March 2017

Executive Summary

Residential Development Margin

Competitive Return to a Willing Developer

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The level of return required by a willing developer needs to have regard to the scale and complexity of the project in question, its cash efficiency, the scale of investment required and the embedded sales risk. Returns need to be set at a level which supports existing business models, stimulates new entrants into the housing market and which do not act as a barrier to entry to smaller less efficient companies. With no new entrants of scale into the housing market over the last 10 years, and SME's in perpetual decline, the evidence would suggest that current returns are not adequate for the risks involved.

In all cases developer margin is essentially split into three components with Net Operating Margin, overheads and finance needing to be considered in order to derive a gross hurdle rate. This is more easily explained as follows:

Figure 1 – Understanding Gross Margins

Source: Savills

Establishing the correct Site Level Net Margin for incorporation into residual land value calculations used during development viability discussions is key to ensuring the continuation of a robust and sustainable residential development industry.

Our analysis indicates that Operating Margin targets for housebuilders across the economic cycle are 15-20% on Gross Development Value (GDV). Overheads vary significantly (5% - 12%) depending on the scale and type of developer. For the purpose of our analysis we have used an average of 8% on GDV and, after adjusting for site specific finance the resultant suggests a Site Level Net Margin target of 20 – 25% of GDV. It should be noted that this does not take account of any exceptional items or planning costs associated with the promotion of strategic sites. Similarly it does not take in to account the cost of securing and promoting unsuccessful sites, which developers have to cover centrally. This figure could subsequently be higher for certain types and scale of development, such as high capital projects in London and provincial City Centres.

Also, in most cases, Return on Capital Employed (ROCE) is considered to be an equally important indicator, particularly on large capital intensive schemes. A target ROCE needs to be achieved alongside the Site Level Net Margin of 20-25% on GDV. This means that the minimum KPIs used within viability testing (the hurdle rates) should be a Site Level Net Margin of 20% - 25% on GDV, blended across all tenures, subject to also achieving a minimum site level hurdle rate of 25% Return on Capital Employed (ROCE).

Introduction

The Savills Community Infrastructure Levy (CIL) team has a national mandate from the Home Builders Federation (HBF) to prepare CIL representations, attend Examination Hearings and offer CIL consultancy advice across the country. Savills is the only consultancy firm to have a team of this scale solely focused on CIL advice; making the CIL team a market leader.

The CIL team has been involved with all stages of the CIL process (both pre- and post-implementation) offering advice to landowners, housebuilders, developers and local authorities. Since its inception, the CIL team has submitted over 250 separate representations and formed over 100 local housebuilder and developer consortiums.

We are therefore well placed to observe trends in the emerging viability work and subsequent CIL examinations.

Purpose

The purpose of this Briefing Note is to present evidence of what represents a competitive return to a willing developer, taking account of the Government's policy priority to stimulate new entrants into the housing market, support the SME sector and to build one million homes during the course of this Parliament.

Please note that this report is based on research and publically available data compiled in the period January 2016 - February 2017.

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Definitions

The following definitions will be referred to throughout the report:

Description	Calculation	Target Percentages
Gross Development Value (GDV)	= Total Development Receipts (Turnover)	n/a
Operating Profit (£)	= Turnover less All Development Costs (Excl. Cost of Debt) - Overheads	n/a
Operating Margin	= Operating Profit (as a % of GDV)	15% to 20%
Gross Profit (£)	= Operating Profit + Overheads	n/a
Gross Margin	= Gross Profit (as a % of GDV)	23% to 28%
Site Level Net Margin (% of GDV)	= Minimum profit margin, or hurdle rate, required to allow the development to commence[1]	20% to 25%
Return on Capital Employed (ROCE)	= Site Level Net Margin divided by annualised cumulative funds employed (including overheads)	Min. 25%
Overhead (%)	The level of overhead required by a home builder (of any size) to undertake residential development (*NB: In addition to normal overheads many housing developers include the cost of directly employing design managers, buyers and surveyors within their cost of overheads*).	5% to 12%

[1] *It should be noted that this figure excludes finance costs. For the purpose of CIL and viability testing, industry practice is to use ARGUS Developer or similar modelling tools that include a developer margin separately to the finance rate. For the purpose of our analysis, we therefore make recommendations in relation to the net site margins as finance will be charged in addition.*

Development Margin

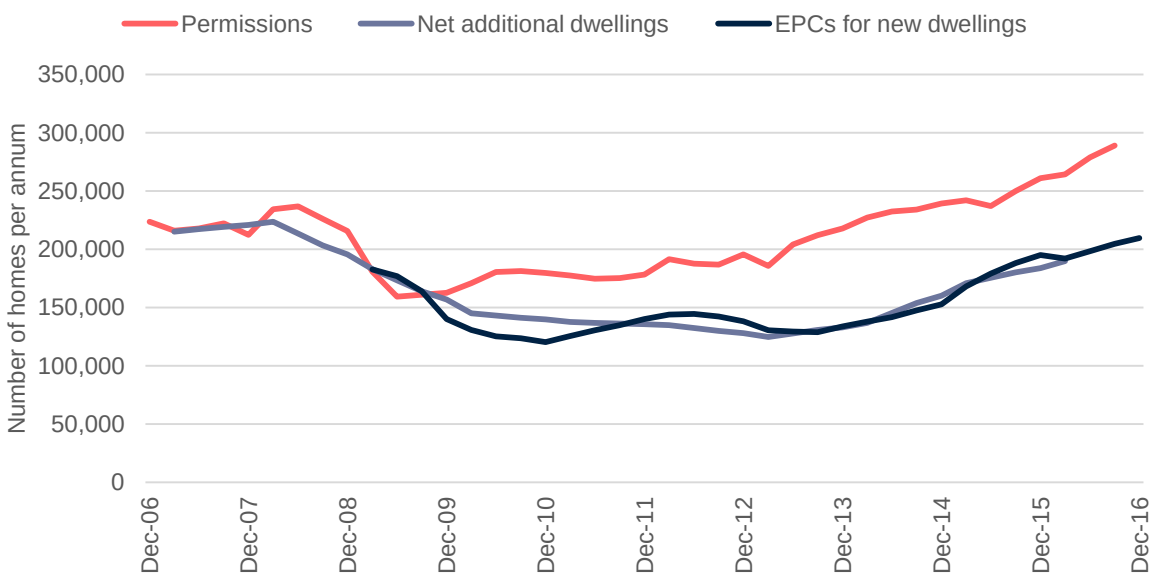
Policy Background

1.1 The NPPF states that to ensure viability developments should provide competitive returns to a willing land owner and willing developer[2].

1.2 A competitive return to a developer is one that provides a sufficient return for the developer to continue a successful and resilient business through the economic cycle; taking account of the risk profile of the business and its development programme, within the current policy environment.

1.3 The Government has a strong housebuilding agenda. It started with the aspiration to deliver 1 million homes over the course of the Parliament. In the first year of Parliament the 189,000 new homes delivered fell just short of the 200,000 homes per year average required (Figure 2). Subsequently, Government ministers have stated that delivery of 225,000 to 275,000 homes per year is needed. To achieve this, continued expansion of the housebuilding sector is required. Expansion of output by Small and Medium-sized Enterprises (SMEs), including new entrants, is an essential part of the route to building more homes. The steep decline in output from SMEs since the 2008-09 downturn is still holding back housebuilding, as shown in Figure 4.

Figure 2 – Housebuilding and planning permissions in England



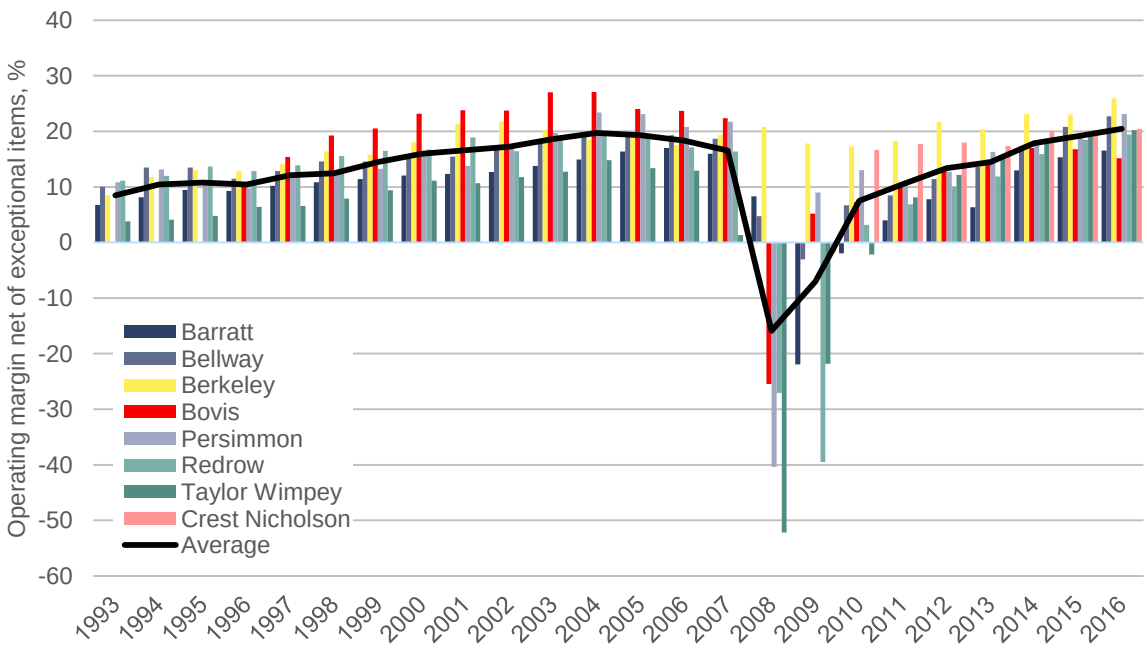
Source: DCLG, Glenigan (Please note that the total planning permissions figure includes those applications submitted by non-housebuilders (i.e. land promoters, Local Authority).

[2] *NPPF, Communities and Local Government. Para 173. March 2012*

1.4 Expansion will require additional financial investment. A necessary condition of the financial investment required across both new entrants and existing developers is that developer margins and the return on capital employed are seen by those in the capital markets as being sufficiently robust and sustainable to justify that investment. In the case of quoted national housebuilders their finance is secured at a corporate level via capital markets. This enables them to secure competitive rates, as the majority of their business is undertaken by way of equity rather than debt. In contrast, SMEs secure finance on a project-by-project basis from third parties lenders at much higher rates (8-14%).

1.5 The most readily available market evidence of a competitive return is the return achieved for the shareholders of the quoted Plc housebuilders, noting that the Top 17 House Builders accounted for 66% of new home starts in Great Britain in 2016[3]. The Operating Margins (based on Earnings or Profit before Interest and Tax) of the Plc housebuilders are shown in Figure 3 below.

Figure 3 – Operating Margins of major housebuilders 1993 – 2016



Source: Thomson Reuters

1.6 It should be noted that the analysis above refers to blended margins across the business, including:

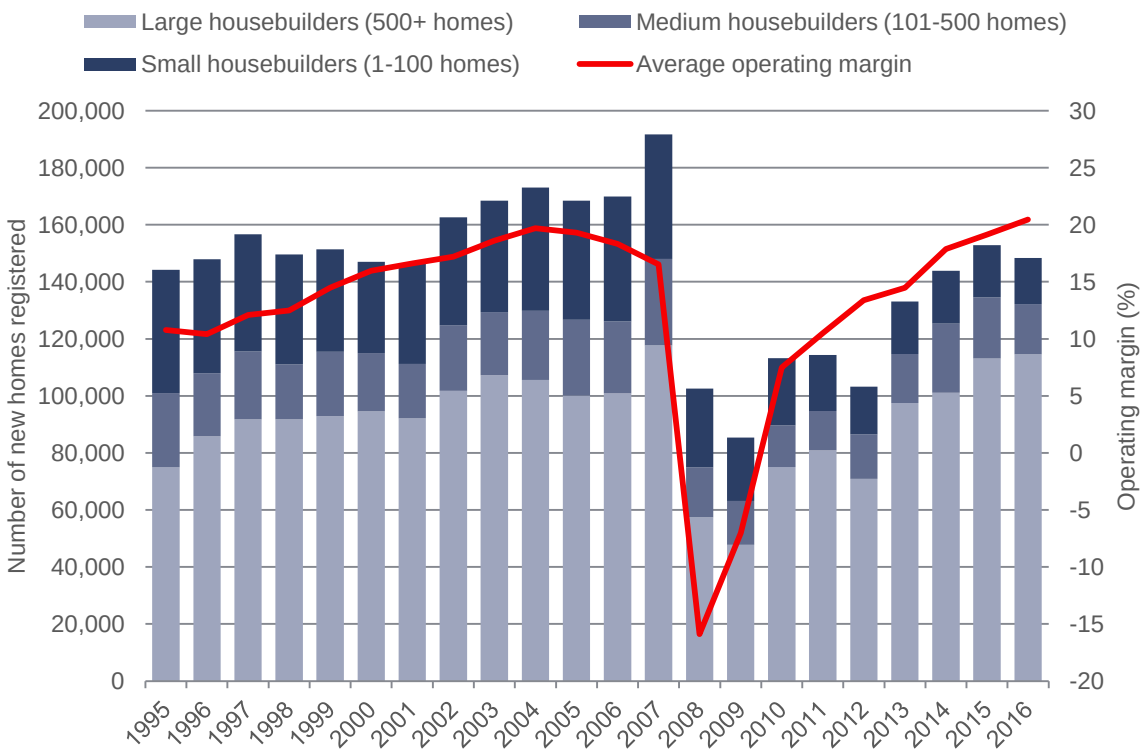
- All types, size and risk profile of site;
- All tenures of housing, including market sale, market rent and affordable;
- The costs of securing and promoting unsuccessful sites; and
- Overheads.

[3] *NHBC registrations as published in Housing Market Report, January 2017*

1.7 A number of viability consultants argue that a different developer margin should be applied to private and affordable housing. However, it is increasingly common for developers to purchase land prior to securing an offer from Registered Providers who are subject to more market risk from the current affordable housing regime than in previous systems of funding. It should also be highlighted that even when a Registered Provider has been secured on a site, the developer is open to risk from planning, ground conditions, delays and abnormals. Developers will therefore review a site as a whole, adopting a blended development margin to reflect the risk of the project in its totality.

1.8 Since the economic downturn, the average level of Operating Margin achieved has been building back to 15% to 20% which was achieved during the 2000 to 2007 period, when sector output was approaching and then exceeding 200,000 additional homes per annum (Figure 4 and Figure 2). Only if margins are maintained at these percentages will the required levels of investment in housebuilding be made, enabling significant investment in new entrants and reinvestment amongst existing developers. The margin needs to be sufficiently high to protect, or at least cushion, investors from such downturn risks as evidenced during the 2008-2009 downturn.

Figure 4 – Registrations by size of housebuilder compared to margin levels



Source: Thomson Reuters and NHBC (NB: These reported figures are after the cost of Overheads has been deducted)

1.9 With the number of new entrants and SMEs in serious decline (as highlighted in Figure 4), this analysis highlights that existing and historic margins have been insufficient to stimulate a broader range of operators into the market. In order for the Government's targets to increase housing supply and SME operators to be realised, the level of competitive returns secured needs to be reflective of the risk and lending requirements of this key part of the sector.

Providers of Finance & Capital

1.10 Shareholders in the quoted housebuilders are principally institutional investors - pension funds, insurance companies and private equity funds. They have a wide range of companies and sectors to choose from, including retail, house building, mining, transport, energy and telecommunications, all with different risk and return profiles. If shareholders' hurdle rates are not achieved then they will invest in other sectors, reducing the development capacity of the house building sector.

1.11 In the case of SMEs the profile of their finance providers is different. Given the varying covenant strength of these companies (compared to national housebuilders) the requirements of lenders for development funding are much stricter. SMEs will therefore be required to demonstrate sufficient site level margins to cover the additional risk implied by their respective covenant strength. Acknowledgment of the additional overheads and finance costs incurred by SMEs needs, therefore, to be recognised.

Market Trends

1.12 The key measures are Site Level Net Margin and ROCE associated with a cashflow that is deliverable from a funder's perspective. For a development to be viable, all of these measures need to meet acceptable target levels.

Gross vs. Net Margins

1.13 As illustrated in Figure 1, it is important to distinguish between site level margins and the Operating Margin reported in house builder accounts. This is discussed in the Harman Report, which suggests that:

"*Overheads for house-building typically lie in the range of 5% - 10% of gross development value, with only the very largest developers operating near the lower end of the scale*"[4] (emphasis added)

1.14 JP Morgan's analysis[5] of Plc housebuilder performance for the financial years 2012 and 2013 indicates that the average overheads of the quoted housebuilders (the difference between Gross Margin and Earnings Before Interest and Tax) were 6.4% and 6.0% of revenue respectively, averaging 6.2%. However, it should be highlighted that SMEs are subject to higher overheads, within the range of 5-12% of GDV. This suggests that an average of 8% for overheads is more appropriate, which when applied to a target Operating Margin range of 15% to 20% of revenue derives, at a corporate level, a Gross Margin of 23% to 28% of GDV.

[4] *Viability Testing Local Plans, Chaired by Sir John Harman, June 2012*
[5] *UK Housebuilding, Europe Equity Research. J.P. Morgan. September 2013*

1.15 In viability testing, if delivery is not to be constrained, operating margins should be set at a level which facilitates developers of all shapes and sizes; as opposed to a level which relies upon the efficiencies of scale achieved solely by the larger developers.

1.16 Both Operating Margin and Gross Margin are quoted before deduction of the cost of paying interest on debt, which at a corporate level has averaged 3-5% of GDV in recent years. Therefore the hurdle rate for Site Level Net Margin for larger housebuilders is 20-25% of GDV. For SMEs the hurdle rate will be higher (in the region of 25-30%) to reflect their higher project finance costs.

1.17 This is the basis of the developer margin hurdle rate that is applicable to site level development appraisals calculating the Residual Land Value (RLV), in which the cost of debt is included separately[6].

1.18 Around this average, there will be a range of site specific development risks and therefore a range of site level hurdle rates for developer margin. For example:

- Smaller, lower density, less constrained sites are inherently less capital intensive and represent a lower delivery risk than costlier larger sites and higher density sites. It therefore follows that smaller, lower density site's hurdle rate will be below the corporate average. Although it should be noted that sales risk and delivery risk are inherently different. For example, a small site with low delivery risk can still represent a higher risk to the developer if in a high value location above the Help to Buy thresholds. In this case the site will require a higher hurdle rate to reflect the increased sales risk.

- In contrast, larger complex sites requiring up-front infrastructure delivery and protracted timescales will be above the corporate level average. This is particularly relevant for brownfield sites where the extent of abnormal costs (ground conditions and remediation) is largely unknown at the outset. Furthermore, on large sites there is significantly more sales risk, as there is greater uncertainty about the strength of market conditions over the life of the development, which is likely to include a market downturn. Such uncertainty both in terms of cost and timings increases the risk profile and therefore the hurdle rate required.

- The variance in sales rate also needs to be considered, with the relative strength of the market reflected in the risk profile of a site. It therefore follows that larger sites in weaker or over-supplied markets reflect a greater risk and subsequently require a higher hurdle rate than similar sites in stronger markets. Similarly, larger projects pose a greater sales risk as they are likely to be developed across a property cycle introducing more uncertainty.

1.19 The above is particularly relevant for large-scale development and regeneration areas, where large up-front costs hamper the developer's ability to achieve the required ROCE, such that a higher margin is necessary to reflect the additional risk. In these instances, ROCE becomes the primary hurdle rate as highlighted by the Harman Report:

[6] *Refer to footnote 1*

"Developments of large flatted blocks on previously used land in urban areas with high cash requirements will demand significantly higher levels of profit to achieve an acceptable ROCE than developments of a more standard, less cash intensive nature on virgin ground. Likewise, projects with significant up-front infrastructure may also require higher levels of profit to generate an acceptable ROCE."[7]

1.20 The requirements for those investing in the sector will subsequently be a minimum hurdle rate of 25%. Although it is worth highlighting that our analysis is based on typical hurdle rates on sites across the Country. It does not therefore reflect the additional cost and risk associated with delivering sites in London. In this instance, different investment requirements may be sought, reflecting significantly higher minimum hurdle rates.

Appeal Precedent

1.21 For the reasons outlined above, development margin is a key point in viability discussions and will vary depending on a number of factors. This point has been acknowledged by a number of Inspectors at appeals, including the following:

Land at The Manor, Shinfield, Reading[8]

"The appellants supported their calculations by providing letters and emails from six national housebuilders who set out their net profit margin targets for residential developments. The figures ranged from a minimum of 17% to 28%, with the usual target being in the range 20-25%. Those that differentiated between market and affordable housing in their correspondence did not set different profit margins. Due to the level and nature of the supporting evidence, I give it great weight. I conclude that the national housebuilders' figures are to be preferred and that a figure of 20% of GDV, which is at the lower end of the range, is reasonable."[9]

Land at Lowfield Road, Rotherham[10]

"The Council's approach, set out in the DVs report, is that a profit of around 17.5% is reasonable for a scheme of this nature, which equates (on a 'blended basis') to 16.47% on revenue. The DV has provided evidence to support this view, based on a range of sites – identified only in general terms.
The return to a developer is inevitably going to vary considerably between one development and another, and will properly reflect the risk of a specific project. Reference has been made to a number of appeal decisions where varying levels of developer profit have been accepted. However these other decisions are of limited value, as much will depend on the individual circumstances of the particular site and development.

There are various 'rules of thumb' which are quoted when discussing developer profit, and these generally vary between 15% and 25%. However, in general, it is reasonable to assume that on more marginal sites,

[7] *Ibid. p46*
[8] *Ref: APP/X0360/A/12/2179141 – dated 8th January 2013*
[9] *Paragraph 44*
[10] *Ref: APP/R4408/Q/14/2216976 – dated 9th September 2014*

profit expectations would be higher. In this case, the developer has been very clear about the slow sales and the reasons why the site has not been mothballed, as it otherwise might have been. This background tends to support a figure in the upper part of the 'normal' range.

In this case, recognising the approach of this appellant to the use of in-house professional expertise, the appellant's proposed level of developer profit shown in the viability appraisal (22% - i.e. 15% profit and 7% overheads) is reasonable."[11]

Land between Lydney Bypass and Highfield Road[12]

"The Council considered that due to the improving market a profit level of 17.5% would be reasonable. The Appellant on the other hand considered that 20% would be the minimum on which finance could be obtained. The amount required by a developer to undertake the development is a reflection of the anticipated risk. In this case the evidence indicates that the market is not an easy one within this part of the country. Although the Council considered that work had started on the site with the installation of the pumping station, I am not convinced that this would greatly reduce the risk element of the project. Whilst the greenfield site has an attractive position with enviable views it is not within a prime location on the edge of one of the major towns such as Gloucester or Cheltenham. Furthermore the scheme would be carried out over a relatively long time period and this would add to uncertainty in terms of future economic conditions.

Taking all of the above circumstances into account I consider that it is reasonable to adopt the Appellant's figure of 20% of gross development value as the input for Developer's profit in this case."[13]

Land to the North and East of Lisvane, Lisvane, Cardiff[14]

"A blended developer profit of 20% is appropriate in this case, noting that two appeal decisions29 (at Pinn Court Farm and Shinfield) where the blended rate of 18.8% and 20% on gross development value (GDV) were found to be acceptable. The attractiveness of the site to the market is acknowledged, but this is reflected in the high GDV which has been used, which in itself introduces an increased risk if that assumption proves to be overly optimistic. The DVS has assumed that site purchase would take place in staged payments - this is a crude approach that fails to establish the appropriate value at the time that the appraisal is undertaken. The rate suggested by the DVS is the same as that adopted in relation to the adjacent, recently approved Cefn Mably Road scheme. There are significant differences between that scheme and the appeal which is at outline stage and is much larger. These differences represent an appreciably greater risk for a developer."[15]

[11] *Paragraphs 31 - 34*
[12] *Ref: APP/P1615/Q/14/2215840 – dated 18th June 2014*
[13] *Paragraphs 24 - 25*
[14] *Ref: APP/Z6815/A/14/2224216 – dated 28th August 2015*
[15] *Paragraph 51 (v), Pinn Court Farm ref: PP/U1105/A/13/2208393*

Summary

The evidence in this paper indicates that the minimum margin used within viability testing for development sites should be a Site Level Net Margin[16] of 20-25% on GDV, blended across all tenures, subject to achieving a minimum site ROCE of 25%, subject to consideration of the risk profile of the scheme. Those sites with a higher risk profile (i.e. longer term projects with significant upfront infrastructure costs and abnormals) will be at the upper end of this range, shorter term projects with less capital intensive infrastructure are likely to fall at the lower end.

The reference to ROCE is particularly important on large, capital intensive schemes. This needs to be achieved in addition to the Site Level Net Margin of 20-25% on GDV. Typically, the assessment of viability is undertaken using ARGUS Developer or a bespoke residual land value model. These include a developer margin and normally report on IRR not ROCE. In these cases the relevant hurdle rate for site specific appraisals is an Internal Rate of Return of at least 25%.

A number of viability consultants argue that a different developer margin should be applied to private and affordable housing. If this is the case, then the blended margin across all tenures should equate to the hurdle rate referred to above.

It is increasingly common for developers to purchase land prior to securing an offer from Registered Providers who themselves are subject to more market risk from the current affordable housing regime than in previous systems of funding. There is, therefore, a heightened risk associated with the affordable housing in addition to increased holding and finance costs. We would also highlight that the potential for the introduction of Starter Homes results in an additional level of risk for developers (these units being retained by the housebuilder as opposed to being sold to a Registered Provider). Receipts from Starter Homes are received later on in a project's cashflow and, to reflect this increased risk, developers will subsequently require a higher return on these units compared to 'traditional' affordable housing.

[16] *Please note that this excludes finance, which will be included separately in viability appraisals.*