IPD REGENERATION INDEX

AUTUMN 2009

EXECUTIVE SUMMARY

- Despite worries over funding and concerns that many new regeneration schemes have become unviable in the current economic climate, this survey shows that regeneration property is surprisingly resilient and hasn't significantly underperformed in comparison to the IPD All Property average.

- Some sectors, notably offices and industrial, have performed better than the IPD universe. It is regeneration retail that drags down the performance of the sector. Small, local 'high street' retail units in the regeneration sector cannot compete with the recent performance of shopping centres and retail warehouses but it would also appear that, where 'big-box' retail-led regeneration has occurred, it has underperformed relative to the industry average.

- The best potential for outperformance has been where smaller-scale schemes within mixed-use regeneration has occurred. In these cases, residential value uplift, both on and off site, can be a powerful value generator. The capture of this value uplift over the longer term could be a powerful investor motivator and a potential source of regeneration funding.

- If the incentive to participate in the longer-term investment returns of regeneration property can be captured and translated into new forms of development finance, there may be hope that mothballed schemes can recommence in the near future.

REGENERATION AFTER THE CREDIT CRUNCH

While recession continues to hold back property demand and investment performance, property development is further impaired by the lack, and cost, of debt finance. This has hit all development – commercial, residential and mixed – and it looks as if it will be particularly protracted on large, complex sites.

There are some signs in the residential sector of developer appetite returning for very small 'oven-ready' plots that can be easily financed with relatively small amounts of equity but virtually any site that requires longer-term and costly promotion and infrastructure remains mothballed. In the case of regeneration sites, the particular complexities that require intensive capital investment prior to build-out and marketing mean that they are amongst those least likely to be brought forward unless long-term alternatives to debt finance can be found.

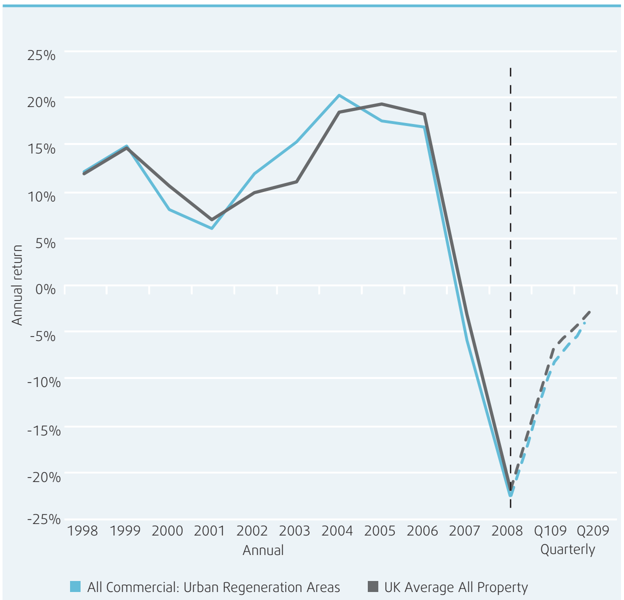
If equity funding of development by investors becomes a more commonplace alternative to regeneration finance, this means that the longer-term investment performance of regeneration property will be an important issue in encouraging funding of development in the future.

It is against this backdrop that the 2009 Regeneration Index is issued. The implications for the future of regeneration projects are at the forefront of our analysis. The conclusions drawn are that, in the field of regeneration, considerable change is needed in the way the property industry and its funders operate. This is particularly the case at the boundaries between investment and development, short-term holding and long-term holding and the boundaries between different property types, including residential.

Regeneration property holds its own

All commercial property, taken as a whole, in regeneration areas has shown itself to be broadly as vulnerable to the wider market downturn as other types of investment property. The total return for All Commercial regeneration property was -22.6% in 2008, compared with -22.1% for the IPD All UK Property average (Figure 1). That regeneration property returns are now closely tracking those of the UK average in the last year suggests that the wider property downturn has affected all segments of the property world more or less equally. However, these averages disguise sectoral variations.

Figure 1 – All Property annual returns



Source: IPD

Analysing only commercial property, the investment returns strongly suggest that regeneration property needs to be a longer-term hold. In all but the longest time frame regeneration areas have underperformed the UK average (Figure 2). Annual returns in 2008 were below -20%. During the first two quarters of 2009, returns across all groups remain negative, but improved significantly. Five year returns stand at -5.3% for regeneration areas, and -3.9% for the All Property average. Over 10 years, however, regeneration areas compete head-on with All Commercial property. Returns for the regeneration areas and the UK average are close, at 7.2% and 7.5% respectively.

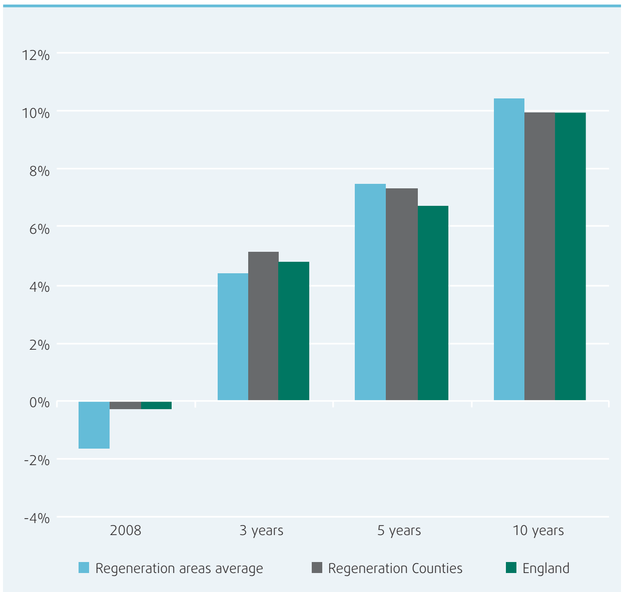
Figure 2 – Average medium and longer-term total returns for All (Commercial) Property

Source: IPD

Residential is a big value-generator

Residential property is an important component of most regeneration projects, making significant contributions to overall regeneration returns, through development, and to a lesser extent, rental investment. During 2008, residential property in regeneration schemes underperformed relative to the counties in which it was located (Figure 3). This has also impacted the three-year average, with capital growth now below that of both the wider regeneration counties, and England as a whole.

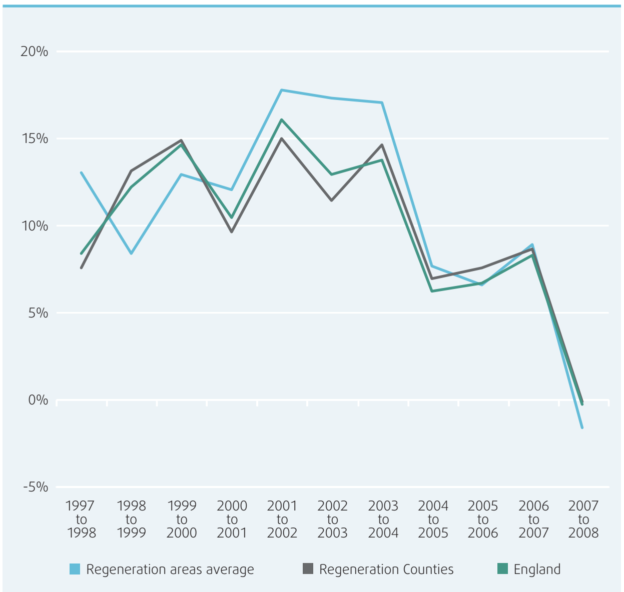
Figure 3 – Short, medium and longer-term Residential capital growth



Source: Land Registry / Savills

Volatility characterises capital value growth of residential property in regeneration areas (Figure 4). While over the longer-term, residential regeneration property outperforms surrounding, non-regeneration areas, in the short-term, it is highly sensitive to wider market conditions. The downturn in the residential property market has affected worst those locations which are less established, in particular with high-flatted supply – a characteristic of regeneration areas. With investor appetite for city centre flats diminished, particularly for those in areas without a track record in the market (i.e. regeneration schemes), residential regeneration property capital values have suffered.

Figure 4 – Residential capital value growth



Source: Land Registry / Savills

Regeneration schemes are long-term endeavours, typically with 10 to 20-year time frames. It is therefore useful to analyse regeneration areas according to how much of the regeneration has actually taken place. We have therefore looked at performance by the extent of completion (Figure 5). This is a new piece of analysis that first identifies each regeneration scheme in the Index and then assesses the extent to which it is complete. Areas are assessed as to whether they are:

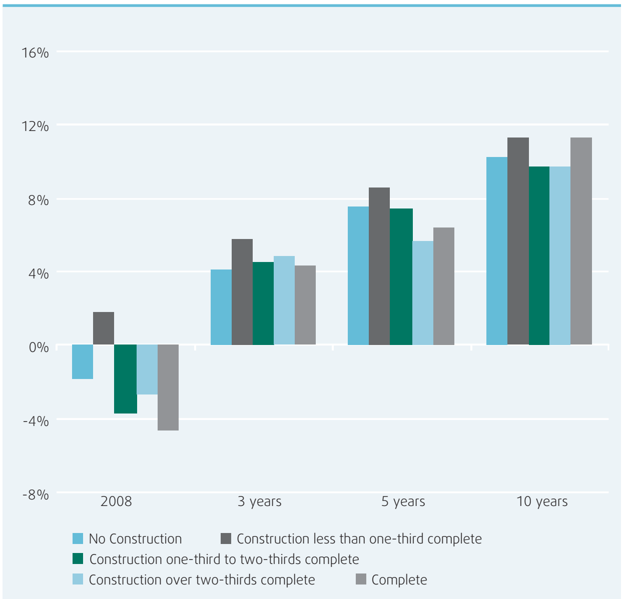
a) Fully complete
b) Over two-thirds complete
c) Between one-third and two-thirds complete
d) Less than one-third complete
e) Construction has not started

It is telling that regeneration areas where construction is at a relatively early stage (less than one-third complete) carry the strongest capital growth. It would appear that expectation of improvement is sufficient to move residential property values. Speculative investment and off-plan sales are usually high in this initial period, where initial construction marks commitment to the scheme and a tangible presence is established.

Residential property in completed regeneration schemes has fared particularly poorly in the property downturn. These city centre markets, formerly under the reign of regeneration programmes, such as Canary Wharf, Manchester and Leeds, have been plagued with oversupply of high density flatted schemes. The market could tolerate this in buoyant times, but as confidence has waned, the markets have become more reliant on needs-driven purchasers, most of whom require family houses rather than investment flats so these less-established markets are the first to suffer. Questions may therefore be raised over the sustainability of regeneration schemes based on the traditional flatted model, reinforcing the need for an integrated, placemaking led-approach with finely grained and broad ranging property types and supporting services.

Having said this, it looks as if residential property in regeneration areas (and indeed more widely) remains an untapped source of potential investment growth, particularly over the medium to long term. The challenge is establishing ways to capture value uplift seen in the existing second-hand stock, as well as from the new build, for which regeneration acts as a catalyst for growth.

Figure 5 – Growth by level of scheme completion



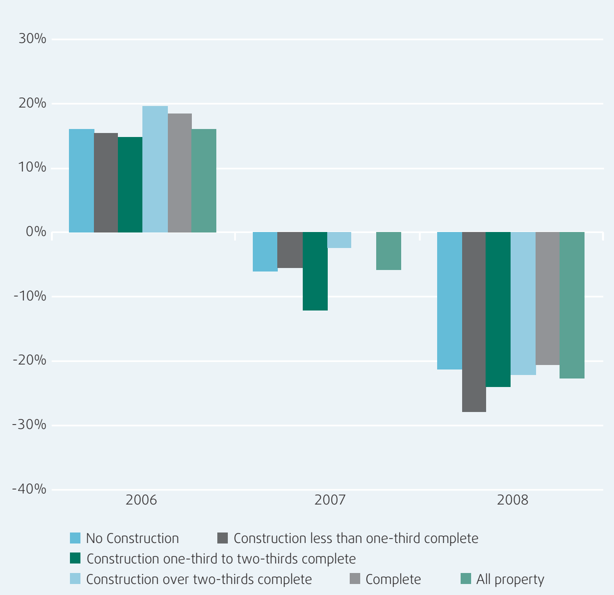
Source: Land Registry / Savills

Completed placemaking pays off for Commercial

In the case of commercial property, the story on performance prior to completion is different. Commercial property on completed regeneration schemes has outperformed assets in other phases as well as the All Property (in 2008).

Returns improve moving from the 'Construction one-third to two-thirds complete' phase to the 'Completed' phase (Figure 6). Newly completed regeneration commercial property would appear to exhibit superior qualities to most standing commercial property investment. This analysis does perhaps highlight the riskier nature of regeneration investment in the sometimes lengthy phases pre-completion.

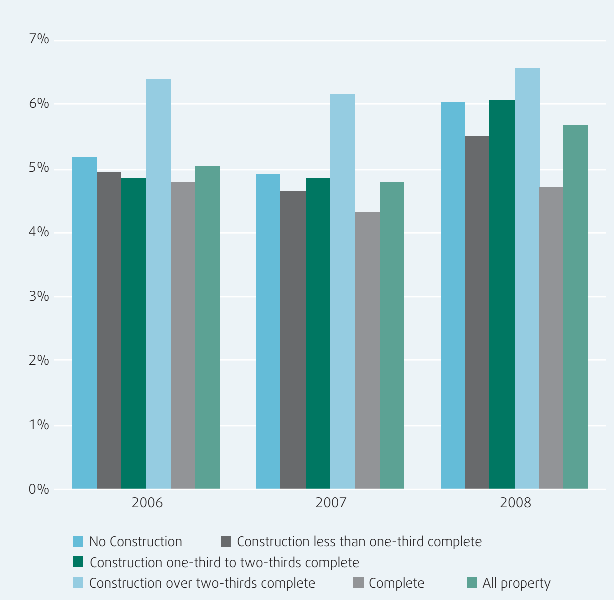
Figure 6 – Total returns by level of completion



Source: IPD

The nature of returns on regeneration looks different to standing portfolios. The level of income return is significantly lower for the properties in the completed regeneration schemes than elsewhere (Figure 7), this may well be due to the lease incentives needed when a location or scheme is not yet established. Clearly, such incentives, if successful, will create potentially attractive income reversions in the future.

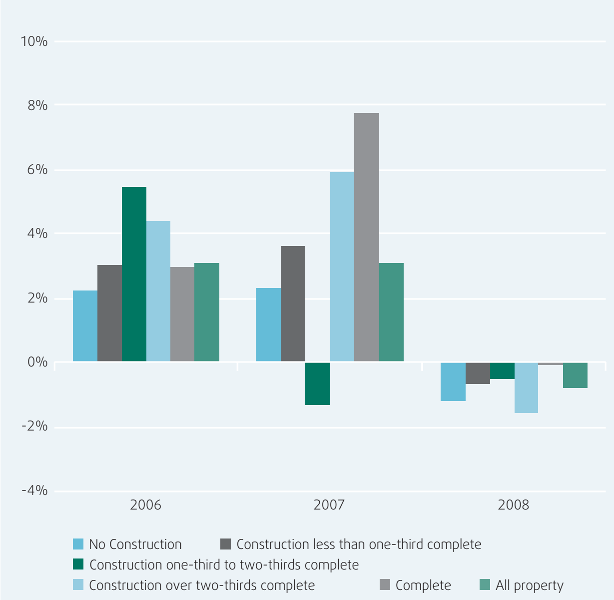
Figure 7 – Income returns by level of completion



Source: IPD

In 2008, yields moved out significantly across the board, reflecting the property downturn more broadly. Not surprisingly, yields paid are higher in earlier stages of development, reflecting uncertainty. Schemes appear to be at their most vulnerable in the later stages of construction, just prior to completion.

Figure 8 – Rental growth by level of completion



Source: IPD

In 2008, schemes at all levels of completions were distressed, and in turn rental growth suffered across the board (Figure 8). What is of note is the change in balance of rental growth from 2006 to 2007. While in 2006, schemes with construction well under way, but not yet complete, experienced the best rental growth; by 2007 this had shifted primarily to complete schemes. The stability of complete schemes offers the best returns in a less stable market.

It is important to remember that in measuring returns by completion stage, we are capturing the effects of regeneration on standing investments in that area. The results show that when regeneration has completed in these areas, it has a positive impact on the capital values on held assets in its vicinity. This shows how placemaking and regeneration of one localised area can 're-make' a much wider local area. The wider area benefits from value uplift when regeneration projects complete.

DIFFICULT ISSUES

FOR REGENERATION LAND

Savills' monitoring of development land values in the UK has shown that development land values are now at less than half their peak 2007 value, with the market for 'bulk land' all but dried up. Scarce and expensive debt funding has fundamentally changed the way in which the development land market works and is set to have a long-term impact on the players operating within it. The challenge is even greater in regeneration areas, where proven, established schemes are limited, costs of remediation are high, and spending required on infrastructure is significant. However, in this environment, the long-term view taken by regeneration agencies may in turn yield their greatest opportunities.

Regeneration schemes, by their nature, typically consist of large tracts of contaminated land. Often former industrial sites, docks, transport sidings, or derelict urban areas, their land does not convert easily into residential and commercial use. Under the current 'trader' model it is difficult to see how these large, complex and expensive brownfield sites can be brought forward, when debt funding is hard to come by for even the most viable schemes.

In this context, activity of developers and mass housebuilders is likely to focus on low-risk sites for fast cash flow. Demand will see a shift to small, readily developed sites with planning permission, and serviced plots for houses rather than flats. This is a mismatch to the current offering from regeneration agencies, of large tracts of bulk land, and sets the scene for change in the regeneration development landscape.

Regeneration agencies will need to consider parcelling up their land and installing infrastructure to provide fully serviced plots. Those who have the foresight to work on the raw material within their portfolios now will be better placed to have a product available that would capture industry demand associated with future recovery. This is particularly critical to those regeneration projects in the north of England where some of the largest schemes are located, which is set to lag a recovery led by the south east.

The higher-cost, lower-demand markets which characterise regeneration areas will take some time to recover to viability, within the conventional land trader development model. It is these sites that will benefit most from a long-term placemaking approach, where the property is retained over a longer period and either retained in a form of co-ownership or gradually released as serviced sites in a phased manner. Such an approach will reap the benefits of early investment in place, via high quality layout, infrastructure, mix of uses, and public realm. The long-term view of regeneration agencies, combined with their focus on wider social and economic improvement, makes this group well-placed to adopt the placemaking methodology.

Commercial regeneration investment pays off

If a mixed approach to regeneration development is needed in order that residential investment on site and in surrounding areas works, then the performance of the commercial elements need to stack up too.

Happily, it would appear that investors have not lost faith with commercial regeneration property. Yields in urban regeneration areas and the UK average are tracking each other closely (Figure 9). The recent willingness of investors to pay slightly more for income streams which, at over 7% look highly attractive next to alternative investment classes, means that yields have moved in during 2009 for regeneration property as well as the All Commercial property universe.

Figure 9 – 10-year movements in initial yields

Source: IPD

Commercial rents have not fallen as far in regeneration areas

This confidence doesn't look misplaced. Rental value growth in regeneration areas is historically less volatile the UK average, and in 2008 outperformed, with -0.6% rental growth compared to -1.2% for the All UK Property average (Figure 10), a trend that continued into the first half of 2009. This reflects the nature of the stock in regeneration areas. A significant element of the stock is small retail units, small and tertiary industrials and small and tertiary offices. These properties have an advantage in being cheap and therefore appeal to a wide and diverse range of potential users, not reliant on one occupier or industry. Consequently, void periods are low since the demand base is so wide. It is the 'big box' properties, less common in regeneration areas, that have suffered.

Figure 10 – Rental value growth

Source: IPD

Capital growth has slightly underperformed

Regeneration property showed excess capital growth between 2001 and 2005, but has since slightly underperformed IPD All UK Property (Figure 11). This suggests that it has been easiest to add value in the middle of the cycle, but more difficult towards the end of the cycle.

Figure 11 – Capital growth

Source: IPD

Some offices have outperformed

The office sector stands out as the property type in regeneration areas that has outperformed the UK average over the short, medium and long-term (with the exception of the most recent quarter). Total returns in regeneration areas were down -19.4%, compared to -22.4% UK average in 2008 (Figure 12). Over 10 years, returns were 8.3% to 7.1%. This probably reflects the higher and more reliable income returns from the small tertiary properties with a wide range of tenants. Such a diversity in an office portfolio comes into its own in an economic downturn.

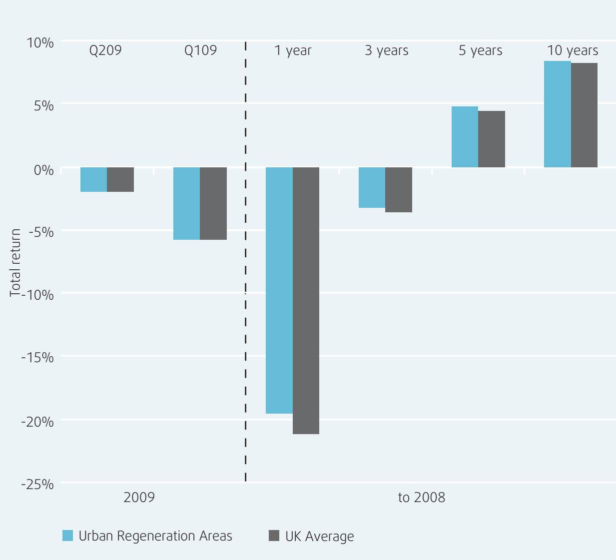
Figure 12 – Office property total returns

Source: IPD

Industrial properties have outperformed

Industrial property in regeneration areas, like offices, also appears to perform better than the UK average in the short and long term (Figure 13). As with offices, this may be because the properties themselves are more likely to be tertiary in regeneration areas and priced/pitched accordingly. As markets have turned down, standard industrials in regeneration areas have held up better than the 'big box' distribution warehouses in the same locations.

Figure 13 – Industrial property total returns



Source: IPD

Retail underperforms

Retail property in regeneration areas has underperformed the UK average across all time periods (Figure 14). This is due in part to the high weighting of standard retail properties in the regeneration portfolio, which have seen much lower capital growth (not just in regeneration areas) than shopping centres and retail warehouses. The residual underperformance not due to differences in retail mix may also suggest that perhaps the 'big box' retail-led regeneration schemes are less successful than those with a more diverse and small-scale retail and commercial offerings.

Figure 14 – Retail property total returns

Source: IPD

CONCLUSION

This year's Regeneration Index has painted a picture of surprising resilience in regeneration investments. The longer-term incentives for investment in regeneration products are not impaired. What is an issue is the shorter-term debt funding for regeneration.

If the incentive to participate in the longer-term investment returns of regeneration property can be captured and translated into new forms of development finance, there may be hope that mothballed schemes can recommence in the near future. This is a tall order for an industry distinguished strongly between development and investment and that employs very different agencies and corporations in each phase.

A few pioneers have a decade or so experience in combining the finance of land promotion and development through to ongoing standing investment in their schemes. The results of this analysis suggests that by extending the investment and land-owning remit to surrounding residential properties and by retaining at least some degree of ownership in built residential, the longer-term returns from regeneration property presents a prima facie case for investment.

The challenge facing the future of the industry is that this investment is capital-intensive and non-income producing for a significant period at the outset of a scheme (at point of infrastructure provision for example). Investors and policy makers need to be aware of the nature of long-term cash flows from regeneration investment in order to create the right vehicles for their promotion. This is a tall order for the property industry but not out of reach for those willing to do things slightly differently in the new era of constrained credit.

ABOUT THE INDEX

The IPD Regeneration Index was created by IPD, Aviva Investors, and the HCA seven years ago and was later expanded to include a residential view with the support of Savills. The Index was originally conceived to discover whether the property investment world's traditional adversity to regeneration locations was justified or whether the industry was missing an opportunity by tending to avoid regeneration areas.

This year's Index, based upon data from 2008 and the first half of 2009, captures the full impact of the economic downturn. The analysis suggests that regeneration areas are more affected in the short-term by wider market conditions, although it is equally clear that investing at the right point in the cycle in regeneration areas is an astute thing to do.

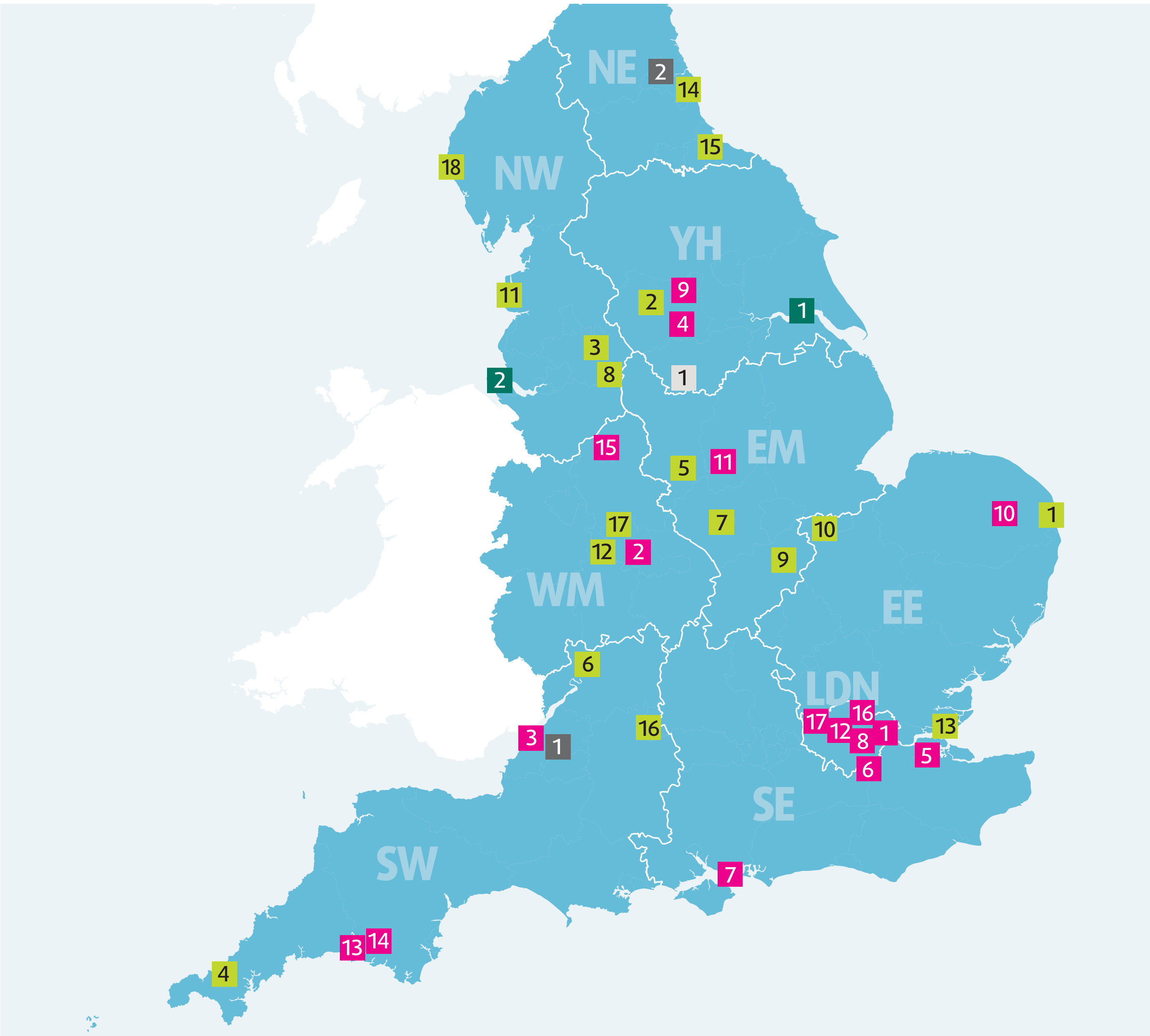
The data presented has been compiled by IPD from their universe of standing investment properties in regeneration areas – see Methodology on page 14. These areas typically cover the fringe of major towns and cities' central core. Although some of these areas have had active regeneration programmes for only a couple of years, others have been subject to more long-standing regeneration initiatives where the property has become part of prime locations due to the success of the regeneration.

We continue to develop the Index. This year we have added more regeneration areas into the sample, with the aim of making it more representative of the sector. We have also introduced a new level of analysis based on scheme completion. This has proved particularly revealing of the stage in the regeneration development cycle where the greatest returns are had.

Sample

This 2009 Index covers the period to the end of H109 using an extended sample to 40 regeneration areas – see map opposite. The research covers all those areas where there are current regeneration programmes and includes URC areas in England.

The analysis includes all the properties in these areas where IPD has a record for commercial performance. However, for the residential performance measure we included all residential property in all postal sectors these URCs belonged in order to capture the wider impact of these regeneration initiatives.



Regeneration areas covered in the Index

Urban Regeneration Companies

1 1st East, Lowestoft and Great Yarmouth
2 Bradford Centre Regeneration
3 Central Salford
4 CPR Regeneration, Cornwall
5 Derby Cityscape
6 Gloucester Heritage
7 Leicester Regeneration Company
8 New East Manchester
9 North Northants Development Company
10 Opportunity Peterborough
11 ReBlackpool
12 RegenCo (Sandwell)
13 Renaissance Southend
14 Sunderland arc
15 Tees Valley Regeneration
16 The New Swindon Company
17 Walsall Regeneration Company
18 West Lakes Renaissance

City Development Company

1 Creative Sheffield

Economic Development Companies

1 Hull Forward
2 Liverpool Vision

Former Urban Development Corporation Areas

1 Bristol
2 Newcastle

Other Major Regeneration Areas

1 Ambition for South Dagenham, London
2 Brindley Place, Birmingham
3 Bristol Harbourside
4 Central Wakefield
5 Chatham Maritime and St Mary's Island
6 Greenwich Peninsula, London
7 Gunwharf Quay, Portsmouth
8 Isle of Dogs, London
9 Leeds City Centre
10 Norwich City Regeneration
11 Nottingham Regeneration Limited
12 Paddington Basin, London
13 Plymouth Docks
14 Plymouth International
15 Stoke City Waterside
16 Stratford City, London
17 Wembley Regeneration, London

METHODOLOGY

Commercial performance

The data presented has been compiled by IPD from their universe of standing investment properties. They are held by a large number of various investing institutions, companies and other property-owning organisations. The analysis is based on 565 standing investment properties in regeneration areas with capital value of £5.71bn, using a sample of regeneration areas – see map on page 13.

The sample is dominated by retail, which accounted for two-thirds of total capital value at H109. There are no regional shopping centres, or major retail parks in the regeneration sample. Offices accounted for just 15% of the total value, reflecting the historic difficulties of regeneration areas in attracting financial and business services companies.

All the performance data has been compiled in accordance with IPD's standard definitions and conventions and is fully comparable with IPD's other series. For more information please visit www.ipdglobal.com. The Rest of UK is all of the UK outside London, the South East and Eastern regions, as defined by Communities and Local Government.

Residential performance

The residential performance measures show capital value changes only. These measures are compiled by Savills from Land Registry data of residential property within all postal sectors of regeneration areas. These results are compared with residential property capital growth in the rest of England, excluding London and the South East and then again with all residential property in the relevant counties in which each regeneration area falls.

The counties are, therefore, areas more directly comparable with the regeneration areas themselves than national benchmarks. The sample areas are defined more clearly as:

- Regeneration areas – all residential property sold and recorded by the Land Registry between 1997 and the end of 2008 and located in the same regeneration areas used for IPD's non-Residential property performance analysis.
- Regeneration counties – all residential property sold and recorded by the Land Registry between 1997 and the end of 2008 situated in the geographic counties in which the regeneration areas are located.
- England – all residential property sold and recorded by the Land Registry between 1997 and the end of 2008 in England.

The capital value performance measure compiled from the Land Registry data provides a comprehensive measure of residential capital value movements as it is based on transaction data for all residential property. This differs from IPD's Residential Investment Index measure which is based only on residential investment properties let on modern residential leases, with the capital value growth measure based on annual valuations rather than transactions. As a result, the Index sample would have been too small to allow any meaningful analysis at regeneration area level.

WHAT IS REGENERATION?

Regeneration is hard to define. The word means different things to many different people. In the main, regeneration refers to the act of transforming places – be they places where people live, work or socialise. A generation of experience appears to have taught us that big one-off projects do not change lives. These days it is commonly accepted that regeneration is about whole areas or neighbourhoods, involving a number of projects within focussed geographic boundaries. Even where the regeneration process is led by the private sector, there is always (eventually) some sort of clear public sector recognition of the target area, either in local planning or in the bending of public funds. Beyond such basics, however, there is little consensus about the best means of achieving transformation of places. This is because regeneration now covers a very wide range of activities – physical, economic and social.

The inputs encompass a massive range of investments in transport, civil engineering, land remediation, property development and construction, business formation, social welfare, community infrastructure, skills training, cultural and heritage development and housing. There are an incredible number of potential players, each with their own agendas.

For public policy makers, regeneration areas (or the people living in them) have priority needs caused either by market or social failures. For the private sector, on the other hand, regeneration areas may primarily be viewed as places of opportunity. It takes good leadership to marry together the many divergent interests. So, the final hallmark of modern regeneration is a dedicated body to lead the process. For all the effort that goes into regeneration, therefore, it should be easy to recognise success. But proof of the benefit of regeneration is notoriously hard to come by. This is where the IPD Regeneration Index can help.

We devised the Index to measure property values, just one of the many factors at play in regeneration areas. We have focussed on some of the former Urban Development Corporations and Urban Regeneration Companies – and their recent successors, City Development Companies and Economic Development Companies. These bodies are, or have been, charged with managing regeneration areas and are partnerships between public and private partners.

The Index includes regeneration initiatives led by private sector companies, where they have plans for long-term multiple sites and also have responsible delivery teams working within boundaries agreed by the local authority. We do not pretend that the Index reflects all the dynamics involved in regeneration, but property values matter a lot to the well-being of an area and we think it is worthy of measurement.

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