Viability Evidence in connection with the Eastbourne Employment Land Local Plan & Sovereign Harbour

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Appendices

1 Introduction

We have been asked to provide advice in connection with the public examination of the draft Employment Land Local Plan.

This advice relates to the likelihood of a new building, similar to the existing Pacific House, being built in the absence of public funds and in particular the use of Pacific House as lending collateral to fund a second building of the same size and design as existing.

We have been advised in connection with Pacific House that:

- office suites in the building range in size from 627 to 4,412 sq ft.
- occupiers are offered certainty of occupation of 3 years or more but have the right to break their tenancy at any time on 3 months' notice.
- occupiers pay a deposit of 3 months' rent which is forfeited in the event that the occupancy is broken.
- rents agreed and asked seem to equate to between £16:00/ sq ft and £16:50/sq ft.
- tenants have been given a 1 month rent free for a 3 year term and in one case a year's rent free for a 10 year lease.
- the tenants also pay a service charge and business rates.
- marketing began in Q2 2015 and the building was ready for occupation in August 2015
- subject to confirmation, 27% of the space is occupied, i.e. approximately 6,800 sq ft, with interest in a further 2,000 sq ft.
- the existing building cost in the order of £5m and the total development cost might have been in the order of £6m including land and site wide costs. We do not know whether finance costs are included in the above. See for example the financial case which was submitted as part of the business case for Sovereign Harbour contained in Appendix 1(page 320 SD13) which was included in the background to a Report to the Lead Cabinet Member for Strategic Management and Economic Development in June 2013.

2 The Eastbourne Office Market & Sovereign Harbour

The GVA Report entitled "Employment Land Supplementary Evidence Report November 2014" – Appendix 5 sets out a case for a choice between B1 space in the town centre and out of centre locations. The classic out of town location would be an office park located on a main arterial road with high levels of accessibility. A professional practice or company may prefer such a location if car borne access to the wider region is important.

Sovereign Harbour, whilst technically out of the town centre, would not in our opinion be the preferred location for occupiers seeking an out of town location in Eastbourne as it is distant from the main arterial roads connecting Eastbourne with neighbouring towns.

More recently Cushman & Wakefield have submitted an Eastbourne Viability Report dated June 2016. This has been submitted too late to allow us to provide any detailed comments. However we would refer you to the following:

- the office leasing deals Table 1 and the investment comparables Table 2. The rental transaction data suggests that rents for new and refurbished space are in the order of £14.50 - £16.50 psf. There is no mention of rent frees but we would expect incentives to have been provided. The Ivy House investment sale analysis is an important for yield purposes. Our understanding is the price achieved was £3.23m, the annual passing rent was £282,037 per annum and the full actual and estimated rents assuming 100% let was £319,639 per annum assuming the vacant space were to let up at £15 psf which after allowing for purchasers' cost would give an initial yield to a purchaser of 8.25% and a reversionary yield assuming 100% letting of 9.35%.
- paragraph 2.4 refers to the out of town offer at Sovereign Harbour. Our view is that Sovereign Harbour should not be considered as out of town but rather edge of town centre without the supporting facilities such as retail, rail station, numerous bus services etc.

These are low levels of rents compared to the average across the south-east region. Low rents do not encourage development and are a symptom of weak demand.

3 Viability Analysis

We have reviewed the viability analysis contained in Section 5 of the GVA report and have updated it to reflect the passage of time since this work was undertaken.

We have recreated the appraisal in Table 8 to reflect rents actually being achieved in the order of £16.00 to £16.50 psf, rent frees of say on average 6 months, a letting void allowance of 12 months, a yield of 8% after making a permanent void allowance equivalent to 15% of the full Estimated Rental Value of the building and purchaser's costs of 6.8% of Net Development Value.

We have increased the building cost by 7.3% to reflect building cost inflation over the last two years (BCIS Tender Price Indices All-in TPI + 7.33% June 2014 – June 2016).

Stamp Duty Land Tax has been increased to reflect the changes brought in by the 2015 budget.

The profit allowance is usually calculated on all costs including land and we have calculated it in this manner.

Based on these assumptions we have recalculated Tables 8 & 9 on pages 36 & 37 of the GVA report below.

Table 8

		Value	Cost
Development Value	Rent	£16.25 per sq ft	
	Yield	8%	
	Purchaser's Costs	6.80%	
	Capital Value	**£33,488,741**	
Development Cost	Construction Cost		£37,850,638
	Contingency		£1,892,532
	Professional Fees		£3,028,051
	Sales, Marketing & Legal		£1,430,639
	Profit		£5,581,456
	Finance		£5,610,605
	Total Costs		**£55,393,921**
Residual Value			**-£18,946,780**

Table 9

Table of Profit on Cost% and Land Cost

	Construction: Rate pf²				
Rent: Rate pf²	-20.00 pf²	-10.00 pf²	0.00 pf²	+10.00 pf²	+20.00 pf²
	119.53 pf²	129.53 pf²	139.53 pf²	149.53 pf²	159.53 pf²
-3.00 pf² 13.25 pf²	-35.921% (£1)	-40.743% (£1)	-44.890% (£1)	-48.494% (£1)	-51.656% (£1)
-1.50 pf² 14.75 pf²	-28.887% (£1)	-34.223% (£1)	-38.814% (£1)	-42.806% (£1)	-46.309% (£1)
0.00 pf² 16.25 pf²	-21.897% (£1)	-27.740% (£1)	-32.770% (£1)	-37.146% (£1)	-40.986% (£1)
+1.50 pf² 17.75 pf²	-14.949% (£1)	-21.295% (£1)	-26.759% (£1)	-31.513% (£1)	-35.688% (£1)
+3.00 pf² 19.25 pf²	-8.044% (£1)	-14.885% (£1)	-20.779% (£1)	-25.909% (£1)	-30.415% (£1)

The supporting appraisals from which these numbers are taken are contained in Appendix 6.

At all the points in this sensitivity analysis the scheme fails to reach the level of profitability necessary to encourage a private developer to bring the site forward and these appraisals assume that the site can be acquired for a pound which will not be the case in reality. In our opinion the GVA analysis updated by us suggests an unviable proposition likely to remain unviable for the foreseeable future.

In support of this conclusion I note that NCS in undertaking viability assessment for offices as evidence to support the CIL charging schedule undertook sample appraisals for both greenfield and brownfield locations within Eastbourne and that in both cases the appraisals demonstrated a significant negative potential margin for CIL as the sample appraisals showed development to be unviable. See sample appraisals in Appendix 2.

Mr William Fieldhouse the Examiner appointed by the Council concluded that based on the evidence no CIL should be charged for office development. It is interesting that no evidence was presented either for the Council or by representers challenging the suggestion that this should not be one of the categories accepted as not being generally viable. See paragraph 47 of the Examiner's report attached as Appendix 3.

Cushman & Wakefield have also provided insight into the underlying issues relating to viability in their Eastbourne Viability Report dated June2016. See attached at Appendix 4.

- we note that in Section 5 in response to question 1 Cushman & Wakefield state "both GVA and SHW agree that speculative office development in Eastbourne (regardless of this being in or out of town) in unviable." This view is qualified by their analysis of DO sites 1, 2 and 3 – see Tables 10, 11, 12 and 13 in their report.
- site 2 is a mixed use scheme with office, residential and retail and albeit that the calculations show a small negative land value this has to be set against a considerable increase in station car spaces compared with the current number (from 331 to 400 spaces). Although in the time available it has not been possible to undertake full appraisal to this site it may well be that the landowner is getting value through additional car spaces and therefore this scheme may well be viable.
- site 3 is profitable and provides a significant land value but contains no office content.
- paragraph 4.6 refers to a benchmark land value of £0.84m per hectare based on "a high level blended assumption of 50% office land and 50% residential land".

Putting all the pieces together it can be seen that the Cushman evidence, the NCS CIL Viability evidence and indeed our own view all supports the conclusion that offices are not viable in isolation whether in town or out based on current market evidence. However they could be viable if they were part of a mixed use scheme. In our opinion such a development is best suited to a town centre environment where there are the best supporting facilities and public transport links. Both sites DO 2 and DO 3 do/could accommodate some office content but even then the weakness of underlying occupational demand would caution against large quantities of office space being supplied at any one time.

4 Loan Collateral

Notwithstanding the basic lack of viability we now look at the options for financing a new development of a similar size and scale to Pacific House using Pacific House as lending collateral and our conclusion is that this type of asset would be regarded as unsuitable as security for lending by mainstream lenders due to the short term nature of the leases.

Lending on better let assets than Pacific House is typically for 5 years in duration. The ability of the borrower to repay/refinance at expiry is crucial and the lender will also be concerned about the income cover (the ratio between the net income generated by the property and the interest on the loan).

For these reasons, even if at the time of seeking finance more lettings have taken place we believe no mainstream lender is likely to wish to lend on such an asset in Eastbourne.

Having regard to the above our assessment of the likely position if a secondary lender could be persuaded to lend is as follows:

Estimated Realisation Price		
Full ERV (if fully let)		£415,000
Permanent Void	15%	-£62,250
Net Income		£352,750
Estimated Realisation Price		
Net of purchaser's cost to provide a yield in perpetuity of 8%		£4,125,000
Loan based on 50% Interest cover and 5 year term		
Net Income		£352,750
50% cover		£176,375
Loan capacity		£2,672,348

5 Cost of New Building

We understand the outturn cost of Pacific House to be in the order of £5m. Allowing for building cost inflation of 7.3% and the consequential impact on other costs (including finance) we estimate current costs to be in the order of £6.44m.

6 Conclusion

- The GVA analysis updated by JLL to reflect the actual experience at Pacific House demonstrates that the viability fundamentals are not present that would allow private sector development to be brought forward.
- It is unlikely that lenders will consider Pacific House as adequate collateral for a loan.
- If a secondary lender could be found (and finance costs/fees for this option are likely to be high) our assessment of loan capacity is in the order of 50% of the cost of a new building.
- We are unaware of the arrangements that were entered into when Pacific House was built but if the building could be sold to finance a second building, it is, in our opinion, unlikely that the price achieved will be sufficient to meet current day replacement costs. We assess the estimated realisation price of Pacific House – assuming a cash flow based on 85% let and income producing – to be in the order of £4.125m if/when lettings take place of most of the remaining vacant space.
- Office development is not viable without cross subsidy from more valuable uses and/or grant.
- The optimum sustainable solution for offices is in the town centre supported by other uses and as part of mixed use developments allowing cross subsidy to facilitate what in isolation would be an unviable use.

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