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## Land values go up like a rocket and fall like a stone

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**SITEEVALUATION:** Why would a developer bid €225,000 an acre in 1999 and €2.8m an acre in 2007? Bill Nowlan explains

**WHY HAS THE** value of development land fallen so precipitously, by over 50 per cent in the past 12 months, when residential and other property values have only fallen by 25 per cent or 30 per cent?

There is an old property cliché which says that "land values go up like a rocket and fall like a stone" and this seems to have been borne out in Ireland over recent years. Why does this happen?

To answer this question requires an insight into the way developers prepare their bids for development land and I set out below a glimpse into that process.

Let me start by looking at how a developer in normal times estimates his bid for a plot of land with planning permission, which in estate agents' parlance is ready-to-go.

The key starting point in a developers equations is the expected sale price of the finished buildings which they intend to build on the land. In a stable market this is generally easy to predict as developers will be familiar with sales prices for new and second-hand houses in their area. They will know, for example, that three-bed semis sell for a certain level.

But, in a rapidly rising (or falling) market it gets more difficult because it takes at least two years from the time a developer buys land with planning permission until they have houses or apartments to sell - or even longer if they want to alter or improve the planning permission.

Also, bear in mind that land to a developer is only one of the ingredients that goes to make up the finished product of a house, or an office or a shopping centre. The other ingredients being bricks and mortar, taxes, professional fees, financing, local cost, local authority levies, social and affordable obligations and a profit margin - all of which will change over time and have to be estimated in his bid price.

Let us look at a situation of a hypothetical fully serviced plot of 10 acres which comes up for sale with full planning permission for a scheme of 100 houses in an area where three-bed semis sell for €350,000. Let's also assume that there is a normal market.

A developer's calculation of the price they could afford to pay for such land would look like that outlined in table 1 (see near right). The price the developer bids would be calculated by multiplying the value per site at €84,000 by the number of sites and, hey presto, you have a bid price for the 10-acre plot. In this case at a density of say 10 to the acre, this would give a bid price of €840,000 per acre or €8.4 million for the 10 acres.

This looks quite simple and was so at the beginning of the Celtic Tiger. But other factors got added into the melting pot of land values over the past 10 years.

First, there was the rapid growth in overall prosperity and population linked to cheap and available credit.

This created a demand for accommodation over and above the development industry's capacity to deliver. In turn, this resulted in sales prices for new and second-hand houses being increased to ration available supply through the process of market price escalation.

The average price of a house in Dublin increased from €82,400 in 1996 to €428,000 in 2007 - but fell to €395,000 in January 2008 and is still going south. My projection for January 2009 is €350,000.

Second, various State planning rules significantly increased the permitted density of new developments on each acre of land - in some cases by more than doubling the permitted density of units per acre.

Third, from 2002 onwards the Government introduced the Part V Social and Affordable obligation which transfers 20 per cent of land or its value to the local authority. They also significantly increased the levy for services.

These factors changed the developers' calculations progressively. Some of the changes increased land values and others had a downward influence. How did this pan-out over the long term?

In the set of calculations (see table 2 right) I have taken the average sale price of a Dublin house from the Permanent TSB Index over a 10-year period from 1999. Then, using professional quantity surveying advice and the SCS building cost index for houses, I have worked out the value that a developer would bid per acre at different times between 1999 and 2008 with a projection for 2009.

Thus a developer would only bid €225,000 an acre in 1999 but by 2001 he could bid €1,069,000 for the same acre and still make his margin. By 2007 he could nearly bid double this amount again at €2.8 million per acre and still expect to make his 15 per cent margin.

The reason for this is that, for every €50,000 increase in house prices, almost €40,000 went straight into land values. Thus the leverage effect of increasing house values went straight into the pocket of landowners.

This table traces reasonably accurately the actual value of land in suburban Dublin over the 12-year period. There would be variations for the attributes of any given location which cannot be captured in a generic example but it verifies the "up like a rocket" part of the cliché. The calculations for apartment sites and other city sites would be similar but the technical details as to construction cost and sales prices would be different and give different site values.

The calculation also demonstrates why land values have increased for the 10 years of that period and why they have fallen so significantly over the past 18 months. They also show why the sky high land values of early 2007 are unlikely to return for some time, particularly as the oversupply of houses and the ready availability of development land are unlikely to replicate the condition of the mid part of this decade. Indeed, it would be hard to imagine a situation where developers will bid for land based on sales prices of completed units escalating by 10 per cent or 20 per cent per annum which they did up to 2007.

But, like it or not, this is the way that developers did and do their sums. It is this bidding process that forced land values up to close to €3 million per acre in many Dublin suburban locations. But it is also the logic behind why land values have come back down to about a quarter of this level today when individual house values have fallen by only about 25 per cent. As house prices fall the impact of a €50,000 decrease goes straight into the land element and thus multiplies the effect of a fall in site values.

The second question posed was to know how professional valuers actually value ready-to-go development land. In fact, the professional valuer simply does the developers calculations exactly as above. In real life far more detail goes into the calculations than I can show in this example but the essence of the analysis is the same. A valuer will also look at comparable sale prices of other land in the vicinity to verify their opinion of value.

I am sure that you will be saying to yourself that this is all very well for ready-to-go sites but what about the pricing of land that is not ready-to-go. The developer's bidding and valuation process for such land is more difficult and the valuer prepares similar calculations but discounts them for the delay, cost and risks of making the site ready-to-go.

And of course there is no guarantee that such land will become ready-to-go or when it might happen, so this factor is also built into the valuation.

The detail of valuing land that is not ready-to-go is a subject that I will come back to.

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