

FINANCIAL APPRAISAL



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london

MARCH 2020

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GUIDE SUMMARY

In this guide, we cover development appraisals, introduce cash flow concepts, and cover long term financial modelling.

We talk about where the money comes from in the guide 'Development Finance'

HOW TO READ THIS GUIDE

Throughout the guide, there are links to useful documents and websites for further reading. These are highlighted in [blue](#)

We have also suggested group activities and outputs to help you and your group work through each stage.

If at any point you would like advice and guidance, you can contact us at info@communityledhousing.london

DISCLAIMER

Our team and associate Advisers encourage groups to think openly and clearly about their objectives and how to achieve them. The information in this guide is for general guidance and is not legal, financial, or professional advice.

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WHAT IS A FINANCIAL APPRAISAL?

A financial appraisal helps check that the project is viable in terms of development and in the long term. For private developments, the appraisal establishes the potential for profit in relation to the risks incurred. For non-profit organisations, appraisals attempt to ensure that the costs are recoverable, and the scheme achieves what you want.

Assessing and evaluating a development is not just a one-off task, but a continuous process which needs constant monitoring and revisions, typically on a spreadsheet. Different scenarios should be tested and the implications of changes to assumptions understood. It is very important to use realistic assumptions rather than trying to make the numbers say what you want.

Because the assumptions are so important, appraisals should be carried out by experienced RICS valuation surveyors¹ and informed by the advice of your wider professional team, and the market.

You need to understand what they are doing and how they arrived at different costs as the decision to proceed and carry the risk, ultimately rests with your organisation.

An indicative site is often useful in order to work up a model. This can be translated for

different sites. The work will become more resolved as more detail is added.

Development appraisals look at the development phase of a scheme. This may be sufficient if the intention is to sell all of the homes.

Long term financial appraisals or 'investment appraisals' should be included if the organisation intends to hold rented units. We will cover these later.

'Residual' valuations use the known variables, or those easier to estimate, to assess an 'unknown' value. The residual equation can be rearranged depending on what you want to find out. To work out a residual valuation, you will need to isolate components of the proposed development such as land price, construction cost, finance cost and housing rents/prices.

In a residual land value appraisal, you assess whether your likely eventual income can cover the costs of your development. Whatever remains is the Residual Land Value, i.e. what you can pay for the land.

If you know or assume the cost of land, it can also tell you the likely return or profit.

Residual Land Value Appraisal

$$\text{Gross Development Value}^2 - \text{Development Cost}^3 - \text{Return Requirement} = \text{Residual Land Value}$$

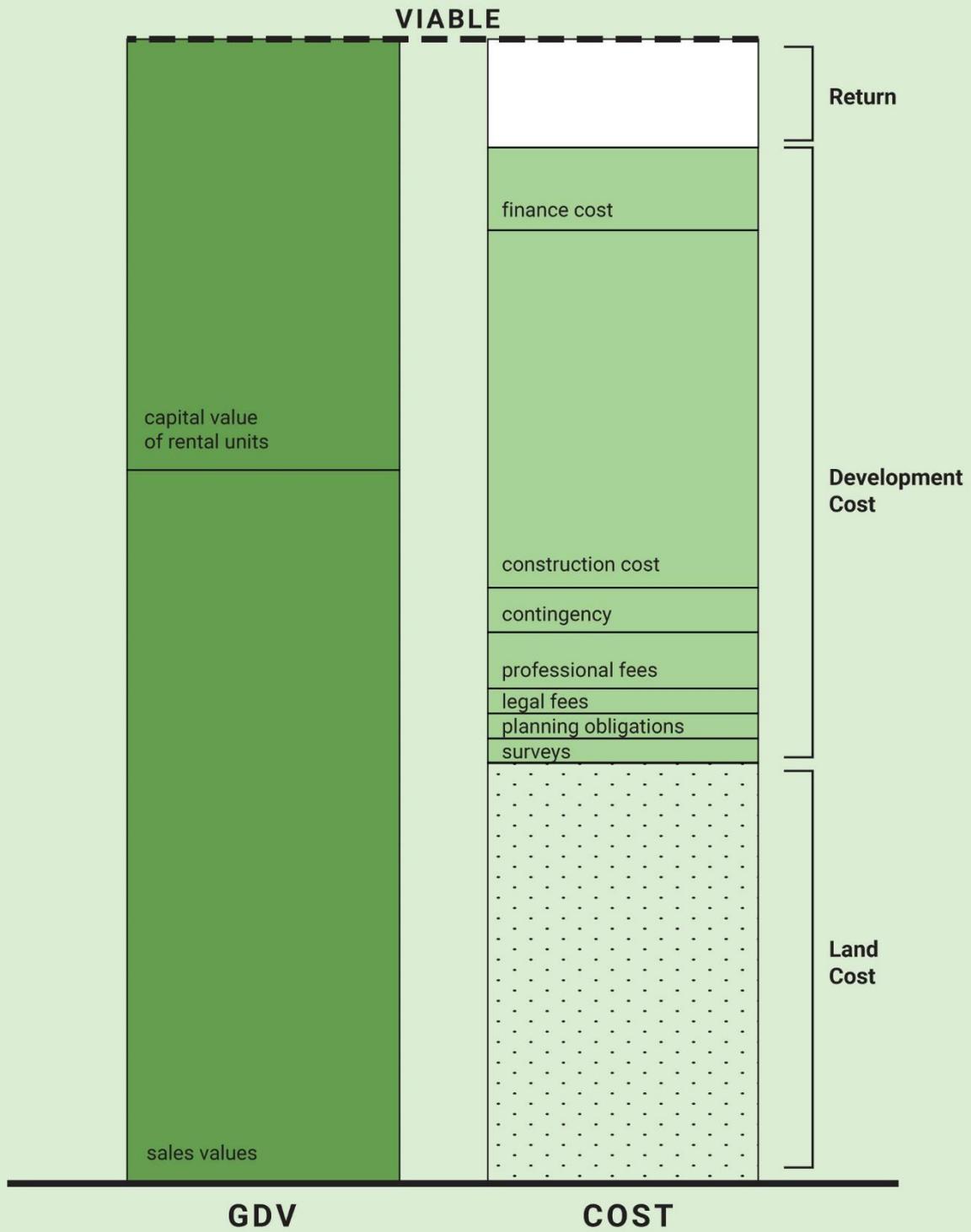
Development Return Appraisal

$$\text{Gross Development Value}^3 - \text{Development Cost} - \text{Cost of the Land} = \text{Return (on Capital or IRR)}$$

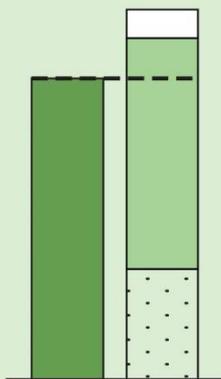
¹ The professional body in the UK is the Royal Institution of Chartered Surveyors (RICS), not to be confused with Quantity Surveyors.

² Gross Development Value is the estimated value of the completed development.

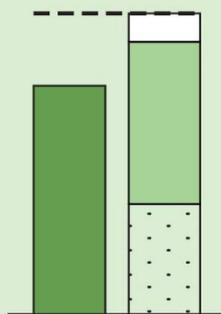
³ Development Costs are all of the likely costs involved in building the project.



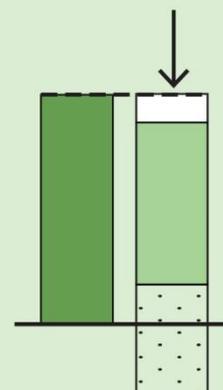
the project is unviable if costs exceed values



the project is unviable if values cannot cover costs eg if the desired affordability doesn't generate enough GDV



this can be addressed by subsidising the project from elsewhere (eg grants or reduced land value)



GROSS DEVELOPMENT VALUE

The Gross Development Value (GDV) is the final capital value of the completed development. It is calculated by assessing what the properties would be sold or rented for, based on current comparable evidence⁴.

SCHEDULE OF ACCOMMODATION

To work out the GDV, you will need a schedule of accommodation which outlines:

- how many homes you are proposing
- their net internal area (NIA)⁵.
- their tenure.

It does not need to be the definitive design but should be realistic. This is usually prepared by an architect, following an initial capacity study of the site. For example:

- RUSS [Schedule of Accommodation](#)
- OWCH [Unit Mix Schedule](#)

RENTS AND SALES VALUES

Market rents and sales values are best established with an agent or a valuer. The estimates must be as realistic as possible and based on a thorough analysis of the market, referring to comparable evidence, based on recent sales or lettings of similar schemes in the surrounding area.

Information from property sites such as [Zoopla](#) and [Rightmove](#), collate all their information from Land Registry and can provide a rough starting point.

As no two properties are identical, it is important to make adjustments to reflect differences in size, age, quality and

specification. It's important that you base the estimate on firm reliable evidence and careful analysis and not to rely heavily on a forecast or overestimations. The property market is impossible to forecast accurately so the emphasis should be on the current market.

Annual rents and sales values are usually best analysed by reference to a rate per square foot (or per square meter) and are based on net internal area (NIA).

Investment yield of rental property

The investment yield is a quick way to estimate the capital value of rental property. A snapshot of the annual rental income is multiplied by the inverse of the yield which represents the growth in the rental income and the risks associated with it.

$$\text{Annual Rental Income} \times \frac{1}{\% \text{ Yield}} = \text{Capital Value}$$

The yield can be obtained by comparing similar recent sales of rental properties for investment purposes. In general, the faster the rent is expected to grow, the lower the yield, and the higher the level of perceived risk the higher the yield.

AFFORDABLE HOUSING

The GLA set out a series of [affordable housing products](#):

- London Affordable Rent
- London Living Rent
- London Shared Ownership

⁴ The emphasis should be put on current and not projected values.

⁵ The net area of the housing unit (the internal usable space excluding lifts and corridors in a block etc) needs to be established and is known as the net internal area (NIA).

The GLA defines and publishes rents for differently sized units in different parts of London. These can be used for your appraisal, however there is still a need to establish market values, as this will be needed by lenders to act as their security, and will help you work out how others would approach a residual valuation (to compare your valuation against).

Community led housing organisations can innovate in affordable housing products and tenures, working out what affordability means to their community, and how it can be set. The [London Community Housing Fund Prospectus](#) has further information about the fixed and negotiated grant rates available.

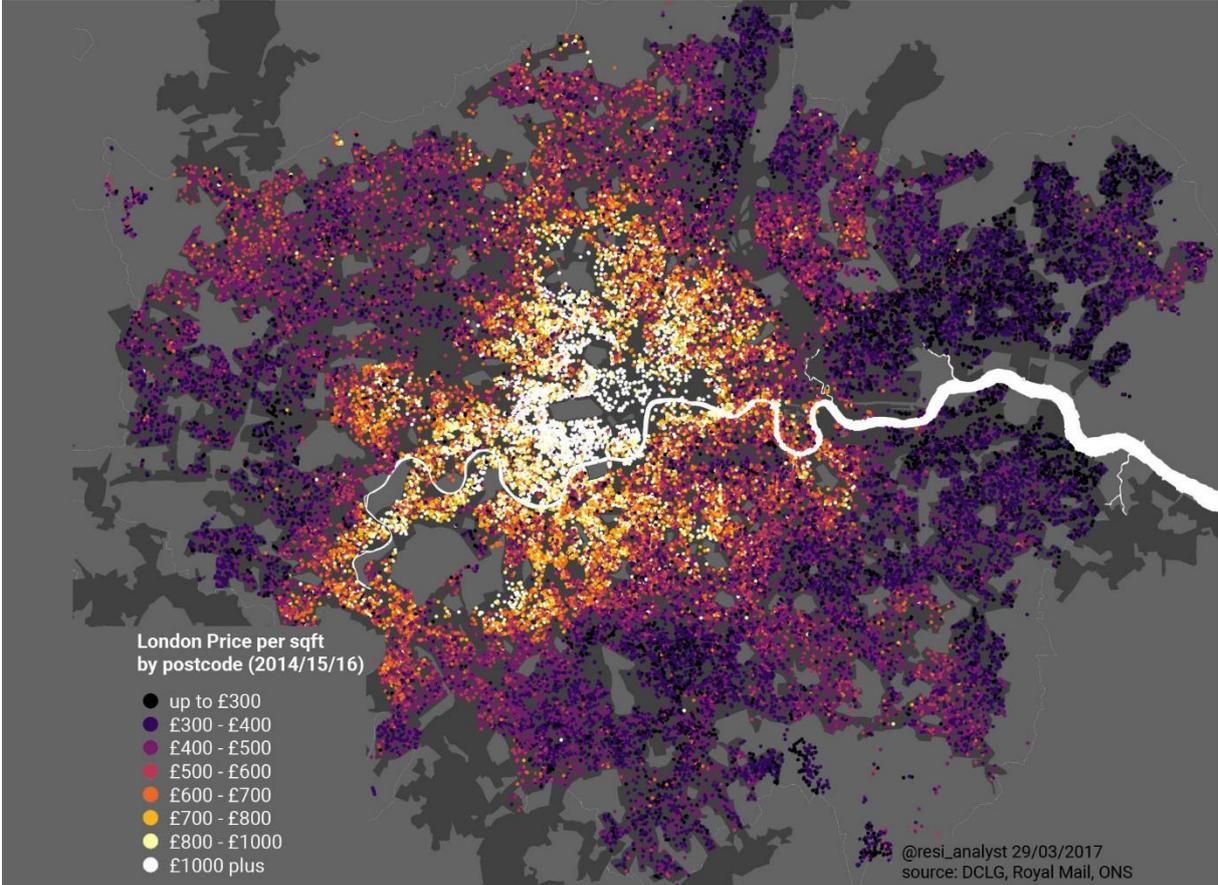
Income from grants

Grants are usually included as another form of income for the scheme. This may include

funding from the GLA or other funders. The affordable housing grant rates are fairly low and unlikely to fully cover the gap between market values and affordable housing. Established housing associations typically use the income from unencumbered existing stock or build market value units to cross-subsidise additional social units. [This GLA report](#) finds that this may not continue to work, and greater levels of affordable housing grant are needed.

TRANSACTION COSTS

Regardless of whether the you intend to hold the property to let or sell units to residents, the gross development value needs to be expressed as a net development value to allow for purchaser’s costs such as stamp duty, agent’s fees and legal fees (incl VAT).



Map showing the price per sq. ft by postcode. Interactive version [available here](#)

COSTS

SITE INVESTIGATION COSTS

Investigations and surveys should give a better idea of what can be built and reduce the risk of unexpected costs further down the line. To begin with, you may rely on desktop research and surveys which can be cheaper to carry out. When you need more intrusive surveys, you will probably need the landowner's permission.

A list of surveys you may want to commission are listed in our guide on 'Finding a Site'.

While it is good practice to systematically investigate everything about a site, it is more economical and efficient to focus on particular aspects that are likely to pose issues, so you can understand their implications better.

CONSTRUCTION COSTS

For simple appraisals, construction costs are usually estimated as a rate per square metre. This is then multiplied by the gross external area (GEA) of the proposed building⁶. The building costs are estimated at the time of the proposed implementation of the development project. Usually no allowance is made for construction cost inflation, but a contingency of 10% is included.

[Spons'](#) and [BCIS](#) provide average construction cost data, for different building types and construction methods.

As designs develop a Quantity Surveyor will come on board and work alongside other consultants to provide further resolution. They will look at a detailed breakdown of the

materials used in the building and the cost of labour, as well as the following extra sums:

Abnormals are additional costs that may be required on a particular site, such as dealing with contamination, asbestos, flood risk, or infrastructure.

Demolition of existing property either in full or partially, including.

External works including landscaping and access, such as car parking, outdoor amenity space, highways, footpaths, cycle and refuse storage.

Self-build is where prospective residents and volunteers contribute their labour into the construction. It can make some savings on construction cost, although it is usually relatively small compared to overall development costs (including the cost of land). The labour and materials cost in construction are usually evenly split. You may still require professionals to carry out more specialist and complicated work, and there will still be supervision and insurance costs. It is also important to bear in mind labour with limited training and experience may take longer on site, and time spent working on site, may mean you are not able to earn as much in other work. However there may be non-monetary benefits in self-build, when considered holistically.

Pre-fabrication and off-site manufacture is not necessarily much cheaper for smaller schemes where economies of scale may not be possible, and where tight sites require creative design responses to optimise

perimeter walls, or the centre line of the party wall. It does not include open balconies, external fire escapes, parking areas, terraces, gardens or covered walkways.

⁶ Gross area of the building can be measured in a number of ways. For construction cost, you measure the Gross External Area (GEA) includes the whole area of the building up to the external face of the

housing density, rather than units with standard dimensions. It is important to establish what is included in quotes from off-site manufacturers, as foundations and groundworks are not often included and are significant proportion of construction costs.

Although it may actually be more expensive on a per square meter rate, off-site manufacture can make the overall construction time period shorter and may provide cost certainty compared to traditional construction methods. It is usually better to ask your professional team to explore the role of pre-fabrication in your project, without being fixed on something that may not be the best suited for your particular site or project.

External works, such as landscaping and highways, are often treated separately with different square meter rates or fixed sums.

CONTINGENCY

Developments never stick entirely to the initial budget forecast. It is important to include a development or construction contingency to cover unexpected costs. Contingency typically ranges up to 10% depending on the complexity of the development and usually covers the potential increases costs such as labour, construction or unanticipated delays.

The actual contingency itself depends on your ability to plan and execute:

- an accurate development plan
- the associated time period
- the level of risk and return built into the proposal

PROFESSIONAL FEES

These fees are normally calculated as a percentage of the 'hard' construction costs and include all fees for professional services employed in the development.

This includes the architect, the quantity surveyor, the structural engineer, the mechanical and electrical engineers and the project manager. It may also include environmental and planning consultants, landscape architects, traffic engineers, acoustic consultants, party wall surveyors and other specialists. Community led housing projects may also want to make special allowances for a deeper co-design processes than conventional schemes.

The total cost of professional fees is normally estimated around 12–18% of the 'hard' construction cost. The actual rates can vary with the size of the project and complexity of the task.

They are either calculated on a 'flat fee' basis or a negotiated percentage. The agreed fee may depend your relationship with each professional. Small refurbishment schemes normally attract higher percentages than larger development projects. If professionals perceive your scheme to be high profile or innovative in some way, they may compete to be a part of the project and reduce their rates.

PLANNING FEES, BUILDING REGULATION FEES

These fees are paid to the local authority in making a planning application and are based on the scale and nature of the scheme. A list of fees can be found on local authority websites.

If obtaining planning permission proves difficult, or in the event of an appeal, you may have to allow for planning consultant fees, solicitors, counsel and expert witnesses. The extra time period involved will need to be reflected in the finance costs too.

Building regulation fees are on a sliding scale based on the final building cost. Details are

available from the council's building control department or other approved inspectors.

PLANNING OBLIGATIONS

These are payments made to the Local Authority and GLA to account for the impact of development on the surrounding area.

Community Infrastructure Levy (CIL) is a set rate per meter square of development collected by Local Authorities to fund transport, schools, open spaces and other infrastructure across the borough. It is set differently in different places and for different kinds of development, and you need to check planning policy documents.

Affordable housing doesn't usually require CIL payments to be made, although planners will have to accept your proposals meet their affordable housing definitions and policies.

Self-build and custom-build is also exempt from CIL, and most community-led housing should fall within this definition even if there is no physical construction work by residents.

Section 106 agreements are negotiated on a scheme by scheme basis, and place obligations on the development including payments for individual site-specific items. These could include contributions towards affordable housing if it is not being provided on site.

FINANCE COSTS

Very rarely will a developer cover the development costs entirely with their own money. Normally finance is arranged through a funder who will lend a proportion of the costs for a return on the loan. This is the interest rate charged on the loan for the 'term', or duration of the loan, which is a further cost for the development.

In the residual calculation, the interest rate on costs traditionally takes the market interest

rate that a developer would be offered for senior debt. However, the actual cost of the finance is affected by many factors which can include:

- varying underlying interest rates
- refinancing of loans on differing terms
- amortisation (reducing or paying off a debt with regular payments)
- the risk in the development
- the relationship between the borrower and the financier
- the risk that the borrowed funds will be paid in full by the due date

Different lenders will lend on different criteria but they will all look closely at security value and asset cover:

Security Value is the value that a lender can expect to recover should the borrower default on a loan and the lender must repossess the property. This tends to be below the price of a new home, to reflect that if it were repossessed, it would by that time be second hand, and the lender would wish to sell it quickly and would also incur costs in selling it again.

Asset Cover is a test to determine an organisation's ability to cover its debt obligations with its assets, after all liabilities have been met. In effect it determines if, in a worst-case scenario, an organisation has enough assets that can be sold to repay its loans. Funders cover this issue by lending up to a set percentage of overall value of the development. This is called the Loan to Value ratio. Thus, if the value of the site was £1m and the Loan to Value (LTV) percentage was 70%, the maximum debt that could be raised would be £700k.

It is usual for lenders to stipulate their desired level of Asset Cover and Interest Cover in the loan documentation and agreements. These are known as Loan Covenants and will be clearly outlined in any term sheets.

Finance is needed over a period of time. Interest is only paid on funds drawn down. The drawdown of funds, and therefore distribution of finance costs are not incurred at once, or even in a linear manner. In order to calculate the interest costs, it is common to estimate the total length of the development, when expenditure will stop and cash inflows will occur (when the homes are sold, or let and refinanced).

Pre-development

Typically, you might assume a 12-18 month pre-development period where you obtain planning permission and prepare for start on site⁸. Costs prior to site acquisition, such as searching for potential sites, are usually not considered to be substantial enough that you will need to borrow.

Development

The site acquisition is usually the first commitment that requires a major outlay and, therefore, interest is calculated on all site acquisition costs over the entire development period.

You would assume 18-24 months of construction time, plus any time after construction completes before income comes in⁷. Many developers try to defer the payment for the land until later to reduce the interest payments.

A 'rule of thumb' assumes that costs are incurred evenly over the construction period.

⁷ These are assumptions and do not take into account the scale or complexity of the project. Delays in the project such as planning or abnormal

The finance cost is therefore divided in half and the interest is calculated on that sum over the whole construction period.

In order to calculate compound interest on a quarterly basis the annual interest rate is divided by 4 to obtain the quarterly rate (say 2%).

This produces a compound interest formula of $(1.02)^n$, where 'n' represents the number of quarters over which the interest is calculated.

Finance fees

These fees are related to the costs associated with arranging development finance. For example, you will need to pay the bank's arrangement fees, solicitor's fee and surveyor's fee. Fees can be negotiated, but usually reflect the size of the required loan and may be anything between 3-10% of the value of the loan.

AGENT'S FEES AND MARKETING

Agent fees are what a developer would pay an estate agent to sell or let individual units. Most developers will also make an allowance to spend on promoting and marketing the project. This may not be needed to the same extent for community led housing projects, which may have a ready pool of people looking to move in. However, it may be a good idea to make an allowance for running allocation and selection processes and checking eligibility for sub-market housing.

RETURN

The return requirement⁸ in your model depends on the risks involved with the scheme, a higher level of risk will need a

on site, can add a significant amount of time into the pre-development and construction time.

⁸ Also known as Developer's Profit

higher level of return. So this can also be interpreted as a 'risk allowance'.

Return is usually expressed as a percentage of the total development costs in straightforward or simple projects.

It is difficult to generalise but often developers will seek between a 15% and 25% of the total cost as return, the percentage rising with perceived risk. You may also include contingencies within your return, rather than a separate allowance for contingencies as discussed below.

For projects with greater complexity, for example larger developments that will take a long and make be built in phases, return may also be expressed as the profit on GDV. More sophisticated developers will consider the Internal Rate of Return (IRR) calculated using a Discounted Cash Flow (DCF) model (see page 16). This allows a better comparison between different projects of different lengths.

It is important not to confuse the not-for-profit nature of community led housing projects, and assume a profit margin does not need to be included in the appraisal. Not-for-profit housing associations typically seek an Internal Rate of Return (IRR) of 7%. This ensures there is some money to keep the organisation going to the next scheme.

LAND COST

The price to be paid for the land may already be agreed or sought by the landowner (vendor). In most cases the developer has to establish a land price that can be offered to

the landowner in order to achieve a target rate of return through the Residual Land Valuation (see page 4).

SITE ACQUISITION

Site acquisition costs and fees usually include: legal fees between 0.25–0.5% of the land price, depending on the complexity of the deal, and agent's introduction fee normally agreed at 1–2% of the land price. These have to be set aside from what can be offered to the landowner.

TAX

Stamp duty is paid as a percentage of the land price. You can look up [stamp duty rates](#), as well as [reliefs and exemptions](#), and other information. Stamp duty will also have to be set aside from what can be offered to the landowner.

There are usually VAT implications to be factored into the development appraisal. Different types of developers and different types of schemes all have different VAT implications including standard, reduced and zero-rated VAT scenarios. Even if VAT is recovered, there may be a cash flow implication between the payment of VAT and its recovery.

Stamp duty and particularly VAT are complex, and you should get a relevant accountant or tax adviser on board, to structure the development in the best way.

CASH FLOW AND DISCOUNTED CASH FLOW

Cash Flow appraisals allow the timing of costs and income to be spread over the development period, or the long term, to give a better assessment of finance costs. While Residual Valuations are relatively simple, they are not very flexible in handling the timing of costs and income.

In practice, some of the development costs are incurred before the start of the building contract, e.g. finance fees and much of the professional fees. The construction costs usually follow an S-curve of cumulative expenditure. The final 3% of construction costs is usually held back as a 'retention' under the building contract. There may also be a gap between completion of the construction until the full letting, sale or re-finance. Quantity surveyors and project managers can estimate the timing of costs.

In the cash flow model, interest is calculated on the outstanding balance (including interest) at the end of each month at a monthly rate equivalent to the effective annual rate (EAR). Adjusting the pattern of expenditure, may lower the total interest figure. The cash flow method is particularly useful where receipts come in before the completion of the full scheme, e.g. a phased development. The model also allows you to adjust for changes in interest rates over the development period or for different sources of finance within the appraisal.

A cash flow appraisal will be required to satisfy potential lenders with a detailed business case. You may use both techniques together, using the cash flow method to calculate the interest cost and put this into a conventional residual appraisal for clear presentation. The cash flow method will be used throughout the development to evaluate the project as costs are incurred and influencing variables change.

Discounted Cash Flow (DCF) models examine the different cash flows, but they are all discounted back (using a present value formula) to a common point in time to allow an even comparison.

The DCF approach is a method of valuing an asset using the concepts of the time value of money. It is an explicit approach where all future cash flows are estimated and discounted to their present value. The discount rate reflects the time value of money and a risk premium, representing compensation for the risk inherent in future cash flows that are uncertain.

In simple terms, the time value of money can be considered to represent interest foregone.

The discounting acknowledges the relationship between time and money. The "time value of money" can be explained by thinking about if you'd prefer £100 now or £100 in a years' time. Clearly you'd prefer it now. If you're offered £100 now and £200 in a years' time you'd choose £200 in a years' time, as it is unlikely you will more than double the money in that time. Somewhere between those figures is a figure that will make you equally happy either way. Say £120 in a years' time is equivalent for you to £100 now. So £120 in a years' time is worth 83% of its value in today's money. ($100 / 120 = .83$)

This allows a calculation of the 'internal rate of return' (IRR), which considers both the timing and the size of each cash flow. This can be used instead of a percentage return on cost and is ideal for comparing different potential projects. However, the DCF method does not show the outstanding debt at a particular time. It shows the profit in today's value rather than the actual sum that will be received at the end of the development.

LONG TERM FINANCIAL APPRAISAL

Long term modelling considers the life of the scheme after the development period. A 30-40-year cash flow analysis will be required where you intend to hold property to let. This may integrate with your development appraisal, or if you are buying homes built by another developer it can establish what price you can afford to pay for the homes.

A long-term financial model will establish whether a single development will be financially viable after it is built and can be managed and maintained at agreed standards.

If this is the only scheme of a new organisation, it must also ensure that it can sustain itself over the long term. Existing organisations will adapt their financial plans to include the new scheme and ensure that it does not place an unreasonable burden or drain on existing residents or other activities, and that the organisation is viable over the long term.

Whilst a yield can be used as a quick way to establish the capital value of rented homes, long term modelling should consider the following in more detail:

Rent inflation or growth rate

As well as knowing the rent, long term appraisals must make assumptions on how much the rent will be increased each year over the long term. If the community led housing organisation is a Registered Provider (RP), or the homes are being managed by one, the Rent Standard will place restrictions on rental increases.

Void and bad debt levels

Rent and service charge income will be lost due to periods when homes are 'void' or untenanted. Usually assumed around 2% of

annual income. Simply being a community led organisation is unlikely to reduce voids. Similarly, an assumption must be made for rent and service charges which are not paid by tenants who fall into arrears. This is usually around 2% of annual income but may be greater if specialist groups with multiple needs are to be housed.

Management costs

Management costs will be influenced by the model of management chosen, for example; volunteer, employee, agency, or a combination of these. Typically, these are assumed at around £500 per property per year. Management costs may include office costs and other associated overheads, employee or managing agency costs, recruitment or procurement costs and contract management costs.

Maintenance and servicing

There will be an expected annual cost of maintaining the landlord's fixtures and fittings in each property. Whilst day to day repairs should be low in the early years after construction or refurbishment, the costs are likely to rise over the medium and long term. The maintenance of common parts and the landlord's structural elements should also be considered. The cost of servicing the scheme will be present throughout.

Asset management

A costed asset management plan should inform the financial plan regarding the long-term costs of major works programmes and cyclical maintenance (such as lifts every 15 years for example). Enough funds should be set aside over several years.

Governance costs

Running the organisation brings on going costs including meetings, member expenses, consultation and involvement, comms and marketing, insurance, annual return fees, accountancy and audit costs and legal fees.

Cost inflation assumptions

All costs increase over time as inflation impacts on the initial cost base. However, cost inflation is not uniform and realistic assumptions must be made for different costs such as materials, wages, insurance, utilities and professional fees. Unrealistic assumptions about cost inflation when compounded over the long term can be catastrophic to financial viability.

Tax liabilities

The taxation implications for long term models should also be considered, including VAT, Corporation Tax, Annual Taxation on Enveloped Dwellings and employer tax liabilities, where relevant.

Financing or net borrowing costs

The remaining rental income after management and maintenance etc must be able to pay down any debt outstanding when a development is completed (ie development finance that is not paid back through the sales of homes). This may require assumptions over long term financing and interest rates. Typically, the first 5-10 years are most challenging as rents will not grow significantly. A healthy margin of error for 'interest cover' during this time will be key.

Interest rates will also apply to reserves accumulated over the long term, although this will likely be lower.

UNCERTAINTY AND RISK

Risk is an inherent part of the property development process and needs to be assessed as part of this process. You can reduce elements of risk at a cost. The degree of risk is usually related to the complexity and scale of the proposed development.

It is important that the inputs as reliable as possible and based on the experience of professional advice and/or robust sources of information.

You should avoid getting caught up with making an appraisal “work”, if it means you are being unrealistic or over optimistic about assumptions. It is also good to test scenarios to understand what things are more sensitive, and to make sure your project can cope with a margin of error. Sensitivity analysis can be built in the appraisal to clearly identify changes in inputs.

The two major types of risk are systematic (wider market context) risk or unsystematic (property specific) risk.

Rental and sales values and construction costs are usually the most sensitive variables and are subject to fluctuations outside your control.

Over the development process, your commitment to the scheme increases and it becomes more difficult to change course, even if things around you are changing. At the same time risks reduce over the development period, as they either emerge, or as pass away. For example, a project very close to completion will not have any planning risk, minimal construction risk and very little market cycle risk, hence the developer’s profit required in taking such a scheme on at the valuation date will be a much lower percentage of profit on cost than a scheme without planning permission.

PLANNING RISK AND LAND COST

Planning risk refers to the risk in a change of use, or detailed design consent for the development, or other relevant government consents required to progress to the construction phase of the development.

The purchase price of the land is usually the first major financial commitment (page 11). In order to reduce risk, it is common to try to agree an ‘option’ or negotiate a purchase that is subject to obtaining a satisfactory planning consent, when the detailed construction cost is also clearer.

The greater the possibility that planning and related permissions will be denied, or complicated and time consuming to achieve, the greater the assessed planning risk. This translates into a higher developer’s risk required, and likely lower land value.

Once planning consent has been obtained, the value of the scheme is clearer. Before a planning consent it is unclear what exactly you will be able to get permission for, and how long that will take. Further applications may be made after a site is purchased. However, planning applications take time and any potential increase in value needs to be balanced against the cost of holding the site.

FINANCE RISK AND INTEREST

Funding arrangements need to be in place before any major commitment is made. In obtaining the necessary finance to acquire the land and build the scheme, you will be exposed to any fluctuations in interest rates during the development period. However, at a cost, you can either fix or cap the interest rate. The terms of long-term finance negotiated before the development are likely to be less favourable than those that can be

negotiated upon completion, although you can secure both together.

CONSTRUCTION RISK AND COST

The construction cost is the second major financial commitment.

Construction risk refers to the risk that construction will be delayed potentially due to variations or late information, labour becoming unavailable, labour and materials costs rising during the course of works (partly due to inflation) or that unexpected events cause sudden escalations in the cost.

The more technically demanding, large, complex and long the build programme is, the higher the risk.

There are some ways of making the construction cost more certain by passing all or some of the risk and design responsibility onto the contractor, although greater certainty of cost usually means a higher cost overall. Good project management is vital to preventing increases in cost and time delays. You should question every aspect of the building contract in order to manage any problems as they arise.

MARKET CYCLE RISK AND VALUES

Market cycle risk is the risk that during the course of the development market demand for the development changes. The longer the development programme, the more uncertainty there is in the prevailing market,

local or global economy, the higher the risk that the market could change to the developer's detriment before the delivery of the scheme.

Rental values for affordable housing tend to be well defined and increase in line with set formulas or local incomes etc, rather than the speculative property market. However values may be more closely linked to the property market (for example as a percentage of market values)

It is essential to obtain the most reliable, up-to-date value estimates. Due to the complexity of the property market, valuers are unable to predict future changes in property values with a high degree of certainty. You therefore shouldn't try to predict future values, even when construction costs in the appraisal grow at current inflation rates, as this would expose you to more risk. It cannot always be assumed that rises in construction costs during a development, will be saved by rises in values. However, the level of uncertainty associated with achieving an estimated sales value can be removed if a pre-sales or off-plan sales can be achieved.

The benefit of a pre-sale reducing risk has to be weighed against the opportunity costs of achieving a potentially higher value in a rising market. Although there may be an advantage in reducing void periods before income is received, as the building will be handed over on completion without further interest payments.

COMPARABLE VALUATION

Although the residual method is usually preferred for development projects, the comparable method of valuation is commonly used by valuers for other property valuations.

The comparable method is typically adopted in markets with enough recent evidence of similar transactions. It involves searching for recent transactions that give an indication of the price the market would pay.

Land transactions that can act as comparable guides to the price that can be achieved on a site, should be similar to the site in the following ways:

- situated nearby or in a similar type of location to the subject site
- of the same planning category or permissions as the subject land (e.g. both sites have planning permission for industrial use);
- identical or similar in respect of the utilities present or near the site (e.g. both sites have water, electricity and gas present and capped on site or access at the edge of the site);
- topographically like the subject site (e.g. both sites are flat and have vegetation);
- with similar access to transport links (e.g. both sites have direct highway access);
- surrounded by similar infrastructure (e.g. both sites are situated in the town centre with good access to the surrounding retail, leisure and town centre amenities);
- situated in a position with access to a similar socio-demographic profile as the subject site (e.g. both sites are situated close to small towns with affluent catchments);
- not too historic to be irrelevant to the current valuation (e.g. a transaction that

took place 2 years ago may not be relevant to a valuation where the market has changed significantly over that period).

The above list is not exhaustive. It gives an indication of the thinking adopted by valuers. Other factors may need to be considered depending on the value drivers for the type of development. For example when assessing land value for a retail development or an office development.

After establishing relevant comparables, the valuer usually adjusts the sale prices evidenced by these transactions to reflect differences between the comparable land's value driving factors/characteristics and those of the subject land. This is often practically achieved either:

- through an implicit adjustment to the prices achieved on the comparable sales by an experienced valuer; or
- through a more explicit process of listing each value factor and applying a premium or discount to the comparable price achieved to reflect an adjustment due to differences between the comparable and the land/site being valued.

Valuing land with the comparable method can be tricky as it is difficult to find suitable comparables and any attempt to 'equalise' the differences can become a fruitless and unverifiable exercise. Land transactions also lack the transparency of other property transactions. It is not easy to find out how the deal was structured and influencing factors. The residual method usually offers a more rational alternative as to what a potential purchaser ought to pay, although the comparable method may be used to determine GDV.

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