

Homes for Londoners

Draft Affordable Housing and Viability Supplementary Planning Guidance

Consultation Response

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(Please note that the comments below represent the personal views of Professor Pat McAllister)

Introduction

Whilst the scope of the document is broader, the Draft Affordable Housing and Viability SPG published by the GLA is part of a body of documents issued by central and local government, other governmental agencies and professional associations that are attempting to guide and govern the use of financial modelling of development projects in the development management and policy formation. In addition to the NPPF, key documents include:-

- London Borough Viability Group *London Borough Development Viability Protocol* (November 2016)
- Islington BC *Development Viability: Supplementary Planning Document* (January 2016)
- RICS *Financial Viability in Planning*, (2012)
- Local Housing Delivery Group, *Viability Testing Local Plans* (2012)

To some extent, this ‘guidance glut’ can be interpreted as a competitive process between institutions and agencies to control ‘the terms of reference’ of viability appraisals and how viability appraisals should be executed and interpreted in the plan making and development management processes.

It seems clear that previous attempts to provide authoritative guidance by the RICS have been perceived as unsatisfactory. Given the perceived problems with the practise of the ‘dark arts’ of viability appraisals, there has been acknowledgement of the need for improved guidance. For instance,

- In the 2015 *Spending Review and Autumn Statement*, it was stated that “[T]he government will bring forward proposals for a more standardised approach to viability assessments...”
- In 2016, the LGA’s Housing Commission recommended the establishment of “a clear, robust and transparent viability procedure”.

My comments below are focussed on the guidance on viability appraisals in the draft SPG.

Overall

The discussion of information provision, justification of assumptions, scope of information etc. in the draft guidance would be regarded as good practice for any appraisal report.

Appraisal method

Para 3.4 states that the Mayor will use the residual land value methodology to determine the underlying land value. However, it is worth noting that there is no standard method in practice to applying the residual land value method. Evidence from appraisal software, real estate textbooks and development appraisals that are in the public domain suggests that a range of variations of the residual method are used in practice. The different methods use different approaches to: the timing of costs and revenues;

whether cost and revenue inflation should be incorporated; the inclusion of and assumptions about debt; and the appropriate metric of return or profitability.

Whilst there is no single accepted approach to development appraisal, it is accepted that development appraisal as commonly practised has evolved since the 1970s separate from mainstream project appraisal theory and practice. In mainstream project appraisal theory and practice, the basic tenets of applying discounted cash flow techniques to project appraisal are fairly straightforward.

A project investment appraisal should involve the estimation of all **relevant** cash flows and discount them at the appropriate risk-adjusted target rate of return. If the Net Present Value (NPV) is zero or higher, then the project is viable. In the context of a development opportunity, the Gross Present Value can be the worth of the land.

Mainstream project investment appraisal guidance suggests that finance costs, contingencies and overheads are **not** relevant cash flows.

- Finance costs are implicit in the discount rate. The investment and financing decision should be separate.
- Contingency is really a risk management issue. It's not an actual expected cash flow
- Overhead costs are largely fixed and taking on a project often has little incremental impact on them.

However, contingency and finance costs (to a less extent overheads) are routinely included as costs in development viability appraisals in the planning system. An even bigger issue is the fact that viability guidance explicitly advises that expected changes in the cash flows should be ignored i.e. no forecasting. Profit is also included as a cash margin on development values or costs since this ignores the fact that different profits have different values depending on when they are expected to be received. These points are summarised in Table 1

Whilst it is accepted that many flawed assumptions are deeply entrenched in how many practitioners carry out development appraisals and that changing the 'traditional' approach to development appraisal would be very challenging, the comments on other elements of the draft guidance should be seen in the context of the discussion above concerning the weaknesses and simplifications commonly applied in development appraisal modelling.

Key Point: Conventional development appraisal techniques contain significant theoretical weaknesses and flawed assumptions. These weaknesses and flaws are firmly embedded in professional practice. Therefore, it may not be appropriate for the guidance to suggest overly detailed calibration of inputs and assumptions in development appraisal models.

Table 1

Unconventional Practices in Development Appraisal?	
Mainstream project appraisal theory and practices	Common practices in development appraisal
<u>Financing</u> is not considered a relevant cash flow and is excluded from the project appraisal. The financing or capital structure of a project is a separate issue to the appraisal of the project. Financing should not affect the value of the project.	<u>Financing</u> is included as a cost in the development appraisal. A number of additional unrealistic assumptions are made regarding financing <ul style="list-style-type: none"> • It is assumed that all negative cash flows can be borrowed. • In some versions, it is assumed that costs are incurred in advance and interest is paid in advance (i.e. in a quarterly cash flow, the payments are assumed to be made at the beginning of the quarter). • In some versions, it is assumed that the same interest rate is applied to negative and positive balances.
The value of the project represents the (present) value of the relevant cash flows discounted at <u>the target (internal) rate of return</u> .	Profit is included in the cash flow as a <u>cash margin</u> on development value or development costs.
<u>Expected changes in revenues and costs</u> are incorporated into the project appraisal.	<u>Expected changes in revenues and costs</u> are not incorporated into the development appraisal.
<u>Contingency and overheads</u> are typically not considered to be relevant cash flows.	<u>Contingency</u> is routinely included in development appraisals. Overhead is sometimes incorporated into development appraisals.

Forecasting changes in costs and revenues

Para 3.10 reinforces the practice of ignoring expected changes in costs and revenues. Other than the fact that it is consistent with other guidance (e.g. NPPF), no rationale is provided for this recommendation. The use of current costs and values means that a viability model is assessing whether a project is viable if it could be built at the date of appraisal. Clearly, the project will actually be implemented *after* the date of the appraisal. Alternatively, the assumption results in a ‘hidden’ forecast of no change in revenues and costs.

It is standard practice (outside of the world of viability appraisal in the planning system) to incorporate expected changes in costs and revenues from current levels. It is acknowledged that a key issue is measuring these expectations.

Similar to the actual development revenues and costs themselves, expectations about how costs and revenues will change will also be changing over time and will vary among market participants at any particular point in time. Forecasts contain lots of intrinsic uncertainty and disagreement and, more debatably, are also prone to behavioural biases such as herding, optimism etc. These points are fairly well-recognised. However, in most financial activities, the cost-benefit trade-off of projecting costs and revenue changes is assumed to be superior to the cost/benefit trade-off of ignoring them.

It is worth noting that, in a high land/residential value city such as London, it will almost always be the case that, where revenue inflation is expected to be positive i.e. residential values are expected to grow, failure to incorporate such an expectation into an appraisal model will result in a lower estimate of residual land value and, consequently, potentially underestimate the capacity of a project to deliver affordable housing. This may explain why this point has not been raised by developers/land owners.

<p>Key Point: The use of expected development revenues and costs rather than current revenues and costs would provide an improved model of development projects' expected financial performance.</p>

Finance costs

In Para 3.26, given the comments above, the concept of a “generic average finance cost” seems quite vague. Bearing in mind all the points made above about the principle of considering financing costs at all and the limitations of the common practices of financing costs calculations in development appraisals, financing costs tend to be a relatively minor element of a development appraisal. Assuming the traditional model of development appraisal is used, then it should be relatively straightforward to assume a typical borrowing rate (albeit it is worth noting the many development loans have significant fees attached).

Profit and return

It is notable in Para 3.32 that the guidance refers to profit rather than return. As noted earlier, conventional project appraisal focuses on whether a project meets a target or hurdle rate of return. Whilst there has been some theoretical analysis on approaches to estimating the appropriate target IRR

for a development project, a convincing practical method has not been identified. Similarly, this can also be a common practical problem in the wider application of target/hurdle IRR criteria to broader business decisions. Nevertheless, target/hurdle IRR seem to be commonly applied in the broader business environment.

As the guidance points out, required profit level is likely to be variable over time, between projects/locations and between developers. Ultimately, the level of project risk (driven by the project-specific and market-systematic factors) is going to be the main determinant of the risk premium required for undertaking a development project. Market drivers will vary over time driven by the interaction of local and macro-economic performance and the capital markets. Projects will have different risk profiles. With or without planning permission? Phased or single building? Long-term or short-term? Pre-let or speculative? Greenfield or brownfield?

So required rates of return (and required profits) should vary over time for the same project and vary between projects at any given point in time. Consequently, a standard profit assumption is clearly inappropriate. The central problem that a local authority needs to address is how it determines the appropriate level of developer's profit or return in a viability appraisal. This is a straightforward question without a straightforward answer.

The distinction between rates of return (IRR) and profit margins (percentage of revenues or costs) has been perhaps too starkly drawn. An explicit requirement for x% profit on costs implies a target rate of return of y%. In turn, an explicit requirement for x% IRR implies a profit on cost of y%. A number of measures of profitability or return should be compared for reasonableness and benchmarked appropriately when assessing viability. For instance, if a short-term project is providing a Profit/GGDV ratio of 20% and IRR of 40% per annum, it could suggest that abnormal returns and profits are being obtained. In turn, if a long-term project is providing a Profit/GDV ratio of 30% and IRR of 5% per annum, it could suggest that insufficient returns and profits are being obtained.

It is also important to be clear that the target rate of return should be for the project as opposed to the target rate of return for developers' higher risk equity investment.

3.33 It's not clear why, all else equal, commercial or PRS development should require a lower return or profit. The office sector in central London has been much more volatile (risky) than the residential sector. PRS development remains a relatively immature sector.

Key Point: There is no accepted technique for estimating the required profit or return from a development project. However, given the level of variation in project risk, a standard rate is not appropriate. The provision of a number of profit and return metrics is straightforward and would improve understanding of the expected financial performance of a development project facilitating improved scrutiny and transparency.

Benchmark Land Value

In Para 3.36 the guidance provides a good discussion of the issue of Benchmark Land Value (BLV) which attempts to establish the primacy of policy compliance in its estimation. The guidance seems to be attempting to establish EUV as the ‘anchor’ against which the estimated residual land value should be compared.

BLV has probably been the most difficult area in viability appraisal. Whilst the calculation of the competitive return to a willing land owner tends to be framed as a technical and technocratic process, at its heart is land value capture. There needs to be a clear political decision about the appropriate distribution between the community and land owners of the (often huge) land value uplifts that are triggered by obtaining planning permission. There is clearly a lot at stake for land owners and the community and a clear, unambiguous, transparent and practical procedure for estimating BLV is needed if viability testing is to be applied consistently.

Table 2 seeks to illustrate the nature of the decision that needs to be made. The Market Value of £9 million represents the estimate of what a site would sell for based on evidence from market transactions involving the sale of similar sites. However, let’s assume similar sites have been providing an average of 15% affordable housing. If £9 million is adopted as the BLV to provide a competitive return to the land owner, then 15% affordable housing will become the maximum that can be delivered. This is the well-known ‘circularity’ problem of using a mark-to-market, comparable approach to estimating BLV.

If the land owner can sell the land for £4 million for an alternative use, then clearly they will only bring forward the land for housing if they receive £4 million or more. Hence, as the draft guidance accepts, AUV needs to be a standard BLV indicator. It is expected that evidence of AUV will be based upon a mark-to-model method such as the residual method rather than a mark-to-market method such as a comparable method.

Table 2 Land Values and Affordable Housing

EUV	£1,000,000
AUV	£4,000,000
RLV (assuming 50% affordable housing)	£2,000,000
RLV (assuming 40% affordable housing)	£4,000,000
RLV (assuming 30% affordable housing)	£6,000,000
RLV (assuming 20% affordable housing)	£8,000,000
RLV (assuming 10% affordable housing)	£10,000,000
RLV (assuming 0% affordable housing)	£12,000,000
Market Value	£9,000,000

The Residual Land Value estimates are also expected to be based upon a mark-to-model method such as the residual land value method rather than a mark-to-market method such as a comparable method.

Given that there needs to be a political decision taken about the appropriate allocation of the uplifts in land value triggered by granting planning permission, no comment is offered about the appropriate level of this allocation. However, the nature of the trade-offs could be made more explicit if viability reports were required to set out clearly estimates of

- Existing Use Value
- Alternative Use Value
- Residual Land Value based upon an assumption of policy compliant provision of affordable housing
- Residual Land Value based upon evidence from recent market transactions
- Residual Land Value based upon an assumption of no affordable housing

Key Point: The draft guidance fails to provide unambiguous and practical guidance on estimating BLV. The estimation of a competitive return to the land owner requires a political decision on the allocation between the community and land owners of the land value uplifts triggered by the granting of planning permission. Whilst it does not address the issue directly, the provision of land value estimates on a range of bases should improve understanding of the nature of the trade-offs between affordable housing and land prices that are being made through the planning process.

Moral hazard in the production of viability appraisals

The draft guidance has little to say on the moral hazard issues inherent in the way that viability appraisals are currently produced. The vast majority of development viability appraisals are produced by external consultants. To be blunt, for scheme-specific viability calculations, land owners and developers have the means, motive and opportunity to try to bias viability appraisals produced by external consultants and consultants themselves have the means, motive and opportunity to bias their appraisals accordingly.

Appraisals are typically commissioned by land owners and developers. It is the land owner or developer who pays for the viability appraisal. The substantial economic incentives for the land owner and the consultant to produce biased appraisals are fairly obvious. The land owner or developer themselves is often an expert on development appraisal and can exploit intrinsic uncertainty in appraisal assumptions and estimates to their advantage. The viability calculations are often confidential and not subject to public scrutiny.

Guidance on the conduct of viability appraisals has emerged that attempts to control for potential opportunistic behaviour. For instance, the Islington SPD on development viability appraisal introduced a requirement for a statutory declaration from the applicant company confirming that the assessment submitted to the council is a true and fair reflection of the viability of the proposed development.

The formation of an expert panel to scrutinise appraisals will help to control such opportunistic behaviour. It may be also be worthwhile to commission the creation of a database by a close-to-market consultancy which provides frequently updated guidance on expected appraisal inputs e.g. construction costs, professional fees, contingency, typical loan costs, marketing costs, profit and/or return expectations etc. with applicants being required to justify deviation from such guide figures.

Key Point: Development appraisals are subject to unavoidable uncertainty in their inputs and, therefore, their outputs. This provides an obvious opportunity for their inputs and, therefore, their outputs to be biased. Where applicants are responsible for the production of viability appraisals, such bias is inevitable. Creating an independent, real-time database of indicators on key appraisal inputs would improve the consistency of the application of viability tests.