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ISSUE TWO
thinking
Real Estate

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Trowers & Hamlins is an international law firm helping businesses and governments change the way we live and work for the better by providing commercial advice geared towards tackling tomorrow's challenges in the industry.

Fascinated by the future of our towns and cities, the firm delivers valuable opinion, beyond just interpreting the law, by balancing the needs of commerce, culture and communities in the built environment.

With a genuine edge in inward investment and a growing reputation in the private sector, Trowers & Hamlins provides a bridge between the public and private sectors, and is the firm best equipped to connect business and the wider infrastructure of society ultimately to create more sustainable communities.

Extensive experience across the real estate market has driven behaviours that set the firm apart with a team of open-minded, unstuffy and refreshingly collaborative people.

Also refreshingly different is our approach to sharing our experience and insight. That's why we created 'thinking real estate' – this second issue draws on this year's MIPIM theme of 'Housing the World' and focuses on the need for more creative thinking in the UK and global housing markets. We hope you find this edition interesting as well as useful; we'd love to find out. Email us at enquiries@trowers.com with any comments or to get in touch, or follow us on twitter @Trowers.

MARCH 2016

DEVOLUTION: SOMETHING FOR EVERYBODY?

Rebalancing the UK economy and developing the regional cities, particularly in the North, Midlands and South West, has been high on the government agenda for nearly 20 years, but the government's decision to create a series of Combined Authorities (CAs) to devolve a large proportion of government spending to the regions is probably the boldest overt policy to date.

The first of the Combined Authorities elects its first mayor in April next year, kicking off a radical economic experiment with one clear aim.

The idea is that this is very much localism in practice," says Tonia Secker, regeneration specialist partner at Towers & Hamlins. "But the message from government is clear: this is all about economic growth."

Ahead of the pack in terms of regional devolution is Manchester, where the Greater Manchester Combined Authority (GMCA) will take charge of specific functions currently provided by ten local authorities. It will also determine how the £6bn North West health budget will be spent, together with overseeing transport, police, fire services with potential for greater engagement in the employment and skills agenda.

David Vayro, a partner in Trowers & Hamlins' Manchester office who leads the Projects and Construction team in the North West, explains the central importance of the funding calculations behind devolution.

"The current cost to the government of funding what we might call Greater Manchester plc is about £22bn," he says. "Contrast that with the £17bn it gets in revenue, and you have a £5bn funding gap. That's the gap which has to be made up for the North West to be a net contributor to the UK economy. The whole drive is towards realistic cost savings, creating efficiencies and yearly productivity with integrated planning and a strong regional focus to ensure that gap is eliminated and the GMCA starts to become a net contributor to the UK economy."

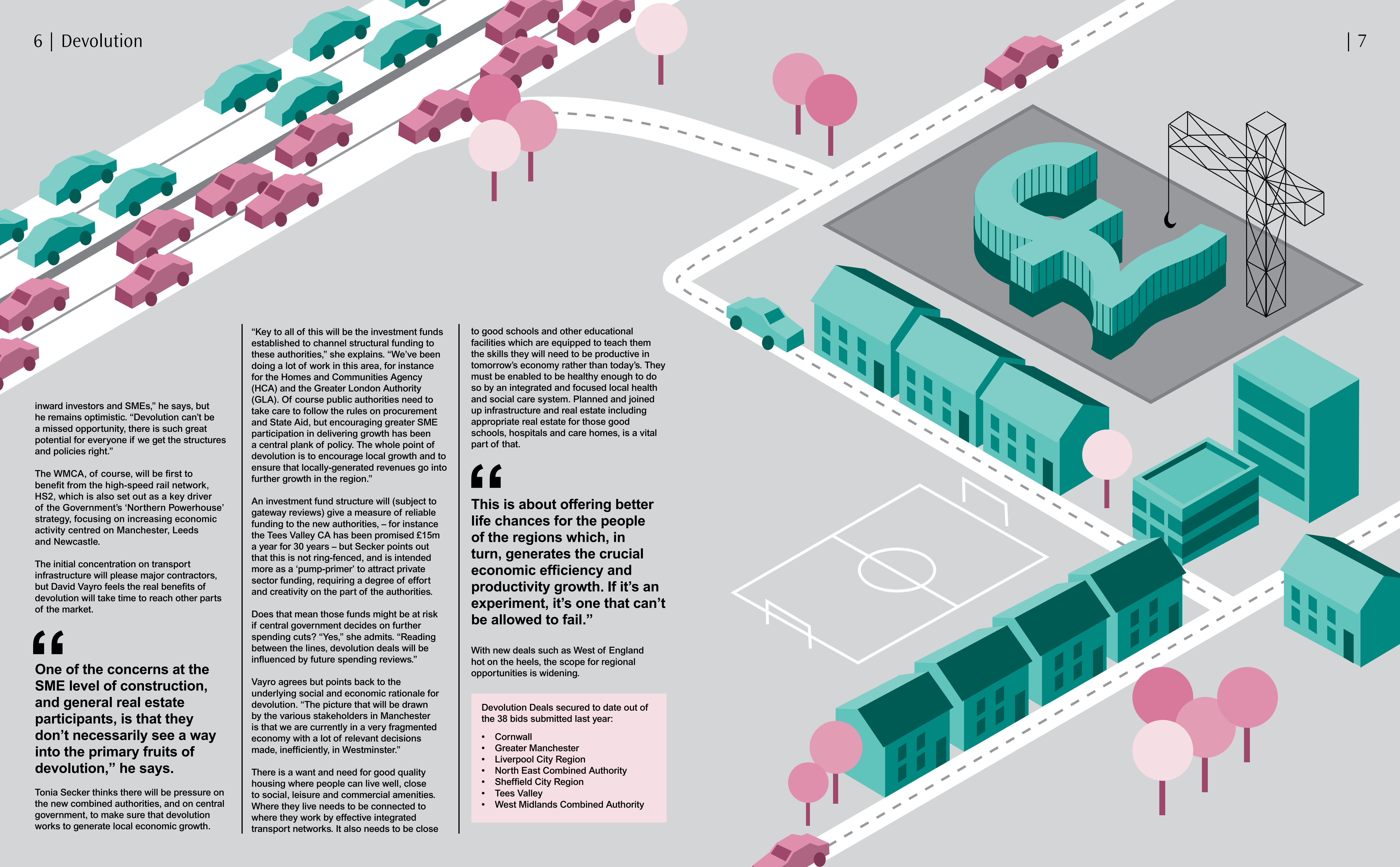
So far, so logical, and even the casual observer can tell this is going to have a major impact on the real estate sector in the region.

"The primary effect as regards real estate will be in relation to housing and to transport infrastructure," Vayro confirms. "Commercial, retail and leisure development will be a spin-off from increased economic activity rather than a direct product of devolution itself."

Amardeep Gill, partner and head of Trowers & Hamlins' Birmingham office, thinks that the West Midlands Combined Authority (WMCA) – which has signed its devolution agreement, but is slightly behind Manchester – will be "transformative" for the region, despite the narrower range of new powers in the governance package (essentially pan-regional transport, economic development and regeneration).

"In contrast to the North West, which already enjoys a high degree of political cohesion, the West Midlands has never had a coherent regional strategy, due in part to the more varied nature of the political landscape," he says. "In a sense that's the opportunity and the challenge. The election of the first-ever metro mayor is a historic chance for everyone in the region to come together and back a democratically-elected single figure with a regional mandate. We've never had that degree of power passing from the centre to the regions before, and it's very exciting."

Gill points out the potentially much greater opportunity in the WMCA, which accounts for an estimated £80bn GVA and 1.3m private sector jobs. "One potential difficulty I could see is competition between regions to attract investment, if authorities decide to compete by lowering business rates to influence



inward investors and SMEs," he says, but he remains optimistic. "Devolution can't be a missed opportunity, there is such great potential for everyone if we get the structures and policies right."

The WMCA, of course, will be first to benefit from the high-speed rail network, HS2, which is also set out as a key driver of the Government's 'Northern Powerhouse' strategy, focusing on increasing economic activity centred on Manchester, Leeds and Newcastle.

The initial concentration on transport infrastructure will please major contractors, but David Vayro feels the real benefits of devolution will take time to reach other parts of the market.

> **"One of the concerns at the SME level of construction, and general real estate participants, is that they don't necessarily see a way into the primary fruits of devolution," he says.**

Tonia Secker thinks there will be pressure on the new combined authorities, and on central government, to make sure that devolution works to generate local economic growth.

"Key to all of this will be the investment funds established to channel structural funding to these authorities," she explains. "We've been doing a lot of work in this area, for instance for the Homes and Communities Agency (HCA) and the Greater London Authority (GLA). Of course public authorities need to take care to follow the rules on procurement and State Aid, but encouraging greater SME participation in delivering growth has been a central plank of policy. The whole point of devolution is to encourage local growth and to ensure that locally-generated revenues go into further growth in the region."

An investment fund structure will (subject to gateway reviews) give a measure of reliable funding to the new authorities, – for instance the Tees Valley CA has been promised £15m a year for 30 years – but Secker points out that this is not ring-fenced, and is intended more as a 'pump-primer' to attract private sector funding, requiring a degree of effort and creativity on the part of the authorities.

Does that mean those funds might be at risk if central government decides on further spending cuts? "Yes," she admits. "Reading between the lines, devolution deals will be influenced by future spending reviews."

Vayro agrees but points back to the underlying social and economic rationale for devolution. "The picture that will be drawn by the various stakeholders in Manchester is that we are currently in a very fragmented economy with a lot of relevant decisions made, inefficiently, in Westminster."

There is a want and need for good quality housing where people can live well, close to social, leisure and commercial amenities. Where they live needs to be connected to where they work by effective integrated transport networks. It also needs to be close to good schools and other educational facilities which are equipped to teach them the skills they will need to be productive in tomorrow's economy rather than today's. They must be enabled to be healthy enough to do so by an integrated and focused local health and social care system. Planned and joined up infrastructure and real estate including appropriate real estate for those good schools, hospitals and care homes, is a vital part of that.

> **"This is about offering better life chances for the people of the regions which, in turn, generates the crucial economic efficiency and productivity growth. If it's an experiment, it's one that can't be allowed to fail."**

With new deals such as West of England hot on the heels, the scope for regional opportunities is widening.

Devolution Deals secured to date out of the 38 bids submitted last year:

- Cornwall
- Greater Manchester
- Liverpool City Region
- North East Combined Authority
- Sheffield City Region
- Tees Valley
- West Midlands Combined Authority

Middle East affordable housing gets creative

The UK's initiative in encouraging private capital to meet public need reached its zenith in the early 2000s with the rollout of an extensive programme of public sector building funded under the Public Finance Initiative (PFI), itself an exponent of the Public Private Partnership (PPP) model. Though PFI/PPP has become something of a political football in the UK these days, its principles and structures – and the lessons learned during its development – are underpinning a remarkable and unprecedented interest in affordable housing in the Middle East.

"Politically, the governments of the region have come under real pressure to deliver social and affordable housing, particularly in the wake of the so-called Arab Spring,"

explains Abdul-Haq Mohammed, international managing partner at Trowers & Hamlins, who is based in the firm's Bahrain office and leads its affordable housing initiative in the region.

Trowers is currently working on four Pathfinder projects across the Gulf, ranging from the first-ever social housing PPP for the Government of Bahrain, to what might be one of the largest PPP projects ever undertaken: the Kuwaiti government's plan to build 9,000 affordable dwellings.

The casual observer may be forgiven for asking why Gulf governments might need private capital, given the perception of how wealthy they are, but as Mohammed explains: "Public sector budgets have in recent years been predicated on the basis of reasonably high oil revenues, so while we may have seen a peak of over $100 a barrel not too long ago, they have tended to plan at a level of $65–$75. Now, with oil at araound $28 a barrel, that means a large deficit, hence the need to attract private capital."

Of course, the need for capital is not the only factor driving the use of PPP-type structures. In many instances the private sector can allocate capital more efficiently than the public sector can, and private sector providers bring expertise and experience public authorities do not have, as well as spreading the risk.

While big funders are still more interested in things like power projects, where there is a continuing 'offtake' as generating capacity comes onstream, affordable housing projects have certain advantages over other investment opportunities.

"Property has always been an asset class of considerable interest to investors in the region, and after the financial crash, and the failure of some speculative luxury residential developments, these kinds of housing projects offer a much more solid return, coming as they do with government backing," Mohammed explains, but he says there have been challenges to overcome.

"The lack of legislative or infrastructure frameworks means that we've had to do a lot of the groundwork, putting basic structures in place."

One project of this kind saw the firm appointed alongside consulting firm KPMG to advise the Supreme Council for Planning (SCP) in Oman on a pilot housing project, after which the SCP approached the firm directly to completely overhaul the housing framework in the Sultanate, including drafting a new policy on housing and a new law, which envisages the creation in time of a new independent housing authority.

While Trowers has compiled comparative studies of similar initiatives in such diverse places as Singapore, Denmark, Taiwan and Jersey so that clients can compare available solutions, governments in the GCC (Gulf Cooperation Council) seem most interested in learning from the UK model.

“One issue has been that the UK is so far ahead in some senses that we couldn’t implement certain elements,” says Mohammed.

“For instance, one client was very excited about using ALMOs (Arms-Length Management Organisations), but you don’t have the structures or the scale for that right now in the GCC. You might look at that in 10 years’ time but not for now. If it does evolve in that direction though, I can see Middle East housing becoming of real interest to some of the UK’s sophisticated FM providers such as Capita or Serco.”

Mohammed says there are other reasons why UK practice cannot be directly applied in the Gulf.

“Each of the Gulf nations, despite them being relatively young states, has a deep, longstanding culture, and it is very important to understand where UK thinking might need to adapt to local norms.”

Funding, for instance, has been a strictly local affair thus far. The Bahrain PPP was underpinned by funding from a major Islamic bank using Islamic finance structures, although Mohammed is quick to point out that non-Islamic funders would not necessarily have to go down that route.

It seems unlikely, however, the GCC would follow the UK in using public-private hybrid financing techniques to develop a large private rented sector, at least for now. “In the Gulf, the intention is usually to build properties for people to buy, rather than rent,” says Mohammed, “so that might be less interesting to, say, a pension fund looking for regular, high rental income from a BTRS (Build To Rent Scheme).” Where leasing is used, it is for the lowest income tier and the appetite for innovation in that area is lower.

Building on its work in the Gulf, the firm has been exploring working with UK Government bodies, such as UK Trade & Investment, to develop such structures as a recognised export product. Other countries with large, often young, populations and high levels of housing demand, such as Saudi Arabia, Malaysia and South Africa, are on its radar.

“Investors will, inevitably, be very concerned about stability and about their return, but it’s vitally important to look at the underlying structure pursuant to which investment will flow in the future,” cautions Mohammed.

He points again to the Omani experience. “There, we had to look at the general framework of property law and property rights, as a robust property ownership system boosts the economy. If you get that right, you’ll encourage investment in the longer term.”

A BLUE-CHIP FIX FOR JUNIORS' HOUSING ISSUES

If you were to go back ten years and tell people that come 2016, young professionals such as accountants and lawyers would not only be unable to afford to buy a property, but would also be priced out of the rental market, they would have thought you were mad.

But in the UK's overheated property market – nowhere hotter than London, where many of the major accountants and law firms have their head offices – the failure of wages to keep pace with prices (and rents) has created something of a 'perfect storm' for young people, even those earning decent salaries.

Big Four accountancy and consulting practice Deloitte announced in autumn 2015 that it was going to help its new recruits in the capital with subsidised rental accommodation, but took the market entirely by surprise in January 2016 by revealing that it was looking at going a step further, and working with developers to secure houses and flats in new developments for its people, from apprentices to existing senior staff. Other accountants and some major law firms are known to be looking at similar ideas.

Andy Barnard, private rented sector and regeneration specialist partner at Trowers & Hamlins, says it is unsurprising that large professional services organisations are taking exceptional measures to secure accommodation for their staff.

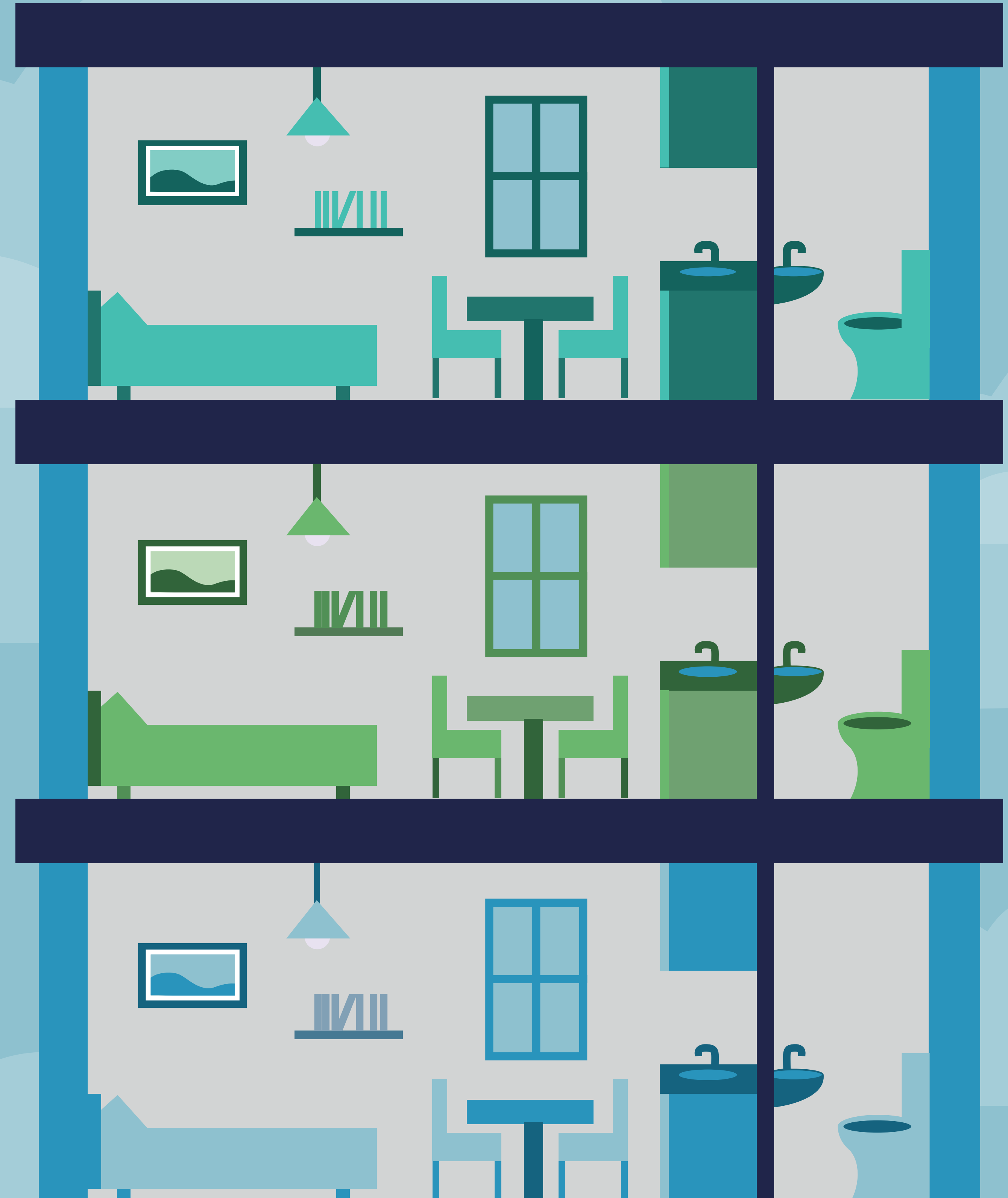
"We don't know the details of the scheme yet, but on the face of it this looks like an enterprising move by Deloitte to mitigate the impact of high property prices, and rents, on recruitment," he says.

"While the media was keen to bill this as 'Deloitte builds worker housing', I don't imagine they want to start being property developers or landlords," he adds. "We're not going to see 'Deloitteville' popping up in central London.

"What's much more likely is that they will negotiate a certain number of nominations in new developments. But this could be very attractive from a developer point of view, especially if Deloitte or a similar blue-chip organisation, is going to offer a covenant too. That kind of thing could make funding a development more attractive to an investor, rather like the effect an anchor tenant has for a shopping centre."

"This is one of a number of changes we're seeing in the residential market in response to continuing high prices," notes Ian Doolittle, public sector housing specialist and partner at the firm.

"Quite a number of local authorities have decided to be proactive in the market, using local housing companies to provide not just key worker and social housing, but also affordable units up and down the value chain. They have moved away from the old idea of mono-tenure, large estates towards mixed developments, recognising that attracting economically active people is key to regeneration."



Some local authorities outside of major cities are taking creative approaches, such as Cherwell District Council in North Oxfordshire. Here they are creating the largest self-build scheme in Europe as a way of engaging previously disengaged members of the community, encouraging working families to the area whilst generating revenue for the authority.

Whereas London is the centre of the housing 'storm', the attractive, regenerated centres of some of the UK's major cities, such as Bristol, Manchester and Leeds, have also seen hikes in property prices, with local salaries struggling to keep up. PRS (Private Rented Sector) is the obvious solution to getting large numbers of affordable units into the market quickly, but the UK's complex property market inveighs against easy solutions.

"PRS is proving to be successful in some areas," says Andy Barnard, "but a major block in many areas is land value. In most cases, a developer building to sell is prepared to pay more for the land."

"There are probably some public sector landholdings which could be brought into play for PRS," says Ian Doolittle, "but historically, many local authorities have tended, for understandable reasons, to want to hold onto prime land for that 'perfect' scheme which will solve numerous local issues at once. I sense things are beginning to free up a little, in the face of the evident crisis in housing."

Density is also an issue. Many areas of London, especially some of the large local authority estates, are not sufficiently dense to allow for a healthy commercial 'street life'. Central Barcelona, for instance, has four times the residential density of central London.

Ironically, says Barnard, "a major hurdle to redeveloping and increasing the density of much of the existing local authority estate in London, for instance, is the presence of individual leaseholders on estates, as a product of the Right To Buy policy."

One solution could be repurposing underused office buildings as residential property, something which has been done to a certain extent in London and Manchester, for instance, but the issues for local authorities, caught in a spending squeeze, are far from simple.

Barnard points to a large scheme in Archway, London, where Trowers client Essential Living is converting the landmark 17-storey Vantage Tower – which sits on top of the Tube station, with stunning views of the City – to 118 PRS units, with a roof terrace, winter garden and club room. In this example the local authority challenged the use of the rules giving "prior approval" to office to residential conversion.

As Ian Doolittle warns, most UK towns and cities have far less office space, and conversion to residential is something of a 'one-way street', with local authorities reluctant to sacrifice precious business rate revenues for council tax.

In many cases, converting office to residential is indicative of market failure, rather than part of an active economic strategy," he says. "Local authorities find themselves in the unenviable position of having to balance the often competing interests of different community and business groups, and that kind of move is often a last resort."

Ultimately, whatever the pressures on this complex market with huge demand, high land values and skills and materials shortages in construction, developers, local authorities and large employers alike will need to look to more creative methods in order to make sure young workers can afford a place to live.

ARCHWAY STATION

ENERGY REMAINS CENTRAL TO UK CITIES' DEVELOPMENT

There are few topics more politically-charged than energy, and fewer still where minor changes in government subsidy arrangements can change the whole complexion of a market.

Access to energy is one of the basic life-needs, and yet the consumer cannot choose between different qualities of product, simply different pricing arrangements, which makes the way that heat and power are generated vitally important.

Developers in the UK have not, traditionally, chosen to focus on the role of energy, but as Chris Paul, energy and infrastructure partner at Trowers & Hamlins and specialist in district heating/cooling schemes, explains, many projects now include a significant energy component.

"Planning policies often drive the energy solution – pushing low carbon sources, on-site CHP (Combined Heat and Power) or connection to existing (or future) heat networks, but there is little real incentive to consider the wider issues beyond the boundaries of your site," he adds.

"Early consideration of energy strategy is important," says Paul. "While the media has got very excited about what seem like radical changes in the incentives available for certain renewables, the general upward trend of energy prices will continue to drive interest in energy efficiency and renewables."

Rob Beiley, a partner in the firm's regeneration practice who advises local authorities and housing providers in the sector, agrees. "Some developers are starting to realise that the economics of certain renewables are coming close to standing on their own two feet, and using energy generation to mitigate the costs of running their buildings or at least provide a hedge against variability in energy prices.

"There are problems with the tariff regime, it's true, but the UK remains a country where the opportunities for energy are often missed or under-exploited," he says.

Beiley and Paul point to examples of best practice across Europe – including energy cooperatives and decentralised energy. Denmark shows what can be achieved when local authorities take a more strategic role in developing heat networks, linking heat sources with demand and enabling properly joined-up city-scale installations.

"Things are beginning to change here," says Paul. "The government has announced £300m of targeted funding to support heat networks, which is likely to focus on local authorities. This will hopefully result in some more joined-up thinking."

"Communal heating got a bad name here in the 1960s," adds Beiley, "when some councils attempted – badly – to implement the idea in the big-slab estates. But times have changed, technology has moved on, and energy needs to be high on the agenda for developers and local authorities."

Trowers took a leading role at the outset of the Feed-In Tariff regime, designing documentation for the solar market which has become industry standard for housing providers in the social and affordable market.

But it is not just developers who need to focus on the potential of technology to unlock value in their real estate.

"Major institutional investors and many large tenants could be missing a trick," says Paul. "If you think about an investment fund, say, with large commercial holdings, that's thousands of square meterage of roofspace which could host solar PV. That can generate electricity which can either be sold to tenants, bundled as part of a rental package to boost yields or sold to the grid."

Just 400 of the UK's 1.8m commercial properties play host to commercial scale (100kWp) solar PV installations according to 2014 figures from commercial solar provider SolarCentury, although there are some big names – including IKEA, Sainsbury's, Wal-Mart, Greggs and storage company Big Yellow – on the early adopter list.

At Big Yellow, where 16 solar PVs provide up to 20% of the company's electricity, solar is part of an energy strategy including underground heat pumps and energy conservation measures, which has won the company awards and which it uses as a marketing and recruitment tool.

The government is very keen on breaking the dominance of the Big Six [energy companies]," says Paul, "but even with innovations like Licence Lite [the junior electricity licence regime], the pace of change is glacial. It remains a challenging market for new entrants.

"It would be nice to see more joined-up thinking, both between government departments and among the various stakeholders in the market. There is so much potential, but so much ends up in the 'too difficult' box because of the complexities."

Complex markets force investors to get creative for better returns

The UK property market has never, arguably, been harder to read. And this is particularly true where residential property is concerned.

Massive pressure for new housing and lots of potential investor capital should be driving large amounts of development, but the picture is complex.

The key underlying issue is land value, which has bolstered house prices in many areas and continued rises in others. But against a backdrop of flat or declining real wages for the majority of workers and continuing caution on the part of mortgage lenders, many buyers simply cannot afford house prices in their area, even if prices are stagnating.

"It's a real headache for residential developers," says Adrian Leavey, real estate investment partner at Trowers & Hamlins.

The market is largely flat, but disturbingly peaky. There are pockets of real forward movement, but some holes, and it's quite easy to get caught out, find yourself exposed and go bust."

Residential developers usually have a "get in, get out" attitude to investment, but there are signs that some are trying to change their business model in response to market uncertainty, focusing more on longer-term, guaranteed revenue, even if the margins are lower – a pattern more usually associated with institutional investment.

And that goes hand in hand with a change in institutional behaviour.

"We have seen a couple of institutions getting further into the deal, getting 'dirty', if you like," says Leavey. "They're not getting in JCBs and doing the digging themselves, but we've seen them buying sites direct and taking on some of the risks affecting developers, such as cost or time overruns, and effectively using a developer as main contractor. That means lower returns for developers, but without a lot of the risk, and the reassurance of a large fund behind them."

Partnering more closely with institutions could also benefit developers combatting other obstacles, such as a dearth of skilled builders, electricians and other construction workers (especially in the capital), a brick shortage and the drying up of cheap steel imports.

"Unpredictable supply of labour and materials means delayed projects, and that means delayed returns," says Leavey. "That means developers need to be looking in every direction at once, not only making sure they've got funding in place but considering resources, labour supply and, of course, the perennial planning issues."

Despite rumours that the government was going to relax planning around residential development in order to ease the housing crisis, Leavey is sceptical that much will change very quickly.

There are so many interested parties when it comes to planning, and so many regulations that don't necessarily fall directly within the ambit of the local authority planning department but which can have an impact on a planning process, that I don't think we're looking at the floodgates opening.

"I think what we will see is more creativity around the edges, for instance a relaxation of the rules around self-build, which can be a very attractive option for those on a budget. I suspect we'll also be looking at a lot of pressure for redevelopment, particularly of sites in the public estate which can be densified."

Leavey's view is reinforced by a recent report – Completing London's Streets – by surveyor Savills, which calculates that around 20% of London's 8,500 hectares of the capital's local authority public housing estate, built in the 1960s and 1970s when London's population was in decline, could be redeveloped and densified, providing up to 360,000 new housing units.

"We may also see a few ideas from the past resurfacing," he adds. "For instance, with some developments in the 1950s and 1960s, the developer had an ongoing rent interest, which, with inflation, became nominal, but at the time was reasonably significant, and acted as an incentive to build and saw developers get a stable return over many years – effectively a 'builder's pension'! With uncertainty the watchword in all quarters, any initiatives designed with a view to the longer term will, I think, be very attractive to those companies looking to give a solid, but not necessarily spectacular, return to shareholders.

"Complexity forces creativity," he says. The trick in this market is to look at more creative structuring, partnership with other organisations and type of organisations and the ability and willingness to take a broader, longer-term view of projects."

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