12 STEPS

OF THE DEVELOPMENT PROCESS

STEP SEVEN: VALUATIONS

35 LATITUDE PROPERTY DEVELOPMENT

Valuations can be the most misunderstood functions of the development process (or even just purchasing a property). The most common valuation type conducted in Australia is a current "Market Valuation", which is generally defined as:

"Market value is the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing where in the parties had each acted knowledgeably, prudently and without compulsion."

Search a Valuer's website and you will also find reference's to:

- Valuations for lenders
- Rating and taxing valuations for councils and state governments
- Rental valuations of either the lessors or lessees interest
- Retrospective valuations (at a historical point in time)
- Asset valuations for company financial reporting purposes
- Insurance valuations
- Valuations for resumption or compensation matters
- Valuations of Plant and Machinery
- Valuations for litigation purposes (expert witness advice)
- Forensic Valuations

The most interesting one to me is the "Valuation for lenders"? What exactly could that mean, that a "Valuation for a Lender" is different to a "Market Value" valuation? I'll let you join the dot's, but just remember, a lenders job is to reduce their risk.

The thing to also remember when you are doing your feasibility is that you are determining the value of the potential development site relative to the outcomes of your development. This may or may not match the valuation that a bank may come to.

In your case the bank may need to look at this proposal as a simple investment property purchase, and dependant on your financial situation, they may need to assess the deal in a way where they actually assess the rent being achieved on the existing property (if there is one) to help support your affordability to purchase the site. This will change once you get to a point with development approval and look to construct new homes on the property.

The big thing with a bank when you start talking development is their appetite for risk. They don't know if the property makes a good development site or not, or if you have any chance of getting your initial concept approved through council. Nor is it their job to know, they simply lend money. I frankly couldn't be less interested in my bankers view, as most often, they have absolutely no experience in actually developing property.

Now, I have seen instances where a property makes perfectly good sense from a development perspective, however the bank has value data lower figure than that negotiated, as they are simply looking at what they can sell the property in 30 days (fire sale) if the loan goes into default. In this case, the developer has to make the decision if they walk away from the deal, or use more of their own money to get the sale over the line.

Development Finance

Once you have your development approval, it is normally time to involve the bank again, and the valuation strategy your lender may use will again dictate your terms. Different banks have differing ways that they like to assess development finance. Now it is widely accepted that once you have a project progress to approval stage, that it is often worth considerably more than it was before you started. However most banks aren't interested in this fact, again, they focus on minimising their risk. How they assess your project from a financing policy perspective will directly relate to how your end valuation will appear.

A couple of key terms to understand with a bank are:

TDC - Total Development Costs: this includes all costs incurred along the way through the development process, including the cost of the site and any GST payable on the sales. Some banks will include/exclude selling agents fees, interest and finalisation costs in this calculation.

GRV - Gross Realised Value: this is the realised sales prices of the project. This has nothing to do with your costs, and everything to do with how much you can sell the properties for. Often lenders are interested in these numbers, as their lending policy will generally equate to a percentage of either one or both of these figures. For example, a lender may be prepared to lend up to 70% of your total development costs (TDC), whilst another may also have a restriction to 60% of your gross realised values (GRV) as well. This second lender will work on the percentage that provides you with the lowest amount of money, as a way to further de-risk the process for the bank.

The other thing a bank will normally factor in is a 5% contingency amount above your build contract price (to cover variations or unexpected costs) along with a minimum profit percentage. This will normally be based on the total sales prices, and equate to a fixed percentage of profit. If you aren't able to demonstrate to the bank that the project has enough profit (to match their credit policy), they simply won't be approving your loan.

This is often the hardest thing for a novice developer to understand. You may assume if you are prepared to do a project for a lower profit than another developer, this is your own business. Lenders, however have another view. They believe if a project doesn't have enough upside for a borrower, if things don't go to plan, a developer will decide to "quit" the project because it is no longer profitable or becomes too difficult. Lenders aren't in the business of development, and don't want to be in the position where they have to organise completing the project (or even selling it) in order to get their money back, so these formula's form the basis of their internal risk minimisation strategies.

Remember, lenders are in the business of lending money, not property development, and their job is to take as little amount of risk as possible.

Now you might be wondering, what all this has to do with the Valuation. It relates back to your valuation, because dependant on how the actual lender assesses your loan will reflect in the instructions the lender provides a valuer on HOW they need to value the property (what parameters they need to use).

The other thing you will also need to consider is if you are prepared to pay the interest costs along the way, or are looking to capitalise the interest (add it to the principal of the loan and pay the total out at settlement of the sales).

So let's look at some big picture feasibility numbers, just to give you a feel of how this looks.

Land Acquisition			GST		Total	
Purchase Price	$	1, 050, 000			$	1, 050, 000
Stamp Duty	$	40, 000			$	40, 000
Pre Consultants						
DA	$	40, 000	$	3, 636	$	36, 364
CC	$	40, 000	$	3, 636	$	36, 364
Council Contributions						
Contributions	$	50, 000			$	50, 000
Construction Costs						
Unit Construction	$	2, 200, 000	$	200, 000	$	2, 000, 000
Contingency	$	110, 000	$	10, 000	$	100, 000
Post Consultants						
Agent Fees	$	100, 000	$	9, 091	$	90, 909
Legal Fees	$	10, 000	$	909	$	9, 091
Finalisation Costs	$	10, 000	$	909	$	9, 091
Total Dev Costs	$	3, 650, 000	$	227, 281	$	3, 422, 719
Gross Realised Value	$	4, 500, 000	$	313, 636	$	4, 186, 364
Gross Profit before Int	$	850, 000	$	86, 355		763, 645 -135, 000 (INT) =628, 645
Profit to TDC						18.37%
Profit to GRV						15.01%

So based on the above scenario if your lender had a requirement that their maximum LVR (Loan to Value Ratio) is set at 70% of TDC, the maximum they would lend is $1,330,000. Now provided your Profit to TDC/GRV also meets the requirement of your lender, this is the amount your lender will make available to you.

But if they also have a figure of restricting debt to 55% of TDC = $1,275,000. This would reduce your borrowing capacity by a further $55,000.

Then if you are also looking to capitalise the interest, you then need to take this amount off the borrowed amount, to allow for paying this amount internally inside the loan account.

And all of these items have a bearing on exactly how the lender instructs their valuer to treat the development. Now there are certainly other options when it comes to finance, where a 2nd or 3rd tier lender will have more accommodating requirements, however this will also generally reflect in a higher interest rate, which further effects the profitability of your deal.

The important take out is getting an understanding of how lenders will actually assess your project, because how they treat your development will directly affect the valuation you receive. Now there are a few tricks (and traps) to try to maximise your valuation, but that's for another time.