Viability Podcast 2 : Transcript

This is the second podcast in my mini-series summarising key points from talks from the Planning Advisory Service's course on development viability a few years ago. In it I will attempt to describe some characteristics of the development business which you need to understand when considering viability issues.

It is quite reasonable to regard all developers as being anxious to make money and also to avoid losing it. But beyond that they are not all the same. For instance, most development in the UK is undertaken by volume housebuilders whose modus operandi is different from, say, commercial developers or smaller companies in several crucial respects. This is reflected in the stocks listings in the Financial Times, where you will find commercial developers in the ‘Real Estate’ section while housebuilders are listed under ‘household services’, and it has implications for how you do the sums.

For example, in the previous podcast I made the point that while residential developers only have one customer for their product a commercial developer will often have two; an occupying tenant and an investor looking to purchase the building for the rental income

I also explained the importance of cash flow. It is better to be a volume housebuilder than a commercial developer in this respect because you can sell the houses that you build as your scheme progresses. You can build a few, then sell a few, build a few more and sell a few more. So at any one time the amount of your money tied up in unsold houses should be limited. Returning to my earlier analogy of paying for things with a credit card to illustrate the return that a developer might want from the money invested in a scheme, a housebuilder can reduce the overall cost on the credit card by using sales receipts to reduce the outstanding balance as the scheme progresses.

In contrast a commercial developer or for that matter someone building a block of flats will have a significant sum of money tied up in a large building until it is entirely completed.

Another important way in which volume house builders differ from other developers is in the limited use they make of debt. They do borrow money; but generally do so in modest quantities and at the company level rather than for individual projects. In contrast large commercial developers will often use complex financing packages to pay a large proportion of the cost of a development and in order to avoid tying large amounts of their own precious capital. Smaller developers of all stripes tend to be more heavily reliant on bank loans. In all cases using large sums of borrowed money is an adrenalin charged approach to business, magnifying the potential percentage return on the developer's own capital while also substantially increasing the risk of losses.

This is obviously a huge generalisation and there is no good way of explaining in a podcast how the range of financing strategies plays out in practice. For now, just keep in mind that many of the appraisal models that you will see lead you to assume that a development will be funded by debt whereas in reality and in particular for volume housebuilders that is usually not the case. If your goal is to second-guess a developer’s calculations, this is important. I suggest that you find a simple appraisal model and play around with the various assumptions to see what a difference the changes make. The spreadsheet models that you will find on the links page of my website www.regenerate.co.uk are fine for this purpose.

Now, I want to discuss some of the things that developers think about when seeking new opportunities and which drive land values. Housebuilders first.

The first is the outlook for the market. Over the longer term, the value of land for housing before taking planning requirements into consideration, has risen because of constraints on the supply of land. But in the short and medium term small changes in house prices in particular will often trigger a much larger change in land values which can be traumatic for housebuilders. So their main use for a crystal ball will be to read the outlook for demand. House prices in the recent recession fell by around 10% on average and have largely recovered since. Over the same period the stockmarket value of the major housebuilders, which reflects the value of their land assets, fell by 80% and in late 2014 it was still not even close to the levels achieved before the credit crunch.

One problem with crystal balls is that they cloud over when asked about the longer term. This increases the risks involved so developers compensate by trying to reduce the other tend to be keen to pin down short term risks at the outset. The reliability of cost estimates is obviously one important risk and while most housebuilders will be fairly confident that they can predict and control the basic cost of building a house they have more difficulty in predicting infrastructure and other extra costs that are imposed though the planning system.

There are some obvious examples of direct extra costs such as those imposed by the Community Infrastructure Levy, S106 and highways agreements. But planners also affect both costs and potential receipts by restricting development options, through design and layout requirements. The impact of these on viability is rarely considered in the planning system and I sometimes wonder what choices planners would make if they understood how much they costs and had the option of effectively using the resources involved to achieve something else!

The second thing that housebuilders will think carefully about is the mix and density of the scheme they are proposing. Contrary to rumour there is no simple and positive relationship between development density and land value because, beyond a certain point, increasing the density of a residential scheme means building flats. When you build higher than three stories, it becomes more difficult to use the common and inexpensive load-bearing brick construction techniques and you might need to opt for a more expensive framed structure. And when you build flats you lose the cash-flow advantage of housebuilding because you normally have to complete the whole block of flats before achieving any sales receipts. Then, you can't sell all of the area within a block because some of it must be used for common areas and access. It also becomes more expensive to provide car parking. At ground level this doesn't cost much but it eats up land and rather defeats the objective of higher density. But the alternative of putting cars under a building is very expensive.

In high value areas the ability to build more floorspace on a site covers all of these extra costs. But in many places there is no automatic advantage to be gained from densification and careful analysis is needed.

Another thing that housebuilders pay attention to, is optimising the layout of their development taking into account the cost of the external works that will be needed. The shape of a site and the proportion of it that can actually be used to build houses on, has a significant impact on both cost and receipts. A site which requires a long access road and provides scope for fewer houses will often be worth quite a bit less because of the sensitivity of land values to anticipated sales receipts.

You are a planner so you know this. But it is worth reflecting that all of these factors affect the ability to judge the worth of one site by comparing it with another whose sale price is known. This is the approach to valuation preferred by the Lands Tribunal and is formally known as the comparative method. But as practiced by some armchair pundits and in some planning departments in water-cooler conversations it might be better called valuation by unreliable anecdote. I will return to it in the third podcast.

The impact that the nature of a site and its layout and servicing effects its viability is some other ways that you might not expect. For instance, many people expect brownfield sites to be more expensive to develop than greenfield sites. But that is frequently not the case. Greenfield sites are more likely to be remote from existing roads, utilities and social facilities such as formal open space and schools. Aside from the extra direct costs involved, this implies providing open space and sites for schools etc which reduces the proportion of the site that can actually be developed. The effect of this loss of land can be invidious because it doesn't appear as an explicit cost in an appraisal but can act as a major drag on scheme viability in the round. In contrast the costs of remediating brownfield sites are usually fairly modest. The real viability issue with brownfield sites in not usually their condition but rather either their surroundings or their existing use value, if they are currently occupied. This is why a little government encouragement has led to a respectable increase in the pace of redevelopment of brownfield land, but proposed new settlements such as eco-towns, new garden cities and whatnot stubbornly fail to appear.

I will now turn to the drivers of commercial development. I have explained that in the longer term the value of land for housing has risen in real terms before you take the impact of planning contributions into account. This positive pattern is not generally apparent in the commercial market. In most areas there is enough land for most forms of commercial and industrial use, which in many cases are actively encouraged. The result is that there is no reason why commercial land values as a whole should rise over the long term.

Rather, the main characteristic of the commercial property market is what is known as its cyclicality. In other words the demand for and value of commercial property tends to fluctuate pretty sharply on a fairly regular. This reflects changes in the underlying demand from occupiers but also, and perhaps more significantly, investor interest in purchasing the completed buildings and changes in the availability of loan finance. Usually dips in all three arrive together to create a perfect storm for commercial developers and in particular those who rely heavily on borrowed funds.

This is yet is another important way in which commercial development differs from residential development. Housebuilders operate in a large and fluid market in which, even when sales are weak, a relatively small price reduction can find you a buyer for a house. In contrast while a recession doesn't lead to shrinking households it often results in shrinking or stagnant businesses. The occupiers and investors in commercial property can virtually disappear when this happens and the price reductions needed to guarantee the letting or sale of a less attractive building can be jaw-dropping when the economy is not doing well. It is difficult to use pricing to get a company to rent an office block that they simply don't need.

So the appetite of commercial developers to buy land and to take the risk of developing it, will depend critically on the stage reached in this development cycle. Companies who have sites that are ready to be developed at the beginning of the cycle are on easy street. In contrast, companies who still have schemes underway as the cycle swings down will desperately try to dispose of them before demand falls and values collapse. You don't want to be left holding the parcel when the music stops! This all makes the commercial development business very risky. If you could find a list of quoted companies that were solely involved in commercial development say thirty years ago, you would find that few if any still exist today. Long term survivors like Land Securities, British Land and Hammerson are not pure developers but also property owners who have the comfort of substantial portfolios of existing buildings to provide a cushion of rental income to support them in hard times. But retaining properties as investments absorbs a lot of capital so it is a luxury that only the larger firms can afford.

The second factor that is central to the deliberations of a commercial developer can be summarised in a phrase that you will have heard many times before. Location, location and location. This plays a huge role in determining the appetite of both occupiers and investors. Functional quality also plays a role in determining the attractions of a building but at the risk of over generalising, while the provision of practical features and facilities always helps, when it comes to aesthetic factors it is probably more true to say that bad design reduces the value of a building rather than to say that good design increases it.

Obviously there are a myriad of other risks involved in the development process. Some of those need not concern us here. Market risks, such as a building taking longer than expected to sell, are a good example. Unhelpful weather or unexpected site conditions might be another. The developer is best placed to judge these risks and is rewarded for taking them through the profit margin built into his appraisals.

A bigger concern for you as planners should be those risks which are directly or indirectly imposed through the planning system and which are difficult or the developer to gauge at the point at which an appraisal is done in order to buy a site to establish a scheme to be submitted for planning permission.

For instance, planning policies are often expressed in general terms and Local Planning Authorities trumpet their flexibility and readiness to negotiate. This isn't as helpful as you might think because, at the point at which an offer for a site is being made and planning permission has not been applied for, it adds to the other risks that cannot be easily quantified. If you recall the discussion of the so-called 'Winner's Curse' in the first podcast, you will realise that this just leads to a tendency to overpay for the land and thus benefits the landowner rather than the developer. This is one reason why the development industry supported the Community Infrastructure Levy even though it has many of the attributes of a new tax.

Similarly, requirements for ‘high quality’ design are gloriously vague and leave the developer at the mercy of subjective judgement. Sometimes these result from the public consultation exercises. Because these usually take place after a developer has bought a site and submitted a planning application the outcome cannot be factored into the appraisal. Particular bugbears of mine are requirements to conform to visionary master plans which in some cases have so little connection with commercial reality that no attention can sensibly be paid to them.

The issue then becomes the extent to which viability appraisals can respond to this and reflect the real economics of development. That is a question I will attempt to address in the third podcast in this series.

To summarise:

Different sectors of the development business operate in different ways. Ideally this should be reflected in the way appraisals are undertaken but in practice this is not always the case.

Cash flow is very important in the development business because developers need to make a high annual return on the net capital that they have invested in a scheme to compensate for the risks involved.

Developers will also try very hard to 'read' the market. Mistakes can be very expensive, particularly for highly geared commercial specialists.

Some of the risks that plague developers are quantifiable and can be reflected in appraisals. Others are not, and many of these stem result from the operation of the development control system. It follows that one way of promoting development is to make the development control regime responsive to development risk issues.