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**

**Less**

**DEVELOPER’S PROFIT**

**Equals**

**RESIDUAL LAND VALUE**

*MUST EXCEED Existing Use Value*

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- **Percentage / Tenure and new types of Affordable housing**
- **Reduction**
- **CONSTRUCTION COSTS, FEES Etc**
  - Planning Obligations / CIL
  - Affordable Housing
- **GDV decreases with A/H**
- **Costs increase. Nb. Contingency Ancillaries, and Borrowing**
- **Profit falls**
- **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**

<table>
<thead>
<tr>
<th>Rental Value</th>
<th>Yield</th>
<th>Multiplier Years Purchase</th>
<th>Capital Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000,000</td>
<td>7.5%</td>
<td>13.33</td>
<td>13,300,000</td>
</tr>
<tr>
<td>1,000,000</td>
<td>8.0%</td>
<td>12.50</td>
<td>12,500,000</td>
</tr>
<tr>
<td>1,000,000</td>
<td>8.5%</td>
<td>11.76</td>
<td>11,760,000</td>
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</table>

**LOW YIELD = HIGH VALUE**

Feb. 5
The Peak of the Market

- Development activity
- Rents rising
- Capital Values rising

Demand falls – Rental growth slows

- Capital Values fall
- Developments Unviable
- Banks stop lending
- Bankruptcies

Recession – little or No development activity

Increased demand as Recovery begins

Reduction in over-supply

THE PROPERTY ‘CLOCK’
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- **The Peak of the Market**
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Decrease in supply

- Reduced demand as Recovery begins
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WHAT TIME IS IT?

- Development activity
- Rents rising
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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: £2,500 psm
- Affordable units: 55-65% of OMV
- Office rents: £320 psm, pa.
- Base Residential Build costs: £1350 psm
- Office costs: £1250 psm
- 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 (Gross to Net 80%)
Capital Value £12,250,000
Ground rents 70 @£400 pa @ 6% yield 466,667
30 Affordable units at 55-65% OMV 3,150,000

Offices rental income (1500m2 at £320 psm) 480,000pa
Yield at 8% - YP multiplier 12.5
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

<table>
<thead>
<tr>
<th>Component</th>
<th>Area</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Build Costs (gross) Resid</td>
<td>5690m² (£1350psm)</td>
<td>£7,684,000</td>
</tr>
<tr>
<td>AH</td>
<td>2440m²</td>
<td>£2,928,000</td>
</tr>
<tr>
<td>Offices</td>
<td>1500m² (£1250psm)</td>
<td>£1,875,000</td>
</tr>
</tbody>
</table>

**Total**          **£13,487,000**
# Construction Costs - Breakdown

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>£13,487,000</td>
</tr>
<tr>
<td>Ancillaries</td>
<td>£674,350</td>
</tr>
<tr>
<td>Fees</td>
<td>£1,685,875</td>
</tr>
<tr>
<td>Contingency</td>
<td>£674,350</td>
</tr>
<tr>
<td>Planning Obs</td>
<td>£700,000</td>
</tr>
<tr>
<td>Commercial space, say</td>
<td>£200,000</td>
</tr>
<tr>
<td>Borrowing</td>
<td>£1,065,000</td>
</tr>
</tbody>
</table>

**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: £3,210,000
  - 15% on Value (Low)

**RESIDUAL LAND VALUE** minus £296,675
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
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!

Feb. 5
NPPF and PPG 2018-19

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

POTENTIAL ‘GAME CHANGER’ BUT WILL TAKE TIME
Contacts / Queries

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