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thinking

Real Estate

ISSUE SEVEN

Contents

Welcome to the seventh edition of Thinking Real Estate, where we share thoughts and ideas on topics across the real estate industry. In this latest edition we're focusing on some practical issues affecting various parts of the sector:

- The real challenge of electric vehicles – With the Government indicating that diesel and petrol powered cars will be phased out by 2040, what must be implemented now to make the necessary charging infrastructure readily available?

- A flexible future for retail – In light of the recent struggles facing many retailers, we look at tactics that landlords or local authorities could adopt to encourage footfall back to the high streets.

- Factory manufactured homes – In our issue of Thinking Real Estate a year ago, we looked at some of the issues and challenges surrounding modular construction, what have been the key developments since then?

- Risky business – Strategic land promoters face a lot of criticism for adding another link and expense in the development process, but how important are their roles in providing much needed housebuilding?

- Powering economic growth – In order to stimulate productivity and economic growth, our experts discuss the options available to developers of infrastructure and the benefits this will bring.

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.

Please get in touch with any of us directly at thinkingrealestate@trowers.com with any questions or comments, and continue the debate with us on twitter @Trowers.

OCTOBER 2018

THE REAL CHALLENGE OF ELECTRIC VEHICLES

Much has been made about the rise of electric vehicles (EVs). That should be no surprise. After all, the UK Government has indicated that diesel and petrol powered cars will be phased out by 2040 as part of its commitments under the Paris Agreement, which will remain binding whatever happens on Brexit. What has received less attention, however, is the charging infrastructure that needs to be available to make the move to electric practical.

In short, far more thought needs to be given to how the necessary charging infrastructure will be delivered – both for new developments and retrofit for existing properties. According to Chris Paul, Real Estate Partner at Trowers & Hamlins, it's an area that developers and landlords are only now starting to get to grips with in a serious fashion.

“The decisions our clients make on the capacity of electricity connections and the route of supply cables for new developments will have a real impact on what they can provide in their car park spaces over the long term,” he says.

“So, it's about asking those questions early enough so that we don't end up digging up carparks and public realm in 10 years' time to add more capacity.”

With new developments, decisions may soon be taken out of developers' hands. The draft New London Plan, due to come into force next year, contains strong policies on EV charging points. For residential parking, this includes a requirement that at least 20% of new spaces are to have active charging facilities, with passive provision (ie electricity supply) for all the remaining spaces. “The New London Plan is already having an impact on how client's view the requirements for new-build schemes,” says Paul. “The requirement for spaces to be enabled for EV means that these decisions need to be made now.”

Of course, there is a world beyond London. The development of a national charging network is one of the key aims of the Government's current policies, and the Automated and Electric Vehicles Act 2018 is an important step in facilitating the necessary infrastructure. However, Paul believes that the lack of charging infrastructure remains a significant barrier to general take-up of electric vehicles. “If you look at where the charging points are at the moment, there are more per square mile in London than there are in other cities,” he says.

“But the availability of charging infrastructure outside our major cities remains a real concern - we’re at a tipping point and that will have to change.”

One issue that still needs further consideration is how the market delivers smart charging points (e.g. managing demands to avoid overloading local electricity networks). Unlike choosing a mobile phone provider, the need for integrated infrastructure means that this cannot be left to individual consumer choice – it is simply impractical. “What you can’t have is lots of competing charging companies in the same space because it doesn’t work very easily,” says Paul. “If you allow pepper potting of different charging providers, you’ll end up with cables everywhere and your substation getting overloaded because the systems can’t talk to each other.”

Instead, what is needed is a more strategic approach from developers and landlords whereby they grant a longer-term concession to a charging provider, which is then responsible for operating and maintaining charging points within a development and recovering their investment from their customers. “That way you will get an integrated installation and it is going to work properly,” says Paul. “It’s much easier to manage performance and from a tenant’s point it’s simple – if they want a charging point they sign up with the appointed provider. It is important that landlords properly manage charging arrangements to ensure performance, fair terms and reasonable tariffs. All those issues should be addressed in the contract documents to help give comfort about the issue of choice and monopoly.”

Installing EV charging points for existing detached and semi-detached housing presents fewer difficulties – it is simple enough for a homeowner to install a charger and run a direct connection to their parking space. Retrofitting apartment blocks is more problematic, however, not least due to the fact that existing leases are unlikely to consider EV charging issues. As Paul puts it: “landlords won’t want to invest in the infrastructure as they have no way to recover the cost – looking at EV infrastructure as a potential new service charge issue is going to be a non-starter for existing leases.”

Instead, Paul predicts that charging providers will look to target residential block managers and residents with a similar concession model to the one proposed for new developments. Providers would need a certain number of residents to sign up in order to make the business case for the installation of the primary infrastructure but given the increasing popularity of EVs he doesn’t predict that will be a problem for long. “It’s much better if it’s structured as an opportunity,” says Paul. “I can imagine providers engaging directly with tenants and if they get enough signing up at a site then they will make the leap to invest.”

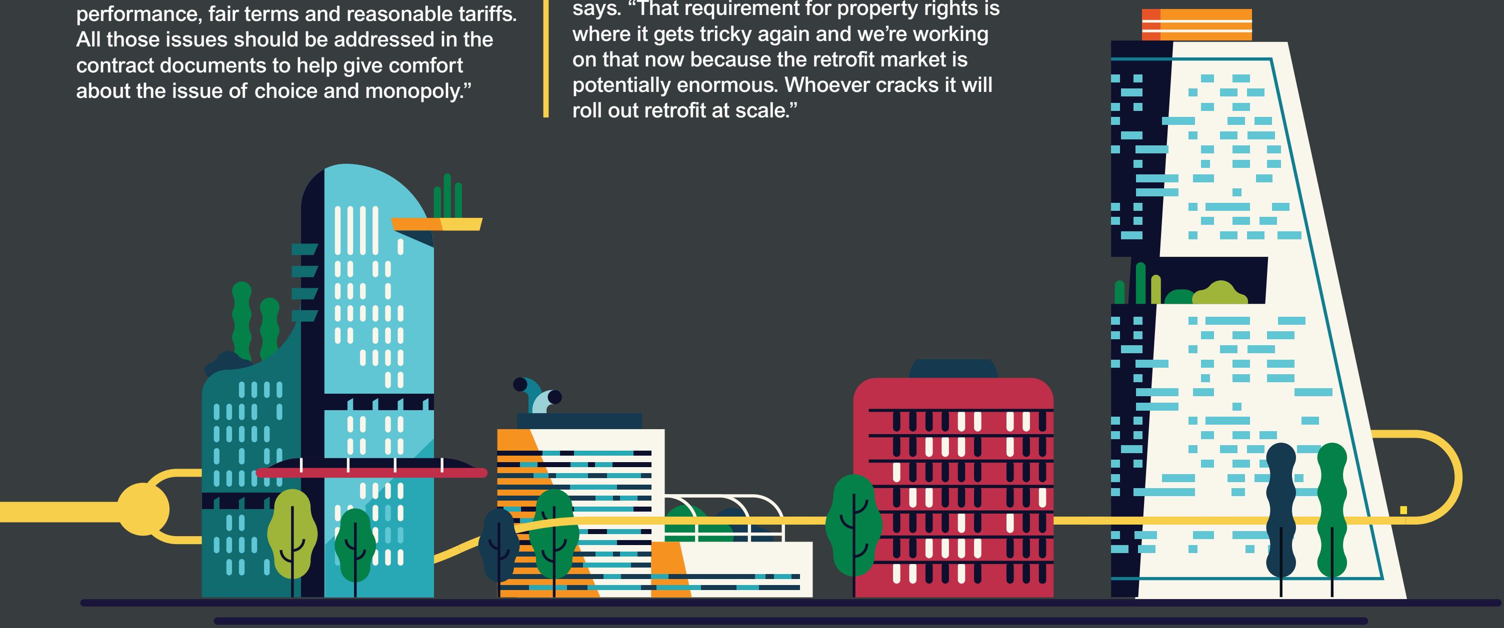
If charging providers are investing in the necessary infrastructure, then they will want exclusivity to make a return. Alongside a long-term concession contract, they may also need the additional security that comes through property rights. It’s an issue Paul is actively working on resolving with the Trowers Real Estate team. “You can imagine charging providers saying to a management company that they will put it the infrastructure at zero cost to the landlord, but that they will need a long-term agreement, a lease of the plantroom and connected easements,” he says. “That requirement for property rights is where it gets tricky again and we’re working on that now because the retrofit market is potentially enormous. Whoever cracks it will roll out retrofit at scale.”

Charging points are only one of the ways in which our cities need to adapt to support the rapid technological change, not just with the roll out of electric cars but with the roll out of 5G and the broader smart city agenda. With a recent article from the National Grid stating that capacity demand will increase from 103 GW today to between 189GW and 268 GW by 2050, possibly even greater a challenge is how we generate and store the electricity needed to power the charging infrastructure..

Real estate is a key consideration for installing EV charging infrastructure. “Put simply an EV charging provider cannot install its equipment on someone else’s property without a lease, licence, easement or other land interest in place” says Paul.

“Developers should consider the requirements at an early stage, and make sure that both designs and property structures can deal with large scale EV roll-out.”

There is no doubt that Trowers have the necessary expertise and experience here, having acted for developers and landlords dealing with utilities connections, district heating concessions and connected property issues on a range of schemes.



A FLEXIBLE FUTURE FOR RETAIL

It has been a bloody time of it on the UK's high streets. In the recent past, a string of household names, including BHS, Debenhams, M&S, and House of Fraser, have either ceased trading or announced store closures, quite a death toll.

What is often overlooked is that many of the retail assets are owned by pension funds and the downward pressure on rents has the potential to affect pensioners and pension-savers. Melanie Leech, Chief Executive of the BPF, recently countered the comments about landlords being greedy stating that

“there will be a range of factors to consider on a store-by-store basis but what property owners won’t be doing is simply leaving stores empty for the sake of it, that would be in no one’s interests.”

But the fate of some of the stars of the retail sector is only part of the story. Smaller, less well-known retailers have been shuttering their windows too: at the beginning of the summer, the Local Data Company stated that 11.2% of the nation’s retail units stood empty. So how can our high streets and shopping centres fight back?

According to Katie Todd, Real Estate Partner at Trowers & Hamlins, the first thing to do is to recognise that while there are universal challenges – not least the unstoppable rise of internet shopping – all retail centres are unique. “The high streets that aren’t doing well need to be evaluated on a case by case basis because no two high streets are the same,” she says, adding that lessons from successful areas with similar demographics could be learned and replicated.

“Once differences, including the demographic make-up of a catchment area have been understood,” she adds, “council leaders can tailor their strategies to suit local need.

“If you have a young demographic, they’re not really interested in going and buying their goods; they want to go and have an experience,” says Todd.

“So, you’re talking about taking high street centres and turning them into places where, yes, they can shop but also somewhere they can grab a coffee, have some dinner, have a drink, maybe just hang out with friends and play some indoor crazy golf. With an older, less affluent demographic, you need to bring in community uses, giving people somewhere to congregate, which would also benefit retailers because it would generate footfall.”

Of course, if such strategies are to be sufficiently nimble to avoid units remaining vacant for long periods of time, the planning system needs to be far less prescriptive about how buildings are used.

"I think there needs to be more flexibility so that when landlords are faced with empty units you can change it to something that is a different use and don't have to go into planning every time," says Todd.

Such a change would be likely to require intervention from central government, with local planning authorities directed through planning policy to amend use class restrictions. "If each landowner could be master of their own destiny, then would the market be more capable of correcting the situation?" asks Yvette Bryan, Real Estate Partner at Towers & Hamlins. "The system could be much more responsive and avoid a downward spiral more effectively."

Regional centres that are seen as doing well such as Exeter, Bristol and Plymouth in the South West are those that are driving a re-gearing of the retail area, with a tighter focus on a prime retail patch and a move to develop neighbouring areas into complementary dining, leisure and cultural quarters with their own distinctive identities that feed into, and draw from, footfall in the retail core.

This is being coupled with an integration of residential accommodation that adds to the general buzz around these areas, and a wider strategy from savvy local authorities to develop and promote heritage, cultural or other brand identities that increase their pull as destinations in their own right and expand the wider catchment for live, work and visit.

Then there is the not insignificant issue of business rates. When the new valuation kicked in early this year, there were winners and losers – the system is designed, at least in theory, to be revenue neutral. However, a challenge that all retailers face is the fact that the current business rates regime favours online retail. "The physical stores have a much higher tax base than the online stores," says Bryan. "The system simply has to change to reflect modern retail."

However, the challenges faced by retailers aren't just down to internet shopping and business rates. The rise of destination malls is also playing its part, with vacancy rates at Westfield London low by national standards, for instance. "Some of the glamorous retailer schemes like Westfield are very successful in attracting retailers and consumers," says Bryan. "Your local area needs to offer something that a Westfield or the equivalent can't offer."

Such a strategy could involve offering competitive rents to start-up companies, thereby ensuring that local centres offer something genuinely different. However, Bryan warns that some landlords may resist such a move. "If a landlord is looking to replace a retailer that has gone bust, in an ideal world it's going to want a like for like covenant," she says. "But given how much empty space there is at the moment landlords are looking at these issues and how they can build more flexibility into their asset."

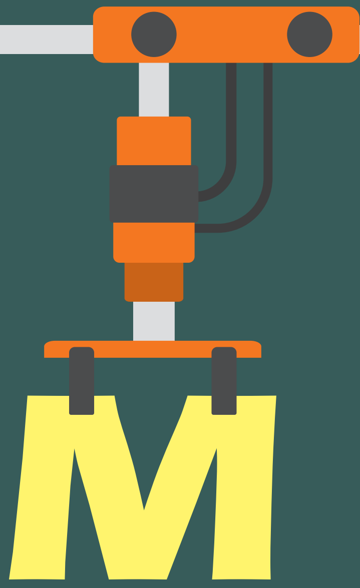
Councils too may be able to help. The last two years has seen a sharp increase in local authorities buying up commercial assets, according to research from Savills, so the public sector is increasingly in a position to offer discounts to innovative young companies. “If they’re buying it in order to breathe life back into their communities they could have the flexibility to provide lower rents and possibly hybrid turnover rent leases or rent holidays,” says Bryan.

Finally, it is possible that new models will emerge that will take the WeWork model of providing landlords with a long lease, but then renting space to retailers on a flexible basis. For example, Appear Here has pioneered and built an enormous profile, growing quickly and fulfilling the need for short term lets in this context. It’s an interesting idea, but one with several challenges that would have to be overcome.

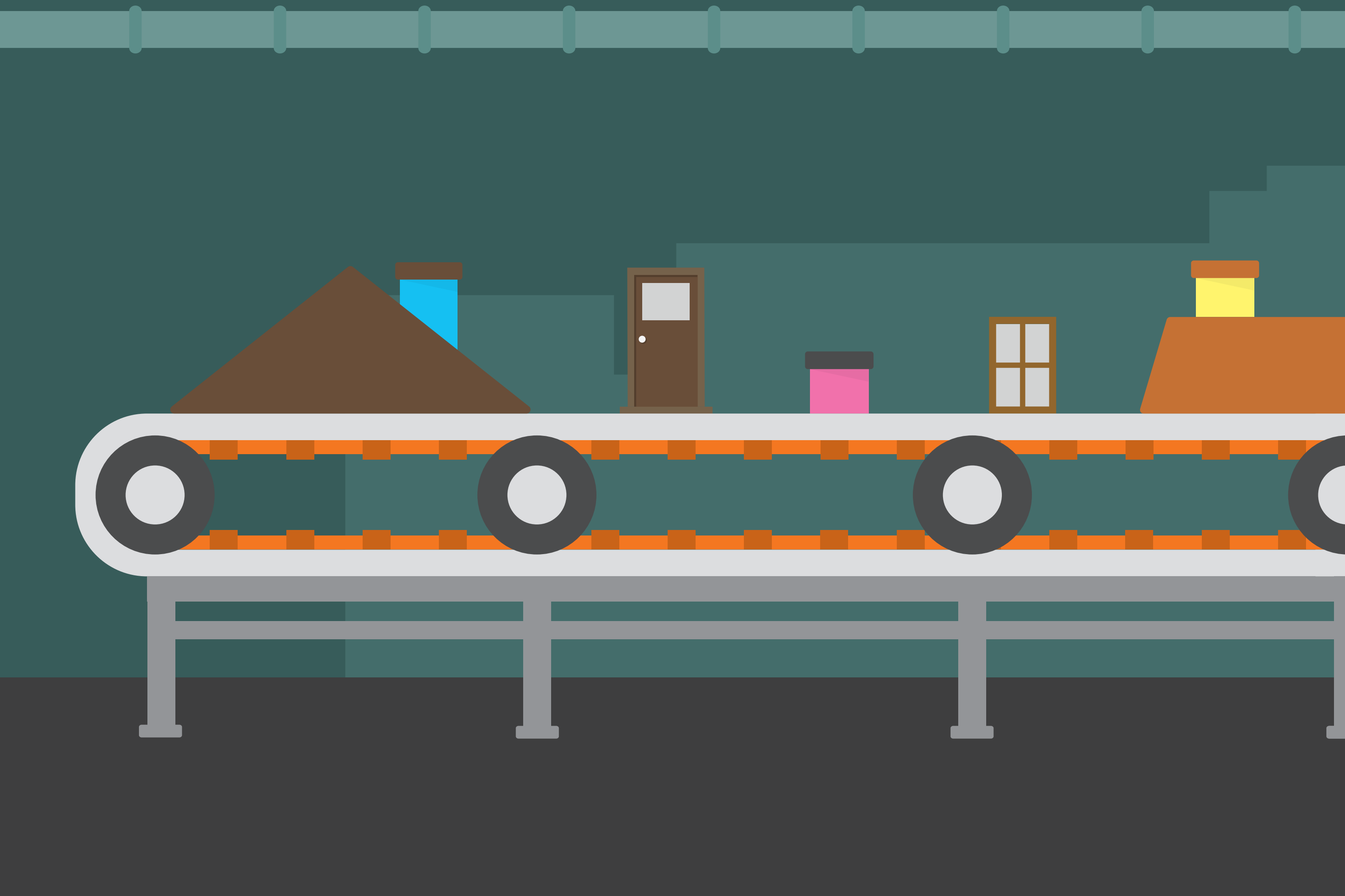
“Maybe a shopping centre landlord might recognise that their centre isn’t working and they decide to turn it into something flexible and funky,” says Bryan.

“But companies with leverage won’t always be able to do it because they will be beholden to the banks’ cooperation. Banks will be flexible to save an asset – but only up to a point.”

BUILDING MOMENTU



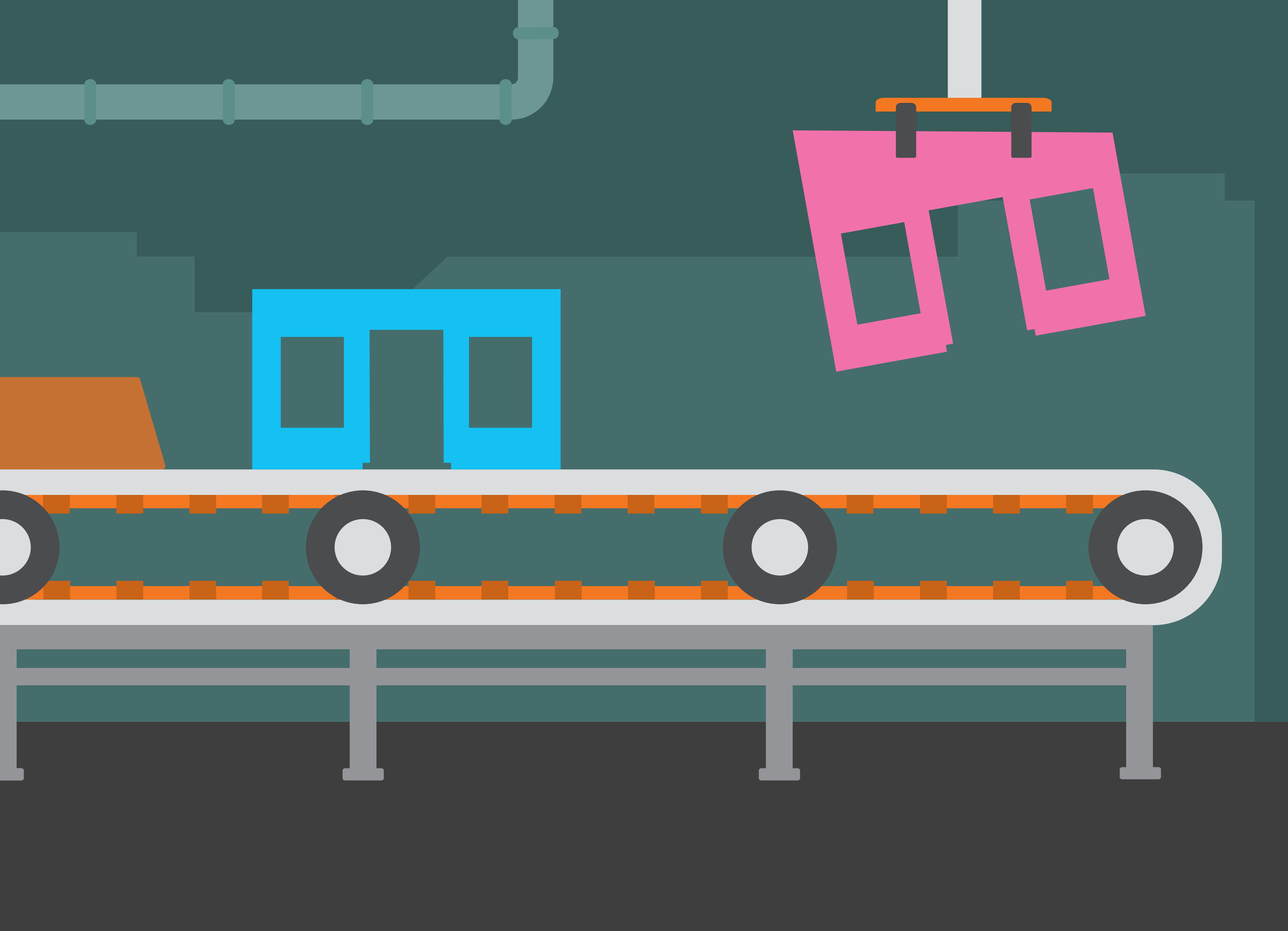
In our issue of Thinking Real Estate a year ago, we looked at some of the issues and challenges surrounding modular construction; the current byword for describing ‘off-site construction’ and ‘modern methods of construction’.



In the housing sector, modular methods have since been given a boost. First, it was announced that the Department for Transport, the Department of Health, the Department for Education, the Ministry of Justice, and the Ministry of Defence would be adopting a presumption in favour of offsite construction by 2019 across suitable capital programmes, where it represents best value for money. Then, in April 2018, the Government announced £1 billion worth of investment for housing projects using modular through the Home Building Fund.

The support was welcome and will no doubt encourage companies that would not otherwise have the resources or the finance to consider deploying modular techniques; following the likes of Berkeley Group and L&G, who are already invested heavily in their own production lines.

"Mostly the success stories for modular have been the large developers who want to be vertically integrated so that they aren't dependent on a third party supplier," says Paul Bartter, Real Estate Partner at Trowers & Hamlins. "Their approach is organic and steady; you find a suitable location for your first factory and make sure that your process is sufficiently replicable so that you can set up another factory in another region when you have the demand."



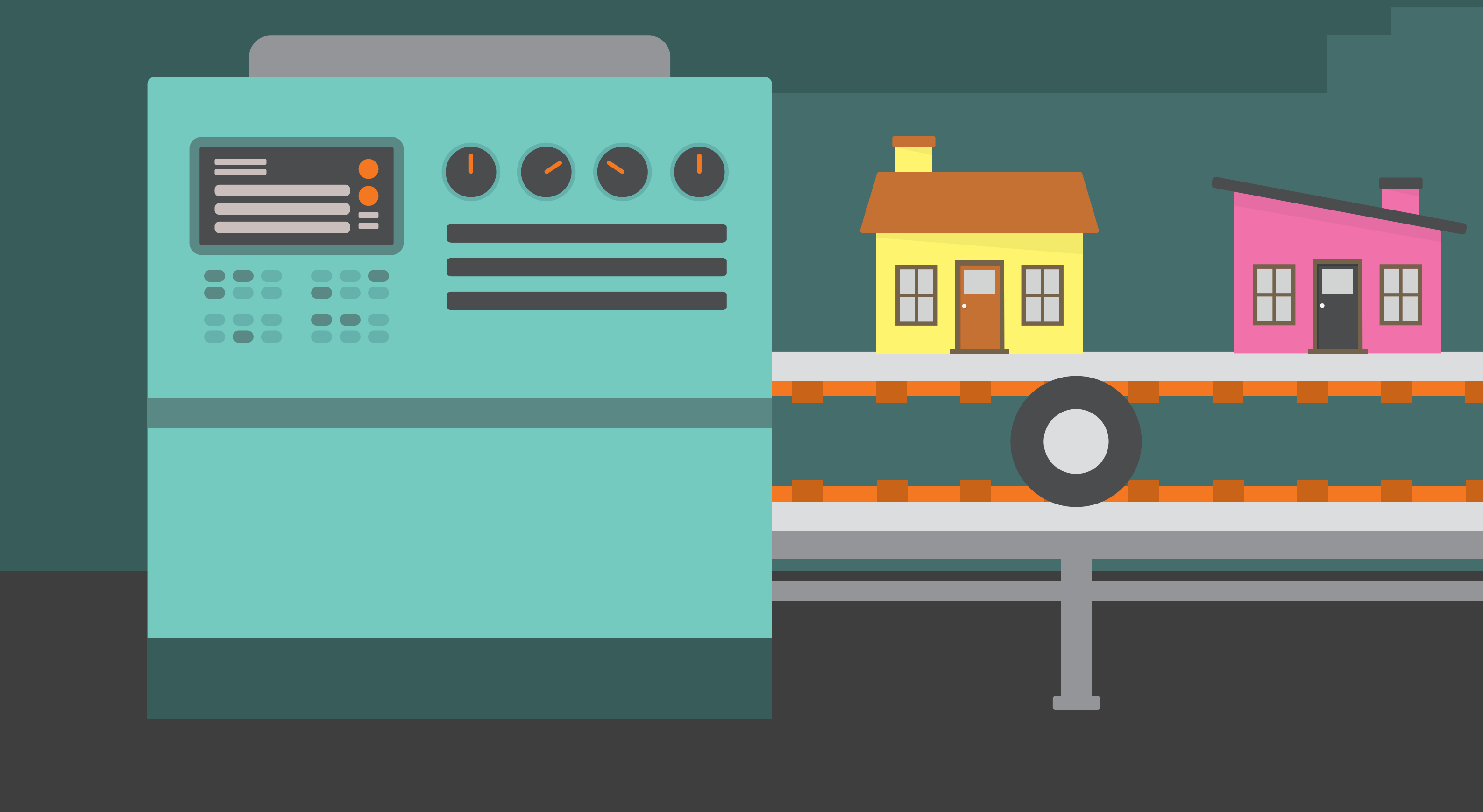
There has also been real appetite in the institutional private rented sector (PRS), attracting interest from both the traditional private developers and housing associations with a commercial arm who are looking to diversify into PRS. "With PRS they have had much better take up than in the private for sale market," says Bartter.

> **It's about the repeating nature of the units and the ability of the developer to pay for modules up front with institutional backing.**

In fact, some housing associations, notably Swan, have already established factories of their own in a commitment to innovation that has put some private developers to shame. This model for housing associations however is unfortunately less common, especially outside of the South East; the reality for most is that they lack the funds to do so especially when acting alone. "We've been having various conversations with housing associations in Manchester and the wider North West and they simply don't have the money to invest up front, especially when acting alone," says David Cordery, Senior Associate in the Real Estate team at Trowers & Hamlins. "Some of them are hanging back a bit to learn the lessons from the private developers, but there is a clear enthusiasm to explore the opportunism that modular brings and to work collaboratively both with other housing associations and the private sector to pool resources."

Some of this collaboration has begun already. "A group of housing associations in the North West has petitioned Homes England saying if they received additional grant funding of £15,000 more per unit then they would do it on a modular basis," says Katie Saunders, Real Estate Partner at Trowers & Hamlins. "It will cost the Government more at this point in time, but they would get a better quality, sustainable product in the long term."

Another success story is Accord Group, based in the West Midlands, which has made the step of setting up LoCal Homes, and producing low-carbon sustainable units from a purpose-built factory in Walsall. This was not as much of a leap as it may seem; Accord built up experience by working with other modular providers on several schemes, developing its own expertise, before making the investment. LoCal now supplies Accord as well as other housing associations and developers. Digby Morgan, a Real Estate Partner in Birmingham, said "It seems to really work for them. It reduces their reliance on third parties, and has attracted a lot of political interest, locally, regionally and nationally, with Homes England and the West Midland Combined Authority both seeing modular as one way of achieving the really radical increase in delivery that's needed."



These operators seem to be winning the battle to produce modular homes that people want to live in. The fear for a long time was that in order for modular factories to be viable, they would need to essentially churn out the same product, resulting in identikit units. However, it is clear that the product has moved on significantly, offering much a wider choice than previously.

"Effectively the floorplate will be standardised, but then within those buildings you can configure them in different ways," says Cordery. "So, you can have different room sizes but also, for example, have the kitchen on the top floor and the bedrooms on the ground floor. If you're talking about towers, you can choose a range of cladding solutions, so from the outside you can still give each building a unique character."

Bartter agrees. "With some of the completed buildings we've seen recently you wouldn't be able to guess that they're modular," he says.

"Modular construction has moved on a lot, even in the last five years, with the end-product now indistinguishable from a traditional build."

"A lot of people do have that fear of everything looking the same, so they want to personalise their units and with today's technology that is possible. Swan has a service where residents can choose different elements and configurations online."

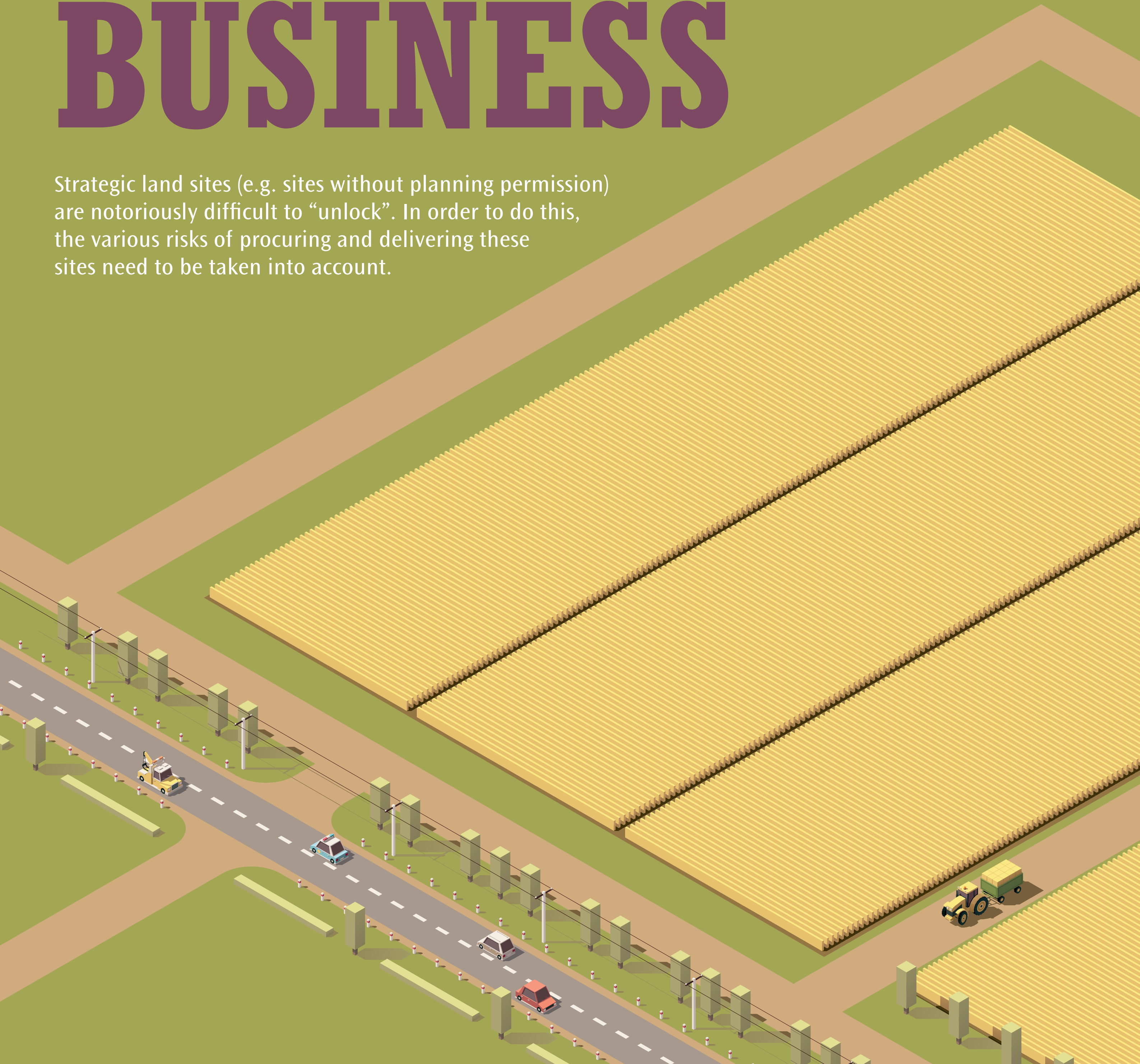
The perception of modular from lenders, however, is still fairly cautious; partly as a result of having large amount of risk sitting with a single supplier."

The issue of securing the approval of lenders is key to the success of modular, especially for small and medium-sized businesses – both in terms of development finance at one end of the process, and mortgage lending at the other. "There has been reluctance to sign off the funding for modular products, mainly because of the perceived quality issues, and sometimes this is because they or their advisers (including lawyers) don't understand the product," says Bartter.

Mortgage lenders have been similarly cautious but are increasingly understanding the product and adapting. "The mortgage lenders' have typically viewed modular as a 'special construction method' which puts the development into a higher risk category," says Cordery. "If your mortgage lender is making an issue of the method of construction, many people would simply prefer to buy a house that has been built using traditional methods, so as to avoid any difficulties. This should change over time, as the lenders start to understand the product a bit more. Some developers and RPs have established good working relationships with their lenders and we are optimistic that the industry as a whole will soon start to reap the benefits."

RISKY BUSINESS

Strategic land sites (e.g. sites without planning permission) are notoriously difficult to “unlock”. In order to do this, the various risks of procuring and delivering these sites need to be taken into account.



Perhaps prompted by the Letwin Review of housing delivery, national news outlets, as diametrically opposed politically as The Guardian and The Telegraph, have decried the practice of land promotion, accusing those in the sector of profiteering from land speculation while doing nothing to help solve the housing crisis.

The counter-argument, however, is that strategic land firms play a key role in assembling sites and gaining planning permission which, according to many in the sector, the major housebuilders have increasingly shied away from (with some exceptions) following the 2008 global financial crisis. This is possibly due to the fact that it is an inherently risky business.

More than just being legitimate, it can be argued that strategic land firms' role in the housebuilding industry is vital. A report published last year by consultancy WYG estimated that up to a third of councils do not have a five-year housing land supply, as required by central government. In other words, up to a third of local authorities are failing to plan for the housing needs of their populations in the medium and long term. At a time when the UK is facing a housing crisis, strategic land specialists' work identifying unallocated sites for potential development could be seen as making an important contribution.

They are certainly active. A recent analysis by Savills found that strategic land companies are now the most active group in the pre-planning process, with plans for approximately 250,000 units in the pipeline. When plans that have been submitted or received outline permission are included, the figure rises to 350,000 homes.

Notwithstanding the above, strategic land promoters have had a hard time of it in the press lately. One of the charges laid at their doors is that their work is inflationary; that because they represent another step in the process and demand high profit margins, land rises in value, something which is then represented in inflated house prices in order for a housebuilder or developer to also make a profit. In part, the charge is countered by the fact that housebuilders are not, in general, promoting unallocated sites themselves.

But according to Julian Keith, Real Estate Partner at Trowers & Hamlins, it also fails to recognise that strategic land companies take on huge risks, particularly given the current planning processes and these risks have to be rewarded. "There are different people taking risks at different stages of the process," he says. "There is land assembly risk, planning risk, building risk and then sales risk. Strategic land companies are exposed to the first two and if you are taking a risk you should be rewarded. What's more," he adds, "there is nothing stopping the public sector, or savvy investors from doing the same thing.

Ultimately, the key is more housing and, as the Letwin Review indicated, a greater diversity of tenures to assist absorption in the market."

Companies in the strategic land sector are also accused of taking an aggressive stance when it comes to dealing with the planning system. Where they are able to persuade a planning authority to simply allocate their site in the next iteration of their local plan, this shouldn't be the case. But Rory Stracey, Real Estate Partner and Planning specialist at Towers & Hamlins, says that situations can become combative when a company is unsuccessful or unwilling to wait and seeks permission for an unallocated site.

"When you talk about gaining planning permission for non-allocated sites, it's an inherently adversarial play because the planning authority will have deliberately chosen not to allocate a site, probably for political reasons," he says. "That's when you tend to get into the adversarial territory because you start arguing about housing land supply – arguing that the local plan isn't meeting local housing need. That's where a strategic land promoter's skill in navigating the planning system can play a key role in winning planning consent where a more generalist developer or housebuilder that is not geared up for contentious planning issues wouldn't be able to achieve it."

In part, that skill involves calculating what level of community benefit is viable for a given site and what level of community benefit is necessary to tip the planning balance in favour of consent being granted. After all, it is in the strategic land company's best interests to make a scheme as politically palatable as possible. "If you're trying to promote a site that isn't allocated then selling the community benefits of the scheme is central to winning favour for the proposal," says Stracey.

"The more that can be brought to the table in terms of infrastructure will help with making the planning case."

Equally, it is important from a placemaking perspective and absorption to ensure mixed tenure schemes with adequate community benefit are sought, but also it is key in terms of creating a coherent community.

Controversy or no controversy, without strong intervention from government the strategic land sector is here to stay. What's more, Keith predicts that a new wave of investors could be about to enter the market. "There is a place for people – the public sector, long-term investors or other capital – to get involved," he says. "If we have another dip in currency post-Brexit, I think there is a big opportunity for investors to come in and assist in bringing these schemes forward by obtaining planning and putting in infrastructure. This would help deliver the much needed housing the country needs and, for them, hopefully make returns when the schemes are finally sold."

POWERING ECONOMIC GROWTH

Most people, whether pro- or anti-Brexit, agree that the UK leaving the European Union next year will have at least a short term negative impact on the economy. The question, therefore, is how to prepare; how to put in place measures that will stimulate economic growth.

For many, one of the solutions is to focus on infrastructure and specifically infrastructure that will unlock housing development on brownfield sites in the parts of the country where new homes are needed most. After all, the Office for National Statistics' latest forecasts predicts that an additional 844,000 new homes will be needed in London alone by 2041. Housebuilding on that scale simply won't happen without the necessary infrastructure.

> **"Particularly post-Brexit, when economic growth is going to be vital, infrastructure is going to be the key bedrock for growth,"**

says Tonia Secker, Real Estate Partner at Trowers & Hamlins. "If you're going to generate productivity then you need to have people in the right places so they can be productive. From a real estate perspective, residential supply needs to support that. So, we need infrastructure that isn't just the nuts and bolts in terms of rail and roads, but also the right social infrastructure."

The good news is that many planning authorities appear to be up for the challenge. According to Chris Plumley, Real Estate Partner at Towers & Hamlins, public sector clients understand that they need to be proactive when it comes to readying sites for development. “Local government, including the combined authorities, are working tirelessly to bring sites to market and are creating infrastructure in order to do so,” he says.

“Developers have a lot of opportunities to work collaboratively in joint ventures or other forms of partnership to bring development forward.”

“We’ve been talking to chief executives and heads of place and it’s really struck us how buoyant the mood is in the public sector in terms of creating communities and really pushing forward on the property front.”

Of course, infrastructure doesn’t come cheap, but there are a number of options available to both local authorities and private sector developers. For instance, a number of institutional investors, notably Legal & General Real Assets, have announced recently that they are seeking to invest more in infrastructure, in addition to traditional real estate asset classes.

That is certainly the expectation at the vast Old Oak and Park Royal development site in west London. Whereas the state picked up the tab for the infrastructure works required for the Olympic Park in the east of the capital in its entirety. At Old Oak the current understanding is that two thirds of the infrastructure funding needed, will be paid for by the private sector.

However, the right incentives do need to be in place. “Investors will only invest in infrastructure if there’s a return for them further down the line. For example housing, retail or commercial are assets they can sell or from which they can secure a long-term income stream,” says Scott Dorling, Real Estate Partner at Towers & Hamlins. “It’s about what might facilitate their investment coming on stream.”

An interesting example of how this can work is to be found in Hong Kong, where the MTR Corporation, which is listed on the Hong Kong Stock Exchange, is charged with running the city’s mass transport railway. When a new line is needed, the Government provides the corporation with a licence to develop public land near proposed transport nodes, while the corporation agrees to fund the new line and cap fares. Similarly Transport for London is using their property assets to generate income streams to subsidise their operating costs and reduce fare increases.

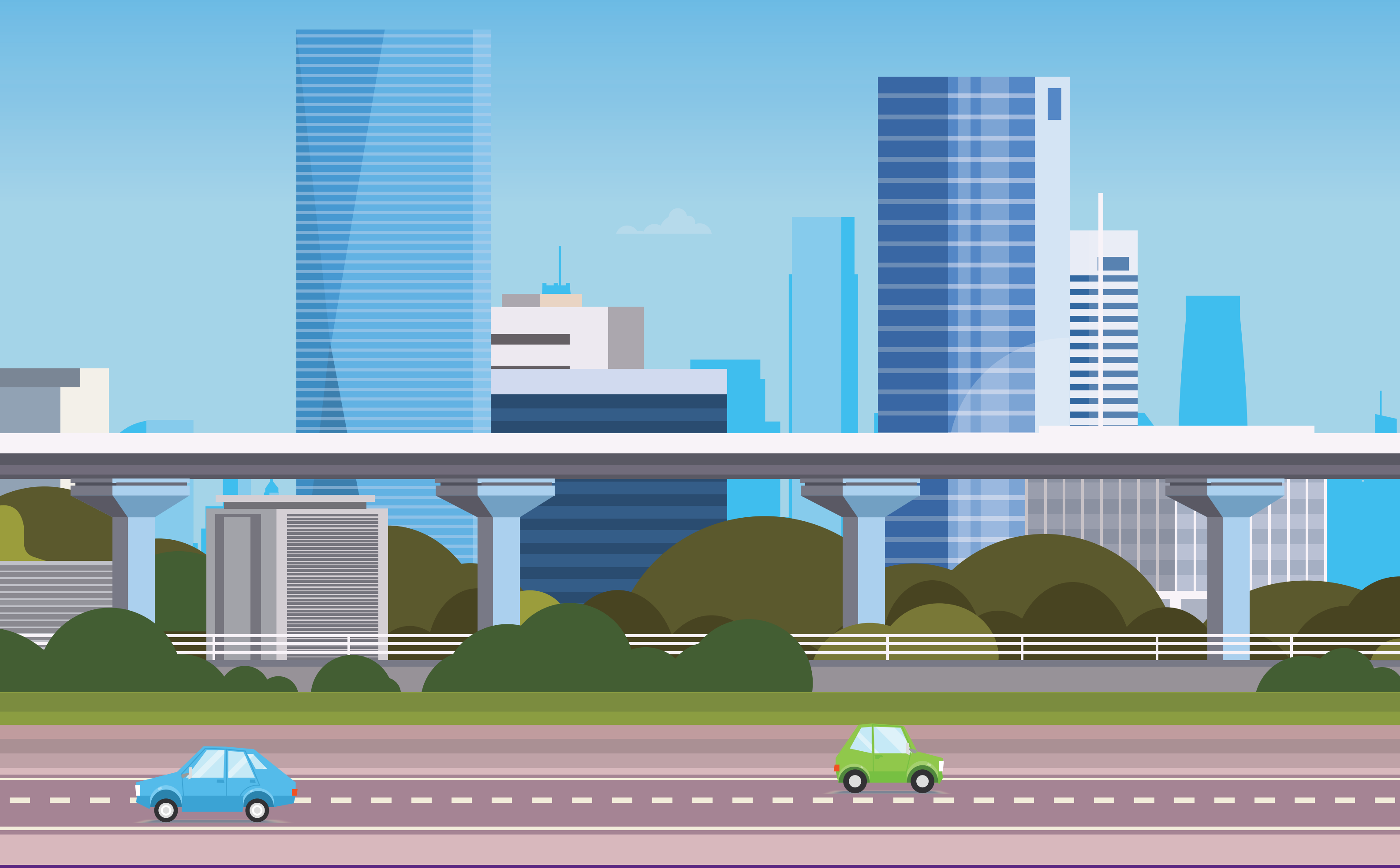
Alternatively, forward thinking local authorities in the UK could seek to fund enabling infrastructure themselves. Public bodies can currently borrow at low rates, from the Public Works Loans Board for instance, and can take comfort from the fact that they will be able to repay loans with the additional revenue resulting from the development their investment stimulates.

“If they want to play a placemaking role and put in infrastructure to get a regeneration scheme off the ground or attract match funding, they could easily borrow at very cheap rates,” says Dorling.

“There are some authorities that are borrowing significant amounts knowing that ultimately they will get the commercial, retail and residential on site, although different authorities have very different attitudes to risk and what they deem to be a prudent level of borrowing.”

Finally, both authorities and developers can take advantage of various central government infrastructure funding streams, which are more plentiful than might be expected. The combined authorities, Sport England, Homes England and other, private, entities all have available funding for site infrastructure, focussed at accelerating housing supply and wider developments. “There is a lot of available cash out there,” says Secker. “It’s about how to access it and which are the right pots to go to. It seems to me that a lot of the developer market still doesn’t realise that it’s available. The bigger players do, but often developers think it’s inaccessible or the process just too time consuming and complicated. That’s something we are keen to address.”

It’s clear there are plenty of options in terms of how to fund the infrastructure necessary in order to stimulate growth. What’s required is for both local authorities and developers to think more strategically about which option is most appropriate for which site.



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