Institutional Investment in Regeneration: Necessary conditions for effective funding

Executive Summary

May 2006

The IPF Educational Trust and IPF Joint Research Programme

This research was commissioned and partially funded under the auspices of the IPF Educational Trust and IPF Joint Research Programme.

The three-year programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with the other financial markets, wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 16 businesses, representing key market participants. The IPF Educational Trust and the IPF gratefully acknowledge the contributing organisations: Capital & Regional, Donaldsons, Grosvenor, GVA Grimley, Investment Property Databank, KPMG, LaSalle Investment Management, Land Securities, Lovells, Morley Fund Management, Nabarro Nathanson, Prudential Property Investment Managers, Quintain Estates & Development, Scottish Widows Investment Partnership, SJ Berwin and Strutt & Parker.

Joint funders of the research

The project was jointly funded by the British Property Federation (BPF), British Urban Regeneration Association (BURA) and English Partnerships. The IPF gratefully acknowledges their substantial financial support and the invaluable contributions from their representatives on the project steering group.

Launch event supporters

The research findings were launched at the International Conference Centre, Birmingham on 19 January 2006. This was only possible with the financial support of Locate in Birmingham (Birmingham City Council) who provided the ICC. The launch was generously supported by Pinsent Mason, Miller Developments Argent, Calthorpe Estates, Urban Splash, Eastside Partnership, AWM, Targetfollow and Birmingham Developments Company.

The research team

Professor Alastair Adair, Professor Jim Berry and Professor Stanley McGreal (all of the University of Ulster) and Professor Norman Hutchinson (University of Aberdeen). Suzanne Allan, (formerly of the University of Ulster, now PriceWaterhouseCoopers), was part of the research team in the first two thirds of the project.

In addition, Deborah Lloyd, Justin Cornelius and James Dakin of Nabarro Nathanson (a donor to the IPF and IPFET Joint Research Programme) greatly assisted the research team towards the end of the project.

The project steering group

The IPF appointed a project steering group to guide and assist the research team. The IPF gratefully acknowledge the contribution from the Chairman – Phil Clarke (Morley Fund Management) and David Shevill (observer from ODPM), Faraz Baber (BPF), Justine Lovatt (English Partnerships), Paul McNamara (Prudential), Peter Freeman (Argent), Rebecca Worthington (Quintain), Simon Burwood (BURA), Steve Carr (English Partnerships), Tom O'Grady (SJ Berwin) and Charles Follows (IPF).

The regeneration of communities and localities across the UK is a central part of Government policy and local planning policy. To that end, Government has introduced various policy initiatives, set up agencies and encouraged the re-use of brownfield sites to stimulate urban regeneration. However, successful regeneration often relies on the private sector landowners and developers to bring forward sites and for banks and investors to provide finance at the various stages of specific projects. Ultimately all property requires an end owner or investor to provide long-term capital. Therefore, Government policies will not be completely successful unless the interests of the private sector are harnessed, alongside the policy agenda. Regeneration uses different sources and types of finance at the different stages of the process. Disparate funding sources have different returns targets, assessment criteria, timescales and objectives. In addition, regeneration, particularly large-scale projects, is messy, management intensive, often complex, impacts on many stakeholders, can involve variety of landowners and requires public sector intervention.

The IPF and funding partners wish to more fully understand the reluctance of many institutional investors to engage in regeneration projects in order to encourage further dialogue between the policy makers in Government and the sources of finance. Consequently, they funded this research project, undertaken throughout 2005. This project examines the requirements of the private sector sources of short-term funding and long-term capital. It looks at the main finance sources – banks, private equity, fixed interest and long-term property investors – to understand their needs and requirements. It will identify the necessary conditions that need to be in place to get the private sector to engage fully with

Government, national and local, and regeneration agencies. By explicitly identifying these necessary conditions, it is hoped the project will help to build a bridge and dialogue between the private sector and Government policy.

Many sources of finance shy away from regeneration projects because of the perceived difficulties and protracted timescales. Financiers and investors perhaps over emphasise the risks and many projects are placed on the 'too difficult' pile. As a result, investors may forgo attractive returns. The research suggests that a regeneration investment vehicle with a mix of capital sources and a portfolio of regeneration projects would attract considerable interest across the sources of capital. Each participant would receive appropriate tranches of return reflecting their risk capital and objectives. The vehicle would hold a portfolio of projects at differing stages of the regeneration process to generate a diversified cash flow. The vehicle would provide management expertise and continuity for protracted projects.

The IPF, BPF, BURA and English Partnerships invite comments on the findings. Please address comments or suggestions to Charles Follows, Research Director, IPF, New Broad Street House, 35 New Broad Street, London EC2M 1NH. Email cfollows@ipf.org.uk 020 7194 7925 Switchboard 020 7194 7920. Fax 020 7194 7921

This research seeks to identify the conditions and type of vehicle that are required to attract more institutional investment into regeneration. The issue is resolved by examining the compatibility of the regeneration process, in whole or in part, with the investment characteristics of the different asset classes.

A cross-asset comparative perspective is used comprising property, bonds or fixed income, equities, private equity and hedge funds, including socially responsible investment, enabling a fuller awareness of both the asset allocation decision-making process and the key criteria used in investment selection.

Regeneration is currently at the forefront of the Government's priorities. The research shows that various sources of finance would be likely to invest in a regeneration investment vehicle provided it is suitably structured to meet their differing demands for returns and appetites for risk. An essential requirement is an expert and experienced management team. It cannot be over-emphasised that large scale regeneration is a lengthy process and any delay in implementing initiatives of this nature may impact on the delivery of institutional investment into regeneration and sustainable communities.

The research identified a number of options for a regeneration investment vehicle. However, the exact choice is determined by the objectives of the investor, the macro-economic climate prevailing and the degree of support provided by government reflecting the priority of regeneration.

In the proposed tiered structure the bond provides the first layer of regeneration finance and is complemented by a second layer, depending on the scale of the regeneration project, of private equity and long-term funding. Linkage of the vehicle to product is important. Hence, it is desirable that the vehicle complements existing and new regeneration projects.

It is vitally important that a dialogue should commence among the interested parties such as IPF, RICS and BPF, representing institutional investors, and the ODPM and HM Treasury to ascertain the level of support for direct government involvement in a regeneration investment vehicle. The dialogue should extend to include representatives of local authorities, Regional Development Agencies and English Partnerships to ensure support for the initiative, as well as to identify regeneration opportunities. While central government support is essential, the engagement of local government and public sector agencies cannot be understated. In addition, the dialogue should also extend to developers to assist them in identifying regeneration opportunities at the appropriate scale to enable the implementation of a regeneration investment vehicle.

The proposals for REITs under the 2006 Budget and their introduction in 2007 with the likely growth in REIT products raises the potential for significant institutional investment into regeneration over the longer time horizon. The benefits of Tax Incremental Financing in the remediation, infrastructure or development phases of regeneration should be fully researched.

The dialogue should commence as soon as possible in order to meet the government targets for greater and more effectively delivered private sector involvement in the financing and implementation of regeneration and sustainable communities. To this end a pilot project of an appropriate scale, say in the Thames Gateway, should be identified to examine the feasibility and implementation of the regeneration investment vehicle on the ground.

The UK government is increasingly seeking to ensure greater involvement of the private sector in the financing and delivery of regeneration and sustainable community targets (Urban White Paper, 2003: Miliband, 2005). However, the scale of institutional capital targeted towards the regeneration process is limited. This is a particular concern where major regeneration schemes such as Thames Gateway will manifestly require enhanced participation by institutional investors. To achieve stronger institutional involvement, the public sector is being encouraged to take on a more strategic role, which creates confidence for the private sector to invest. However, the success of such an approach depends on meaningful engagement between the public and private sectors and with the financial institutions in particular.

A criticism of past regeneration initiatives and policies is that all too often they are seen as public sector driven with the aspiration that the private sector will follow through the use of incentives such as grants and tax breaks. However, the dialogue or absence of dialogue between government and the financial institutions means that the weight of institutional capital in the regeneration process was limited and effectively employed. This is worrying when the delivery of major regeneration schemes such as Thames Gateway will require enhanced engagement by institutional investors.

The financial institutions are major players in the UK capital market, controlling assets in excess of £1,500 billion. Research into the size and the structure of the UK commercial property market has estimated that at the end of 2004 the value of the total stock of commercial property was £611 billion of which £489 billion is investment grade. The value of commercial invested stock stood at £265 billion of which £254 billion is in the core sectors (Key, 2005).

The engagement of the institutions in financing regeneration is central to this research, which addresses the conditions necessary to attract institutional finance into regeneration schemes. The research does not limit its scope to conventional property involvement but takes a cross-asset perspective involving other investment classes namely equities, bonds, private equity, securitised vehicles and others. In this respect the research moves beyond the existing question of involving institutions in property investment to potentially more strategic issues related to infrastructure and other opportunities within regeneration.
Central to the study is an understanding of institutional requirements, namely, their expectations of asset returns over a three to five year time-cycle and longer term horizons, how investors perceive the packaging of returns, understanding their risk tolerances, the nature of security they require, alternative financial models and market testing.

The aim of the research is to understand the needs of investing institutions and to identify the likely constituents of a working model suitable for encouraging institutional investment and bank finance into regeneration schemes. The research adopts a cross-asset perspective (property, bonds or fixed income, equities, private equity, hedge funds and alternatives), enabling an understanding of both the asset allocation decision-making process and the criteria used in the investment selection procedure of respective asset classes. By considering the views of decision makers, a profile is constructed of the factors and inputs necessary in designing a regeneration investment vehicle that would prove attractive to the financial institutions.