

Valuation of development land



Valuation Information Paper No. 12

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Valuation Information Papers

This is a Valuation Information Paper. Valuation Information Papers are intended to provide information and to outline current practice for RICS members. The function of this paper is to discuss valuation methodology and the regulatory context and thus give an indication on the approach to issues that may arise in the subject to which it relates.

Valuation Information Papers are relevant to professional competence and in order to keep up-to-date valuers should have informed themselves of their content within a reasonable time of their promulgation.

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1 Introduction

- 1.1 A valuation of property that is considered to be suitable for development, or redevelopment, may be required for many reasons. These may include advice on loan security, acquisition, sale, valuation of options, capital taxes, planning purposes and appraisals.
- 1.2 This Information Paper discusses the approach to the valuation of property where the proposed development is of a cleared, or greenfield site, or the site is to be redeveloped by removing all, or substantially all, of the existing buildings and constructing new buildings. These various scenarios are referred to throughout as 'development land'.
- 1.3 This Information Paper does not apply to redevelopment based on a refurbishment of existing buildings, with limited demolition. For instance, the conversion of a multi storey commercial property to residential use where the original structure is retained. It does not specifically relate to valuations for land in the course of development which is covered in UK Appendix 1.2, para. 3.8. However, the principles are similar and this Information Paper may be of assistance in the approach to such valuations.
- 1.4 Development schemes can vary from single or multiple residential schemes to industrial estates, a shopping centre or a New Town. Although there may be differences between, say, a valuation prepared for a proposed acquisition or sale and an appraisal by a developer in connection with its own business model it is considered that the principles are the same. This Valuation Information Paper deals with the principles underlying the valuation approach.
- 1.5 There are two approaches to the valuation of development land:
- comparison with the sale price of land for comparable development; or
 - assessment of the value of the scheme as completed and deduction of the costs of development (including developer's profit) to arrive at the underlying land value. This is known as the residual method.
- In practice it is likely that a valuation would utilise both approaches, and the degree to which either, or both, are relevant depends upon the nature of the development being considered, and the complexity of the issues.
- 1.6 Valuation by comparison is essentially objective, in that it is based on an analysis of the price achieved for sites with broadly similar development characteristics. The residual method, in contrast, relies on an approach that is a combination of comparison and cost and it requires the valuer to make a number of assumptions – any of which can affect the outcome in varying degrees.
- 1.7 The aim of this Information Paper is to assist the valuer in the approach to development land valuations which are site specific and unique. However, these types of valuation can be very complex and relate to specialised markets. Therefore they require a high level of expertise. Valuers are reminded that PS 1.5 (Knowledge and skills) states that they must possess the skills and knowledge to undertake the valuation competently, and recognise that assistance may be needed from other professionals.

- 1.8** In accepting instructions the valuer will need to include in the terms of engagement (see PS 2.1) an indication of the large number of matters to be agreed.
- 1.9** This Information Paper has been written specifically with regard to practice in the United Kingdom. However, members operating in other states may find the process of valuation discussed helpful and capable of adaptation to their local circumstances.
- 1.10** To reflect the approach to this type of valuation this Information Paper has been divided into the following sections:
- Establishing the facts;
 - Assessing the development potential;
 - Valuation by the comparison method;
 - Valuation by the residual method;
 - The residual method;
 - Assessing the land value;
 - Reporting the valuation.

2 Establishing the facts

- 2.1 To judge the certainty of the outcome of the valuation, and the processes involved, it is essential that the valuer has an awareness of the characteristics of the existing site and an adequate knowledge of each of the development components. The level of detail that is appropriate when assessing development potential varies according to the purpose of the valuation. Judgement is required as to what is appropriate in each case.
- 2.2 The level of information available for a residual valuation is determined by the stage at which the valuation is being prepared. For example, a valuation in advance of an acquisition is based on less certain estimates than if the land has been held whilst planning has been progressed, or the valuation is at a date where the redevelopment has commenced. It may therefore be necessary to review the valuation as more detailed information becomes available.

Inspection and site specific information

- 2.3 Valuers are reminded that sites for potential development may contain many hazards. A guide to personal safety at work, *Surveying safely*, has been published by RICS and is available from www.rics.org in the knowledge zone.
- 2.4 Physical inspection of the site, and related enquiries, will reveal site specific information. Such information, either positive or negative, could include the following, which are not intended to be exhaustive or to apply to every case:
- extent of the site – in order to ascertain frontage, width and depth, gross and developable areas;
 - shape of the site and ground contours – ideally in the form of a topographical survey;
 - history of previous, and risk of future, flooding;
 - sizes of any existing buildings. Where buildings are to be retained it is recommended that measurements are taken in accordance with the RICS *Code of Measuring Practice*, available from www.rics.org.
 - existing building height and that of adjoining properties;
 - efficiency of existing building(s) (if to be retained);
 - any matters that may result in excessive abnormal costs (such as constrained site conditions, and poor or limited access), from development and occupational perspectives.
 - party wall, boundary and rights of light issues;
 - geotechnical conditions;
 - evidence of, or potential for, contamination;
 - availability and capacity of infrastructure (such as roads, public transport, mains drainage, water, gas, electricity and telephony);
 - evidence of other head or occupational interests in the property, whether actual or implied by law;
 - physical evidence of the existence of rights of way, easements, encumbrances, overhead power lines, open water courses, mineral workings, tunnels, filling, tipping, etc.;

- an assumption may be made that the land is owned by the client. Where other ownership arrangements are revealed, for instance in joint ventures, the valuer needs to establish the full details and agree with the client how the valuation is to be reported (see para 8.1);
- where there have been preliminary legal investigations, information may be provided by the client concerning details of easements not apparent on inspection (for instance underground utility easements), restrictive covenants, rights of way, rights to light, drainage or support, registered charges, etc.;
- the presence of archaeological features. These may be evident, or there may be a high probability of their presence due to the site location (for instance, close to city centres);
- evidence of waste management obligations and whether those obligations have been fulfilled; and
- water or mineral extraction rights that may be available.

2.5 Existing planning matters

The planning regimes in England, Wales, Scotland and Northern Ireland have differing legislative and regulatory controls. The extent of the enquiries that are necessary and appropriate vary in each case but the following matters may need investigation:

- in England and Wales: The Local Development Framework (LDF) and the Regional Spatial Strategy. Also, where a LDF has not been fully implemented the extant Structure Plans, Local Plans and Supplementary Planning Guidance;
- in Scotland: Local Development Plans and Strategic Development Plans. Where these have not been developed the extant Structure Plans and local plans are also required;
- in Northern Ireland: Area Plans, Regional Development Strategy and Planning Policy Statements;
- the existence of a current planning permission. This may be outline or full and may include conditions or reserved matters;
- where the permission is time limited it is necessary to establish if it is still valid and, if close to expiry, if a similar permission would be granted again;
- regulations that specify the extent to which development of the site might be permissible without the need for a planning application or consent;
- the permitted use of existing buildings (if to be retained), or the possibility of identifying an established use;
- legally binding agreements that have been, or are to be, documented, in order to secure the grant of planning permission;
- any special controls that may apply to the site or buildings included (for example, conservation area designation, green belt, tree preservation orders, listed buildings, etc.);
- requirements to protect or enhance environmentally sensitive features such as SSSIs or water courses, and to comply with the relevant environmental protection legislation; and
- any requirements for view corridors, sight lines or buffer zones.

3 Assessing the development potential

- 3.1 Where the current permission(s) is not considered to be the optimum permission for which there is a reasonable prospect, having regard to the applicable planning regime, it may be necessary to form a view as to what permission is likely to be obtained and the associated planning agreements that would be required to obtain that consent. This includes consideration of published planning policies recognising that they heavily influence future additions to the supply of particular types of building. Emerging consultative planning policies may also be relevant, including national or regional guidance that may be taken into account when deciding planning applications and, in the longer term, may influence the supply of competing space or otherwise affect the value of the completed scheme.
- 3.2 An accurate assessment of the form and extent of physical development that can be accommodated on the site is essential having regard to the site characteristics, the characteristics of the surrounding area, and the likelihood of obtaining permission. In more complex cases it is recommended that this assessment is undertaken in consultation with appointed project consultants, such as architects, quantity surveyors, and environmental and planning consultants.
- 3.3 Matters that may be considered include:
- the period estimated to complete the new buildings;
 - achieving a high efficiency ratio (net internal area expressed as a percentage of the gross external area), which may be affected by car parking standards, without compromising quality;
 - environmental issues that may have a material bearing on the success of the project (sufficient enquiries need to be made to establish whether the presence of on-site or neighbouring environmental features influence the development process, the density or even the viability of the scheme);
 - the extent to which the planning system is being used to help deliver climate change obligations. (Some planning authorities employ policies stipulating the minimum amount of energy that must either be produced on-site or else obtained from renewable sources. This may be evidenced by the incorporation of conditions incorporating renewable and/or low carbon measures as standard requirements.)
- 3.4 Although the valuation is required of the actual site there may be a possibility of increasing the development potential by acquisition of, or merger with, adjacent land. Conversely it may be necessary to acquire adjacent land, or rights over adjacent land, before the proposed development could take place. The likelihood of resolving such matters and whether such matters are to be reflected in the valuation require discussion with the client.
- 3.5 The valuer needs to liaise closely with both the appropriate planning authorities and the client to ensure that the appraisal reflects fully the various aspects of the proposed development.

The development programme

3.6 An outline programme may be provided but its achievability needs to be assessed. It might include the following components:

- the pre-construction period;
 - site assembly, obtaining vacant possession, negotiations with adjoining owners, extinguishing easements, or removing restrictive covenants, rights of light etc, negotiating the planning process, agreeing architectural and engineering design and/or solutions, soil investigations, the building contract tender period, etc.; and
 - negotiating the form, extent and value of the building contract(s), including demolition and any necessary site preparation (it may be appropriate to seek advice from an environmental, quantity or, building surveyor, mechanical engineer or architect);
- the principal construction period;
 - site preparation (certain enabling works may be necessary in complex cases – these may include an archaeological dig, demolition, de-contamination or the provision of infrastructure prior to the main works commencing); and
 - main build , which may reflect phasing; and
- the post-construction period;
 - usually understood to be the period from completion of the construction contract until one of : the full letting , sale or re-finance of the completed development; and
 - any defects liability period.

Analysing the market

3.7 In considering the development potential it is necessary to establish the potential demand for the optimum alternative forms of development that may be possible. Clearly it would not be appropriate to consider building a high specification office block in an area where there is no, or limited, demand for such a property. Matters to be considered could include, but not exclusively:

- an owner occupier's preferences for particular design features, building layouts and specifications (that is, the degree of specialisation and its impact on marketability);
- investors' requirements;
- the location;
- access and the availability of transport routes;
- car parking facilities;
- amenities attractive to tenants and/or purchasers;
- the scale of the development in terms of sale or lettable packages;
- the form of the development; and
- market supply, including actual or proposed competing developments.

4 Valuing by the comparison method

- 4.1 Valuation by comparison is only reliable if evidence of sales can be found and analysed on a common unit basis, such as site area, developable area or habitable room. Although comparable sales can be analysed in unit terms there are many other factors that determine the price paid and unit comparison may not, in a particular case, be the most significant. Enquiries may also reveal recent marketing, or even transactions, of the site. Even where reliable information is not available the comparison method can provide a useful check of a valuation prepared using the residual method.
- 4.2 Typically, comparison may be appropriate where there is an active market and a relatively straightforward low density form of development is proposed (for example, if the land is greenfield within a rural economy where infrastructure costs are consistent and not excessive, or small residential developments, and small industrial estates), and it is likely that the density, form and unit cost of the development will be similar. Less frequently, it may be possible to compare larger sites for housing developments on this basis.
- 4.3 In comparing sites the following factors, which are not exclusive, may be relevant:
- values may differ considerably within a small geographical area;
 - the condition of the site and associated remediation costs are very site specific and could differ significantly between greenfield and brownfield, and between brownfield, sites;
 - site and construction costs, for example, in terms of infrastructure and service requirements differ;
 - the type of the development will vary and may reflect a requirement to provide affordable housing. In the case of residential developments the density achieved can also affect the price;
 - the price may be affected by planning obligations; and
 - in a rapidly changing market, the date of the sale of the comparable is relevant.
- 4.4 Generally, high density or complex developments, urban sites and existing buildings with development potential, do not easily lend themselves to valuation by comparison. The differences from site to site (for example in terms of development potential or construction cost) may be sufficient to make the analysis of transactions problematical. The higher the number of variables and adjustments for assumptions the less useful the comparison. Comparison is rarely appropriate where construction has begun.
- 4.5 Where the comparative method is used it is assumed that the valuer adopts standard valuation techniques. However, some of the elements of a residual valuation may also be relevant to a valuation on this method.

5 Valuing by the residual method

- 5.1 Where the nature of the development is such that there are no (or limited) transactions to use for the comparative method, the residual method provides an alternative valuation approach. However, even limited analysis of comparable sales can provide a useful check as to the reasonableness of a residual valuation.
- 5.2 The residual method requires the input of a large amount of data, which is rarely absolute or precise, coupled with making a large number of assumptions. Small changes in any of the inputs can cumulatively lead to a large change in the land value. Some of these inputs can be assessed with reasonable objectivity, but others present great difficulty. For example, the profit margin, or return required, varies dependent upon whether the client is a developer, a contractor, an owner occupier, an investor or a lender, as well as with the passage of time and the risks associated with the development.
- 5.3 The client's instruction may ask for advice taking into account the client's specific circumstances. For instance, in recommending how much to bid for the purchase of a site based on the construction costs that can be delivered by the client as a contractor. Such opinions may be a calculation of worth (see PS 3.4 and the reporting requirements in the commentary) and will not represent Market Value. For more information about the calculation of worth for assets in general see the RICS Information Paper *Calculation of Worth* which is available from www.rics.org in the knowledge zone.

6 The residual method

- 6.1 Having established the development potential a residual valuation can be expressed as a simple equation:

$$(\text{value of completed development}) - (\text{development costs} + \text{developers profit}) = \text{land value}$$

Each element of this equation is discussed in the following paragraphs.

Value of completed development

- 6.2 The value to be adopted is the Market Value of the proposed development assessed on the special assumption that the development is complete as at the date of valuation in the market conditions prevailing at that date. This is widely referred to as the Gross Development Value (GDV).
- 6.3 For some developments, particularly residential, the approach may be to adopt the total of the values of the individual properties. In other cases an additional special assumption may be that the completed development is let and income producing rather than available for sale or letting.
- 6.4 As the GDV does not incorporate an allowance for purchaser's costs the net proceeds are more often aligned to the Net Development Value, which reflects the transaction costs that would be incurred if the completed development was sold, again, on the date of valuation.
- 6.5 The finance costs, notional or actual, are included in the residual value calculation and therefore there is no need to adjust the GDV to reflect these.

Development costs

Obtaining planning permissions and associated matters

- 6.6 Where there is no existing planning permission for the project it is necessary to allow for the costs of obtaining that permission. Where the development may be contentious allowances may be made for the potential additional costs, including delays caused by appeals and/or inquiries, (these include fees and additional holding costs and may extend to creating models, lobbying, etc.). This heading would not normally include any deferment of the scheme as a whole due to the contentious nature of the development as such matters would properly be reflected in the final assessment of the land value, (see para. 7).
- 6.7 The impact of legally binding agreements linked with the grant of planning permission has to be considered. The obligations usually, but not always, are deliverable on-site but, for instance, in the provision of local, or wider, highways provision could be elsewhere. The requirements might be for a cash payment, the provision of community facilities, affordable housing or providing enhanced public transport. Also the timing of the payments, or the fulfilling of the obligations, may be relevant in these cases.

- 6.8** There are various matters relating to statutory and regulatory obligations that may have to be considered. Such matters, which could incur significant costs, could include:
- listed building consents and associated negotiations with English Heritage, Historic Scotland, or similar bodies.);
 - the accommodation of archaeological surveys or digs;
 - environmental protection during demolition and construction;
 - obtaining necessary approvals under Building Regulations; and
 - inspections of residential development related to new-build insurance schemes.

Acquisition costs

- 6.9** These include agents' fees, legal costs and stamp duty land tax that would be incurred on the acquisition of the land prior to the commencement of the development.

Site-related costs

- 6.10** It is necessary to consider the costs to be incurred before the main construction activity can proceed. These include:

- the cost of meeting any environmental issues. (Whilst this can relate to any remedial works it can also reflect important conservation or flood protection requirements. Such costs have to be provided by an appropriate expert);
- there may be an obligation to remove contamination, and the consequential waste management obligations, and special environmental provisions to abate noise or control emissions;
- there may be ground improvement works needed before the main construction period begins to make the site safe for development (liaison with a civil and/or structural engineer may be necessary);
- any archaeological investigation costs may be borne before the main contract is let (the time to undertake such work and its cost needs to be understood);
- diversion of essential services and highway works and other off-site infrastructure costs;
- creating the site establishment and the erection of hoardings;
- the costs of conforming to appropriate health and safety regulations during the course of the development; and
- there may also be issues surrounding sustainability that may have a direct bearing on the site (in England this can include the provision of Sustainable Urban Drainage Schemes (SUDS) and site specific transport plans).

- 6.11** If appropriate, it may be necessary to estimate the costs incurred in securing vacant possession, acquiring necessary interests in the subject site or adjacent property, extinguishing easements or removing restrictive covenants, rights of light compensation, party wall agreements, etc. Realistic allowances have to be made, reflecting that the other parties expect to share in the development value generated.

- 6.12 The letting out of advertising space on hoardings or the securing of short-term tenancies (for example, surface car parking) can help to offset finance costs before and during the development phase.

Phasing of the development

- 6.13 Larger schemes are likely to be phased over time. Phasing of the infrastructure provision or distinct elements of a complex development site may be as a result of planning requirements. For example, that the car parking provision and highways improvements are complete prior to occupancy, or to maximise cost savings in labour or materials. These are reflected in the developers' cash flows when formulating their bids and are likewise be reflected in any valuation of such property. In such cases it would be appropriate to reflect the deferment of some of costs, listed in the following paragraphs, to a date when it might be reasonable to expect them to be incurred. Similarly, not all receipts occur simultaneously.
- 6.14 In many cases where individual buildings or units may be sold, particularly where the development includes residential properties, the sales may be achieved over a period that may start before the development is completed and be phased over a long period of time. In these circumstances the income is to be recognised in the cash-flow at the appropriate time and the incidence of the relevant costs needs to reflect the actual timing of such payments.

Building costs

- 6.15 A reasonably accurate estimation of the building costs, at the valuation date, of the development is a major component in a residual valuation. In other than the most straightforward schemes it is recommended that the costs be estimated with the assistance of an appropriately qualified expert. Detailed costings are conventionally based on the Gross Internal Area (GIA) (see the RICS *Code of Measuring Practice*) and are usually recorded on this basis in reference books. Care is to be taken to check that calculations provided by other professionals are on the basis of GIA.
- 6.16 The residual method is very sensitive to variations in the estimated costs and the accuracy with which costs can be assessed may vary greatly according to the specific site characteristics or the requirement, or plan, to retain specific structures, any unusual building specifications and the extent to which a new building has to reflect relevant sustainability policies. Therefore, the use of reference books, and websites, including the BCIS website, are considered to be only guides and undue reliance on them can compromise the accuracy of the valuation.
- 6.17 The choice of procurement route imposes differing responsibilities on the parties and is a key consideration in determining the building cost. Reference is often made to a fixed price contract. Whilst this does allow for inflation it is only fixed to the extent of the works outlined in the contract. A contractor can amend the pricing if any variations to the specification are made, or unforeseen events occur.
- 6.18 It is essential that the valuer understands which route has been, or is likely to be, chosen. The suitability for the particular development and the implications

of that choice on the relevant elements of the residual calculation may require recourse to other surveying disciplines.

- 6.19** In all cases the inclusion of a contingency allowance to cater for the unexpected is essential. The quantum which is usually reflected as a percentage of the building contract sum is dependent upon the nature of the development, the procurement method and the perceived accuracy of the information obtained.

Fees and expenses

- 6.20** The incidence of fees and expenses can vary significantly according to the size and complexity of the development. The following items may need consideration:

- professional consultants to design, cost and project manage the development – The development team normally includes: an environmental and/or planning consultant, an architect, a quantity surveyor and a civil and/or structural engineer. Additional specialist services may be supplied as appropriate by mechanical and electrical engineers, landscape architects, traffic engineers, acoustic consultants, project managers and other disciplines, depending on the nature of the development;
- fees may be incurred in negotiating or conforming to statutory (for example Building Regulations) or planning agreements;
- the costs of conforming to the relevant health and safety regulations during the course of the development;
- legal advice and representation at any stage of the project;
- lettings and sales expenses – where the development is not pre-sold, or fully pre-let, as a single unit this item includes incentives, promotion costs and agents commissions. The costs of creating a show unit in a residential development may also be appropriate;
- rent free periods, whether as an incentive or recognising the tenants fitting out period. These may be reflected by either:
 - continuing interest charges on the land and development costs until rent commencement. This approach is usually favoured by the financing arrangers; or
 - taking account of the costs in the valuation of the completed development. This approach is usually favoured by investors because there is an assumption that market conditions will not change;
- costs related to the raising of development finance (these can include the lender's monitoring surveyor's fees and legal fees); and
- in some cases the prospective tenant/purchaser may incur fees on monitoring the development (these may have to be reflected as an expense where they would normally be incurred by the developer).

Interest or financing costs

- 6.21** Interest is incurred on land and development costs. It is either paid when due or deferred (rolled up) throughout the projected programme during the pre-contract, contract, and post-contract stages. An allowance is to be made to reflect the opportunity cost of the monies, even if the developer is funding the project internally, on the assumption that the completed fully let and income

producing development is to be sold, or long-term finance obtained on its transfer to the developer's investment portfolio. This allowance is also included where the development is to be owner occupied.

- 6.22** It is usual for interest to be treated as a development cost up to the assumed letting date of the last unit, unless a forward sale agreement dictates otherwise. In the case of residential developments the sales of individual units may occur at various stages during the development and appropriate assumptions have to be made regarding cash flow, both inward and outward. The rate of interest adopted reflects the levels adopted in the market for the type of scheme involved.
- 6.23** The approximate timings for the pre-construction, principal construction and post construction periods have to be determined. The valuer is recommended to liaise with the client, such professionals as might be appointed, or colleagues with relevant experience, to assess an appropriate, realistic time frame for each of the phases.
- 6.24** Conventionally the chosen interest rate is usually compounded, either quarterly or annually in line with the current market practice.
- 6.25** In applying interest two approaches are commonly used:
- Straight line:** This assumes that the preliminary costs are incurred at the valuation date and the principal development costs are incurred in equal tranches and at regular and equal intervals throughout the development. The post development costs are assumed to be incurred at the start of that period.
 - S-curve:** The weighting of the build costs be may be incurred early in a scheme, (for instance in industrial development), or at a later stage, (for instance hotels and high value residential development). The purpose of an s-curve is to reflect more accurately the incidence of the costs in a particular scheme. This approach is sophisticated and specialised, and, if used without the necessary expertise, is as likely to produce less accurate values as it is to produce accurate assessments.

Holding costs

- 6.26** The attendant costs (excluding interest) in holding the completed building up to the assumed date of the final letting or sale, including such items as insurance, security, cleaning and fuel. A proportion of the service charge on partially let properties may have to be included together with any potential liability for empty rates.

Tax relief and grants

- 6.27** In some areas and on some properties special allowances, or grants, may be available to the developer. These may relate to the cost of remediation of contaminated land, promotion of job creation, or assistance to ensure that a scheme proceeds. The availability of such funds needs to be established with the relevant government office and the possibility of their availability being changed, or withdrawn at short notice, is to be recognised.
- 6.28** Capital allowances might be available on the cost of plant and equipment and certain buildings. They are available as an expense of the business being carried

on by the property owner, whether that is as an owner occupier or an investor. They are not available to developers, unless the property is to be retained as an investment.

- 6.29 The worth of capital allowances is not assessable by way of a formula as they are dependent on the particular circumstances of the property owner. They are not usually explicitly included in development appraisals, but their potential availability may be reflected in the price offered by certain clients.

Value added tax

- 6.30 The decision as to the inclusion of VAT is best resolved by discussion with the client but, in the absence of explicit instructions, the Valuer may have regard to current practice in respect of the election to tax for the type and location of property concerned. In more complex developments it may be necessary to explicitly include the incidence of both payments and recoveries of VAT. Any assumptions made are to be stated in the report.

Developer's profit

- 6.31 The nature of the development, and the prevailing practice in the market for the sector, helps to determine the selection of the profit margin, or rate of return, and the percentage to be adopted varies for each case.
- 6.32 It is usual to assume that the developer seeks either a capital profit expressed as a percentage of the total development cost (including interest) or of GDV. The former approach is more common. The latter derives from the traditional financing of commercial developments where the completed property is sold to a long-term investor. Although the valuer has to exercise judgement on the figure to be incorporated, it may be helpful to obtain the client's views.
- 6.33 It is also common practice for development companies who retain completed schemes in their investment portfolios to judge the success of a scheme in terms of the enhancement of the balance sheet (net asset value (NAV)) rather than the profit and loss account (income).
- 6.34 There are, however, other criteria that are sometimes adopted. These include:
- **Initial yield on cost** – The net rental return calculated as the initial full annual rental on completion of letting expressed as a percentage of the total development cost. This criterion may be significant in establishing whether the developer could service a long-term mortgage loan, or for evaluating the effect of the development scheme on the profit and loss account of the company;
 - **Cash-on-cash (or Equity Yield)** – The capital uplift or (more usually) net income (after interest charges on any long-term mortgage loan) expressed as a percentage of the long-term equity finance provided by the developer;
 - **Interest on capital employed** – A technique that has regard to the rate of return on actual costs expended calculated net of interest and corporation tax;
 - **Discounted Cash Flow (DCF) methods** – The income stream is projected with explicit assumptions about rental growth and discounted back to a net present value (NPV) using an appropriate discount rate; the scheme is deemed viable if NPV exceeds the total development costs. The discount

rate includes an allowance (profit margin) for the management requirements and risk of investing in a development project rather than an existing fully let property. This approach is particularly appropriate for large, phased schemes;

- **Equated yield (or Internal Rate of Return (IRR))** – A variant of DCF in which the yield is defined as the discount rate which equates NPV with total development cost. For further information on the DCF method see the RICS Information Paper *Commercial property valuation methods* available from www.rics.org in the knowledge zone;
- **Amount of cover** – The extent to which the rent or sale price can be reduced, or the letting or sale period extended (often expressed as a number of months of rolled-up interest or loss of rent) without suffering an overall loss on the scheme.

6.35 The appropriate level of profit to be assumed in the appraisal cannot be specified in this Paper as market requirements vary from project to project and from time to time. Evidence may be deduced (with difficulty) by analysing transactions, but it is better obtained from the valuer's knowledge of the market or of developers' requirements.

6.36 In any event, the appropriate profit to be expected from a particular development may be influenced by a number of factors which might lead to the departure from the market 'norm'. High amongst these is the certainty of the information available to the valuer, and the general risk profile (for example, whether the interest rate is fixed, whether the scheme is pre-let or pre-sold) but the scale of development, the amount of financial exposure and the timescale are also relevant.

7 Assessing the land value

- 7.1 Where a comparative approach has been followed the land value is determined at an early stage. However the valuer may wish to check the result against a simplified residual valuation, or consider if any of the factors explicit within a residual valuation, (such as specific planning or site characteristics), have not been appropriately reflected in any adjustments that the valuer has made to the comparables.
- 7.2 Where a residual approach has been followed the valuer draws together the various elements and, having established the completed value, by deduction of the various costs determines the residual land value.
- 7.3 The residual value is not necessarily the same as the value of the land as it has to be considered in the context of the valuation as a whole. The following matters may have an impact on the residual value and need to be addressed before the final conclusion is reached:
- Some elements of the calculations may be very sensitive to adjustments and, although these may be reflected in the cost calculations, such sensitivities may also be reflected in an adjustment to the residual value. A sensitivity analysis, for instance a 'Monte Carlo' simulation, may be undertaken and the results incorporated into the report;
 - If at all possible an attempt can be made to compare the result with such market evidence as may exist because the residual method sometimes produces theoretical results that are out of line with prices being achieved in the market. For example, in a large, phased scheme (such as a major residential development) cash-flow constraints may prevent the theoretical value being realised (that is, there may be a quantum discount that applies in the market). Similarly, in some circumstances, for instance where site remediation costs are very high, the residual appraisal may produce a negative figure. There is plentiful experience of sites finding buyers even though a residual valuation shows a nil, or negative, value. This does not negate the requirement in PS 6.8 that negative values should be reported if appropriate.

8 Reporting the valuation

- 8.1** The precise nature of the report depends upon the instructions given and its purpose but regard must be had to the requirements of PS 6.1 (a) to (s) and in particular:
- the basis of valuation must be clearly stated. Where a basis other than Market Value is adopted this must be fully explained. (PS 6.1(f));
 - all the assumptions made must be stated and, where appropriate, comment made on the effect of those assumptions where they are material. (PS 6.1 (k)); and
 - the statement requiring comment on the valuation approach is particularly important in these valuations (PS 6.1 (q)).
- 8.2** It may be appropriate to present an appraisal based on provable values alongside a sensitivity analysis to show the effect on the land value of differing assumptions as to the future rent and yield. The aim is to assist the client in assessing the likely land value by reference to present and future market trends, and the likely shifts in supply and demand. Wherever possible, the treatment and presentation of these issues is to be discussed with the client.
- 8.3** In some cases the client may request the valuer to identify any hope value that may be reflected in the valuation. Hope value is the popular term for the element of the difference between the value of the land with the benefit of the current planning consent and the value with an enhanced, assumed, consent that is reflected in the Market Value of the land. The proportion that can be properly reflected in the reported value is almost entirely subjective, being based upon comparables and the valuer's experience and knowledge of the market. In common with all other valuation exercises valuers need to be transparent about their approach and, particularly when reporting for loan security purposes, this element of the reported value is to be identified as a separate figure.
- 8.4** Should the land have a negative value, even if it is not to be developed, the negative value must be reported in accordance with PS 6.8.
- 8.5** Where the purpose of the valuation is not one where a single figure valuation is required it is acceptable to agree with the client that a range of values be reported, particularly where the report includes a sensitivity analysis, with an explanation of the reasons for the range adopted.

9 Conclusion

- 9.1 The aim of this Information Paper is to assist the valuer in the more complex cases by providing a framework within which a consistent approach to the valuation of development land is adopted. It does not advise the valuer how to undertake this type of valuation – that is a matter of professional expertise – but, by following the principles, the valuer may have confidence that the significant factors relevant to this type of valuation have been considered.

