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Understanding how policy settings affect developer decisions



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—Executive Summary

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Executive summary

Key points

- Private sector residential development is driven by profit. Developers want policy certainty so they can factor these policy settings into their assessment of the potential financial feasibility of a development site.
- The complexity of the development process, the structure of development organisations, the variety of products delivered, and land ownership issues mean the development decision-making process varies by organisation and site by site. Therefore, it is too simplistic to assume policy settings will have exactly the same impact on each and every developer and on each and every site.
- Housing market conditions drive private sector development. Policies that stimulate or restrict market demand will impact levels of housing supply.
- Once a developer has purchased land for development, any new costs introduced through regulation will impact profitability. Developers will try and pass these costs onto consumers through higher prices in order to maintain profit but their ability to do so will depend on market conditions.
- Reducing development costs will not automatically result in a more affordable end product. Such cost reductions could end up in a higher price paid for the land, additional profits for the developer or a combination.
- Reducing development approval timelines has a positive impact on profitability outcomes. New construction technologies that reduce development timelines can also have a positive impact on profitability outcomes.

- **Affordable housing contributions required from a development site need to be known by a developer well in advance of land purchase so they can be factored into assessments of profitability and land price.**
- **Mandatory affordable housing contributions are the most likely source of large-scale affordable housing contributions in Australia and many sites would be able to absorb the costs of such delivery under a well-designed, efficient and consistent policy.**

Key findings

This research examined how policy settings affect developer decisions, necessary to provide policy makers with an understanding of how private sector housing supply is likely to react to settings and events which affect development costs, revenues and timeframes. The research also examines the issue of new construction technologies and processes to establish their potential for reducing development costs and timelines, improving affordability.

The development industry is incredibly complex, made up of hundreds of different organisations with a myriad of different structures. As such, a project like this can only take a broad-brush approach to highlight the impact of a range of settings on traditional approaches to development. The general findings show the importance of market conditions in driving supply and how factors such as infrastructure costs, delays in development approvals and construction timelines have a negative impact on profit outcomes if they cannot be factored into a developer's initial assessment of site profitability. Such assessments are conducted through a discounted cash-flow based feasibility modelling process. Factors that are certain to the developer, such as prevailing taxes and construction costs, can be carefully considered in a decision to develop, it is the unknowns that developers fear. Clear and consistent policy settings, certainty in development timeframes and certainty in policy advice create the ideal conditions for development. The rest is dependent on market conditions.

Private sector development is driven by profit, specifically the balance between risk and return. There are a number of factors that affect this balance:

- **Market conditions:** strong demand, rising prices, cheap and accessible credit and high levels of consumer confidence are the perfect conditions for developers. Unexpected price rises during a development period will result in higher than anticipated profits for a developer.
- **Risk:** there are a number of factors developers consider when assessing risk and the level of return required to compensate for that risk. Market conditions is one, with the others being related to costs and timelines that a developer is unable to fully predict in their feasibility modelling. Those settings are fixed and easy to predict, and therefore assess. If costs are too high for the level of return required from a given site, the site will not be considered profitable and no development will occur. It is those factors that may vary after a developer has set the development process in motion that are problematic. Unforeseen delays caused by development approval processes, unexpected infrastructure costs, new taxes, labour and/or supply shortages, weather events and changes to design requirements can mean an increase in costs or a decrease in revenue and result in a lower than expected return.
- **Landowner expectations:** landowners will often be well aware of prevailing market values in an area and will engage consultants who will adopt feasibility modelling processes to come up with what they believe is a realistic price. Add additional costs into the development process and a developer may not be able to meet the landowner's price expectations, preventing development on a site until the landowner lowers their expectations, a developer is somehow able to reduce costs or predicted revenues rise. The current model of determining land purchase price benefits the landowner rather than the developer as the landowner benefits from the uplift in value associated with re-zoning and development approval. Reducing the land cost input

could enable a developer to deliver a dwelling product to the market at a lower price. However the prices of new dwellings are generally set with reference to the comparable products in the local market, meaning there is little incentive for the developer to price below market other than to increase sales rates.

- **Cost certainty and price setting:** the costs of development will be factored into the price a developer pays for land. Unexpected cost increases post land purchase will need to be either absorbed by the developer in the form of lower profits, or passed onto the end consumer to maintain predicted profit levels. In some cases, developments will be profitable enough to absorb unexpected increases, but in a competitive development industry these are the exception rather than the norm. While the development industry often states that increased costs will end in higher prices for the end consumer, the ability of developers to pass on these costs depends on market conditions. Prices are determined in the local market and unless the developer has created an entirely new market with no local competition, that market will determine prices, i.e. how much consumers are prepared to pay. In a market with strong local supply and weak local demand, a developer will be lucky to maintain prices predicted at the start of the development process let alone increase prices to absorb costs.

This research conducted feasibility modelling to examine how changes to key input variables affect development return outcomes. The modelling was based on a developer purchasing the land upfront with their own equity. While there are many other models of the development process and the timing of land purchase, this is considered the most common. The modelling outputs can be summarised as follows:

- Small increases or reductions in end sales prices have major implications for Internal Rate of Return (IRR) outcomes. A 10 per cent fall in revenue can mean a 50 per cent drop in the IRR. This means end sale prices are the biggest risk factor in the development process.
- Small increases or reductions in direct costs of construction can also have major implications for returns. A 10 per cent increase in costs can mean a 40 per cent reduction in the IRR.
- Significant reductions in the time taken from the commencement to completion of construction can have a positive impact on feasibility. Even a one or two month reduction in a 24 month build time can mean the difference between a profitable and unprofitable development.
- An increase in the time taken for development approval after land purchase will have a modest, negative impact on return outcomes. The longer the delay, the greater the impact.

Policy development options

Stimulating the market

The Australian Government's response to COVID-19 through HomeBuilder and associated state government grants showed how quickly demand side incentives can stimulate the housing industry and deliver new housing supply. Grants increase a consumer's capacity to buy while also increasing confidence in the market. This reduces risk for the developer, which along with higher prices, stimulates the development of new sites.

If governments are to use such spending to stimulate housing markets in the future, they must learn from HomeBuilder and how sharp increases in supply puts pressure on the building industry through labour shortages and material price increases. Smoothing housing supply over a longer period rather than a HomeBuilder-like rush would help the industry cope and avoid capacity constraints. A stimulus scheme operating across the entire industry, rather than concentrating on detached homebuilding, would also be more equitable. But what HomeBuilder has shown is demand side grants are an effective way of boosting housing supply in the short term and bringing forward development activity reliant on greater certainty and improved market conditions.

Inclusionary zoning

The introduction of affordable housing contribution requirements through inclusionary zoning can have a major impact on development feasibility. While density and height bonuses can help replace revenue, the developer needs to be able to pass costs onto the landowner and that means knowing well in advance what such requirements are likely to be. It will then be up to the landowner to determine if the resulting land price is sufficient to stimulate a sale. On smaller sites, the land price could fall by as much as 50 per cent if there is no capacity to increase the number of market units. If the developer already owns the land, the introduction of new contribution requirements will have a major impact on returns. Policy makers need to be conscious of the impact of such policies on development profitability and ensure they don't stifle supply. Carefully designed schemes, long lead in times and flexibility around site by site negotiations are essential. Such mandatory affordable housing contributions are the most likely source of large-scale affordable housing contributions in Australia, and many sites would be able to absorb the costs of such delivery under a well-designed and consistent policy.

Taxes and infrastructure

The costs of upgrading local infrastructure can prevent development so state and local government needs to determine whether there is merit in co-funding such infrastructure, otherwise they risk no development occurring. This is true of both infill and greenfield sites. Upfront investment in infrastructure can unlock sites for development which would otherwise be unviable for individual developers. A strategic approach to infrastructure investment to ensure a steady supply of developable sites is essential.

Stamp duty is widely perceived as a barrier to household mobility, impeding transactions. From a developer's perspective, not only does the upfront stamp duty on land purchase add to costs but stamp duty removal would likely boost demand, increasing sales rates and impacting on end sales prices. Certainly, the removal of stamp duty would have a positive impact on development industry activity by reducing end sales risk. Foreign duty surcharges also impact the development industry by making it harder to secure sales, particularly pre-sales for apartments. In some developments, particularly those with strong overseas investment interest, this has a negative impact on viability.

Urban regulation

To operate efficiently and deliver housing supply where it is most needed, the development industry needs a steady supply of sites that are financially viable to develop. This requires long term strategic thinking by all levels of government and a mechanism where investment in infrastructure is coordinated and shared between government, landowners and developers. Improvements to strategic planning with the setting and delivery of housing targets at the local level, both market and affordable dwellings, are essential.

The general complexity of the regulatory system with multiple layers of plans and approvals adds to uncertainty as a development could be blocked at any time. Timeframes can slip, which impacts on development viability. The growing complexity of the environmental approvals process state by state adds to development risk and can be a barrier to supply. Improved clarity of procedure and defined timelines can reduce risk for the developer. Changes to national construction codes (NCC) and local design guidelines can also add to costs and make certain types of development in certain local markets unviable when prices are too low to generate a profit for the minimum development cost.

Appropriate zoning that considers market demand is another important factor in stimulating development. Consideration for the economics of development within the planning framework is essential. This is also the case for any proposed inclusionary zoning policies.

COVID-19

Rising prices and changing patterns of housing demand driven by COVID-19 potentially create new development opportunities and new challenges for policy makers who must react to changing demand. Ensuring adequate land supply and supporting infrastructure to cope with demand pressures in regional areas is essential to allow the development industry to respond.

The study

The private sector now delivers over 98 per cent of Australia's annual housing supply compared to around 80 per cent in the mid 1950s (ABS 2021). This project was designed to understand how developers make decisions and, through the use of case studies, identify how changing policy settings can impact the supply decision. The project addressed four research questions:

- **RQ1:** What methods do developers use to determine the viability of residential development and set the selling price of the residential product?
- **RQ2:** What factors determine a developer's decision to develop and how important are the various inputs to the decision such as required returns, local prices, construction costs, infrastructure charges etc. across a range of different products?
- **RQ3:** Can new building technologies and processes reduce the total cost of construction, increase efficiency and feed through into improved affordability outcomes?
- **RQ4:** Given the key inputs to the development decision, to what extent can policy settings influence the cost of development, development returns and therefore housing affordability?

The methodology comprises three inter-related parts. First, we conducted 12 interviews with developers from a range of different development organisations delivering different types of housing and land product. From these interviews we were able to determine the feasibility software used by developers, the key inputs to their feasibility models and how policy settings affect development outcomes.

The second stage of the methodology concentrated on one aspect of the feasibility modelling process, construction costs, to discuss whether it was possible to reduce the cost input through new building technologies and processes. A series of interviews was conducted with organisations, nationally and internationally, using innovative processes to uncover how such processes could affect the delivery of developments. Eight interviews were conducted with organisations delivering a range of different products. Additionally, seven case studies were developed from the interviews, designed to highlight how new technologies and processes can deliver quality outcomes and potential cost savings.

Finally, the interviews conducted during the research informed the development of five case studies covering five different development products:

1. land subdivision
2. detached dwellings
3. townhouses
4. apartments
5. mixed residential development.

These case study developments reflected typical development schemes and were modelled using Argus Estatemaster Development Feasibility (EMDF) software (industry standard software used to calculate development feasibility) with price and cost inputs derived from comparable developments. Development return outcomes were calculated for each development and then key variables changed to simulate the impact of different policy settings on profitability outcomes.



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