RICS

## Residual valuation

Status of current RICS guidance and a focus on the 'reasonableness' of assumptions

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RICS

## Objectives of paper

RICS

- Outline current RICS Guidance on Development Appraisal and Development Viability Assessment (DVA)
- Examine developments in residual valuation methods and applications
- Examine the application of residual valuations to DVA

## Context

RICS

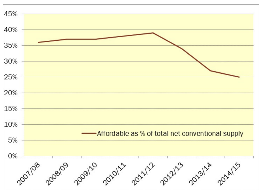
- Little development of technique over last 30 years
- Textbook coverage very basic
- No academic or professional public critique of method
- Nothing like the same interest as in investment appraisals which have taken off relatively over the last 40 years
  - Reasons difficult to judge –
    - Variability of outcomes makes development decisions more intuitive?
    - No real public scrutiny - until now with DVA
    - Are we now at the centre of a storm?

## RICS Guidance Development Appraisal

- RICS Valuation Information Paper 12 - The Valuation of Development Land
  - 2008 – getting a bit past its sell by date – current re-write with anticipated publication this year
  - Incorporates a traditional text book approach which struggles to identify different approaches to inputs required for Traditional versus Cash Flow approaches to residual valuations
  - New Guidance Note will make those distinctions

## RICS Guidance Development Viability

- RICS Guidance Note – Financial Viability in Planning
- 2012 – application of development appraisal to development viability assessment (DVA) within the planning system
- Dev App now at the centre of the planning system
- Levels of affordable housing completions in London – permissions 2014/15 = 13%
- Is RICS Guidance partly to blame for this reduction?
- Supplementary note in preparation by RICS for publication this year




Source: Annual London Plan Monitoring Reports as reported in Sayce, et al (2017)

## Residual Valuations

### Reasonableness of inputs

- Traditional residuals (and cash flow residuals taking a similar stance on inputs to the residual) have been characterised as assuming:
  - Current values and costs are used throughout the development period
  - Construction related costs are spread evenly through the development period
  - 100% debt financing on both the construction and related costs and the land value
  - Profit is expressed as a lump sum at the end of the development, and
  - Profit is expressed as a proportion/percentage of development value or costs.

## Residual Valuations

### Reasonableness of inputs

- Finance/investment appraisal theory and practice would suggest
  - Traditional residual format is now completely unnecessary in a modern age with plenty of cash flow applications available (most of those will tell you what the actual internal rate of return is even if you undertake the valuation by a traditional residual)
  - Finance should not be taken into account in the project cash flow
  - Profit should be expressed as a rate of return (IRR). Return on cost/value measures are not time dependent therefore need adjusting for different development periods.
  - Nominal rates of return should be matched with actual prospective cash flows (forecasting) or real rates of return should be used.

## Current costs and values

- What happens to a residual site value of £715,000 based on current values and costs when rental/capital values and costs rise in 5% steps by 20%?
- What if current tender prices include growth expectations already?
- Would £715,000 represent a fair price

| | Rental Value | | | | |
|---|---|---|---|---|---|
| **Construction Costs** | ***£200*** | £210 (5%) | £220 (10%) | £230 (15%) | £240 (20%) |
| ***£969.0*** | ***£715,446*** | £863,016 | £1,010,586 | £1,158,156 | £1,305,726 |
| £1018.5 (5%) | 617,564 | £765,134 | £912,704 | 1,060,274 | £1,207,844 |
| £1067.0 (10%) | £521,659 | £669,229 | £816,799 | £964,369 | £1,111,939 |
| £1115.5 (15%) | 425,755 | £573,325 | £720,894 | £868,464 | £1,016,034 |
| £1164.0 (20%) | £329,850 | £477,420 | £624,990 | £772,560 | £920,129 |

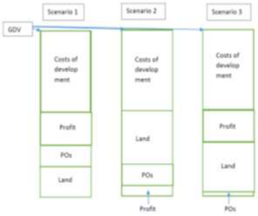
## DVA Applications

- RICS Guidance Note 2012 - "An objective financial viability test of the ability of a development project to meet its costs including the cost of planning obligations, *whilst ensuring an appropriate site value for the landowner* and a market risk adjusted return to the developer in delivering that project."
- The task is to balance the gains from the granting of planning permission between the three parties
  - Incentivise the landowner to release their land for development
  - Give the developer a return for risk of undertaking development
  - Reward the community for the gift of development gain.
- So the objective is clear – POs must not stifle development
- The application of residual valuations is the vehicle for this

## The residual trap

**DVA is a game of pass the residual parcel. If you can leave your opponent holding the residual they are the ones who pay for any "overpayments"**

- GDV £1m, Costs £500k, POs £90k Normal Profit £200k Land EUV £100k.
- Normally should result in the landowner getting in Scenario 1 £210k (policy compliant Land Value) for the land with development, and more than enough to make it worthwhile bringing to market.
- Scenario 2 – Developer pays £300k for the land (overpays). They should take the hit in Scenario 2 with their profit squeezed to £110k or 11% of GDV.
- Scenario 3 - if they can persuade the planning inspector that the land price they paid was fair, the POs become the residual and they then get £10,000 and the community gets no affordable housing




## DVA decisions

- National Planning Guidance (PPG Para 14) lays the foundations for the appraisal. Suggests that the land or site value should in all cases;
  - "Reflect policy requirements and planning obligations and, where applicable, any CIL charges:
  - Provide a competitive return to willing developers and landowners; and
  - Be informed by comparable market based evidence wherever possible. Where transacted bids are significantly above the market norm, they should not be used as part of the exercise."
- Issue here is that PPG implies that if prices can be proved by other market evidence, they are policy compliant. The market evidence test overrides the policy compliant test.

## RICS Guidance

- ...has been used by some to support the Scenario 3 approach.
- Scenario 3 requires systematic overpaying for land across the market to lead to systematic under provision of policy compliant POs – which is exactly what is happening given the consistent fall in AH in London.
- However, RICS guidance supports the *policy compliant* market value. This rider was expressly added to stop the residual being passed on to the LPA
- So RICS Guidance should not be used to support this transfer of development value from the LPA to the landowner
- I am hoping the supplementary note to the RICS (2012) Guidance Note will make this absolutely clear
- RICS has a public interest remit and should never forget it. And Expert Witnesses should inform the Inspectors, not advocate for clients