STAG BREWERY
PROFIT MARGIN

During the meeting on 15 July 2020, GLA officers confirmed that the proposed development satisfied policy requirements in terms of provision of the maximum reasonable proportion of affordable housing. Furthermore, officers accept that the present day viability position is that the Scheme is in deficit. The Applicant is therefore taking a commercial view on future prospects of the scheme in order to achieve a reasonable profit.

As the Scheme is overproviding affordable housing and, as a consequence, in a deficit position, it will be necessary to quantify that deficit for the purposes of the review mechanism. We have provided a set of calculations of the deficit which we understand GLA officers broadly accept, with the exception of profit where there is a push for return to be based on Internal Rate of Return. Officers referred to other schemes where this approach had been adopted on the basis that they were multi-phase schemes.

IRR as a concept

IRR addresses the issue of schemes being developed over extended periods of time which often have significant capital lockup. In these situations, profit on GDV does not reflect the time over which the developer needs to invest to achieve the return. An IRR based measure of return was first used in a viability assessment for planning decision making in 2010, when Treasury Holdings UK argued that a profit on GDV measure for their proposed development at Battersea Power Station would be an inadequate reflection of the risk of significant works to the Power Station and the length of time over which the scheme was planned to be developed. This was accepted. The ungeared IRR on that scheme is 9.08%, which equates to a blended profit on GDV of 24.4%. The agreed minimum target IRR for the scheme is 15%, which would equate to a blended profit of 30.8% on GDV. If the 14% IRR figure now mooted by GLA for Stag Brewery were applied to the BPS development, the profit on GDV would be 29.9% on GDV.

Planning Practice Guidance

Paragraph 018 of the Planning Practice Guidance indicates that a profit margin of between 15-20% of GDV should be applied, with a lower figure for affordable housing.

We recognise that IRR has become an alternative measure of profit for schemes developed over long periods, but it was never intended as a tool to penalise such developments. Clearly if a return on IRR at, say, 14% generates a significantly lower profit when measured against GDV, the planning system would make larger schemes less attractive to developers. Developers bringing such schemes forward would be doubly penalised; not only are they carrying a higher risk burden, but they receive a lower return for taking that risk than developers who bring forward smaller schemes. Meeting London's housing targets relies upon developers bringing forward developments of significant scale, which often act as a catalyst for wider regeneration of the areas in which they are located.

Stag Brewery

In our discussions with the Council (and their advisors) and with the GLA, we have consistently been clear that the Applicant's target profit is a minimum blended profit margin of 18.15% on GDV.

GLA officers have acknowledged that the Scheme carries the burden of significant upfront infrastructure investment. This increases risk, not decreases it. The upfront investment in infrastructure makes it more difficult for the Applicant to pause the later phases if market conditions become unfavourable; as it has more capital tied up with no return until the whole scheme is completed, it is more likely that they will need to continue the scheme through many market cycles. This makes the Scheme riskier than other schemes where IRR has been utilised (such as Berkley Homes' scheme at Stephenson Street, which has separate phases capable of being built out independently of each other).

If the scheme were required to generate a minimum return based on an IRR of 14%, this would equate to a profit of 10.92% on GDV. A return at this level would dis-incentivise the Applicant from proceeding with the Development and would be counterintuitive; a scheme with a higher risk profile than 'average' developments of this scale would achieve a lower return. This would turn the original logic of adopting IRR-based returns completely on its head.

Applying a threshold profit on GDV for the Stag Brewery Scheme would not set any adverse precedents as this is the measure of profit applied on all but a small handful of developments.

BNP Paribas Real Estate
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