Thought Leadership

Alternative Development Funding

Spring 2013

Introduction: **New thinking, new funding**

In the wake of the global financial crisis, development and urban regeneration in the United Kingdom is facing a challenging period. In 2009 the funding system had ground to a halt. Cities which had previously relied upon state funding and private investment to improve the physical, social and economic development of previously deprived areas are under even greater pressure to provide the necessary infrastructure and funding to deliver much needed regeneration.

Following this period of inertia, there are signs that some liquidity is starting to return to the system, thanks largely to public sector intervention. The government has transferred the responsibility for stimulating development from regional development agencies to a more local level.

At the same time, the constraints on public spending mean that there are limited funds available for property development. The government's response to this, which GVA welcomes, has been to give local authorities more powers to support growth through development. The new framework includes LEPs, Growing Places Fund, City Deal, European funding (and JESSICA mechanisms), Regional Growth Fund, CILs, TIF and the HCA. At this early stage, some of the sums involved are a drop in the ocean compared to what is required for some much-needed major infrastructure projects. However, they are starting to gather momentum and will contribute towards a new framework of funding resources.

There has also been some activity in the private sector with traditional equity funds now setting up debt funds or moving into bridging finance and senior debt. GVA is actively involved in securing new sources of funding and helping to create innovative funding structures as this bulletin describes.

This report is aimed primarily at developers and private investors who are finding that traditional sources of finance have become too restrictive. We examine the alternative development funding available and how it can be secured with support of the public sector in order to drive development in those markets that need it the most.

The key issues and challenges facing development

One of the biggest problems the property industry has faced in recent years is the collapse of speculative development. If the demand and infrastructure is not in place, there will be limited new supply to enable future demand to be fulfilled. Where schemes are viable, loan-to-value ratios have fallen while lending costs have increased and pre-lets or forward sales are essential to obtain funding.

New debt markets have developed as a way of providing mezzanine and bridging finance where traditional bank finance has virtually dried up. However access is not widespread and funds are focused primarily on prime property. There is a lot of hope that the insurance market will be prepared to step in, similar to the US market, although the estimated funding gap of £165 billion may be too much to cover. Developers seeking these ancillary funds are now increasingly turning to bonds, raising more funds in 2012 in this manner than from traditional finance.

The problems are not just faced by developers. Local authorities have had to adjust to new policy guidance but more importantly, plan all new future regeneration with reduced spending. In the face of austerity, there have been some benefits, like reprioritised asset management leading to site disposals, but this alone is not enough of a fix.

These are the changes that developers and local authorities have had to deal with, but what about the opportunities and solutions that lie ahead? And perhaps more importantly, where is the money for the new funding model going to come from? We address these questions later in the report but before we do it is worth looking at some of the priorities that are emerging from the UK's core cities.

City priorities and the context for new alternative funding measures

GVA believes that the next generation and evolution of public funding support will increasingly be about the public sector taking an 'equity stake' in new economic development priorities. Existing vehicles, such as 'Evergreen' in Greater Manchester and 'Chrysalis' in Merseyside, have established the template for other core cities and city regions to follow, or at least learn lessons from.

Evergreen and Chrysalis were born out of the Project JESSICA instrument but are now much more than simply a European programme. Both fund vehicles have already attracted other sources of public cash investment and are set to grow further. They are not the only way in which public funding will be channelled into urban regeneration priorities of course, but they both represent a contemporary and forward-thinking way of working and importantly of channelling private capital into urban regeneration.

Such city and city region structures are important as they are the means by which public sector priorities are communicated to external investors. Whilst each city and city region will be unique and have its own priorities, GVA believes that the following investment priorities are common to all areas:

1. Connectivity for sustainable growth
    - Access to international markets
    - Super/ Ultrafast broadband
    - Low carbon infrastructure
2. Economic base for smart growth
    - Investment in science and innovation assets
    - Creating new businesses and business models
    - Growing existing sectors and supply chains
    - Higher level skills & attracting talent
3. Creating the conditions for inclusive growth
    - Business infrastructure in key locations
    - Tackling deprivation and supporting communities
    - Growth via 'unique place' attributes
    - Enterprise skills for all

At the very least the above represents a package of economic development priorities on which public sector organisations will increasingly focus. For the private sector investor therefore, investing alongside a more engaged public sector may offer significant potential for value growth.

Area specific solutions and sources of funds for development

In the wake of the widespread planning reforms the government has shifted the focus of regeneration and overseeing development away from a subsidised, regional strategy (except in London where the mayor and the GLA implement a regional strategy) to a more localised, independently financed model. Public money is being channelled through a series of programmes and is there to 'lever in' private sector investment, including taking a more risk-based position.

A summary of the funds involved are shown in Table 1 and are examined in more detail below.

Table 1 – Sources of funds for development

Source	Funding available
JESSICA & European Regional Growth Fund	Joint European Support for Sustainable Investment in City Areas allocation for the UK is €9.9 billion, of which 50% has already been allocated. €436 million earmarked for urban regeneration, with second round of funding due in 2014.
European Investment Bank	Closely associated with the above but increasingly active in investing in high value knowledge economy, infrastructure and social housing. Has a particular priority in investing through the JESSICA Urban Development Funds that have been established in the UK.
Regional Growth & Growing Places Fund	RGF allocated £1.4 billion in the first round and a further £1 billion in the second. GPF of £730 million used towards transport and infrastructure improvements.
HCA	£570 million as part of the Get Britain Building plan to assist delivery of 16,000 stalled housing units. Agency has also taken control of 350 plots owned by the former RDAs which will be used for development.
TIFs & Rate retention	Up to £2.6 billion of funding to be raised by TIF over 25 years within the City Deals. All local authorities will now be able to keep up to 50% of any increase in business rates.
CIL	Funds raised via the levy will be used to generate further investment. £640 million target in first wave of City Deals.
Pension Funds	LEPs have power to commit local public pension funds towards infrastructure projects and development to act as leverage.

City Deals and LEPs

It is outside of London where the need for a coherent policy is greatest. The first wave of City Deals identified the eight largest regional cities and has put in place a programme for these areas to create 175,000 jobs over the next 20 years and provide the necessary infrastructure and investment to enable this.

This will be done by giving the cities the powers and tools to deliver economic growth, as well as attracting private sector investment using local authority assets, European Investment Bank (EIB) growth funds and prudential borrowing as leverage. The government has a memorandum of understanding with pension funds to provide this additional funding. However similar pledges have been discussed for increased bank lending and it remains to be seen how effectively this commitment will be met.

Table 2 – City Deals: first wave funding requirements

City Deal	Funds to be raised by public sector as leverage to deliver City Deal vision	Funds to be raised from private sector to deliver City Deal vision
Bristol and West of England LEP	£1.3 billion	£670 million
Greater Birmingham and Solihull LEP	£1.5 billion	£15 billion
Greater Manchester LEP	£1.3 billion	£850 million
Leeds City Region LEP	£1.2 billion	n/a
Liverpool City Region LEP	£940 million	£625 million
North East LEP (Newcastle region)	£117 million	£1.3 billion
D2N2 LEP (Derby/Nottingham region)	£155 million	£20 million
Sheffield City Region LEP	£196 million	£500 million
TOTAL	**£6.7 billion**	**£19 billion**

The eight City Deals are made up of local authorities in the city area and based on the Local Enterprise Partnerships created under the Localism Act 2011, to encourage private and public sector involvement in policy making based on local need. However any decision on policy, particularly planning, must be made by the local authority, not the LEP.

A second wave of City Deals is due to be announced in early 2013. Twenty cities and towns have been invited to tender bids for the second wave, with a more regionally balanced selection than the first; including areas such as Reading, Cambridge, Southampton and Brighton. These city deals will provide a direct conduit for government to financially stimulate the economy, with the focus of its resources going to these successful LEPs.

HCA

The Homes & Communities Agency (HCA), which has taken control of the land amassed by the now defunct Regional Development Agencies and stalled house builders, has no direct involvement with the LEPs, meaning there will inevitably be areas that ultimately miss out as a result.

Under the Get Britain Building programme the HCA has a £550 million fund to help stalled residential development sites with a minimum of 15-25 units get off the ground. The HCA now owns over 10,000 hectares, making it the largest public landowner after the Ministry of Defence. So far 200 schemes have been resurrected under this scheme, accounting for 1,500 units by Q1 2013.

The government has set a target of 100,000 new homes to be built on public land by 2015 and the HCA has a key role in enabling that. Many of the sites it owns are very large and fell foul of the major correction in residential land prices in 2008/9. Not all are yet viable, so the HCA has a £225 million 'large sites' fund to improve the viability of those which aren't, with additional support of a £190 million public land infrastructure fund.

Pensions and private investment

But behind these concerns are some more serious questions which need closer scrutiny. Within the first round of the City Deal, based on the submissions made by each of the eight LEPs, a total of £25.6 billion is required over the next 25 years to deliver the necessary social, economic and structural improvements to bring about the proposed benefits of the deal. This figure is equivalent to just £1 billion less than the total new lending secured for commercial property in the UK for 2011.

Yet of the total funding requirement, the private sector is expected to provide at least 70% (£18.9 billion) in some shape or form. Sheffield, Nottingham and Manchester have committed a combined £170 million from local authority pension funds to help finance development, but the acid test will be how readily the major institutional pension funds support the shortfall in these cities by also investing there.

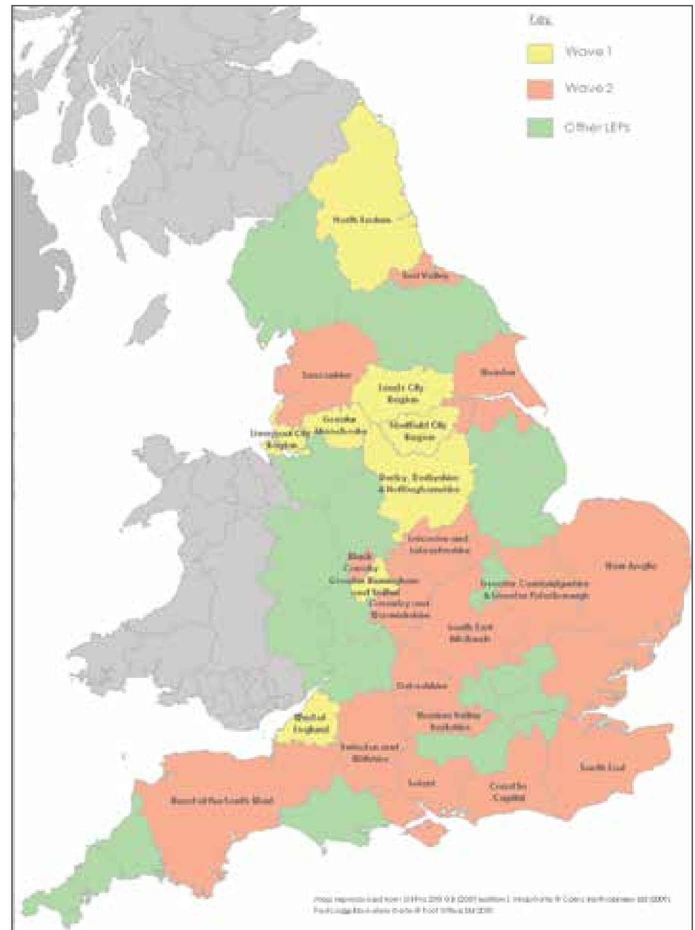
Pension funds, both public and private, are traditionally risk adverse in order to preserve the fund for future pension distributions. Therefore these funds are likely to invest in low risk investments or limit the level of investment in riskier projects. Any increase in investment by the private sector is unlikely to be in the traditional equity form. Instead these equity funds have started providing debt, mezzanine and bridging finance, albeit in a few core cities and the south east, with the focus primarily on residential development.

TIF and rate retention

Obviously not every LEP will be able to rely on a tube extension or new embassy like the Vauxhall, Nine Elms & Battersea (VNEB) TIF zone to help act as an anchor for attracting additional investment. But now local authorities have the stimulus for leveraging funding. The problem is that not many developers would consider going to a local authority to ask for help with financing a scheme.

Previously all local authorities saw business rates go into a central pot and then be redistributed. Now councils are able to keep up to 50% of any increases to invest locally or borrow against.

Figure 1 – LEPs & City Deals (waves 1 & 2)



Almost 40% of public funds identified in the first wave of City Deals come from TIF or business rate retention. Indeed the target amount of £2.58 billion for the eight growth cities over the next 25 years is equivalent to the rateable value of Wales as of April 1st 2012.

Taking the idea of business rate retention further, Manchester is the first city in the UK to get devolved tax retention powers under the Earn Back scheme. This will enable the council to raise £30 million per annum from tax growth that new development creates.

TIF and business rate retention are a welcome funding mechanism which has been used for over 60 years in the USA, particularly for funding infrastructure. However, the ability to access funding will depend significantly on the level of regulation, risk and ease of use.

Community Infrastructure Levy

A further 10% of funds are due to be raised by the Community Infrastructure Levy (CIL). This type of measure has already contributed towards the funding of Crossrail in London and is starting to be adopted across the rest of the country.

Yet whereas TIF and rate retention allows local authorities to borrow against future income following development, CIL payments need the development to take place first. Given the current outlook for financing and development, some local authorities and LEPs might have to take additional measures to assist the development that will generate the levy.

Alternative funding for site specific development

The collapse in the funding market has left many development projects in need of refinancing or seeking new sources of finance. Private sector funding for new development is currently severely restricted to low risk projects. Higher risk projects need to look elsewhere and local authorities are in many cases the obvious place to look, when schemes provide community benefits such as job creation and/or affordable housing.

As previously explained there have been large cuts to overall local authority funding but there are also some new sources of money targeted at helping to stimulate urban regeneration, new employment, new housing and economic growth. Gradually the public sector, especially at the local level, is becoming more aware of the powers it has and various ways it can lever in new private sector development. There is a new clarity of thinking emerging regarding funding.

Where local authorities are involved in initiating or supporting new development and working closely with the private sector to achieve new development, the following steps should be used to ensure the scheme is implemented and successfully achieves its objectives. Where local authority involvement includes assistance with funding, these steps are even more important.

The first step is to ensure that there is the necessary level of market demand from occupiers, and where relevant investors, so that local authorities can be convinced of a scheme's viability. For commercial and industrial schemes, the scheme's size must match occupier demand and care is needed to ensure that it is not too large/too ambitious after consideration of potential and competing schemes in neighbouring areas. Is the size right in relation to expected population growth, socio-economic changes, past levels of take up and potential levels of future economic growth?

The second step involves ensuring that there is a clearly defined scheme and the potential will and motivation at officer and member level to ensure its implementation. Suitable sites must be assessed and it must be demonstrated that the most appropriate available site (or potentially available site using local authority site assembly powers) has been selected. Also important is how commercial and design/conservation conflicts can be reconciled and how viable the development is.

Where the income from lettings/sales is insufficient to meet the development costs, or provide an adequate return to cover risk and profit, the scheme is unviable and needs to be re-assessed. Consideration must be given to the scheme's size, its quality and rent levels, its design and cost of construction, the level of infrastructure costs and the cost of planning obligations, its land acquisition costs and their timing. It may, therefore, be possible to modify the scheme to make it viable – financial viability is of prime importance and must be clearly demonstrated, but other problems involving financial restructuring may still need to be resolved to ensure deliverability.

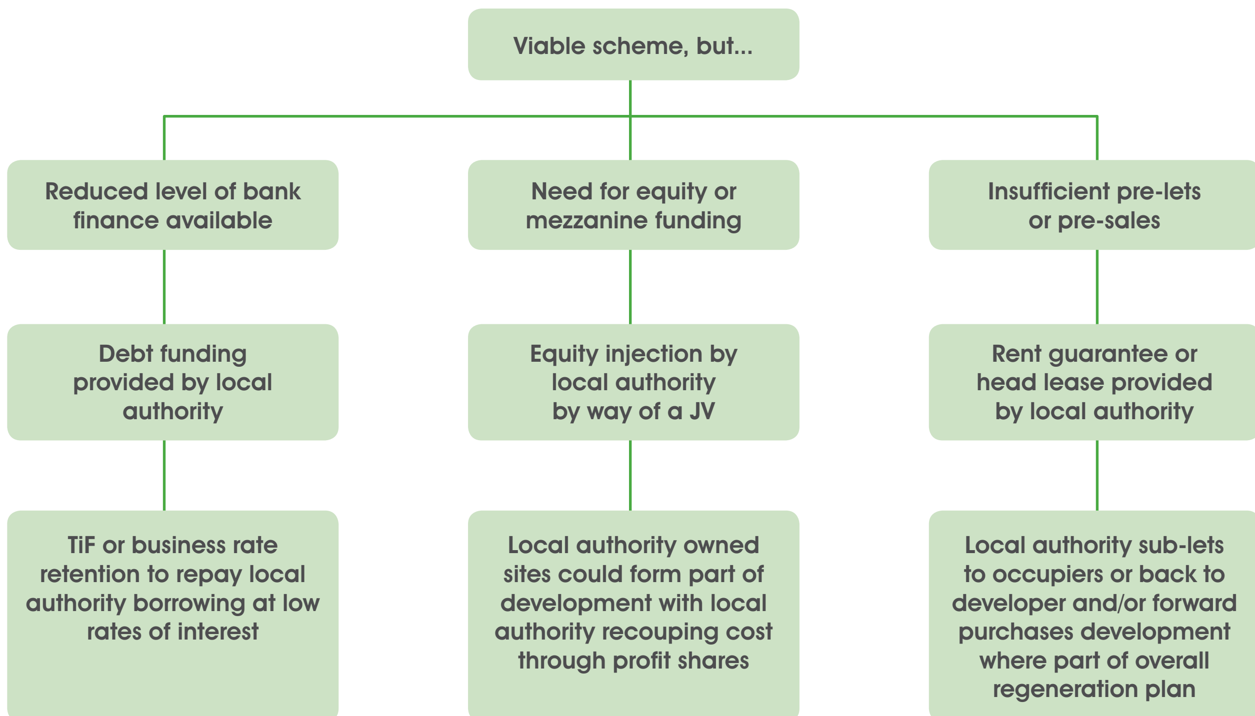
Financial restructuring

The flow chart in Figure 2 summarises various problems that can threaten a scheme, even though it may be technically viable, and illustrates possible actions that a local authority can take to help achieve deliverability.

Reduced funding

In the current market, a common scenario is that the development is financially viable, but banks have reduced the level of debt funding (loan to cost ratio) to mitigate their risk and the developer is unable to provide additional equity funding due to funding constraints. In this instance, debt funding can be provided by the

Figure 2 – Financial Restructuring



local authority, either replacing a bank loan or providing junior/mezzanine debt. This form of funding is usually provided to higher risk projects where the local authority achieves primary security, specifically a first charge over the land and development.

The development funding can be provided via Tax Increment Finance (TIF) or business rates retention. The required capital sum would be borrowed at low rates of interest using the local authority covenant and repaid over time through retention of the increased rate income expected from new development.

Lack of equity

If the development is financially viable but the developer requires equity or mezzanine funding, either due to the impact on its finances or a reduced land value; equity funding can be provided by way of a joint venture or mezzanine funding for projects that have a lower risk. There is an opportunity for the local authority to make some profit as well as helping get the development off the ground and improve the town.

Where local authorities own sites which could form part of the development then this will reduce up-front expenditure by the developer and potentially give local authorities greater control over development and its tenant mix. When the scheme is completed the local authority, as a JV partner, will potentially share in the development profits which can then be recycled to cross subsidise other schemes that are less profitable.

Exit route problems

The local authority can provide a rent guarantee on the income of the completed scheme or take a head-lease if the developer's preferred exit route, whether sale or leasing, is no longer considered financially secure to the bank, whether this be from weak pre-sales or pre-lets or poor covenant strength of the purchaser or tenant.

Options include either leasing some or all of the space within the building and sub-letting to occupiers to influence the tenant mix, or sub-letting back to the developer, so that the developer can control letting to occupiers. The local authority lease would count as a pre-let, counting as a good covenant and help to obtain bank finance.

Rent guarantees or funding to tenants could be provided by way of di minimis funding under State Aid rules of approximately £50,000 per business, per year for a short period of time. This can be provided by way of a grant, rent rebate or a contribution towards business rates to give smaller occupiers time to establish themselves without the full initial financial burden.

Alternatively, the local authority could purchase the building where private sector investment is unlikely, especially if the building is part of an overall regeneration plan and so has reasonable capital growth potential. Such a forward sale would help free up bank lending to the developer, and give local authorities influence over the occupier mix where desirable.

Housing schemes and the private rented sector

The downturn in the funding market has left many residential developers unable to commence or complete their development schemes and this directly impacts on the contribution of affordable housing (through planning obligations) provided to local authorities. As a result there is now a significant shortage of new affordable housing being supplied.

Under plans in the Localism Act in England and changes in the Housing Revenue Account (HRA), local authorities in England have been looking for innovative ways of developing affordable housing. These include setting up subsidiary companies to develop and fund affordable housing by the local authority (through prudential borrowing) or utilising external funding from pension/insurance funds and international funds.

GVA has been working closely with Long Harbour, an internationally backed property investment manager, which provides low cost development finance for affordable housing. The manager provides the development capital for the construction of affordable housing which is built on local authority owned land. The homes are then leased to the local authority on a long lease with the management and maintenance undertaken by the local authority or outsourced. At the end of the lease term, the homes are transferred to the local authority.

An alternative or supplementary way of achieving affordable housing (albeit not low income social housing) and increased housing supply generally, could be via the private rented sector. This is the kind of low risk, enabling development that could help meet the housing shortfall and act as a catalyst for further development.

Traditionally private residential development has been achieved mainly through housebuilders developing schemes for sale, with properties being sold to generate cash flow for new development. However, institutional investor developers could be attracted into private rented sector housing investment/development, as they have been into student housing and before that commercial property investment/development. But there are significant potential problems with this approach and some form of public sector/local authority funding involvement would probably be necessary.

The main potential benefits to the financial institutions of residential sector investment are the high investment return profile, stability of income and capital value and the low correlation with other asset classes. But the main potential drawbacks to investing in the sector are management issues (short leases, voids, repairing obligations, lack of economies of scale etc), potential low income yield (but high return), lack of liquidity initially due to small market scale, and high pricing as price is related to open market vacant possession values.

Some of these deterrents could be lessened/overcome by central government (eg by tax incentives/relief, or the reduction in VAT on repairs and management fees, or changes in the planning system (use classes) in connection with affordable housing provision.

Other deterrents could be lessened by local authority action relating to affordable housing requirements, or by taking head leases (pre-letting) to guarantee income stability (and growth if there are index linked uplifts) and lessen management issues if local authorities were responsible for repairs and maintenance. This would help secure development finance from banks and/ or help secure forward sale/forward funding agreements with institutional investors.

Conclusions

The economic crisis of recent years has had a notable effect on development activity. The resulting lack of debt funding and lower levels of liquidity in the equity markets has seen development come to a standstill in markets which need it most. However through public sector intervention and funds changing their funding priorities, we are now seeing changes in the way funding is sourced by developers and investors. These changes, while providing relatively low levels of funding, are helping development to progress.

The HCA, LEPs and some local authorities are now providing senior debt funding and we have seen an increase in joint ventures between local authorities and property developers. Private equity funds have also started to diversify from providing equity funding to providing mezzanine, bridging and debt funding. These interventions and many other changes in the funding markets are creating a funding platform to provide liquidity for current and future development.

The transition between traditional and these new methods of development funding will take time to become established and widespread, but there are encouraging signs that local authorities are realising that they now have the powers to help local development to progress.

The inertia in property development has not been helped by the major reforms to regeneration and planning policy in the UK. After years of reliance upon national and regional spatial policy, there is bound to be a period of adjustment as the acknowledgment of local responsibility sinks in. Manchester is arguably the only area outside of London with something that resembles a cohesive strategic vision involving a group of local authorities and provides a much heralded model for other LEPs and towns to aspire to but can it work for everyone?

One issue that arises is that of the short term five year political cycle versus the longer, 25 year strategic property vision that is required to support large scale development and regeneration. The biggest challenge that LEPs face is to prove that they are the correct mechanism to help fund and drive development. What is certain is that however LEPs are able to raise funds, there is still a heavy reliance on the private sector to help deliver their plans. Greater involvement from the public sector will go a long way towards mitigating the perception of risk that is currently holding development back.

Funding Directory	
Regional Growth Fund	Tax increment financing
New Homes Bonus	City Deal
HCA Affordable Housing programme	Prudential borrowing
HCA Property & Regeneration programme	Local authority bond
Ecotown	PFI/PPP
EU Regional Development Fund	Salix/Amber infrastructure funds
Department for Transport - Transition funding for growth and Housing Market Renewal areas	Renewables obligation certificate / Partnership for Renewables / Renewable Heat Incentive
Miscellaneous grants	Feed in tariffs
Carbon Trust	Green Investment Bank
Localised business rates	Multi Utility Service Company (MUSCO)
Growing Places Fund	Energy Service Company (ESCO)
Section 106	Real Estate Investment Trusts (REIT)
Community Infrastructure Levy	Community land trusts
Capital & Assets Pathfinder programme	Utility companies
Local asset backed vehicle	Private sector investment including through the LEP / Pension funds
EIB JESSICA funds	Asset rationalisation – receipts / revenue savings
Housing Guarantee Scheme	Local Enterprise Partnerships (LEPS)
Public Works Board	Infrastructure Guarantee Fund

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