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London Borough of Southwark

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Dear Sirs,

High Level Viability Review – Elephant and Castle Shopping Centre Redevelopment

Instructions

We have been instructed by the London Borough of Southwark ("the Council") to undertake a high-level review of the information provided to Avison Young on behalf of Elephant & Castle Properties Co. Limited ("EC") in relation to the Council obtaining Cabinet approval to make a Compulsory Purchase Order (CPO) to complete the redevelopment of the Elephant and Castle Shopping Centre.

Avison Young were instructed on 7 August 2023 to review the viability appraisal underpinning the planning application for the shopping centre redevelopment and thus we are familiar with the proposed scheme. We have been advised that the required area is smaller than that considered as part of Avison Young's review of viability for the planning application and relates solely to arches on the East site and various rights on the West site. The purpose of our instruction is to confirm viability of the consented scheme which is currently under construction for consideration by the Council's Cabinet in obtaining authority to make the CPO. We previously advised on this in December 2022 but as time has moved on the Council have asked us to carry out a further review and provide a letter update.

Our advice assumes the time and costs associated with the CPO are fully accounted for within the costs and programme outlined in our letter. Any changes to these may impact viability.

In broad terms, the outstanding interests and rights that still remain to be acquired are as follows:

- Arches 6 and 7 Farrell Court on Elephant Road are required to provide the pedestrian link between the East Site, Elephant Road and Elephant Park, to be known as the Park Route.
- A corridor of land immediately to the west of the viaduct which is needed to provide the public realm to connect the East Site (including the new London Underground station) with the new public route beneath the viaduct and the overground railway station.

- A new right of way for pedestrians over the small area of Network Rail land to the immediate west of the railway station is required. A tiny fragment of Network Rail land, which is not used operationally, is also required as part of the public realm area.

- Arches 113A, 120, 113B and 121 on Elephant Road (to the north of the railway station). Arches 113A/120 formed the vehicular access to the former Shopping Centre, while Arches 113B/121 formed a private pedestrian route providing access to the rear of the former Coronet. Both access routes are no longer needed following the demolition of those buildings on the East Site.

- Arches 4 and 5 Farrell Court. These arches are currently home to Corsica Studios who will stay in these arches but require the construction of a sound box on the western elevation of these premises. In order to complete these works the developer will need to acquire the lease for the premises.

- On the West Site there are a number of relatively minor issues but which could still potentially jeopardise the delivery of the Scheme. There are two small areas of unregistered land and two sub stations that the developer will need to acquire in order to proceed with the Scheme. The developer also requires some rights over the Metropolitan Tabernacle land (but not the acquisition of their title) to facilitate demolition of the current LCC building and to decouple the current LCC building from the northern façade of the Tabernacle. Some crane oversail rights are also sought over the Tabernacle and other areas adjacent to the LCC site.

Our practice reviewed the viability of the Elephant and Castle proposals for the planning department at the time the original scheme was promoted and more recently in June 2021 when a Section 73 scheme was approved. This Section 73 scheme is the scheme that is being delivered and the proposed CPO resolution is to facilitate its delivery in entirety.

As per our December 2022 exercise it has been agreed that we will undertake a high level review to establish if the scheme is viable going forward. In effect we are reviewing the proposed scheme appraisals and commenting upon whether the inputs are reasonable at this point in time. This high-level review has been undertaken on a desktop basis to inform the Council's decision making and would likely have to be reviewed again and in more detail in the run up to any CPO Inquiry.

Basis of Assessment

In order to establish the viability of the scheme today we have considered the value of the site as it is today. Effectively we are trying to establish whether the proposed scheme generates a positive land value when all the costs and revenues are taken into consideration. Our assessment on this basis is on a current day basis and factoring in any potential pay away from the upcoming early-stage review. In the time available we have not had the opportunity to explore rental growth assumptions which would enhance the outturn and is ordinarily reflected as part of assessing a BTR scheme. This further analysis might be useful if preparing for a CPO Inquiry. Our commentary on the inputs adopted by the DS2/EC and any adjustments we have made are detailed below.

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High Level Review of Values

The values provided by the applicant were as part of our December 2022 review. Since this date there has been a shift in the market as the UK economy weakens and interest rates climb. We comment upon how this may have impacted the applicants 2022 inputs below:

Value input	Applicant's assumption as Q4 2022	AY Comments
Car parking	£60,000 per space	With only 34 spaces available within the development this is a reasonable value to assume per space.
Social Rent	£271 per sq ft	This reflects London Living Rental levels for 2022 / 2023.
Educational pre-sale	£191,359,027	An agreed price.
Residential Rental Value	£47.50 per sq ft	DS2/EC has provided us with helpful comparable evidence to support this rental level as at November 2022. Since this time there has been considerable rental growth, so whilst it is difficult to stablish an appropriate rent in the time available, we do believe it will be in excess of £47.50 per sq ft. Our evidence supports this with the average rents achieved at 351 Southwark Bridge Road based on our research being £57 per sq ft on lettings achieved between June and October 2023. We have therefore run a sensitivity exercise demonstrating the impact on value of a 5% increase in this rental value. A 23% deduction for OPEX has been made which we consider consistent with market parameters.
Retail Rental Value	£44 per sq ft	The new retail space will be located within a regenerated town centre. Whilst there is no evidence of this level being achieved currently in the Elephant and Castle we understand that the recently formed retail and leisure destination Elephant Park is quoting upwards

		from £35 per sq ft. This is aimed at independent occupiers with an aim of place making. We consider that the subject property with more superior frontage and prominence will command higher rents and therefore can accept that £44 per sq ft is not unreasonable on a high-level review. This would be subject to further investigation at a later date if required.
Intermediate Market residential rental value – West site	£29.42 per sq ft	This reflects the mix of residential units and the discount to Market Rent. Detailed supporting calculations have been provided by the applicant which we have updated to reflect the new London Living Rent levels – minimal uplift to £29.42 per sq ft.
Intermediate Market residential rental value – East site	£28.96 per sq ft	This reflects the mix of residential units and the discount to Market Rent. Detailed supporting calculations have been provided which we have updated to reflect the new London Living Rent level – minimal uplift to £28.96 per sq ft.
Leisure rental value	£20 per sq ft	DS2/EC has applied £20 per sq ft to the NIA whereas it is more common to analyses rents on leisure on a GIA basis. On a GIA basis the rent is closer to £16 per sq ft which does not look unreasonable when considering evidence, however, it should be noted that the majority of available evidence is pre-pandemic and this use is seeing turbulence both due to increased operating costs and reduced consumer spending. So whilst this looks optimistic currently the total rent attributed to it is circa £500,000 which for a scheme of this size is negligible. On this basis we are happy to accept this rental level. This is the figure we adopted in June 2021.
Music Venue Rental Value	£40 per sq ft	Analysed on a GIA basis the rent applied to the music venue reflects £15 per sq ft or £40 per sq ft on a NIA basis which is what we adopted in June 2021. There is limited evidence to support it. There has been a resurgence in popularity for live 'experiences' since the pandemic, however the UK economy is now

		likely to go into a period of recession which is likely to impact this industry negatively.
Workspace rental value	£50 per sq ft	The development on completion will offer a new workplace destination within Zone 2 of London. Whilst there is no evidence to support rents of £50 per sq ft being achieved in the location currently there is evidence of other regeneration areas such as Stratford, Wembley and Battersea achieving these rents following their regeneration. We therefore consider this a reasonable assumption.
Workspace rent free	1 year	1 year rent free is not an unreasonable assumption for the new office space.
Workspace Yield	5%	Due to adjustments in market conditions we have revised this to 5.5%.
Commercialisation	£1.5 million	This covers advertising revenue from the scheme. We have used this sum in previous assessments and assume it is correct.
Residential rent capitalisation rate	3.25%	Prime Built to Rent capitalisation rates in central London currently stand at 3.6%. We consider this asset to be prime and therefore would demand a 3.6% yield upon stabilisation.
Retail rent capitalisation rate	6.25%	The retail market is being affected by the move to online shopping as well as the UK recession. The reduction in consumer spending along with increased costs is impacting retailers which is seeing major brands such as Wilko go into administration. This is impacting investor demand and yields are softening. On this basis 6.25% does seem optimistic, however by the time the development completes the UK is forecasted to have finished recession (end of 2024) and therefore any current purchaser of the site is likely to be slightly more optimistic on the yield which could be achieved. As a regeneration scheme you would expect a lower yield to be assumed given the potential for retail in the vicinity of circa 1,000 new homes and its strong location. We have made an adjustment

		of 50 basis points to reflect market conditions, adopting a yield of 6.75%.
Retail rent free	6 months	This is not an unreasonable assumption for a new retail destination such as this.
Leisure capitalisation rate	5.5%	Prime Leisure Parks are currently trading at yields of 7.5% with the trend weakening. This is a central London scheme as part of a regeneration and includes fitness as well as a cinema. Therefore we consider that a 100 basis point downward adjustment from this would be reasonable. We have therefore applied 6.5% to reflect
Leisure rent free	6 months	Not unreasonable.
Music Venue capitalisation rate	6.25%	These venues attract poor covenants and therefore trade at a higher yield than other leisure. We have used a yield of 7.25%.
Music Venue rent free	6 months	Not unreasonable.
Affordable retail space	£5,273,037	This reflects the investment value of stepped rents for the affordable retail space. We have updated the investment calculations to adopt a 6.75% yield and stepped rents.
Intermediate and intermediate market residential rent capitalisation rate	3%	We have adopted the same yield as for the market residential of 3.6%.
Commercialisation capitalisation rate	6%	We have kept this consistent with our June 2021 assessment.
Additional Revenue	£25,867,625	This comes from Grant Funding and LUL TfL credit. This is a balance of money left to receive.
Potential Early Stage Review	£0	The Section 106 agreement includes three opportunities for a viability review. The first review date is 36 months from the date of planning permission where the development has not been substantially commenced. This will be triggered due to delays in commencement relating to the High Court proceedings on this site. Target returns are

		specified and are set at a profit of 11% ungeared IRR for Viability Review 1. The site value shall be fixed at £142 million. Site value shall be subject to indexation in accordance with the MSCI UK quarterly index capital value shopping centres for the East site and MSCI UK quarterly index capital value offices for the West site. Indexation of the site value for the West site shall be calculated from the earlier of the date of purchase or the date the West site is commenced. There are a number of inputs which are fixed including purchases costs at 6.8% of gross development value, design contingency at 2.5% of construction costs, construction contingency at 5% of construction costs, professional fees at 12% of construction costs and commercial marketing at £2.00 per square foot. The applicant has provided us with a worked version of the appraisal for Early Stage Review purposes. This shows an IRR of 3.31% being generated which is beneath the trigger for additional affordable housing to be provided. At this stage at a very high level it appears that there will be no provision of additional affordable housing on site. However, the early stage review process has not commenced and a full audit of the values will be required to substantiate this. The Early Stage Review assessment includes all costs from commencement as well as a fixed land value as a carrying cost (which differs the exercise we are undertaking now for CPO purposes). Hence one would expect a very different outturn to the exercise we are undertaking today. The Early Stage Review remains outstanding.
Total Net Realisation		**£935,925,908**

If we adopt an increase of 5% on the private residential rents the net realisation changes to £947,896,560 (an increase of circa £11.97 million).

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High Level Review of Development Costs

We have not been provided with any updated cost data and have therefore adopted the same assumptions as at our November 2022 review. The Fixed Price Contract on the East Site will have remained constant. BCIS TPI for the last year shows an increase of 4% in build cost over the last year. This is a high level estimation of how build costs may have adjusted since the applicant last provided us with data. We have tested this on the West Site Construction costs by way of sensitivity analysis.

Cost input	Applicant's assumption as Q4 2022	AY Comments
Construction Costs West Site	£275,062,121	Increasing the build costs on the West Site by 4% increases the build cost on this part to £286,064,606 (an increase of circa £11 million). We have adopted this sum within our review.
Construction Costs East Site	£372,093,004	A fixed price contract has been agreed and we have been provided with the remaining costs to be spent. We have relied upon this and in the timeframes available not been able to assess it further.
Other development costs	£5,045,177	This is made up of costs associated with gaining vacant possession, voids etc. We have assumed these costs are correct and have been unable to verify them further in the timeframes available.
Land Purchasers Costs	6.8%	This is a market assumption and reasonable to adopt.
Design Contingency	2.5%	This is a market assumption and reasonable to adopt.
Construction Contingency	5%	This is a market assumption and reasonable to adopt.
West – CIL / MCIL	£5,760,346	This is as per previously adopted in assessments. Supporting calculations are being prepared by applicant but are not available for this review.
West – Other development costs	£1,000,000	Awaiting further information on what these costs cover.

West – estimated Section 106	£1,667,550	We have assumed these are correct. They have been used in the June 2021 assessment.
East – estimated Section 106	£4,064,585	We have assumed these are correct. They have been used in the June 2021 assessment.
East – other development costs	£480,000	Awaiting further information on what these costs cover.
East – Utilities connections	£591,419	Supporting evidence provided. Has not been reviewed by a QS in the time frames available.
Professional fees	12%	This is a market assumption and reasonable to adopt.
West – Residential marketing costs for the private flats	1%	This is a market assumption and reasonable to adopt.
Commercial marketing	£2 per sq ft	This is a market assumption and reasonable to adopt.
East - Residential marketing costs for the private flats	1%	This is a market assumption and reasonable to adopt.
Letting Agent Fee	10%	This is a market assumption and reasonable to adopt.
Letting Legal Fee	5%	This is a market assumption and reasonable to adopt.
Sales agent fee – PRS and commercial	1%	This is a market assumption and reasonable to adopt.
Sales legal fee	0.5%	This is a market assumption and reasonable to adopt.
Arches Refurb	£894,996	We have assumed these are correct. Have been used in previous assessments.
IRR target	11%	This target rate of return has been agreed previously and is documented in the Section 106 agreement. In the context of this exercise we think it is appropriate given the extended timeframe for this development.
Total Costs		**£881,207,231**

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Programme

We assume there has been no change to the total remaining programme which from November 2022 was estimated to be 91 months with completion of both sites due in May 2030 (now 80 months). Work has commenced on the East site and there has been significant progress and associated sunk costs to include demolition and ground works. This phase is due to complete in April 2026 (31 months time).

EC/DS2's appraisal assumes sale of the residential element upon completion. This assumption arose from the viability review in June 2021 where this optimistic assumption was made. In reality, it will take a period of time to let the flats and secure stabilisation prior to sale. In the time available to us we have not been able to undertake a detailed model factoring in rental receipts and growth. We have instead varied the model to allow for a 12 month void at the end of each construction period to allow for a period to let the flats. In reality, it would be longer but rental receipts would be incoming over the period to ameliorate the financial position. We have not allowed for any rental receipts during the run up to stabilisation.

Conclusions

We have used the inputs outlined above to run a residual valuation of the scheme. The residual land value generated is £86,453,788. This reflects the following outturns:

Profit on Cost: 9.14%

Profit on GDV: 8.16%

Ungeared IRR: 11%

The IRR is an overall return and includes costs of finance and is an annualised return. It is commonly used in the context of developers undertaking developments over a longer than standard horizon to measure the overall return, other than on cost or value. It is also a measure in cases where the developer is looking to hold the asset as is the case here where considerations go beyond a short-term disposal and profit. Here the asset will be held for the longer term and the developer is looking at the long-term income potential. As the scheme produces a positive site value outturn, we consider the scheme viable.

If residential rents are increased by 5%, then the land value generated increases to £959,867,213.

As part of any assessment of scheme viability it is also important to undertake sensitivity testing:

Firstly, we have considered how movements in IRR (given the increased costs of borrowing) impact the residual land value:

At 11% IRR the land value is £86,453,788.

At 12% IRR the land value is £81,490,519

At 13% IRR the land value is £76,753,680

At 14% IRR the land value is £72,231,330

Secondly, we have considered movements in commercial rent, a 10% reduction in commercial rents reduces the land value to £78,043,962.

Finally, we have considered the impact of yield movement. This shows how a shift of 25 basis points across all investment yields adopted and moves the residual land value down to £57.5 million.

In light of the sensitivity analysis we conclude on the basis of our high level analysis that the scheme is viable.

The developers agent, DS2 have also advised us of the following:

- The East Site works have been procured under a fixed price Design and Build Contract with a major building contractor, Multiplex.
- Full funding for the East Site has been secured.
- Contractual agreement with UAL/LCC.
- The Development has commenced and is proceeding.
- Whilst the current macro-economic situation is challenging, there nevertheless remains underlying demand for high quality professionally managed residential stock, and rental forecasts remain positive.

These points made by DS2 set the context under which our assessment has been undertaken. The developer is proceeding with the scheme which they advise is fully funded insofar as the East site is concerned and there is a contractual agreement in respect of the educational space with UAL/LCC - this is reflected in our analysis. These points reinforce the conclusions we have reached in this high level review.