



Department for
Communities and
Local Government

Estate Regeneration National Strategy

Financing and Delivering Estate Regeneration

Introduction

Estate Regeneration is a long term process that often requires significant investment to support a wide range of activities. In many cases the risk profile of investment changes over time and can present challenges to ensure viable and sustainable delivery.

This guidance document aims to help landowners explore the options available to them when beginning an estate regeneration project. It outlines different routes to private investment and the ways in which the public and private sectors can create effective partnerships to deliver successful schemes.



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Financing and delivering estate regeneration

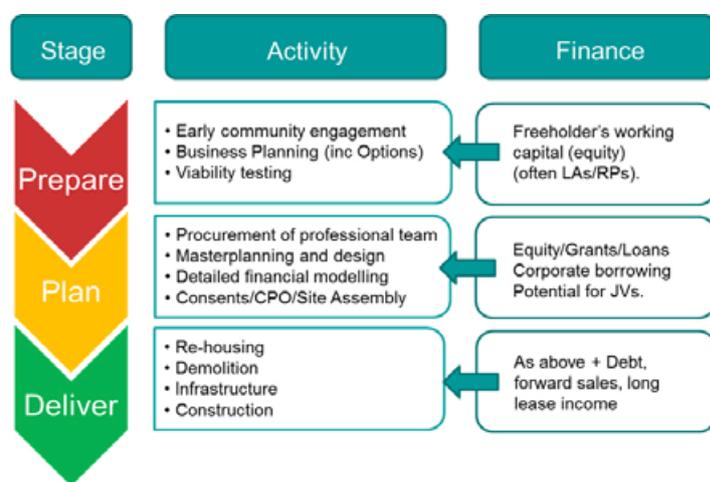
The Estate Regeneration National Strategy aims to support and encourage estate regeneration throughout the country while seeking to reduce reliance on public finances by encouraging investment from the private sector.

Regenerating a housing estate requires significant investment, over an extended period of time, to support a wide range of activities. Attracting private finance can be difficult, particularly for the up-front and riskier expenditure that is required to achieve financial viability, especially when the financial returns can take many years to realise. Government acknowledges that the financing and delivery of any regeneration project is one of the greatest challenges faced by a landowner.

There are many good examples from across the country of landowners working with partners and residents to regenerate estates (see the case studies section of the national strategy). These include some highly innovative funding and delivery structures with the potential for wider application.

Unfortunately, a large number do not progress beyond the concept stage. This can be due to a combination of factors including a lack of staff or financial resources to take projects forward or test their potential, low public support or the underlying economic viability of a scheme.

In general terms, there has tended to be a three-stage process to the funding of estate regeneration programmes, each with their own finance requirements. These are referred to as Prepare, Plan and Deliver – more detail of which is provided in the estate regeneration **good practice guide**.



This guidance seeks to help more schemes progress and is particularly for those at the earliest stages of project preparation and working through the viability considerations of estate regeneration. It is intended to supplement the existing body of published research by providing advice on how estate owners might prepare for and undertake the process of estate regeneration. It does not set out to be exhaustive, but seeks to illustrate approaches that may help with the key challenges and common issues faced by landowners.

1. Overview of challenges

It is evident from our discussions with estate owners across England, and feedback from other estate regeneration stakeholders and practitioners, that there are common challenges that landowners and communities face when considering the financing and delivery of estate regeneration.

Managing the range of perspectives

A key challenge in any regeneration project, but especially housing estate regeneration, is managing the competing demands that need to be balanced to promote and deliver a financially viable scheme.

For residents, estate regeneration can be an uncertain and anxious time; the prospect of moving house, and seeing homes demolished is likely to bring with it many emotions, and there may be ongoing disruption for many years if the scheme goes ahead. But regeneration also provides an opportunity for residents to be involved in transforming their neighbourhood and improving the quality of life for the local community.

Landowners need to work with residents to understand how they feel about their area and what they might like to see change. They need to find ways to address their particular needs, involving them throughout the process in discussing and making decisions on options for the estate. Alongside this, landlords also need to create the legal, property and financial conditions for development to take place, ensuring residents understand the full range of issues and factors for regeneration of an estate to take place; and that this will include some necessary and often complex processes, such as ensuring viability, procuring services and seeking planning permission. Where a public body is leading a project, the need to undertake compliant procurement can create processes that seem 'closed' to scrutiny and public engagement and risk suspicion of 'done deals'. Being clear at the early stages about the need for these processes will help to mitigate these risks.

Not surprisingly, there is the potential for these different perspectives to lead to confusion and misunderstanding over the interests, intentions and incentives of the different parties. It is therefore critical that a plan for an inclusive, robust and resilient regeneration programme is at the heart of any estate regeneration scheme, and is understood, accepted and agreed by all the parties involved.

Ensuring financial viability

Estate regeneration, given its complex nature, is a long-term undertaking. For the landowners and investors, the fact that it may take six or more years from first expenditure to the start of receipts, results in an investment profile that presents a number of material risks that can prove difficult to resolve. Planning, land assembly, re-housing of existing tenants and residents and the building of new homes for sale can combine to create an overall risk profile that can be difficult to finance. Committing to spend money on the basis of returns linked to market conditions in six or more years' time can make for a difficult commercial decision.

Historically, estate regeneration schemes have almost always relied upon some government investment in the form of grant. A major ambition of the new approach to estate regeneration is to explore and promote innovative methods of financing estate regeneration, in ways that deploy limited public finance more effectively and ultimately reduce the need for such significant recourse to the public purse.

A key element is often the promotion of a mix of tenures on previously single tenure estates. Some element of increased density to enable build for sale or private rent is therefore likely to be a pre-requisite within schemes – either on site or elsewhere, to enable similar levels of affordable housing to be retained. Maximising the effective use of land through higher densities on estate schemes can also contribute to meeting local authority housing targets.

Government recognises that this is challenging even in high land value areas such as London and the South East, where development for sale is often viable and can generate cross subsidies to assist with mixed-tenure solutions, including sub market rents. In mid-range and lower land value areas the challenge is much greater. Contributions to solving this challenge can include the incorporation of further public land holdings and co-ordinated business planning and expenditure between public authorities (those bodies responsible for housing, education and health, for example).

In 2006, the Policy Press and the Joseph Rowntree Foundation produced a report on the conditions of 20 housing estates over the 25 years from 1980 to 2005.¹ The study concluded that:

“The experience of the past 25 years shows that it is possible to make progress over the long term but narrowing the gaps takes sustained commitments of capital funding, revenue funding and attention from central government, landlords and housing manager and residents’ groups.”

In the context of the need for ‘sustained commitment’ and co-ordinated engagement, over the last 10 years the Chartered Institute of Housing (CIH)^{2,3}, the Investment Property Forum (IPF)⁴ and the Royal Institution of Chartered Surveyors (RICS)⁵ have published research into the financing and delivery of regeneration projects. The IPF was particularly interested in how to increase the participation from institutional investors in the regeneration process.

All studies seem to recognise that regeneration programmes demand specific finance packages that are able to deliver long-term project resilience. Both the IPF and RICS reports acknowledge the significant interest in regeneration investment from the private sector, whilst illustrating the challenges faced by potential funders. These challenges have also been acknowledged previously by DCLG⁶ and the GLA.⁷

“The great challenge is: how do we attract the long-term investment opportunities that could come along with pension funds, for example, to regenerate these houses and make an incredible difference.”

HRH the Prince of Wales.⁸

The need for long-term project resilience suggests that the question of how to raise the required finance for a given opportunity is directly linked to the delivery structure.

¹ *Twenty five years on twenty estates*, Policy Press/JRF, 2006.

² *Transforming Estates*, CIH, October 2009.

³ *Regeneration revival? Making housing-led regeneration work across England*, CIH, April 2016.

⁴ *Institutional Investment in Regeneration: Necessary conditions for effective funding*, April 2006.

⁵ *Innovative Finance for Real Estate Development in Pan-European Regeneration*, March 2015.

⁶ *Evaluation of mixed communities initiative demonstration projects*, DCLG, 2010.

⁷ *Knock it down or do it up? The challenge of estate regeneration*, GLA, 2015.

⁸ *Estate Regeneration: Six steps to success*, The Prince’s Foundation and Hyde Housing, 2015.

2. Developing the delivery structure

The process of project delivery is one of setting a vision, creating a strategy to realise the vision and then letting and managing the contracts to implement the strategy. The process of letting contracts, the question of who pays and the appetite for exposure to the risk of performance all inform how a landowner might approach a given opportunity. The differing appetites for risk, the source of finance and the processes through which construction is procured can combine to create a wide variety of methods for implementation.

There are some key aspects that demand very particular responses and considerations when selecting a delivery strategy and structure. These include:

- Legal and regulatory frameworks (that guide delivery structures or Compulsory Purchase Orders (CPO), for example) that influence what the landowner can and cannot do.
- Public sector ownership and existing tenants (both social and private) preclude the early raising of debt (charging) against assets.
- The costs of site assembly, CPO, demolition and re-provision of existing homes create high costs early in the process. The question of how to finance these costs is a key issue in estate regeneration.
- If the landowner is a local authority, that the housing estate will be held in the Housing Revenue Account (HRA) which brings with it borrowing restrictions.
- That resident communities have a long-term interest in helping to create successful outcomes. These long-term interests demand long-term delivery strategies to accommodate changing circumstances over the lifetime of the project and beyond.
- That estate regeneration demands a combination of professional skills (services) and finance. Where the public sector buys services, procurement (Official Journal of the European Union – OJEU) considerations arise.
- The legal obligation on local authorities to demonstrate that any transaction is delivering Best Consideration.

Much has been written on good practice in estate regeneration. The CIH, the Joseph Rowntree Foundation⁹, the G15 Registered Providers¹⁰, the Centre for London¹¹, ResPublica¹² and the 4 Housing Architects¹³ have all produced papers directly in response to, and in support of, the work of the Estate Regeneration Advisory Panel chaired by Lord Heseltine and the Housing and Planning Minister. In 2015, The Prince's Foundation and Hyde Housing produced a short paper on best practice based on their experience on the Packington Estate in Islington.¹⁴ From these, and our work with over 100 estate regeneration schemes, there are several common themes emerging on best practice in estate regeneration.

Robust project preparation

The desire for estate regeneration tends to arise from three key sources:

1. The local community in response to particular estate conditions or design issues.
2. Freeholders/leaseholders/tenants due to property condition issues.
3. Statutory bodies seeking to increase local housing supply

Regardless of the origin, however, development of an estate regeneration scheme should be undertaken in a robust and objective manner.

Government has developed an estate regeneration good practice guide to support all stakeholders in developing estate regeneration schemes. It is not intended to be prescriptive but aims to help to ensure all matters are considered and addressed. For landowners in particular, it should assist them in developing robust and comprehensive plans, including consideration of the process needed for testing the development options and the legal and corporate relationships required to deliver them.

For local authorities, some of the key questions that will arise during the preparation stage will relate to statutory obligations such as the need to demonstrate best consideration in any transaction and the sourcing of professional support and finance. All matters will also raise procurement considerations. These two matters are expanded on in the next section.

⁹ *Estate Regeneration: Briefing for expert panel*, Joseph Rowntree Foundation, May 2016.

¹⁰ *Meeting the challenge of urban renewal, The G15's contribution to regenerating London's estates*, October 2016.

¹¹ *Another Storey: The real potential for estate densification*, Centre for London, Sept 2016.

¹² *Great Estates: Putting communities at the heart of regeneration*, ResPublica, November 2016.

¹³ *Altered Estates: How to reconcile competing interests in estate regeneration*, HTA Design; Levitt Bernstein; Pollard Thomas Edwards; PRP, 2016.

¹⁴ *Estate Regeneration: Six steps to success*, The Prince's Foundation and Hyde Housing, 2015.

Selecting the right approach

There are a number of ways in which the public and private sectors might work together to implement property development and regeneration projects. These range from land sales through to development agreements and the creation of jointly controlled, special purpose companies.

Each different approach has its own project and financial risk and reward profile. In 2014 the Local Government Association published a detailed introduction to the wide variety of delivery options open to the public sector, including case studies.¹⁵ Many of the options described have relevance to estate regeneration. This work has more recently been supplemented by the work of the Housing & Finance Institute (HFI) which has identified 26 techniques for local authorities, in particular, to lever-in private finance and housing related expertise to support local housing activity and estate regeneration.¹⁶

The HFI's 26 techniques are formed of three groupings:

Money/Investment

- Borrowing
- Investment

Creating Value

- Masterplanning
- Consents
- Agreements

Cashflow/Value Enhancers

- Deferred considerations
- Pre-lets

There are many combinations and variations to all of these options, but in relation to structuring delivery, the following five mechanisms are generally at the heart of the variations in some form and often in combination.

1. Unconditional land sales
2. Conditional land sales
3. Development Agreements
4. Corporate joint ventures
5. Self delivery

More detail on these options is provided in **Annex A: Delivery Transactions**.

It is important that each of these options, and any variations, are properly considered and tested for a given estate regeneration opportunity. Each route will have implications for financing, procurement and project management. In many cases, the challenge of how to structure delivery is likely to be addressed by a combination of approaches.

Land sales

The challenge of using land sales at the early stages of estate regeneration tends to centre on the loss of control on the part of the landowner and wider community. Development Agreements can be used to help the landowner retain some controls but the use of these contractual agreements can lead to difficulties in ensuring that all scenarios can be equally planned for and that land value is fairly apportioned. Development Agreements can also be complex for a landowner to procure and usually require an OJEU Competitive Dialogue process. In addition, in many cases the actual development within the 'red line' of the project boundary will be influenced by regeneration activities that are taking place outside of it. This creates a challenge when seeking to capture the financial benefits of infrastructure investment. For example, public sector investment in offsite infrastructure is likely to enhance the value of the land, but capturing the benefit of this investment becomes much more difficult if the land has been sold.

Self-delivery

Self-delivery, either through the use of public finance (HRA headroom for example), corporate finance or through the creation of a wholly owned local housing company, provides greater control for a local authority. It exposes them to full cost risk but also to any value enhancement over time. Local authorities have the power to create wholly owned Local Housing Companies (LHCs) under the Localism Act 2011, to deliver mixed tenure developments. The transfer of land to the LHC must be undertaken at 'open market' rates, as must be the supply of services back to the council, and government has been clear that affordable housing should be managed through the Housing Revenue Account. There are an increasing number of examples of LHCs developing across the country – most schemes being relatively small compared to most estate regeneration schemes. The complexity and financial resources required for estate regeneration, to date, appear to have precluded the use of LHCs to promote such projects.

¹⁵ *Supporting Housing Investment*, LGA, 2014.

¹⁶ *Overcoming challenges using finance and structuring opportunities*, Housing & Finance Institute, 2016.

A number of LHCs, however, have the stated aim of helping to facilitate regeneration and it may be just a question of time, experience and up-skilling before this option becomes more popular amongst local authorities.

Some examples of LHCs are below.

- LB Ealing - Broadway Living
- UAC Thurrock - Gloriana
- Blackpool Housing Co. Ltd

Joint Ventures

Feedback suggests that, currently, the most favoured option for the delivery of estate regeneration is the creation of joint venture companies (JVs). If supported by robust business cases and created relatively early in the regeneration process, these have the potential to give landowners the long-term control they require, help open up the market for institutional investment in estate regeneration and facilitate efficient procurement processes.

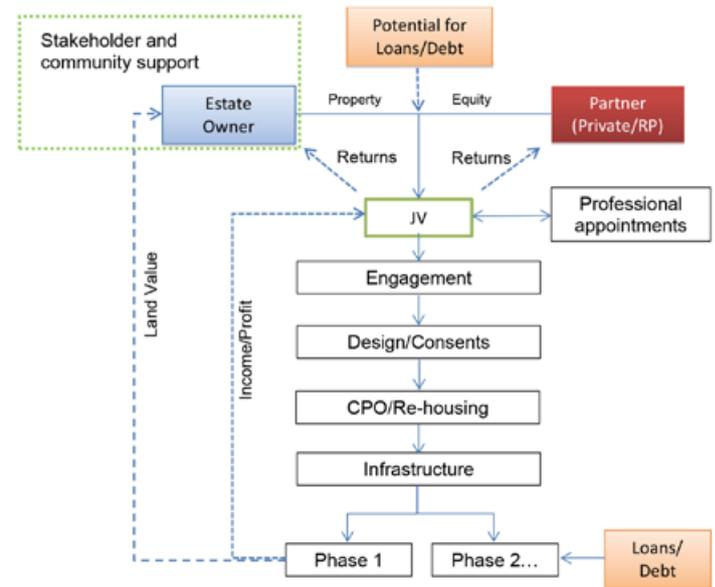
Where a public body is using the procurement process to test for design ideas and needs to develop the contract through that process, a competitive dialogue will often be required. This process involves at least two parties staying in competition until the public body is ready to sign with one of them. Competitive dialogue can be a time consuming and expensive process. If the public body is creating a joint venture – the contract for which is restricted to defining behaviours and not services or outcomes – then it may be possible to pursue alternative procurement routes. Specialist advice should be sought when considering procurement options.

A further potential benefit of the use of JV structures is that they can enable resilient project delivery by ensuring that both the public and private sectors are represented properly throughout the process and risks can be readily identified and managed. A detailed guidance note for local authorities considering the use of joint venture companies to deliver against their strategies was published by HM Treasury in March 2010.¹⁷ As noted in the Treasury’s report, the guidance is not a replacement for independent specialist advice and those who use it should ensure that they take appropriate legal, financial and technical advice.

The use of JV structures is intended to allow the public sector to be able to commit its land interests alongside private sector finance and expertise to facilitate the appointment of professionals, detailed community engagement, the design of outstanding schemes and the eventual letting of construction contracts.

Such delivery models can also facilitate early third party and government investment and can also deliver enhanced transparency from the community’s perspective.

Example JV structure



¹⁷ Joint Ventures: a guidance note for public sector bodies forming joint ventures with the private sector, HM Treasury, March 2010.

There are a number of benefits of JV partnership models. For example, they:

- Create a singular body for overseeing the entire regeneration process.
- Allow the early pooling of skills and resources to ensure the best outcomes for all parties.
- Help reduce reliance on public finance.
- Keep open the potential for central government investment (as shareholder).
- Allow the transparent management and mitigation of risks.
- Create early chargeable (shareholder) interests.
- Enable simplified procurement and delivery mechanisms (creating a private entity through which services are procured).
- May reduce the need for OJEU Competitive Dialogue in favour of alternative procurement routes.

However, there are also risks that will require local review including:

- Tax implications for the owners of the JV.
- State aid considerations if public money is invested, in addition to land.
- The potential dilution of control, away from sole discretion of the landowner.
- The need for strong governance and board representation.
- Mechanics for securing best consideration as land is transferred to the vehicle.
- Partnership documents must make clear provisions for deadlocked decisions and disputes.
- Roles and responsibilities of the partners (and to what extent will they be responsible for both infrastructure and development).

Examples of JV delivery partnerships:

- Sheffield Housing Company - Sheffield City Council, Keepmoat and Great Places Housing Group.
- Brent Cross South - London Borough of Barnet and Argent Related.
- Evolution Gateshead - Gateshead Council, Home Group and Galliford Try Partnerships North East.
- Barton Park, Oxford - Oxford City Council and Grosvenor Developments Ltd.
- Haringey Development Vehicle - London Borough of Haringey, in procurement at time of writing.

The encouragement of the use of such methods does not and should not preclude the selection of any of the alternatives available to promoters of estate regeneration. All parties will need to consider how their delivery model is addressing their particular needs and circumstances.

3. Financing estate regeneration

While robust preparation and the right partnership arrangements are important, the final key to effective estate regeneration is the investment itself.

Finance for estate regeneration can be complex due to the changing requirements and risk profile of the project over time. Due to this, the investment package tends to be a combination of public and private finance; comprising grant, loans, equity and debt. This finance may be sourced from public borrowing but can also be raised through issuance of bonds and forward purchase commitments. A glossary of some of these key terms is appended.

Uncertainty or the risk of not receiving a return is 'priced' for by an investor. This 'price' is the cost of the money being offered. The price of any investment will be the product of the investor's perception of the risk of the project failing to deliver on its promises. Any investor will demand a clear plan of action to return the investment (with interest), a risk mitigation strategy and usually some form of security.¹⁸

The landowners' commitment to estate regeneration must therefore be shown to:

- Enjoy the support of all the key stakeholders.
- Be broadly supported by the resident community.
- Be financially viable.

Reference to the estate regeneration good practice guide will assist in meeting these criteria.

In terms of being satisfied of scheme viability, it is usual for any project proposal to be accompanied by a cashflow model – a residual appraisal or a Discounted Cash Flow (DCF) appraisal that shows both the expenditure and receipts and the time frame across which these will take place. In estate regeneration appraisals, these appraisals will inform investors with a projected viability, Internal Rate of Return (IRR) or Net Present Value (NPV) (see Glossary). The rate of return (the target profit or Discount Rate) that the investor will apply to their investment in the project, and thereby informing the scheme's viability, will depend to a great extent on the way in which the landowner agrees with the assumptions within the appraisal. It is important, therefore, to ensure that the early project preparation and planning stages are comprehensive and robust. Professional advice in support of these assumptions should be obtained wherever possible. The Homes & Communities Agency (HCA) can assist with the procuring of this support.

In addition to a detailed project appraisal and cashflow model, the investor will need to know that landowners have explored all options available to create the best possible chances for a viable scheme – namely that revenues are likely to be in excess of project costs. Landowners should include in this process:

1. Testing of the underlying assumptions around density, mixes and tenures and the potential to introduce private rented accommodation and sales;
2. Contribution of further public or third party land and property assets to assist with viability and phasing of delivery;
3. Use of long-term institutional investment and/or other long-term partnerships with private sector investors.

Local authorities have a key role in estate regeneration, particularly, but not only, where estates are in their ownership. The need for local authorities to view estates as a long-term, income generating asset, with the associated revenue from affordable rents, private rented stock and commercial property projected over a 30-50 year period, has been identified by investors as key to encouraging private investment.

Our research and engagement, and the work of the HFI, has shed light on a wide number of solutions and innovations in the area of regeneration finance. These go beyond borrowing or the use of Registered Provider corporate finance options. Many local authorities have been proactive in driving this innovation.

It is likely that a combination of strategies will provide the long-term financial resilience that is required to deliver estate regeneration. Amongst these are the use of other public sector land, the role of private rented housing and opportunities for long lease income investment.

¹⁸ Detailed guidance on the management of project risk is provided in HM Treasury's "Green Book: Appraisal and Evaluation in Central Government", July 2011.

Public sector land and assets

The contribution of third party or further public sector land and assets to estate regeneration projects can help to both support the provision of new homes for existing tenants, minimising disruption, and provide interim income and bring uplifts in land value and capital receipts that can support the broader agenda. The value uplift that can be achieved through development can be captured and recycled to support regeneration.

A common challenge faced by local authorities when seeking to pool property resources is the specific obligation to achieve best consideration under the Local Government Act 1972. The responsibility to obtain consideration that is the best that can be reasonably obtained for surplus property can create a particular tension when seeking to promote broader social and economic outcomes that may serve to reduce the value of the land in question.

Early collaboration between public bodies and co-ordinated asset strategies within the One Public Estate agenda may help to resolve this tension, as it creates the framework within which the land can be valued.

Government guidance on the disposal of public sector land states that disposals should be “rooted in local plans”.¹⁹ As part of the One Public Estate programme, co-ordination of planning policy allocations across public sector land interests will help to address concerns over best consideration whilst supporting estate regeneration.

Providing a site has been allocated in the local plan, and in connection with an estate regeneration proposal (for affordable housing for example), this will be a material consideration in the valuation process. The planning process can therefore be a tool for addressing best consideration concerns between willing public sector institutions. This however requires the respective bodies to be collaborating for a broader collective social-impact interest than their own specific financial gain. It is acknowledged that this will require senior commitment at a local level.

Private Rented Sector

Encouraging mixed and balanced communities is an ambition of many places. This has often been interpreted as a balance between private and affordable housing tenures, but it actually encompasses the provision of housing products suited to people at every stage of life and all situations.

Institutional Build to Rent can provide high quality homes and contribute to meeting this ambition. In addition to creating opportunities for people who cannot, or choose not to, buy their own home, market rented accommodation can help to create certainty of capital and revenue income for a project. At the early stages this can help to populate and activate a scheme without being subject to open market sales or the need for pre-sales. This can speed up delivery and lead to greater programme and funding efficiencies.

Market rented accommodation within estate regeneration schemes, therefore, can contribute to creating mixed and balanced communities, a greater range of housing products and also encourage long-term institutional investment.

¹⁹ *Local Authority Assets: Disposal Guidance*, March 2016, DCLG.

Long lease income

Some high profile housing and regeneration schemes have been facilitated through the use of institutional investment in long leases, sometimes referred to as ‘income strips’.

‘Income strip’ relates to a forward funding deal where an investor and a developer deliver new homes (e.g. rental units) on an estate regeneration site. The landowner or JV partner (such as the local authority or housing association) commits to the development by agreeing to taking on a long lease on the units (say 35 to 45 years). At the end of the lease term the homes revert to the freeholder who can do with them as they see fit. The benefit for the investor is they acquire an income from the asset for an extended period. The benefit for the landowner is they gain a new development on the basis of a revenue commitment as opposed to a capital sum.

One example is the Thames View estate in Barking and Dagenham, where the local authority partnered effectively with Longharbour. Capital costs of development were met by Longharbour and these will be paid back through the rent receipts. The local authority oversaw lettings and management, and the land will transfer back to them once the investor has achieved their target return. The new ‘Legacy’ development vehicle (led by Rio Ferdinand, Mark Noble and Bobby Zamora) also demonstrates an appetite for partnerships between long-term investors and estate regeneration opportunities.

Long lease/income strips have a role to play in raising finance for the creation of income-producing assets and should be considered when seeking to deliver new housing.

Government support

Feedback from the sector suggests that Government investment in the form of recoverable investment at the early stages can help to de-risk schemes. Government also recognises that some schemes may need some funding in the form of capital grant to help with, for example, feasibility studies, viability assessments, masterplanning, community engagement and partner or procurement advice, in order to progress.

Before committing any investment in support of estate regeneration, the government will expect landowners to have explored all available options to create the best possible chance for success. These include:

1. Testing of the underlying assumptions around density, tenure mix and the potential to introduce private rented accommodation and sales.
 2. Contribution of additional public or third party land and property assets to assist with viability and phasing of delivery.
 3. Use of long-term institutional investment and/or other long-term partnerships with private sector investors.
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Glossary

1. Bank and non-bank debt

Debt (or senior structured finance) is one of the lowest cost sources of finance available to a development project. This is due to the debt provider having priority return and a risk ranking security against the asset. Pre-2007, development finance in the UK was dominated by banks and, currently, they remain the largest source of senior secured development finance. However, on the basis of the IPF 2015²⁰ research sample, the banks' overall dominance is being eroded by the increasing prominence of alternative lenders. These lenders include debt funds and alternative non-bank lenders deploying professional or institutional money from multiple sources. The growth of non-bank (i.e. non-regulated) debt being in part a response to the more stringent 'slotting' regulations that banks must now abide by.²¹

The key features of debt (or senior secured development finance) are a need for certainty in all respects. This can include:

- First charge on the registered title and/or charge over shares in SPV.
- Loan to development cost of generally between 50-65% (with equity spent first).
- Town planning certainty and detailed cost plans (and in some cases cost-overrun guarantees).
- Minimum hurdle for pre-lets and/or sales, based either on the percentage of space or interest cover.

Due to these requirements, it can be difficult to fund infrastructure with debt. Infrastructure tends to require equity or corporate finance solutions. Average interest rates for debt are presently around 3% over LIBOR (London Interbank Offered Rate).²² It should be noted that there are usually further fees charged by the lender including arrangement fees, exit fees and non-utilisation fees (on undrawn funds that are being reserved for the purpose). In addition, there may be an array of management and monitoring fees. These transactional costs tend to add a further 2-4% to the rate of borrowing.

2. Mezzanine debt

The mezzanine lender typically takes a second charge over the development which ranks behind that of the senior lender. In practice, this means that in the event of default by the borrower a mezzanine financier will only get paid after the senior lender's debt has been paid off. This increased risk is reflected in the cost of the mezzanine finance.

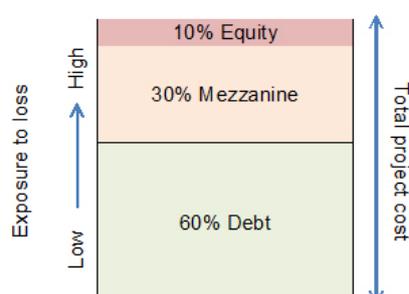
Mezzanine lenders can be invited to 'top up' the senior lender up to 90% of the total development cost, leaving not less than 10% to met by equity. Due to the increased exposure to default or underperformance, the IPF (2015) notes that there is less scope for mezzanine finance on speculative projects and this type of finance is typically associated with projects funded on a profit share basis. The price of mezzanine finance will depend on the loan to cost ratio but could range from 7-15% over LIBOR.²³

3. Equity

Equity financing typically refers to the provision of capital through the sale of shares in a development project (usually the particular SPV delivering the scheme). Equity can also take the form of land or other assets being committed to a JV. It is through the shares, or proportionate value of contribution, that profits are distributed to the investor on the completion of the project, after all costs have been covered. Because of this, equity is sometimes referred to as 'junior' to the debt. Given the low ranking in the 'debt-stack', it is the equity that is at the greatest risk. To reflect this risk property developers are generally pursuing returns on their equity of equivalent to 15-20% per annum. This rate is referred to as the Internal Rate of Return (IRR).

The diagram below illustrates how debt, mezzanine and equity can combine to fund construction of an opportunity that is capable of securing debt. Costs are normally met through the generation of receipts, by selling completed properties.

An example 'debt stack' for project finance



²⁰ UK Development Finance Review 2015, IPF.

²¹ See Appendices to UK Development Finance Review 2015, IPF, for more detail.

²² 6-month LIBOR, 0.91%, May 2016.

²³ May 2016.

4. Corporate Bonds

Corporate bonds are a way for a company to raise debt for unspecified operational purposes. They can be issued in many forms but all bonds are essentially promises to pay back both the principal debt and a return to the purchaser over a defined period of time. Generally bonds pay a fixed rate of interest and over a relatively long period (15-25 years) and are often traded, providing the added advantage of liquidity to investors.

Bonds can be both secured (against assets held by the company) or unsecured – unsecured bonds are sometimes also called debentures. Debentures are backed solely by the good faith and credit of the borrower. The issuance of bonds are an effective way for companies to raise finance as in some cases they can be more keenly priced than debt (in part due to banking regulations governing debt). The interest rate payable by companies will depend on the perceived risk of interest rate rises and the risk of default.

Corporate bonds are always considered to be higher risk than government issued bonds. Credit spread is the difference in yield between a corporate bond and a government bond at each point of maturity. As such, the credit spread reflects the extra compensation investors receive for bearing credit risk. Therefore, the total yield on a corporate bond is a function of both the market price of government bonds and the credit spread, which is greater for lower-rated bonds.

The risks associated with a given company and bond are judged by credit rating agencies such as Standard and Poor's (S&P), Moody's and Fitch. Each agency has its own format for reporting risk. For example, Standard and Poor's highest rating is AAA – once a bond falls to BB+ status, it is no longer considered investment grade, and the lowest rating, D, indicates that the bond is in default (the issuer is failing to make interest and principal payments to bondholders). Credit rating agencies are therefore a useful indicator of the financial strength of a given company at a point in time.

Dependent on the need of the project in question the money can be deployed by the company to reflect the behaviours of debt, mezzanine or equity.

5. Revolving Credit

Revolving credit facilities (RCFs) provide companies with similar access to funds that could potentially be raised via a bond or project debt but without having to draw down the entire amount at the outset and without necessarily having to charge any assets. It helps to consider an RCF on the lines of a company credit card. The lending institution grants a maximum credit limit, which can be drawn down at any time and for any purpose. Any income can be recycled back in to the facility and drawn back down at a later date, giving flexibility.

Generally, companies pay the price for flexibility through slightly higher rates than might be achieved through bond or debt structures. Depending on the creditworthiness of the company, rates can vary between 17 and 25%.

RCFs can be helpful in the context of providing certainty through land acquisition and the financing of certain aspects of early stage property development where debt may not yet be possible. RCFs can also be useful to address unforeseen costs or where the project is at a stage where there is both income and expenditure 'coming and going', potentially being more cost effective than debt.

6. Forward funding and forward sales

In the case of a planned development, a further method through which a developer can fund delivery is via 'forward funding' and 'forward sale' agreements.

A forward sale is a commitment from a buyer to purchase a property from a developer on completion, whereas 'forward funding' is the process through which a purchaser of a property provides the finance for the actual construction in return for the completed scheme. The key difference between the two is that under a forward sale contract, the developer will still have to separately raise the finance for the construction process.

Forward funding is commonly used by developers when selling to pension funds, life assurance companies and other institutions.

The benefit of this method is that the developer can remove market risk and secure a very efficient finance structure.

7. Residual Appraisal

This is a valuation approach which deducts the gross development costs (including profit and bank interest) from the scheme's gross development value. The balance (residual) is the value of the development land. Generally, for a scheme to be considered 'viable' the residual land value must be in excess of its existing or alternative use value.

8. Discounted Cash Flow (DCF)

This is a technique for appraising investments. It reflects the principle that the value to an investor (whether an individual or a firm) of a sum of money depends on when it is received.

9. Discount Rate

This is the annual percentage rate at which the present value of a future pound, or other unit of account, is assumed to fall away through time.

10. Net Present Value (NPV)

This describes the discounted value of a stream of either future costs or benefits. The term Net Present Value (NPV) is used to describe the difference between the present value of a stream of costs and a stream of benefits. A negative NPV suggests rate of return lower than the discount rate, whereas a positive NPV suggests rate of return in excess of the discount rate – subject to the assumptions used.

11. Internal Rate of Return (IRR)

This is the discount rate that would give a project a Net Present Value of zero, i.e. all costs would be covered by revenues, allowing for the discount rate.

Annex A: Delivery Transactions

Structure	Description	Benefits	Constraints
Land Sales (unconditional)	<p>Sale of land to highest bidder.</p> <p>With or without planning consents.</p> <p>Often the later stages of a project, when the sites have been serviced and consented.</p>	<ul style="list-style-type: none"> • High certainty of income. • Full transfer of risk and cost. • Relatively simple contracts. • No need for OJEU 'procurement'. • Receipt of income can be deferred to aid cash flow. 	<ul style="list-style-type: none"> • Compared to alternatives, a high price of risk transfer (i.e. higher profit margins requirements reduce land receipts). • Limited capacity for vendor to inform processes, pursue social and economic benefits. • Land price can create pressures on other outcomes (e.g. affordable housing).
Conditional land sales	<p>Sale of land to highest bidder, the sale being subject to specified events.</p>	<ul style="list-style-type: none"> • Tends to involve a pre-agreed land price (or can be 'open book'). • Sale can be linked to agreed outcomes. • Can be conditional on anything – planning, infrastructure etc. • Allows vendor to inform outcomes. • Income is contracted for. 	<ul style="list-style-type: none"> • Contracts can be cumbersome to draft and enforce. • Risk transfer comes at a price. • Once in contract, limited scope to inform processes, performance long-stop dates can be many years away.
Development Agreements	<p>Contractual agreement and relationship between landowner (vendor) and developer (buyer).</p>	<ul style="list-style-type: none"> • Creates opportunities for landowner to inform processes and behaviours of the developer. • Clear statement as to share of costs and proceeds. • Can allow for sharing of profit. 	<ul style="list-style-type: none"> • Greater share of project risk for landowner. • Contract must provide for a wide range of eventualities – can be time consuming to agree, and unlikely to capture all eventualities. • Disputes can be hard to resolve without recourse to third party support. • Procurement process can be complex.
Corporate Joint Ventures	<p>Jointly controlled and owned corporate entity (limited company, limited liability partnership for example).</p>	<ul style="list-style-type: none"> • Full transparency and shared input in to all decision making, costs and revenues. • Joint ownership and control create flexibility in decision making. • Less reliance on contracts to manage relationships. 	<ul style="list-style-type: none"> • Demands senior commitment and assumption of legal obligations to the new entity. • Full sharing of risk. • Distribution of returns subject to full Board approval.
Self-delivery/ Wholly Owned Company (WOC)	<p>Landowner self-finances and procures development services and contractors</p>	<ul style="list-style-type: none"> • Retain full control over all costs and revenues. • Full discretion over professional appointments. • Innovative models emerging (e.g. pre-sales paying for construction finance). 	<ul style="list-style-type: none"> • Complex procurement processes (unless WOC). • Demands experienced client team. • Landowner retains all project and cost risk. • Public sector borrowing regulations may limit capacity.

