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During his years with Hillier Parker he headed its specialist public private partnership/PFI unit for four years.

Stephen is a Senior Director in the Regeneration and Development team, advising clients on property strategy, development and procurement issues. From this platform, he has been involved in providing a very wide range of property advice. Some of his key clients include Cornwall Council, Brighton and Hove City Council, City of York Council, London Borough of Barnet, London Borough of Camden, London Borough of Tower Hamlets, Oxford City Council, Royal Borough of Kensington & Chelsea, and many others.

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PROPERTY PARTNERSHIPS: EMERGING FORMS OF FINANCIAL STRUCTURES

CONTENTS:

DRIVERS

THE ECONOMIC CONTEXT

DEVELOPMENT FINANCE

RETURNS FROM PROPERTY DISPOSALS

LOCAL AUTHORITIES AS DEVELOPERS

THE ROLE OF PARTNERS

CHOICE OF PARTNERS

ASSET BOND VEHICLES

INFRASTRUCTURE FUNDING

CASE STUDIES

URBAN DEVELOPMENT FUNDS

EVERGREEN

CONCLUSIONS

ACES Presidential Conference
Newquay, September 2010

ACES Paper No 10.09/8 by

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INTRODUCTION

This paper follows the conference theme of "Property: A Driver For Change", that is property as a means to an end, and how it fits into a broader context of cultural changes, increased use of technology and increased affluence. In our vision of the future we see the public sector using its assets to create high value jobs. We also see homes as a big issue. We are not building enough homes. Generally housing is not affordable; and the younger generation feel they will never get on the housing ladder.

Agenda

The topics we are going to cover are: -

- Property objectives in an age of austerity
- Current issues that are affecting property development
- Options in relation to partnership
- A view on how the public sector might approach regeneration partnerships in the future.

Drivers

In our view the most important local authority drivers are: -

- Reduced Costs
- Capital released
- Regeneration of run down areas
- New jobs
- Increased housing supply and affordability

These are all pretty familiar. The first two are about service efficiency and delivery. In our opinion the regeneration of run down areas will become a bigger priority in two or three years time. From recent discussions with politicians we get the feeling that the Government is very much adopting a free-market approach concerned about cutting public spending and allowing London and the South East to flourish whilst in practice withdrawing finance from other regions. Over the first half of this Parliament we expect to see issues arising out of this but as the next election comes nearer we can expect regeneration to come back up the agenda.

New sources of employment are absolutely the key issue - and not just any old jobs but high value knowledge based - if UK Plc is going to compete on a worldwide basis. Much of the thinking that goes into Urban Development Funding coming out of the European Union is about enabling Europe to compete against the other main economic blocks in the world.

Housing starts are at a record low. Getting on the housing ladder is a big problem for the vast majority of first time buyers. How do you pay back a mortgage of £200,000 to £300,000 out of taxed income and how do you find deposits of £80,000 to £100,000 having just come out of university

with a £30,000 debt? There are some real issues here and solutions will become political priorities in the next few years.

The Economic Context

Much has been said about the economic outlook and we do not intend to go into detail on this here. However, "austerity" is likely to be with us for a number of years to come and there are persistent fears that there could be a double dip recession. It seems that government will place great emphasis on the private sector generating new employment and nationally it is prepared to see London and the South East take the lead. However, other parts of the country are much more heavily dependent on public sector employment and in the medium term at least, whilst in property terms London might flourish, the situation in relation to the rest of the country looks much less certain.

It is necessary to recognise that developers are in the main severely hamstrung by the economic crisis. There are now only a small number of national house builders whose actions are not either controlled or very closely scrutinised by their lenders. The major players such as Barratts and Taylor Wimpey still have huge debts and some might say are working through developments to pay off the loan book.

So you have to work out who you are working with and what the implications are for the type of partnership you are considering

The banks are adopting an especially cautious stance in relation to property lending. This is exacerbated by the fact equity is both scarce and demands a high price. In order to fund development, the banks are likely to either look for a very high proportion of equity or for an exit position to be assured. In many cases this means either a forward purchaser or an occupier coming into a scheme.

Development Finance

As noted developers seeking to raise bank finance to undertake developments are facing very considerable challenges. When banks are restricting lending, developers have got to find more equity - and there is not much of that around at the moment! Even an RSL with hundreds of millions on the balance sheet, in looking for bank finance gets offered loan to cost ratios of about 50%. They are also required to guarantee the construction cost, and for the parent organisation to come in if the units are not sold in a year, to basically create the funder's exit.

The cost of borrowing is around 6 or 7% and is very high in relation to base rates. The impact on the property industry is that whilst the banks require 50% of scheme value as equity, this is not generally available to many developers. Even where it is, given the returns now being sought on true equity (which can be as much as 25% per annum), the blended cost of capital is very high. The practical impact is to make funding of early development costs (e.g. in relation to site purchase and infrastructure) very difficult and expensive. This has significant implications in terms of the way that development partnerships might be structured in the current climate.

In addition promoters of regeneration schemes need to recognise that the pool of developers is now much reduced. The net result is that there is much less competition and significantly increased requirements in terms of target profit margins. In order to address these issues the public sector should look to ways of structuring development opportunities so that the need for private sector equity is reduced and the projects are de-risked as far as possible.

How to Respond

In our view it will be necessary in future for the public sector to consider different bases for taking returns from land and using asset value to help leverage schemes. In addition, mechanisms such as tax incremental financing need to be pursued for pump priming infrastructure.

Returns from Property Disposals

In the good times it was possible for local authorities to put sites on the market and look forward to receiving substantial upfront payments. Outside of prime locations this is far more difficult to achieve now.

Working for a London based authority recently we evaluated different ways of taking asset value to promote regeneration and increase returns within a regeneration partnership. Options included seeking an upfront payment (which is costly and may exclude many bidders), taking deferred payment for land (this reduces the requirement for initial equity and will increase the number of developers and therefore competition, resulting in reduced profit margins), or putting land value in without any reserve price and treating it as risk capital (and taking a higher proportionate share of the overall return from development).

Local Authorities as Developers

In order to overcome market constraints, and to maximise their return, some local authorities have actually used prudential borrowing in order to fund and undertake development directly. However, given the squeeze on public sector spending, this is likely to be more difficult in the future and in any event it is unlikely that many public sector bodies will want to expose themselves to the full risks of development (i.e. in relation to construction and sale value), rather than just putting the land in on a risk basis.

The Role of Partners

On the assumption that local authorities will need to approach property partnerships in a different way in future, it is worth thinking what different types of partners actually bring to projects. The different types of partners include: -

- Development managers
- Equity providers
- Debt providers

Development managers can offer the following services: -

- Planning and design

- Construction procurement
- Sales and marketing
- Accounting

Equity providers on the other hand provide access to cash and, as they are providing the risk capital, are effectively involved in underwriting the exit position.

Debt providers, in practice in the majority of cases banks, enable equity to be leveraged, although at a far lower level than historically was the case.

Remember that in selecting partners, different types of partners bring different qualities and different pricing structures to each project. Therefore, in our view, development partnerships should not be set up on the basis of a “one size fits all” solution. Local authorities need to think very carefully about getting locked into any form of overarching “borough wide” partnership without understanding the dynamics of the specific development opportunities they will be addressing.

Choice of Partners

In choosing partners, and working in partnership, it is still very important, to be clear about what they are bringing to the table. Remember that pricing and suitability of partners will vary dependant on the circumstances of each scheme and over time, as economic conditions change. Flexibility is key as a badly structured partnership can be very difficult to get out of. We favour the use of property and assets as equity in developments, but think if you are considering asset backed vehicles or using property in that sort of way to leverage development, then very careful thought needs to be given about how you set these up.

Asset Bond Vehicles

There has been a lot of talk about local asset backed vehicles (LABVs). Under these structures land is put in as equity and private sector partners provide development management services, and potentially private equity as well as development finance. There are two basic approaches that can be adopted. Either the vehicle undertakes or arranges everything to do with a scheme or schemes (including taking construction and sales risk), or alternatively it can adopt more of a “propco” type of approach. In this scenario, the partner will focus its efforts on preparing schemes by achieving planning consent, site assembly, servicing etc and then dispose of ‘clean’ opportunities on a competitive basis in relation to each particular opportunity to sub-developers. In our view the second approach is likely to work better for most local authorities as it avoids being tied into a “jack of all trades” single partner. From our experience, each time a site is put to the market different bidders adopt different assumptions in relation to what will sell, the prices that can be achieved, different design approaches and appetite to risk. Through going down the propco route the public sector has a much better chance of achieving best value as well as increased flexibility.

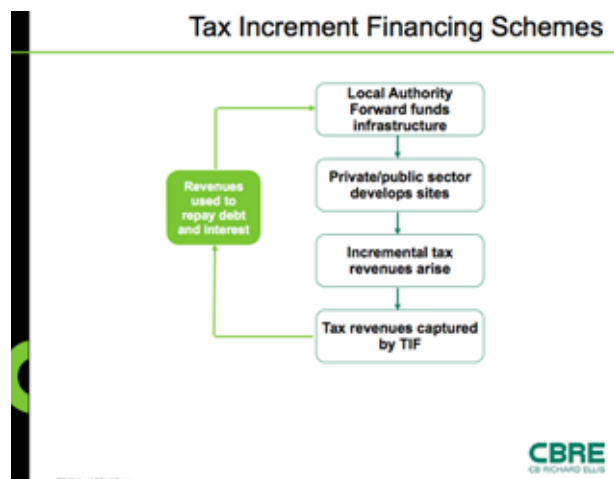
Infrastructure Funding

Given the high cost of equity and upfront costs, finding new ways of funding infrastructure will be most important in the future. Tax incremental finance (TIF) is back on the agenda and we want to deal with some of the issues that are coming to us as part of some of the work that we are doing in this area. Some authorities have already looked at tax incremental finance in some detail and we hope that our experiences give a useful pointer to how the system might unfold.



To start the process this first example is a project conceived in a time of economic boom when of course projects are much easier to do. The Emirates Stadium is a 60,000 seat stadium and its development has had to address the upgrading of public transport requirements, the relocation of a waste transfer site and a host of Section 106 requirements, some of which have proved to be very difficult to achieve in current financially straightened times. The development was achieved through a combination of enabling development (flats), naming rights, and critically a £260 million bond that was secured against future revenues.

In these more austere times innovative financial models are needed that are aware of the difficult funding and funding capacity constraints that the public sector have to work within. So I will briefly confirm the basic parameters of a TIF based scheme and provide an update on prospective pilot projects. Hopefully I can make a case for TIF prior to the CSR and the expected October white paper.



This is a reasonably good capture of what a TIF comprises. Tax increment financing is a method of forward funding infrastructure works through borrowing against projected incremental tax revenues created by the development scheme. This may be the simplest form of TIF model but there are a number of more advanced models and varieties of model within the basic parameter that have been considered over the last year or so. Irrespective of what model is chosen the public and the private sector work closely in collaboration to deliver successful projects.

Before going into further detail you will appreciate TIF is not the only route to funding major infrastructure works. There have been suggestions of municipal and local government bonds and these and other ideas may come back in the forthcoming white paper. However in a period of financial nervousness I do not think that bonds are a clear-cut alternative. You will be familiar with PFI and PPP. These are relatively complex vehicles and many of these projects are now going through a value for money process and some are being renegotiated and recalibrated to recognise changed financial circumstances. TIF, at its simplest, has the attraction of being entirely related to incremental taxes arising post-development and as there is no new tax created and no loss of tax to account for, it is a win/win. Furthermore, post development the Treasury collects all the incremental taxes once the basic loan payment terms have been completed.

The question that remains is how and when will TIF based projects be selected? Many of you will be aware DCLG invited expressions of interest in Spring 2009. In 2009 there were some 120 expressions of interest from English based local authorities, which is approximately 60% of English local authorities, a significant number of interested parties. Meanwhile this pressure to deliver acceptable and deliverable models is much in the mind of Scottish Government at the moment. TIF is being considered with a good deal of care and we are looking to bring forward acceptable solutions to deal with physical regeneration that simply cannot be done yet South of the border. The Scottish Futures Trust, an agency of the Scottish Government, has entered into detailed discussions with a variety of prospective TIF candidates and there are a number of very good outline proposals that would be useful to look at.

In North Lanarkshire the Council is seeking a £600 million Phase 2 regeneration of Ravenscraig Steelworks, a massive regeneration project.

Edinburgh Waterfront



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Across in Edinburgh the City Council is working with Forth Ports to regenerate the Edinburgh waterfront, an area of 500 acres at the end of the tram link that takes you through to Edinburgh from the airport. This is a major regeneration undertaking involving employment use, leisure based uses, and a new residential community with retail alongside.

The City Square, Aberdeen



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In Aberdeen the emphasis is on public and community facilities, a very different type of project.

Ravenscraig



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The Buchanan Quarter



Meanwhile across in Glasgow the City Council is working with the Buchanan Partnership, which is a JV involving Land Securities and Henderson Global Investors to secure the £450 million Buchanan Quarter scheme which will provide an enhanced railway station in Queen Street, new and improved city centre car parking, a whole range of public improvement works and an improved concert venue. More importantly it will provide a catalyst to Strathclyde University to bring forward its regeneration proposals and for other partners to bring forward other major regenerations too.

As we develop the business plan for the Scottish Government to consider we have to look at issues of best practice, which we can take from a variety of places, including the USA. The US has extensive experience of TIF based projects.

We need robust financial models; we need to address the tensions between public and private partners and the pressures on public sector financing. We need to ensure that, "but for" TIF there would not be a scheme and the economic case is very clear and robust. The economic case is the driving force and the financial structuring has to recognise the very different roles and risk-taking abilities of the public and private sectors.

All four Scottish councils promoting the projects already discussed have the benefit of in principle political support for TIF. Interestingly the view north of the border is that within existing devolved powers there are the powers to deliver a TIF, and there is no reason why the Scottish Government will have to go through a long and time consuming additional legislation process. However this is not the position south of the border.

Debate on the workings of the Local Government Act 2003 and the Local Government Finance Act 1988, and others, has divided opinion. For some practitioners it is not the legal aspects of TIF that is the problem but the political will to implement that is the blockage. Hopefully the White Paper due to be published shortly will unblock that. In trying to second-guess the mood of Government, many of you will be familiar with the Conservative Control Shift Paper



This was published before the election, part of which deals with TIF, as well as reference to the new homes bonus and municipal bonds. Time will tell whether these initiatives get carried forward into the White Paper. As we contemplate the prospect of the need for decentralisation we have to also confront the fact that not withstanding economic austerity, urban regeneration solutions for most of our towns and cities have never been more urgently needed.

Urban Development Funds

In our opinion these will become increasingly important in future. The underlying principles behind an urban development fund is that public sector finance is put in as investment rather than grant and returns can be recycled and reinvested in new regeneration projects, on a revolving basis. If the fund focuses activities on public sector sites the land value can be used as match funding, sometimes drawing down other forms of complimentary public sector financial assistance. Through intervening by tipping the scales just enough in favour of development, it should be possible to make the most of public sector resources, optimising leverage and maximising regeneration/economic outputs.

This is the principle behind JESSICA, established under the EU's ERDF regime. Although JESSICA has been around for 2 or 3 years it is only now that the concept is really taking hold. JESSICA funds are currently in the course of being established in the North West of England, Merseyside, Wales, London and Scotland.

Evergreen

CB Richard Ellis produced the business plan and has been appointed as fund manager in relation to the Evergreen fund, which has recently been selected by the NWDA and EIB to be the conduit for JESSICA finance in relation to the whole of the North West of England, (outside of Merseyside which will have its own Urban Development Fund). Initially the fund will be capitalised at £60 million, comprising £20 million top sliced ERDF, £10 million single programme and £30 million match funding, although over time the aim is to leverage the fund up to £½ billion or more.

Evergreen is structured as an English Limited Partnership consisting of 18 local authorities, supported by 2 pension funds (Greater Manchester and Lancashire) with CB Richard Ellis acting as the General Partners' Real Estate Advisor (GPREA), (the fund's manager).

Initially the fund will concentrate on debt provision (Senior & Subordinated), but if a notification in relation to State Aid can be obtained it will also be able to provide equity—which should improve private sector leverage considerably. The driver behind the majority of urban development funds established under JESSICA is to promote high value knowledge based jobs and infrastructure on a sustainable basis, reflecting the EU Gothenburg and Lisbon treaties. The Evergreen fund is due to go live in January 2011. The project sponsors have great ambitions for it. Initially there is a 10-year life but the business plan anticipates this being extended to 50 years, with liquidity windows every 10 years.

Conclusions

This has been a very brief overview in relation to the way that the economic downturn and the forthcoming period of austerity are likely to affect development funding and regeneration partnerships in the future. In our view the development of innovative forms of partnership and financial frameworks are now inevitable. It will not be possible to promote schemes on the basis they were in the past.

We believe that if a true understanding of the dynamics of partnership is available and partners are chosen in the right way, substantial additional value and regeneration outputs can be achieved.

It will be very interesting to see how partnership structures evolve in an age of austerity!

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