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regeneration

Note for Braintree District Council on viability issues in relation to development proposed for land west of the A131 at Great Notley

Michael Beaman: March 29th 2010

Introduction

Savilles and Retri on behalf of Countryside properties Ltd have argued that:

- The inclusion of B8 warehouse space in any development on the sites in question is critical in terms of financial viability and delivery. A development including B8 warehouse uses would probably be delivered earlier than a scheme based on either B1 office or industrial uses. This is because the market perception is that the latter would take longer to let.

- A B8 warehouse scheme could in any event have a greater impact on local prosperity.

In the note that follows I examine the veracity of the former argument. I review:

- The outlook for the property market in the short term.

- The commercial dynamics of developing the type of scheme proposed.

I understand that the economic and employment impact assertions will be assessed by Roger Tym & Partners.

I am a chartered surveyor (practising solo through Michael Beaman Ltd since 1998) specialising in development viability and delivery mainly in the context of strategic planning studies. In 2007 I was involved in the Braintree Employment Land Review together with Llewelyn Davies Yeang. Prior to establishing the practice I had long and directly relevant experience of commercial property development in South East England most recently as a Director of Trafalgar House Business Parks Ltd during the last major recession in the property business.

The Market for Commercial Property

The key issues are whether it is likely that an employment scheme at Great Notley is likely to go ahead if B8/warehouse space is excluded. The other options are B1 industrial or office space. This raises two critical subsidiary questions:

- Whether the inclusion of B8/ warehouse space is a pre-condition of viability or merely enhances it.
- Clearly anything is possible in the fullness of time so if B8/warehouse space is not permitted when might an alternative form of development materialise.

Savilles' analysis is primarily based on historical data aimed at demonstrating that:

- Macro economic forces in the UK have resulted in a reduction in demand for industrial space and an increase in the demand for B8 warehouse space.

- Braintree is not over supplied with B8 warehouse space compared with other areas.

- The success of the Skyline 120 scheme both commercially and as an economic asset for Braintree can be attributed - at least in part - to B8 warehouse development.

- The office market in Braintree has not been and is not likely to be big enough to support a major new scheme.

The macro economic data that they use is broadly supported by data published in the trade press and research reports from other major property consultancies and estate agents. The wider argument has some merit but is not compelling. There are counter arguments.

- There is no absolute reason why de-industrialisation in Britain and the growth of the service economy needs to be reflected in the balance of uses in every area of the country or why the growth of warehouse space in each of the varied District Council areas cited by Savilles should be the same.

- One reason why B8 warehouse schemes have probably been successful is precisely because they tend to be unpopular with local planning authorities. The resulting restrictions in supply have boosted the price and take up of the space that does become available.

- It is at least arguable that the Skyline 120 scheme was successful was because it has addressed a need that has now been met.

- There are examples of business parks that are quite remote from existing major towns. (For example, Kings Hill in Kent).

However what is important here is not so much whether Savilles' views are valid, but whether they are widely enough held by those in the property industry to influence the decisions of developers and investors and thus impact on viability. Our view is that they probably are. It would be difficult to sustain an argument that Braintree in general or Great Notley in particular has a suitability or attraction for industrial or office development that would give it an outstanding competitive advantage in a very competitive market.

Savills’ argument draws on the past to explain the present but developers and investors will also look forward and anticipate - up to a point - changes in market conditions. In this context it is useful to consider other sources of information on the outlook for development.

In the Employment Land Review reference was made to the regular RICS Commercial Property Survey because it bases its analysis of the outlook on reports of market sentiment and expectations about the short term future rather than an analysis of the past. This has recorded steep falls in demand for all types of property throughout the recession but now reports some improvement in demand across both the commercial and industrial sectors. For offices, this is concentrated in London which usually leads the rest of the UK property market out of recession. As far as industrial and warehouse space is concerned the survey unhelpfully does not distinguish between them but simply points to improving activity and demand albeit from very low levels.

A longer term perspective is provided by the widely respected research team at Capital Economics. In the 'UK Commercial Property Analyst” published in Q1 2010 they point to the possibility that while the value of investment property might improve in the short term, driven by a recovery from low prices and the weight of money pumped into the economy, the longer term outlook is poor. This reflects the expectation of a slow recover and subdued economic growth over the medium term at least and perhaps for as long as a decade. Interestingly they believe that the industrial market might prove stronger than others in the longer term. This might be based on a common perception that sterling weakness might in time boost the export of manufactured goods and contrasts with Savilles conclusion which is based upon the relative weakness in demand for production space in comparison with warehouses as the role of industry in the economy has declined.

Other agency firms also publish market research.

- In their analysis of Office Enquiries in Q3 2009 King Sturge concluded that "Despite the increase in 2009Q3, the current level of enquiries remains far below that of mid 2007 when the credit crunch first started. A swift return to precredit crunch levels of requirements for office space is unlikely with the UK economy facing a slow recovery".

- GVA Grimley in their 'Economic and property Market Review for Q1 2010 says that “the economic growth outlook remains weak and fragile in the UK, as it does in much of the western world. The increase in VAT, the end of the car scrappage scheme and the end of quantitative easing, together with the inevitable tax increases and public sector spending cuts will offset the usual post recession bounce back. This continuing weakness will be reinforced by restricted bank lending".

- DTZ in their various sector reports during 2009 pointed to continued activity in the 'big shed' market in the South East and suggested that while the demand for offices outside of London had also shown signs of recovery this primarily reflected the take up of vacated space. They questioned the sustainability of the improvement.
- In a report on the logistics market published late in 2009 by BNP Paribas Real Estate (formerly ATIS Real) they comment that "To date, total investment in property in 2009 has been significantly lower than at any time in the last decade. However, as a proportion of total investment, industrial and logistics makes up 14% of the proportion.......This proportion is higher than at any point this decade".

This last point partly explains the developers' enthusiasm for B8 / warehouses.

Historically office development has been most sensitive to falls in service sector output. While the demand for industrial space might in the longer term be relatively stronger than it has been in recent decades it is unlikely to supplant B8/warehouse use as the main component of demand for 'shed' space in the South East.

A summary of the overall situation might be that:

- In the short term while values will probably recover a continuation of weak occupier demand together with a shortage of bank funding for speculative schemes will severely limit new development.

- Weakness might continue into the medium term given the frailty of the banks and difficult outlook for the economy generally.

- Office demand in difficult times tends to be focused on the very best locations. While there is a strong possibility that in the medium term at least there would be demand on a small scale for office space in Braintree, it is relatively unlikely that there would be demand for a major facility.

- In the longer term pent up demand might restore activity but although there are different views about the prospects for the industrial economy the effect of this difference on demand for space would almost certainly be marginal with any increase in industrial demand not compensating for a reduction in demand for space is B8/warehousing is not permitted.

The Dynamics of Commercial Property Development

Typically, commercial developers seek bank funding to cover development costs and then sell the completed and let building to a property fund which holds it as a medium or long term investment. Sometimes the fund itself will provide the short term funding in return for a keener purchase price. This is known as forward funding. The availability of short term funding and the demand for the buildings as completed investments will be reduced if there is doubt about occupier demand for the building or restrictions on long term use which increases the risk of the building becoming and remaining empty in the longer term. Both of these are more likely if there are restrictions on what can be developed and how it can be used.

As stated, at present there is a paucity of bank funding available to support any form of development. Most banks are trying to reduce their property lending and the two biggest lenders in the UK, RBS and HBOS, have virtually withdrawn from the market. In the rare instances in which bank loans are provided the terms are usually onerous both in terms of rates and conditions Jones Lang LaSalle's Report on Lenders Expectations published in December 2009 said that "speculative development finance will not be available in the short term" and that this was unlikely to start to change until 2013.

Some developers can meet development costs from their own resources but most are still stretched following the ravages of the recession and even when they are in a position to do so, seek a high return on the limited sums that they can put at risk in order to ration their scarce capital efficiently.

As far as investor demand for completed schemes is concerned there is currently strong demand good buildings let to strong tenants in the best locations. However:

- The number of investors willing to consider forward funding or investment in secondary quality stock is much more limited and prices remain low. In this respect, Braintree might be considered a reasonably attractive location for a good quality commercial B1(c)/B8 scheme, but not if the use was restricted to B1(c) only.

- Some analysts believe that even this improvement in the market will not be sustained. On Feb 19th the Investors Chronicle reported that: "At least some of this apparent strength in capital values is down to banks sitting on troubled property assets rather than crystallising a loss by selling them. As in the US, this "extend and pretend" approach has kept distressed assets off the market, leaving an army of 'vulture' and 'opportunity' funds with nothing to spend their money on. The weakness of sterling has also helped, attracting foreign buyers".

What effect does this shortage of short and long term funding have on the economics of development? An inability to obtain short term funding can completely frustrate a scheme but any reduction in the price that investors are prepared to pay will have a disproportionate effect on the land value generated by development and thus on viability.

For instance, assume that industrial or warehouse space which costs £800 sq m can be let at £75 sq m and sold to an investor seeking a return of 7.5% for £1000 sq m. i.e. [£75 x (100/7.5%)]. The land value generated by each square metre of development is thus £200. (i.e. £1000 sq m value less £800 sq m costs).

If the use of the buildings is restricted the developer will probably factor this into his appraisal and make an assumption that the letting and sale might take longer. And an investor might require an extra 0.5% yield to compensate for the increased long term risk of voids. If we allow an extra £25 sq m for the projected extra short term funding requirement and assume that the price the investor pays drops to around £937 sq m (£75 sq m to offer a return of 8%) ; the land value in the example above falls to only £112 sq. m.

These are illustrative calculations only. We are not aware of the specific proposals in this case and do not have any information on the costs that the developer would incur and which are specific to the site at Great Notley. Rather, it is intended to make the point that relatively small differences in funder and investor perceptions about demand can have a major effect on the residual land values generated by development.

In fact we would expect that either an industrial development at Great Notley or a small and basic campus office development might be viable if there was a reasonable prospect of attracting an occupier for each building within, say, six months after completion. However give the amount of space on the market and current rates of letting activity that would be an optimistic view. Risk is a crucial factor here. In a difficult market and when the outlook is uncertain developers and funders can be unwilling to proceed on any terms because the specific risk of being unable to find an occupier at all or at any realistic price is simply too great. Quite simply, the risk of loss is disproportionate to the potential reward.

Conclusions

In summary I agree with Savilles' assertion that any restriction on the permitted use of this scheme might well impact on the viability of the scheme. The lack of information on the site means that it is not possible to state whether or not the reduced return and higher risks would make development uneconomic; but it would certainly be a major disincentive to investment.

It is quite possible that market weakness will continue into the medium term and in this respect the prospects of development taking place and occupiers being found will be much improved if the developer can be flexible in what is offered.

What is uncertain is whether the developer would actually use a beneficial and flexible planning permission to make an early start. Current market conditions are so poor that it is quite possible that they would still want to wait until things improve. But that date should still arrive sooner if they can respond to whatever forms of demand do emerge first. It is also possible that they might seek an occupier on a design and build basis in the meantime and, once again, a flexible planning permission gives them a greater chance of success.

To return to the question posed at the beginning of this report:

- In the absence of detail It isn't possible to state definitively whether a scheme that does not include B8 is theoretically viable or not. It probably is if occupiers can be found and if the specific costs associated with developing at Great Notley are modest although the value of the scheme to the developer would be significantly reduced. But, putting aside the simple arithmetic of a viability study, in reality in this market it will be difficult to attract occupiers and if this risk is factored into the calculation the chance of a B1 only scheme proceeding in the short term is poor.
- The evidence suggests that an industrial or office scheme might only become a practical proposition in the medium term.

There is obviously no objective basis for calculating what the 'medium term' might be in this respect but a reasonable estimate might be five years or more. I am not aware what the developer's position is but in this eventuality a conventional approach would be to try and attract an occupier on a 'design and build' basis. But this type of occupier is keenly sought by many in this market and success could not be guaranteed.