Viability and Capturing Development Value

The Basics

Anglia Ruskin – Essex Planning Officers – Feb. 5th

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Content

- Principles of Viability Models
- Key financial variables
- Financial Testing and Development Viability and the new NPPF 2018-19

Key Drivers for LPAs

Why is Development Viability so important?

- Underpin and justify Policy positions
- Maximise Affordable Housing
- Maximise S106 / CIL contributions
- Determine Land Values, not react to them
- Defend Adopted Policies against challenges
- Emphasis in NPPF/PPG and revised Plans – testing Viability at the plan formation stage
- Appointing Viability Assessor early

The Importance of Development Appraisals

- **Policy Context**
  - Increasingly critical to test policies in terms of Financial Viability BEFORE adoption. Increasing history…
    - From PPS3 – Changing Affordable Housing Thresholds, Strategic Housing Land Assessments , CIL testing, NPPF 2012 and Growth and Infrastructure Act to the NPPF and PPG 2018-19
- **Site specific testing**

Where do we start?

Understand the Basics of **Residual Valuations** –
That is, where the Developer is coming from!!!

What is it?

- A simple method for Appraising Site Viability
- Filtering before more detailed DCF
- Ultimately, to determine 'bid' value

THE TRADITIONAL RESIDUAL VALUATION

COMPLETED or GROSS DEVELOPMENT VALUE

Minus

CONSTRUCTION COSTS, FEES, BORROWING, Etc

Minus

DEVELOPER'S PROFIT

Equals

RESIDUAL LAND VALUE

Must EXCEED Existing Use Value

COMPLETED DEVELOPMENT VALUE

GDV decreases with A/H

Percentage / Tenure and new types of Affordable housing

Minus

CONSTRUCTION COSTS, FEES Etc
Planning Obligations / CIL
Affordable Housing

Costs increase.
Nb. Contingency
Ancillaries, and
Borrowing

Reduction

Minus

DEVELOPER'S PROFIT

Profit falls

Equals

RESIDUAL LAND VALUE
Must EXCEED Existing Use Value

Land Value falls and failing to exceed EUV becomes more likely (Nb. EUV+ in 2018-19)

Residential v. Commercial Appraisals

Residential Appraisals - Mainly (but not entirely) valuing Freehold interests so price achieved in total equals Development Value
Nb. Rented Housing becoming more popular

Commercial Appraisals - Mainly (but not entirely) rented to occupiers / tenants so there's a landlord who receives rent per annum
That income stream must be capitalised to determine Development value – thus, need a 'Yield' to multiply rental income into Development Value
Yield is a measure of 'Risk' and varies constantly.

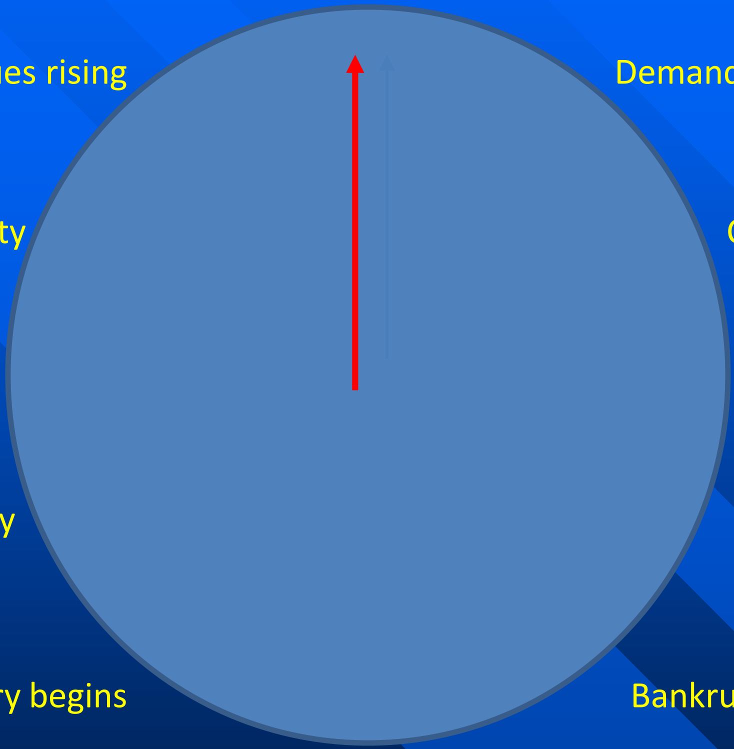
Risk and Yield

Capitalising Rental Stream

Rental Value	Yield	Multiplier Years Purchase	Capital Value
1,000,000	7.5%	13.33	13,300,000
1,000,000	8.0%	12.50	12,500,000
1,000,000	8.5%	11.76	11,760,000

LOW YIELD = HIGH VALUE

THE PROPERTY 'CLOCK'



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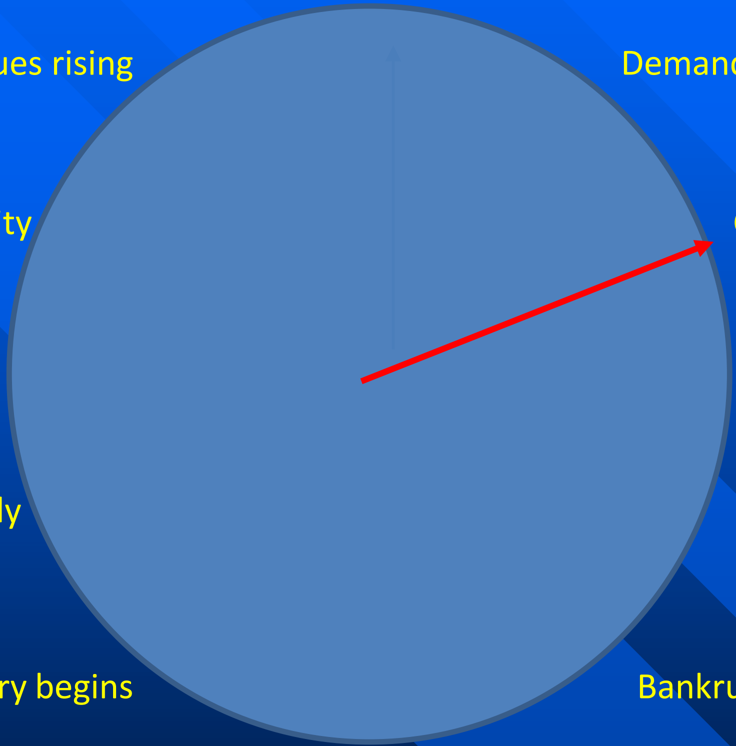

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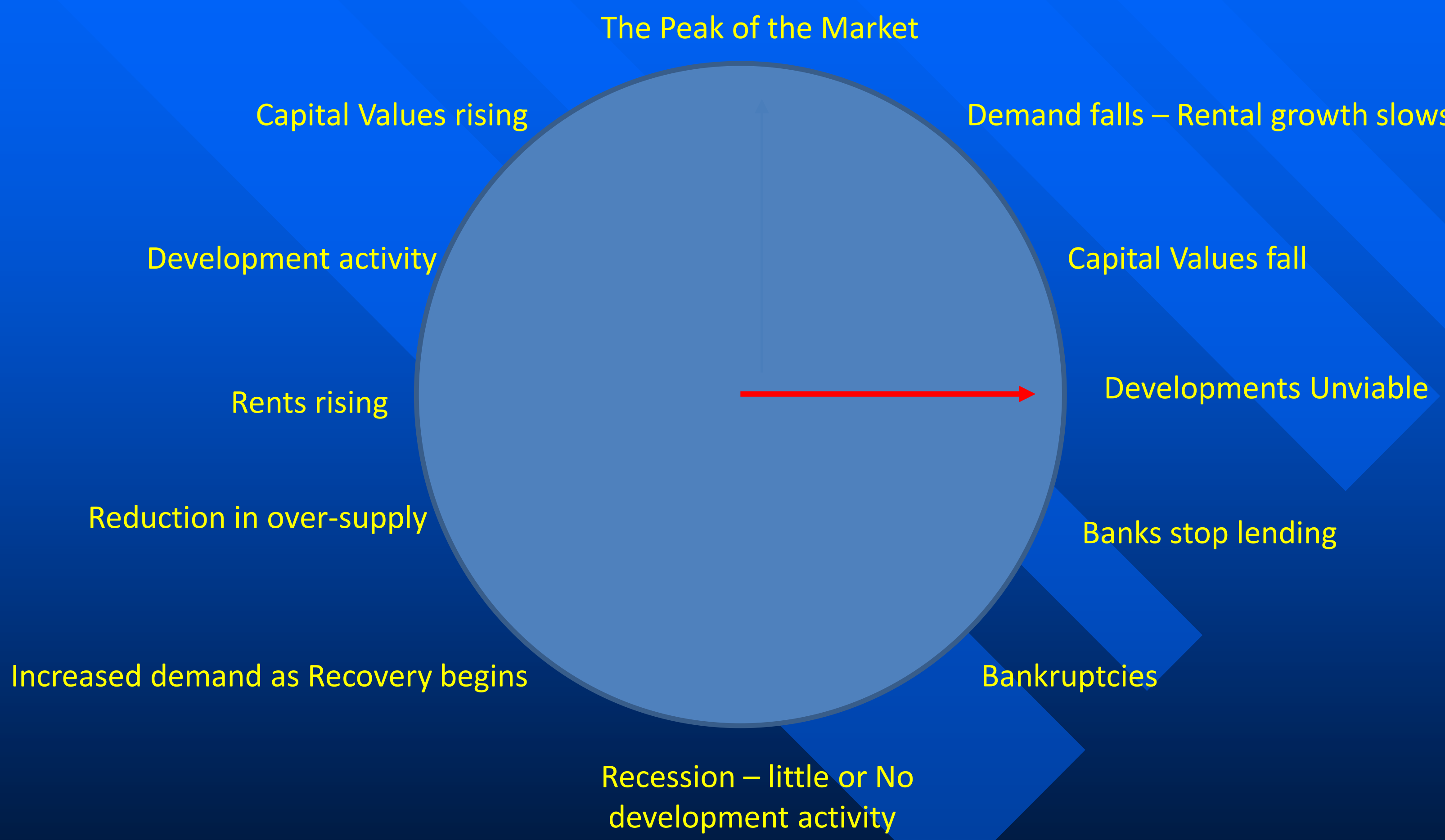

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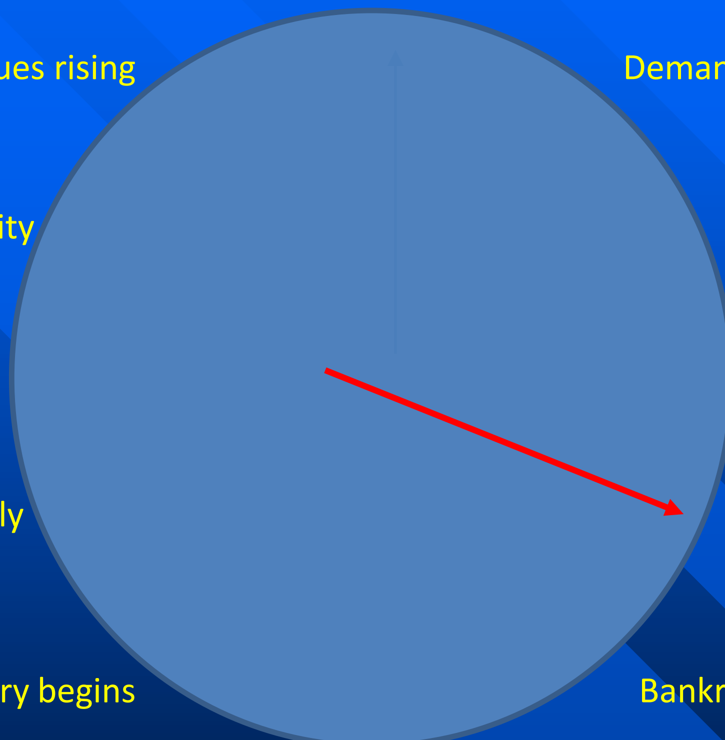

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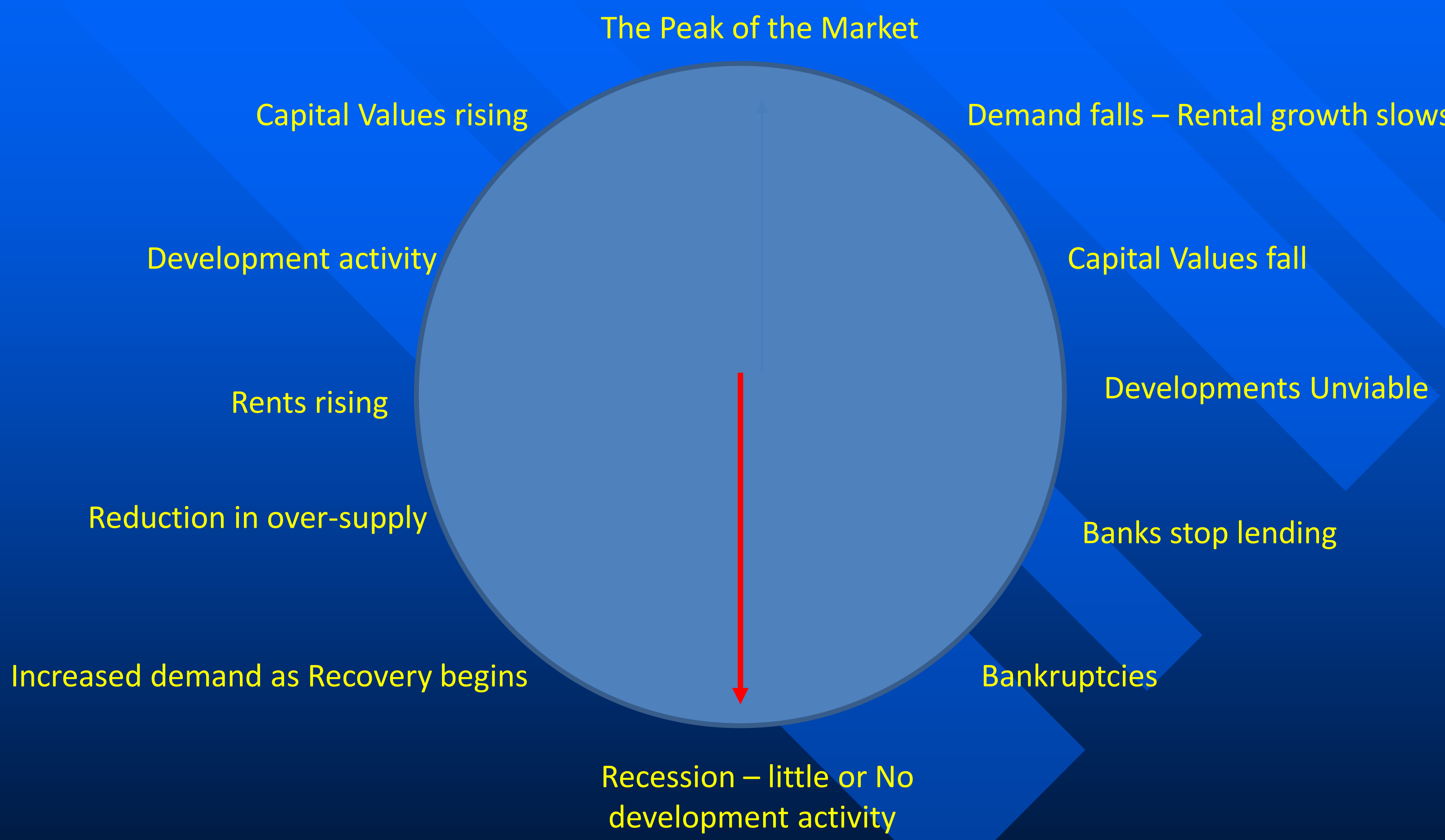

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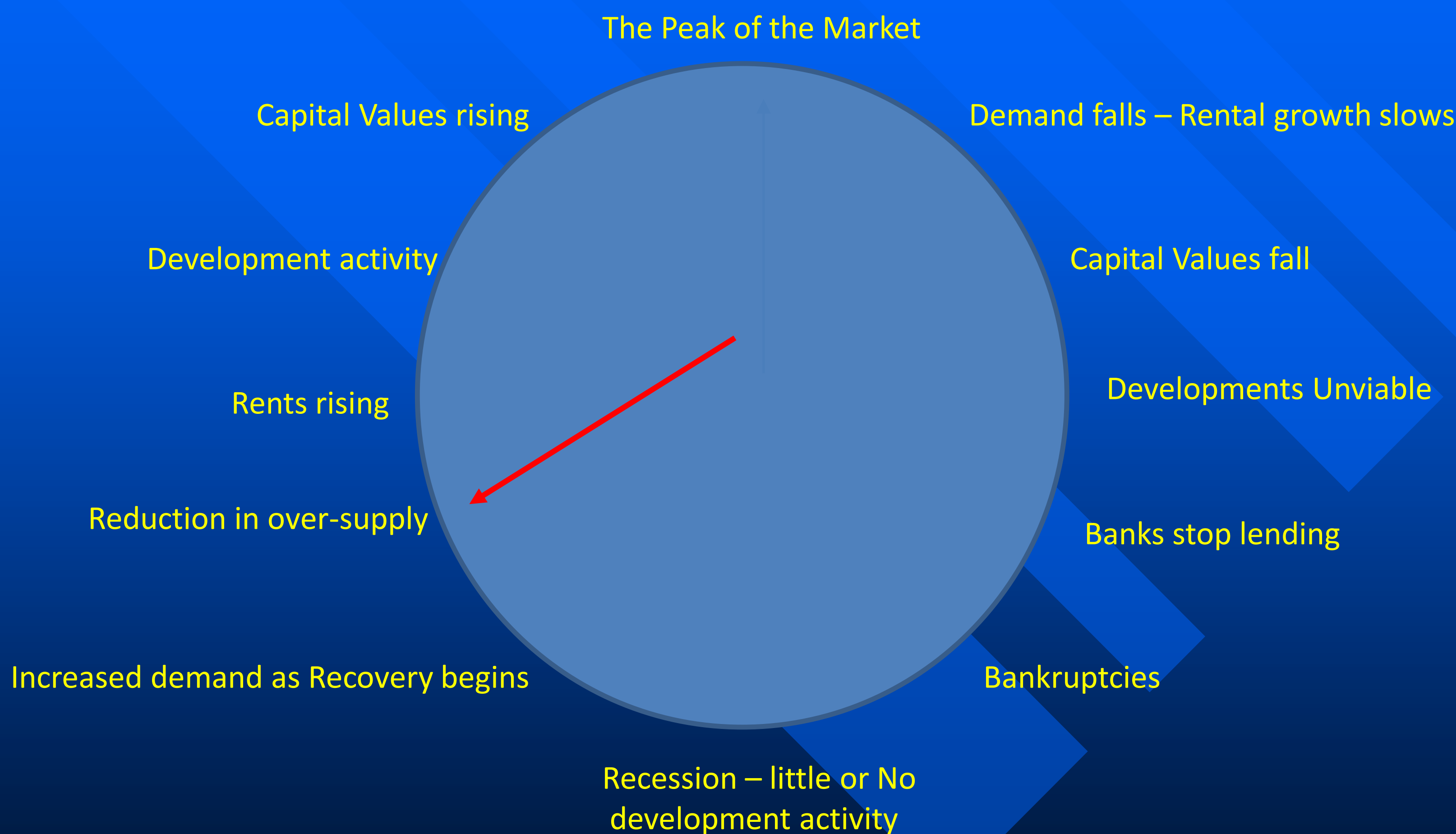

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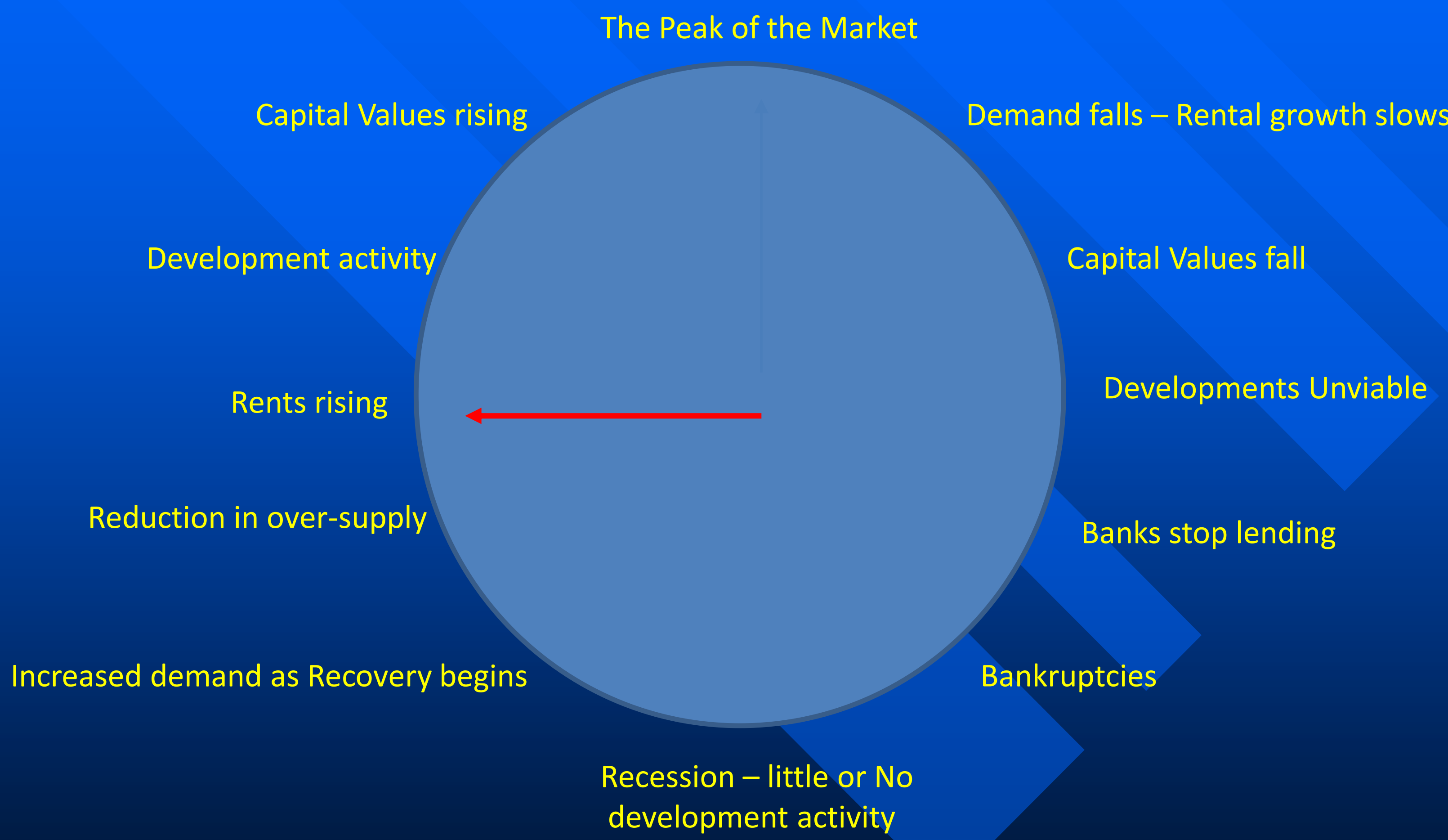

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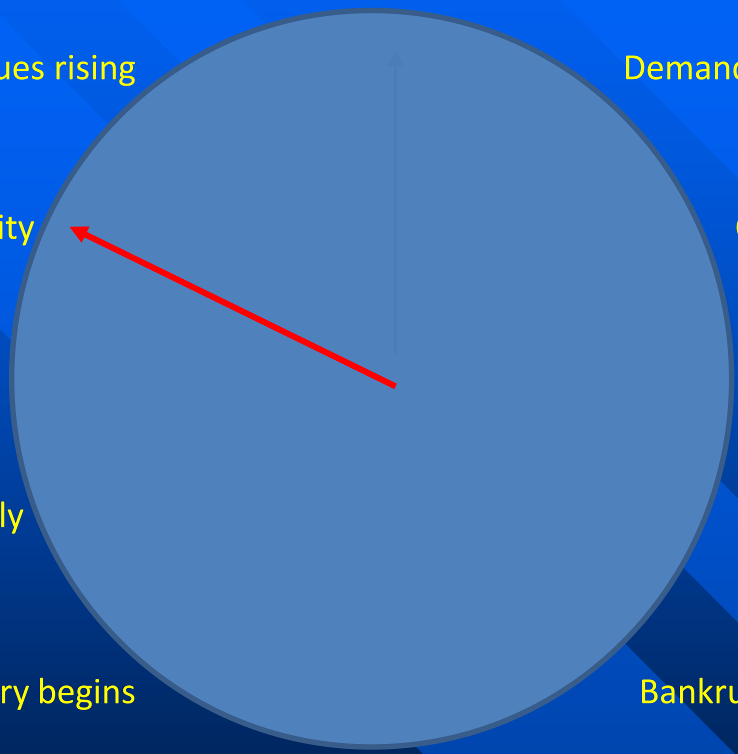
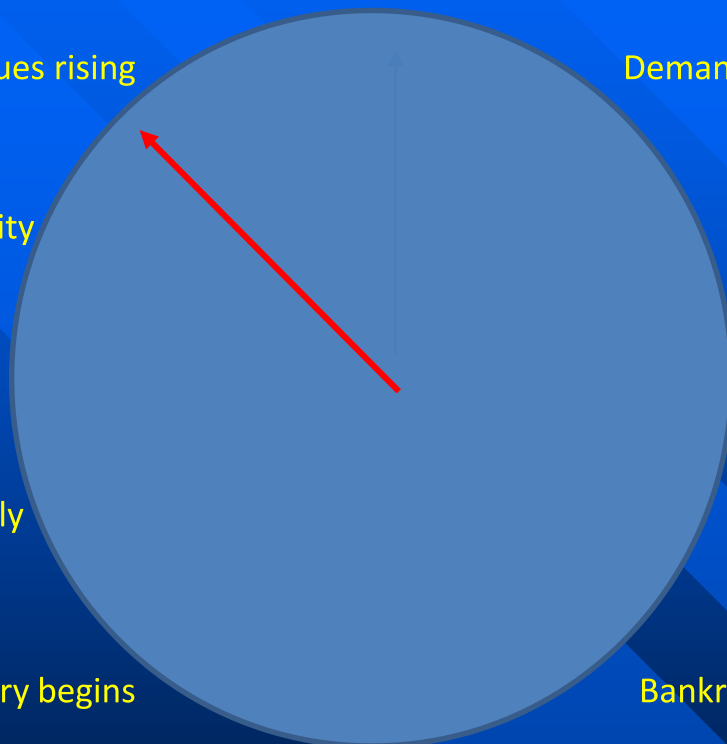


THE PROPERTY 'CLOCK'

The Peak of the Market

Capital Values rising

Demand falls – Rental growth slows



Development activity

Capital Values fall

Rents rising

Developments Unviable

Reduction in over-supply

Banks stop lending

Increased demand as Recovery begins

Bankruptcies

Recession – little or No development activity

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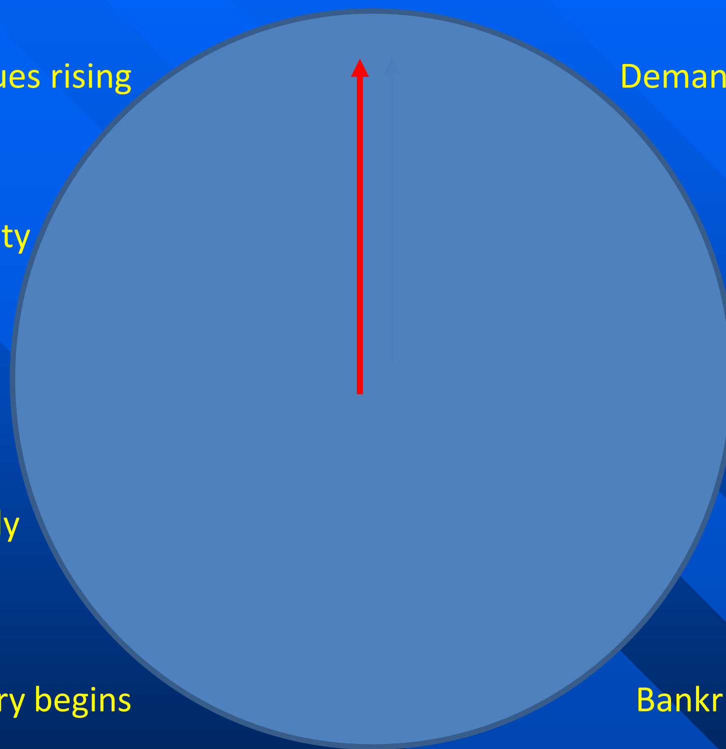

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WHAT TIME IS IT?

Your Case Study

- Mixed use development proposal
- - 100 residential units (average size 65m2)
- - 1500m2 office space
- Town centre fringe location – not 'prime'
- Offices pre-let to solid covenant
- Developer is competing for site
- 30% affordable housing policy – 70-30% A/H tenure split
- Planning Obligations £10,000 per residential unit plus some commercial contribution
- **HOW MUCH DO YOU BID FOR THE SITE ?**

Key Variables

Residential sales values	£2,500psm
Affordable units	55-65% of OMV
Office rents	£320psm, pa.
Base Residential Build costs	£1350psm
Office costs	£1250psm

Contingency	5% on cost
Fees	12.5% on cost
Ancillaries	5% on cost
Borrowing	8% for half the build period (18 months)

Part TWO:Case Study Appraisal

GROSS DEVELOPMENT VALUE

Residential sales values	
70 units at £2500 psm (<u>Gross to Net 80%)</u>	
Capital Value	£12,250,000
Ground rents 70 @£400 pa @ 6% yield	466,667
30 Affordable units at 55-65% OMV	<u>3,150,000</u>
Offices rental income (1500m2 at £320psm)	480,000pa
Yield at 8% - YP multiplier	<u>12.5</u>
Capital Value	6,000,000
Total Gross Development (Capital) Value	£21,866,667

Questions 1

Quality of Comparative Residential evidence
Confirmation of RSL(s) offers (conditional?)
    Grant assumptions - No grant ?
Evidence of Commercial rents and yields
    Investment transactions
Exaggerating gross to net - better layout?
Missing items
    Income sales from car parking
    Ground rents from flatted units

Appraisal 2

Base Construction Costs

Build Costs (gross)	Resid	5690m2 (£1350psm)	£7,684,000
	AH	2440m2	£2,928,000
Offices		1500m2 (£1250psm)	£1,875,000
Total			**£13,487,000**

Appraisal 3

Construction Costs - Breakdown

Total		
		£13,487,000
Ancillaries	5% on Cost	**674,350**
Fees	**12.5% on Cost**	**1,685,875**
Contingency	**5% on Cost**	**674,350**
Planning Obs	**£10k per Sales Unit**	**700,000**
	Commercial space, say	**200,000**
Borrowing	**(18month build @ 8% for 9 months)**	**1,065,000**
Total Costs		**£18,486,675**

Questions 2

- Can the Costs be justified ?
- What has been included?   Exceptional Costs?
- Code level (CSH) 3 or 4 or equivalent ?
- Confusing Gross and Net Costs ?
- Parking costs but no Income ?
- Can the Planning Obligations be substantiated?
- Where are the savings – fees, borrowing etc. ?

Where does it leave us ?

Development Value	£21,400,000
Total Costs	£18,486 ,675
Profit on Value / Cost	
15% on Value (Low)	£3,210,000
RESIDUAL LAND VALUE **minus**	**£29**6,675

So, LA Starting Point 1

- Is it a Policy Compliant scheme ?
- Transparent ‘open book’ appraisals wherever possible – FoI challenges
- Directly comparable or adjusted evidence
- Early discussions and RP offers

LPA Starting Point 2

- Costs detailed and benchmarked, current not projected (unless long term phased schemes)
- Abnormal costs disaggregated, justified and reflected in land value
- S106/CIL costs agreed early and inputted

LPA Starting Point 3

- Profit – LB Viability Group now suggesting 15-20% on cost – controversial but note NPPF – 15-20% on GDV ?
- 20% on GDV remains the lender’s norm (major housebuilders often higher)

LA Starting Point 4

- Establishing Land Value is critical
- RV v Benchmark Land Value (reflecting policies)
- EUV + Premium (Nb – no guidance on premiums inc NPPF)
- Cf – Acquisition cost / AUV
  - Planning policies are ‘squeezed’ ??
- Note: NPPF

Review Mechanisms

- Changing financial variables during build
- May be sought up to policy compliance on phased and non phased schemes (see GLA Housing SPG)
- LBVG – “sharing” surplus profit – challengeable ?
- Review timings ?
- Based on increased GDV, not profit!

NPPF and PPG 2018-19

- New Plans specify contributions – compliant proposals <u>assumed to be viable but must be tested</u>
- > GDV and Costs at <u>plan-making</u> stage. Profit 15-20% of GDV.
- Land Value is <u>EUV+</u> (Existing use value +) - <u>Crucial</u>
- Affordable Housing on all 10+ schemes
- High price paid for land no justification for schemes not being policy compliant

<u>POTENTIAL 'GAME CHANGER' BUT WILL TAKE TIME</u>

Contacts / Queries

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