VALUATION & ADVISORY
OFFICE DEVELOPMENT
PART 1

TECHNICAL MARKET COMMENT - OFFICE DEVELOPMENT PART 1

David Castles
National Director
david.castles@
cushwake.com

As part of our on-going series of market updates and technical papers, this paper comprises 'Part 1' within the Office Development Series.

The intention of this paper is to provide general background on pertinent matters relating Office Developments and related valuation matters, covering off on some common questions, issues and factors to consider when undertaking development feasibilities or involving yourself with development valuations in general.

Given the range of matters, this paper is provided in 2 parts, with Part 1 focused on 'end realisation' matters and Part 2 (to be released shortly) covering wider feasibility and return benchmarking topics.

The 'process risk' with regard to office development valuations is considered high. The wide variability across the market when interpreting key aspects of development valuations further increases this process risk. It is critical to set the correct benchmarks and allowances early in the process to prevent unwanted surprises and adverse profit/return impacts.

Through the process of undertaking many CBD and metropolitan office development valuations, some of these questions can arise quite commonly and many of the considerations within this paper reflect matters discussed and covered off with many development and finance clients. They are not often well understood and can cause confusion. Additionally, industry standards provide only limited guidance on practical application of key factors / allowances.

Whilst it is imperative in the competitive development market to maintain confidentiality between projects, it is important to have a good coverage of project experience to inform these views.

This paper is not intended to explain these matters in detail, merely outline comments which may be of assistance or provide a reference point for further discussion. Cushman & Wakefield Valuation & Advisory is available to discuss in more detail.

THE END REALISATION 'ON COMPLETION' VS 'AS IF COMPLETE'

The end realisation? Is it an 'as if complete' or 'on completion' value???....

When referring to the end realisation, the terms 'on completion' and 'as if complete' can often be interchanged as meaning the same thing. They are not.

In simple terms, the 'as if complete' assessment assumes completion as at today, reflecting no escalation or forecasting. It is typically required under finance standards and is essentially a de-risked figure with any forecasting elements removed.

The 'on completion' assessment reflects escalations/forecasts (ie. in rents, outgoings, incentive expectations, supply/demand etc.) until completion. It is an assessment used by developers and reflects market considerations.

The two terms are distinct and depending upon client instruction, often in conflict, particularly for larger, longer term projects.

Feasibilities should always be undertaken using an 'on completion' assessment as the end realisation. A separate 'as if complete' figure can always be provided as a finance requirement (if instructed), however, should not be used in the feasibility as this would not be reflective of market behaviour and produce distinctly different/skewed returns. There should be greater industry guidance on this matter given the differing interpretations and inconclusive standards that exist in the market.

Practical complications with an 'as if complete' assessment also include:

- If the proposal is partly precommitted at 'on completion' escalated rentals, how are these applied against rentals 'as at today'? Is there a rental overage that actually doesn't exist? Does the

valuer discount the 'on completion' rentals to today's rents, thereby actually reflecting a degree of forecasting which this approach in itself is trying to avoid?

- Incentives? Same issue.
- How is the guarantee/income support/downtime/leasing up period assessed in light of the fact that there is assumed to be no development horizon in which to lease the proposal?– ie. it is complete as at today and needs to be leased immediately?
- What supply/demand conditions are assumed? Those existing as at today or at completion?

Accordingly, it may be contended that the 'as if complete' figure is more hypothetical and difficult to logically rationalise than an 'on completion' assessment.

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The only time the figures under each basis could be viewed as interchangeable is closer to completion when no escalation is being applied to the 'on completion' assessment.

'ON COMPLETION' - FULLY LEASED OR AS LEASED?

Why would we adopt a fully leased 'on completion' value when the asset is not fully leased? Are we therefore saying that the asset will be fully leased on completion?

No. By making the 'fully leased' assumption we do not warrant that the development will actually be fully leased on completion. This is a modelling assumption made purely for the purpose of assessing the potential end realisation. There are various reasons for this assumption.

- No development will ever be sold partly leased (unless potentially under mortgagee conditions – that is addressed below). A fund-through sale of a partly leased investment will include income support and hence a full income position, although covenant risk remains as to the eventual tenant and term over the unsecured areas. This risk is implied in any capitalisation rate adopted.
- The provision of a downtime allowance or income support is a cost to the developer to be included in the feasibility, not in the top line end realisation. The reasoning being the provision of income support as a development cost results in an improved IRR versus the sale of a partly leased investment.
- Treating the asset 'as leased' would create a static assessment which thereby assumes that no further leasing is done until completion. That is not realistic. It is also not our position to speculate on the eventual level of commitment at completion. Hence the fully leased assessment with allowance for income support as a development cost, reflects a position where these costs will be reduced as leasing occurs which impacts the 'as is' assessment but does not result in volatility of the end realisation (and returns) that would occur if a rolling 'as leased' value was assessed.

However, as this figure is notional only for the purpose of calculating the 'as is' value, for finance/mortgagee purposes, we consider that it is appropriate to also note an end realisation figure that is net of allowances and reflects the 'as leased' status. This figure is for reference only and is not used in the feasibility analysis. Using this figure would result in a similar 'as is' value, but notably lower return.

THE RENTAL GUARANTEE, INCOME SUPPORT OR STABILISATION ALLOWANCE

If the asset is only partly precommitted and the 'on completion' realisation is assessed on a fully leased basis, it is necessary to assess an allowance for a guarantee, income support or stablilisation allowance (or alternatively a proxy for a typical downtime/leasing allowance).

This allowance however should have strong regard to the remaining development period within which to secure tenancies, coupled with a detailed analysis of likely tenancies expiries/availability in the market coupled with competing supply and likely retention of tenants within existing assets. This should also be considered against the issues noted within between assessing 'as if complete' versus 'on completion' values – ie. that the 'as if complete' assessment implies there is no development period within which to lease the asset.

Whether or not a rental guarantee is being accounted for by the developer/owner should not be of consequence in the early stages of the project. The calculation is interchangeable with a downtime or leasing up allowance, however the difference being it is reflected in the feasibility and not the top line 'end realisation'. However, this can change closer to completion (see 'What about Rebates or Rent Frees at Completion').

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Additionally, were a rental guarantee actually being provided by the developer (potentially as part of a part share fund through deal already in place), the same principles should apply. The guarantee may be over a 3-5 year period (depending on the market), however that actual cost exposure to the developer/owner of the income support may be less than the term of the guarantee depending upon the remaining time until completion within which to secure tenants. In other words, a term certain guarantee does not mean applying the full cost of that term.

If a guarantee is agreed on a fund through basis (as typically occurs), it is important to consider the target rentals under the guarantee and +/-% tolerance on these relative any previously benchmarked rentals. If outside the tolerance, a +/- capital allowance (based upon the difference in the capitalised rents) may need to be accounted for.

WHAT ABOUT REBATES OR RENT FREES AT COMPLETION

How are rent frees and rebates going to be reflected at completion? You have assumed there is income support for modelling reasons, but we aren't actually providing any support? You assumed incentives as capital but the tenant is taking as rebate?

The divergence between modelling assumptions and reality may become an issue as completion nears.

Whilst income support or incentives have prudently been reflected as a cost in the feasibility over the term of the project, these costs potentially shift up to the 'top line' (the 'on completion' figure) if the tenants have opted for rebates or rents frees and no income support is actually being provided.

The divergence between modelling assumptions and reality may become an issue as completion nears.

In theory, the shifting of these costs from within the feasibility to the end realisation should have a neutral impact on the 'as is' value, assuming the quantum $ amount is the same. However, the shift in the top line figure could create issues re: a divergence in the expected value booked at completion (ie. moving from a notional fully leased figure to an 'actual' figure including incentives or downtime).

This needs to be understood and highlighted by the valuer and managed appropriately to avoid process risk and avoid unexpected shifts at, or close to, completion.

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STAMP DUTY AND SALES COSTS - CONFUSION REIGNS!!

Valuation first principles typically require all transaction and sales costs to be included when assessing a feasibility or residual 'as is' value. However, first principle considerations should be given to the profile of the developer/owner and end purchaser profile.

At an institutional level where a site/development is currently held for the purpose of holding the asset on completion, or an institution acquires the asset on a fund-through basis, stamp duty needs to be considered in a different manner.

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In these cases, the feasibility analysis should consider excluding transaction costs at the date of valuation (ie. stamp duty and legal costs) and selling costs at completion. The rationale for excluding these costs are based upon the premise that a hypothetical purchaser of a site or a partially completed asset 'as is' (versus purchase of the asset at actual completion) would be an institutional investor looking to hold the asset on completion rather than on-selling for development profit or acquiring the asset subject to stamp duty favourable structures.

Therefore, given that stamp duty and acquisition costs are already inherently reflected in the 'on completion' assessment (as with any valuation of a completed asset), there is no requirement to reflect in the 'as is' assessment (ie. the purchaser assesses the value 'on completion' with due account to typical stamp duty costs and then deducts the costs to complete). Therefore, to reflect stamp duty in the 'as is' value under these circumstances would be double counting stamp duty.

This reflects considerations of market participants for this type of transaction/asset. This approach also has regard to the principles outlined within International Valuation Standards Council Note IVS233 for Investment Property Under Construction, although not specifically covered under IVS 410.

Note that this may differ from some bank valuation standards. Were the feasibility or valuation being conducted for the actual developer looking to sell/trade at completion as opposed to a purchaser/institution looking to hold the asset on completion, it would be appropriate (particularly for financing purposes) to reflect stamp duty.

Therefore it is important, as with any valuation or feasibility, to assess the 'market' or purchaser profile for the asset. The inclusion or exclusion of stamp duty can have a material impact on the 'as is' value and/or the development returns.

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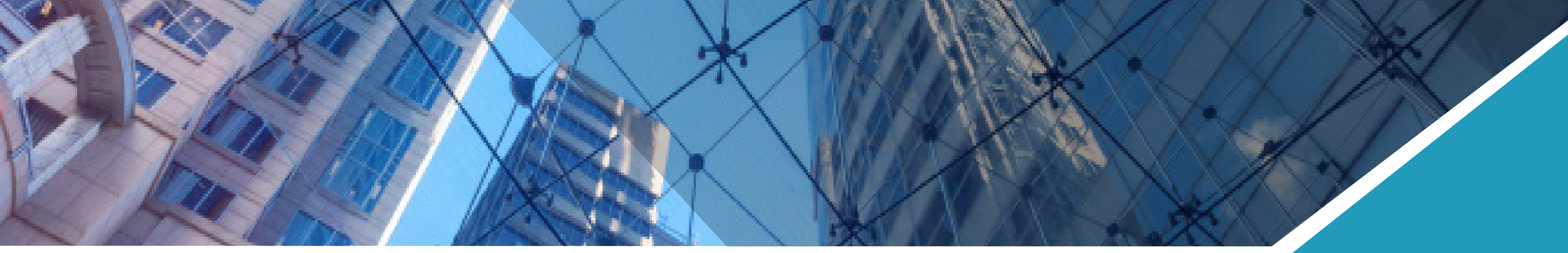
But!!.....this approach typically raises an industry question....

Does this approach correctly reflect the actual stamp duty savings -ie. the difference between the 'as is' stamp duty amount and the stamp duty that is not being paid on the completed product?

Not necessarily, but how is it proposed that these savings are reflected? As an income/savings allowance within the feasibility itself that is never actually paid or realised, or maybe by grossing up the 'on completion' value as some are inclined to do? Herein lies the problem......(continued over)



GROSSING UP THE 'ON COMPLETION' VALUE!!??

Some may consider it appropriate to 'gross up' the on-completion value by the amount of stamp duty not paid at completion and apply stamp duty to the site/partly constructed asset. The difference between the two therefore reflecting the quantum of the stamp duty saving as at the relevant date of assessment.

However, this approach not only assumes a perfect market which in itself may be inherently flawed (wherein all stamp duty savings will flow through to the price), but results in a higher IRR for a notional accrual of profit at completion (the grossed up component) which is not actually realised or booked and hence materially skews the calculations and profit release, particularly as completion draws closer (more so within the final 12 months).

Given the theoretical 'grossed up' value cannot actually be booked/realised at completion, this approach would also require backing out this 'gross up' amount closer to completion whilst potentially maintaining stamp duty on the 'as is' value, or removing it!!. This would be arbitrary (ie. at what point is it backed out) and hence also materially skew the residual and/or P&R/IRR at the point it is backed out. This creates material difficulties and embedded valuation process risk with the financial reporting of an asset, particularly as development progresses further.

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Despite the complexity of thought surrounding this, regard again should be had to the principles outlined within International Valuation Standards Council Note IVS233 (Investment Property Under Construction) and IVS 410 Development Property.

SALES ANALYSIS REFLECTING STAMP DUTY SAVINGS

Should fund-though sales analysis be adjusted for stamp duty savings?

The issues and complexities of adjusting for 'potential' stamp duty savings have already been discussed. However, the same issues flow through to any analysis undertaken for a fund-through transaction.

Defining the level of stamp duty savings and potential yield impact is difficult given this may be clouded by the deal structure (relative coupon rate and/or loan structure) and the level of profit/cost/land value within the 'buy in' price.

Typically many recent transactions have been structured on a fully (not partly) stamp duty effective basis which results in a stamp duty adjusted yield of 0.2%-0.25% above the headline yield which may be analysed on typical first principles assuming the asset was complete as at today.

However, unless the myriad of structuring factors can be compared against alternate fund-though transactions or adjustments made to reflect a comparative yield were the asset complete as at today, it is not possible to accurately define or report a first principles 'market' yield that is adjusted for structuring (including stamp duty considerations) – rather only an approximate comparative yield.

These complexities are even before considering other market matters that may impact yield under a fund-though transaction versus an existing asset transaction – namely being point in cycle and 'thru the cycle' risk between the date of acquisition and completion/settlement. Target and guaranteed rentals and pricing mechanism adjustments can also impact.

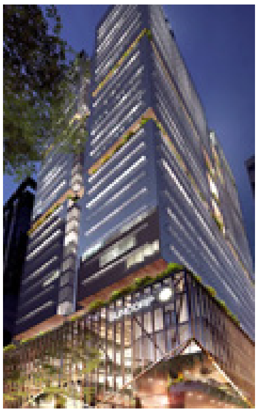
As such, the most appropriate method to cover off on 'stamp duty' and other structuring matters when assessing the end realisation, is to compare with similar fund-though transactions (ie. 'like for like'), rather than make inaccurate attempts to adjust without the detail. Actually applying a notionally adjusted yield to determine an end realisation may also logically conflict with inputs made in the feasibility around transaction costs.

For reference, our current fund-through analysis and associated structuring comments are as follows.

183 Clarence Street (Substation 164), Sydney NSW

$180.3M	*Core Market Yield: 5.04%*
September 2018	*IRR: Approx. 6.60%*
	$22,919/m² of NLA

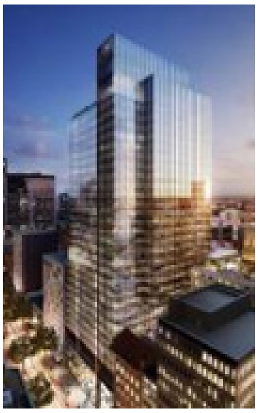
Fund-through sale to TH Real Estate of a proposed A-grade office development due for completion in July 2020. Details of deal structuring and stamp duty are not available.



80 Ann Street, Brisbane QLD

$419.2M - 50% Interest	*Core Market Yield: 4.99%*
July 2018	*(Initial Yield: 4.97%)*
	$13,917/m² of NLA

M&G Real Estate (M&G) purchased a 50% interest in the development on a fund through basis. As is typical of fund through sales, there are acquisition cost savings and M&G will receive a funding 'coupon' rate, payable by the developer on funds advanced during the development process.



Wynyard Place, Sydney NSW

$898.2M - 49.9% Interest	*Core Market Yield: 4.75%*
September 2017	*IRR: 6.6%*
(for completion mid-2020)	*c. $24,000/m² of NLA*

Fund through acquisition by AMP of the Wynyard Place development (completion mid 2020) Stamp duty effective deal. Comparative yield assuming full stamp duty payable is in the order of 5.0% approx. Due to the structure of the transaction and remaining leasing risk, it is difficult to compare the estimated parameters against existing assets.

Quay Quarter Tower, 50 Bridge Street, Sydney NSW

$900M - 33.3% Interest	*Core Market Yield: 4.7%*
(subject to adjustment)	*IRR: 6.25% (before stamp*
January 2018	*savings)*
(for completion early-2022)	*c. $29,000/m² of NLA*

Fund through acquisition by REST of a part share in the Quay Quarter Tower development at Circular Quay/50 Bridge Street. Stamp duty effective deal. Comparative yield assuming full stamp duty payable is in the order of approx. 5.0%. Due to the structure of the transaction and remaining leasing risk, it is difficult to compare the estimated parameters against existing assets.

SUMMARY

Many of these considerations within reflect matters discussed and covered off with many development clients over the years and can be material not only to the static 'as is' value (whether that be a site or partly completed asset), but with regard to the unlocking and managing the realisation of profit over the development horizon.

The same principles apply cross borders in each development market nationally and experience in managing this process and setting expectations/variables early in the process is essential in order to mitigate or eliminate what can sometimes be a high degree of valuation process risk.

Should you have any queries with relation to these or other development matters, please do not hesitate to contact the undersigned or wider team.

We look forward to providing Part 2 of our paper in July 2019.

David Castles
National Director
david.castles@
cushwake.com

In addition to this development update, Cushman & Wakefield Valuation and Advisory look forward to providing updates from our wider team as we expand nationally over 2019.

COMMERCIAL TEAM

SYDNEY CBD

David Castles
National Director
david.castles@
cushwake.com
+61 411 129 100

Tim Miles
Divisional Director
tim.miles@
cushwake.com
+61 433 010 694

Adam Elias
Divisional Director
adam..elias@
cushwake.com
+61 416 058 069

Daniel Hiscox
Valuer
daniel.hiscox@
cushwake.com
+61 416 740 948

METROPOLITAN

Lachlan Graham
Divisional Director
lachlan.graham@
cushwake.com
+61 403 346 842

Matt Lucas
Associate Director
matt.lucas@
cushwake.com
+61 421 012 319

Tony Seo
Senior Valuer
tony.seo@
cushwake.com
+61 413 163 825