# Financiers and Developers: Housing and Residential Development Process

National Science Challenges — BUILDING BETTER HOMES, TOWNS AND CITIES — Ko Ngā wā Kainga hei whakamāhorahora

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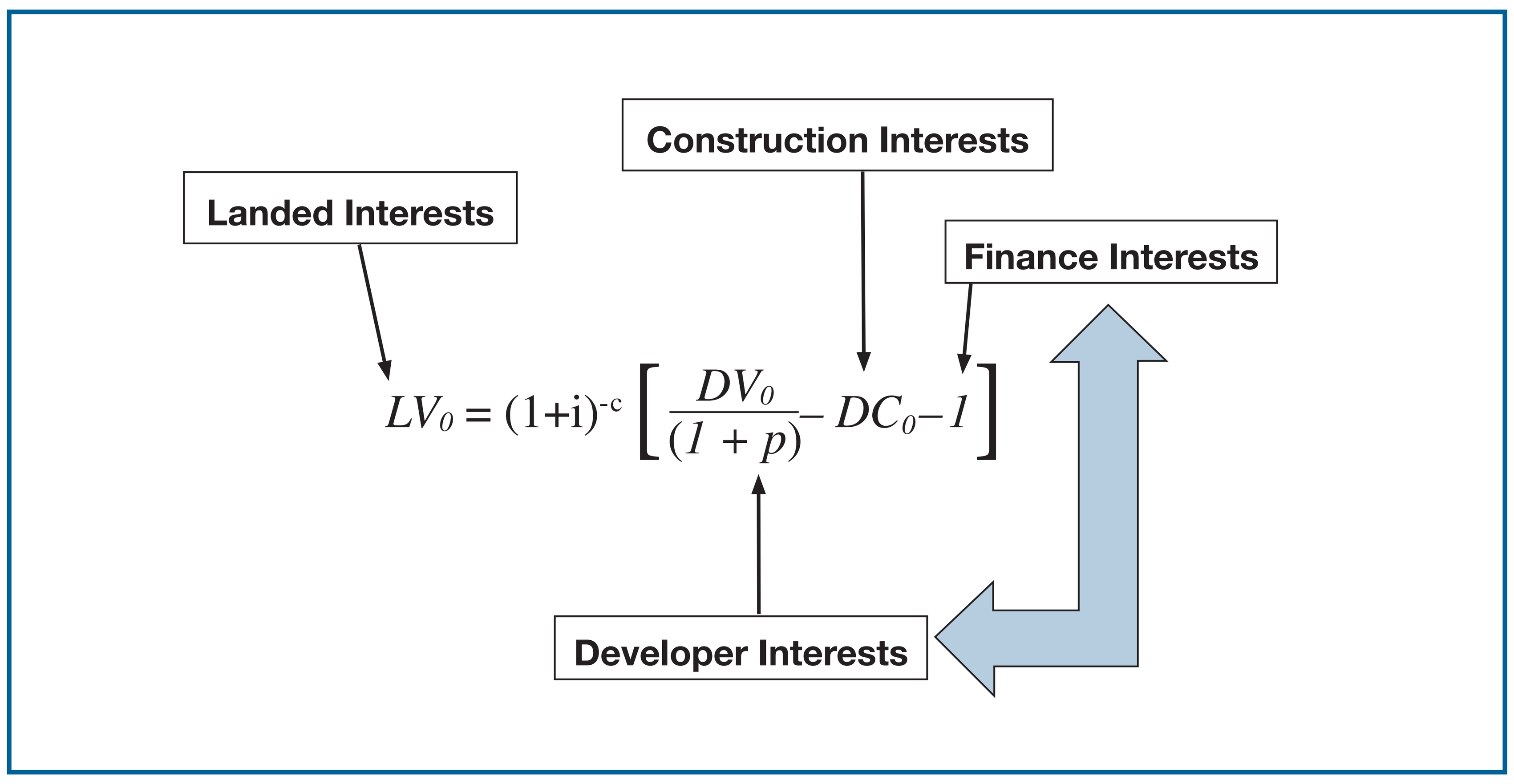
New housing supply produced in New Zealand is strongly conditioned by the actions of various actors operating in the residential development sector. Within the context of private market housing provision successful development outcomes need to meet the demands of a variety of interests including: land, developer, construction and finance interests. For those interests, development feasibility analysis is a key practice in determining the potential financial viability of any residential development. At its simplest, development feasibility is a residual calculation that provides either a measure of the land value or developer's profit.

Development feasibility analysis is more than a financial calculation. It is also a social process in which different interests look to maximise their position and returns and minimise risk. Figure 1 shows the developer seeks a profit margin (p) that reflects the level of risk involved in a development. Finance interests (banks, equity investors) are seeking a return, as expressed in the costs of finance (I).

**Figure 1: Property interests reflected in a residual valuation**




A series of 11 interviews (Table 1) was undertaken with senior professionals in the sector

**Table 1: Characteristics of Interviewees**

| No | Occupation | Area of Expertise | Activities | Industry Experience (yrs) |
|---|---|---|---|---|
| 1 | Senior Consultant | Commercial and Residential Development management | Development Feasibility | 43 |
| 2 | Group Property Manager | Community Housing | Development Feasibility | 4 |
| 3 | Developer (large Scale) & Development Director, Advisory Consultant | Large Scale Residential Development | Development Feasibility | 35 |
| 4 | Managing Director- Finance Group | Development Finance | Development Feasibility | 30+ |
| 5 | NZ Director- International Consultancy (NZ) | Valuation and Research Services | Development Feasibility, Market analysis | 40 |
| 6 | Partner- Advisory Services/ Consultant (International Firm) | Valuation, Advisory (large scale multi-year developments) | Development Feasibility | 25+ |
| 7 | Director –Property Development and Investment Firm | Large Scale (High end) residential developments | Finance, Development Feasibility | 25+ |
| 8 | General Manager- Community Housing Provider | Affordable Housing | Policy, Funding | 5 |
| 9 | Development Management- Community Housing Provider | Affordable Housing | Range of Development activities | 30 |
| 10 | Strategic Planner-Urban Regeneration | Large Scale Urban Regeneration programmes | Range of Development activities | 15 |
| 11 | Director Research Consultant International Consultancy (NZ) | Finance, Banking, Development | Consultancy | 9 |

Those interviews show that:

- In order to initiate a development, developers need to create a 'capital stack' (or 'funding stack') that consists of both debt and equity.
- The availability and cost of capital have a profound impact on the capacity of developers to undertake any development.
- Bank debt funding is a key requirement for residential development.
- Bank sector risk management strategies typify and treat residential development as inherently risky.
- Banks' risk management strategies can affect the organisational structure of developers and promote particular organisational forms (e.g. special purpose vehicles (SPVs)). A SPV is a company that is established specifically to undertake a particular development. SPVs restrict a bank's risk exposure to a single development and avoids the complexity of having to deal with a development company that has financial interests across a number of developments.

*"Banks are very simple. They take no risk. They go, 'we want equity from somewhere else'… So typically, any bank… will want to see the feasibility…they will want to see a profit margin…in excess of twenty percent. They'll want to see a margin. Twenty percent is the magic kind of number…"*

- The banks' preference for a pre-sales development model is designed to manage finance risk. But the model itself can alter the profile of a development's risk and the viability of a development.
- Development feasibility analysis is a key industry calculation that is embedded in everyday developer practices and conditions the financier/developer relationship.
- The developer's acceptable profit margin (a key component/output of a development feasibility analysis) is strongly conditioned by the needs of financiers.
- Developers need to be seen to achieve a certain level of profitability in their feasibility analyses if they want to secure funding. This conditions what are viewed as acceptable price forecasts and residual land valuations.

*"Every bank isolates every project;… every single project I do, the bank insists that I set up a new SPV; special purpose company. They take a first mortgage charge of shares in the company over its GSA [General Security Agreement]; over all its undertakings and all its assets. They will not allow anybody to get near their securities."*

Those findings:

- Challenge narratives common in the policy sector that portray developers and financiers as simply responding to market wide forces of supply and demand. Instead developers and financiers actively create and operationalise practices that govern acceptable profit margins, operational structures and house prices.
- Highlight the fundamental importance of finance to the residential development process. The needs of financiers and their risk management strategies profoundly affect developer behaviours and influence the nature, quantum, and price of houses developed.

*"You could say in the normal market somewhere between swings and roundabouts they'd be looking for seventy percent pre-sales… The current thing is that basically they want, before construction, one hundred percent pre-sales to the value of the money that they are lending." (Development Management*

- Highlights the impacts of risk management strategies adopted by financiers. For, example, encouraging developers to form special purpose vehicles (SPVS) is an effective strategy for banks wanting to minimise their risks but it has the effect of transferring risk to the long-term owners of the dwellings once a development is completed. Moreover, this organisational form is problematic when dealing with the consequences of serious building defects and legal liability.

Together those findings suggest policy attention should be directed to examining how alternative and innovative financing structures could be employed to encourage the production of affordable housing.

See the full report at **http://www.buildingbetter.nz/publications/SRA1/Murphy_2019_developer_financier_interviews.pdf**

CRESA Centre for Research, Evaluation and Social Assessment | Architecture of Decision-making Strategic Research Area, BBHTC Programme Leader Kay Saville-Smith, Centre for Research, Evaluation and Social Assessment