DVS Property Specialists for the Public Sector

FINAL REPORT

RESTRICTED

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Date : 26th June 2012

Dear [redacted]

Development Viability Assessment - Imperial West

Introduction

1.1. I refer to our fee quote dated 16th December 2011 with regard to the review of the appraisal and associated information on the proposed development scheme.

1.2. The principal objective of the brief and the subject of this report is to review the financial viability assessment together with supporting information supplied by the applicant and advise whether the scheme is capable of supporting additional S106 contributions and affordable housing

2.0 Background

2.1 The application scheme proposes a mixed use development comprising 6 buildings to include residential, office, retail/restaurant, hotel, community and Imperial College and research uses.

2.2 Our report dated 24th April 2012 assessed the viability of the application scheme and our conclusions were that the scheme was unviable.

2.3 However, the applicant has now provided a revised appraisal which assesses the non-college elements of the scheme on a stand alone basis in order to assess the profitability of these elements and their ability to cross subsidise the college elements of the scheme.

2.4 The applicants conclusions are that the revised appraisal does not make a sufficient developers profit that would be capable of subsidising the non-college buildings of the scheme. However, the applicant is willing to take forward the scheme.

Revised Appraisal Methodology

2.5 The applicant revised appraisal assesses buildings B (Postgraduate accommodation), Building D (Offices), Building E (Hotel) and Building F (Residential) within their appraisal.

2.6 Building B does not form part of the application scheme and was subject to it's own separate planning application. Whilst Building B will form part of the overall masterplan that is envisaged for the site.

2.7 For the purpose of viability assessments, best practice guides us to ignore and accordingly we have removed Building B from our assessment, as it does not form part of the current application scheme.

2.8 It should be noted that the applicant's appraisal does not reflect all buildings within the red line boundary of the planning application and excludes the educational buildings. Consequently, the conclusions of this report does not reflect the viability of the whole scheme.

2.9 The applicant has provided an appraisal model that considers an out-turn approach which takes into account future revenue growth and cost inflation.

2.10 The development period is envisaged to be c. 8.25 years, therefore a growth model approach (revenue growth and cost inflation) having regard to an Internal Rate of Return (IRR) as a measurement of risk reward has been adopted.

2.11 The approach is not a common method of considering viability assessments but it is an appropriate measurement of return for multi-phased schemes over the anticipated project programme.

2.12 The merit of using an out-turn approach is that it can secure a known amount of affordable housing and S106 planning obligations when the scheme on a current cost and revenue approach is not viable.

2.13 The downside, however, is that growth and cost inflation is difficult to predict and the amount of affordable housing and S106 contributions secured could look insufficient if the market grows at a faster rate and the scheme outperforms current forecast revenue and cost inflation projections.

Internal Rate of Return

2.14 The IRR is calculated using a discount rate which equates the total costs and total revenue over the cashflow programme period. An IRR measurement takes full account of the time value of money and is used as the measure of profitability having regard to the time the project takes to complete.

2.15 An IRR has been applied to the out-turn model where as an annualised percentage this provides a measure of the rate at which the scheme generates a return.

2.16 The applicant has not set out in writing what their required IRR hurdle benchmark would be. However, their appraisal model returns an IRR of [redacted](which includes building B).

3.0 Information provided by the applicant

3.1 In undertaking this viability assessment we have had regard to the following information:

- Toolkit Viability Assessment together with supporting appendices prepared by Savills dated 17th February 2012
- Report prepared by TRI Consulting dated August 2011
- Imperial West Pricing Schedule prepared by Savills dated 23rd February 2012
- Affordable Housing Appraisal prepared by Savills dated December 2011

- Schedule of Ground Rent Comparables prepared by Savills
- Schedule of Office Rents prepared by Savills
- Toolkit Viability Assessment Addendum prepared by Savills dated 23rd May 2012

4.0 Review of the Applicant's Viability Assessment

4.1 We have relied upon the floor areas provided by the applicant. The areas have been provided as both a Gross Internal Area (GIA) and Net Internal Area (NIA). However, any change in these areas may affect our view on the end sales revenue and the viability of the scheme.

Residential Revenue

4.2 The applicant has provided a unit by unit pricing schedule prepared by Savills dated 23rd February 2012 together with a commentary on pricing logic dated February 2012.

4.3 We have reviewed the pricing prepared by Savills and the revenue relied upon by the applicant for this location at present does not seem unreasonable.

4.4 The applicant has adopted an average ground rent across the scheme of [redacted] per unit capitalised at 5.5%. For the purpose of this assessment we find the ground rents to fall within an acceptable range.

Sales rates assumptions

4.5 The applicant's appraisal model shows a 12 month sale period with 12 sales within the first month after practical completion reducing to 11 sales per month for the remaining sales programme.

4.6 We would expect off-plan sales to be factored into the appraisal. The applicants 12 sales upon practical completion equates to c. 9% of the total private residential units.

4.7 We are of the opinion that a developer would seek to achieve a greater percentage of sales by practical completion and for the purpose of this assessment we have modelled 40% off-plan sales by practical completion having regard to the scheme characteristics.

Affordable Housing

4.8 The applicant has provided an affordable housing appraisal prepared by Savills dated December 2011. The appraisal assumes the units will be affordable rented units with rents at 70% of market rents.

4.9 We understand the affordable units will comprise the following:

59 No. Key Worker Units let on Assured Shorthold Tenancies subject to the following household incomes (to be increased on an annual basis in line with increases in average incomes):

Studios, 1 bed flats, Small 2 bed flats:	£19,000 - £64,300 p.a
Large 2 bed flats, 3 bed flats:	£19,000 – £77,200 p.a

4.10 We have not been provided with the evidence that supports the adopted market rents that inform the basis of the assessment.

4.11 We have considered the rents in relation to residential rents within the immediate locality and based upon current rents they would appear to be optimistic. However, clarification is be required from the applicant in terms of the evidence based used to assess the market rents.

4.12 We have noted the appraisal assumes 68 units, which includes 9 three bed units in building J. We understand that Building J does not fall within the boundary of the phase 2 planning application and consequently the number of units assumed within the appraisal would appear to be overstated.

4.13 Savills have assessed the average rent per week per unit at [redacted] however, excluding the units from Building J (and on the basis the rents adopted by the applicant are supportable) this will reduce the average rent per week per unit to c[redacted] per week.

4.14 On this basis, the affordable housing would appear to be over-valued. However, we would require the evidence base to support the market rents adopted in addition to an amended appraisal reflecting the affordable units in phase 2 only.

Office revenue

4.15 The applicant has applied a range of rents in Building D from [redacted] per sq ft. In support of these rents the applicant has provided a schedule of comparable evidence of office lettings rents ranging from [redacted] per sq ft in established office market locations including Chiswick Park, Hammersmith, Ealing and Kensington Village.

4.16 At present, the immediate locality is not an established office location and at present it is unclear whether the adopted office rents could be realistically achievable.

4.17 The applicant's viability assessment states the range of rents are optimistic and from comparing the adopted rents to the comparables relied upon, it is unclear how the adopted rents are supportable.

4.18 The applicant's appraisal adopts a yield of [redacted] In support, the applicant has provided a schedule of investment transactions from West London office locations. It is unclear whether the yield adopted is appropriate as the yield will be influenced by factors such as future rental growth and tenant profile etc.

4.19 As White City is not currently an established office location, the yields adopted may be considered optimistic as outlined in the Savills Viability Assessment.

4.20 In addition, the applicant's assessment does not take into consideration any void periods. On the basis the applicant is adopting "optimistic" rents in an uncertain office location it is not unreasonable to assume a void period to enable the building to be fully let to tenants.

4.21 For the purpose of this assessment, we have adopted a 12 month void period.

Retail/Café Revenue

4.22 The applicant appraisal adopts a rent of [redacted] per sq ft for the retail and restaurant units. In support of this rate we have been provided with evidence from retail units mainly located within Shepherds Bush Road and Goldhawk Road with achieved and asking rents ranging from c. [redacted] per sq ft to [redacted] per sq ft.

4.23 A large majority of the comparables are not located within a close proximity to the subject site and it is unclear how these comparables inform the rates adopted for the units for the application scheme especially when the nearest comparable relied upon at Pavillion Parade, Wood Lane has a quoting rent of [redacted] per sq ft.

4.24 On this basis, the rents adopted may be optimistic.

4.25 In addition, the applicant's assessment does not take into consideration any void periods. On the basis the applicant is adopting "optimistic" rents; it is not unreasonable to assume a void period.

4.26 For the purpose of this assessment, we have adopted a 12 month void period.

<u>Hotel</u>

4.27 The applicant has provided a residual land value for the Hotel revenue as appendix 6 of the Savills together with a report dated August 2011 prepared by TRI Hospitality Consulting.

4.28 The hotel revenue equates to c. [redacted] and has been derived from a capital value per room of c.[redacted] Appendix 6 to the Savills report shows that the capital value per room has been based upon an [redacted] yield.

4.29 Our leisure valuer has considered the values relied upon and supporting evidence. However he has advised that the report prepared by TRI consulting does not contain the following information to allow him to conclude his assessment:

- A breakdown of how the capital value per room has been arrived at
- Comparable evidence to support the capital value per room

<u>Revenue Growth/Cost Inflation</u>

4.30 The applicants out-turn model reflects revenue growth assessed on the basis of a Savills forecast for the years 2012 – 2016 for the residential units and for retail and office use revenue growth is based upon "Investment Property Databank forecasts for average capital value growth".

4.31 Whilst the residential growth does not appear to be unreasonable. We have reservations as to why retail and office growth has been assessed on the basis of IPD forecasts for average capital value growth.

4.32 The applicant has applied the IPD forecast for Capital growth to the rental values and left the yields unaltered, this has the effect of increasing the capital values in line with the predictions.

4.33 We would usually expect to see revenue growth by reference to a property market indices which considers rental growth and yield forecasts over the project programme.

Construction Costs

4.34 The applicant has provided a construction cost plan prepared by Sweett dated 15th February 2012.

4.35 Our cost consultant colleague has reviewed the costs and he is of the view that the costs adopted generally fall within an acceptable range.

Professional Fees

4.36 The applicant has adopted 10% of construction costs for professional fees. This rate falls within a range we would expect for a scheme of this nature.

S106/CIL Contributions

4.37 The applicant's appraisal includes S106 payments of £4.2m and CIL at £2.5m and clarification is required from the LPA that these contributions are acceptable.

Marketing, Letting & Disposal Fees

4.38 The applicant's appraisal adopts letting agent's fees at 10%, letting legal fees at 0.5%, sales agent fees at 0.5% and sales legal fees at 0.5% and 0.25%.

4.39 For the purpose of this assessment, we find the rates adopted to be reasonable.

Project Programme

4.40 The appraisal proposes a project programme of c. 8.25 years. The applicant has provided details of the assumed development timescales for each building within their Argus appraisal. For the purpose of this assessment we have adopted the applicant's project programme.

Finance

4.41 The applicant has adopted a finance rate of 7% and this rate falls within an acceptable range albeit at the upper end of this range.

Benchmark Land Value

4.42 The applicant has revised their benchmark land value seeking to rely upon the purchase price paid by the applicant in 2009 at c.[redacted]. The purchase price has been apportioned across the plot size of each building within the appraisal.

4.43 Current best practice directs that viability assessments have regard to current day Market Values and assumptions and disregard historic purchase price paid to inform the benchmark land value to assess scheme viability. In this case the applicant is seeking to rely upon an historic purchase price which is a flawed approach.

4.44 In order to determine the Benchmark Market Value we are guided to have regard to the current day values, costs and assumptions which satisfies local plan policies in all respects in order to determine the current day residual land value of the parcel of land which is identified by the red-line area identifying the land subject to the planning application.

4.45 In undertaking our assessment of viability the responsibility rests with the applicant to provide and fully evidence the land values, revenue, costs and assumptions they are seeking to rely upon. The applicant has not provided this level of information or analysis.

4.46 However after taking account of the various comments above and changes to the various inputs to the residual land calculation results in a negative land value of c. - [redacted]m which indicates the scheme is not viable by a considerable margin. Academically the land has a negative land value but in reality no landowner would transfer land together with [redacted].

5.0 Conclusion

5.1 The applicants revised appraisal generates an IRR of [redacted]% and the applicant sets out the scheme as proposed does not generate a market risk adjusted developers (at a minimum threshold) return that would be capable of subsidising the non-college buildings – but the applicant maintains they are prepared to take the scheme forward.

5.2 In carrying out our assessment we are guided to have regard to market risk adjusted returns to inform whether a scheme is indeed viable for the purposes of assessing a development proposal.

5.3 The scheme returns a negative land value and therefore we have not considered the benchmark land value further as the scheme will need to generate an additional revenue income of c. [redacted]m[1] to support a nil residual land value. Consequently, if allowance was made for a benchmark land value it would serve to necessitate either a reduction in costs or an increase in excess of [redacted]m as identified above.

5.4 It should be noted that the conclusions of this report do not reflect all of the buildings that fall within the red-line boundary of the application scheme.

5.5 The applicant undertook this approach as they were seeking to assess the viability of the non-College elements of the scheme on a stand alone basis to identify the profitability of these elements and their ability to cross subsidise the College elements.

5.6 Consequently Buildings A, C and G have not been considered as part of this assessment. Therefore, the approach adopted by the applicant is flawed.

5.7 Furthermore it should be noted that our assessment captures the applicant's revenue assumptions which are highlighted by the applicant as being optimistic and it remains the scheme deficit could be greater.

[1] The calculation assumes additional Phase D revenue necessary to drive a nil land value with all other model assumptions remaining constant.

5.8 Best practice guides us to adopt a market risk adjusted assessment of the applicants proposals and on this basis we do not consider the scheme would be deliverable.

5.9 In summary, the applicant's revised appraisal still demonstrates that the proposal is unviable on the basis of a market based approach to assessing the viability of the scheme and consequently it is unlikely that the "market" would implement the scheme at such a significant deficit.

I trust this report sets out clearly our position but please do not hesitate to contact us if you have any queries.

Yours sincerely,

DVS Development Consultancy Service