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CASE STUDY: WINNING THE UK'S (RE)GENERATION GAME

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Local authorities in the UK are procuring larger, more flexible PPPs through joint ventures valued at up to GBP 1bn. The latest, in Brentwood, outside London, promises much for developer Morgan Sindall with little commitment from the council, reports Colin Leopold

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When house prices in Brentwood increased 16% during 2016 – the highest jump in the UK at the time – British tabloids were quick to call it 'the TOWIE effect, after ITV reality show The Only Way Is Essex, which is based in the town. But the same reporters could just have easily circled any stop outside London on Crossrail's planned Elizabeth Line (now set to connect Brentwood with central London in 2021) and found a similar trend.

Essex commuter town Brentwood is under enormous pressure to deliver new housing, despite having one of the fastest growing rates of unoccupied homes in the country, and last year its borough council selected Morgan Sindall Investments Ltd (MSIL) for a landmark regeneration deal, worth around GBP 1bn over a 30-year development period.

The deal is not structured as a traditional public-private partnership (PPP) nor does it oblige the council to provide any land to the private company, yet it is an extremely attractive arrangement for MSIL and the fourth it has won of the kind in recent years.

LLP, not PPP

Brentwood Council and MSIL share ownership of a newly created limited liability partnership (LLP) responsible for the development of homes, public spaces, commercial units and leisure facilities.

The UK investor will need to pay between GBP 20m and GBP 30m for land for the scheme provided by the council, said one source speaking to Inframation last year. According to MSIL, the land value is subject to a number of factors determined in a business case for each site.

The Local Asset Backed Vehicle (LABV) is set to deliver a programme of developments for three decades by combining MSIL's development expertise with private capital and a portfolio of the council's sites. MSIL could design, build, finance, operate, manage and maintain housing, commercial units, public spaces and leisure facilities and the council will contract these through its wholly owned property company, Seven Arches Investments Ltd.

Sources involved with the scheme were reluctant to provide information on sites or development plans but according to information previously released by council and recent local newspaper reports, the JV is set to initially focus on three sites: William Hunter Way Car Park; Westbury Road Car Park; and the Maple Close garages site. All three sites are expected to provide new homes, with approximately 300 homes already identified for William Hunter Way.

Brentwood has a housing need of around 380 dwellings per year up to 2033, according to its 2016 development plan. If this target is achieved over the 30-year regeneration period, it would equate to 11,400 homes and represent a tripling of annual housing completions compared to the years between 2013 to 2017. The council would not confirm these figures or provide a more recent update.

The GBP 1bn investment figure for the Brentwood regeneration JV includes more than housing and represents the gross development value if the average number of sites included in the framework are built out. The figure is important for regeneration schemes to reflect the pipeline of development opportunities and attract a “certain scale of partner,” says Andy Howell, general manager at MSIL.

“[In the initial procurement phase] the more [sites] the local authority can promise, the more attractive it will be to the market but realistically [there can be] around five,” says Justin Mendelle, partner and head of construction at Sharpe Pritchard, legal adviser to the council. “Typically, it is about three, and a couple more speculative ones. But one big one can justify procurement on its own”.

According to a third person who worked on the scheme and wished not to be named, the Brentwood deal is made attractive by one site in particular – representing around 25% of the total GBP 1bn value. The person would not name the site, but said it was a commercial, mixed-use opportunity.

Fifteen investors expressed an interest in the Brentwood and three of these were shortlisted in August 2018: MSIL; Countryside Properties; and Places for People, which dropped out of the competition before final bids were submitted in December that same year.

Over the past 10 years, MSIL has secured similar joint ventures with local authorities in Bournemouth, Slough and Hertfordshire. Financial results for MSIL are not published but a source close to the company says its success in the wider Morgan Sindall group is judged by the construction and regeneration opportunities it generates.

MSIL is the group’s specialist in partnering with local authorities. Another subsidiary, Muse Developments, is Morgan Sindall’s urban regeneration arm for major single-site developments. Muse helped to generate an operating profit for Morgan Sindall’s urban regeneration division of GBP 19.6m at the end of 2018 – almost double the amount in 2017 and demonstrating what is a booming sector across the UK.

Lending support

Last year, when MSIL was announced as preferred bidder for the Brentwood scheme, a lending consortium was said to include Barclays, RBS, Investec, Aviva and UK residential developer financier Pluto Capital by reports at the time. Sources at RBS, Barclays, Investec and Aviva told *Inframation* that they have yet to be approached for financing on Brentwood, however. Pluto Capital could not be reached.

“No funding lines have been established for Brentwood,” says a source close to MSIL, adding that working capital for the scheme will be sourced from shareholders.

Again, figures for MSIL could not be found but Morgan Sindall Group, which owns MSIL, shows a strong balance sheet with net cash of GBP 114m at mid-2019. When external debt financing is required, lenders will be put through a funding competition, says Howell at MSIL.

Asset-backed loans can be anything between 60-80% loan-to-value of the property being developed. Where individual sites are de-risked or pre-rent, the JV will have the option of engaging with institutional investors, now “showing a lot more interest”, says the source close to MSIL. Student accommodation or social housing are two examples where long-term revenues based on amortising leases may attract infrastructure debt.

Amortising leases are increasingly being seen as a preferred funding option for regeneration projects in the UK and their value has increased threefold between July 2014 and June 2019, according to a white paper by Avivia on the topic published in December. These “ultra-long” leases typically range between 30 and 50 years which “aligns well with the time horizon of pension liabilities and the yields tend to be more attractive than government bonds… with spreads of between 2% and 3% above gilts as of 31 October, depending on tenant covenant strength”, writes Aviva.

A London-based infrastructure banker confirmed that the bank had been in discussions on the Brentwood regeneration scheme but no decision had been reached on whether it would be funded through the bank's infrastructure or real estate desk.

"If there is still a lot of development thought to be done on the site it will usually fall to our real estate team," says the banker. "The main risk for them is the property price capital risk… so they will look at things like location, location, location; who is the developer; and what's the value?"
MSI also has access to the capital markets. The council has access to the Public Works Loan Board to fund projects through the JV such as libraries and leisure centres, says the MSIL source.

Withering vines

Though Brentwood promises a large investment, the delivery of regeneration JVs in the UK does not always work out as planned.

"All these property joint ventures have similar drivers, they use the same structure and legal documentation – with the principal of equal share in risk and return [between public and private partner]. The model of bringing forward development is the same but how you use it can be different," says Howell.

In Slough to the west of London – a GBP 1bn of development over a 15-year agreement – "the council realised it could push the delivery of social infrastructure assets through the JV with new council homes and new education and leisure facilities," says Howell. The Bournemouth regeneration represented around GBP 500m of development over a 20-year agreement and they have focused on commercial development; securing planning consent in early 2019 for a GBP 150m mixed-use scheme at Winter Gardens.

Rather than facing contractual penalties for not bringing through sites, sources say there is no obligation on Brentwood Council to provide or develop sites with MSIL.

"The break on the whole thing from the local authority perspective is if it's not going well [they] just won't put any more sites through so that acts a natural incentive," says Mendelle, "[so] it's easier for both sides to the let the thing wither on the vine effectively."

This "withered vine" can be caused by lower than expected demand from residents or the authority may have found other development routes or frameworks to follow. "These long-term joint ventures provide both flexibility and control for councils; as a result sometimes the development use and delivery route of sites change," says Howell.

With housing demand driven by commuters to and from London, higher land values and good levels of existing business in the town, "Brentwood is not a stereotypical location for regeneration," says the source close to MSIL. "The town doesn't have large swathes of brownfield sites and over 80% of the borough is greenbelt."

The extras

On regeneration JVs, development profit and the return on investment from building out sites are typically shared between the private developer and the local authority. But depending on the structure of the JV, there are also various services that the private company can offer into the partnership, such as design, consulting, surveying and even in some cases community investment companies which can manage the estate or market the partnership.

In Brentwood, the arrangement also allows the council to act as a central purchasing body through which other local contracting authorities in Essex can procure a similar partnership with MSIL.

According to document published by private procurement agency Bloom, the Brentwood regeneration scheme is targeting an overall return to the council of at least GBP 500,000 per annum with the ultimate goal of covering the council's projected revenue deficit. Adviser to Brentwood council J C Gill has also created a property asset register allowing the council to understand its asset base and potential. A spokesperson at Brentwood council did not respond to a request for clarification on this point, and people at J C Gill could not be reached for comment.

There are also more strategic, long-term drivers for the council.

“[Councils], by their nature, are political institutions so the ability to move at pace or take commercial decisions or do anything that is achieving the objections that they supposedly set out to do was becoming quite difficult,” says the second source. “[The new JV] is meant to be more agile and flexible... Where we’re seeing a trend is in creating an intermediary between the council itself and the ultimate vehicle that delivers.”

A long-term goal in Brentwood, and for other regeneration schemes, is for the private partner to become a trusted brand in the community, allowing for additional sites to be brought through quickly and in great numbers. But reputational risks remain on both sides.

Policymakers may still face a public backlash if they opt to pay the rent owed to investors before other expenditures such as social services, even if they are legally bound to do so, says the Aviva white paper. For the private sector, assessing that risk not only requires a clear understanding of the council’s balance sheet, but also other factors including the level of public support for the project.

Banking on Crossrail or the TOWIE effect is one thing but gauging public support for your development projects over the long-term is a different risk entirely.