Development and Value-Add

Interview preparation summary · RE track

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INT.ED.1.a · Developing

Build a development appraisal and solve for residual land value, then show how sensitive the answer is to the exit yield.

A development appraisal works backwards from what the finished building will be worth to what a developer can afford to pay for the site. Start with gross development value: the rent the scheme will achieve, capitalised at the exit yield, then reduced for purchaser's costs to give the net value a buyer will really pay. Deduct construction cost, professional fees, a contingency, letting and sales fees and finance on the build, then deduct the developer's profit, set as a percentage of cost or of value. What is left is the residual; remove acquisition costs and the cost of carrying the land to reach residual land value. Land is the small balancing item between two large numbers, so it is geared: a modest fall in the exit yield or rise in cost removes a much larger share of land value. Interviewers ask this to see whether you understand why a bid must be tested against yield and rent. Usual mistakes: forgetting purchaser's costs, ignoring finance on the land, and mixing profit on cost with profit on value.

WORKED EXAMPLE: RESIDUAL LAND VALUE FOR THE WEXCOMBE QUAY OFFICE SCHEME

An invented developer is appraising Wexcombe Quay, a new office building of 10,000 sq m net lettable area and 12,500 sq m gross. Expected rent is 480 per sq m a year, the exit yield 5.5% and purchaser's costs 6.8% of gross value. Build cost is 2,600 per sq m gross, professional fees 10% and contingency 5% of build cost. Letting fees are 10% of first-year rent and sales fees 1% of net value. Finance on the build is 7% for two years on an average half-drawn balance. Target profit is 15% of net value. Acquisition costs are 6.8% of the land price and the land is carried at 7% for 2.5 years, treated as simple interest. What is the most the developer can pay for the site? All figures in millions, rounded to two decimals from an unrounded model.

Answer: The most the developer can pay is about 22.4m, and that value is very sensitive to the exit yield: a 25 basis point rise in yield removes about 2.4m.

> **Interview tip:** Say it aloud in this order: value the building net of purchaser's costs, take off build, fees, finance and profit, then divide out the cost of buying and carrying the land. Finish by saying the land price is the geared leftover, so you would bid below the residual to leave a margin.

INT.ED.1.b · Developing

Calculate yield on cost, the development spread over the exit yield and profit on cost, and use them to judge whether a scheme is worth its risk.

Yield on cost is the stabilised net operating income of a finished scheme divided by the total cost of delivering it, including land, acquisition costs, construction, fees, finance and letting costs. It is the return the developer earns if it simply holds the asset. Compare it with the exit yield a buyer would accept for the same completed, let building. The gap, the development spread, is what pays for planning, construction and letting risk, and it is often looked for in a range of around 100 to 150 basis points depending on property type and risk. Profit on cost follows from the same figures: it is yield on cost divided by the exit yield, less one. Interviewers like this metric because it ignores the exit price and shows how much room a scheme has if yields move. The usual mistakes are leaving finance or land costs out of the denominator and quoting profit on value as if it were profit on cost.

WORKED EXAMPLE: YIELD ON COST FOR THE TARN ROAD DISTRIBUTION UNITS

An invented fund will build the Tarn Road distribution units. Total cost, including land, build, fees, finance and letting costs, is 31.2m. Stabilised net operating income once fully let is expected to be 6.4% of that cost. Comparable completed and let units trade at a 5.4% yield. Ignore purchaser's costs for simplicity. Is the scheme worth the risk, and how much can the exit yield and the rent move before the profit disappears?

Answer: Yield on cost is 6.4% against a 5.4% exit yield: a 100 basis point spread and 18.5% profit on cost, and the profit is gone if yields rise by 100 basis points.

Interview tip: Lead with the spread, not the profit figure. Say what the spread pays for, give the yield move that wipes it out, and say whether a pre-let and a fixed-price contract would let you accept a thinner spread.

INT.ED.1.c · Developing

Assess programme, construction cost, planning and pre-let risk, and put a price on a delay.

A development's return depends on a chain of dependent events: planning consent, discharge of conditions, contractor appointment, construction, practical completion, letting and sale. Each link can slip, and a delay is rarely free. It extends interest on land and drawn debt, exposes the remaining build cost to inflation, defers rent and can push a deal past a tenant's long-stop date or the end of a hedge. Price a delay by adding these channels for each month and comparing the total with contingency and with profit. Construction risk is reduced by a fixed-price contract, a sound design, ground investigation and contingency sized to the stage of design. Letting risk is reduced by a pre-let or forward sale, which also makes funding easier. Interviewers ask about this to see whether you think about sequence and about who bears each risk. The usual mistake is treating contingency as a spare margin rather than the first loss for known uncertainties.

WORKED EXAMPLE: PRICING A PLANNING DELAY AT ORRIN PARK

An invented developer has bought the Orrin Park site for 9.0m with debt at 8%. The build budget is 28.0m, with remaining build costs expected to inflate at 4% a year until the contract is fixed, and the scheme will earn 2.4m of rent a year once let. Base profit is 4.7m. Planning is delayed by six months. Estimate the cost of the delay and compare it with a contingency of 5% of build cost. Treat the delayed rent as lost, and use simple interest.

Answer: A six month delay costs about 2.1m, around 45% of base profit, and more than the 1.40m contingency.

Interview tip: Say that delay is a cost per month, give the three channels and the total, and then say how you would cut it: planning risk priced into the land deal, a fixed-price contract, and long-stop dates in any pre-let.

INT.ED.2.a · Value-add and risk

Underwrite a refurbishment or repositioning by comparing the return on the extra spend with the cost of buying the finished product.

Value-add means buying an asset with a fixable weakness, such as tired space, a poor layout, short leases or an outdated specification, and spending capital to lift rent and value. The business plan has three parts: what the building earns today, what the refurbished building should earn, and what it costs in capex, fees, finance and lost income to get there. The test is the incremental one. Divide the extra net income by the extra spend, including the cost of carrying the asset while works are done, and compare the result with the exit yield: if the incremental yield on cost is well above it, each pound of capex creates more than a pound of value. Also compare the all-in cost with what the finished asset would cost to buy, and test the rent assumption against evidence for refurbished space. Interviewers probe whether you separate the price you paid from the value you add. The usual mistake is forgetting finance, voids and leasing costs.

WORKED EXAMPLE: REFURBISHING HARCOURT HOUSE

An invented fund can buy Harcourt House, an office let at 1.2m a year, for 18.5m plus 6.8% purchaser's costs. It would spend 6.0m on refurbishment over 12 months, then take six more months to let. Finance is 7% a year on the purchase cost plus half the capex over 18 months, simple interest. Leasing fees are 15% of the first year's rent. The refurbished building should let at 1.9m a year, with non-recoverable costs of 0.08m, so stabilised income is 1.82m. Similar refurbished offices trade at a 5.5% yield. Is the plan worth doing?

Answer: The plan costs 28.4m all in, is worth about 33.1m, and earns an incremental yield of 7.1% against a 5.5% exit yield, so it is worth doing if the 1.9m rent is achievable.

Interview tip: Separate the purchase from the plan: say what you pay for the existing income, then show the extra spend and the extra income, and state the incremental yield against the exit yield. Close with the two assumptions that matter.

INT.ED.2.b · Value-add and risk

Model the letting-up of a part-vacant asset, including voids, rent-free periods, leasing costs and the effect on exit value.

In a value-add plan the income is not there on day one. The business plan has to show when each vacant floor is let, at what rent, after what rent-free period, and with what leasing cost, and the investor carries the empty building meanwhile: empty rates, service charge shortfall, insurance and the interest on the capital. A headline rent overstates the economics when incentives are given, so compute the net effective rent, which spreads the rent-free months over the term. A buyer at exit will normally deduct any unexpired rent-free from the price, so incentives are a cost even when the lease is signed. The pace of letting matters more than a small change in rent, because each extra empty month costs the full rent plus the void costs. Interviewers ask for the sensitivity to letting speed and for evidence of demand. The usual mistakes are using headline rents, ignoring void costs, and assuming every floor lets on the same day.

WORKED EXAMPLE: LETTING-UP DUNMORE POINT

An invented fund owns Dunmore Point, a 60,000 sq ft office with 36,000 sq ft vacant. The target rent is 38 per sq ft a year. Typical deals are five-year leases with nine months rent-free. Empty space costs 7 per sq ft a year in rates and service charge shortfall. Letting fees are 15% of first-year rent. The business plan assumes the vacant space is let after 12 months, but a rival scheme may delay it by eight months. The stabilised yield is 6.0%. Quantify the economics and the cost of a slower letting.

Answer: The headline rent is 38 but the net effective rent is 32.3, and every extra empty month costs about 0.14m, so eight months of delay costs 1.08m.

> **Interview tip:** Say the net effective rent first, then the monthly cost of an empty building, and use the monthly cost to decide whether a bigger incentive to let sooner pays for itself.

INT.ED.2.c · Value-add and risk

Size the margin of safety in a development or value-add plan by finding break-even points and running a combined downside.

The margin of safety is how far things can go wrong before the investment loses money. For a development, profit is the gap between completed value and total cost, so find the break-even for each driver on its own: how far value, rent, exit yield or construction cost can move before profit is zero. Divide the profit by the item that moves: by the variable costs for a cost overrun, by the value for a fall in value. Then run a combined downside in which several things go wrong together, because rent, yield, cost and timing are often correlated: a weak market raises yields and slows letting at once. Compare the downside with the equity at risk and with what lenders will accept. Interviewers want to hear that you know the single-variable breakevens look comfortable and the combined case does not. The usual mistake is testing each driver separately and concluding the scheme is safe.

WORKED EXAMPLE: MARGIN OF SAFETY AT CALLOWAY YARD

An invented developer's Calloway Yard scheme has net income of 2.75m at a 5.5% exit yield, so a completed value of 50.0m. Total cost is 41.0m, made up of 10.0m of land, which is already paid for, and 31.0m of variable costs. Profit is 9.0m. Find the break-even for value, cost and yield. Then run a combined downside of rent 5% lower, exit yield at 6.0%, variable costs 7.5% higher and 0.8m of extra finance from delay.

Answer: Alone, no driver breaks the scheme until value falls 18% or costs rise 29%, but the combined downside loses about 0.6m.

> **Interview tip:** Give the single break-evens in a sentence, then say that real downsides are correlated and give the combined result. End with the action that would put the combined case back to break-even.