Viability analysis needs fixing

Financial viability analysis does not work. Andrew Wood suggests what should replace it

For the last year as the Councillor for Canary Wharf ward in Tower Hamlets I have been allowed to read the financial viability reports submitted by developers in my ward. I also get to read the independent reports commissioned by Tower Hamlets Council which review each viability report.

As a qualified accountant who has built a fair number of financial models in my professional life I read them with interest although given how detailed & thick the reports are I cannot to pretend to have read them all, they are impressively complex documents. I am not allowed to repeat the detail contained in the reports but the most common phrase in the Council's independent analysis is 'the assumptions are not unreasonable', developer's assumptions while not perfect, are not unreasonable and therefore are hard to dispute. This is as much an art as a science despite the detailed numbers in each report.

But they are also largely pointless documents. They are trying to do something which is almost impossible to do, to calculate a schemes profitability years in advance of work starting and even before permission to build is granted, sometimes even when the developer has no intention of actually building anything. The only point of the viability report is to calculate the percentage of affordable housing to be offered by each scheme plus

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any other S106 commitments. This is why developers profit is normally set at 20 per cent in the model, not because this real profit but as a risk reserve. The 20 per cent number is effectively the fudge factor that makes the whole model work.

I have read reports where the developer is clearly trying to downplay the potential profitability of a scheme by emphasising how far away they are from Canary Wharf but it might surprise you to learn that some schemes I have read appear overly ambitious in the affordable housing they are offering given the risks they are taking on.

By comparison the calculation of Community Infrastructure Levy (CIL) has been more successful, it is a much simpler calculation, in my ward £200 * per square meter of development for Tower Hamlets CIL + £35 for the Mayor of London CIL. It is a simple mathematical calculation fixed in advance. After Tower Hamlets adopted it last year, one development went from a £10 million S106 negotiated contribution to a £16m CIL contribution.

I think it is time we also greatly simplified the affordable housing percentage calculation along the lines of CIL. We should set a fixed percentage to be delivered for each geographic area like we do with CIL. The breakdown by type of unit and between different tenures can be subject to negotiation but anyway will be influenced by the London Plan & national legislation. But the local authority can set some rules on the mix within its Local Plan for different areas.

The local authority can also set guidance over whether that affordable percentage should be provided onsite or offsite. Most sites should have the affordable housing on site but there should be exceptions. For example, a 75 storey tower on South Quay may not be the ideal place for large family sized social rent home.

This can all be set in advance by the Local Authority, it can be examined in the same way that CIL is. Once adopted developers know exactly what they have to deliver. National government should not be averse to this change as it simply extends the logic of CIL into a new area. It also reduces risk and complexity which should simplify the process, surely the holy grail of recent reforms.

There is however a difficulty, what percentage should we set the affordable housing number at? Too high and we discourage building, too low and we miss out on the provision of affordable housing.

Perhaps the answer is to have a two stage process. Set a percentage perhaps based on a slight stretch of today's actual numbers as we know this is deliverable even before the reduction in cost and risk that this change introduces, as we know this change will reduce costs and risks for developers but not too high as we do not know how the London property market will perform over the next few years.

But then on completion, when the developer has sold the majority of units, has collected the cash & actually knows whether the scheme has made a real profit or not we can set a review mechanism. If the development generates 'excess' profit, then a profit-sharing mechanism should operate whereby the developer pays the Council cash to build more affordable housing. It also incentivises the Council to support the developer, the sooner the development is delivered the sooner it can share in the profits.

In effect we will be setting the actual allowable profit percentage for each development, this may encourage the delivery of more new homes as the only way developers can increase profits is by delivering larger schemes. This profit percentage probably should be set by the GLA across London, it should be set so as to 'provide competitive returns to a willing land owner and willing developer to enable the development to be deliverable' as the NPPF requires.

While the developer may not like sharing excess profits, they will benefit from the reduction of risk, they know this profit share only operates if they have indeed made a profit and they can increase profits by delivering more homes. We can also set different profit percentages if we want to encourage different forms of development, if a developer for example provided new homes within a set price limit by using new forms of construction we may incentivise that through a higher allowable profit percentage.

It probably makes sense therefore for each development to be set up as limited trading company whose accounts are then easily audited. There will have to be some rules about overhead cost allocation but a simple template can be set up based on audited accounts defining how the profit calculation should be done, but all on real and final numbers not guesses years in advance. For smaller sites & schemes we may simply set the percentage to be delivered up front and skip the profit share at the end.

Tower Hamlets Council unofficially already operates such a scheme. Developers know that anything under 25 per cent in my ward is likely to get rejected so in effect there is a fixed minimum percentage in place and it also operates a review mechanism as well. But it lacks clarity.

The impact of the scheme is that it is likely that the price of land will be affected by the percentage set. The landowner may end up taking a financial hit but it has been fascinating for me to read in the viability reports how different the prices are for plots of land next to each other all with similar development potential so perhaps this may help set a more uniform and predictable price for land. As long as the profit percentage is not set too low, landowners can still benefit as the NPPF requires.

Hopefully such a process would take some of the political heat out of the process as it balances building more new homes (which is the only long term solution to the affordability crisis) with delivering more affordable homes. Publicising viability reports on their own will provide little help as they are so complex and make little sense in isolation. This is why as an interim step the GLA should focus on setting up a database of submitted viability reports from across London.

On the Isle of Dogs, we are building a lot of very similar schemes, sales prices and cost of construction should also be very similar. Such a database means we can more quickly spot outliers in the assumptions submitted by individual developers. Information on current sales prices is easily available as is the cost of construction of different types of developments and can be used as a benchmark against new schemes. Such a database would then provide the background information to then set the affordable housing percentage in each area.

LEFT BELOW: Landmark Pinnacle

RIGHT: Foster + Partners' South Quay Plaza