

Viability Podcast 1 : Transcript

I'm Michael Beaman. What follows is a summary version of talks that I originally gave as part of the Planning Advisory Service's short courses on development viability for town planners. I am afraid that in the interest of brevity I have left out the more slanderous and entertaining stuff from the talks. Sorry!

The aim of this introductory element of the course was to explore appraisal techniques in the wider context of the property development business. Quite simply, if you don't understand the business, you can't understand the appraisals. To make it more digestible I have chopped the material up into bite size pieces, so there are three podcasts with a fourth in development.

- This, the first, looks at some of the basic financial hydraulics of development such as what constitutes an acceptable return and the effect of debt and risk on the economics of it all.
- The second introduces developers and development as an activity, what makes companies and projects tick.
- The third is an introduction to viability appraisals. I show how they can be understood and misunderstood.
- The fourth, when I get around to doing it, will look at some of the

implications for the way in which these viability appraisals are used in planning.

So, let's start with the basics. There is one fundamental misconception that I want to tackle head on at the outset. In practice many people assume that a developer's objective is simply to maximise the difference between what a scheme costs to create and what it can be sold for. This is loosely referred to as the profit or margin on cost and a figure of twenty percent is often touted as the typical target. In many of the appraisals that you see this is treated as the sole yardstick of viability. I argue that in the planning context this degree of simplification is misleading and unhelpful.

This is why. Supposing I ask you to lend me £1000 for my latest zany venture on the basis that I will give you back £1200 in one year's time. Using razor-sharp acuity you will quickly see that the amount you get back equates to a 20% return on your money over the year. You might regard this as attractive when compared with the pitiful sums that you could earn by investing the cash in a typical savings account.

But suppose that I were to tell you that, rather than getting your money back in one year, it might actually be ten years. You might reasonably take the view that if was going to take that long to make a 20% return on your money, you might indeed do better by depositing it in a savings account and that this might also prove to be safer home for your precious loot over an extended. After all, I might decide to abscond and squander the money having a good time somewhere with a warm climate and an understanding tax regime, but without an extradition

treaty with the UK.

In other words the adequacy of the 20% or £200 return on the £1000 you invested with me is entirely dependent firstly on how long it takes you to make it and secondly in the associated risk of you losing all or some of it.

It follows that, whether you are looking at my dodgy proposal or a property development scheme, what you need to consider when judging whether it represents a worthwhile piece of business is firstly the **annual return** on the money and secondly whether this provides a big enough reward to compensate you for accepting the **risk** of losing all or some of it if things don't go according to plan. An appraisal based on a simple measure of absolute profit or margin on cost doesn't tell you these things.

In practice, in the development business, the level of return that is considered adequate varies between companies and schemes. But if I am forced to generalise then I would say that a 15% annual return on the cost of a project is probably average. In calculating this cost in most cases I would exclude the interest on any loans used to finance the scheme because, like the developers profit, they do not reflect the scheme itself but rather how the developer chooses to pay for it. Two identical schemes could be financed in two very different ways and produce very different returns. I will return to that in a minute.

Now, I want to stress again that this 15% is an **annual** return. It is not the same as saying that a project simply needs to be worth at least 15% more than it costs. With larger and longer term projects there will usually be marked difference.

Having said that, developers recognise that if a project isn't actually worth more than it costs then there will be no annual OR absolute return to argue about, so as a shorthand measure they do seek to ensure that there is a basic margin on cost as well as a decent annual return. In this context the achievement of a 20% margin on cost **as well as** a 15% annual return is probably the least-bad rule of thumb.

Ideally a development viability appraisal tool would allow you to mirror the developers own calculations and to explicitly assess risks and to gauge the impact of the timing of both costs and receipts on the adequacy of the return. In practice it is not possible to read the developers mind and most appraisal models don't measure either risk or returns very well and the mirror is cracked. I will deal with this in the third podcast.

At this point your head might be spinning so for now I want to give you way of thinking about these timing and return issues that might be a bit more intuitive. When looking at a scheme, imagine that a developer will be paying for it using a credit card which charges interest at 15% and that, at the end, he has to have repaid all of the outstanding debt on the card. If he can do so, then the scheme is viable. As you know, credit cards can be useful if you can pay off the outstanding balance every month or in any event as soon as you can afford to. If you can't, the amount needed to settle the bill and close the account can be astronomical. This underlines the point that for a developer, the timing of the income from sales which he can use to offset against the various construction and other costs, is critical.

It is more difficult to get an intuitive understanding of how perceived risks might be expected to affect the required level of return. I would emphasise again that a 15% annual return and 20% margin on cost are simply generalisations and since both developers and projects vary they should not be automatically used as a benchmark. A developer of a scheme that is risky, perhaps because it is innovative or in a marginal location, might well want more. In contrast a developer involved in a low risk scheme such as building houses that have been pre-sold to an RSL, will almost certainly settle for a good deal less. A good way to think about whether these typical returns might be appropriate in any particular case in the context of the risks involved can be to imagine that the money invested in the development is your own. Would you invest your money in the scheme for that level of return given the risks involved? Personally, I would happily settle to invest some of my retirement savings for a return of say 8% per year on money invested in a scheme to build houses that have been pre-sold to an RSL but it would take much more than 15% a year to get me to invest in a major regeneration project where the returns wouldn't start to flow for years to come, because I have seen too many fail.

The second fundamental concept is the impact that borrowing money can have on the percentage returns from development. This is perhaps most easily illustrated by an analogy to Britain's most boring dinner table conversation topic, namely house prices and mortgages.

You know that if you buy a house for £200,000 with the help of a mortgage of £180,000 you effectively have a share in your house worth £20,000. If house prices go up by a mere 10% to £220,000 the value of your share rises to £40,000.

In other words the 10% increase in house prices has actually doubled the value of your investment in your house. On the other hand if house prices fall by £20,000 so that your house is only worth £180,000, the value of your share in it net of the mortgage is wiped out. In short using borrowed money to finance the purchase of a property magnifies any percentage gains and losses. I guess that you know that, but I want to cover all the bases. In the development business this tactic is known as gearing or leveraging and the developers own investment in a scheme is referred to as his equity.

This phenomenon of the returns from development being hypersensitive to small changes in values and costs also affects the pricing of sites. For instance if the developer of your house assumed at the outset that you would buy it for £220,000 and that he could build it and provide himself with an adequate return on his investment for £170,000, then he could afford to offer £50,000 for the land to build it on. But using our earlier example, his estimate was too optimistic and you actually only paid £200,000. If he had known that at the outset, then if he wanted to achieve the same adequate return he could only have afforded to pay £30,000 for the site; that is the £200,000 that you paid less the £170,000 that the scheme cost. In this case, the 10% difference between his expectation of what you would pay and the amount that you actually paid resulted in his paying £50,000 rather than £30,000 for the site, an overpayment of 67%. And if he had borrowed money to buy the site, then the percentage loss on his 'equity' would have been greater still. A true double whammy! The key point here is that property development is usually a highly 'geared' business in that small departures from sales and costs lead to big differences in the percentage margin

and annual return on investment.

The third concept that you need to be familiar with arises from the fact that a commercial developer, unlike a house builder, will normally have two customers for a scheme. Firstly, there will be an occupier paying rent under the terms of a lease. Secondly there will be an investor who buys the building with the benefit of that lease and the rental income. This is the yield. It is the rent expressed as a percentage of the purchase price. In a minute we will be visiting an office building, Knockdown House, which your pension fund will buy for £1,000,000. The tenants are paying £50,000 a year rent so the initial yield or return enjoyed by your pension fund is 5%. So in a commercial development appraisal you have to worry about both of those elements of value, rent and yield and the yield that buyers expect when they purchase a property as an investment tells you a lot about its perceived quality.

One way of understanding the factors that influence the yield on a property investment is to return to that boring dinner table conversation and think about buy-to-let flat investments. If you want to buy a 'safe' investment of a modern flat in a popular area where relatively affluent and responsible tenants might want to stay a while, you will probably settle for a lower initial return on your investment than you would if were considering a dilapidated flat in an economic backwater where finding any tenant at all might be a struggle. You could put that another way and simply say that you would pay more to purchase the better flat even if the initial return was lower, simply because in the longer term it would be a safer investment.

The issue of yields crops up most when considering commercial development so I will use another example. Let us say that your pension fund believes that buying an office building might represent a good opportunity at the moment and that the going rate for office investments means that they can expect to get an initial return of 5% per annum on the amount they invest. At that level it would take twenty years to get their money back but in fact their expectation is that rents will rise in the future so that in the long their return would be higher.

Now let's go back to Knockdown House which to remind you has been bought by your pension fund for £1,000,000 with the benefit of a rental income of £50,000 a year from Megacorp plc to give them an initial yield of 5%. This simple calculation might look more baffling when shown as an equation. Luckily I can't show you anything in an audio podcast. But the arithmetically literate among you would have realised that this effectively means that the value of the building is equal to 100 divided by the percentage yield times the rent or in this case 100 divided by 5 and then multiplied by £50,000.

You might also have spotted that this means that the yield and the value of the building are inversely correlated. A higher initial yield equates to a less valuable investment. You might find this a bit counter-intuitive, if so don't worry, you are not alone. I suggest that you get a piece of paper and a pencil and simply write out the equation and do the calculation yourself. Then try this little exercise.

I suggested that the logic of buying Knockdown House was that the rental return would rise from the initial 5%. Now let us assume that the office is not let to

Megacorp but to Michael Beaman Ltd, a company which is definitely not as long term security for a rent of £50,000 a year. To add to that, your pension fund is gloomy about the prospects of rents increasing in the area because there is limited local demand for offices. In this case KnockDown House is only worth buying if the initial rent gives them an 8% return on the price they pay.

Try adjusting your sum. It now becomes 100 divided by 8% multiplied by £50,000. That equals £625,000 which is a big fall from the £1,000,000 price envisaged in the original scenario. As you can see, their gloomy outlook which led to a requirement for a higher initial rental yield from their investment has in turn resulted in a reduction of the amount they are prepared to pay for the property. And that is exactly what you'd expect.

The next key concept that I want to introduce you to is one of the endemic risks of the development process itself which you will probably only have experienced obliquely as a planner. This is the Winner's Curse.

Developers need land to survive and are faced with a conundrum when bidding to buy for a site. If they calculate the price they are prepared to pay using assumptions about values and costs based on hard evidence and a balanced judgement of the risks involved, they will probably be outbid. The winner of the site might simply have a better idea of how it might be developed, but more frequently has simply made unreasonably optimistic assumptions about values and costs and ignored some risks. The result is that they have won the site but have paid too much for it. This is known as the 'winner's curse'. You might well have experienced it yourself when bidding on eBay! One of the causes of the

collapse of the banks in the credit crunch, and RBS and the Irish banks in particular, was that they increased the finance available to developers just when the competition for the land and thus the danger of over-paying for was the greatest.

It is one of the reasons why many developers will often claim that the viability of a project is compromised because planning requirements would result in their site being worth less than they paid for it. As often as not that isn't because the planner's requirements are unjustified but rather that, when making the purchase, the developer had assumed that they could be reduced in negotiation in order to justify overpaying for the site and thus beating their competitors to make the purchase.

The winner's curse is the bane of the development business and at a personal level explains why I got out of it. The 'back to the wall' negotiations in the busts were an interesting if bleak challenge. But there was no sense at all in the kamikaze economics of some of the buyers in mature boom markets.

So, to summarise:

The viability of a development critically depends on timing and risk as well as on the profit margin. Remember the credit card analogy and try to imagine that it is your own money involved.

Using borrowed money to finance development is known as gearing and

dramatically magnifies the percentage upside and downside in a development project. Small differences in assumptions about costs and values also have a 'geared' or disproportionate effect on the calculation of the value of land for development.

When land is bought in competition, the buyer usually pays too much for it. That is the Winner's Curse. From that point on, making money out of a scheme can be an uphill slog in all but the most unexpectedly benevolent market conditions.

Finally, do familiarise yourself with the concept of 'yield' and the arithmetic involved. Do the little exercise I described. When wondering what commercial investors look for a scheme, think about what you would look for in a buy-to-let investment. It isn't that different.