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13 August 2012

## **FINAL DRAFT – SUBJECT TO CONDITIONAL LAND SALE AGREEMENT**

Dear Mel,

### **EARLS COURT REGENERATION – VALIDATION OF CAPITAL & COUNTIES' OFFER**

We refer to the ongoing discussions between the London Borough of Hammersmith & Fulham (the Council) and Capital & Counties Properties plc (CapCo) concerning the proposed redevelopment of the land holdings of the Council, CapCo and Transport for London (TfL) in the Earls Court regeneration area and the offer from CapCo to acquire the Council's interests in land.

#### **Scope of this advice**

We have been asked to comment on the acceptability and deliverability of the offer, as the basis for a Conditional Land Sale Agreement (CLSA) to be entered into by the Council and CapCo (the Parties). This advice relies on the following:

- the data contained within the financial model prepared by CBRE Ltd (CBRE) on behalf of CapCo and disclosed to the Council to allow an assessment of CapCo's proposals;
- the assumption that CapCo will enter into similar arrangements with TfL to enable the holistic redevelopment of the joint landholding;
- the Parties acceptance that further design and cost plan development will continue until and beyond the submission of detailed planning applications for development phases and that this will affect the programme, costs and values currently reflected in the financial model; and
- spreadsheets provided by LBHF which are used to calculate the value of the 171 leaseholder/freeholder replacement units. We understand these values to have been provided to LBHF by CapCo based on valuation advice provided to CapCo by Savills plc.

**CapCo's offer**

- CapCo has offered to enter into a CLSA with the Council, committing to acquire the Council's landholding of approximately 20.855 acres for the main site as well as properties at 8a and b, 10 & 12 Seagrave Road and 1 Rickett Street (the Seagrave Road Houses) and 11 Farm Lane for the following consideration:
  - the provision of 760 replacement homes to an acceptable specification and delivery programme;
  - an additional five replacement homes to replace the Seagrave Road Houses; and
  - a cash payment of £105 million, payable in tranches against an agreed programme.

In our opinion, based on the data available at this stage and subject to the specific assumptions provided below, this consideration is acceptable when derived from an assessment of the information currently available and would reflect best consideration for the Council.

The principal elements on which this assessment is based are the EC Harris LLP (ECH) whole site cost plan and the CBRE financial model. We understand that a warranty or duty of care has been obtained from ECH concerning the accuracy and market alignment of the cost plan and from CBRE concerning the accuracy of the financial model and its constituent data. Furthermore, we understand that the CBRE financial model has been independently audited on behalf of the Council by Mazars LLP.

Appendix I, attached to this letter, provides an analysis of the principal assumptions contained in the financial model and our analysis and sets out a number of factors that will affect the value inherent in the CapCo offer.

Yours sincerely



**Christopher Pratt**  
European Director

## APPENDIX I

### 1 Implications of the timing of the cash payments

The timings of the cash payments determine the total present day value of the payments (based at May 2012). The table below shows the implications (in net present value terms) of receiving payments in line with the agreed receipt profile.

| Payment Schedule   | NPV of £105m<br>discounted at 6.6%*<br>pa |
|--|---|
| £30m (May 2012)**<br>£15m (Dec 2015)<br>£15m (Dec 2016)<br>£15m (Dec 2017)<br>£15m (Dec 2018)<br>£15m (Dec 2019) | £82.41m                                   |

Notes:

\* Treasury nominal discount rate (with an allowance for inflation at 3%)

\*\* We understand that £15m of this amount was transferred to LBHF in July 2011. The early receipt of this sum is not reflected in the discounting above, where it has been assumed to be received in May 2012.

### 2 These factors increase the strength of the current consideration offer

#### Finance Rate Assumed

The model has adopted a universal finance rate of 6.5%. Although the finance rates have not been revisited in the model for some time, this remains a realistic blended assumption.

The current mid-price of the 20 year swap rate is circa 2.7%, assuming a typical development period margin of up to 4%, this would give rise to a total rate of 6.7%. If this higher rate was to be incorporated in the model the land value would reduce.

Also, arrangement fees are currently not included in the model and when incorporated will increase financing costs and consequently reduce land value. It is anticipated that arrangement fees of 1-2% would be charged in the current development finance market.

As 100% financing has been assumed in the model, the equity has therefore also been priced at 6.5%; we consider that this is low for the nature and risks of development that CapCo is

accepting but indicates that CapCo is intending to take its equity return from development profits.

#### **Code for Sustainable Housing**

CapCo has assumed that Code Level 5 will be required by the time development is undertaken on site, the current financial model reflects costs delivering a standard in excess of Code Level 4.

We understand that CapCo is expecting to absorb the additional cost of any normal industry sustainability requirements that are in place at the points at which detailed planning consents are obtained.

#### **Private residential sales rates**

The private housing sales rates included within the model are fair and reasonable in the current market, with rates ranging from £736/sqft to £1,488 /sqft.

Under the current CapCo offer, however, the Council's cash receipt is protected if the sales values reduce in the future.

### **3 This factor introduces a degree of risk at present**

#### **Section 106 contributions**

In the planning applications submitted to the boroughs CapCo has set out the full range of community benefits and planning gain assumptions (education provision and local job creation, for example) that it believes will be required across the development.

We understand that commercial negotiations surrounding the cost contributions to the boroughs' and GLA's requirements are still on-going and will ultimately need to be reconsidered in the context of the financial model out turn values.

#### 4 Table of Assumptions

| <b>Assumption</b>   | <b>Comment</b>   |
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| Overall scheme size of 10.1m sqft                                 | <p>The model currently reflects a scheme size of 10.11 m sqft GEA (or 9.64m sqft GIA). We understand that this is acceptable to the Council.</p> <p><i>GEA – gross external area</i><br/><i>GIA – gross internal area</i></p>  |
| Financial Model – Status of replacement home unit numbers.        | <p>Please note that the latest version of the model that we have does not reflect the current commercial negotiations regarding the number of decant affordable units to be provided on the main appraised site.</p> <p>The model currently assumes 560 decant affordable units on the main site and hence a remaining 200 decant affordable units off this main site. However we understand that the current anticipation is for between 137-187 units to be delivered off the main site at Seagrave Road.</p> <p>However the overall sqft of decant affordable units on the main site will be at the same level that is currently appraised in the current model, which uses values and costs on a per sqft basis.</p> |
| Procurement Method  | <p>This advice is based on the assumption that a public procurement exercise would not need to be undertaken relating to the delivery of replacement affordable housing.</p>   |
| Implication of new social housing policy on social for rent units | <p>It has been assumed that the proposed new social housing policy will not have an impact on the value or cost of the social for rent units that are being returned to the Council as they are replacement homes.</p>   |
| Phasing of replacement homes                                      | <p>The delivery of the 760 replacement homes should be prioritised over the delivery of the additional 740 affordable homes.</p>   |
| Indexation of cash payments                                       | <p>Indexation is applied to payments that are not made at the agreed milestone.</p>  |
| Indexation of overage rate  | <p>Indexation is incorporated into the overage provisions.</p>   |

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| Parking provision                       | <p>Adequate parking provision relating to the 760 replacement homes will be required.</p> <p>It is understood that the main site planning application incorporates a residential parking ratio of 0.6 and that the Seagrave Road planning consent (across the whole scheme) provides the same ratio.</p>   |
| Reliability of the CBRE financial model | <p>The residual land value approach taken by CapCo is considered to be a normal market methodology for valuing developable land, especially in the absence of direct market comparables.</p> <p>We have undertaken a high level model review with queries and comments directed to CBRE. Necessary amendments have been made by CBRE and revised models have been released. We have again reviewed the revised model. The model results appear robust with sensitivity results as expected. In line with our earlier recommendation, we understand that Mazars LLP has completed a comprehensive independent audit of the financial model and that no material concerns have been raised.</p>  |
| Financial results                       | <p>The adequacy of the CapCo offer has been assessed in relation to the results of the current financial model.<sup>1</sup></p> <p>Based on existing assumptions in the model, a residual land value of £8.74 million per acre is calculated, equating to a total LBHF land value of £182 million. This value includes no growth or discounting (which we consider to be robust).</p> <p>However, the current model excludes value for the replacement (decant) units contained within it. We consider that there should be some value attributable to these units.</p> <p>The model also includes two “Payments to Seagrave Road” totalling £33.5m. We don’t consider that these costs should be included within the model.</p> <p>Finally, the model assumes a universal profit on cost level of 20%, which we consider appropriate for the private residential units but too high in relation to the commercial and affordable residential spaces.</p> <p>We have run a revised model with three key changes.</p> |

<sup>1</sup> The CBRE financial model version reviewed/adapted in compiling this analysis is: DFBC 4 for JLL (13.12.11) inc Variable Profit

1. We have attributed value to the decant units: using the CapCo affordable sales rates presented within the model (which were switched off in the model for the decant units) we have run the model with the inclusion of value for the decant replacement units. The CapCo affordable sales rates are £125/sqft for the social rent units and £285/sqft for the intermediate rent units, both representing tenure value.
2. We have removed the £33.5m “Payments to Seagrave Road” cost.
3. We have adjusted the developer profit levels to 20% (Private Residential), 10% (Commercial) and 6% (Affordable Residential).

The adjusted land value with this change is £10.83m per acre, equating to a total LBHF land value of £226 million.

The output value from the model does not consider the land at 11 Farm Lane, which we understand to be priced at an additional £5.7m as agreed between CapCo and LBHF or the Seagrave Road Houses for which the consideration is agreed at £500,000 plus an additional five houses. Although the Farm Lane consideration is arguably at the lower end of an independent market sale value range, this value is considered acceptable to LBHF as part of a large scale scheme of this nature. This land will accelerate the rate of decant within the scheme and will facilitate value on the main site which may otherwise have been lost without this additional decant site.

The cost per unit obtained from the CBRE financial model for a social rent affordable unit is £174,400 (construction cost, contingency & professional fees).

The total number of replacement social rent council owned units is 531, which will partly be delivered outside of the main site appraised by the financial model. Using a pro-rata calculation, this equates to a total cost of £92.61m for the provision of the 531 replacement Council owned social rent units when using this per unit average cost. The provision of these units by CapCo saves the need for LBHF to deliver these units itself, which would have been a requirement for LBHF to achieve full vacant possession of the land.

The average size of the social for rent affordable units in the model is 1,000sqft GEA (952sqft GIA/ 786sqft NIA).

An additional 58 RP units will also form part of the consideration and we

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|  | <p>understand these will replace the current 58 affordable units held by RPs. The additional cost for these 58 social for rent RP units is £10.12m<sup>2</sup> using the average cost per unit of £174,400 (as per the financial model). Although the value of these units will ultimately lie with the RPs, the provision of these units by CapCo saves the need for LBHF to deliver these units itself, which would have been a requirement for LBHF to achieve full vacant possession of the land.</p> <p>The market value of the additional 171 homes forming part of the Consideration is £104m<sup>3</sup></p> <p>It is understood that value for these units will be achieved by LBHF as part of the consideration by way of either:</p> <ul style="list-style-type: none"> <li>- the sale of the units at market value; or</li> <li>- the use of the units as replacement leaseholder homes, and therefore meeting LBHF vacant possession costs (equity offer to leaseholders) with the additional equity being retained by LBHF.</li> </ul> <p>Of the 171 leaseholder units 117 are resident leaseholder units and 54 are non-resident leaseholder units. If these 117 new homes were all to be used to replace the existing units we understand the equity in the new homes may be attributed as follows:</p> <p>117 Resident Leaseholders<sup>4</sup><br/> Full Market Value: £72.16m<br/> Equity Offer to leaseholders : £47.91m<br/> Retained Council Equity: £ 24.24m</p> <p>However we understand LBHF wishes to discount the retained equity relating to the 117 current resident leaseholder units to simulate the period over which the Council will be able to realise the equity. We have made no allowance for capital value growth over this period. LBHF has reduced this value from £24.24m to £15.53m. This provides a reduced total value of the 171 leaseholder units to LBHF as part of the consideration of £95.37m.</p> <p>The Council will also receive a number of car parking spaces, at this stage a</p> |
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<sup>2</sup> These calculation is a pro rata linear calculation performed using cost per unit and applicable number of units

<sup>3</sup> This figure relates to 100% market value.

<sup>4</sup> It is understood that when calculating equity stakes in the units a discount to market value may be incorporated. The equity breakdown figures above have been provided to us by LBHF in the spreadsheets "LH Equity-April2012 non residents.xls" and "LH Equity- April 2012 residents"



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|   | value has not been attributed to them, doing so would increase the value of the consideration.   |
| Value of 171 non-social rent units                          | <p>We have used spreadsheets provided by LBHF that calculate the full market value of the 171 units based on the defined unit mix within the spreadsheets. We understand these values to have been provided to LBHF by CapCo, and are at a level that LBHF is comfortable with.</p> <p><i>1 bed £400,000 - 21 units</i><br/> <i>2 bed £575,000 – 85 units</i><br/> <i>3 bed £650,000 – 24 units</i><br/> <i>4 bed £728,000 – 2 units</i><br/> <i>3 bed house £750,000 -29 units</i><br/> <i>4 bed house £795,000 -10 units</i></p> |
| Value of Affordable units within model.                     | The output land value from the model is affected by the affordable rates in the model (£285/sqft for intermediate units and £125/sqft for social rent units). We understand that although CapCo considers that no value should be attributed to these units in the financial model, LBHF is satisfied with putting value into the model at these rates.  |
| Cost of 589 social rent units forming part of consideration | <p>We have taken the per unit cost directly from the model for the social for rent units in the model and applied this to the total number of replacement social for rent units</p> <p>LBHF needs to be satisfied with the assumption that the cost for the social for rent units on the Seagrave site is at the same level as the costs for the social for rent units on the main site, and that the average unit size across the two sites is closely comparable.</p>  |
| Properties at Farm Lane and Seagrave Road                   | It is understood that the Farm Lane site is being bought by CapCo from LBHF for a price of £5.7m and that the properties at 8a and b, 10 & 12 Seagrave Road and 1 Rickett Lane (the Seagrave Road Houses) are being purchased for £500,000 plus an additional five social rent units on the main site and that these properties will be used to facilitate the decant of the existing homes.   |
| Growth and discounting                                      | <p>The land value calculated in the model is derived from costs and revenues that do not include any growth – including growth would be likely to increase the land value.</p> <p>However, the land value also excludes any allowance for the time value of money – that is, no discounting has been applied to the cash flow or capital receipts in future periods, this would reduce the present value of the land.</p>  |

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|   | <p>In summary, assuming that the downward value impact of discounting is greater than any increase achieved through adding growth, the land value would reduce.</p>  |
| <p>Contingency, professional fees and development management fees</p> | <p>The model is based on contingency and fee rates as follows:</p> <ul style="list-style-type: none"> <li>Enabling Works 5%</li> <li>Off Site Road Improvements 5%</li> <li>Road, Structural and Civil Infrastructure 5%</li> <li>Public Transport; Rail Infrastructure, Bus and Cycle Provisions 15%</li> <li>Utilities / Site Services Infrastructure 5%</li> <li>Infrastructure Abnormals 15%</li> <li>New Buildings – Abnormals 10%</li> <li>Car Parking - basement (all uses) 15%</li> <li>Public Spaces 5%</li> <li>Construction Contingency 5%</li> <li>Development Contingency 2%</li> <li>Professional Fees 12.5%.</li> </ul> <p>We consider these rates to be fair and reasonable given the nature of the scheme. A construction contingency of 5% is reasonable given the scale, complexity and timings of the scheme. The higher rates relating to infrastructure costs are deemed to be reflective of the uncertainty surrounding the exact level of these costs as they are unique to this scheme.</p> |
| <p>Category and value of additional affordable homes</p>              | <p>The consideration has been assessed in relation to the current out-turn land value from the financial model and is therefore based on the current inputs in the model.</p> <p>It is understood that the additional affordable homes will take the form of shared equity units and this is reflected in the model. These units are not transferred to the Council and the Council doesn't participate in the value of these units.</p>   |
| <p>Justification of/change in construction cost levels</p>            | <p>Given the scale and complexity of the scheme, it would not be practical for each party to have its own cost consultant build an independent cost plan.</p> <p>Clearly, the effect of any deviations from the current costs in the model would need to be considered when determining residual land value.</p>   |

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| <p>Developer's profit of 20% on land and affordable units</p> | <p>The model currently assumes the developer profit levels on cost and land at 20%:</p> <p>20% is at the higher end of the acceptable profit margin and reflects the risk profile and scale of the project. We would consider this to be too high for the affordable and commercial units and have run the model with the following developer profit levels:</p> <p>Private Residential: 20%<br/>Affordable Residential: 6%<br/>Commercial: 10%.</p> <p>We understand that LBHF is comfortable with these revised levels of developer profit and considers the 20% level applicable to the private residential fair given the quantum, nature/complexity and risk profile of the scheme.</p> |
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