

# Tea House Redevelopment Proposal

Report to Heritage Victoria on Economics of  
Redevelopment

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EXECUTIVE SUMMARY



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# EXECUTIVE SUMMARY

The subject site contains a heritage-listed building with a chequered history. The State Government sold it to the current owner subsequent to attempts to feasibly integrate the heritage building into the aborted Melbourne Museum project and later the Exhibition Centre. Many proposals have been promulgated with towers around 50 stories in an attempt to cross subsidise refurbishment of the Tea House building. In consultation with planning authorities a scheme has been formulated based on a 25 level hotel tower to the south of the Tea House with a degree of physical separation.

This report Addresses the matters that are required to be considered pursuant to Section 73(1)(b) of the *Heritage Act* pertaining to the questions of reasonable and economic use. The analysis behind the report includes:

- A feasibility study applied to a scenario where the Tea House heritage building is retained essentially in its current form and is upgraded to enable continuation of its current office use.
- A variation on the above with a basic upgrade only.
- A feasibility study of the current proposal for a 25 level hotel tower to the south of the Tea House and adaptive re-use of the heritage building for offices with hotel facilities on the ground floor.
- Testing the feasibility of reduced tower height scenarios.

Refurbishing the Tea House presents a number of issues including extraordinary costs that would not be incurred with a new build project. These include heritage requirements, stripping out, underpinning and seismic upgrade. It is proposed that the building will be refurbished to address all of these issues and to accommodate office uses on floors 1 to 5. The ground floor is proposed to provide hotel reception and bar facilities.

A 25 level tower is proposed to be located to the south of the Tea House providing 280 hotel rooms. A basement wraps around the Tea House and provides 39 car spaces and bicycle parking. The ground floor is the lobby and reception and the first floor is for back of house uses. The top level provides a terrace with a pool. There are 21 levels of hotel rooms with the first 8 levels detached from the Tea House, except for a glazed connection at the ground and first floor levels.

A number of 'economic concepts' are explored to place the economic analysis in context:

- An appropriate 'hurdle rate' for a development of this nature is a 20% Internal rate of Return (IRR).
- The appropriate land value to assume in the development equation is the Government land value.
- Notwithstanding the multiple options for structuring the development package the appropriate structure to assume is one where the floor space developed is sold at market value upon completion.
- The cost of capital for the project is most appropriately assumed to be the Weighted Average Cost of the equity and various levels of debt.
- The hotel industry is notoriously a difficult one and with a pending increase in the supply of hotel rooms it is somewhat risk laden.

The concept of fixed versus variable costs and revenues is explained, highlighting the sensitivity of the development equation to the number of hotel rooms and hence floors in the hotel tower.

In the current environment of property market investment dynamics, the landowner (or any future owner if the site were sold) has four options:

- In the absence of procuring a hotel investor / operator, an option is to mothball the site. This would involve physically securing the site and enduring on-going security costs, land tax and rate costs. The building would be subject to on-going deterioration.
- Lease the site for 'marginal uses'. This may involve commercial car parking in the open areas and occupation of the building for 'low rent' uses. This would not generate sufficient funds to maintain the heritage assets and the building would be subject to on-going deterioration.

- Upgrade the Tea House building for office use (either a 'basic' or a 'full' upgrade).
- Refurbish the Tea House together with a hotel tower.

The first two options would jeopardise the building's future and are not recommended. The feasibility of the second two options is explored in the modelling.

On the revenue side of the development equation, data on hotel sales has been analysed and advice has been taken from a hotel industry expert and it has been concluded that it is appropriate to adopt a range between \$450,000 to \$550,000 per hotel room. Office floors in a refurbished Tea House are estimated to sell for \$8,000 per square metre with a full upgrade and \$6,500 per square metre with a basic upgrade.

On the cost side of the development equation the statutory land valuation of \$11,750,000 is adopted. WT Partnership, Quantity Surveyors, have provided construction costs estimates.

The model is based on a cash flow analysis over a 33-month period with sensitivity analysis of key variables. It is found that refurbishing the Tea House building as a stand-alone development (either basic or full upgrade) would not be economically feasible due to the very high costs involved, relative to a 'new build' situation. This is despite the fact that a relatively optimistic estimate of office space sales prices has been adopted.

The hotel tower as proposed is by any measure economically 'marginal' at best. Even with the most optimistic assumptions the hurdle rate of a 20% IRR is not achieved.

The modelling results are:

Option 1 - Refurbish Tea House for Offices (no Hotel).	IRR -32.4%
Option 1A – Basic Repairs to Tea House for Offices (no Hotel).	IRR -23.4%
Option 2 - Refurbish Tea House for Offices and Build Hotel as Proposed.	IRR +14.8%
Option 3 –Development Proposal with Floors Deleted.	Lose 2% IRR for each floor deleted.

Conclusions are drawn on the matters specified in the Heritage Victoria and Heritage Council of Victoria Policy Guideline:

### **Reasonable Use**

The current building configuration does not support an industrial use. The site hosts buildings of heritage significance that are partially vacant and are potentially fully vacant in the near future. In these circumstances the building is potentially under threat. New uses must be found and guidance on this is contained in the current zoning.

### **Other potential uses, of the place or object,**

The Tea House building is not suitable for an industrial or a warehousing use due to its multi-storey configuration and such uses would not generate the funds that are essential to conserve the building on a sustainable basis. Residential use or a hotel would compartmentalise the spaces, which may be inconsistent with conservation objectives. Office use appears to be most suitable on the basis it can be open plan. Offices are the 'highest and best use' from an economic development perspective.

The question of what is a reasonable use on the open parts of the site is a matter for consideration. The planning scheme specifies a non-mandatory FAR of 6:1 but the context created for the Tea House building is an issue. To resolve this apparent conflict an important consideration is the imperative to find the funds for refurbishment of the Tea House to conserve its heritage values in the long-term.

In the past, high rise apartment developments have been tested (around 50 stories) and while they were economically feasible in that they could 'carry' a hotel component and generate sufficient funds to refurbish the tea house, they have been ruled out on planning grounds relating to height and inclusion of a podium carpark.

A 'wrap around' development has been dismissed on planning and heritage grounds, as it would obfuscate views of the heritage building. It would also require 50% of windows to face the tea house building, which would be unsuitable for a hotel development.

**The context within which the place or object is located.**

In close proximity to the site are the Exhibition Centre and Plenary, the Crown Casino and Entertainment Complex and the 29 level Crown Metropolis Hotel. Within walking distance are the Southern Cross Station, Southbank, the CBD and Docklands. The Tea House is set with a backdrop to the south of tall buildings. In a 'market sense' the site is ideally suited to a large hotel.

**The long-term financial viability of the place or object if the current use is maintained.**

The options for the site are to mothball it with serious risks to the heritage asset, to lease it for 'marginal' uses, to upgrade the building (either basic or full upgrade) for a stand-alone office use or to pursue the hotel proposal. In the absence of a commercially feasible development to subsidise the conservation outcome, the likelihood is that the site will host marginal uses that will not generate the funds that are necessary to maintain let alone conserve and adaptively re-use the heritage assets. In this scenario the future of the building is under threat.

**Economic Functioning of the Place**

The prospect of disallowing use of the open spaces of the site for a hotel tower of sufficient height (and hence number of hotel rooms) will create a situation where there will be an inability to generate income to fund future conservation and maintenance of the place and object.



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