

**Manchester City Council
Report for Resolution**

Report To: Executive – July 2010
Subject: Equity Investment Funds – A framework for investment
Report of: Director of Housing

Summary

The report outlines a proposal to develop housing equity investment funds which offer an innovative opportunity to bring in finance to sustain development in the city during the housing market downturn, and provide good quality rented homes to help meet housing demand.

Recommendations

The Executive is requested to:

1. Consider the report in the context of a changing housing market and the need to support house building within Manchester
 2. Grant delegated authority to the Director of Housing and City Treasurer in consultation with the Leader and Executive Members for Finance and Neighbourhood Services to enter into formal negotiations with relevant partner organisations on the development of specific equity based partnerships.
 3. Once these negotiations are complete a further report will be brought back to Executive for approval with details of the sites and developments involved and the expected financial returns.
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Wards Affected:

All

Community Strategy Spine	Summary of the contribution to the strategy
Performance of the economy of the region and sub region	The use of Equity Investment Funds will bring a substantial amount of funding directly into the local and sub regional economy. This will also be complemented by indirect investment through the construction related supply chains

Reaching full potential in education and employment	The level of activity in house building that will be directed through the fund will create and retain a number of employment opportunities. Development of skills for Manchester residents will be a key element of the project linked to and associated with the construction industry.
Individual and collective self esteem – mutual respect	Maintaining the supply of good quality homes through a range of flexible tenure and opportunity will allow residents to fulfil their housing aspirations
Neighbourhoods of Choice	By stimulating house building activity within areas that may remain undeveloped for a number of years the fund could play a major part of neighbourhood regeneration. It will allow a wider choice of housing and tenure for areas with an imbalance in supply.

Full details are in the body of the report, along with any implications for:

- Equal Opportunities Policy
- Risk Management
- Legal Considerations

Financial Consequences – Revenue

We anticipate there to be set up and administration costs for the fund as well as transactional costs associated with the transfer of any council land. The level of costs apportioned to the city council will be based upon the percentage level of investment that our land contribution equates to.

Financial Consequences – Capital

We have assumed there will be no capital contribution required as we are only investing land where we own sites and where the investment meets the relevant criteria set out in the report.

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy please contact one of the contact officers above.

1. Six proposed residential sites at Moston and Harpurhey - report to Executive February 2010
2. Response to the HM Treasury Consultation April 2010 – Investment in the UK private rented sector – Manchester and Salford Pathfinder and Manchester and Salford City Councils.
3. Response to the HM Treasury Consultation April 2010 – Investment in the UK private rented sector – Combined response of the:
 - Property Industry Alliance (PIA)*
 - Council of Mortgage Lenders (CML)
 - Association of Real Estate Funds (AREF)

*The Property Industry Alliance comprises: British Council of Offices (BCO), British Council of Shopping Centres (BCSC), British Property Federation (BPF), Investment Property Forum (IPF) and Royal Institution of Chartered Surveyors (RICS)

1.0 Introduction

- 1.1 Demand for housing continues to increase due to household and population growth. Along with the forecast economic and employment growth in the city these factors will continue to generate further need for additional homes, and extended choice of housing type and tenure. Lack of market access for first time buyers, and lack of finance for development are seriously affecting the house building industry and in the short to medium term building for sale will be high risk, with no certainty of sales. Approximately three quarters of recent house building across the City has been subsidised with some form of public funding, and this is unlikely to continue given the cuts in spending announced by the coalition government. As a Strategic Housing Authority, Manchester, along with other local authorities, will need to attract different types of private sector investment into the residential market.
- 1.2 The City Council has submitted a bid to act as the Urban Development Fund holder for the North West JESSICA initiative. The outcome of the bidding process is awaited. This initiative highlights the potential to establish an investment fund or funds that will play an active role in using public sector assets to secure private sector investment towards infrastructure and employment generating projects.

The investment fund model may also have the potential to deliver funding for projects in other sectors including transport, housing and low carbon initiatives. The purpose of this report is to inform Executive of the emerging proposals for establishing an investment fund or funds focussed on the private rented housing sector and to seek approval in principle to working with potential partners to develop a commercial proposal for consideration by the Executive at a future meeting.

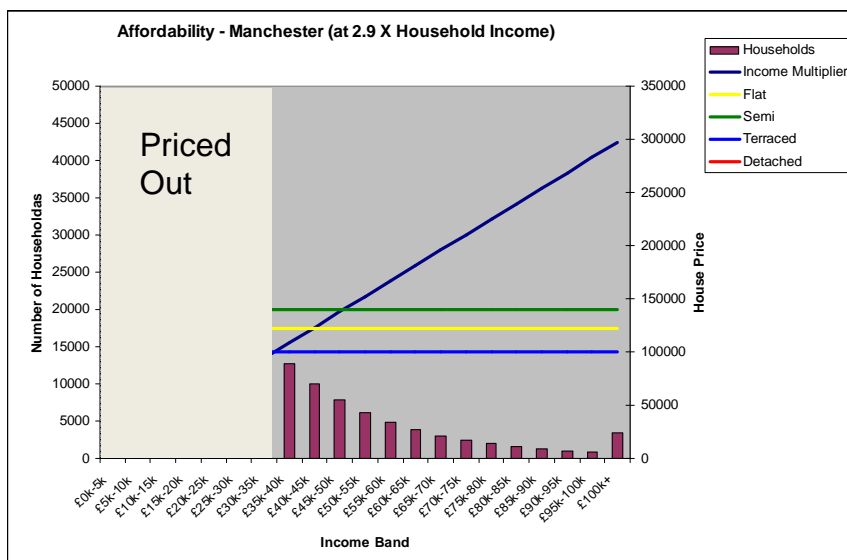
- 1.3 Opportunities have been presented to the City Council that could play a major role in continuing the supply of new build housing across Manchester. The City Council has been invited to consider joining a number of Equity Investment Funds. These funds are designed to attract institutional investment into the residential market across the City. The proposals are initially focussed on market renting with sales to follow. The medium to long-term objective is to provide a pathway to homeownership for economically active residents who may otherwise be reluctant to enter into home ownership now or in the near future. In light of the slow recovery from the recession we are still experiencing, an Equity Investment Fund could provide a pragmatic approach that will stimulate activity in the house-building sector and help meet housing need and aspirations across the City.

2.0 Background

- 2.1 Manchester has achieved significant economic growth over the last two decades. The Community Strategy 2006-2015 spells out further tangible commitments which Partners have made to accelerate this economic growth and ensure that more people and communities share its benefits. Within the Strategy the role of housing is clearly articulated and geared towards the

creation of successful neighbourhoods which attract and retain successful people from diverse communities and in which people feel secure and supported.

- 2.2 To achieve this we need to redress the balance of housing in the City which, in the past, has provided limited choice. Manchester's Local Area Agreement (LAA) set out the targets we must reach over a three-year timescale if we are to deliver the ambition of the Community Strategy. Within this Agreement Manchester set an explicit target to rebalance housing markets by achieving an owner occupation figure of 60% by 2015 (50% by 2011).
- 2.3 The needs and aspirations of a significant sector of the population cannot currently be met from the sales market. Evidence shows that the only area of the market where sales are increasing is the sector serving "wealthy achievers" who have equity within their existing properties, rather than first time buyers or lower-income households. This is highlighted in the chart below with 71% of households whose combined earnings are below £35k per year currently priced out of the owner occupier housing market and unable to afford an average terraced property (£100K) within Manchester.



- 2.4 Recent reports indicate that the average age of unassisted first time buyers is 37. For a variety of reasons not wholly related to mortgage finance younger households and graduates expect to be more mobile to take advantage of employment opportunities. This age group, and particularly recent graduates, are likely to play a major role in the forecast employment expansion in the City, reflecting the growth of knowledge industries, requiring high skill levels and mobility. The private rented sector as a whole now provides real quality and choice for them with commentators suggesting that there may be a more lasting change to the market, for financial and lifestyle reasons; it is possible that private rental may become a more significant tenure, in line with the US and areas of Northern Europe.

2.5 While owner occupation is an important aspiration for the City, an affordable, quality private rented sector can offer households the opportunity to save for a deposit while retaining flexibility and mobility to access employment and enjoying the quality of home they aspire to. The private rented sector can therefore play a vital role for many households as their needs change, and offers a flexible and responsive housing market where supply adjusts to changing demand. The following section explains in more detail the current rationale behind the increasing importance of the Private Rented Sector and the role this will play as we move forward out of recession.

3.0 The emerging role of the Private Rented Sector (PRS)

3.1 There is strong evidence to indicate that the private rented sector (PRS) is growing across Manchester. At the regional level, figures for the North West (from 1998) show that the number of people opting for this sector has increased by over 100,000. At the local level, monitoring estimates that since 2003 the PRS sector has grown in Manchester and Salford by up to 3%. Pressure has resulted from the gap between earnings and house prices and this along with the scarcity of mortgage finance (equity led high loan to value ratios) has constrained house sales by first time buyers in entry-level borrowing markets. The result is pent up demand from people who are forced to rent in the hope they may be able to save a deposit at the same time. An intermediate option could aid this process allowing a longer-term "stepping stone" approach.

3.2 Relative affordability, in comparison with owner-occupation has changed significantly over the past decade. Growth in private sector rents has broadly kept pace with average earnings, meaning for those in work, the PRS is no more expensive than it was a decade ago. Average house prices on the other hand, even allowing for the corrections over the past two years, have nearly doubled. We are not yet in a position to tell whether the swing to home ownership will return to pre-recession levels once mortgage finance is eased, but it is unlikely to change significantly within the life of the current Community Strategy. Given the likely workforce demographic in the City, and the availability of attractive private rented housing, it is likely that renting will remain a tenure of choice in significant areas around key employment sources.

3.3 Kate Barker's Review of Housing Supply in 2004 concluded that a consistent under-supply of housing was a major factor contributing to the UK's historically high upward trend in prices. Therefore, to reverse this trend, improve affordability and help those priced out of the housing market, the Government committed itself to a step-change in housing supply. Subsequent Budget announcements and policy statements continued to support and build on that agenda and recognised that the PRS was playing an increasingly important role in the housing market. In 2009 the Government published a consultation paper by the Treasury – Investment in the UK Private Rented Sector, to consider the contribution the PRS could make to addressing demand and increasing housing supply, and any barriers to investment. The City Council responded to this jointly with the Manchester and Salford Pathfinder; the

response is included as a background document to this report.

- 3.4 The two key areas of the consultation were around individual smaller scale investment such as buy-to-let and the emerging institutional investment that was more traditionally aimed at commercial property rather than the residential market. Over previous years the ability and willingness of buy-to-let investors to forward purchase new units 'off-plan' became a vital part of funding new development, particularly higher density and Brownfield schemes. Owner – occupiers traditionally purchase homes following or just before construction completion. However, as lenders have become a lot more cautious about financing the purchase of new-build property, both for owner-occupiers and buy-to-let investors it has had a real impact on developer's ability to access commercial finance. The recent budget announcement of an increase in Capital Gains Tax will also likely to deter smaller investors
- 3.5 The key to unlocking finance for the developers is to replace the gap left by the buy-to-let market and the reduction of potential owner-occupiers with large-scale institutional investment, which will guarantee a proportion of future sales on housing developments. The proposed equity investment model outlined below is particularly attractive to institutional investors as it is targeted at market demand, combines good quality management and long-term tenancies to provide a stable and competitive return on investment. It is the market for the product, which will attract private investors and banks at an early stage of the project.
- 3.6 Both London and Birmingham are actively engaged with the concept of Equity Investment Funds and this presents a real opportunity for Manchester to be at the forefront of this approach. The key for Manchester will be to ensure that a large proportion of this 'new wave' of Private Rented Sector will have the opportunity and flexibility to move towards home-ownership in the very near future. Equity Investment Funds could provide the mechanism not only to attract the institutional investment into the City but also allow control over the size, type and location of high quality housing suitable to achieve our vision for Manchester. This approach and level of investment can play a major role in supporting regeneration in key parts of the City and help to encourage activity on sites that have currently stalled. We anticipate that the activity will provide a catalytic effect on surrounding sites and areas.

4.0 How the Equity Investment Funds will work

- 4.1 An equity investment fund is an innovative partnership with the private sector where a special purpose vehicle is established through a Limited Partnership or Limited Liability Partnership that raises finance to acquire completed residential units or raise development finance to bring forward residential schemes in a tax efficient manner. These types of partnership are 'tax transparent' meaning that the partners are taxed individually. They are therefore tax-efficient vehicles for the City Council, which can benefit from the fact that it is not liable to pay corporation tax, which would be levied against the profit of a limited company of which the Council was an owner.

- 4.2 The City Council's participation in the establishment of an equity investment fund could take a number of forms but is likely to involve the investment of land for development on behalf of the fund. The land invested would be made on terms that represent best consideration having regard to the City Council's statutory obligations for disposal of land and the State aid rules.
- 4.3 The fund will subsequently build agreed developments or acquire units in completed schemes at agreed prices. The fund will then rent out these units in anticipation of generating a strong rental scheme and enhanced future resale values as the market improves. It would aim to build or acquire up to 1000 properties over 3 – 4 years which would initially be offered for market rent with the intention to begin a sales programme from year 3 onwards. The length of time the fund will operate is dependent upon the scale, type and level of investment.
- 4.4 The investment fund would, as part of its governance arrangements, have an investment strategy that identifies its target market, project appraisal criteria and requirements for a financial return. The City Council's work to date indicates that a sustainable investment model may exist under which the City Council invests land value into a scheme alongside private sector equity, securing debt finance at a loan to value ratio of 65% and delivering an internal rate of return (IRR) on the equity investment in excess of 15%. This is based on the delivery of a typical residential scheme where the properties would initially be privately rented with a view to disposing the properties to owner-occupiers in subsequent years.

A typical example is shown below:

Table 4 – Working example of a 25-unit development built through the fund

Description	Value	Notes
Construction phase		
Cost to build	£2.5m	£100k per unit
Comprising of: Equity (35%)	£0.88m	This includes the deferred land receipt for MCC, which will equate to say, 30% of the equity. Fees, Contractors margin and private investment make up the remainder of the equity.
Debt (65%)	£1.62m	
Rental period		
Annual net rental income	£0.15m	Based upon £500 per calendar month after management fees, voids and bad debts have been accounted for.

Less annual debt service (repayments)	£0.10m	Based upon 6.5% interest
Annual return to equity	£0.05m	c. 5.5%

Disposal (sales)		
Sales value	£3.12m	£125k per unit
Less debt	£1.62m	
Equity return	£1.5m	Repayment of initial equity plus uplift in sales value

Return on MCC investment		
	£0.45m	MCC land made up 30% of the original equity contributed to the fund. This means that MCC receive 30% of the total equity return after sales

- 4.5 A robust investment appraisal process will be wrapped around this, such that for any given investment of Council land it can be demonstrated that its investment in the fund is the best option for delivery of our outcomes. Value for Money is the first part of the assessment criteria detailed in section 6 of this report.
- 4.6 A Registered Provider would be an integral member of the partnership and would provide a rental guarantee and management for the completed units in each development. The Registered Provider would be one of the City's key regeneration partners who has an established reputation for high quality management of their stock and is active within the intermediate rental market. This is a key consideration for both the city council and institutional investors as this brings together certainty around quality management and longer-term tenancies that make this arrangement more sustainable. The Registered Provider would also have the opportunity of becoming an equity investor.
- 4.7 The City Council has discussed the possibility of establishing a fund based on the private rented sector model with several organisations. This work has overlapped with the work to prepare the bid to host the JESSICA UDF and has provided an insight into the options available to the City Council for establishing a fund. Subject to securing the approval of the Executive to the development of the model it is proposed to focus on two key issues going forward. The first is to identify possible development sites that might be suitable for use within an investment fund. This is discussed further at paragraph 6. The second is to identify suitable partner or partners to take this work forward. This will involve a robust market appraisal, which may include a market testing exercise, which will allow the proposals to be fully evaluated against identified criteria. A project team has been established, including representatives from City Treasurers and Legal Services, which will ensure compliance with relevant procurement and other regulatory requirements.

- 4.8 In this way, the Partnership will kick-start development activity across a number of sites in and around the City, bringing forward new rented housing. It is anticipated that up to 1,000 properties will be built over a period of 36 - 48 months. Opportunities for the sale of additional properties will also be considered during this time.
- 4.9 The positive activity generated by the funds (both in production and rental terms) could also act as a catalyst to neighbouring sites, impacting positively on the City's wider regeneration aims. On larger sites where the fund purchases a percentage of the overall development it will act as an anchor tenant increasing confidence for potential purchasers for remaining properties.
- 4.10 In addition, the Council would see significant economic benefits flowing from the activity of the fund. Savills PLC have researched the direct impact on the local economy of the construction of 100 new houses and found that, typically, such activity puts £6 million into the local economy and creates a stimulus to other activity. If the proposal of up to 1000 units is built through the Equity Investment Fund it could add around £60 million to the local economy over a relatively short period. Up to 1,000 jobs would also be created or safeguarded in this period and the fund would be able to support local contractors and suppliers.
- 4.11 There are still a number of issues with the proposed Equity Investment model that need to be resolved through the negotiation. These particularly relate to how the land that the City Council invests in the fund is valued and what priority the City's investment takes in terms of any return paid. Dependent on how these issues are resolved there may be further considerations around State Aid that will need resolving. These issues along with any other considerations will be resolved as part of the detailed negotiations that, subject to this report being approved, will be entered into with the partner organisations.

5.0 How the City Council is currently using equity related products

- 5.1 Manchester as a local authority is already well advanced in its approach to the use of equity related products. We have been the leading authority in developing simple yet effective methods of financial assistance for our residents, demonstrating a progressive and responsive attitude to a changing policy environment, which will be built upon and moved forward through the use of the proposed equity investment funds.
- 5.2 These are the some of the schemes that are in place, in development and planned:
- **Manchester Home Improvements and Relocation Assistance Policy** - The City has been operating an equity loan system since the introduction of the Manchester Home Improvements and Relocation Assistance Policy in July 2003 so is well advanced in the administration of this arrangement. This has been groundbreaking in the use of equity loans for home improvement or repair, energy efficiency, group work

and security. Experience gained and lessons learned with this process will put the City Council in an excellent position as we move forward.

- **Development Agreement with Redrow Homes Limited** - The partnership between Manchester City Council and Redrow Housing Ltd in North Manchester shows the innovative approach we can take to stimulate housing development. The use of our land as an equity stake is opening up sites that in the current climate might have taken several years to develop out. The project also recognises the need to help residents to access an affordable property. There is already confirmed interest in the scheme from a large bank and we are confident that as the properties are built and marketed we will see a positive response from purchasers.

5.3 Along with the North West JESSICA initiative the schemes above show how we are taking a step change in how we use our available assets to attract alternative forms of funding. The principles of the Equity Investment funds naturally follow this direction, which will be a creative use of asset management that secures continued economic growth with Manchester.

6.0 Site availability and criteria for inclusion

6.1 We have a comprehensive list of development sites across the City that have either been granted Planning Permission or are suitable for residential schemes and could be considered for use within the equity investment fund. The Scheme Appraisal Group, which contains representatives from Regeneration, Strategic Housing, Corporate Property and Corporate Finance would assess the sites against an agreed criteria.

6.2 The proposed criteria will be developed so we can ensure that potential schemes correspond with the City's priorities identified through the Strategic Regeneration Frameworks. The criteria will consider the following areas:

- The scheme must represent Value for Money
- Development proposal must be larger than 25 units
- It must not have significant levels of unfunded infra-structure costs
- Planning status
 - Sites with full planning approval.
 - Sites with Outline approval for housing.
 - Sites with no planning approval but within the current LDF plans or agreed masterplans for residential.
 - Sites with no planning status.
- An initial judgement on the likely demand for proposed property type as indicated by surrounding property types, i.e. an apartment development in an area with no apartments could be considered as high risk
- Who the developer is (if known). This may affect the risk.
- An initial judgement on the likely impact on adjacent development, which may be on the market.
- An initial judgement on whether or not the site would require further public subsidy in order for it to be taken forward.

6.3 In consultation with the Leader and Executive Members for Finance and Neighbourhood Services, the Director of Housing, City Treasurer and the City Solicitor would agree the necessary approval process.

7.0 Conclusion

7.1 We are facing challenging times now and in the foreseeable future with planned cuts in public spending. Although this will be felt across a number of areas we should not underestimate the role that house building plays within our economy. If the city is to continue to grow in economic terms it needs to ensure that there is a housing supply for those people who work in the economy. Equity investment funds will provide some of the stimulus to meeting this challenge. It will also give the City Council the opportunity to utilise its land asset while maintaining capital value, influence the nature and shape of the future housing market, and to start building homes on land that would in other circumstances remain dormant for the foreseeable future.

7.2 This type of approach will bring with it substantial private sector investment into the City's house building sector and stimulate the local economy through the creation and retention of construction related employment and their associated supply chains. As a Local Authority we will ensure that these investments will be closely aligned with our wider regeneration ambitions for the city thus protecting the existing investment made.

7.3 The use of equity investment funds will allow Manchester to lead the way in supporting the house building industry within Manchester and Greater Manchester. It will build upon the work already underway in North Manchester with Redrow Housing Ltd to:

- Allow an accelerated and sustainable recovery of Manchester's Housing Market.
- Ensure that there is an adequate housing supply for those people who work in and contribute to the economic growth of the City
- Align with our wider regeneration ambitions for the city that and protect the existing investment that has been made
- Maintain supply and go some way to alleviating potential demand expected due to population growth.
- Replace the need for large amounts of public funding to go into house building in the future.
- Retain and create employment opportunities with the construction industry and associated supply chains
- Ensure continued economic growth
- Allow housing mobility through a range of tenures for existing and future residents

7.4 As we look forward through the recession it will be more important now than ever to create a flexible pathway to homeownership that suit our resident's aspirations. This approach will retain our aspiration for a 60% home-ownership target though over a longer timescale. We will also need to monitor the

changing role of the Private Rented sector and be flexible with changing perceptions and requirements of new and existing residents.

- 7.5 We recognise that there are still a number of outstanding issues that need to be worked through in order to satisfy financial, procurement and potentially state aid regulations. These will be dealt with, resolved and incorporated into the next report that will be brought to Executive.

8.0 Contributing to the Community Strategy

8.1 (a) Performance of the economy of the region and sub region

The use of Equity Investment Funds will bring a substantial amount of funding directly into the local and sub regional economy. This will also have be complemented by indirect investment through the construction related supply chains

8.2 (b) Reaching full potential in education and employment

The level of activity in house building that will be directed through the fund will create and retain a number of employment opportunities. Development of skills for Manchester residents will be a key element of the project linked to and associated with the construction industry.

8.3 (c) Individual and collective self-esteem – mutual respect

Maintaining the supply of good quality affordable homes through a range of flexible tenure and opportunity will allow residents to fulfil their housing aspirations

8.4 (d) Neighbourhoods of Choice

By stimulating house building activity within areas that may remain undeveloped for a number of years the fund will play a major part of neighbourhood regeneration. It will allow a wider choice of housing and tenure for areas with an imbalance in supply.

9. Key Policies and Considerations

9.1 (a) Equal Opportunities

The details of the scheme have not been finalised but we expect there to be opportunities for local residents around employment and affordable homes. Specific considerations in relation to equal opportunities will be detailed in the report that is brought back to the Executive.

9.2 (b) Risk Management

An internal project team of officers from Housing, Regeneration, Corporate Property, Finance and Legal has been established to look at the initial

proposals received. A Risk workshop is planned in line with the Manchester Method of project management with the relevant documents and processes to follow.

9.3 (c) Legal Considerations

The report highlights the contribution the initiative will make to securing the objectives of the City Council's Community Strategy which supports the use of the well being powers under s2 of the Local Government Act 2000. This power authorises the City Council to do anything it considers it to be in the interests of promoting the social, economic or environmental well-being of the area. Reliance on this power is subject to the proviso that it cannot be used to authorise actions that are expressly prohibited by other statutes.

The City Council may participate in the establishment of an equity investment fund in several different ways. Section 12 of the Local Government Act 2003 gives local authorities the power to invest for any purpose relevant to its functions, which would include the promotion of well being under s2 Local Government Act 2000. Where the City Council disposes of land, whether by way of investment or otherwise, it will be necessary to ensure compliance with s123 Local Government Act 1972, s233 Town and Country Planning Act 1990 or other applicable legislation.

At this stage the detail of the proposals has not been fully identified. Therefore it will be essential that individual schemes be considered as they are brought forward to ensure that the proposals are consistent with relevant legislation. Officers from City Solicitors are working closely with colleagues as part of the project team in order to ensure appropriate legal terms are agreed for participation in any investment fund and to ensure compliance with the legislative framework.