The destination effect

James Alexander, Managing Director of Locum Destination Consulting, believes that property developers can create more imaginative schemes for visitors - and better returns for investors - by having faith in the 'destination effect'.

For some time now, I have struggled to come to terms with what I view as the very traditional and inflexible attitudes taken to the valuation of property for investment. To my mind, the tried and tested practices of surveyors strangle the more imaginative and innovative development aspirations of the property sector, and force out a huge number of opportunities that, if viewed differently from an investment perspective, would deliver success over time. Following publication of the Carsberg report (on related matters) there has been a flurry of articles in the property and other press relating to valuation methodologies and their use and misuse within the property sector.

It is well understood that property development lives or dies at the hands of the investment teams who are seeking to serve the needs of their own financial masters - the big institutional investors. Without funding, schemes fall at the first hurdle. But why should the investment teams (arguably the least qualified people to be making decisions about the future of the property market) wield such power? They are, after all (and as pointed out by Tom Bloxham in an interview printed in this issue), simply a 'supplier' to the process. The current regime has as an axiom the need for 'day one' rental flows supported by strong covenants (anything else slips down the rating scale very rapidly). This in turn depends on 'blue chip' tenants lined up by the agents of the very companies responsible for the valuation. It is a delightfully cosy arrangement for everyone except the individual with the bright idea in search of development funds.

This is fine as far as it goes. Indeed, in terms of traditional commercial investment, time and experience have demonstrated that there is probably no better way. To my mind herein lies the problem for the more innovative and unusual 'destination' that constitutes the other end of the property development spectrum (the 'live, work, play' philosophy). Getting caught up in the traditional miasma of valuation methodologies does nothing to adequately measure opportunity presented by the successful nurture of these projects.

In circumstances where a number of the key property variables fluctuate from the accepted norm, the ability of the traditional surveying practices to embrace these differences in a manner that still enables them to deliver meaningful valuation and investment appraisals seems limited. The stock response is always one that errs on the side of caution, therefore reducing substantially the chances of securing institutional funding. Were it not for the more avant-garde principals working in the development world, the only thing that would ever get built would be straight up and down 'cloned' product.

Whilst breaking down the barriers and delivering the unique has always been the preserve of the more independent and free-thinking development entrepreneur, it is time that the sector as a whole cast off the shackles of the notoriously cautious investment community to encourage more individuality and greater variety. At Locum, we are trying to accelerate this process through challenging the 'default' position adopted in most circumstances and seeking to demonstrate that innovative one-off development projects do have a place within a balanced investment portfolio.

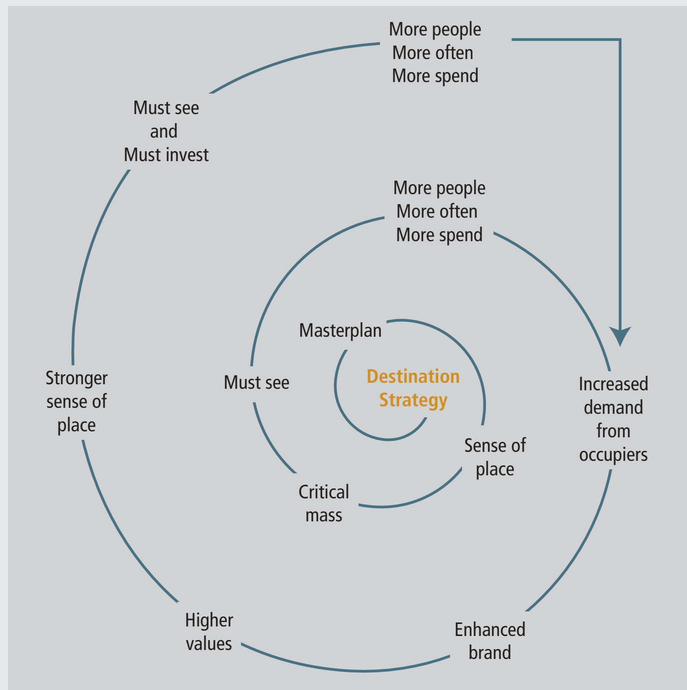
Whilst we all accept that high risk must lead to even higher return, the key is managing that risk without forfeiting the extended upside. As Michael Brett put it in the *Estates Gazette* recently, over-reliance on a simple 'all risks yield' approach conveys a certainty, or lack of it, that fails to recognise the opportunities presented by more idiosyncratic development proposals. Brett advocates greater use of a Discounted Cash Flow-based approach that makes explicit a series of variables, and whilst I would agree that this is a vast improvement, it still runs the risk of too much groaning disbelief and 'discounting' when applied to the more unusual schemes.

At Locum, we are privileged to work on some unique and challenging development schemes up and down the country (and indeed across Europe), from Ravenscraig in Scotland to the South Bank and Silvertown in London. The nub of conflict in the more demanding cases is familiar: a disbelief on the part of the property establishment in the deliverability of short-term return on investment, playing off against the certainty in the minds of the renegade developers that success will only come through doing something different. The upshot is a less than 'A1' sign-off from the surveying

fraternity that immediately threatens the scheme by placing a burden on the developers either to conform (groan) or scratch around for higher priced financial support that further handicaps the project. And it's a downward spiral from there.

We argue that given a compelling and well-articulated destination strategy, carried through over time, the returns on these projects can in fact outperform the market, and by a considerable margin. This is particularly the case in consumer-led destinations, where footfall and spending patterns are so key to success. A terrific example of this can be seen in Baltimore, where the Rouse Corporation has managed the destination successfully for long-term investment growth. The financial returns flow from the growth in reputation of a development, which in turn drives footfall and spend. This we have christened the 'destination effect' and our thinking is illustrated in Figure 1.

Figure 1: The virtuous destination spiral



Understanding destination dynamics

The long-term viability and sustainability of a destination development demand belief (and understanding) by a broad range of different interest groups and stakeholders: operators, investors and critically the consumers themselves. Over time, a vibrant and active 'sense of place' - of visiting, living and working in a destination - will ensure that more people, returning more often and spending more money, will deliver the returns required. In a commercial sense, this means growth in value as demand pushes up rent-roll, and in the traditional rent/yield dynamic (all other things assumed to be equal), growth in capital value.

Take a retail example: we all understand that rent is directly proportional to turnover, either in a 'smooth' relationship (i.e. a turnover-based rent) or in a 'stepped' one (a more traditional commercial lease), in which they diverge temporarily and then re-unite at rent review points.

Turnover, for a retail or catering unit, can be described by the formula in Figure 2a. Of course each of these 'variables' can remain static or grow over time, and the growth rate for turnover is the multiple of all three (i.e. market size, market penetration and average spend). This growth formula is laid out in Figure 2b, which implies that over a period, the growth in turnover achieved in commercial

Figure 2: Impact of the 'destination effect' on turnover

a In all cases

Turnover = (Number of Transactions) (Average Spend)

Where

Number of transactions = (Market Size) (Market Penetration)

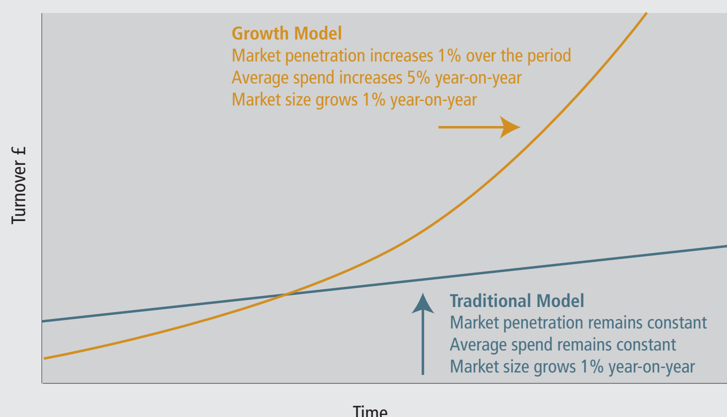
b In all cases

$(\text{Turnover})_{\text{year } n} = (\text{Growth Factor})_{n-1} (\text{Turnover})_{\text{year } 1}$

Where

Growth Factor = (growth rate of market) (growth rate of penetration) (growth rate of average spend)

Figure 3: Traditional vs. Growth Models of Turnover



units benefiting from the 'destination effect' (where market size, market penetration and average spend can all be expected to show healthy growth) is exponential. Figure 3 shows the result of some very basic assumptions governing growth in turnover, contrasting a 'traditional' model with a 'growth' model.

Consequently, rent for a development as a whole can be expected to rise (either immediately or in the medium term through review), by virtue of the same factors obtaining destination-wide.

And this effect holds true for other sectors of the market: quality destinations deliver higher demand for office spaces (which in turn delivers better rent returns at review), and the ability to charge premiums on hotel or conference accommodation. The impact on the residential market is clear for all to see. An example of the 'destination effect' can be seen in Camden Town, where growth in office and residential rents has outstripped the IPD average.

Put simply, a successfully implemented, destination-driven strategy should be expected to generate much larger growth in rental flow over time than 'traditional' environments usually experience. This comes down to the exponential nature of the destination effect. More dramatically, on the basis that the destination effect is characterised by all-round improvements beyond footfall, spend and occupation levels (e.g. public realm, PR, profile, and management), the uplift in rental growth should be matched by a tightening of yield. QED better investment return.

Having belief

Getting to the point at which the destination effect can be modelled in terms of its impact on investment return demands an understanding of, and confidence in, what is achievable beyond the immediate short term. This is where a more imaginative approach to up-front analysis and the traditional investment appraisal (with its short-term bias), is required, demanding a move away from the norm and a bit of effort.

The challenge is to develop the thinking in the places where it matters: the investment departments of the surveying practices and the analysts at the institutions. The current situation is one where the ability to influence investment decisions lies very much in the power of the individual (as is the wont of the property world), and as a result debate is outside the norm.

Change driven by one or two pioneers takes time, and without a more wholesale shift in thinking, we should settle back and prepare for the continued rollout of development product in the unimaginative vein to which we have all become accustomed. Save for the odd occasion where a bold and imaginative individual funds a development off his or her own bat, the continued pursuit of copper-bottomed security will deliver the lowest common denominator at the expense of flair and imagination. To my mind this isn't good enough. The profession has a duty of care to try harder: to make the system work better in the manner in which it responds to the more unusual investment opportunities that arise in the market.

And there are plenty of examples of success. Love it or loath it, Covent Garden has worked and is putting a smile on investors' faces literally as I write. Further afield Darling Harbour works, as does SoHo in New York, both examples that are worthy of greater note. And of course the charge of Urban Splash is now being praised across Europe.

As the country responsible for putting surveyors on this planet we should take a lead in evolving them. This means being prepared to take more innovative approaches to the valuation and appraisal of projects that will really make a difference to our lives. It is these projects, after all, which will demonstrate that the UK property sector can think, as a whole, more constructively and more ambitiously. Sure, there are examples of where this happens now, but the change is not being embraced by the system (profession?) itself. I advocate a change of sectoral attitude that seeks to support and encourage individuality rather than homogeneity. If this involves a little more risk, all to the good. Bring back vision and passion and let the system encourage the property entrepreneur.