Module 8: Climate Change & Viability

October 2012

Jon Sawyer, Managing Director, Eye

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Introductions

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I am the MD of Eye, a small specialist company that advises on and manages complex development projects

A number of our past and present projects are in Yorkshire and the Humber, hence it is a pleasure to be here today

We act for a broad range of clients with about half of our work representing Local Authorities, on land sales and planning negotiations and the other half acting for developers bidding for and negotiating on sites

My hope today is therefore to try and strike a balance between the needs of planners and developers

Aims and objectives of viability module

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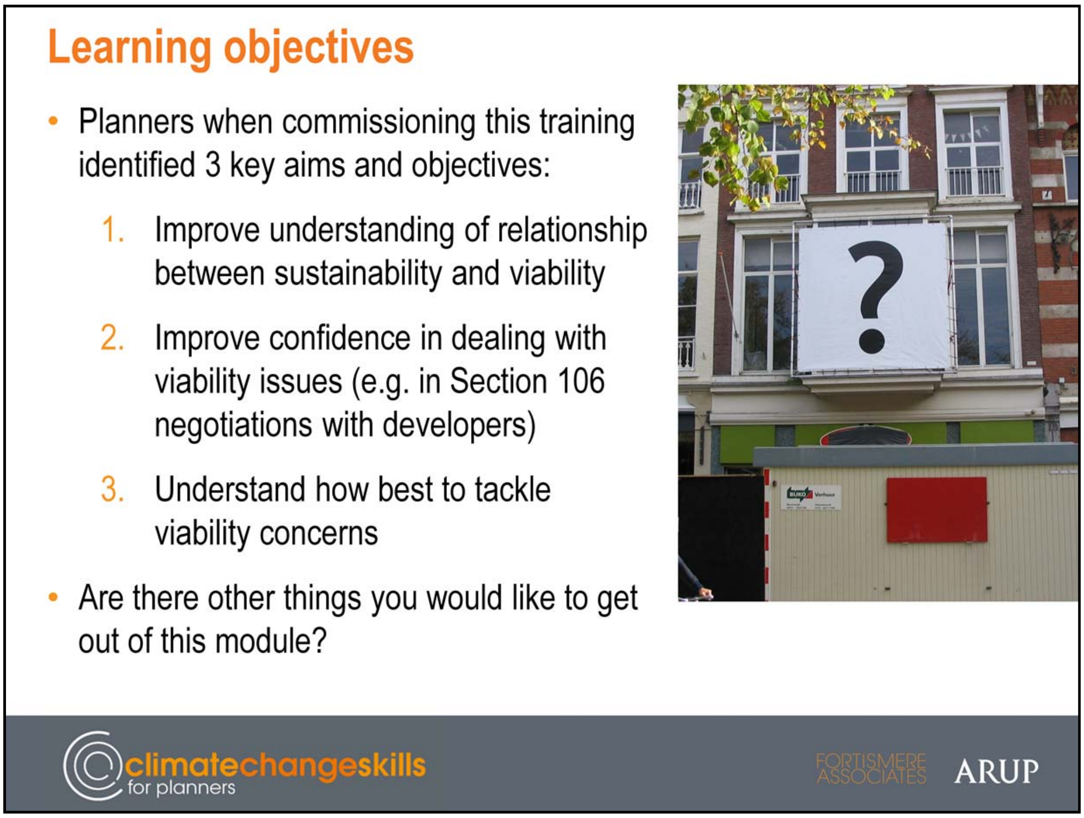

When commissioning this training LGYH asked planners what they wanted and 3 key questions came back, that they wanted to...

1. Improve understanding of relationship between sustainability and viability
2. Improve confidence in dealing with viability issues (e.g. in Section 106 negotiations with developers)
3. Understand how best to tackle viability concerns

Although I have tailored this session today around these 3 key questions is there anything else that you want to get from this session?

Learning objectives

- Remember the aim is to improve your understanding. You aren’t expected to be an expert at everything!

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Remember the aim is to improve your understanding. You aren’t expected to be an expert at everything!

Certainly every developer I talk to would welcome more informed local planning officers – or at least that’s what they tell me!

Structure of day, learning style and housekeeping

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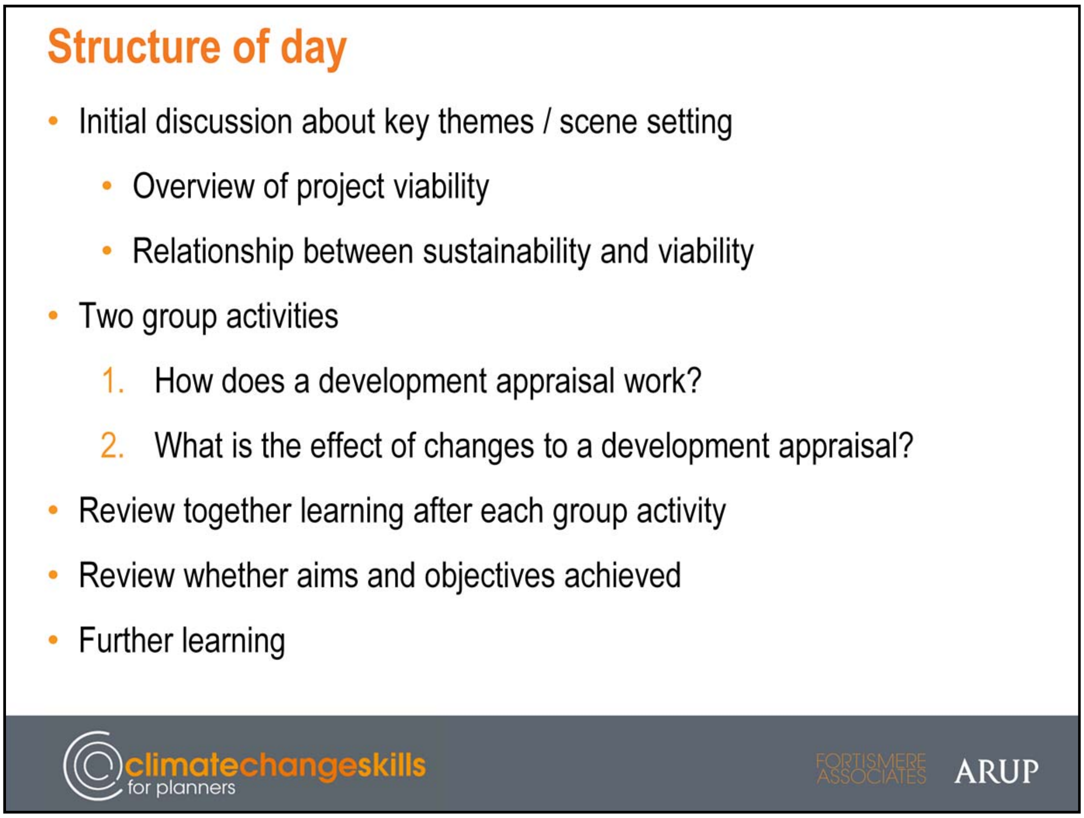

The day begins with discussions all together, to set the scene and ensure you have the information and confidence to start work with a “real” development appraisal

We will then during the day have two group sessions, where you will break down into smaller groups for more intensive group work. I will be on hand to help you with any queries

After each group session we will come together to consider what you have learnt and discuss any questions that have come from the group sessions

We will then consider whether what you have learnt has delivered on your original aims and objectives and consider sources of further learning

We will aim to be finished at 4pm

You have a more detailed agenda in your pack

Learning style

- Interactive
- Mix of work together and activities in smaller groups
- Open and honest
- Try to avoid jargon – see jargon buster sheet
- If you have questions please ask – don't bury your head in the sand!

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The aim is that everyone partakes and that this is interactive.

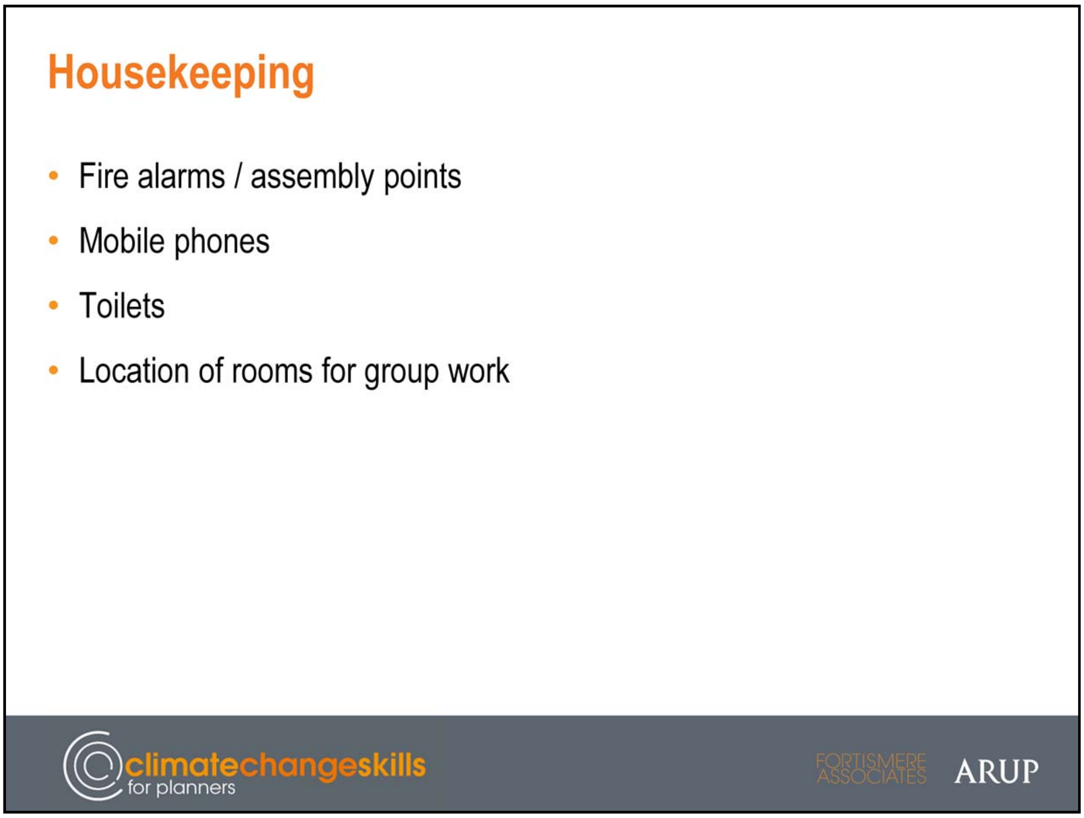
This is one of the most important of the modules so please take part – please don't bury your head in the sand

As previously explained some of the work will be undertaken here in this room and some in smaller groups [Arup assistant to explain how groups allocated]

I would like us to have an open and honest style – if you want to know "where developer's hide their money", as I am often asked, then please say so!

I shall try and avoid using jargon, but if I do please ask me to stop and explain. I have also provided a 'jargon buster' sheet that I hope will help with some of the terms that you will encounter later on

In fact if you have any questions of any type please ask



[Arup colleague to confirm details]

An introduction to viability

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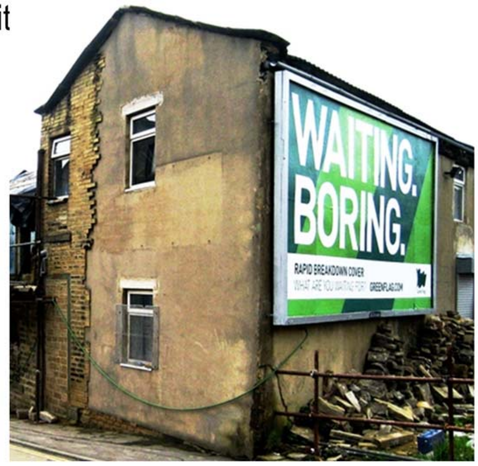
Why does viability matter?

- Development won't happen without it
  - New homes
  - Economic development
- Leads to training and employment (HCA £1 leads to £2.60)
- Central to planning policy-making (i.e. "soundness")
- Central to planning permissions (i.e. Section 106 agreements)
- Viability a barrier to sustainability



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Fundamentally viability matters because delivery matters. No doubt everyone here needs to see more homes and more employment land in their local authority areas - and have confidence in its delivery. Viability is central to planning policy making and development management. Viability is often quoted by developers as a barrier to adopting sustainability measures.

Why does viability matter?

National Planning Policy Framework, Paragraph 173

"Pursuing sustainable development requires careful attention to viability and costs in plan-making and decision-taking … the plan should not be subject to such a scale of obligations and policy burdens that [the]ability to be developed viably is threatened. To ensure viability, the costs of any requirements likely to be applied to development, such as requirements for … [sustainability] standards, infrastructure contributions or other requirements should, when taking account of the normal costs of development and mitigation, provide competitive returns to a willing landowner and willing developer to enable the development to be deliverable."

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Even in the last 12 months the importance of viability has heightened for planners. Whilst the NPPF is a much slimmer document than its predecessors the term viability appears many more times that in the documents it replaces

How can viability be assessed?

- Via a “residual development appraisal”
- Various residual appraisal tools available, including:
  - Standardised software (e.g. Argus/Circle)
  - Homes and Communities Agency model
  - 3 Dragons model
  - Bespoke Excel appraisals

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Viability is assessed through a “residual development appraisal”

The term residual is used because we are working backwards from a variety of inputs to work out something – we will return shortly to what that something might be

Residual appraisals are available in specialist software or can be developed in Excel.

My own preference is with Excel because it is more “hands on”, meaning that you can see the calculations more easily – our clients often express a similar preference. However there is no right or wrong approach. In Eye’s case we use Excel based residual appraisals and I have tailored one of our appraisals for this training today

What does a residual development appraisal do?

- It has multiple applications.
- It can be used by a developer to calculate:
  - Land value
  - Construction budgets
  - Section 106 / CIL
  - Profit

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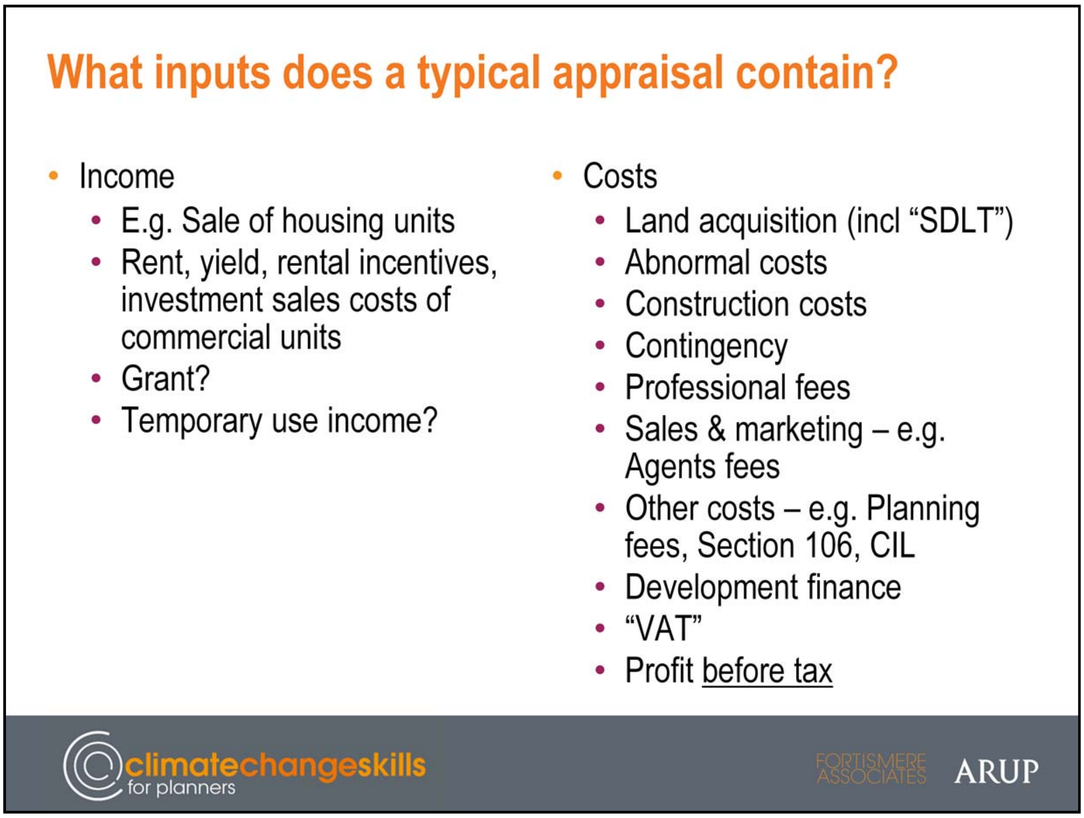


The typical income and costs we would expect to see are

Income...

Sales for housing – we will explore affordable housing later today but again that is a source of income

For commercial units it becomes more complex as these units are rented out, so we need to work out their capital value. We do this using a yield. We also need to take account of any rental incentives to the tenants and any costs an investor will incur buying the completed unit. We will discuss all of this later today.

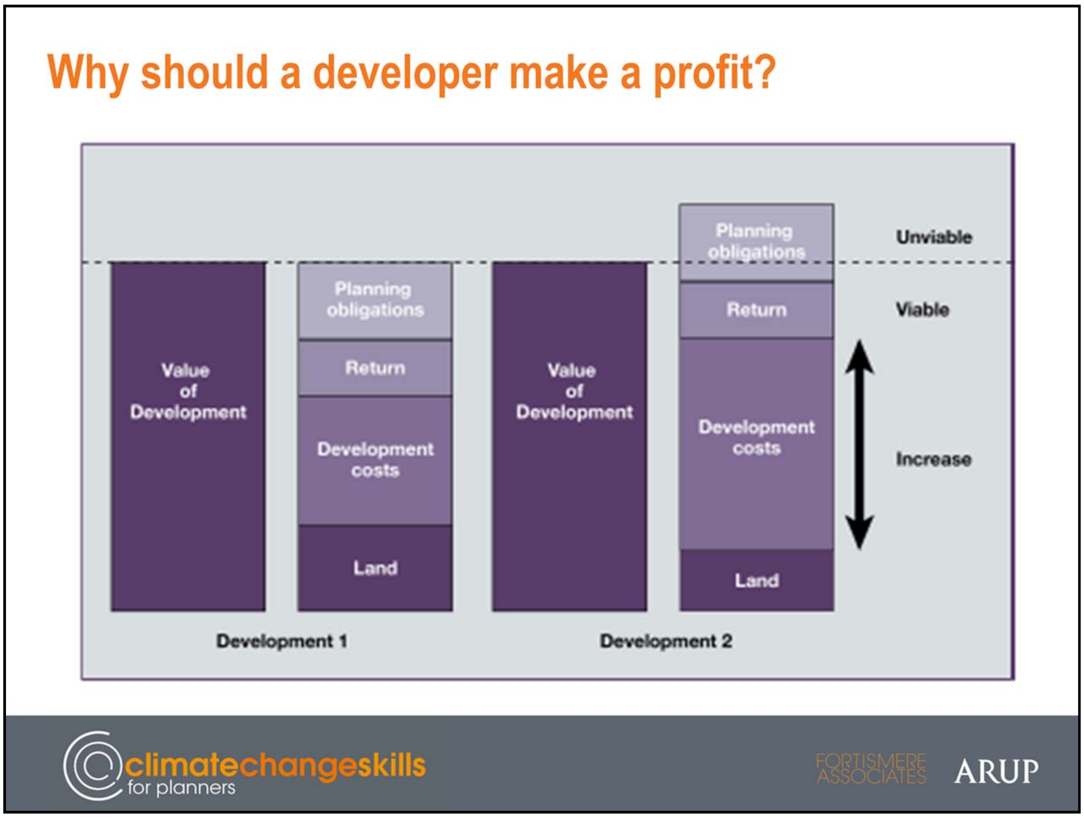
There could also be grant and temporary use income

Costs...

For the purposes of this training we will assume that all VAT is recoverable as is generally the case with most developments you will look across – however if in doubt you will need to seek specialist VAT advice. The one caveat is that VAT recovery takes time and hence there may be a small amount of finance cost

It is a convention that development finance is assumed on 100% of the project costs

How is profit calculated? This can vary. Housebuilders often calculate it on value. Commercial developers often calculate it on cost. These are the two most straightforward mechanisms. There is a third mechanism called an Internal Rate of Return (IRR). For simplicity this training does not consider this method but if you have questions on it you are welcome to ask me later today.



The main challenge for a developer is that they bear risk because certain income and cost is not known until the end of the development and although they budget to make a profit they may not or they may make a lower return than they budgeted. Remember of course they could also make an additional return and that is central to any viability dialogue between developers and Local Authorities.

What is a reasonable level of profit?

- No right or wrong level, dependent on project circumstances
- It generally varies from 15% (lower risk) to 25% (higher risk) though can be lower or higher than this
- What factors might determine a reasonable profit level?
  - Availability of grant
  - Availability of “pre-sales”/”pre-lets”
  - Phasing
  - Certainty of cost

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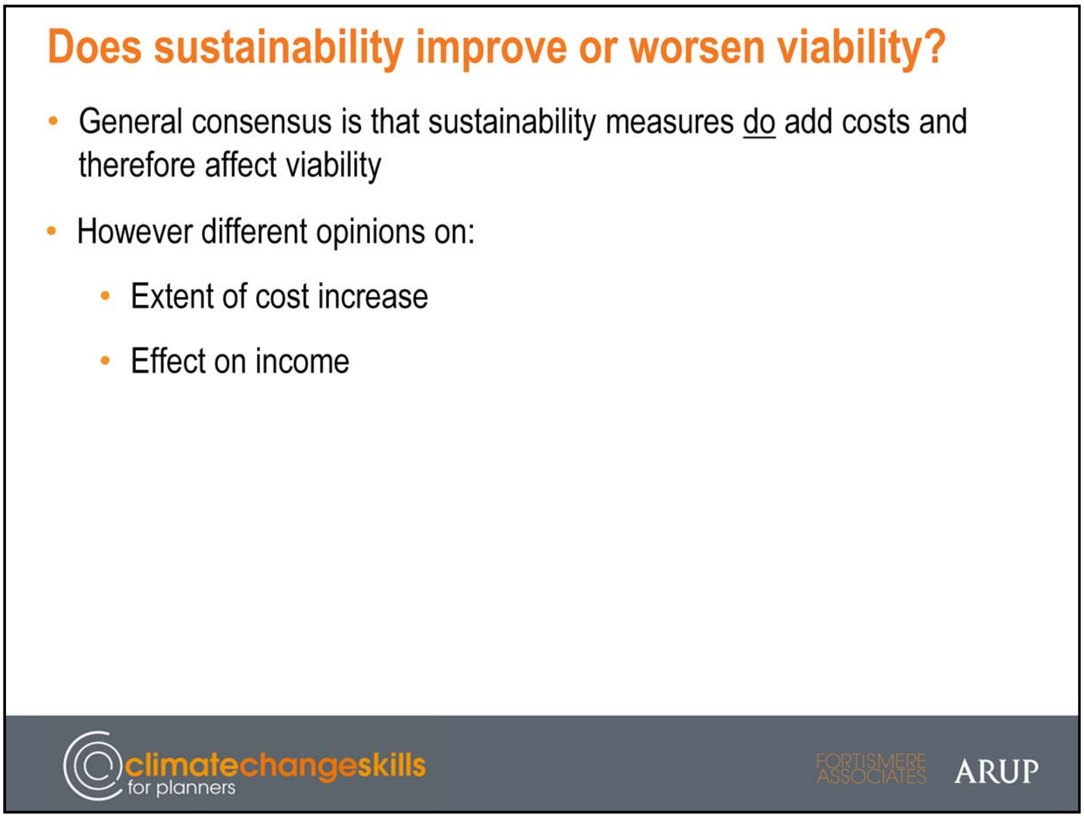
So what is a reasonable level of profit?

For profit on cost, which as I said is typically used by commercial developers, we see ranges of 15-25%. 15% is generally only seen where there is grant. Inspectors generally accept 20% as a reasonable cost.

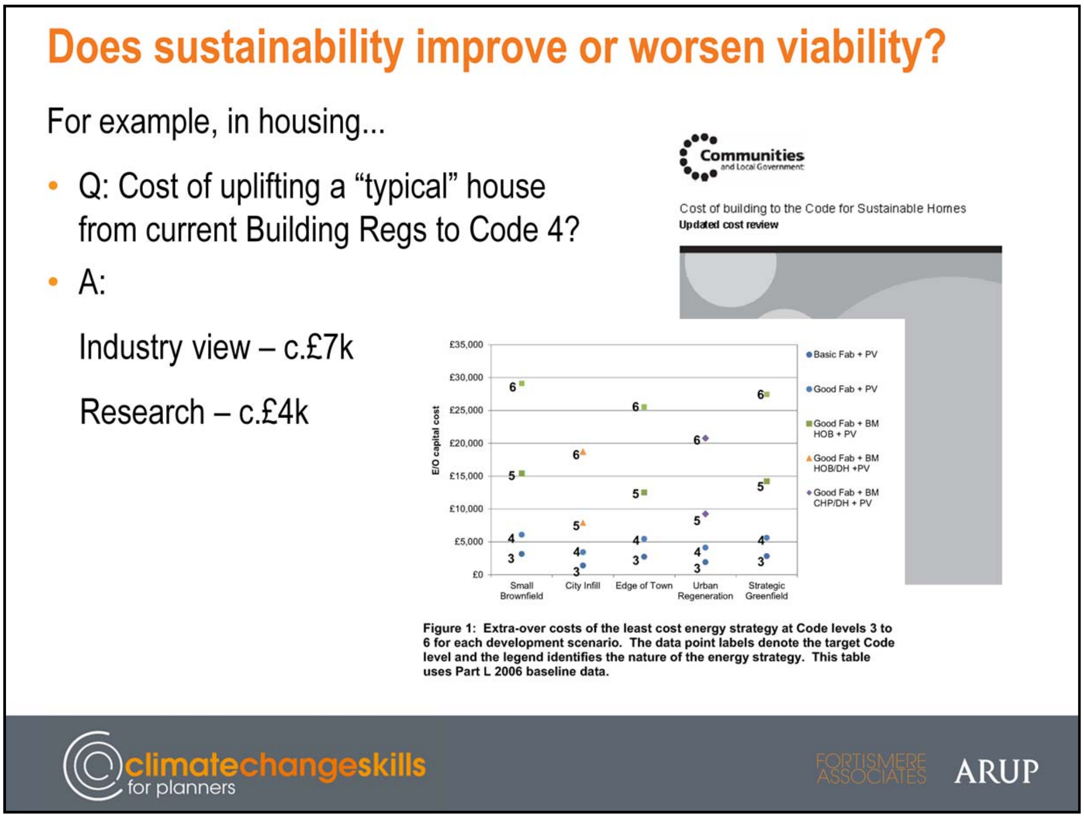
For profit on value there is a slightly less wide range. Again less than 20% tends to only occur where there is grant

It is important to bear in mind that there is no right or wrong level of profit and it depends on the project circumstances but if you start from 20% of value or cost that is a reasonable place to begin from

What is the relationship between sustainability and viability?



It is generally accepted amongst those I know from the public and private sectors that sustainability does come at an added cost. Where there seems to be more disagreement is over the extent of that cost and whether sustainability measures lead to improved income which as you now know would, if it were the case, offset some of this extra cost in the viability equation

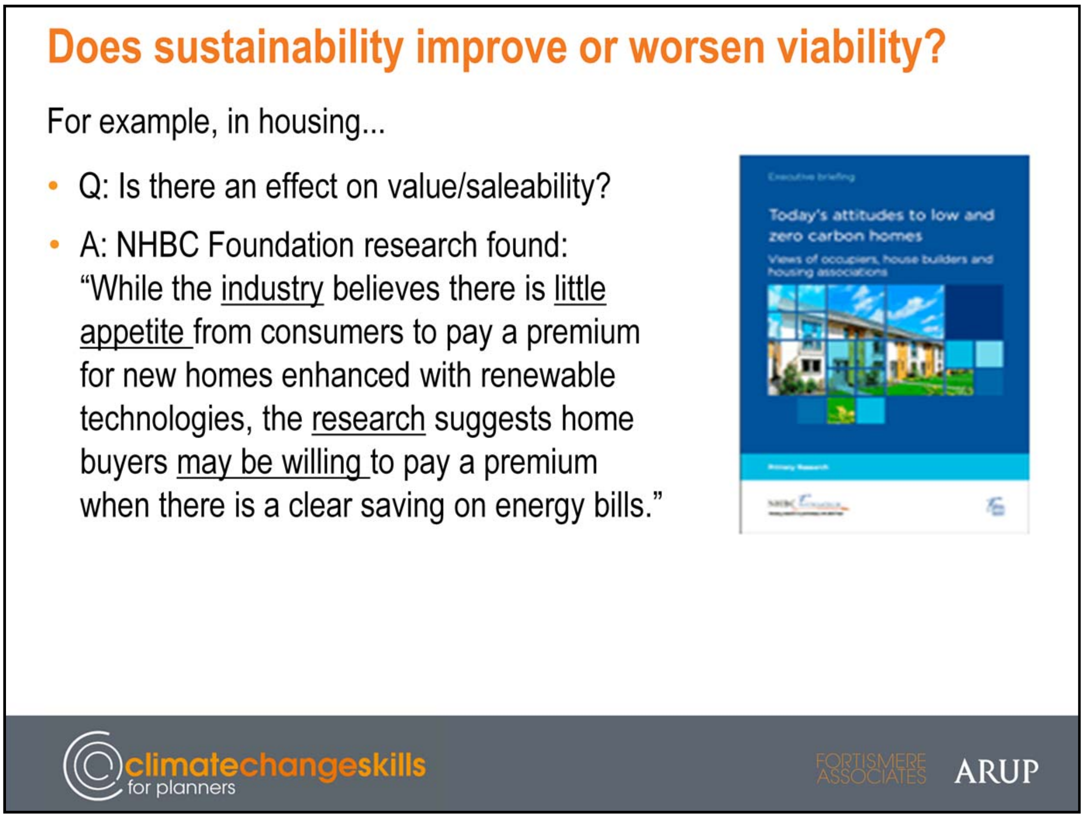


For example in housing what do you think the cost of raising a typical housing from Building Regulations standard to Code for Sustainable Homes Level 4 is? For a 3 bedroom semi-detached house we are finding in practice that this is around the £4k mark. Though we are being quoted up to £10k by some housebuilders (indeed one consultant suggested £30k to me recently). We are typically assuming closer to the £4-5k mark but requiring developers to provide evidence. It is important to remember, as I will explain further later on, that these are the base construction costs, before professional fees, development finance and profit are added on.

Perhaps the more important question is whether this extra expenditure leads through to additional income

At present the answer is generally "no", but there are glimmers that this is starting to change. For example recent independent research, which surveyed not only housebuilders but also the occupiers of environmentally efficient housing. The research goes on to say that "Unfortunately this is currently not reflected by surveyors, who attribute little or no added value to enhanced new homes."

Although I am using a residential example here the position is fairly similar with most property sectors



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Introduction to case study project and explanation of 1st group activity

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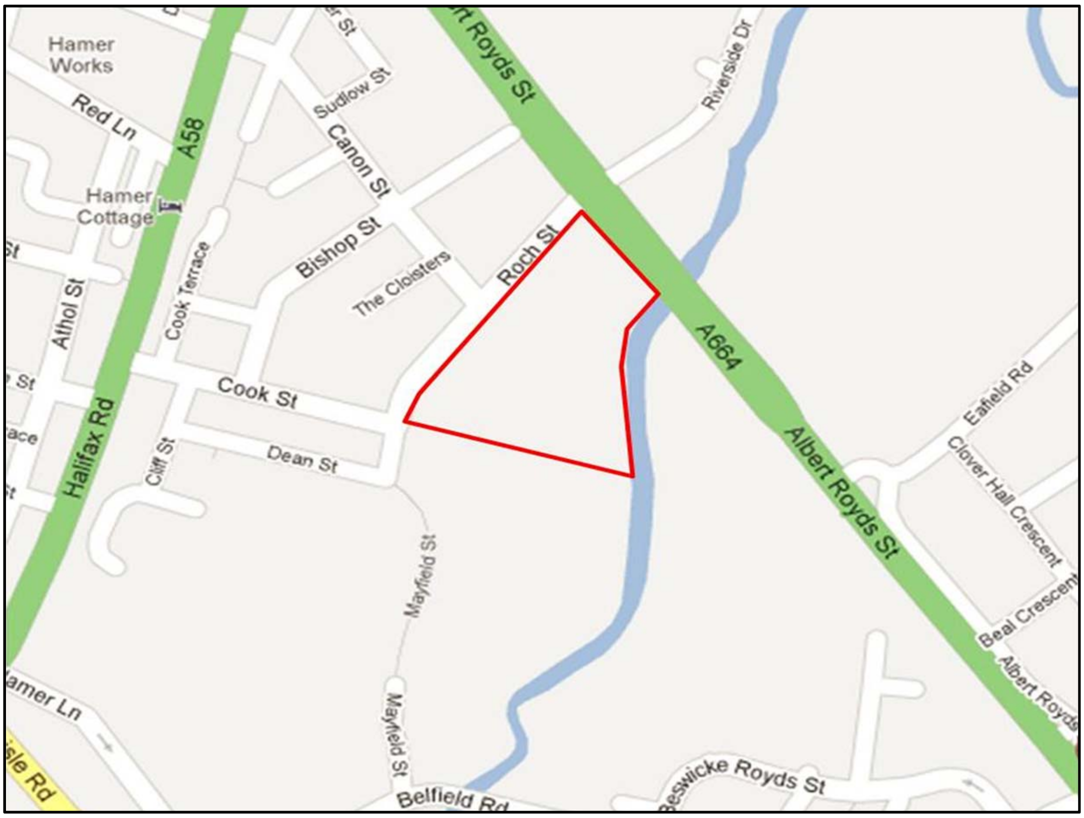

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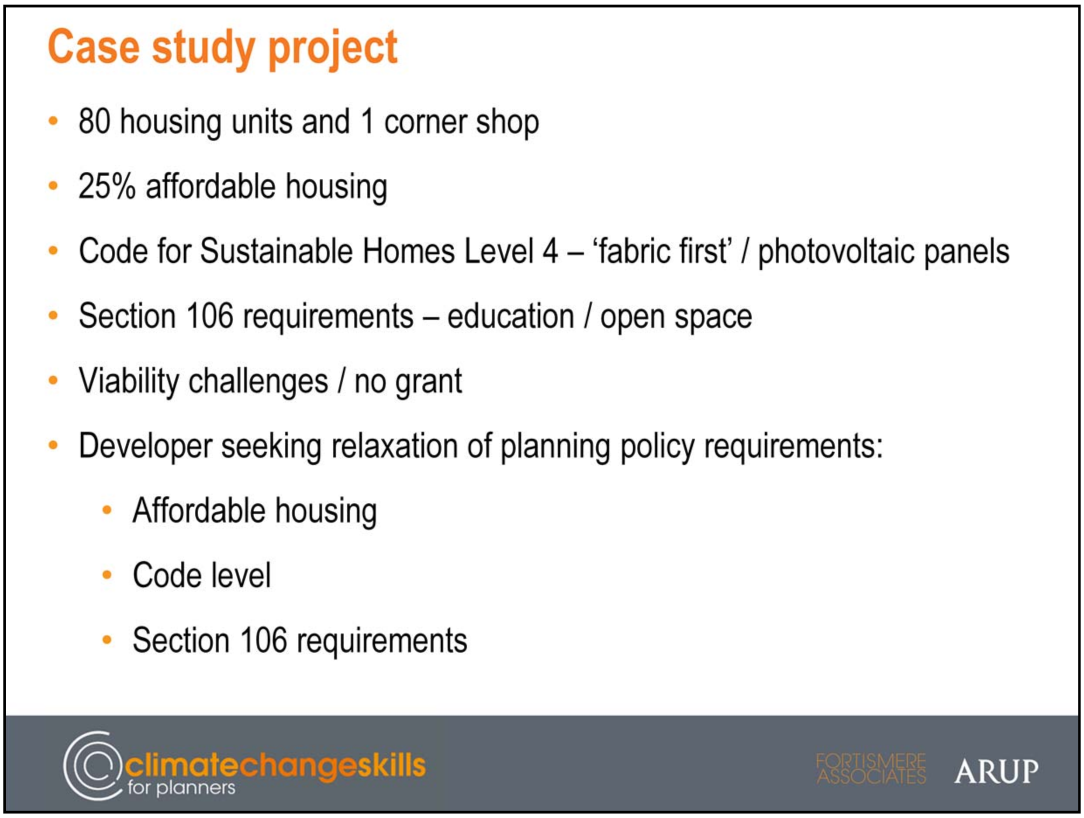
Red Ln
A58
Hamer Cottage
Athol St
Cook Terrace
Bishop St
Canon St
Sudlow St
The Cloisters
Roch St
Albert Royds St
Riverside Dr
A664
Albert Royds St
Cook St
Dean St
Cliff St
Halifax Rd
Mayfield St
Mayfield St
Eafield Rd
Clover Hall Crescent
Beal Crescent
Belfield Rd
Beswicke Royds St



In the group rooms you will find further information

In summary the challenge you are looking at today is a case study project that involves the development of 80 housing units and a corner shop

The Developer has prepared a residual appraisal incorporating all planning requirements and has realised that the project is not viable – i.e. It cannot generate the level of development return they require

In the group rooms you will find further information

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Case study project

Income			
Housing Income			£13,050,000
Retail Income			£57,290
Total Income			**£13,107,290**
Costs			
Land Acquisition Costs			£846,000
Construction Costs			£8,340,150
Professional Fees			£1,251,023
Other Costs			£131,860
VAT			£0
Finance Costs			£994,185
Developer Return	25.00%	on costs	£2,890,804
Total Costs			**£14,454,022**
Surplus/Deficit			**-£1,346,732**

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Here is a summary of the Developer's appraisal. In your group rooms you will have a full version of the appraisal.

1st group activity

- What questions do you have when you review this appraisal?
- What feels right and what is worth questioning further?
- For those assumptions that seem reasonable, what has led you to that conclusion?
- For those assumptions that need further questioning, what has led you to that conclusion?

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Better sales values? Lower incentives? Cautious sales rate? Phase 2 higher values? Better affordable housing deal?

Higher rent? Better yield? Lower rent free?

Other Income? (e.g. grant / temporary income)

Reasonable level? Overpaid?

Cost evidence? Why 3% inflation? Why 5% contingency?

Reasonable level?

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Reasonable level?

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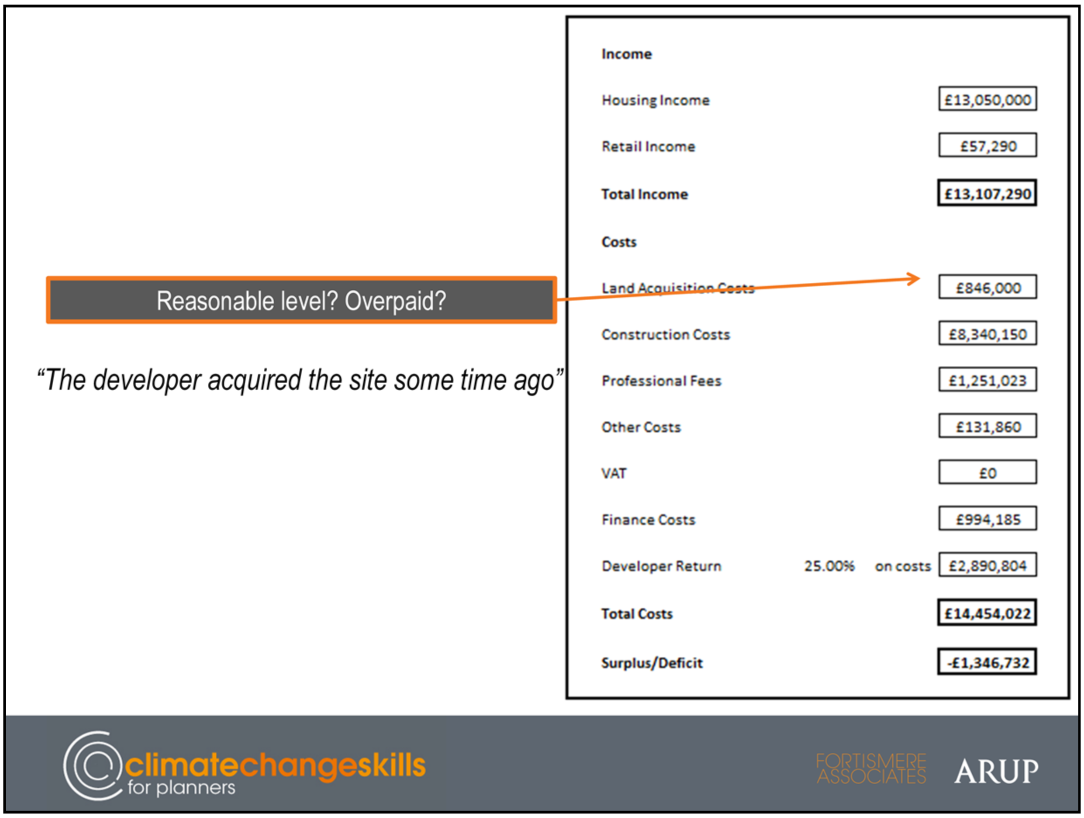

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At face value the land value paid seems too much. How would the correct figure be identified?

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How should you approach discussions with developers?

- Ask for assumptions
  - Amounts
  - Timings
- Ask for evidence
  - Valuers advice
  - Costplans
  - Fee quotes
  - Bank terms
- Ask for justification of developer return

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Your first port of call with your questions should be the developer who you are within your rights to ask for more assumptions, evidence and justification

In addition to discussions with the developer, there are other information sources you can call on

There may be in house expertise – from the Local Authority estates team. The housing team should also have a good feel for social housing payments and the housing and economic development teams should have a good feel for available grants, if any.

You may also have a consultant panel who handle more complex viability appraisals

You can contact local property agents and estate agents who will generally give you free advice

The RICS runs a specialist construction data service called BCIS. Some of this is freely available and some requires subscription. It may well be that your Local Authority estates team or any teams involving in construction/maintenance work or building regulations are already members.

Where should you generally avoid looking?

- The internet
  - Estate agents websites
  - Developers websites
- Ad hoc comparisons with other projects

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Also its important to be mindful that some information available to you may not always be accurate

Generally avoid google and other general internet trawling

Estate agents websites typically sell secondary real estate

Some agents and most developers sell new real estate, but asking prices will not necessarily reflect discounts

2^{nd} group activity – interrogating a development appraisal

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2nd group activity

- How much does project viability change when certain inputs / assumptions are changed?
- Changes in which assumptions have the most impact on project viability?

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The logistics for this session are as previously – however please change who operates the appraisal and who presents your findings

What have we learnt?

- Appraisals can be very sensitive to changes in their own inputs
- Changes to some figures are magnified – For example on the case study project:
  - A **£100k reduction** in land value = **£187k improvement** in viability
  - A **£100k reduction** in build costs = **£215k improvement** in viability
- Avoid altering all of the numbers – ultimately a developer will only develop if they consider that a scheme is viable

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Where is the developer's return?

Here?

Here?

Here?

Here?

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Overall conclusions and recap learning objectives

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Overall conclusions

- Viability is critical to successful plan making and decisions
- Residual development appraisals can be used to identify a reasonable level of sustainability requirements and/or planning obligations
- Sustainability generally leads to additional costs; there is growing clarity on what these costs are; there is not yet agreement that people will pay more for sustainability, but watch this space!
- If sustainability - or any other planning requirement (e.g. Affordable housing) - is within building regulations or adopted policy it should be reflected in land value and you should take account of it in viability assessments; judgement is required where policies are changing
- Developers make a profit for the risk they take - a reasonable profit depends on the individual circumstances of a project

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Overall conclusions

- It is important that developer's assumptions are properly evidenced
- Focus on bigger numbers and numbers which can have a bigger impact (through "multipliers")
- A current land value is very important
- Residual development appraisals are very sensitive to their inputs, with small changes in inputs leading to potentially larger changes in outputs
- Professional expertise is required on complex projects

When commissioning this training LGYH asked planners what they wanted and 3 key questions came back, that they wanted to...

1. Improve understanding of relationship between sustainability and viability
2. Improve confidence in dealing with viability issues (e.g. in Section 106 negotiations with developers)
3. Understand how best to tackle viability concerns

Although I have tailored this session today around these 3 key questions is there anything else that you want to get from this session?

Further learning

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Importance of further learning

- Viability important
- Operating environment for planners changing
  - Government policy / guidance
  - Market changing – nationally and locally
- Guidance for appraisers changing

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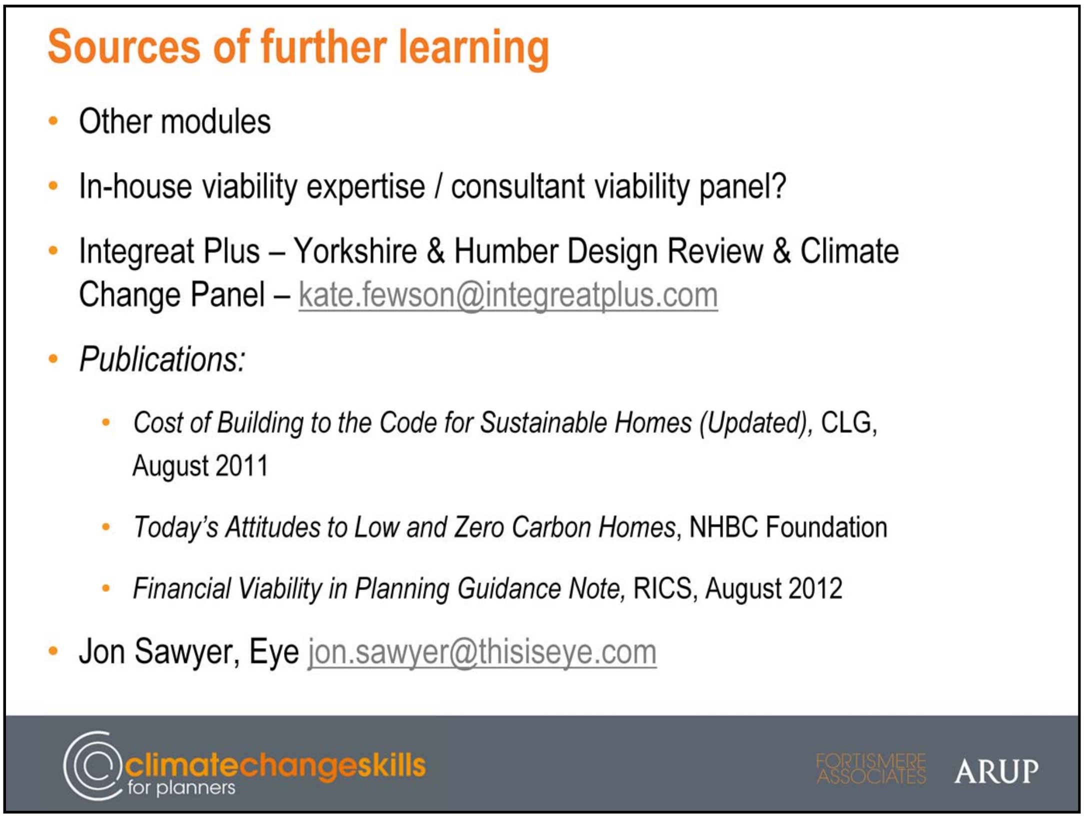

Remember that this is an only an introductory module on viability and that the world is constantly changing and so you will need to commit to further learning

You may find a variety of people within your Local Authorities with viability expertise

Many Local Authorities have panels of viability specialists

Integreat Plus operate an expert panel for the benefit of all Yorkshire and Humber Local Authorities

RICS has just published an important guidance note advising surveyors on how to deal with viability issues in planning

In addition you are very welcome to contact me if you have any follow up queries

Any further questions?

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Thank you

Please complete the evaluation form

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