Leicester City Council - Leicester CIL

Student Accommodation – Leicester City University Response to Adjournment Note Issued 27th August 2015

These are the University of Leicester's answers to the areas of contention as referred to in the shaded boxes of the HDH response dated 27th August 2015.

With reference to Paragraph 6 of HDH response – DTZ (Cushman & Wakefield) are specialists in the field of Student Accommodation, Derek Nesbitt is Head of Student Valuation and has over 25 years' experience of valuing and appraising purpose built student accommodation. DTZ are a firm of International Chartered Surveyors who have a dedicated Student Team, not only selling sites but providing consultancy and valuation advice to Universities, Major Operators and Developers of Student Accommodation. DTZ have valued in excess of £2b of student assets in the last 18 months comprising 109 schemes and circa 35,357 bedspaces.

The amount of the uplift over and above the EUV is central to the assessment of viability, and manipulating the market inputs by excluding costs such as purchaser costs and excluding the additional Acquisition SDLT and Fees on residual land calculation provides a distorted position on the revised financial models thus producing an elevated viability position to support a CIL charge.

CIL contributions need to be shown to be capable of being viably paid out of the 'additional profit' as referenced ref. Para 5.4 Executive Summary of the January 2013 VS report.

"In setting CIL the council will need to weigh up a wide range of information – including the viability evidence. Our recommended strategy for setting CIL is to set CIL "low" (that is to say well within the limits of viability)".

Para 1.12 Also in HDH January 2013 VS report their recommended strategy for setting CIL was "to take a cautious approach, to set CIL well within the margins of viability so it can be borne by most development sites".

In reviewing the Additional Paper now produced by HDH on 27th August 2015, it must be read in the context of HDH review in their January VS report which stated in a number of places that "appropriate available evidence" would be used.

Para 2.12 "Appropriate Available Evidence"

The legislation (Section 211 (7A)) requires a charging authority to use "appropriate available evidence" to inform the draft charging schedule. Need to demonstrate that their proposed CIL rate or rates are informed by "appropriate available evidence".

Para 2.16 "Normal Cost of Development"

Legislation (Section 212 (4) (b)) requires a charging authority to use "appropriate available evidence" to inform the draft charging schedule, (paragraph 2.26).

Para 2.26 "In the approach used in this report the amount of the uplift over and above the existing use value is central".

Indeed the NPPF says "Evidence supporting the assessment should be proportionate, using only appropriate available evidence".

Charging authorities need to demonstrate that the proposed CIL rate or rates are informed by "appropriate available evidence".

Para 2.38 "CIL Regulations and CIL Guidance are clear that the assessment of the potential impact of CIL should, wherever possible, be based on existing available evidence".

Answers to HDH Questions

<u>Point 1</u>

POINT 1
Are the above statements common ground? If student accommodation is not viable what is the explanation for the activity in the sector?

The University consider that student accommodation in Leicester is viable at land values at or close to Existing Use Value (EUV/AUL) for alternative use but development is not necessarily viable above these figures to provide the **<u>"additional profit"</u>** margin that HDH seek to show and out of which a CIL rate can be charged.

The position on "additional profit" or lack of it is clearly shown when the HDH revised viability residual calculations include all appropriate assumptions such as Purchasers costs.

HDH are seeking to prove that there is "additional profit" in student development above EUV / AUV based upon £2,000,000 per hectare plus 20% increase at "2,400,000 per hectare, however at or around the existing use / alternative use value there will be development activity and viability of student accommodation.

The additional profit calculated by HDH in their financial viability calculations is in essence the issue in dispute not the wider viability of the student sector.

<u>Point 2- Modelling</u>

POINT 2
Is it correct to base the modelling on recent planning applications, if not what should be used? Should different modelling assumptions be used?

On the evidence shown in Table 3, Review of Recent Planning Applications relating to letting room areas there is only an analysis of circulation space with an assumption of 26% circulation spaces for a student development and 35% for cluster flat development. There is no evidence shown in relation to the room sizes in these schemes.

The circulation space that has been indicated appears to be realistic however the issue is when the circulation space calculated by HDH is added the total area per Bedspace the figure that is put forward is low compared to our analysis of recent schemes where we have full knowledge of all the areas.

Our analysis attached as appendix 1, shows 6,776 rooms in 9 schemes with an average of 26 sq m per cluster which is higher than the 23 sq m put forward by HDH. There is a limited number of studio's schemes able to be analysed. However there is insufficient evidence provided by HDH to check their assumptions for both clusters and studio's with Table 3 not having all the relevant information on bedspace areas to then add to the circulation figures to provide defendable areas. Should the area of the units need to be increased the rent would remain the same but the build costs would increase making the models less viable.

However for the purpose of the calculations we have kept these adopted areas as we believe there is a more fundamental error in the calculations.

Point 3 - Rentals

> POINT 3
>
> The University has not commented on these assumptions – are these rents agreed? If not what alternative evidence is there that different income levels should be used.
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> CODE has suggested that the average charged over the 660 unit Western Road (which was voted the UK's best student accommodation in 2013-14) was £5,904/room. It is suggested that this is the norm – if so why should the examples set out in Appendix 3 not form the basis of the analysis?

In Table 5 of HDH response, Student Accommodation Costs £ / year are referred to, this title is misleading as it should be Student Accommodation Rentals £ / year.

The assumed rental levels are considered to be reasonably realistic however the operating costs for the cluster bedspace is understated as highlight in the next section.

Studio:	£6,800 pa @ 51 weeks	£133.33 per week
Cluster:	£4,750 pa @ 44 weeks	£108.00 per week

Point 4- Management Costs

> POINT 4
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> Is this approach (25%) agreed – if not what alternative approach should be taken?
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> Would it be preferable to consider gross rents – see Point 5 below.

HDH have put forward a 25% cost of management position based upon advice they received from Matthews & Goodman who are not specialist student valuers, and comment that "traditionally

deductions of 20% to 25% are industry standard" – they are not. The specialist student valuers do not assess operating cost on a % of gross rent basis they analyse the costs in detail.
We provide in Table 1 attached an analysis of circa 12,647 student bedspaces in 27 purpose built schemes which shows a relationship of management costs for the cluster bedspaces at 30% of the gross rental at an average cost of £1,382 per bed for the direct let schemes. This is in comparison to the £1,187.50 assumed by HDH based upon Matthews & Goodman rule of thumb of 25%, there is a shortfall of £194.50 per room per annum, a difference of 16.38%.

HDH and Matthews & Goodman have suggested that valuing based upon the gross rental with a gross yield taking no account of the management operating cost is one way of valuing the scheme's , this is not an acceptable approach.

Valuing by gross yield applied to gross rents is only applicable to HMO student accommodation. In valuing £2.0 billion of purpose built student assets this last 18 months DTZ have not used a Gross Rent / Gross Yield methodology it is not appropriate and could be considered negligent.

The 25% operating / management cost for cluster flat model is an inappropriate percentage to take irrespective of Matthews & Goodman's view which is not based on any detailed analysis of the costs of operation.

However for the purpose of the calculations we have kept these adopted cost of management as we believe there is a more fundamental error in the calculations.

Point 5 – Values and Yields

POINT 5
Are the values of £81,000 per Studio Flat and £57,000 per Cluster Flat appropriate? If not what alternative value should be used and why? Do you wish to comment of the gross approach and the net approach – clearly a building is worth what it is worth and the method of getting to the value is mainly of interest to valuers…. CODE suggested an approach based on 'height and density' but did not elaborate – do you want to elaborate now?

We would highlight that the Savills yield table in paragraph 24 of HDH response has an error in the yields, the Secondary Regional Direct yield is wrongly stated at 5.75% it should be 6.75% and I provide the copy of the Savills report from which HDH has copied the yield table from.

At Paragraph 26, the cluster flat management costs as shown from our comments above are understated they should be 30% of £4,750 providing a management cost at £1,425 pa per cluster room. If this is applied to the calculation of value the value per room would reduce.

Net Rental at £3,325 x 15.38 (6.25%) = £51,154 less purchaser costs at 5.8% at £1,432, provides a room value of circa **£49,721** which is less than the stated £57,000 in HDH's modelling.

At Paragraph 27, HDH again refer to valuing on an adjusted gross yield basis, we would advise that only HMO operators take a view of Gross Yield on Gross Rental, all other developers and operators who would deliver purpose built of the nature of the assumed schemes in HDH modelling would review operating costs and apply a net yield before deducting appropriate purchaser costs.

If the operator does not know his operational / management cost he will not survive the market and will not be capable of obtaining finance as the banks wish to see the net net rental cover to interest payment.

The gross calculated values shown by HDH in Table 7 are irrelevant as they are not based upon any market obtained yield evidence. Even if it were, purchaser costs would still need to be deducted.

The method of getting to a value is relevant to all parties in the market, the land purchaser, developer operator, bank funder, institutional purchaser and the valuer. Without knowing the net value the market cannot function. To imply it is of interest only to valuers is a misleading statement.

Again for the purpose of the calculations we have kept these adopted values as we believe there is a more fundamental error in the calculations.

<u>Point 6- Buyers Costs</u>

POINT 6 Is this a correct understanding of the representation?

The standard market approach is to calculate investment value by applying a net yield to the net rent which is then reduced by the purchaser costs of SDLT, Agents and Solicitors costs and to imply otherwise is misleading.

The reason for the deduction is not for discount but that on all investment calculations to calculate the net receivable value there is stamp duty to pay on the assumed hypothetical transaction plus solicitors and agent's fees which have VAT applied which total 5.80%.

In 25 years of valuing student accommodation for either development, operational, disposal and or acquisition but particularly on site residual calculations purchaser costs are deducted, even if the party who is developing the scheme such as a University intends to hold the investment. The assets are still valued with a reduction for Purchaser costs, Agents and solicitors Fees.

We have as HDH have sort support from Matthews and Goodman for their modelling assumption also sort confirmation from a number of major student developers and RBS Bank who are a major bank funder in this market. All confirm that Purchaser costs are always deducted.

We would also would refer you to the following documents which indicate what the definition of Purchaser Costs are as they are similar to the Acquisition costs that HDH have partially taken account of on the site residual and existing use value.

They are the very same costs applied for the same reason when the site is sold or acquired stamp duty and acquisition costs are paid as is the stamp duty and purchaser costs when the developed scheme is sold or acquired.

- GVA Property Definitions
- VIP 12 RICS Guidance Note
- Encyclopaedia of Real Estate Terms by Damien Abbott
- Email from Simon Pollitt MRICS Head of UK Property – Student Housing Company
- Email from Charles Marshall, Head of Liberty Living (a developer and operator of 20,000+ bedspaces who have recently purchased Student Castle) dated 01-Sept-2015.
- Email from Heath Thomas Head of Real Estate Finance RBS specialising in Student Housing
- HMRC Stamp Duty Land Tax guidance note

Deducting purchaser's costs is not replicating "a particular developer's business model" as inferred by HDH, it is standard market practice, and as pointed out by Matthews & Goodman who HDH have sort further advice from "It is standard valuation and appraisal practice to deduct notional purchaser's costs". These costs will be incurred as the assumption the property will be sold and what is the net value to be received.

We have valued for York University, Leeds University, Aston University to name a few and all their calculations of value have purchaser costs deducted. With my team in Manchester we have valued in excess of £2 billion of student assets in the last 18 months alone for developers, funds and Universities all have purchaser costs deducted.

Not to take account of purchaser costs would be considered a gross error by a valuer.

Developing a student scheme for operational reasons does not mean the operator, his valuer or his bank ignore purchasers costs, the developer / operator cannot sell at the gross price and all valuers in the other specialist student practices over the 25 years of specialising in student accommodation have deducted purchasers costs in these cases.

The valuation for the University of Leicester assets would include a deduction for purchaser costs irrespective that they would develop to hold, not taking a deduction is overstating their value and is inappropriate.

HDH's representation of Purchaser Costs in their modelling as Investor Costs and arguing that it is an allowance or discount not to be taken account of in their calculations is misleading and a gross error in their viability modelling.

To show in Table 8 at para 55 the impact that Purchaser Costs have to the Residual Land Worth (RLW) calculation particularly to the cluster schemes when including stamp and Agent's costs at 4.5% is the reality of the residual. We would point out that the figure of 4.5% is understated and should be 5.8%. If the right figure is used in all the further modelling as it should the figures would show a negative or reduced Additional profit. We have replicated HDH appraisals and attach at Table 3.

Applying Purchaser Costs is actual market reality not an allowance or discount, any holder of investments deduct purchaser costs as it is a normal cost of development and must be deducted.

Not deducting these figures overstates the viability of the sites

Point 7- Development Costs

POINT 7
Are there any comments on the model and inputs to it?

The development cost that HDH have assumed are taken from BCIS however our own analysis of build costs as seen in Table 2 attached is £1,720/m2 we would also assume a higher percentage of Infrastructure costs in the order of 10-15% as the BCIS costs are base build including prelims.

Other cost assumptions appear to be acceptable however we would highlight the error that HDH have made in the assumption of Site Acquisition Costs which includes Stamp Duty and agents Fee and solicitors costs.

The costs are understated at 4.5% and are then only applied to the Land Used/ Site Cost figure based upon the £2,400,000 per ha figure, but they should also be applied to the positive Residual Land Worth for any land value above the assumed Site Cost position, by not applying to this "additional profit" above Site Cost figure further overstates the position especially where this figure is significant. In our revised models in Table 3 we have applied the acquisition Costs to the additional land value and quoted a Net Residual Land Worth position to then compare to the percentage of CIL to Residual Value.

Point 8- Land Values

POINT 8
Are these values agreed?

We agree with Mathews and Goodman that "The rate per room is a more effective measure of site value" for benchmarking student accommodation values and utilising a rate per hectare could be misleading as the land take for a student scheme can take a small percentage of an acre. The assumptions within HDH models are 0.050 to 0.750 of a hectare yet HDH then convert this to a value per hectare which is modelling only relevant to CIL analysis.

We for the purposes of the calculations we have kept the assumed Land Used/Site Cost figure for the appraisals. Although it would be our view that the benchmark land value should be set higher.

Potential for CIL

The HDH full appraisals in Tables 12, 13, and in Appendix 4 have been undertaken excluding Investor Costs and only applying Site Acquisition costs to only the base Land Used / Site Cost. The reason given for not applying Investor/Purchaser costs to the investment calculation is note in HDH Development and Land Assumptions for Review sent to Mathews and Goodman in Question 6 - "We have not made this adjustment as we (HDH) have assumed (rightly or wrongly) that the University will be developing to hold or by a developer to operate- rather than just building it to sell it after a year or so of trading”

Mathews and Goodman’s response in their letter 24 August 2015 to Question 6 was **“It is standard valuation and appraisal practice to deduct notional Purchaser Costs**”. It is therefore rather odd that HDH would take the view that these costs would be excluded from their Viability Appraisals with their only other stated reason being at Para 74 of their Response “It is clear from activity in Leicester City that Student Accommodation is viable.” However they have only been able to show this viability by excluding Purchaser Costs on the gross Investment values and only applying acquisition costs to the Land Used/Site Costs excluding it from the extra land value above this figure.

They recommend setting CIL at £30/m2 in Para 75 on the basis of their flawed modelling and suggest in Para 76 that at this level of CIL it represents about £1,000,000/ha value, yet the excluded Purchaser and Acquisition Costs represent between £3,000,000 to £5,000,000/ha and at these levels the fact that against “standard valuation and appraisal practice “ HDH have excluded these justifiable costs to prove their viability would impair delivery as developer would be including these costs in their appraisals. Adding these normal cost of development into the appraisals would severely reduce the buffer or cushion that HDH have shown.

By excluding these costs from their viability calculations and adding £1,000,000/ha to the development costs would amount to a burden on the assumed sites of between £4,000,000 to £6,000,000/ha which would seriously impair development.

The exclusion of these costs in the HDH models would result in an impact on 40-49% of the suggested current trading range of £7,500,000 to £11,500,000/ha values.

Conclusions

Purchaser’s costs are included in all student valuations carried out by other widely experienced student advisory teams and must be classed as a standard industry and appraisal outgoing. These costs should be included at a total cost of 5.8% of gross scheme value (SDLT at 4% + (1.5% + VAT at 20% = 1.8%) = 5.8%) rather than the 5.5% adopted by HDH in Table 8 (VAT being payable on agent and legal fees).

When Purchaser’s Costs are included in the HDH appraisals shown at Table 8, the Cluster development scenarios are shown to be unviable. When the Purchaser’s Costs are excluded at Table 9, the Cluster development scenarios are all shown to be viable, with viability increasing with the scale of scheme. The positive appraisals in Table 9, therefore, give a misleading impression due to the omission of costs which the market regards as appropriate and essential.

It must be understood the Residual Land Worth includes the Additional Profit HDH refer to as what is released when planning is granted. It is out of this ‘Additional Profit’ that the CIL Charge is calculated and judged. If normal costs of development are left out such as Purchaser costs, then the charge will be overstated. By excluding Purchaser/Acquisition costs, and the additional Acquisition costs when the Residual Worth is higher than the EUV, the Additional Profit is overstated, and consequently the margin of variation is also overstated.

The HDH table 8 includes “Investor’s Costs” and Table 9 excludes “Investor’s Costs”. We regard the “Investor’s Costs” of SDLT and agent / legal fees as more correctly defined as Purchaser’s Costs. They will be incurred by any purchaser of the development and therefore when include the RLW reduces and in most cases is negative therefore the indicated CIL charge at £30 per m2 cannot be supported.

We have been provided with the latest update response by HDH to University of Leicester issued 27 August 2015 which includes HDH further revised Student Accommodation models.

Having undertaken our review of these further revised Residual Value models, we note that there are still fundamental errors / omissions which relate to inputs in the model which need to be corrected. There are also other issues relating to average area size of bedspace and studio's and management costs and the rate per sq m build cost being too low with only 5% infrastructure costs applied.

However for this further review we have focused on the two main matters and reserve our position to review in more detail the other matters.

The two fundamental omissions are:

Investor Purchaser Costs: After the net rental is capitalised by the assumed 6.25% net yield, purchaser costs need to be deducted otherwise the capitalised value is overstated. We have three key parties in the market place indicating that purchaser costs are always deducted in all cases. These Purchaser Costs are the same as the Acquisition Costs which are described and covered in **paragraph 7.52** of the CIL Viability Study dated January 2013 at Page 94.

"The allowance for purchaser costs at 1.5% for acquisition agent and legal fees, and stamp duty to be calculated as at the prevailing rate".

This would add 5.5% under HDH's assumptions although current market costs due to the increase in VAT on solicitors and agent's fees would be a standard deduction to 5.8%. Even Mathews & Goodman who HDH have consulted have advised they are standard valuation and appraisal practice, yet they have been excluded from the models and therefore provide an artificial positive viability position from which HDH then sense check the proposed CIL charge rate of £30/m2.

Site Acquisition Costs: HDH have now amended the position, however HDH have not applied these costs to the additional Residual Land Worth when it is above the Land Used/Site Costs. They only calculate it on the Site Cost figure however in case of the Studio models this figure is less than the Residual Land Worth therefore there will be extra Site Acquisition costs to pay. Excluding this extra cost on residual land values in their viability calculations again leads to an overstatement of land value from which CIL is take and benchmarked.

They use 5.5% although the current market due to the increase in VAT on solicitors and agent's fees has been using for some time now the standard deduction of 5.8%.

The combination of the two fundamental errors / omissions relating to purchaser and acquisition costs overstates the residual value.

To illustrate the impact of the missing costs the Residual Land Worth in the presented models in HDH's Table 9 currently show an average across all six residuals that have been presented for the RLW at circa 2.20%-2.9% for Cluster models and 7.61%-8.04% for Studio models of calculated Gross Development Value before deduction of Purchaser Costs.

Yet the missing Purchaser Costs are 5.8% of Gross Development Value with the Acquisition costs adding a greater percentage when the land value for the studios runs higher than the Site Costs. If these two elements are adjusted they would significantly reduce the Residual Land Worth (RLW) to nil for the cluster models and significantly reduce the land value for the studio models. HDH cannot pick one student type ie Studios, identify these as being viable and then argue the CIL charge can be applied to all schemes whether cluster or studio.

Making the adjustments and reducing the RLW would increase the percentage apportionment of proposed CIL charge to the RLW. Even at the £30 per sq m the proposed charge rate will be in excess of 50% when all other land uses in the CIL including the residential models are at 10% or below.

Benchmarking Proposed CIL Charge to Residual Land Worth (RLW)

We have reviewed the CIL Viability Study Update report prepared for Leicester City Council dated December 2014 and would refer to Page 46 within Table 4.4 where HDH have sense checked the proposed CIL charges as a proportion of GDV and as a Proportion of Residual Value (RLW) for all land uses.

We note that the Student Accommodation charge was not included in the table for comparison we have prepared for comparison purposes at the proposed charge rate of £30 / m2 with and without the errors provided in the following format as Table 4.4. We now show the comparable as follows:

175 Studio Model	CIL	GDV		Residual Value Worth		Assumed Benchmark Land Value		Land Value per Bedspace		
£30 with errors	£163,170	£14,175,000	1.15%	£1,121,405	14.55%	£600,000	27.2%	Value per Bed £6,408	CIL per Bed £932	14.55%
£30 without errors	£163,170	£13,352,850	1.22%	£284,083	57.5%	£600,000	27.2%	Value per Bed £1,623	CIL per Bed £932	57.42%

As calculated by HDH for Student Accommodation

HDH at paragraphs 4.42 and 4.43 of the Update Study reference that the purpose of viability testing is to assess the effect of CIL and to assist the Council in striking the balance and to inform the process further. HDH set out in Table 4.4 on Page 46 the CIL as a proportion of the site Gross Development Value and the Residual Value for the other land uses which excluded student accommodation. At paragraph 4.45 HDH reference that CIL would typically fall in the range of 9% to 16% of the Residual Value being the maximum a developer can bid and make a competitive return. At paragraph 4.46 HDH suggest that in none of the appraisals in Table 4.4 would result in land values falling by 25%.

What is most striking however in relation to HDH's revised 27th August 2015 calculations for Student Accommodation in their Appendix 4, the proportion of CIL proposed as a % of RLW/RV (albeit with errors) was substantially above 25% of the calculated Residual Value especially for the clusters and still high for studios. At these sort of levels it does not strike any balance and therefore it is obvious that the previous proposed rate of £100/m2 would have threatened the delivery of Student Accommodation in the city and with the missing costs the proposed £30/m2 would impact the cluster model and when the missing costs are added the suggested imposed rate would again threaten the delivery of both cluster and studio student accommodation schemes base upon HDH models.

The fact that the proposed CIL payment is such a substantial proportion of the development cost and land value should give the council concern that CIL would threaten the delivery and economic viability of Student Accommodation and therefore the CIL charge should be set at Nil.

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Cushman and Wakefield
11th September 2015