Institutional Investment in Regeneration: Necessary conditions for effective funding

January 2006

Executive Summary

This research was commissioned by the IPF and IPFET with joint funding with BPF, BURA and English Partnerships

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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.

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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. They gratefully acknowledge the contribution from the Chairman - Phil Clarke (Morley) 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).

Disclaimer

Introduction
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/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 jointly 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 fully engage 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 emphasis 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.

This report is the executive summary and is published prior to the completion and publication of the full research findings, which will be available as a separate report from the IPF (contact details below).

The IPF, BPF, BURA and English Partnerships invite comments on the findings. Please address comments or suggestions to Charles Follows, Research Director, IPF, 3 Cadogan Gate, London SWIX 0AS. cfollows@ipf.org.uk 020 7695 1649

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1. Setting the Investment Context

The Government is increasingly seeking to ensure greater involvement of the private sector in the financing and delivery of regeneration and sustainable community targets[1]. However, the scale of institutional capital targeted towards the regeneration process has been limited. This is a particular concern where major regeneration schemes such as Thames Gateway and many others will manifestly require enhanced participation by institutional investors.

The engagement of the institutions in financing regeneration is central to this research which seeks to address 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; 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 investment requirements; their expectations of asset returns over a three to five year timeframe and over longer-term horizons, how investors perceive the packaging of returns, assess risk and the nature of security they require; the scope for alternative financial models.

Institutional investors seek to match their assets with their liabilities. These may vary depending on the nature of the institution whether it is a pension fund, insurance company, bank or other investment fund. Hence to achieve a portfolio that gives optimum diversification of intra-asset risk, institutions will spread allocations across different asset classes, e.g. with contrasting risk/return characteristics, transparency and liquidity opportunities.

[1] Miliband, D (2005) *Power To Neighbourhoods: The New Challenge For Urban Regeneration*, Speech by The Rt Hon David Miliband, BURA Annual Conference, 12 October 2005

The characteristics of the principal asset classes are summarised in Table 1.

Table 1: Asset class characteristics

Asset class/type of fund	**Return**	**Risk**	**Liquidity**	**Transparency**	**Holding period**
Gilts	Low	Low	High	High	Long
Corporate bonds	Medium	Medium	High	High	Long
Property	Medium	Medium	Low	Low	Medium/Long
Equities	High	High	High	High	Short/Medium
Private Equity	High	High	Low	Low	Short/Long
Hedge Funds	High	High	Low	Low	Medium/Long

2. Features of Regeneration

Regeneration as a concept has too often focussed on the perception of halting decline rather than emphasising the positive aspects of renewal and investment potential. Different definitions of regeneration have been used depending upon particular perspectives. One definition that received wide acceptance in the mid-late 1990s is the process of reversing economic, social and physical decay in our towns and cities where it has reached that stage when market forces alone will no longer suffice[2]. However, regeneration is dynamic and more appropriate definitions for the present decade are concerned with raising value, creating sustainable communities and developing innovative ways of attracting private investment.

The analysis presented in this research is based on the contention that regeneration is a process consisting of three distinct but overlapping phases: remediation/infrastructure provision, development and investment (Table 2). While the phases mirror the wider urban land development model, there is added complexity within regeneration arising from the location of sites, primarily in inner city areas, the secondary nature of sites from a property market perspective, the perceived adverse impacts of neighbouring land uses and associated social and environmental problems. These negative characteristics often result in higher costs compared to the development of greenfield sites and have (in contradiction to investment theory) fuelled the perception of lower achievable returns for higher levels of added risk.

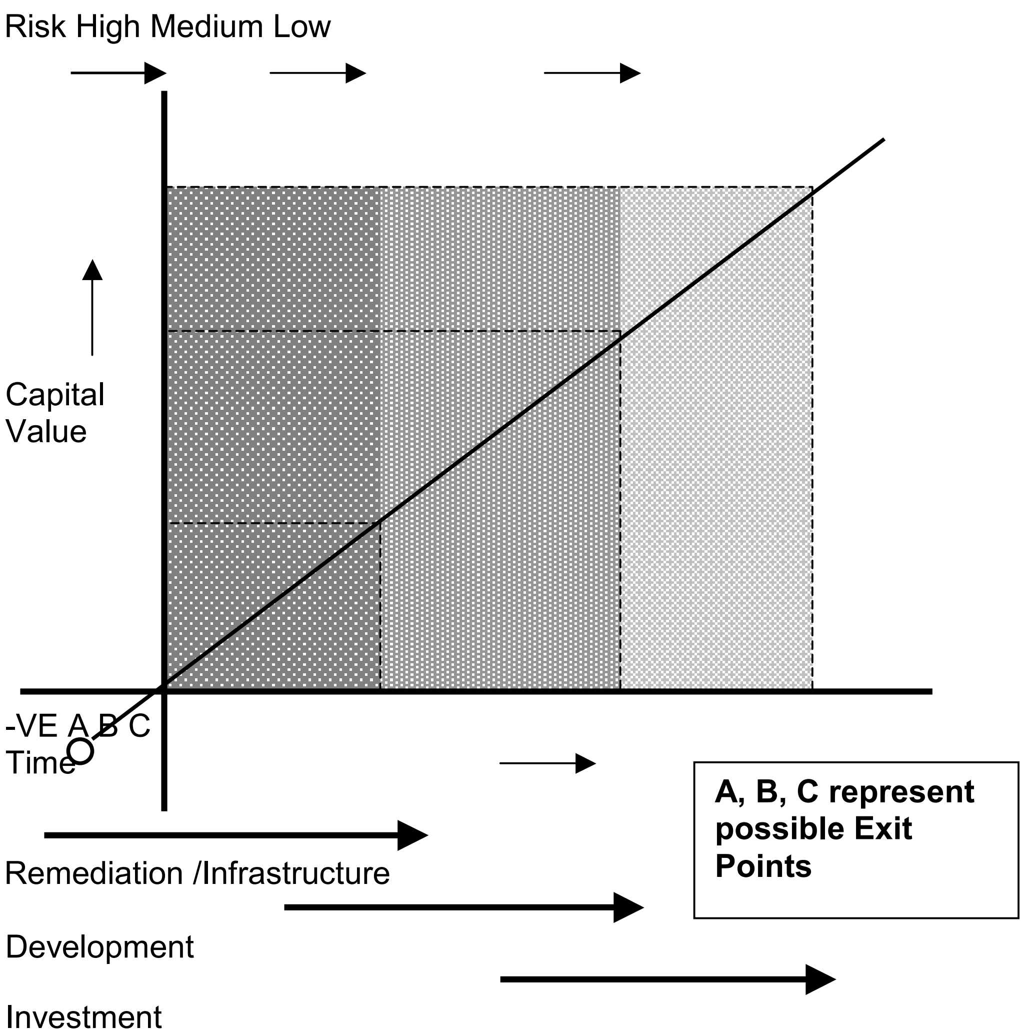
[2] Adair, A.S., Berry, J.N., Deddis, W.G., Mc Greal, W.S., Hirst, S.M. (1998) *Accessing Private Finance; The availability and effectiveness of private finance in urban regeneration*, RICS Research, London.

Table 2: Institutional involvement in the three phases of regeneration

Regeneration phase	Main activity	Characteristics	Institutional involvement	Funding options
Remediation / Infrastructure (2 to 5 years)	• site assembly • site remediation • freeing-up development potential through infrastructure	• high cost • high risk • potential for high return • major uncertainty over end value • low liquidity • low transparency • medium timeframe	• some investment from direct/indirect property allocations • some institutional activity through bond issues	• Higher yielding or 'protected' bonds • Indirect property investment • Private equity is a possibility, but long lead time, low liquidity, nil income and uncertain capital values may not match many investors' objectives. • Bank finance
Development (2 to 5 years per phase)	• construction of the property asset • letting of the property to tenants	• debt-financed • high risks especially at early stage • potentially high return • lack of income stream • uncertain capital values • low liquidity • low transparency • short-medium timeframe	• bank-lending dominant • limited institutional involvement although some investment from direct/indirect property allocations	• Direct property investment • Indirect/direct property investment • Private equity • Bank finance • Bonds
Investment (2-5+years until re-development of asset)	• sale of occupied property asset into the established investment market • holding of developed property	• secure revenue streams • capital value growth • lower risk • returns above bonds • diversification benefits • liquidity dependent on vehicle structure • transparency dependent on vehicle structure • medium/long timeframe	• main entry point for many institutions • under-weight in regeneration property	• Quoted equity • Indirect/direct property investment (incl. REITS) • Private equity

Each phase of the regeneration process has distinct characteristics within the overall risk-return continuum (Figure 1); from the remediation/infrastructure phase, characterised by high levels of risk but with the opportunities for high returns, to the investment phase at the other end characterised by lower risk and corresponding lower levels of return, with secure revenue streams and more predictable capital values resulting from the occupied development entering the property market. Intermediate points include the potential risk of an unfinished building through to the completed building remaining unlet, lacking an income stream, having uncertain capital values and not being taken into the established investment market. In compensation for these risks, the developer expects higher return. Over time the liquidity of the regeneration property asset increases (Figure 1) with exit points based on predetermined valuation dates or market drive.

Figure 1: Regeneration phases and risk profiles



This research has not considered the planning regime directly. However it is clear that many of those interviewed during the research feel that a simple and clear planning process was a major element in successful regeneration. Planning uncertainty complicates matters and adds a further layer of unnecessary risk. Clearly extensive discussions on planning are likely to precede, or work in parallel with the remediation and development phases in our schematic of the regeneration process.

3. Identifying institutional investment opportunities in regeneration

The current situation is one of limited institutional investment across the three phases of regeneration. Traditionally what has been sourced has originated from the institutions' property allocations (Table 2). However such investment is increasingly being recognised as matching the demands of quasi-private equity. In addition there has now been some limited investment through bond issues at the infrastructure stage whereas the investment phase is the typical entry point for institutional investors into regeneration.

The property asset class has provided the strongest link between institutional investment and regeneration both through the development of new property assets and the purchase of standing investments. Currently the market offers a range of regeneration funding vehicles supported by institutional finance spanning single scheme vehicles through to vehicles supporting whole portfolios of schemes.

There are a number of recognised regeneration-oriented property investment vehicles. For example, Morley's Igloo Regeneration Fund[3] is a collective investment fund open to external institutional investors, which invests in regeneration to capture superior returns that regeneration can offer. Likewise the English Cities Partnership[4] a joint venture between English Partnerships, Amec Developments and Legal and General, is a vehicle that invests in regeneration, though the regulations of the fund specify that it can only operate in assisted areas. Both Igloo and English Cities Fund are recognised as two of the most innovative vehicles utilising private finance in regeneration, although targeting slightly different risk profiles.

The varying and overlapping risk/return profiles found across both the regeneration-related investments and the investment asset classes, should provide a range of opportunities to match different forms of institutional investor requirements with the different phases of the regeneration process for example, bank and bond finance to the infrastructure phase, equities and institutional property finance to the development and investment phases, either directly into the assets or through ownership vehicles or companies dealing with the process of regeneration.

[3] http://www.igloo.uk.net
[4] http://www.englishpartnerships.co.uk

Our empirical research suggests that investment through the different asset classes, either directly or indirectly, is already occurring to varying degrees. However, the connections are not always made and are often not entirely explicit. Extensive discussions with institutions underpin this research. The key messages emerging from our interviews with investors are:

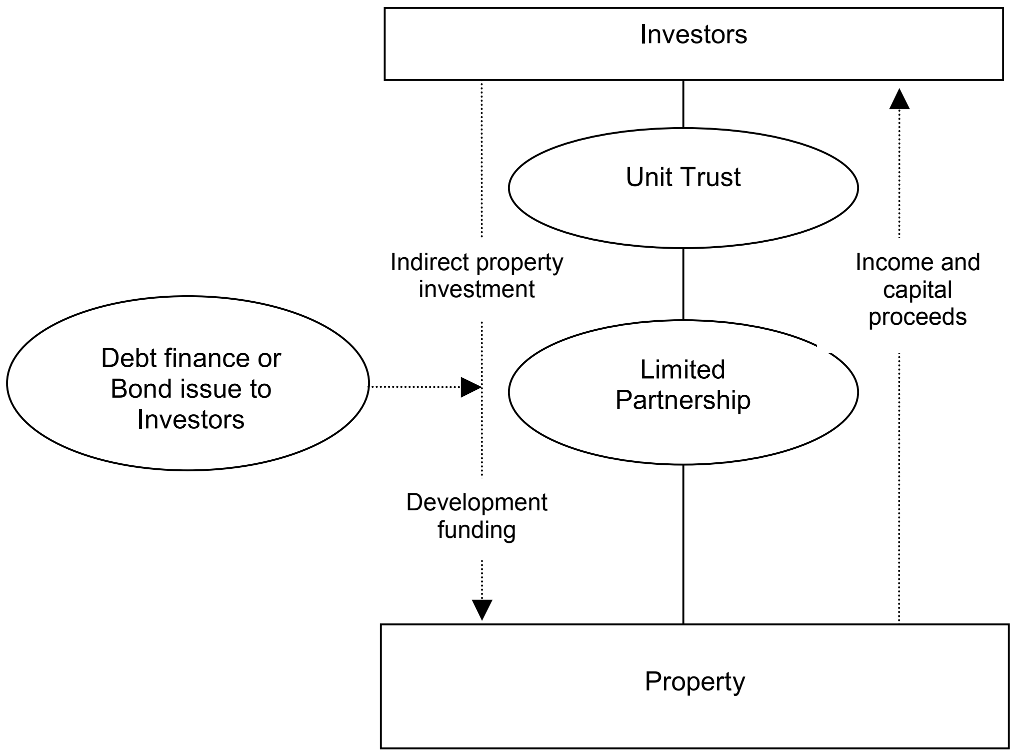
- Address the lack of understanding of the business case for investing in the regeneration process.[5]
- Acknowledge that the range of risk, return and maturity profiles across the regeneration phases offers significant diversification opportunities.
- Build upon existing links between the property asset class and regeneration as demonstrated by existing institutional regeneration funding vehicles such as Igloo and English Cities Fund. A further example is the Blueprint East Midlands Partnerships between Igloo, East Midlands Development Agency and English Partnerships.
- Adopt innovative approaches to securing future income streams from prospective assets (whether publicly or privately held) to fund the early costs of upfront remediation and infrastructure.
- Encourage opportunistic funds to become more active potential investors in regeneration.
- Package up equity investment opportunities including the potential for REIT vehicles.
- Facilitate private equity higher risk/return investment opportunities.
- Raise awareness of the SRI (socially responsible investment) characteristics of regeneration for SRI investors.
- Encourage bond investors into the infrastructure phase of regeneration, resulting in a cheaper overall cost of finance to the project.

4. Regeneration Investment Vehicle

The central question at the heart of this research was to explore the conditions and type of vehicle that would attract more institutional investment into regeneration. The present regeneration funds are typically established using tiered limited partnership and unit trust structures. Figure 2 shows this structure in simplified form. In the structure the institutional investment is made by way of subscription for units in a unit trust which in turn invests the subscription proceeds in a limited partnership. The limited partnership combines the equity subscriptions with bank debt or a bond issue to fund the development of the project. On completion of the development, net income arising from the property is distributed through the partnership and the unit trust to the investors. Net capital proceeds (arising from a disposal of the property) are distributed in the same way.

[5] Adair, A.S., Berry, J.N., Deddis, W.G., Mc Greal, W.S., Hirst, S.M. Poon,J., Hutchison,N., Watkins,C. and Gibb,k., (2003) *Benchmarking Urban Regeneration* RICS Foundation, London; Morley Fund Management, English Partnerships and IPD

Figure 2: Traditional investment vehicle structure



The key characteristics of the most commonly used co-investment vehicles are show in Table 3. The need to combine the limited partnership with the unit trust arises because the UK limited partnership suffers from burdensome transfer tax treatment (which diminishes returns, hampers liquidity and ultimately affects project viability).

The key messages from our interviews have led us to propose a regeneration investment vehicle which, from a funding perspective, allows the combination of bond and indirect property investment/private equity elements (Table 4) coupled with traditional bank debt. From a structural perspective the vehicle facilitates efficient management while offering tax efficiency, liquidity and flexibility to investors. The combined structure shown in Figure 2 has emerged as a viable fund model that can meet most of the funding and structural objectives. However, we consider that certain inefficiencies (in particular, the requirement to operate part of the combined vehicle offshore coupled with a sometimes cumbersome management framework arising from the fact that decision making takes place at various points in the structure) could be improved by the introduction of a new vehicle.

Table 3 – Typical co-investment vehicles used for regeneration projects

Investment Vehicle	Tax Treatment	Transfer Tax	Listable	Open/Closed ended	Investor Restrictions
UK Limited Partnership	Tax transparent	4% on gross asset value of underlying UK property	No	Usually closed ended	Usually limited to institutional investors or high net worth individuals
UK Unauthorised Exempt Property Unit Trust	Effectively tax-free at vehicle level	0.5%	No	Either	Only available to UK tax exempt investors (ie pension funds and charities)
Jersey Property Unit Trust	Tax transparent. Can receive and distribute UK income gross. Not subject to UK capital gains tax	Nil	Yes, but unusual	Usually closed ended	Depends on regulatory approval obtained
Guernsey Property Investment Company	Not transparent but tax liabilities can be mitigated. No UK capital gains tax at property level.	Nil	Yes, in UK and Guernsey	Closed	Open to the public (including ISAs)

This structure could have taken the form of a REIT. However, the conditions proposed under the draft REIT legislation are too restrictive to facilitate the use of a REIT for the infrastructure and development phases of the regeneration process (not least because of the proposed limitation on development exposure to 25% of the REIT's business). Without legislative change this is a lost opportunity.

As an alternative a new structure is proposed. The form of the vehicle could be in the nature of a UK based investment trust (similar to a REIT) which would benefit from tax transparency (allowing investors to be taxed on income and capital gains as though they owned an interest in the underlying property directly) and transfer tax rates comparable to that applicable to equities to encourage investment and a liquid market. The scope of permitted activities of the vehicle would be sufficient so as to allow the development of and investment in "qualifying" regeneration projects. The vehicle would secure finance from banks and investment from fixed income (bonds) and property institutions in order to invest across all phases of the regeneration process. In effect a number of regeneration investment vehicles should be set up operating on a project by project basis.

Table 4: Elements and potential parameters of a regeneration investment fund

Bond Element:	**Purpose of raising up front capital** **Possibility of linking to PFI-type infrastructure projects**
Bond rating	Investment grade
Issuer/ Covenant strength	Various options including Govt backed/LA backed/credit enhanced/insurance wrapper applied
Holding period	20+ years (to allow for development)
Pricing/risk premium	Gilts + 60-110bp
Liquidity	Trade able
Payment of coupon	Fixed or variable coupon
Benchmarking	Against gilts
Fund size	Minimum £200 million per issue
Gearing	Balance from private equity and bank borrowing
Return requirements	Govt backed - LA gilts + 1-2%/PFI projects gilts + 3%
Indirect Property Investment/Private Equity Element:	**Purpose of funding development phase – capital gain & income** **Higher risk and higher return**
Holding period	Rolling 3-5 years in the case of private equity; longer in the case of indirect property investment
Fund size	Minimum £100 million
Return requirement	Mid-teens +IRR
Possible structure	Combination of existing or new co-investment vehicles
Liquidity	Limited
Benchmarking	Absolute returns
Exit strategy	Sell to new investor
Long-Term Funding Element:	**Comparable to direct property investment**
Pricing	NAV of scheme would dictate price
Exit strategy	Exit points at any time

The bonds component of the financing could take a number of forms, ranging from conventional issues (wrapped or unwrapped) secured on the schemes to Government-backed issues funding infrastructure. There is also an opportunity to issue bonds with returns linked to an IPD index or to the value of the underlying scheme.

Our research shows that the 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 will be an expert and experienced management team.

Regeneration is currently at the forefront of the Government's priorities. At this time our evidence shows there to be a substantial weight of institutional money that could be attracted into regeneration. This research is recommending a regeneration investment vehicle as an attractive means of delivering more institutional finance to meet the Government's sustainable community targets. It is vitally important that a dialogue should commence among the interested parties to develop this idea and deliver institutional investment into regeneration.

Methodology

The research adopted a cross-asset class examination involving key institutional investors to determine the components of a model to encourage institutional investment into regeneration. This summary synthesises the key issues from matters discussed and evidence presented at the structured interviews with fund managers and debated at three workshops capturing public and private sector perspectives

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