Y Pwyllgor Cyllid I Finance Committee
Ffynonellau cyllid cyfalaf Llywodraeth Cymru | Welsh Government's capital funding sources
CFS 01 Tirion Group

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Developing Effective Funding Models for Mixed Tenure Housing

1.0 Scope of Evidence

This evidence has been restricted to consideration of Welsh Government's role in helping non-regulated "not for profit" housing providers to access Institutional Finance to support mixed tenure housing provision as part of a more comprehensive strategy to stimulate housing provision. The proposed interventions would not just be applicable to such organisations but could also facilitate increased delivery by the Registered Social Landlord (RSL) sector.

The evidence does not cover the following aspects although I would be happy to discuss these matters as part of the oral session:

- The Registered Social Landlord sector and the role of equitization in facilitating increased scale of delivery; and
- The role of loan and grant finance to support the SME housebuilder sector in provision of open market homes for sale.

2.0 Institutional finance "the opportunity"

2.1 Institutional investors are seeking long-term, index-linked cash flows to match their long-term annuity obligations. Housing currently represents just 1% of UK institutional fund investment compared to 47% in the Netherlands, 15% in France and 13% in Germany. Pension funds are now actively seeking long-term investment alternatives to gilts to improve their returns. RSLs and not-for-profit providers like Tirion are attempting to secure long-term finance no longer readily accessible from the traditional banking sector to support delivery of mixed-tenure housing. Tirion believes that this type of facility, which matches income streams, provides a natural hedge and should form part of a portfolio of loans.

2.2 Typically, institutional investors are offering 20-50 year debt, at highly attractive investment yields, which can significantly reduce the cost of development finance reducing or negating the need for public sector subsidy. In some cases, investors have launched their own vehicles and are looking to acquire housing assets to hold on a long-term basis.

2.3 Institutional investors offer particularly attractive yields for affordable housing due to historically low void rates and this reduces the viability gap between affordable and market housing.

2.4 The potential scale of investment should not be under-estimated. Tirion Group alone is targeting institutional investment of £350 million in Wales and typically individual funds have allocated investment of at least £1bn for housing assets in the UK. L&G are believed to have allocated up to £10bn for investment in affordable housing in the future.

3.0 Barriers to Securing Investment

3.1 Whilst the opportunity to tap into Institutional appetite for residential assets is enormous, it remains a fact that in most cases the funds wish to invest in completed / existing assets. Forward funding for pre-construction and construction activities remains very rare.

3.2 This dis-connect between the development process and long-term investment is further exacerbated by the required lot sizes, at which, most investors wish to transact. In many cases the institutions require investment lot values of between £30 and £50m. This means that additional "warehouse" finance is required so that portfolios can be built to reach this critical mass. Tirion is fortunate in that it's investor is prepared to transact on our units at a much lower value of circa £15m and there are signs that the wider Institutional market is moving in this direction in recognition of the specific characteristics of the residential sector i.e. portfolios made up of small individual units each with their own value.

3.3 The consequence of this dis-connect is that there is a shortage of assets in which institutions can invest. Even where units are being constructed they are not available in sufficient lot value size. This is partly due to much more stringent regulation of the traditional banking sector following the 2008 global financial crisis and consequently greatly reduced appetite to provide development finance. This is further exacerbated by the current practise of valuing assets according to an RICS red book procedure which results in a significantly lower value than that which institutions are prepared to lend against. This further constrains the level of funding Banks can offer for the pre-construction, construction and warehouse phases of large residential projects.

3.4 This has created a vicious circle of dis-connected flows of finance, i.e. the link between development finance, warehouse finance and the long-term debt being offered by the Institutions, that Welsh Government financial interventions should seek to address.

4.0 The Role of WG

4.1 Fiscal restraint will continue to restrict the availability of Social Housing Grant in the medium to long term. However, it is also true that during this period the shortage of all types of housing tenure will grow. It seems sensible that SHG going forward should target the Social Rented Sector and therefore those most in need. It is also clear that Social Rented housing is unlikely to be viable without grant, or without cross-subsidy, in most housing markets in Wales.

4.2 The Planning system seeks to deliver community benefits including social rented housing via the s106 and CIL systems. Values in most parts of Wales do not support sufficient investment in community facilities and the social rented sector. In these circumstances WG interventions should focus on delivering a mixed tenure approach, with the possibility of cross funding (at least in part) the social rented sector on all large-scale projects in Wales. This requires mechanisms that remove elements of financial risk associated with pre-construction, construction and warehouse phases of large developments. In the majority of cases this could be achieved directly through loan finance and in some cases this could be coupled with grant to deal with abnormally high site preparation costs.

4.3 The most effective method in terms of levering private investment in mixed-tenure housing is for WG to take subordinate positions in providing a proportion of debt during the pre-construction, construction and warehouse phases of projects.

5.0 Developing an Effective Model Using Existing Finance

5.1 The effective deployment of Financial Transaction Revenue would appear to offer the best opportunity to support mixed-tenure housing development in the short to medium term. It also offers the best opportunity to minimise financial risk to the public sector. Examples of how FTR loan finance could be deployed include:

- Pre-construction – 100% loans for design, planning and statutory consents – loans would be repayable at the point that construction finance is secured;
- Site preparation works – 100% for site remediation and preparation – generally repayable at the point that construction finance is secured. Where sites are in public ownership, the loan would not be repayable if, for whatever reason the project does not proceed. This is on the basis that the works would have added the equivalent value to those sites that remain in public ownership;
- Construction phase – Up to 30% loan against development costs – loan to be subordinated to senior lender – loan to be repaid at the point warehouse finance is secured; and
- Warehouse phase – Up to 30% loan against warehouse finance costs – loan to be subordinated to senior lender - loan either to be repaid at the end of the construction phase on drawdown of institutional debt or long-term quasi-equity position taken against the loan to provide long-term revenue stream or dividends.

5.2 It should be possible to provide a rolling loan facility for housing providers to reduce the peak debt of any single organisation at the relevant stages of the development process.

5.3 Using the principles set out above it will also be possible to integrate the de-carbonisation of new development into loan programmes. The investment profile for energy investors closely matches that of institutional investment in housing being long-dated with low yields. Tirion are at the forefront of proving the commercialisation of this approach with our partners Pobl and Sero Energy with Innovative Housing Programme grant support our development at Parc Eirin in Tonyrefail.

6.0 Quantifying the Risk

6.1 Adopting a strategy that is predicated either on 100% debt or sub-ordinated debt structure comes with financial risk. However, containing risk should be relatively straightforward particularly if the debt provider (WG or other public sector organisation can adopt a long-term position on the value of assets if necessary). A broad-brush assessment of the risk context is as follows:

- Pre-construction – 100% loan – inherently the greatest risk but with the lowest financial impact – risk mitigated where the site has an Local Development Plan allocation or even better an Outline Planning Consent.

- Site preparation works – 100% loan – where the site is in public ownership it can be argued there is no risk as the works are directly adding to the value of the site. Where the site is in private ownership a legal charge can be placed on the land. The risk here is if the end value of the site remains lower than the loan offered.
- Construction phase – Up to 30% junior loan against development costs – this carries the greatest risk in the development phase due to potential for cost overruns and depreciation of values during the construction phase but still significantly lower than current average grant levels.
- Warehouse phase – Up to 30% junior loan against warehouse finance costs – relatively low risk as debt against completed units.

7.0 The Future – WG Equity Investment?

7.1 Deploying the above loan mechanisms will result in significant increases in the delivery of mixed-tenure housing on large regeneration sites. We can envisage a situation where selling land to housebuilders as part of the development strategy for large sites would cross-subsidise the provision of homes for affordable homes. However, it is unlikely to negate the need for Social Housing Grant to deliver large numbers of homes for Social Rent across Wales.

7.2 In these circumstances Welsh Government should consider its role in providing equity for both not-for- profit housing providers (e.g. Tirion) and RSLs. This could operate on the following basis:

- SHG is replaced with time-limited WG equity investment, to fund new homes for social rent via a financial transaction;
- The WG equity share would be according to need i.e. the discount required to achieve social rent levels;
- WG would forgo the return on its equity share, with the housing provider charging a maximum market rent on its share, giving a genuinely affordable submarket rent level overall; and
- The housing provider would repay WG its equity stake within a 20-year period through the re-financing of the debt against the growth in value of the assets. Alternatively, at the point the rental cashflows are providing enough surplus WG could take a slice of long-term rental income.

7.3 The risk associated with this structure is that property and rental values fall over the 20-year deferred period. This is highly unlikely.

8.0 Conclusion

8.1 There is a huge opportunity to tap into Institutional Investors' appetite for residential assets. Existing funding instruments can be better utilised to help housing providers access this investment through existing vehicles, such as Tirion Homes and RSLs, and new partnerships formed with local authorities and other public sector landowners playing a major role.

8.2 The proposal for a new Housing Land Authority could also play a pivotal role in managing the supply of development land.

8.3 There is an excellent opportunity to integrate the de-carbonisation of new development into the loan programmes, providing household cost benefits to tenants, improving the viability of projects and reducing the carbon impact of new housing.

8.4 The key conclusion is that increasing capital investment in housing, and particularly affordable housing, is not about seeking new sources of finance but rather creating mechanisms that allow existing forms of finance to join up through the public sector taking an element of acceptable risk in the development process.