trowers & hamlins

thinking
Real Estate

ISSUE FOUR

Contents

Welcome to the latest edition of Thinking Real Estate, where we aim to share our expertise and ideas with you to support growth and sustainability for your business.

In this latest edition, we're focussing on some practical issues affecting various parts of the sector:

- Local authorities – with the concept of 'placemaking' now front and centre in large developments, the role of councils has become pivotal, and many are thinking much more commercially

- Estate regeneration – regenerating the UK's housing stock is a key priority in urban areas, presenting the challenge of balancing strategic need with the wishes of individuals

- Senior living – there is huge potential to unlock value in retirement housing, especially with developers and funders creating more rental options

- Wellness – as talk in real estate turns from sustainability to wellness, what might this mean for the buildings of the future, and the legal and regulatory climate?

- Housing – sorting out the UK's housing crisis is a complex issue which requires co-operation and creative thinking from both private and public sector

We hope you're enjoying Thinking Real Estate – we've tried to write it in the way we like to talk to our clients – unstuffy, pragmatic and conversational.

So, please get in touch with any of us directly at thinkingrealestate@trowers.com with any questions or comments, and follow us on twitter @Trowers.

MARCH 2017

A broader role for lawyers, as councils get smart

Local authorities play a, sometimes surprisingly, vital part in shaping our towns and cities. As development becomes more sophisticated – responsible for delivering housing, infrastructure and commercial benefit to a locality – councils have a pivotal role, and so an in-depth understanding of public authorities, and their relationship with both private sector and central government, has great value.

"It's not just about the law," says Chris Plumley, partner in the public sector commercial practice in Trowers & Hamlins' Birmingham office. "It's about understanding the political environment, generating confidence with the council at first instance, both with officer staff and of course the elected members. They know they have to be entrepreneurial but sometimes don't have the right resources to drive things through. And that's where we come in. We're getting engaged more and more to help unlock schemes."

Plumley sees a marked change in the political climate around local development. "There's been a big shift," he says. "A few years back the focus was on asset sales to generate capital receipts, but now councils are much more focussed on place-shaping in order to generate sustainable income for 2020 – when the funding mechanisms change – and beyond. Now, instead of selling them off, they're using assets – in some cases liabilities – to generate jobs, housing and mixed use schemes."

> "It's reinvigorated thinking in local authorities and among developers."

Amanda Hanmore, head of real estate for the Birmingham office, also sees a changing climate. "Private developers have, in the past, been put off by long-winded and expensive procurement processes. We're finding we can advise clients on processes which are compliant, but which make schemes attractive, and that very much fits with the new climate. Developers are finding many more opportunities opening up."

One Trowers & Hamlins client, a developer and forward-funder of budget hotels, partners with local authorities to build hotels on local authority land. Using a shielded lease, the council receives rental income from the hotel and the project provides rent to the funders providing the senior debt, who find such projects attractive from a risk perspective due to the unshakeable covenants a council can offer.

In another case, the firm is acting for a council in a Midlands market town where a town-centre development project has been stalled for years, due to problems with viability and the inadequate size of the various parcels of land involved. With a new entrepreneurial attitude, the council looked at public land either side of the proposed site, and used a combination of land-swaps and joint ventures to break the development logjam and create a bigger, viable mixed-use site.

“It’s an interesting change,” says Chris Plumley. “Now the councils are being more innovative, collaborative and entrepreneurial, and matching the developers instead of being the cautious and risk-averse ones!”

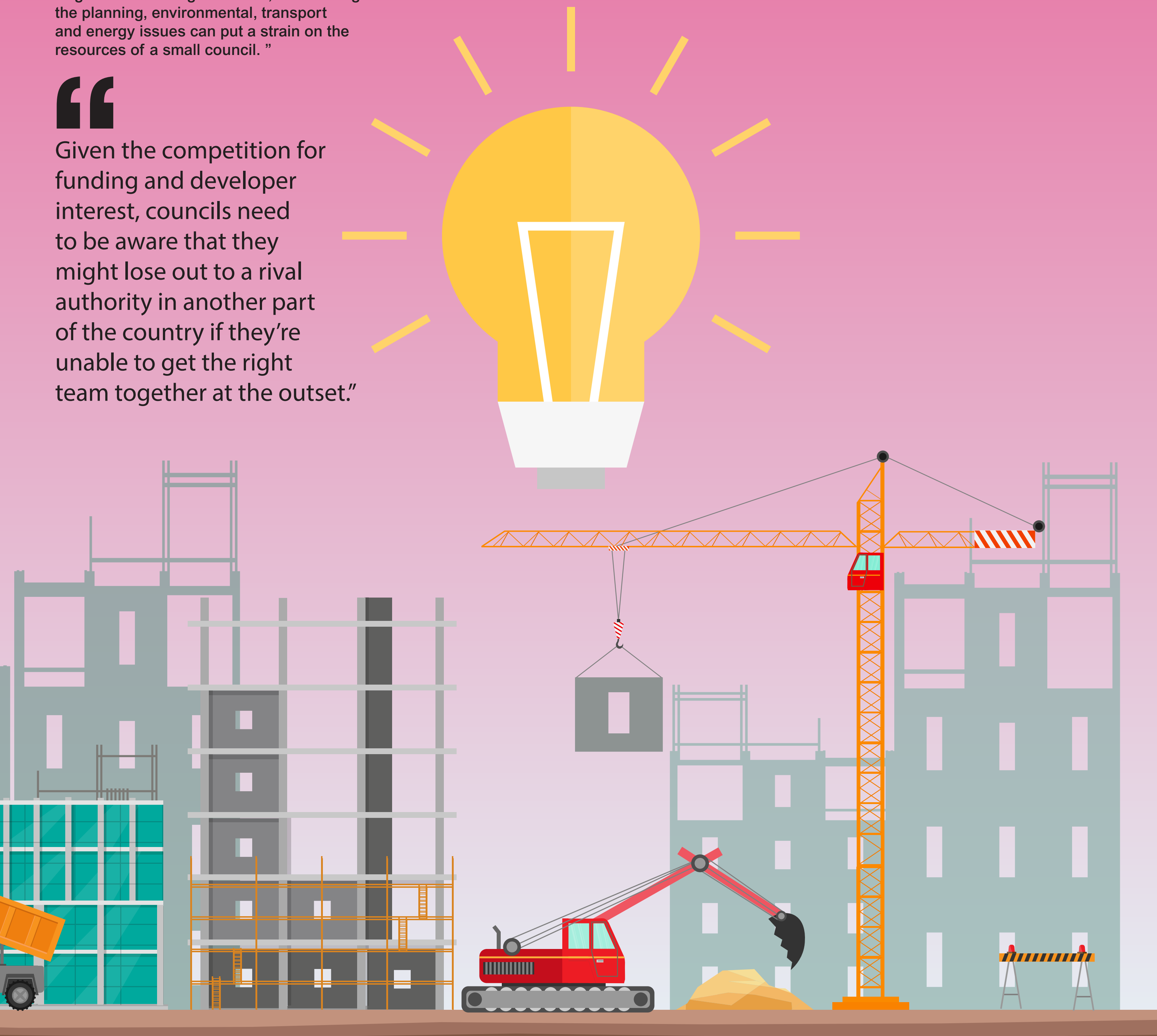
While the climate might be changing, Amanda Hanmore sees an issue around the skills available to some councils.

“Some of the smaller authorities struggle a bit with not having the skills or experience to put together these complex schemes,” she notes. “Co-ordinating various developers and Registered Housing Providers, considering the planning, environmental, transport and energy issues can put a strain on the resources of a small council. ”

“Given the competition for funding and developer interest, councils need to be aware that they might lose out to a rival authority in another part of the country if they’re unable to get the right team together at the outset.”

Local attitudes can also have a bearing. “It’s obviously vital to get the local population on board with any major scheme,” says Chris Plumley, “but it’s important to think about things in the round too, so that projects can get rolling. A project of any size is going to bring jobs and long-lasting prosperity to an area, but if there is a lot of opposition early on, or if councils are difficult to deal with or not genuinely open for business, then it’s possible developers – who are looking for stability and openness to new ideas – may look elsewhere.”

“Ultimately, it’s about finding the right balance,” Plumley concludes. “The macro political environment is very unstable, and it’s likely to remain so for a number of years. But life goes on, and if councils have good leadership, the right attitude as regards welcoming funding and proper governance structures to ensure that projects aren’t subject to the whim of a few powerful individuals, they can make genuine breakthroughs.”



Regeneration is all about strategy

"One of the great frustrations with regeneration," says Sara Bailey, head of real estate and regeneration specialist at Trowers & Hamlins, "is that there is an overriding strategic objective to be met, and yet so many different perspectives, various needs which need to be factored in, a range of drivers for the parties involved."

The objective Bailey refers to is the strategic regeneration of some of the UK's most run-down housing, often, but not always, on large, so-called 'sink' estates, either still run by local authorities or by housing associations created specifically for the purpose.

Central, of course, to the regeneration of large portfolios of housing is the political and economic climate around low-cost housing provision, and the move to more mixed schemes in general across UK real estate.

"There is a huge need for housing, and a great need to regenerate many of the older estates, but there isn't the funding, or the political appetite, to build new, entirely social developments," says Bailey.

The government's recent white paper concentrates primarily on housebuilding, with the focus on getting local authorities to release land for building rather than transforming their existing stock, but the Trowers team sees reason for optimism in how the private sector is responding to the opportunities offered by large-scale regeneration schemes.

"Today's philosophy – you look at Argent's scheme in King's Cross, and the Olympic legacy development in Stratford – is that of placemaking. This not only requires a diverse range of physical facilities and proper thinking about open spaces but also requires a whole different way of thinking from the outset. A different approach to risk on the part of all parties, or it's just not going to get done."

Bailey feels the government may have been missing a trick in not addressing regeneration directly in its white paper.

"The white paper makes it plain that the government thinks not enough units are being built, but many of the old estates present a great opportunity to use public sector land in prime locations to create developments of greater housing density. These would not only address the undersupply issue but provide very fertile ground for commercial development as part of a mixed scheme, which can make it much easier to get things going," she says.

But she cautions that the needs of individual tenants – and leaseholders – are one of the key considerations in any regeneration of existing stock.

"Obviously it's not as simple as just removing all the people from an estate, knocking it down and building a new one," she says.

> **"We are talking about people's homes, and very often they don't want to just leave them, regardless of what the benefits of regeneration might be or might seem to be to developers or local authorities."**

"You might get a guy who has been in his flat for 40 years who doesn't want a new one, with a new heating system or a new kitchen. It might seem completely irrational to an outside party, but people get very attached to their homes, and trying to impose change on them is often the least productive, most time-consuming and most expensive way to proceed."

Mick Donnellan, real estate partner, feels more creativity needs to go into the process at the outset, when all too easily the main focus becomes the removal of the current occupants so that development can start.

"It has become more difficult in some ways," he says. "Because of Right To Buy, many of the occupants are leaseholders, not tenants, and that means buying them out. Compulsory Purchase Orders (CPOs) are, of course, a last resort, but at only a 10% uplift on current market value, it's not that interesting for many. "

"Many people find that even if they were given that money, they couldn't afford to re-buy into the new scheme anyway, so it's not surprising they'll dig their heels in rather than move."

"Developers – and other parties with skin in the game – are coming up with new ways around that, for instance offering the possibility of residents returning to the new development with a part-equity deal on a new flat."

Sara Bailey agrees, "those engaged in planning the regeneration include: funders who obviously have a vested interest in their capital being engaged quickly and getting returns as soon as possible; developers who need to get on with it so as not to tie up cash and construction resources; and local authorities and housing providers who desperately need to develop new housing units to free up their own stock. Beyond any local benefits a major regeneration project might deliver, all these parties need to realise that there are people at the other end of their planning process, and people with a number of legal mechanisms at their disposal, if they want to derail or delay things. And delays mean increased costs."

"Getting around this is about thinking strategically at the outset, not getting fixated on your own commercial objectives but understanding what the other parties to the development are looking to achieve, so that the 'sell' to occupiers – whether tenants or leaseholders – is optimal."

"We find that where we are able to get involved at the strategic level, our experience of what is happening at the ground floor can be invaluable. This is all about spotting the pitfalls and elephant traps before you fall into them, about understanding that these are people's homes that we are talking about but that needs to be balanced with the need to create new homes."

Changes afoot ON RETIREMENT LIVING

With the publication of the government's housing white paper – "Fixing Our Broken Housing Market" – in February 2017, experts in the funding and development of senior housing detect something of a change of tone, with more emphasis on the market for older people's housing, and in particular, to point to alternative ways of stimulating activity.

"A transformation in thinking around senior housing is definitely required," says Kyle Holling, projects and real estate partner at Towers & Hamlins.

> **"There is a huge potential to unlock value in this sector – where the UK lags far behind many other developed economies – but it requires a number of market actors to start thinking differently."**

One of the greatest opportunities is in an embryonic part of the sector - rental.

"People in the UK are very wedded to home ownership," says Holling. "And people in retirement are sometimes more wedded to it. If their house is their only real asset, giving it up to go and live in a rented place might be unthinkable. But in fact it might be a much better way of doing it, giving them a much better standard of living and less worry about the upkeep of a freehold property."

Tim Nye, corporate partner, feels the lack of very visible schemes showing how attractive this option is remains a problem.

"There is a lack of attractive schemes, particularly outside the South of England," Nye admits. "Without examples of what this type of living looks like in practice, seniors don't consider it. And without seniors considering it, many funders and developers don't see that there's a market. It's chicken-and-egg."

Nye feels the answer for developers might be to look at the finances and an opportunity for investors looking for a reliable income-stream with the possibility of some crystallisation of capital down the track, rather than the usual invest-build-dispose model.

"Part of the problem for equity investors investing in a for-sale scheme is that they have to wait until units are sold to recoup their investment," he says. "The advantage with the rental model is that steadier income-stream and – if you can achieve sufficient scale – then the way is open for longer-term investors, such as pension funds, which will bring additional capital into the sector."

"There is a culture-shift needed in senior housing, so developers and funders start looking at the potential of rented units or entirely rented schemes, as the market matures and individuals are looking at different ways of living in retirement. If renting is available in sheltered housing why should it not be available in retirement communities?"

Holling also sees another potential wrinkle in the structure of funders. "This stuff doesn't quite fit into healthcare, doesn't fit in general housing," says Holling. "There are a few teams among the funders who understand, but all too often it falls between two stools."

"But there is enormous potential, and there is precedent," he adds. "Housing for sale starts as a developer model but ultimately is an operational model so people get the services they need. If you're doing it for rent, that too is clearly an operational model."

Positioning rental as a serious option could also have a powerful effect on the housing market, Nye reckons.

"If more seniors could be persuaded to move into new rented units as part of retirement living developments, that would free up a lot of larger, family homes at the upper end of the market and get the chain moving. It could also free up a lot of equity currently locked in those houses to be invested into opportunities such as senior living."

Holling, a New Zealander by birth, notes that New Zealand is 10-15 years ahead of the UK in this regard. There, the market is a mature one, with a number of listed companies and significant interest from private equity providers.

"It would be good to have some kind of awareness-raising campaign in the UK, led from the centre," says Nye. "People need to be made aware not only that this kind of thing exists as an option, but how it works, and how it might benefit them. That would get capital providers moving as well. For example, in Age UK's Housing options guide, retirement living is only mentioned as an option to buy rather than rent."

"Too many people still think of moving into rented accommodation as a downgrade, but if you're moving from your own, private house into a retirement village with enhanced facilities and some kind of care support, it's more of a lifestyle-upgrade!" he adds.

There are, of course, issues. Lifetime affordability is one, but Holling and Nye see ways around this. "Any senior just wants to make sure they have enough money for the remainder of their life, but there are ways of doing this, to give that assurance, and as the model matures it may be seen as a safer option," says Holling. There may be particular opportunity in a smaller market focussed on the 'older old' who see less value in the need for ownership as part of a last move.

To date, the focus across the residential sector has primarily been around building housing units for sale, and one of the complications is siloed thinking among providers, funders and others within the industry.

"There are real opportunities in this sector if everyone can start thinking a little more creatively," says Nye.

"Funders, government and those going into retirement housing would all benefit if there were more focus on the possibility of rental providing people with the right home for their needs."

WELL BUILDINGS

THE WAY OF THE FUTURE

"I think one of the issues we face as lawyers is that people often assume that all we're interested in is the law," says Chris Paul, partner in the Projects & Construction team at Trowers & Hamlins.

"Actually, we're constantly looking at commercial issues in the sector which might affect the way our clients do business, now and in the future," he says. "Things which are just discretionary at the moment may be the subject of regulation down the track, so we need to be aware of issues across a very broad spectrum."

Stephen Marks, real estate partner, agrees. "There has been a lot of focus on the structure of buildings and on external design features," he says. "But I think we're finding that thoughts are turning inwards now, to the relationship between man and building. It's been a long time coming, but it's a logical progression from the sustainability agenda which has been at the forefront of thinking in the sector for some time."

Everyone in the sector will be familiar with the BREEAM initiative around sustainability, a standard supported by governments, banks and developers, and which has seen 2.2m buildings designed to BREEAM's exacting standards since its launch in 1990. Similarly, LEED, its US equivalent, also claims to be the most widely used third-party verification for green buildings but they may be less familiar with wellness which Marks feels is the issue of the day, though unlike sustainability there is no accepted measure.

"Wellness keys into a lot of thinking around how health, happiness and mental state in general can be affected by the built environment," Marks explains. "We spend 90% of our time in buildings, it's very important that people are front-and-centre when thinking about development."

He points out that many large, contemporary developments are already incorporating wellness concepts as part of placemaking initiatives. "Many of the key features of placemaking – accessibility, the nature of the public spaces, the focus on the environmental features of large developments – are supportive of wellness-based thinking," he says.

But neither Marks nor Paul feel the new attention to wellness is likely to spawn a rash of new regulation.

"It's highly unlikely government is going to legislate around wellness in the immediate future" says Marks. "There just isn't the political appetite, and I think the industry would see it as unnecessary interference in an area where the market can apply commercial fixes which address the complex issues involved."

> "But there's no doubt in my mind that wellness will become a bigger issue for property, and it's not going away, and that will manifest itself in all kinds of different ways."

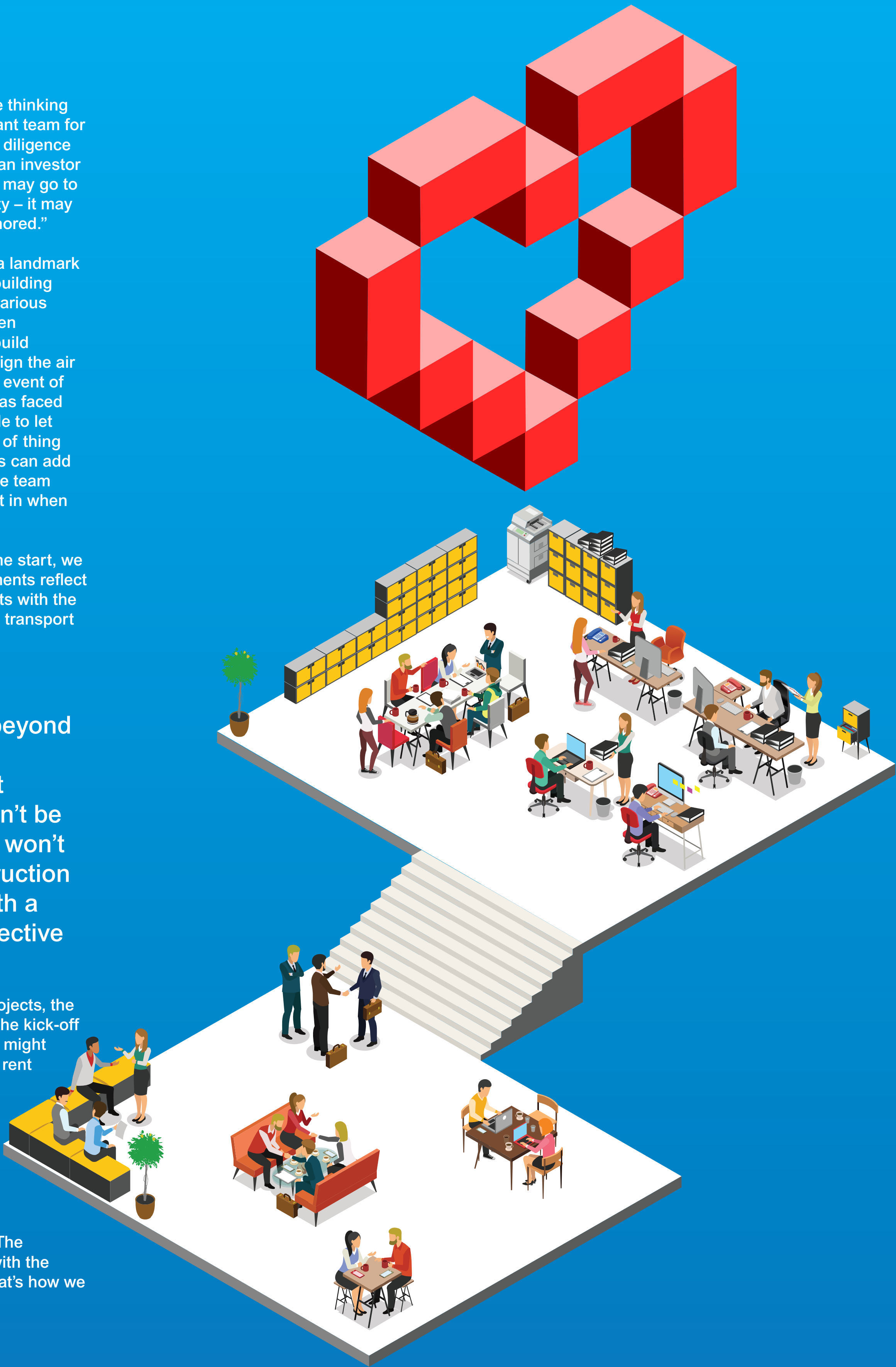
"There is a missing link on the design side," says Chris Paul. "Employer requirements don't yet talk about wellness as a key objective, and the risk is that value engineering can take out many of the features that would improve wellness and employee productivity in the built environment. You need to think about whether your spec meets current needs, and whether at some point down the line if you're disposing of it, there could be a cost to bring it up to standard."

"So there are issues you need to be thinking about when appointing the consultant team for a new project, or as part of the due diligence on an acquisition," he adds. "From an investor point of view, the issue of wellness may go to disposal value or eventual rentability – it may become something that can't be ignored."

"One case I can think of related to a landmark tower," says Stephen Marks. "The building was sub-divided to accommodate various tenants, but because this hadn't been considered during the design and build process, they hadn't thought to design the air conditioning system to adapt in the event of that rental scenario. The landlord was faced with a huge extra cost just to be able to let the space. Thinking about that kind of thing at the outset is exactly what lawyers can add to a transaction, if we are part of the team at inception rather than just brought in when things go wrong."

Chris Paul agrees. "If we get in at the start, we can look at how the contract documents reflect client objectives – linking the outputs with the latest thinking on energy efficiency, transport etc."

"Yes, it may be looking beyond the existing regulatory minimums, but if it's not raised at the start, it won't be considered in design, it won't be considered in construction and you may end up with a building that isn't as effective as it could be."



"Given the size of most of these projects, the cost of getting lawyers involved at the kick-off is minimal compared with what you might end up saving, getting in additional rent or in added end-value when you come to dispose of the asset."

"You can look at these things from a risk/compliance point of view, or you can look at them from the point of view of what's going to benefit my business," he adds. "The notion of benefit resonates better with the businesspeople we deal with, so that's how we like to approach things."

HOUSING:

THE PROBLEM THAT WON'T JUST GO AWAY

"People often talk about a housing crisis, but that's not always helpful," says Amy Shaw, real estate partner. "The picture is much more complex than that. There's huge pressure in some areas, but not in others, and there's a danger that if we just talk about crisis, then the response will be political, not practical, and that is going to affect the quality of schemes as housing is rushed through."

Tonia Secker, real estate partner and a leading name in social housing, agrees that a singular focus on delivery of a certain number of housing units is unhelpful.

She points to attempts to create a much grander strategic vision for housing which the government has outlined in its long-awaited white paper.

Among other things, the white paper focusses on encouraging local authorities to make more creative use of their assets, and partnering with market actors in other parts of the sector in order to deliver ambitious housing targets.

"Housing is such a complex area," she says. "There is lack of supply at the right price points in the private sector and, meanwhile, housing policy from successive administrations has curtailed the historic role of local authorities in building for people who can't afford to access the market 'proper', with the result that every single social housing target, however well intentioned, is never achieved. Why this is happening is understandable," Secker feels.

Austerity and demographics are definitely factors, as is access to land.
Yes, developers might not build out at the rates which government wants, but the reality is that they are commercial organisations with duties to shareholders. You can't expect them to operate in a manner detrimental to their business, particularly given their contribution to GDP. There are lots of factors at play, including a reduction in government funding and constraints on local authorities' ability to borrow, so there hasn't been enough money in the affordable part of the sector full-stop."

But there are more subtle issues too," Secker adds. "For instance, why many local authorities, private developers and housing associations pursue different channels, and fail to get the benefits of scale they might of if they thought more co-operatively."

The team sees a change in the climate, with different patterns of demand driving more creative thinking. "It's not just about gross housing demand any longer," says Amy Shaw. "For instance, in one scheme we've been involved in since the outset, one key driver of the development has been a local authority seeking to create specific 'digital quarters' to attract young, high-growth tech businesses."

"That has interested developers looking for commercial opportunities, but it has also required a lot of thinking around creating low-cost yet desirable housing to provide units at all price points, as well as accompanying retail and infrastructure," says Shaw.

> **"Demand is one driver, but policy has also affected the thinking among the three key market actors – the private sector, housing associations and local authorities – with a blurring of traditional boundaries."**

For instance property companies setting up Registered Provider subsidiaries, allowing them to retain control of affordable units

in their developments rather than turn them over to housing associations, and Registered Providers becoming more like property companies and being re-engaged as such by local authorities for specific developments."

"The climate has definitely changed," says Tonia Secker. "The government's focus has changed from forcing local authorities to sell off high value voids in favour of encouraging innovation over the use of assets. The government is implicitly saying through its policies and the white paper that 'we want you to be more creative in the use of your assets', look at how you can use them more 'commercially' where it's appropriate to do so because they can generate long term revenue streams for the Council. Savills have coined the phrase 'profit for purpose' which I think encapsulates the idea brilliantly."

"But 'creative use of assets' requires a different mind-set, and different skillsets to those some local authorities have been used to employing in the past," she adds. "Establishing joint ventures (JV), for instance, is sometimes tricky, but can be immensely productive. Local authorities tend to be in the driving seat in procuring services, but in these types of arrangement they are a collaborator not a master. That is a bit of a mind-shift for some of them. A JV will involve a degree of risk and compromise. So it is more commercial mind-set that you are asking people to adopt than has previously been the case."

One issue many local authorities face is a lack of specialist skills in particular areas.

"Many local authorities have set up their own housing companies, for example," says Amy Shaw, "but because they haven't been able to build on a large scale since the 1980s, they don't have the experience of developing to scale. There is, however, a growing realisation that it might be a good idea to buddy-up to do this – and there are structures out there that can offer "procurement friendly" solutions."

"Housing associations do have that kind of skill, and local authorities need to be dipping into it, thinking about joint ventures, partnering, new kinds of rental and equity schemes to attract and retain the buyers and renters of tomorrow and the businesses where they'll work and which will provide income."

Corporate partner Ian Dobinson agrees and says that sharing skills, resources and risks are central to joint ventures.

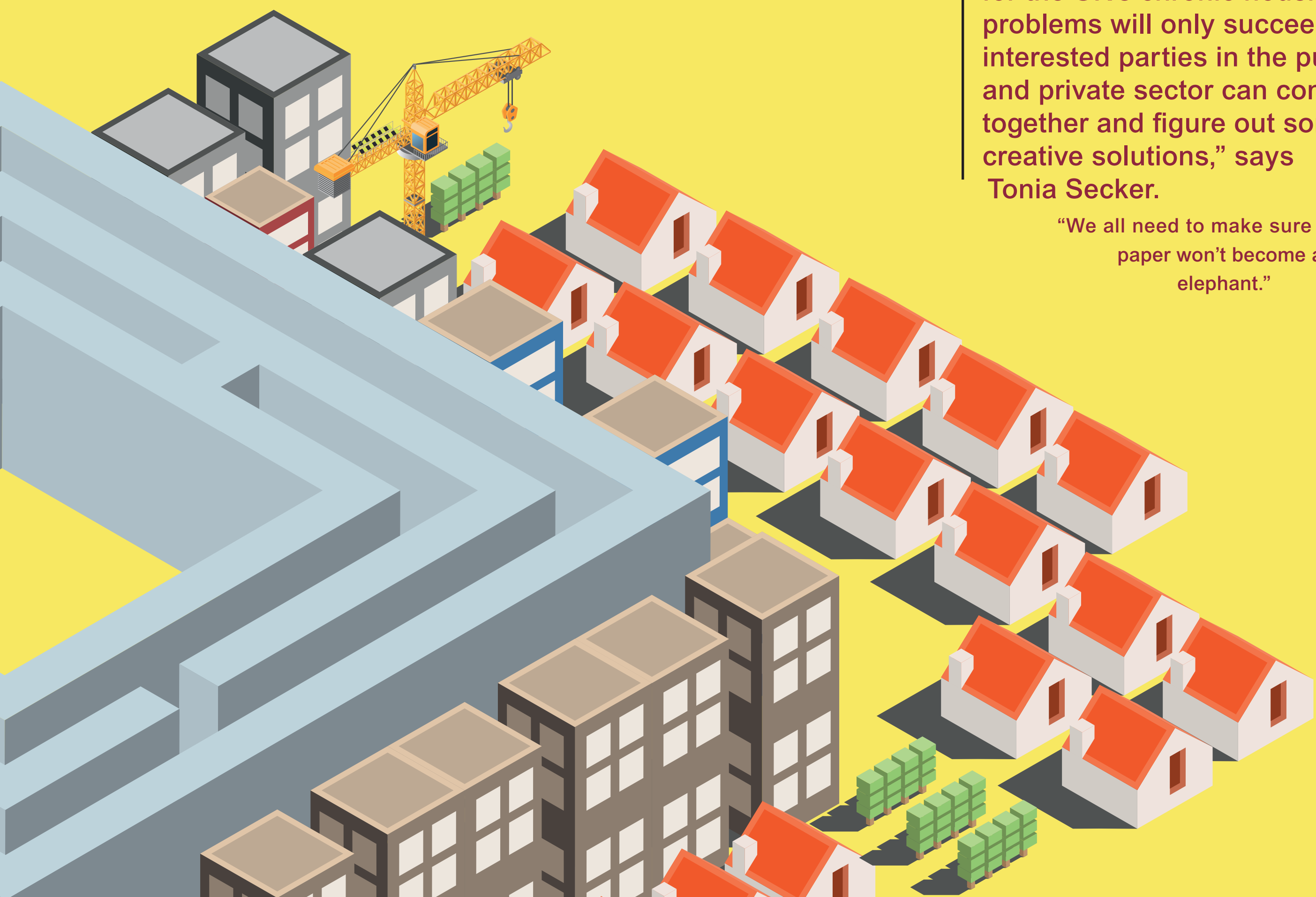
"It's about funding, sales and marketing and longer term management issues," he says. "Many of these partnerships are Special Purpose Vehicles. Now, external funders will look at that, but they'll want a decent slug of equity to cushion their risk. You'll typically get 60%, maybe a little more, on this. Local authority involvement does not affect the analysis because the funding doesn't go through them. How the local authority funds their equity investment is another question, but there are a number of things they can do, for instance they may bring some land to the party."

"Councils sometimes also have a pot of money from Right To Buy receipts," adds Amy Shaw, "and sometimes s106 commuted funds too. Coupled with the ability to access attractive finance from the Public Works Loan Board, funding can sometimes be quite attractively-packaged."

"

Ultimately, any strategic vision for the UK's chronic housing problems will only succeed if all interested parties in the public and private sector can come together and figure out some creative solutions," says Tonia Secker.

"We all need to make sure this white paper won't become a white elephant."



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