

7-8 Wakley Street and 328 City Road

Update Viability Review

24th February 2016

Introduction

- 1.1 We have been instructed by the London Borough of Islington ('the Council') to provide a viability review in respect of the latest revisions that have been made to the proposed scheme at 7-8 Wakley Street and 328 City Road (planning application reference P2014/3572/FUL).
- 1.2 We were previously instructed to review a viability assessment prepared by Quod on behalf of the joint applicants, the National Children's Bureau (NCB) and London Square Development. Following our viability reviews dated October 2014 and April 2015, the scheme has been altered twice, and we have reviewed these changes in order to test their impact on viability and on the level of affordable housing the scheme can deliver. We provided an update review in August 2015, which dealt with the following key changes to the scheme (detailed in Quod's September 2015 report) and discussed how these impacted on viability:
 - Reduction of 3 residential units to the private block
 - Increased lower ground floor area, and therefore an increase in ground floor slab, contiguous piling, internal finishes, and M&E
 - Additional skylight to the rear of the lower ground floor offices
 - External area to the lower ground floor office
 - Inclusion of lift to the office space
- 1.3 A December 2015 report by Quod details the further changes that have been made to the scheme since their September 2015 report:
 - Residential units reduced from 30 to 26
 - Private units reduced from 26 to 22
 - Affordable housing unchanged at 4 units
 - Office floorspace increased from 1,686 to 2,038 sqm (GIA)
- 1.4 Subsequently, Quod provided a 26th January 2016 letter, which showed in a revised appraisal that the scheme is close to a break even position which demonstrated that the scheme is deliverable, and Quod confirmed that the joint applicants are willing to proceed with the scheme based on present market conditions.

Updated viability results & BPS updated conclusions

- 1.5 Quod's December 2015 appraisal showed a residual value of £2,877,944. This contrasted with the £3,884,185 shown in the September 2015 Quod appraisal. This reduction was primarily due to the fall in private residential floorspace, which results in a £3.46m loss of revenue, while the increase in office rents (due to the increased floor area) is lower, at £1.80m.
- 1.6 Quod's latest appraisal includes four affordable housing units and shows a financial deficit of £238,000, which is very close to a break-even position. This break even position is achieved in part by the joint applicants' willingness to proceed with the scheme on the basis of a lower profit target than was adopted in their earlier appraisals. The joint applicants are still offering to deliver four affordable housing units, and we remain of the view that the scheme cannot viably deliver any additional affordable housing.
- 1.7 The applicant has agreed to review of viability at an advanced stage of development, in line with the Council's Development Viability SPD. The review will reassess viability at the point at which values and build costs are realised, thus providing greater certainty and the potential for an additional affordable housing contribution in the event that economic conditions improve further and a surplus is generated.
- 1.8 In our previous reports, we estimated a benchmark land value of £4,920,404, based upon an existing use valuation (EUV) of the existing office building. This benchmark was then adopted by Quod in their revised viability assessment and is included in their December 2015 appraisal. This benchmark has remained unchanged from that which was previously agreed and we remain of the view that this is a reasonable figure.
- 1.9 We would not increase the benchmark land value from the £4.92m that we proposed in our last report (dated August 2015), as the specialist office agency Strettons have confirmed that the office rents in this location have remained stagnant since then, therefore there is no reason to make an upward adjustment to the rents that are applied in the site's existing use valuation.
- 1.10 The total financial deficit in the December 2015 appraisal is £2,042,460, when the £2,877,944 residual value is compared against this £4,920,404 benchmark. This appraisal included a 20% profit on private housing revenues (GDV), 15% on commercial revenues, and 6% on affordable revenues. In the latest appraisal, Quod have reduced the profit to the point at which a break-even position is reached. The revised profits are:
- 15% Profit on Cost for private housing
 - 15% Profit on Cost for affordable housing (increased from 6% on revenues)
 - Nil Profit applied to the office unit that is pre-let to NCB
 - 15% Profit on Cost for the speculative office unit
- 1.11 The nil profit on the pre-let unit recognises the minimal risk associated with delivering this unit, as the tenant has already been secured and the rent has been agreed. The Profit on Cost of 15% for the private housing equates to 8.7% on GDV. This lower profit allowance shows the joint applicant's willingness to proceed with the scheme at this level of profit, which reflects the specific circumstances of this development, which has the benefit of a pre-let and is in a location in which pre-sales of private residential units is common. Furthermore, the appraisal includes a relatively high build costs contingency, which we do not dispute is appropriate, but we do note that this acts to further mitigate the risk of the scheme.

- 1.12 The National Planning Practice Guidance (NPPG) states that profit requirements in residual valuations will vary significantly from scheme to scheme, to reflect “*the size and risk profile of the development and the risks to the project*”. This approach is consistent with the Council’s Development Viability SPD which states:
- “Developers must receive a competitive return for a scheme to proceed and also a level of profit that is sufficient for finance to be secured. The appropriate level of developer profit will vary from scheme to scheme. This is determined by a range of factors including property market conditions and development’s risk profile. The lower the scheme’s risk profile, the lower the level of required profit and vice versa.*”
- 1.13 This SPD suggests that due in large part to improvements to the economy over recent years, “*Profit expectations for private residential / commercial components are.....now likely to fall within a range of 15-20% on Gross Development Costs (GDC)*”.
- 1.14 The Council has corresponded with the joint applicant to set out its concern over a potential S106 BA challenge, in which the joint applicants would seek to reduce the level on affordable housing provision on grounds of viability. In response, the joint applicants have confirmed that they have no intention to challenge under this measure, and have consequently provided an appraisal showing that the scheme can be delivered under current market conditions.
- 1.15 We have considered whether the proposed offices’ rents should be increased to reflect market growth since the rents were last estimated by Stretton. Taking the 4% growth for the City of London over the 4 months since October 2015, and applying this in the appraisal, gives a £435,000 increase in office values, thus a substantial increase to the residual value. However, an increase to the rents applied in the proposed scheme’s appraisal could in turn legitimately lead to a rise in the existing offices’ rents, and thereby an increase to the benchmark land value - thus negating the impact that this rise in rents would have on overall scheme viability. Strettons have, however, informed us that the ‘rental tone’ for this area has remained stagnant since around October, and we have no reason to dispute this.
- 1.16 We suggest that an upward adjustment to the sales values may be appropriate. Increasing this by 2.3% (as suggested by the Land Registry House Price Index) gives £1,014 per sqft, and £366,000 higher total private residential values. We do not have the most current inflation data, as the House Price Index data stops at December 2015, so potentially a further increase could be made to move values up to present day (late February 2016) levels.
- 1.17 The build costs have been reduced by £123,954, to £13,489,674. Faithful & Gould have prepared an updated cost plan. The proportion of office floorspace has increased and the residential floorspace has decreased. The costs rates have been slightly adjusted as a result of these changes, which have a minimal impact on overall costs.
- 1.18 The build costs in the appraisal were updated in November 2015, therefore it is appropriate to update the costs to reflect recent inflation. The tender price index (TPI) has only increased by 0.7% (277 to 279) from Q4 2015 to Q1 2016. However, there has been a substantial increase in the location factor for Islington, which based on the latest Location Factor of 132, shows a £854,000 increase in the base build cost.
- 1.19 In view of the substantial increase in build costs resulting from recent tender price inflation, this cancels out gains resulting from our suggested increase in residential values. Whilst there has been a substantial increase in build costs (shown by increased

TPI and location factor) for Islington, there has also been an increase in private residential values. The residential growth figures for the last circa. 3 months are not available, but extrapolating the previous 3 months' 2.3% growth gives a 4.6% overall increase, and a £760,000 growth in revenues.

- 1.20 All other cost items in the appraisal, including the percentage rate of professional fees, remain at the same rate as in the September 2014 appraisal, therefore in our view these remain appropriate.

Office values

- 1.21 The proposed building now has 516 sqm (NIA) of office space on the ground floor and 1,190 sqm (NIA) on the lower ground. Before this latest revision to the scheme, the office floor areas were 422 sqm (NIA) on the ground and 1,001 sqm (NIA) on the lower ground. The proportion of the office space that is at lower ground floor level has remained largely unchanged (albeit with a minor increase, from 29.7% to 30.2%). This is important to consider, given that the lower ground floor cannot achieve as high rents as the ground floor.

- 1.22 We have considered market changes since the previous appraisal, in order to ensure that the rent and yield applied in the appraisal are appropriate. The rent remains unchanged since the September 2015 Quod appraisal, at £35 per sqft. This rent was recommended by Strettons in a note dated October 2015 (in Appendix Two of Quod's December 2015 report). Since then there has been a substantial upward shift in office rents in many parts of London. We have had regard to the trend shown by Knight Frank for the City, which shows a year-on-year rise of 12%, or 4% over a 4 month period. Therefore it is necessary to consider whether changes in the market over the 4 months since Stretton's appraisal should lead to an increase in the rent of £35 per sqft. We have requested further comments from Quod and Strettons, and they have subsequently informed us that there has been no increase in the 'rental tone' for this location, which is within the City Fringe. Consequentially, they do not consider it necessary to factor in any increase in rents to the October 2015 rent estimate. This period from October 2015 to the present day, follows a period of strong rent growth in this area which has now plateaued. Strettons refer to the large increases in office supply that is forecast for the next 2-3 years, which is affecting rents in tertiary locations such as this, and is likely to result in prospective tenants requiring larger incentives (including rent free periods).

- 1.23 The yield applied in the appraisal is 5.5%. This is the same yield as was applied in the September 2015 Quod appraisal, and we remain of the view that this is a realistic yield.

- 1.24 An 18 month rent free period has been applied, which is the same as in the September 2015 appraisal. We remain of the view that this is reasonable.

Benchmark Land Value

- 1.25 In our last Addendum report (April 2015), we calculated a benchmark land value of £4,920,404. This figure incorporated a 15% landowner premium. All of the inputs had been agreed following detailed discussions between BPS and Strettons, including in respect of rents and yields. As we have stated above, Strettons have informed us that the 'rental tone' for this area has remained stagnant since around October, and we have no reason to dispute this. Therefore we would not recommend any changes to this existing use valuation.

Residential values

- 1.26 The private units had an average value of £992 per sqft in the December 2015 Quod appraisal. This compares to the £991 per sqft in the September 2015 Quod appraisal, which we concluded was a realistic estimate. Currell have provided an updated pricing schedule. In our previous reports, we agreed that the sales values applied were realistic, based on analysis of comparable residential schemes in this locality.
- 1.27 The Land Registry House Price Index shows a 2.3% increase in sale values from September 2015 to December 2015 (the latest month for which data is available). The Currell advice dates from 12th August. Consequentially we suggest that an upward adjustment of the sales values may be appropriate. Increasing this by 2.3% gives £1,014 per sqft, and £366,000 higher total private residential values.
- 1.28 Currell have not provided a commentary or justification for their limited uplift in values in the updated pricing schedule. In the absence of further justification, we consider the House Price Index to be the most suitable way to update values.

Affordable housing values

- 1.29 Affordable housing values remain at £140 per sqft, which remains unchanged from the September 2015 appraisal. Taking into account the impact of the summer 2015 Budget, which has resulted in continued uncertainty amongst Registered Providers, we would not expect to see an increase in affordable housing values over the period since the September 2015 appraisal. We therefore maintain that the values are reasonable.

Build costs

- 1.30 The build costs have been reduced by £123,954 to £13,489,674. Faithful & Gould have prepared an updated cost plan. The proportion of office floorspace has increased and the residential floorspace has decreased.
- 1.31 The rate per sqft for the private residential floor space has increased from £2,124 per sqm to £2,228 per sqm. This is a 4.9% increase. The office cost rate has actually gone down, from £2,307 per sqm to £2,117.36, which we assume results from the increase in overall office floor area which may lead to more costs efficiency for the office element of the scheme. In any case, these changes have a minimal impact on overall costs.
- 1.32 The latest cost plan update by Faithful & Gould is dated November 2015, therefore it could be appropriate to update the costs to reflect recent inflation, but this has not been done by Quod. The tender price index has only increased by 0.7% (277 to 279) from Q4 2015 to Q1 2016. However, there has been a large increase in the location factor for Islington:
- On the 9th November 2015 the Location Factor was 125.
 - On the 22nd February it was 137
 - On the 19th February update it was 132. This is the latest data that we have access to.
- 1.33 Increasing the location factor from 125 to 137, when combined with TPI inflation, leads to a 10% increase in costs. This would add £1.35m of base build costs to the Quod appraisal, together with concomitant increases to professional fees, land finance and contingency - all of which are calculation as a percentage of the base build cost. With the last Location Factor of 132, the increase in base build costs is £854,000.
- 1.34 It is apparent that the Location Factor is highly volatile, which reflects the relatively small sample size that it is calculated upon and thereby the tendency for it to be

skewed by individual schemes or a succession of schemes that differ from the average for the Borough. Therefore short-term variations in this Location Factor should be treated with caution, although the general trend towards relative increases in Central London build costs (primarily due to labour shortage in London relative to other parts of the country) is a more reliable and well-evidenced trend.

BPS Chartered Surveyors