PROPERTY DEVELOPMENT SERIES 2
FEASIBILITY AND DUE DILIGENCE

A PERSPECTIVE

STM Developments

Property Development Series 2
Feasibility and Due Diligence

The critical importance of conducting a solid feasibility analysis and due diligence could not be understated. In a competitive land market, an accurate and reasonably realistic feasibility will guide the maximum price one is willing to pay for any site. Being overly conservative will mean you will never be successful at obtaining any site. But being too optimistic may mean that you will be very prone to the very slightest market movements, escalation in construction costs, prolonged town planning process, or even small uncertainties such as ground conditions or even unexpected electricity authority connection costs! This also highlights the importance of conducting solid pre-purchase due diligence, especially if there is fierce competition for the property, and condition precedent such as finance and due diligence clauses are unable to be obtained!

Our experience in analysing and securing development sites suggests there are several dilemmas faced by developers when looking at sites without planning approvals:

1. What can I develop on this site that is approvable by Council? How far should I stretch the boundaries at this stage in determining my optimal land price? How long should I allow for the town planning approval process? Should the project go to VCAT, or is it worth fighting the VCAT battle in any case?
2. What minimum return on equity do I or my investor require? What minimum return on cost should I or the banks typically require? Do my bank relationships allow me to achieve good leverage for this project given ever changing bank policies and appetite?
3. What square metre rate should I assume in selling this project? Being pessimistic may mean my optimal land price becomes uncompetitive. Is there scope for me to cleverly add value to the project without increasing my construction cost?
4. What is the worst case and best case scenarios for me? Will I still breakeven in the worst case scenario? How do I reasonably define my worst case scenario?
5. Even with permitted sites, is this the maximum development potential that can be achieved? Typically it will be, but is there scope to further increase value within the approved building envelope with a bit of lateral thinking - clever design, development mix or a more sellable floor plan? Sometimes more apartments may not necessarily be always more profitable. In some locations, fewer larger size apartments may actually attract a higher end value due to the local market demand, so it makes sense to combine residences. This may also mean fewer carparks required, and potentially a smaller basement footprint, contributing to a more efficient design from a cost perspective. Furthermore, this will keep Council and your neighbours content.

The price one is willing to pay for a development site is normally determined by working backwards from predicted sales value, less all developments costs, fees and government taxes, developer's margin and finally arriving at a residual land value. Sensitivity analysis is then conducted to determine the upper bounds of what I am willing to pay for the site. Remember – never let your emotions and passion override your analysis! Remember this is an investment, not your own home.

So some critical questions remain

1. How do I ensure all developments costs are included? What are they?
2. What do I need to check in early due diligence?
3. How do I conduct sensitivity analysis? What variables should I test?

We provide some of our initial insights to each of these critical questions below:

Development Costs

Key development costs must be taken into account in feasibility analysis, typically in an excel template format – I have seen many feasibility which either deliberately, or mistakenly leave out some of the key costs, creating an inflated land price. Do not be tempted and influenced by feasibilities other people prepare – always only trust yourself as you are the only person to know how hard you push the assumptions depending on your own risk profile and appetite. Below are the key cost elements for Victoria, but should be quite similar to other states in Australia, only with different terminology:

1. Land Price
2. Stamp Duty and Transfer Duties
3. Legal and Accounting Costs
4. Consultant Fees (Town Planning and Detailed Design Documentation)
5. Construction Cost
6. Contingency
7. Council Contributions
8. Statutory Costs (Utilities connection costs)
9. Financing Costs
10. Building Permit Levy
11. Metropolitan Planning Levy
12. Soft Landscaping (may already be part of construction costs)
13. Marketing Costs
14. Sales Incentives Budget
15. Holding Costs
16. Agent Commissions (normally 50% of total payable, as the remainder 50% is due after settlement, normally)
17. Project Management Fees
18. Demolition and Site Clearance
19. Other Specific Costs (Contamination, Tree Felling etc)
20. Financier Interest
21. GST on Sales (margin scheme may be applied in certain situations)

How much development margin do you desire? This ultimately determines an acceptable land price. Most banks work on 15% return on total development cost in order to qualify for bank financing for construction. Depending on the overall LVR, this may result in a much higher return on equity on an annualised basis. How much margin do you feel you need to compensate for the risk you are taking in delivering this project? What is your opportunity cost? Do you have enough safety buffer against potential market shocks in the next few years? These are matters for yourself and your investors to consider?

There may be other costs specific to the situation or project such as other consultant fees and State Government Costs, but the above list should provide a good first cut of the feasibility of a project, and whether the asking land price is at all reasonable.

How you come up with a number for each of the above items depends on the project itself and can only be assessed on a case by case basis. There is no magic rule or formula. We would be more than happy to assess site feasibilities on behalf of landowners or investors.

Early Due Diligence

OK now, you finally have access to a good site where the vendor is expecting a more reasonable price. What sort of early due diligence do you need to conduct. Below is a non-exhaustive list of things to check as early due diligence. For larger sites, you may be able to negotiate a due diligence period, which will involve a more formal investigation to take place.

There are typically two broad categories of sites for sale – raw sites (those with no planning approval), and permitted sites (those with planning approval). Sometimes, there are sites with full working drawings and building permits, but I normally query why a vendor will take the effort and money to do all this detailed work, when the new owner will most likely completely change the design in any case!

Check the following key items with raw sites

1. Any covenants and encumbrances on the title of the land
2. Check the presence of large trees on your site AND also in close proximity in the neighbour's site. Get advice from an arborist on the value and feasibility of removal of these trees, and also root protection zones of your neighbour's trees. Mostly likely, your new neighbour will be fighting your application in Council and courts, hence they will never agree to remove any trees to facilitate your development. In leafy areas of Australia, I have seen root protection zones covering almost a third of the site, making any form of further development impossible!
3. Presences of utilities – through online search with dial before you dig. These are reasonably accurate and contain location of sewer, stormwater, telecommunications and electricity pits around your site. Some pits may be located further away from your site, and hence will cost more to connect to. This will impact on overall costs.
4. Engage an architect and town planner to investigate feasibility of the proposed development on your site. Gain an understanding of the zoning, and any special overlays on the site. Check for precedents close by. Some form of early concept sket-

ch may be appropriate. A good area schedule with areas of different spaces will be useful in determining your construction cost based on square metre rates.

5. Most important, take a visit to the site and look at the surrounding neighbourhood and streetscape. Interface conditions are always critical. Look at immediately adjoining buildings – their windows, any habitable rooms, street widths, location of power poles and crossover locations, adjoining building heights, and adjoining design character. Are there consistently double storey or higher density dwellings on your street, or more single dwellings. How does shadowing impact the neighbours, or adjoining buildings in a high rise environment. Check adjoining building setbacks, as most likely, your building will need to be set back to an equivalent standard.

6. Assess the site for closeness to transport, amenities, schools, parks and lifestyle amenities. The relative importance of these will depend on the specific suburb. For example, in school zones, access to schools and transport will be most important. For inner city locations, lifestyle amenities and restaurants may be more important. Maintain a business sense at this stage, ant not focus too much on technical details. This early conception is quite crucial in forming your vision for the site.

7. Site dimensions – will basement ramps work, is car parking possible? Is there enough site width for a basement turn? Is the site sloping and how much – these will all affect feasibility and costs. Approximate site topography can be found online.

For permitted sites, there are a few more things to consider

1. Read through both the plans AND the planning permit and any court decisions. Read through the planning conditions one by one in detail. Check the permit has not expired, and check if the plans have been stamped or not. Take note of any special conditions imposed (special condition number 1), and check that the design changes imposed by Council in this condition can indeed be accommodated.

2. Check with town planner and Council to see if the approved plans can be further optimised and increased in density further. This will add further value to the site.

Sensitivity Analysis

Now suppose we have a feasible site at an appropriate price and due diligence is satisfied. What determines the maximum price I am willing to pay for the site? Understanding of one's risk profile and appetite is important in determining the price range for the land, which will then influence your negotiation strategy. As such, testing several key variables and assessing the impact on margin and land price is critical. Some of the variables that we normally test include:

1. Sales Price/Sales Rate – what if the market goes up by 5% in the next year, or 10%? What is the opposite occurs? Am I still making money in the end? What is the breakeven point?

2. Construction Cost – what is costs escalate by 5% or 10% in the next year due to shortage of resources?

3. Time – What if the project is delayed by 3 months? By 6 months in the worst case, resulting in increased interest costs?

4. Interest – What is interest rates increase by 0.5%, or by 1%? Will the increased interest have a big impact on overall feasibility? It should not, but it would be good to test this.

5. Agent Commissions – Can we try market the project through pure retail sales in lieu of through channel sales, and lower the commission by 1%? What if we try and sell a portion of the project directly? What sort of incentives do we need to allow for (rental guarantees, freebies, furniture packages, agent bonuses, cash rebates etc)?

Sensitivity analysis can be done using excel either manually, or using data analysis functions such as Goal Seek, Scenario Analysis or Data Tables.

We hope the above gives a good glimpse of the feasibility and due diligence process and highlights the crucial importance of doing some solid homework!

STM Developments

YOUR TRUSTED AUSTRALIAN DEVELOPMENT PARTNER

OUR CAPABILITIES

SITE ACQUISITION
Solid pre-acquisition due diligence and sourcing of the best on and off market development sites is the first step to a successful project.

PROJECT FEASIBILITY
Thorough market ressearch, detailed risk assessment and a robust project feasibility analysis will provide comfort for a successful aqcuisition.

DEVELOPMENT MANAGEMENT
Leading and managing all project consultants and stakeholders and securing the best planning approval is a crucial first step in the development process.

PROJECT MANAGEMENT & FINANCING
Disciplined project management, design and documentation management and cost control within feasibility limits will ensure projects are completed on time and to budget.

INVESTEOR REPRESENTATION
On larger scale joint ventures or projects, negotiating development agreements, undertake commercial and technical due diligence and representing investors throughout the project will ensure their interest and risks are managed.

ABOUT US

STM Developments is a property development & advisory business based in Melbourne, Australia.

We work alongside developers and investors, providing site acuisition, feasibility analysis and project management services for residential and commercial projects. We initiate and participate in property development joint ventures as project proponent. We also act as investors' independent representatives as their point of contact for their co-investment projects and joint ventures.

Founder and Managing Director Simon Lee has more than 17 years of professional experience in all major facets of the development industry in Australia. He has successfully designed, led and managed major commercial, retail, mixed use and residential projects in Hong Kong and Australia ranging in value form $4 million to $20 billion. Simon is also an occasional guest lecturer and tutor at the Faculty of Architecture University of Melbourne.

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