) of plots not being developed.

"Emissions from domestic buildings is a major contributor to national carbon emissions and housebuilders have been singled out for not doing enough."

THE HOUSE BUILDING SECTOR

Listed housebuilders (home construction sector)

Company	Index	Market capitalisation
BARRATT DEVELOPMENTS PLC	FTSE 100	£5.59bn
BELLWAY PLC	FTSE MidCap	£3.35bn
BERKELEY GROUP HOLDINGS PLC	FTSE 100	£4.45bn
BOVIS HOMES GROUP PLC	FTSE MidCap	£1.32bn
COUNTRYSIDE PROPERTIES PLC	FTSE MidCap	£1.33bn
CREST NICHOLSON HOLDINGS PLC	FTSE MidCap	£0.92bn
MCCARTHY & STONE PLC	FTSE MidCap	£0.69bn
PERSIMMON PLC	FTSE 100	£6.2bn
REDROW PLC	FTSE MidCap	£1.92bn
TAYLOR WIMPEY PLC	FTSE 100	£5.42bn
Total		£31.19bn

The quoted UK housebuilding industry is cyclical in nature. Many of the large builders faced severe financial difficultly during the financial crisis. Since then firms have recovered rapidly with the aid of government programmes aimed at supporting homeownership and other macro-economic impacts such as historically low interest rates.

The quoted UK housebuilding sector is valued at over £20 billion and is made up of ten companies, four of which are in the FTSE 100. There are also seven construction firms.[1] Although there is crossover in many of the issues, this report is specifically focused on the ten listed housebuilders all of which Northern LGPS has investments in.

Product and customer risk

Ensuring product quality within the housebuilding industry is important to the reputation and sustainability of companies within the sector. The industry's reputation has at times suffered because of perceptions around poor design, build quality, space standards and customer service levels. It also faces particular challenges as environmental regulations are likely to ratchet up in the coming years and as customer expectations on reducing fuel costs shift. This section looks at specific product risks and associated implications for companies' relations with their customers.

Customer satisfaction

Customer satisfaction is important in all industries, especially for one in which new supply is less than 1% of the market and accounts for around 10% of homes sold. However, as noted in the 2004 Barker Review into housing supply,[2] there is little correlation between customer satisfaction and market share, with winning the competition for land being of primary importance. If customer satisfaction does play a less important role, then the industry could be sheltered from criticism for the quality, size and design of the new properties they build. These criticisms could impact company brand and affect long-term value creation. Overall industry levels of consumer satisfaction will also be important to ensuring there is not intervention by government.

As a result of the Barker Review, the Home Builders Federation (HBF), the trade association for housebuilders, has conducted an annual survey of new homebuyers measuring satisfaction with the property they have recently bought.

The majority of companies disclose the HBF star rating in their annual report. Most housebuilders also set targets for maintaining or improving their overall star ratings. However, there is often little information beyond the headline star rating numbers on how well companies are viewed by customers and how this compares with the rest of the industry. This potentially makes it difficult to understand specific issues a company might face or for investors to place a distinguishing value on the company.

Building standards

A central component of customer satisfaction is build quality. Ensuring quality standards are met also reduces longer-term costs to the company in addressing snagging issues which are covered by warranties.

Building warranties act as an insurance policy for newly built homes and is taken out by the builder or developer to protect the homebuyer, who will often need it for mortgage funds to be released. The use and cost of the insurance to the housebuilder could be viewed as an indicator not just for future liabilities but also for the quality of the product and long-term sustainability of the business.

Whilst many companies make reference to warranties there is little detail beyond that. For example, few companies appear to disclose clearly the level of provisions made for meeting customer care costs or provide commentary around the level of provision provided which may have reputational implications. Nor is there much, if any, information on the number claims that have been upheld on warranties.

Environmental standards

The sector was recently criticised by the chair of the Committee on Climate Change, an independent statutory body, which warned that the UK would not meet its binding targets unless urgent action was taken to reduce emissions from houses (and cars).[3] This leaves housebuilders vulnerable to additional

1 Listed companies in the heavy construction sector are: Balfour Beatty Plc; Costain Group Plc; Galliford Try Plc; Henry Boot Plc; Keller Group Plc; Kier Group Plc; and Morgan Sindall Group Plc.
2 Barker, K, Review of Housing Supply –Delivering Stability: Securing our Future Housing Needs (Crown Copyright, 2004)

3 Carrington, D "Housing and car industries should be 'ashamed' of climate record", The Guardian, 28 June 2018; See also Committee on Climate Change, Reducing UK emissions 2018 Progress Report to Parliament (2018)

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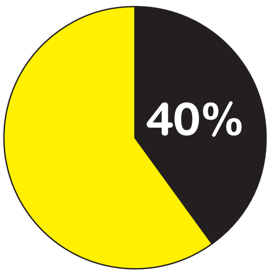
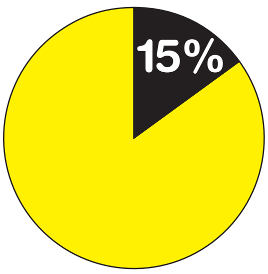
legislation or regulation, increased reputational risks and potentially vulnerable to consumer concerns that they will be left paying for additional energy bills.

The picture on disclosure of environmental standards is mixed. Most companies have an environmental policy that is published, disclose scope 1 and 2 emissions and state who on the board takes leadership on the issue. Emissions levels are also often disclosed in a way that is comparable across companies, such as emissions per 100 square metres. These emissions are generally stated to have been externally verified and companies have targets and performance is evaluated on them.

SELF EMPLOYED IN CONSTRUCTION WORKFORCE



SELF EMPLOYED IN OTHER PARTS OF THE ECONOMY



Nevertheless, a number of companies do not disclose CDP performance scores. And more concerning is that very few companies have plans to quantify Scope 3 emissions, which include the final use of their products, where most emissions are likely to flow from. As such few also have plans to reduce Scope 1-3 emissions in line with a 2 (or 1.5) degree scenario as set out in the Paris Climate Agreement.

Leasehold arrangements

The sale of leasehold properties by housebuilders has led to complaints about escalating costs after a household has bought a property with ground rents rising well above inflation. As a result of some of the practices, government has published a consultation[4] looking at measures to address problems associated with the sale of leasehold properties. Leaving aside intervention from government the issue has important reputational implications for companies as well as costs associated with potential compensation or altering the terms of the lease owned by third parties.

Overall little information is published by companies on the sale of properties on a leasehold basis. A number of companies, but not a majority, state their approach to why and where the company may sell homes on a leasehold basis. However, relatively few disclose the potential legal, reputational or regulatory reform costs. This may be because they do not think it affects them, but this is difficult to know through current disclosure.

4 Ministry of Housing, Communities and Local Government, Implementing reforms to the leasehold system in England: A consultation (October 2018)

Skills and employment risks

The construction industry is heavily reliant on self-employment and sub-contracting. This leaves housebuilders vulnerable to accusations of exploitation while underinvestment in skills could lead to weak productivity growth. The nature of construction also means the sector faces ongoing challenges around health and safety.

Employment rights and relations

The building sector has historically faced serious reputational and legal issues because of the way it has treated its staff. In particular, scandals around illegal blacklisting of workers who were trade unionists has led to significant payouts, although this was focused on the actions of construction firms rather than housebuilders.

A particular issue around employment rights is precarious work and bogus self-employment. Around 40% of the construction workforce is self-employed, much higher than the other parts of the economy (around 15%).[5] Back in 2009 the government noted there was no reason that this disparity should exist. Around the same time, the then Union of Construction, Allied Trades & Technicians (UCATT) published a report it had commissioned from Professor Mark Harvey, at the University of Essex. The report suggested that around 30% of those working in the construction industry were inaccurately classed as self-employed. The government estimate at the time was lower but still significant at up to 200,000.[6]

As recent cases affecting UBER and Ryanair attest, the use of precarious work practices by companies can be detrimental to long-term value. In the specific case of the construction industry, there has been concern about the use of umbrella or payroll companies and the damage these could do to employment relations and company reputation. Umbrella companies have courted controversy with some charging the worker both employers' and employees' national insurance contributions while fee transparency is sometimes lacking.

The picture on employment rights is mixed. Companies do not address the issue of umbrella companies or agency workers in publicly disclosed material. Few have disclosed policies to ensure self-employed contractors are legally self-employed. There is a divide between housebuilders in providing information on how their approach to employment relations relates to the contractual arrangements of workers on their developments. This is something that some do recognise especially in relation to the labour supply and ensuring that the companies have the right blend of skills. Similarly there is a split between companies on whether they have a trade

5 ONS, EMP14: All employees by industry sector, 14 August 2018 accessed on 22nd October 2018
6 Seely, A Self-employment in the construction industry (House of Commons Library , 2018)

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union negotiating framework, works councils or similar arrangement for information and consultation. Furthermore there is a mixed picture on the disclosure of staff turnover levels.

Where there is more disclosure is on employment policy, which all companies provide. Similarly most state that the company regularly undertakes employee surveys. However, only a few companies state that they pay employees the Living Wage and none that this is extended to contractors.

Health and Safety

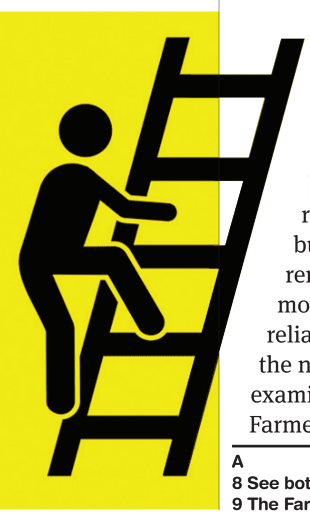
Health and safety risks are high within the construction industry because of the nature of the work. Companies are obliged to report work related accident and illness incidence to the Health and Safety Executive under the Reporting of Incidents Diseases and Dangerous Occurrences Regulations (RIDDOR). Such information could point towards companies that are performing well and where others may need to be doing better to reduce the risks to the company. Focusing on RIDDOR scores may be important but attention can be overly focused on incident rates ignoring the underlying processes. Whilst clearly outcomes are what matters, seemingly good results may mask poor practice or lead to complacency which can lead to accidents further down the line. As such, an understanding of systems in place matters as well.

The majority housebuilders disclose the number of RIDDORs or Annual Injury Incidence Rates. However, a minority do not. Most, but a slightly lower number, also clearly state that the information on injuries covers sub-contracted workers and fewer again report on major injuries. A minority also state that external audits are undertaken.

All the companies have a health and safety policy and the majority disclose that the company has a health, safety and environmental (or safety, health and environment) management system.

Skills and apprenticeships

Housebuilding has increased rapidly since the crash, with the number of starts doubling since the 2008/09 trough.[7] This has created demand for skilled workers to deliver homes on time and to high standards. Against this backdrop, the sector has been concerned about what impact Brexit might have on the supply of skilled workers. In recent years as there has been more focus on building more homes, there has also been renewed interest in the how the sector can use modern methods of construction.[8] This will be reliant on having skilled workforce trained to use the new technology. Many of these issues were examined in the government-commissioned Farmer Review,[9] which highlighted stalling productivity growth within the construction industry alongside an ageing workforce and a lack of skills.



The construction industry has had its own skills levy for over thirty years. Yet despite this, completed apprenticeships in construction, planning and the built environment do not appear to meeting demand[10] and the industry provides little training compared with other sectors.[11] As a result of the high levels of self-employment and reliance on sub-contractors the sector faces its own specific challenges of ensuring an adequate pipeline of skilled workers. There have also been concerns that some contractors have been passing on their levy obligations to their sub-contractors.[12]

All the housebuilders clearly disclose whether they have apprenticeship scheme in place and the vast majority also disclose the number of apprenticeships. However, information is less clear about whether the levels given refer to new apprenticeships in the last year or all apprenticeships being undertaken thus making comparisons between companies difficult. There is much less information on the obligations companies place on contractors on training and development. Furthermore, there was also almost no commentary about how the company's skills policy relates to the company's approach to employment contracts and sub-contracting.

Diversity

Sector initiatives have tried to address the issue of diversity within the construction industry. Despite this, women make up around a third of the workforce of listed housebuilders which have a similar proportion of female directors. This figures drops to under 20% for senior management.[13] As a report by the Equality and Human Rights Commission on behalf of the Construction Leadership Diversity Forum (CLDF) found there was potential for significant improvements in diversity practices within the sector.

The vast majority of companies disclosed equal employment policies. Around half of housebuilders had boards where women hold at least 30% of positions. And most had policies to increase diversity. However, relatively few had set targets while disclosed programmes to increase diversity were often focused on senior staff rather than the workforce as a whole.

Community and social risks

The housebuilding sector is regulated through the planning system. Ensuring good relations with local planning authorities and local communities more broadly is critical to getting homes built. Within this

A
8 See both the Lyons and Farmer reviews
9 The Farmer Review of the UK Construction Labour Model (2016)

10 Department for Education, Apprenticeships level, framework and sector subject area data tool: achievements 2011/12 to 2015/16
11 The Farmer Review of the UK Construction Labour Model (2016)
12 See Construction Industry Training Board, "Deducting levy from wages (Both PAYE and Net CIS)" https://www.citb.co.uk/levy-grants-and-funding/construction-levy/levy-rates-and-exemptions/deducting-levy-from-wages/
13 Based on data from PIRC database for 2018

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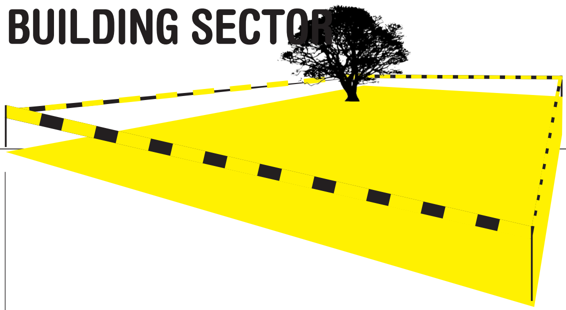

context there is an expectation that housebuilders are playing their part in delivering the homes that people within local communities want and can afford and do not distort the market through the way they acquire and build out plots. There has also been scrutiny of the extent to which the sector has benefitted from the 'Help to Buy' programme and the impact this may have had on executive remuneration.

Planning gain

Developers often have to deliver or contribute towards local infrastructure (affordable housing, schools etc) for a planning consent to be granted. There have been concerns about the approach of housebuilders with regard to planning. This has included housebuilders negotiating down affordable housing commitments, especially since changes to regulations in 2012. More broadly there have been concerns that applications too often ignore local plans or are not tailored to local requirements. There may always be tensions between parties negotiating with each other. Nevertheless, housebuilders are reliant on planning departments approving housing schemes and so is likely to be critical to the success of the business.

Housing affordability has risen up the political agenda over recent years, not least in relation to young people looking to buy. To address the rapid decline in the number of first time buyers, the government introduced its 'Help to Buy' scheme. Housebuilders have been significant beneficiaries of 'Help to Buy', something which they themselves have acknowledged. Despite clarification on the future of the scheme from government, there is some concern that the market is now reliant on the scheme. For some companies last year, half of all homes sold were to those supported by the Help to Buy scheme. Housebuilders have also been accused of unduly benefiting from the scheme.

Housebuilders all outline how their business activities benefit local communities. Almost all also place a monetary value on their planning contributions. However, a number of companies do not go beyond boiler plate descriptions about how they manage their relationships with local authorities. In addition, information on the amount of planning contributions is also not contextualised by the scale of the business.

Housebuilders do provide commentary of the Help to Buy scheme. The commentary is focused on the implications for sales and the need to consider a new offer for when the scheme ends. However, there is little disclosure about how perceptions of the company or the sector might be affected by the programme or the steps they might be taking to manage these risks.

Executive remuneration

Housebuilding by its nature is very cyclical. The significant problems housebuilders encountered in the last downturn give a sense of the scale to which they are affected. Given that changes in company fortunes are highly sensitive to the performance of the economy, it may be sensible for remuneration policies to be designed to reflect this. This issue has come to the fore during the upswing after the recession, boosted by the government's Help to Buy programme. Understanding the scale of executive pay is often achieved with reference to workforce pay rates. However, for the housebuilding sector this may not give a true reflection of pay differentials because of the level of self-employment.

Housebuilders do not tend to disclose executive remuneration as a proportion of pay of the average employee. Furthermore, they do not disclose the information about pay ratios for executives with the sector as a whole. This might be a better reflection given the levels of self-employment within their operations. The vast majority of companies also do not have minimum vesting period of five years to ensure a better reflection of executive performance as opposed to the wider economic context.

More positively a majority of companies do include metrics in performance related pay arrangements based on customer satisfaction. Some also have metrics based on health and safety issues. However, no company appears to have metrics on carbon emissions.

Landbanks

The housebuilding sector has faced criticism for so-called land-banking. A succession of politicians have accused housebuilders of sitting on land with planning permission and either building out sites (completing all the development within a site) or selling properties slowly to maximise their sale prices or sitting on undeveloped land to increase the price of the land. Companies in the sector have defended themselves by stating that holding a stock of land enables them to plan their business. A number of government reviews have also found landbanking has not been used to hoard land and drive up prices.[14]

The issue of land-banking remains highly contentious and contested. In order to allay anxieties of some, transparency from housebuilders about their approach could help. This would also provide investors with an important metric in understanding firm productivity, complementing data on the return on capital employed.

14 See for example: Barker Review (2004) into housing supply; Callcutt review (2007) into housebuilding delivery; Office for Fair Trading (2008) market study into homebuilding in the UK

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All housebuilders provide information about the size of their landbank. Housebuilders also outline the number of years of housebuilding they expect this land supply to last. However, there is little disclosure on the buildout time per plot on purchase or on planning consent. Equally little or no information is provided on the number of plots not currently being developed by planning status or the value appreciation (or impairment) of plots not being developed. Where there is more disclosure is on the regional breakdown of landbanks, but this is not universally provided in company annual reports.

Company comparisons and conclusions

This report identifies and evaluates specific ESG risks that housebuilding companies may face and how these they are being managed. The analysis in the report highlights a mixed picture across the issues identified. In some areas housebuilders are providing investors with information across a range of ESG concerns. In other areas, such as the use of agency staff or issues around self-employment, information is often lacking. However, in the main information within each ESG issue varies. For example, companies do provide detail on direct carbon emissions but when it comes to Scope 3 emissions, relatively few appear engaged in measuring and setting targets. Similarly information on approaches to planning, landbanking, and health and safety can be patchy.

This mixed picture is also observable between companies. Although the report is aimed at looking at the sector as a whole and not individual companies, levels of disclosure by company vary widely. Some companies out-do their peers across the three main areas examined in the report: product and customer risks; skills and employment risks and community and social risks. However, there is a group which provide investors with relatively little information about whether or how they are approaching these ESG risks and opportunities.

This is a concern as across these areas there are substantial threats for the companies and, as a result, for investors. These risks are amplified by a fast-changing public policy environment with the government attempting to address public and local government concerns about what the government itself acknowledges as a 'broken housing market'.[15]

Providing additional detail to fill the information gaps highlighted in the report will give investors a better picture of how these threats are being managed and place a distinguishing value on those companies who are doing more. As such, in the coming months Northern LGPS will be seeking to engage companies on these issues to gain a better understanding of best practice, request better disclosure and seek assurances and improvements where necessary. By so doing the intention is to minimise the ESG risks for a sector facing heightened scrutiny.

15 DCLG, Fixing our broken housing market (2017)