DEVELOPMENT VIABILITY
AND WHY NOT ENOUGH HOMES ARE BEING BUILT

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How can we get more homes built?

Numerous perspectives have been put forward to this question, particularly in recent years as housing affordability has risen up the agenda. Excellent papers from across the development industry have been published on subjects like changing planning law, while successive governments have devised and implemented strategies to increase housing supply, with varying levels of success.

Yet, despite the large number of ideas put forward for getting more homes built, the issue of development viability - which can most simply be described as whether undertaking a development project is worth the risk - is rarely considered in much depth. Worse, when it is considered, it is often done so with confusion, absent of any data analysis.

Instead, soundbite solutions dominate the discourse of how to build more homes. These solutions generally have an ideological or historical basis, whether it is «deregulation», «more local authority house building», «strategic planning», «resourcing planning departments», or whatever else fits into a social media post. While all these ideas could be helpful, development is too complex an industry for the answer to be as simple as adjusting one input or fine tuning one part of the planning process.

In truth, the only way to robustly understand why more homes do not get built is to delve into an Excel sheet and try to figure out what is happening.

01 Understanding viability

Development viability is a complicated issue, more complicated than thought by many new to the industry. It is nevertheless fundamental to understanding the function (or, more commonly, the dysfunction) of the planning system. Small changes in the detail or application of planning policy and the law, or couple of months delay in the planning process, can have outsized impacts on the economics of a development and the residual land value. These impacts are accentuated by shifts in the broader economy, like interest rate changes and construction cost inflation, which are regular occurrences in an industry where it often takes five years to get state approval before you can start building anything.

To regulate the development industry more efficiently, as is necessary to catalyse more homebuilding, policymakers therefore need a decent grasp of how the market functions. Ideally, they would have some knowledge of mathematics (variance, normal distributions, conditional probability, stochastic models, central limit theorem, etc.), finance (cost of capital, sensitivity analysis, etc.), real estate valuation aspects (market requirements, debt/equity funding, taxation, etc.), and planning (especially Affordable Housing). In short, they need a basic understanding of the developer business model. Unfortunately, this is generally not the case. The acute nature of the housing shortage in this country is testament to the mutual lack of understanding (or perhaps trust) between the private and public sector when it comes to development. Rather than get to the crux of the reasons why there are not enough homes, policymakers are too quick to copy and paste policies from other countries in attempts to solve their domestic problems. We are too often governed by a herd mentality.

There is much to learn from other countries about how to better regulate development and the housing market, but it has to be considered in a wider context or reform will fail. In Scotland, for example, private rents have soared relative to other parts of the UK since Vienna-inspired rent controls were introduced (Walker, 2024). Important factors such as demographics seem to have been overlooked when the policy was designed. Vienna's population is lower compared to the early part of the 20th century (Dressel, 2013) when it was one of the two capitals of the Austro-Hungarian Empire. Therefore, its housing is not as constrained and rent controls have a different impact compared to somewhere like Edinburgh. A more detailed statistical analysis might have been helpful before Scotland implemented its policy.

In general, too much policy discussion and formation seems to be divorced from an understanding of how investments create value. As the new UK Government embarks on another homebuilding programme, they would do well to remember the conclusions of a book authored by McKinsey consultants that is regularly used by companies and business schools: «The guiding principle of value creation is that companies create value by investing capital they raise from investors to generate future cash flows at rates of return exceeding the cost of capital (the rate investors require to be paid for the use of their capital). The faster companies can increase their revenues and deploy more capital at attractive rates of return, the more value they create. The combination of growth and return on invested capital (ROIC) relative to its cost is what drives value.» (Koller, T., Goedhart, M., & Wessels, D., 2010)

02 How not to think about viability

An undertone to much of the debate around how to build more homes is the notion that developer profits are substantial and too great. While significant returns have been made in our industry, particularly by PLC developers when the economy was buoyant, the reality is the riskiness of the development model - which is largely created by the inherent uncertainty of the planning system - means developers often lose as much as, if not more than, they win. Many smaller developers struggle or go bust when the market turns against them or when the regulatory regime is made more stringent. Even in areas with high sales values, development viability is normally finely balanced so small shifts in the economy or regulatory environment can be the difference between making a profit or a loss. It should surprise no-one that the industry is so dominated by ten or so volume housebuilders.

The widespread belief that developers make too much money has unfortunately created space for misleading theories and examples to abound in mainstream opinion about development. The most damaging of these to the prospects of building enough homes in this country is the notion that the granting of residential planning permission automatically generates extraordinary increases in land value. A 2018 report by Members of Parliament stated that, "government figures showed… agricultural land granted planning permission for residential use would, on average, increase in value from £21,000 per hectare to £1.95 million per hectare" (UK Parliament, 2018).

This statistic is frequently cited by commentators but without the essential context that the 93 fold value increase assumes that all the infrastructure (e.g., sewers and roads) for these new homes already exists, there is no contribution to Affordable Housing, and no Section 106 or Community Infrastructure Levy cost. Such a scenario is extremely rare, if it exists at all, but it is assumed by many to be the norm and so drives demands for developers to provide more Affordable Housing and infrastructure.

One such example can be read in A Home of One's Own by Hashi Mohamed (2022). The book offers a personal and professional account of the housing crisis, demonstrating the huge cost it has on normal people — a cost that cannot be fully comprehended by simply looking at Maslow's pyramid. Its author advocates a more state-led interventionist approach to development. This type of approach has been practised in the UK and numerous other countries. Even countries like Singapore, which are seen to be low tax and low regulation (some economists would dispute this assessment (Roubini, 2019)), have embraced a state-led housebuilding approach.

Mohamed's book is well worth reading, even if one has a different perspective and advocates for a more liberal development control[1] regime, as was the case in the UK during the 1930s housebuilding boom (Boyle, 1992) or currently in Texas (Burn-Murdoch, 2024). The book might also be a useful read for politicians who have not been touched by a housing crisis.

However, the development viability case provided in the book is similar to the case provided by the government statistic:

> «It has been a long time since I walked past those train tracks on my way to Mahatma Gandhi House. The building itself was sold for £10 million in 2015 by Brent Council, and in the same year, a property development company submitted an application to redevelop the site for office space and 198 residential flats.
>
> Following referral to the Mayor of London, permission was granted in 2016 to include only 20 percent affordable housing, far below Brent's stated target of 50 percent affordable new homes within the borough.
>
> At the time still called Mahatma Gandhi House, the building was sold again on 25 January 2017 with the benefit of planning permission for £18.2 million.
>
> None of this is remotely illicit; it is simply absurd and speaks to the madness of the moment.»

1 - «Development control» refers to the process and regulations governing building construction and land use, encompassing building regulations and various other regulatory measures beyond planning permissions

The reader might conclude from this example that developers are making too much money. However, a quick check of the relevant property development company's financials on Companies House shows they generated a £3.1 million profit, which is significantly lower than what is implied. The reader may still conclude that the profit level is too high, but it is simply a reflection of the cost and risk of navigating the planning process.

Land promotion requires many costs, several of which can be substantial relative to a deal's scale, including Stamp Duty Land Tax and other purchase costs, planning fees, financing costs, sales costs, etc. Inflationary pressures must also be managed. Over a project timeframe of approximately 30 months (the site referenced by above was bought in April 2015 and the final distributions to the shareholders were made in October 2017), the net equity internal rate of return (IRR) amounts to around 15%.

The most important question is therefore whether an IRR of 15% is a reasonable return for the developer and offers enough of an incentive to risk taking the site through the planning process, or whether the state should have required more Affordable Housing on the site and risked no development happening at all by making it unviable.

The reader can make their own conclusion, but before doing so it is important to state that when there is no principal-agent problem (e.g., Government investing), the likelihood of someone being imprudent with £10 million is rather low. It is unlikely that someone with £10 million would not have done their homework before buying a development site. Moreover, the UK is a competitive economy with an effective rule of law and typically a level playing field in business. This means the purchase price is likely to reflect the risks taken by the investor based on the information that was available to them during the purchase process.

It is worth reiterating that the book is well worth reading. Mr Mohammed makes an excellent case on the importance of housing. Also it is a emotive personal story.

03 A risky business

The reality is that land promotion is a risky business. Often planning permission is not granted. Often it is delayed. All the while, the developer has significant upfront costs and capital costs to pay, and a wide array of known and unknown risks to manage before a decision is even taken by the local planning authority.

Planning is generally the source of most risks. For example, formal and informal changes regularly occur in Affordable Housing requirements due to shifts in political governance. If the Brent scheme presented above was brought forward a year or two later, it would have been subject to the current Mayor of London's requirement for 35% Affordable Housing. This would likely have made the scheme loss making. At 50% Affordable Housing, in line with Policy CP2 of Brent's Core Strategy, residual land values in this location would likely be close to zero or even negative. When the Affordable Housing requirement is made too high, developing the site is made commercially unviable. As was mentioned in the Parkhurst Road Ltd v Secretary of State and Islington Council [2018] case, «a residual land value of £2.4m based on 50% affordable housing was insufficient to incentivize a reasonable landowner to sell, given the availability of an alternative reasonable option, namely to hold on to the land until a later date.»

Slow and burdensome planning application processes are problematic too. As research by Lichfields (2023) has shown, the time it takes to secure outline planning permission has risen from 13-14 weeks in the early 1990s to a year in 2023. Full planning permission takes even longer. Numerous impact assessments must be procured, and extensive guidance sought to navigate the demands of local officers and councillors. Meanwhile, planning application costs have increased from £12,000 in 1990 (£28,000 in 2023 prices) to around £125,000, requiring evidence from 10-12 consultants and a 72% rise in planning fees. It is very challenging to operate your business around a process that is so unpredictable.

Policy change by central government can also have a significant impact on development values and costs. New Building Regulations requirements for second staircases in buildings above 18 metres will reduce the residential floor area that can be sold and this is without compensatory increases in development height or any reduction in affordable housing or CIL. The Future Homes Standard, which is a set of changes to Building Regulations to make new homes 'net zero ready' from 2025, is expected to increase the capital cost of building a home by £6,200 (DLUHC, 2024). While these costs can be planned for over the long term in some cases, they are much harder to account for when policy change is announced at short notice, as was the case with the Government's second staircase requirements.

Along with managing regulatory change, numerous other risks can emerge as a planning application is prepared, including legal issues (e.g., easements), impact on views, archaeological and biodiversity concerns, and many others that are often not possible to evaluate accurately or get insurance coverage for, all of which comes at a cost. Like with any other business, there are also macroeconomic factors to contend with that affect development value, like construction cost inflation, falling sales values and higher interest rates.

All of the above is to demonstrate that residual land values are highly volatile. Volatility means more risk. This is demonstrated by the quick example below, which shows how a 5% change in construction costs could result in a c.39% decrease in the residual land value. For simplicity, this example assumes no leverage, which if added, would amplify volatility even further.[2]

Scenario	Baseline Costs	5% Higher Construction Costs
Affordable Units Sale Value	£7,000,000	£7,000,000
Market Units Sale Value	£22,750,000	£22,750,000
Total Sale Value	£29,750,000	£29,750,000
Total Construction Cost	£22,000,000	£23,100,000
Profit Requirement (20% of Cost)	£4,400,000	£4,620,000
Residual Land Value (RLV)	£3,350,000	£2,030,000

04 A systemic approach is needed

An underappreciated consequence of the high levels of risk in land promotion is that it is harder to secure finance. Banks do not usually take planning risks. They will not finance a project that entails planning risk. Instead, developers have to seek money from investors willing to accept higher risks (e.g., private equity). To justify financing the high risks involved in attaining planning, these investors require higher returns, often demanding the project generate an IRR of more than 20%.

Thus, a planning process that is risky, burdensome and slow results in a very high cost of capital. This issue is frequently overlooked in discussions about planning reform, but it is fundamental to whether homes get built as it is another input limiting the contributions that can viably be made to Affordable Housing and infrastructure. Often these limits fall short of the demands placed on new development by politicians and policymakers. This conundrum cannot be resolved by simplistic solutions like «local authority housebuilding», «strategic planning», or «more resources for planning departments». The problem is systemic and requires a systemic approach.

Possible solutions require articles of their own and are beyond the scope of this piece, but more detailed thinking is surely needed on issues like land purchasing costs, the drivers of land value and the use of Compulsory Purchase Orders in land promotion. These issues are written about frequently but rarely in depth or with a full understanding of a development site's finances.

Above all, a more realistic and nuanced debate is needed about development viability. There is a case for developers to provide affordable housing and infrastructure contributions in some cases, but the acute riskiness of the planning process makes it much harder to do so. Unless and until we get to that point, we are unlikely to provide enough homes.

2 - The analysis is also based on the following assumptions:

- Total units: 100 flats of 500 sq ft each (please note that unit mix requirement is not accounted for the simplicity of the case study)
- Average sale price per flat: £350,000 (£700 psf)
- Affordable Housing requirement: 35%
- Sale price for Affordable Housing: £200,000 (£400 psf - within the range for flats sold at London Living Rent or London Shared Ownership, according to Molior)
- Construction cost per flat: £220,000
- Profit requirement: 20% on cost

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