

Understanding how policies can help developers deliver new housing supply



Based on AHURI Final Report No. 384: Understanding how policy settings affect developer decisions

What this research is about

This research examined how policy settings and new construction technologies and processes affect developer decisions to deliver private sector housing supply and might improve affordability.

The context of this research

As the private sector delivers over 98 per cent of Australia's annual housing supply (compared to around 80 per cent in the mid 1950s), understanding how developers make decisions and identifying how changing policy settings can impact supply decisions is very important. For example, housing market conditions drive private sector development and policies that stimulate or restrict market demand, or affect development costs, will impact levels of housing supply.

The key findings

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. Policy settings can affect different developers, and different sites, in different ways. If land is zoned residential this doesn't automatically mean it will be built out, there are many other factors at play and policy makers at all levels of government seeking to stimulate housing supply must understand those factors.

Levels of return drive development

Different developers use different feasibility software to calculate potential returns or land value. All models use a monthly discounted cashflow based approach to discount revenues and costs in order to determine a project and equity IRR (Internal Rate of Return). The other typical measure of return used is the developer margin, also known as profit on costs, which is the developers profit divided by the total project cost.

The required rate of return is based on an assessment of risk for the particular site with the return on built form product generally higher than land subdivision because there is more risk due to being more capital intensive. Developers said *'On longer-term acquisitions on greenfield we will be looking at a 15 per cent equity IRR and a minimum of a 25 per cent development margin and that is because there is so much more risk in the longer term projects. In a quicker infill project, we maintain a 20 per cent margin but in the current low interest rate environment the IRRs can be as low as 10-12 per cent.'*

'On longer-term acquisitions on greenfield we will be looking at a 15 per cent equity IRR and a minimum of a 25 per cent development margin and that is because there is so much more risk in the longer term projects.'

What inputs drive profitability?

The main inputs into the feasibility model can generally be classified as either revenue or cost. The most important input was considered to be end sales prices, as this drives revenue. Understanding market demand and what the market can absorb is critical. Development projects can take many years and generally developers estimate what their products would sell for in the current market using comparable evidence to determine potential sales prices and then apply a revenue escalation figure to try and forecast the actual sales price on project completion. This is fraught with difficulty due to price fluctuations even in the short term, let alone on development projects which may span 10 years. Developers usually adopt a conservative approach to price escalation to avoid overestimating revenues and delivering inflated return projections.

While the planning system will determine what a developer can deliver on a site, the greatest uncertainty comes through market conditions. While developers will estimate the potential revenue generated by the development, market conditions can change quickly during the development period and can have a major impact on projected profitability. Large property price rises not factored into the model will result in returns much higher than projected due to a combination of increased prices and sales rates, while the reverse is also true. Prices may fall, those with pre-sales contracts may attempt to get out of them if the deposit is less than the fall in price, and dwellings may take much longer to sell, increasing finance and holding costs.

‘Being unable to sell dwellings on completion means a developer cannot pay off debt, has ongoing holding costs and may eventually be forced to discount units in order to sell.’

Risk factors

Interviewees consistently identified that the key to successful development was the ability to deliver the required rate of return while minimising risk. It is not a case of maximising return at all costs. Market demand, sales prices and sales rates were considered by many interviewees as the main risks. Rising construction costs have emerged in the last 12-18 months as another critical risk factor. Access to finance was not considered a major issue in the current development climate.

Being unable to sell dwellings on completion means a developer cannot pay off debt, has ongoing holding costs and may eventually be forced to discount units in order to sell. These factors will reduce return. Predicting market demand is fraught with difficulties because markets can change very quickly. As such, most developers rely upon tried and trusted areas, as well as products with which they are familiar, to reduce risk.

The second biggest risk factor identified by interviewees was the planning process: *‘Planning certainty and timeframes, environmental considerations, approvals to clear vegetation and confidence on community perceptions. Community backlash can affect reputation so if public company it is sometimes not worth the fight ...’*

‘While the planning system will determine what a developer can deliver on a site, the greatest uncertainty comes through market conditions.’

Planning policy settings determine what a developer can do on a site. This means that the political stance of the local planning authority can actually deter a developer from operating across the whole of an LGA. Two of the WA based developers highlighted how there are certain local governments where they will not work because of the uncertainty created within the planning approval process. The potential for timelines to blow out or last-minute changes forced upon developers increases risks and can reduce return, leading to developers avoiding these areas all together.

If certainty is there, particularly around timelines, developers can work with the local planning authority and deliver a scheme that is mutually beneficial. Inconsistent planning decisions, and big variations across LGAs cause problems. Not all developers were negative about planning authorities; a number had very good working relationships with local and state government. It was those planning authorities that seemed “anti-development” (a stance often driven by political leanings) that grabbed the headlines and drove tension.

Taxes were also an issue for some developers, particularly around land tax, GST on sales, stamp duty and foreign investor surcharges. Land tax was a particular issue for projects with longer development timeframes and the introduction of new taxes post land acquisition of real concern.

Requirements for major infrastructure contributions, particularly those emerging late in the development process and could not be factored into the original profit projections were problematic. The provision of infrastructure will become more and more important over time.

Impacts of new building technologies

All interviewees agreed that policy is one of the most critical factors that affects the uptake of new technologies, materials or construction methods. These impacts could be negative or positive. Interviewees commented that public policies often do not anticipate technological innovations sufficiently, and often do not keep pace with such innovations. As a result, they could present encumbrances unwittingly.

Another dimension is the issue of blanket mandates—governments making it mandatory for industry operators to use one technology or the other. Interviewees commented that this is counterproductive and against the ethos of competition. When systemic problems become visible and policies are not able to trigger seamless amicable solution, then there is a problem.

‘All interviewees agreed that policy is one of the most critical factors that affects the uptake of new technologies, materials or construction methods.’

Modelling key development variables

The research used industry standard software to model, across a variety of different development products, how policy settings can alter inputs to the feasibility model and deliver very different return outcomes. Such settings can be the difference between profitable and unprofitable development.

The research modelled the impact on IRR outcomes of construction costs; revenue; development timeframe; disposal period; and of policy settings (innovative construction methods; developer contributions; and density bonuses and affordable housing contributions).

One modelling result shows a more efficient development approval process, including planning, infrastructure and environmental approvals, which reduces timeframes has the potential to provide a major boost to project profitability. Not only is the construction period shortened, reducing the impact of cost escalation, but the sales period is brought forward meaning debt is paid off quicker. Finance and land holding costs also fall. There is a varying impact across the five case studies as the construction timelines vary, as do the input costs affected by shortening the timeline. In all cases there is a significant impact on the IRR, ranging from 12 to 22 per cent. This could mean the difference between a developer meeting or not meeting their hurdle rate of return.

Table 1 demonstrates the impact of a six month development approval delay. IRRs fall between 11 and 27 per cent, depending on the length of the original timeframe and other key variables. In order to compensate for lower returns, end prices would have to rise by between 3.5 and 5.4 per cent, so an impact of around \$25,000 on a \$500,000 dwelling.

What this research means for policy makers

The analysis presents evidence of how policy settings can impact on development profit outcomes and how end sales prices could change if developers were willing to pass savings onto consumers.

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 at all levels of government and a mechanism where investment in infrastructure is shared between government, landowners and developers.

The current model of determining land purchase price benefits the landowner rather than the developer (although they can be one in the same). Reducing the land cost input could enable a developer to deliver a dwelling product to the

Table 1: Impact of a six-month delay in development application approval

6-month delay in period to construction commencement	Land subdivision	Apartments	Townhouses	House and land	Mixed residential
Original period to construction commencement	14 months	10 months	6 months	6 months	12 months
New period to construction commencement	20 months	16 months	12 months	12 months	18 months
IRR change	-11.1%	-17.4%	-27.0%	-16.3%	-15.8%
Developer margin change	0.2%	-10.7%	-18.1%	0.5%	-5.9%
Change in end sales values to maintain IRR	3.7%	3.5%	5.4%	3.8%	4.4%
Change in RLV to maintain IRR	-11%	-15%	-22%	-10%	-19%

Source: AHURI Final Report No. 384.

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. The only way for a developer to deliver a more affordable product outside negotiating a lower price is to accept a lower return, reduce direct development costs and/or shorten the development period. Alternative land ownership structures such as joint ventures between the developer and landowner and/or profit-sharing arrangements or deferred land payments, offer alternatives to the traditional maximum land price model and could deliver more affordable products. Any land that is secured 'below market' has the potential to deliver products below a revenue maximising position and still deliver the developer their required return.

Industry lobby groups highlight planning reform as necessary to deliver more housing supply. Consideration for the economics of development within the planning framework is essential. This is also the case for any proposed inclusionary zoning policies. There can be blockages within the numerous agencies that are part of the approval process, with infill development being the most complex. Adequate resourcing of referral agencies and defined timelines can help reduce uncertainty.

Policy settings that force a developer to deliver a type of product unsuitable for a particular market will mean no development. If the developer does not think they can sell the end product in a timely manner, they will not proceed with the site. Trying to force density in an area where there is little demand for that type of product will be unsuccessful. Also trying to force density into an area where prevailing prices do not deliver profitable development will also mean no development. Developers, and financiers, are inherently conservative in nature and like to see evidence of sales for a product that may be new to a market. This requires the first developer to take that extra risk before others follow. In such cases, development by the public sector can stimulate new product in an area.

Land value uplift taxation can deliver community benefits such as affordable housing. Introducing clear policies that require contributions from market development sites can yield significant community benefits over time. The UK model of affordable housing delivery delivers affordable housing contributions with the developer factoring such contributions into the price paid for the land. Any attempt to introduce

mandatory affordable housing contributions from market sites in Australia would require very clear policy, a long lead in time to give the industry time to adjust, and a clear framework for assessing realistic site by site contributions based on a range of site-specific issues.

'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 at all levels of government and a mechanism where investment in infrastructure is shared between government, landowners and developers.'

For governments looking to stimulate housing supply, reducing tax costs for developers would improve profitability and could stimulate supply. For example, land tax has major implications for long term projects and build-to-rent developments (also affected by Managed Investment Trust tax settings). Reform to these settings could deliver a boost to the industry by improving the financial viability of such schemes, and fortunately such reforms are emerging.

Policy makers need to understand that every site is different, and the impact of new policy settings will be determined by the characteristics and forecast profitability of the site, and also prevailing market conditions at point of sale.

Methodology

This research conducted interviews with developers from a range of different development organisations and modelled typical development schemes to calculate development feasibility with price and cost inputs derived from comparable developments.

To cite the AHURI research, please refer to:

Rowley, S., Leishman, C., Olatunji, O., Zuo, J. and Crowe, A. (2022) *Understanding how policy settings affect developer decisions*, AHURI Final Report No. 384, Australian Housing and Urban Research Institute Limited, Melbourne.

Available from the AHURI website at ahuri.edu.au/research/final-reports/384