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Project title	Canal Head Kendal AAP	Job number	213469-00
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Subject	Financial appraisal Version 5 Phased - Gilkes Masterplan		

1. Introduction

The financial appraisal is a high-level overview prepared to establish whether a mixed use development at Canal Head Kendal of the type proposed by Gilbert Gilkes & Gordon can reasonably be expected to be commercially viable and deliverable. The appraisal is based on broad-brush estimations of current values and costs. We have sought the general views of commercial and residential agents and cost consultants but this is not an in-depth appraisal which would require considerably more detailed research.

We have had discussions with GVA Grimley which we understand is acting as development consultant for the proposals but we have not seen their financial appraisals which are confidential in view of commercial negotiations in relation to the various sites.

We understand that the various site owners have reached a significant level of agreement that is expected to enable a comprehensive development to take place over several years. We consider that this will be likely to be delivered most successfully if a soundly financed and suitably experienced professional developer takes the lead role. A more informal arrangement between existing landowners is likely to produce an uncertain result and is likely to take longer. This is particularly the case because of the substantial shared costs of various key enabling works, major elements of which such as the proposed new bridge and junction improvements, are off-site.

2. Information

This financial appraisal is based on the drawing 200:01 by Plus Three Architecture revision 2 05:11:09, a schedule of floor areas from the architect of the same date and exchanges of emails with Michael Cuthbertson of GVA Grimley from 21 June - 4 August 2010, telephone discussions and a meeting between Arup & GVA Grimley on 6/8/10.

3. Phasing/programme

A development on this scale must be phased in the most commercially effective way possible to minimise finance costs and to enable complementary elements to be constructed in the right sequence to maximise sales and lettings. However, in the foreseeable property market commercial prudence and funding requirements will require that the key commercial elements will be pre-let or pre-sold before development can take place. As a result it is not possible to say with any certainty how development will be sequenced apart from some key elements below. Each phase is therefore a separate use type which is assumed to occur when a user has been secured and once the enabling works in Phase 1 are in place. Houses are assumed to be developed in small releases according to demand after essential site-specific infrastructure works are in place.

Month 1 is August 2010 for convenience but represents the date on which the landowners concerned have decided to proceed. It is assumed that they have prepared a detailed planning application and Environmental Impact Assessment, have reached agreement between them to proceed and have put in place the necessary network of development documents. The costs relating to these activities are shown at the outset.

We have allowed six months to determine the planning application and mobilise. This is the pre-construction period.

Following this period the enabling works including a new bridge, demolition, site remediation, off-site junction improvements, canal reinstatement and service diversions will take place over 18 months.

We have assumed that Gilkes will reach agreement to purchase the waste management sites and to allow the facilities to be relocated by SLDC and CCC. We have also assumed that Gilkes will independently finance and procure the construction of a new factory and offices and that this will be cost neutral to the development as a whole. WE HAVE NOT SHOWN THE COST OF THIS IN THE APPRAISAL.

After the six month lead-in we have assumed that Gilkes will build their new factory and offices over 18 months in tandem with the enabling works.

The supermarket is assumed to be constructed from a date six months before Gilkes project is completed so that Gilkes will at the critical point vacate any areas that may be required for demolition and redevelopment of plots C1 and C4.

We have assumed that the new build phases of offices, retail and hotel development will take place when sufficient pre-lettings are agreed and we have made allowance for rent free periods that are likely to be offered as incentives to encourage letting in coming years, rather than the very long allowances currently being offered.

The refurbished offices will start when a sufficient element of pre-letting has been secured.

4. Sales rate - residential

We have adopted an average sales rate of a little less than one unit per week overall to allow some small overlap between phases. This is consistent with or a little better than average housing development sites.

5. Values

The rents and yields adopted are set out in the appraisals. Values have reduced as a result of the recession and levels of value prior to recession were strongly driven by historically unprecedented levels of cheap consumer finance. Since it seems likely that there is a continuing dearth of finance there is no reason to think that values will increase significantly in the near future. However, it is reasonable to expect an eventual return to better market conditions as the banks recapitalise and the market as a whole adjusts to new conditions.

6. Investment yields

Prime yields for well let investments have improved markedly from Q4 2009 but Kendal is a relatively small provincial market town and the covenants for office, retail and leisure tenants are uncertain at this stage. We have therefore adopted a fairly cautious approach except in the case of the supermarket where the covenant is assured and we have adopted a yield of 5.0%. Again, there could be improvement over time for well let investments.

7. House sales

Overall we think that the residential element of the development is very much weakened by a lack of variety in house types and we understand that Gilkes is reviewing this with a specialist housing developer. It is our experience that in England, whilst there is some limited demand for town houses in cities or very large towns, they are generally much less popular with house buyers in provincial towns. However, many traditional houses in Kendal are on three storeys with small yards and no doubt suitable designs and an appropriate house type mix will be established.

In the light of this, and based on the current house types, we have taken advice from Carter Jonas and we have adopted £225,000 per unit for the 2 storey 3 bed houses and £212,500 for the 3 storey 3 bed houses. There are no equivalent new build houses for sale in Kendal and very few new houses have been developed in the town centre in recent years. Values may rise over time and for an optimised housing mix.

8. Finance

Although there will be pre-lettings and pre-sales there will need to be some limited speculative development in relation to the office conversion and the retail/leisure space. Such developments are likely to be difficult and costly to finance for the foreseeable future. We have assumed development funding at 8% which is 250 basis points over the 20 year average for three month LIBOR. However, although certain key costs occur early in the project, the phased nature of the development mitigates the cost of finance which is relatively limited given the overall scale of the development. This will change if (as is essential) land values are generated as land costs normally have to be carried and funded through each phase.

9. Floor areas

The architect shows gross external areas (GEA) and net internal areas (NIA) based an assumed 20% deduction. However, this simplified approach does not reflect market variations by use type. There are no gross internal areas (GIA) which we would have expected as these are the normal basis for cost consultant construction rates. We have therefore adopted a general principle that GIA is 90% of GEA. For retail and leisure space GIA has been treated as the lettable area, 5% less for residential and 10% less for offices and 30% less for the hotel to reflect the substantial common areas including ground floor reception and catering.

Block C4.1 - This looks over the supermarket which we understand has undercroft parking. It appears that the houses would be single aspect at ground and first floor into the internal courtyard because any scope for windows facing west towards the town centre would be ruled out by presence of the supermarket in this zone. The architect confirms that he conceived this as a single aspect block of flats. In the circumstances we have taken this as a floor area for more 3-storey houses achievable somewhere on site. Flats could become part of the mix at a later date but values are currently depressed and for simplicity we have assumed that only houses will be developed.

Block C4.2 - It is not clear how the retail works in conjunction with the houses but we assume that there is parking at the rear and 2 and a half storey properties as elsewhere. If, as seems likely there is ground floor retail with these units over, this makes them two and half storey maisonettes, an unpopular house type which we would discount further in a more detailed appraisal. However, for the purposes of this appraisal we have treated them as houses at the standard rate and have assumed that they can be built somewhere on site.

Block D1 - This looks very much like a block of flats rather than houses but we have followed the guidance in Michael Cuthbertson's email dated 21 June 2010 and treated it as three storey houses in terraces.

10. Land values

Once the likely required developer’s profit is taken into account, the appraisal shows a loss, so there is no residual land value. Clearly in reality some at least of the owners of the various land holdings that make up the site will expect to be paid a worthwhile value for their land and buildings, so site assembly would not be possible without a combination of substantially higher values and lower costs.

11. Enabling Works Phase

Although the proposals should generate substantial values, there are very substantial infrastructure and land preparation costs both on and off site and in appraising the proposals we have assumed the following major budget costs. However, these are what are considered to be reasonable allowances and are not based on costed preliminary designs.

Canal restoration costs - these assume that the canal is restored as far as the Canal Bridge below the site. Recent advice from SLDC has indicated a cost of £2.5 million to meet British Waterways standards.

Road and site works - we have allowed £1 million in total but this is simply a lump sum provision.

Site remediation - £50,000 per acre

New bridge across the River Kent - £6 million but this very much an allowance and is not based on any design work or cost investigations

Junction improvements - £2 million based on a preliminary overview by Arup transport planners. However, there may be some scope for savings as this relates to a range of potential development proposals in Kendal.

Service diversions and connections - £1 million

Legal, professional and planning application fees

12. Construction

We have applied construction rates provided by cost consultants for other financial appraisals supplemented by reasonable assumptions. Retail units are assumed to be let in shell form. All houses are assumed to be constructed by the developer, as contractor. All commercial construction is assumed to be procured on a design and build basis and the fee allowances reflect this. All residential construction is assumed to have obtained approval at the equivalent of Code for Sustainable Homes Level 4. Code Levels 5 or 6 would add very much higher construction costs and would affect development viability adversely and substantially. The rates adopted overall aim to reflect the increased cost that is likely to arise from planning requirements for high quality building design and the use of complementary materials. Canal Head is within a Conservation Area. The rates adopted overall aim to reflect the increased cost that is likely to arise from planning requirements for high quality building design and the use of complementary materials. Canal Head is within a Conservation Area.

The scale of the development may permit the development of a low carbon combined heat and power energy centre to aid the achievement of the required environmental performance standards and this should be considered.

13. Affordable Housing

In accordance with South Lakeland District Council's latest 2009 guidance but abated by 5% for this project we have assumed a 30% affordable requirement with a £110,000 per unit developer contribution. Rather than apply this to any particular group of houses on the assumption that the Council would require the provision to be spread throughout the development, we have treated this as single payment for each phase containing housing development. We understand that Gilkes believes that SLDC should waive this requirement in view of the regeneration benefits of the project. However, land values have reduced as a result of the recession and whilst the Affordable Housing requirement is a major cost to the development, there are indications that it may be possible to optimise the development to substantially improve viability.

14. Developer's profit

A commercial developer might be expected to require 20% of development costs and a residential developer 20% of sales revenues. We have not shown a notional profit but clearly a developer and, crucially, its funder would not proceed on the basis of the current appraisal, particularly as land value is still to be generated.

15. Summary outcome

The key indicators from the appraisal are as follows:

- Net value of development £93 million
- Total cost of development £80 million
- Surplus before land value and developer's profit £13 million

The shortfall or surplus for each phase is as follows and these figures are provided to show which elements support the proposed development or alternatively undermine viability and are effectively subsidised by other, more profitable elements.

Phase	**Description**	**Surplus or (Shortfall) £**
Phase 1	General Enabling	(20.5 m)
Phase 2	Gilkes	Neutral
Phase 3	Supermarket	17.5 m
Phase 4	Offices - conversion	2.6 m
Phase 5	Retail & leisure	2.5 m
Phase 6	Hotel	(2.6 m)
Phase 7	Offices – new build	(2.9 m)
Phase 8	Residential	16.2 m
Merged	**All phases**	**12.6 m**

16. Conclusion

The financial appraisal shows a surplus of c. £13 million of value over cost but this is without any allowance for developer's profit or land value. On the basis of the profit rates suggested above, a developer might require a profit of about £20m. The current surplus is clearly still not sufficient to provide a profit sufficient to reflect the risk involved.

A substantial additional surplus will be required to provide this and to generate sufficient land value to enable the site to be assembled and the project delivered. However, bearing in mind the state of the market and that this project might be delivered over up to ten years, it is reasonable to think that the market might improve. It is also clear that the development mix could be optimised for efficiency and value. In particular:

* The hotel is not profitable and if the prospects are not good another more profitable use could be substituted

* The housing mix is not yet sufficiently varied and efficient and it ought to be possible to add value

* The new build offices are showing a substantial loss because rents in Kendal are too low for high grade office space to be developed profitably

* Substituting another use such as healthcare might provide a better result

17. End note – Tax Increment Financing

This project includes major elements of infrastructure and the burden on the development could be much reduced if the Government decides to permit the introduction of Tax Increment Financing (TIF) (see box). The last Government announced in 2010 that TIF would be explored but it is understood that HM Treasury has concerns about any measure that would increase public sector debt. However, this may be an issue that SLDC might wish to explore in more detail.

What is TIF?
Extract from *Tax Increment Financing: A new tool for funding regeneration in the UK?* (British Property Federation, 2009)

TIF is a mechanism for using anticipated future increases in tax revenues to finance the current improvements (such as new or improved infrastructure) that are expected to generate those increased revenues. In simple terms, it enables a local authority to trade anticipated future tax income for a present benefit. Typically, those who invest in municipal debt which is funded using TIF are incentivized to do so by a tax exemption for interest they receive.

TIF schemes have been favoured by local leaders in the US and elsewhere because of the prospects they offer for attracting investment to sites that might not otherwise receive it. Sometimes the remediation and infrastructure related costs of brownfield sites can be so large that property developers are reluctant to get involved. In these circumstances, the only way to proceed may be for the public sector to help prepare land for development through up-front investments. In the US, TIF is the mechanism by which this is usually funded.

TIF works on the principle that the supply of new or improved infrastructure usually leads both to new development and to an increase in the value of surrounding property, both of which serve to increase the level of property taxation in the area. Within a designated TIF district, this anticipated increased taxation (the 'tax increment') is captured and used to fund the infrastructure that has been provided. Financing debt issued to pay for the project by utilising increased tax revenues can take up to 20-25 years, but in some cases the timeframe can be much shorter.

In the US, TIF has traditionally been used to fund:
- urban renewal
- affordable housing
- cleaning up pollution
- public infrastructure projects such as roads, sewers, pavements and similar improvements.

TIFs are now such an important part of the regeneration agenda in the US that in some areas TIF and regeneration are virtually synonymous terms.

Extract from *Tax Increment Financing A new tool for funding regeneration in the UK?* (British Property Federation, 2009)