

WHITEPAPER

# Urban regeneration

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How a secure income strategy can help revive city centres

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For today's investor





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## Key points

- Urban regeneration is being redefined, going beyond bricks and mortar to harness local advantages by integrating less tangible measures such as skill development, well-being and a sense of community while strengthening ties to major hubs.
- Importantly, environmental, social and governance (ESG) responsibilities must be built in to ensure long-term sustainability.
- While regeneration schemes are becoming more complex, the financial barriers for local authorities are rising. This gap creates more opportunities for investors.
- One opportunity is amortising leases – a relatively new financing solution emerging at the intersection of investors’ demand for secure income and their ESG responsibilities.
- The value of amortising leases has increased threefold between July 2014 and June 2019, attracting investors because of their predictable, inflation-linked and relatively low-risk income potential.

*“By funding regeneration projects, investors can play a socially responsible role in helping to maximise the potential of communities.”*



## Regional imbalances

Like other major cities benefitting from the ability to attract global talent, promote information sharing and foster innovation in the knowledge economy, London scores highly across a range of economic metrics.

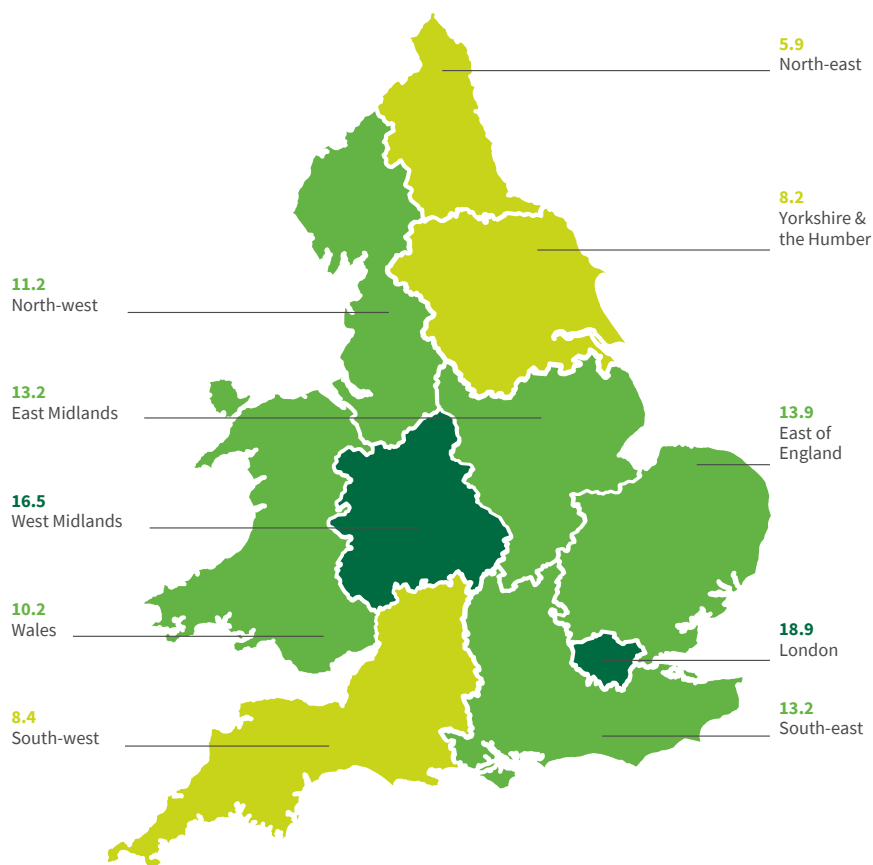
But while London's continued capacity for renewal and attracting investment is undeniably impressive, it is often in stark contrast to other UK cities. This raises questions over what can be done to make those cities more attractive, and the respective roles investors and the public sector should play in that process.

First, some context. The UK capital experienced a job growth rate of 49 per cent between 1996 and 2018 compared to 25 per cent for the UK, according to the Office for National Statistics.

Furthermore, the jobs created in London tend to be more highly-skilled, better paid and contribute more to the wider economy. The gross value added (GVA) per capita – a measure of economic productivity – was £48,857 in London compared to £19,899 for the UK in 2017, the most recently available data.<sup>1</sup>

Unsurprisingly, gross domestic product (GDP) has also accelerated faster in London, growing by 18.9 per cent between 2012 and 2018. See Figure 1.

**Figure 1. Per cent change in GDP, 2012-2018**



Source: ONS, 31 December 2018.<sup>2</sup>

1. Delphine Strauss, 'London accelerates away from rest of the UK economy', Financial Times, 12 December 2018. <https://www.ft.com/content/282a95fe-fe03-11e8-ac00-57a2a826423e>

2. Phillip Inman, 'London's 19% economic surge underlines divide with rest of England', The Guardian, 5 September 2019.



The UK's dependency on its capital exceeds that of many other nations. In Germany, for example, economic activity tends to be more evenly distributed. Berlin may have developed into a tech hub, but Frankfurt's focus on financial services and Munich's manufacturing strength allows each to thrive. In the US, economic growth is also more diversified between cities such as New York, San Francisco, Chicago and Houston. According to Eurostat, London accounted for 13.5 per cent of the UK population but contributed 23.4 per cent to GDP in 2018.<sup>3</sup> In contrast, Berlin and New York contributed about four per cent and nine per cent to their nation's GDP, respectively.

The gulf between London and the rest of the UK is widening at the expense of some smaller towns and cities, most visibly in their centres. They are languishing from a lack of funding, online retail trends that decay town centres, and broad demographic shifts away from urban areas. Meanwhile, local authorities face increasing budget constraints and fewer options to meet residents' needs, exacerbating the problem.

This is by no means a recent phenomenon. Arguably, regional growth imbalances have been occurring over a period of decades in post-industrial Britain, with a detrimental social impact on communities. However, technological advances such as automation threaten even more disruption and job losses, with those communities already left behind likely to be disproportionately impacted.

Regeneration is needed, but not in the traditional context of focusing on the physical environment in isolation. What has worked in previous years to encourage economic activity may not be suitable to promote knowledge-based growth, which is more dependent on factors such as innovation, skill development and connectivity. For this, policymakers are increasingly turning to the private sector to harness competitive advantages locally, while strengthening ties to major city hubs.

By funding regeneration projects, investors can play a socially responsible role in helping to maximise the potential of communities. Urban renewal can also have a positive environmental, social and governance (ESG) impact on portfolios, along with other investment benefits. The most important is the potential to generate stable, inflation-linked cashflows in a lower-for-longer yield environment. And, due to lower correlation to certain publicly-traded asset classes such as equities, regeneration investments offer potential downside protection amid growing uncertainty in the global economy.

In this paper, we will discuss how regeneration is evolving, the changing role of investors, and highlight the potential benefits of amortising leases – a relatively new financing solution emerging at the intersection of investors' demand for secure income and their environmental, social and governance (ESG) responsibilities.



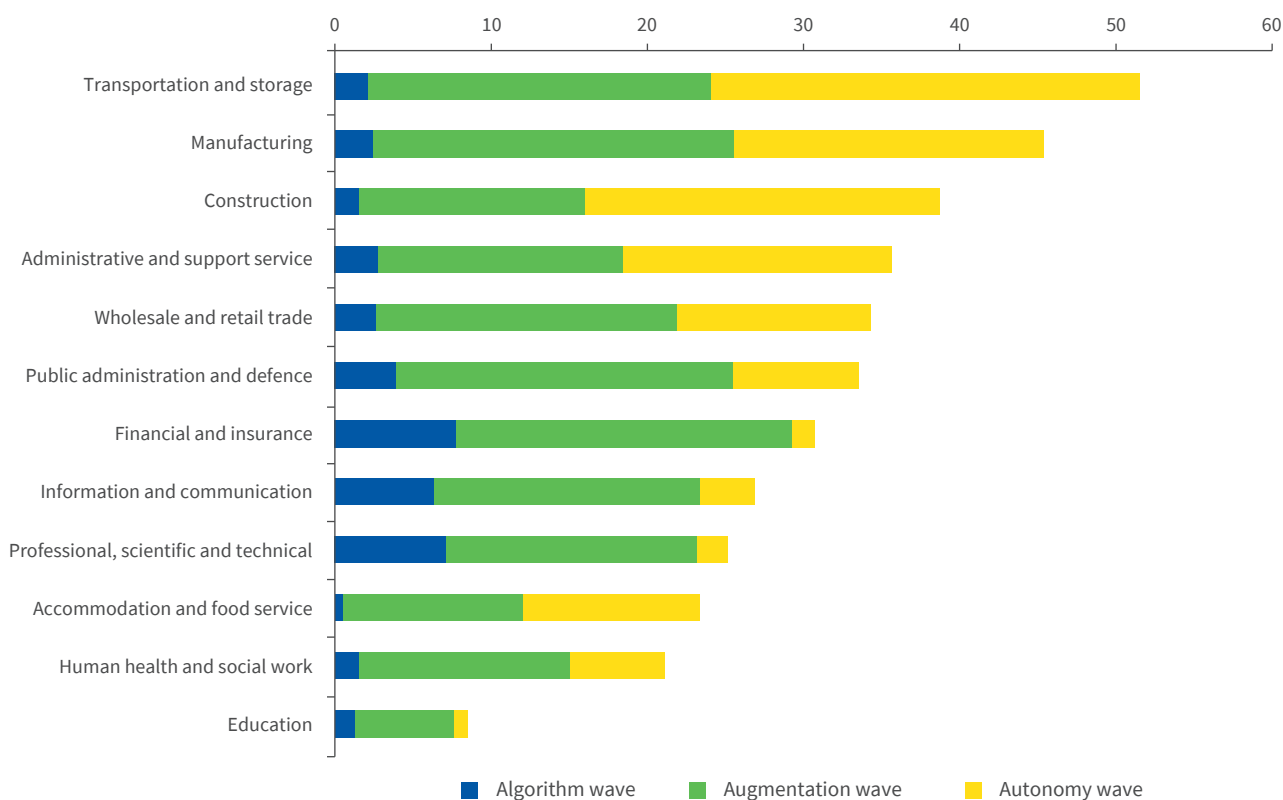
3. Regional Innovation Monitor Plus, European Commission, 2018. <https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/london>

## Redefining regeneration

To establish more effective regeneration programmes, it is important to understand the local impact of broader economic trends. Although the UK's economy may benefit from "a greater concentration on services sectors that tend to be less automatable on average than industrial sectors," some regions are expected to suffer more than others, a recent PwC report concluded.<sup>4</sup> By the 2030s, approximately 30 per cent of existing jobs in the UK are at high risk of automation. Jobs in manufacturing, which are often more concentrated in less economically developed regions, are at a higher risk than those in services. See Figure 2.

Job creation is a complex exercise, particularly for regions lacking the [talent, clusters and scale of major cities](#).<sup>5</sup> To reinvigorate these areas, it is important to connect them to the ecosystems of larger city hubs. According to PwC, some local authority partnerships are better able to compete "on a global stage and unlock transformative growth for the region and the UK" by collaborating on shared economic development strategies.<sup>6</sup>

**Figure 2. Potential rate of jobs automated by sector (per cent)**



Source: PIAAC data, PwC analysis, 2018.

Note: Algorithm wave refers to automation of simple computation tasks and data analysis, for example financial services; augmentation wave refers to the dynamic interaction with technology for decision-making and includes robotics; and autonomy wave refers to automation of physical labour and automated problem solving such as construction.

4. 'Will Robots Really Steal Our Jobs? An international analysis of the potential long term impact of automation', PwC, 2018. [https://www.pwc.co.uk/who-we-are/regions/northernireland/r-WillRobotsTakeOurJobs\\_020218.pdf](https://www.pwc.co.uk/who-we-are/regions/northernireland/r-WillRobotsTakeOurJobs_020218.pdf)

5. 'Talent, clusters and scale: Identifying European office markets in the era of knowledge capitalism,' Aviva Investors, 26 June 2019. <https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2019/06/talent-clusters-and-scale-identifying-european-office-markets-in-the-era-of-knowledge-capitalism/>

6. 'Good Growth for Cities 2018', PwC, 2018. <https://www.pwc.co.uk/government-public-sector/good-growth/assets/pdf/good-growth-for-gities-2018.pdf>



## Social and governance: Pillars of the community

What constitutes an urban renewal project is being redefined, going beyond bricks and mortar to integrate aspects that are more difficult to measure such as skill development, well-being and the environment. Importantly, ESG elements are no longer optional in order to ensure long-term sustainability.

As advances in technology threaten jobs, helping local residents develop new skills to adapt is vital. For example, artificial intelligence and robotics may well replace certain roles, but they can also bring jobs specific to these fields as well as in secondary sectors such as healthcare services. Skills that are in demand generally lead to higher income and higher expenditures for other products and services, helping to raise tax revenues and business rates for local authorities. Investors, therefore, need to consider how the physical improvements of regeneration projects are interlinked with the regional skill base.

In June 2019, for example, we invested in a £22 million sale-and-leaseback transaction with Lincoln College's main campus at the edge of Lincoln's city centre. As well as reducing existing debt, the deal will help the college access capital to improve further education in employer-led courses aimed at students over 18 years old.

The 50-year lease is supported by annual inflation-linked reviews based on the Retail Price Index (RPI). The college has a relatively modest level of gearing, strong operating surplus, and relatively stable funding sources with about half coming from the central government and the rest mostly from course fees and training contracts with local employers. Therefore, its prospects for meeting its rent obligations appear stable, representing a predictable income stream for investors.

In addition to the development of new skills, the success of regeneration projects often depends on less tangible building blocks for growth, such as health, social services and a sense of community.

According to PwC, income level improvements – one of the most widely used measures of city improvements – accounts for less than half the variation between cities in its UK City Index scores, which cover 42 cities with a population of at least 250,000.<sup>7</sup> More emphasis on [how developments may change the fabric of the community](#)<sup>8</sup> is needed to realise the long-term benefits.

A city may add higher-skilled jobs but lack the transportation infrastructure to connect potential employees to those jobs. Social services may be inadequate, impacting the well-being of residents. Or jobs may help to raise income levels but make housing less affordable, breeding inequality and undermining the project's intended purpose of improving the lives of local residents.

It is not always obvious who benefits from regeneration and therefore careful analysis is needed, especially when compared to similar investments in the private sector. Effective and more integrated approaches to governance and risk management are key.

For many local authorities, investing in projects outside of their catchment zone can come with higher reputational risks and lack public support. Since it is not 'in borough', the local authority owner-occupier has less incentive and ability to manage the property to a high standard, again increasing financial risk for investors.

Political trends present another set of challenges. In the private sphere, certain creditors will have a higher claim within the capital structure. While this is also true in city regeneration projects, 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. Assessing that risk not only requires a clear understanding of the council's balance sheet, but also other factors such as how the council manages the underlying asset, the related governance structures and the level of public support for the project.

Hypothetically, a local council may propose a business park redevelopment to house pharmaceutical and medical suppliers, among other tenants. On the surface, the development has economic growth potential. However, investors would need to scratch beneath the surface to analyse the strength of the council's balance sheet under various stress scenarios. If the council faces a significant funding gap, for example, that could prove unsustainable in a downturn, rendering the project both financially and reputationally more risky.



7. 'Good Growth for Cities 2018', PwC, 2018.  
<https://www.pwc.co.uk/government-public-sector/good-growth/assets/pdf/good-growth-for-gities-2018.pdf>

8. 'ESG and real assets: A matter of balance', Aviva Investors, 11 July 2019.  
<https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2019/07/esg-and-real-assets-a-matter-of-balance/>



Reputational problems may also arise from tenant risks. For example, pharmaceutical companies may have a higher chance of being embroiled in a public controversy relating to drug pricing, injuries and fatalities linked to their products, or other business practices such as research with animal testing. Governance screening can help assess risk and includes analysing company policies on executive compensation, board diversity and anti-corruption measures.

The same applies to redevelopments. Take St. George's Shopping Centre in Gravesend, which we are funding. The scheme is part of a regional plan linking Gravesham Borough Council to businesses, national government agencies and other local authorities throughout the region. With multiple parties with potentially different goals, governance structures may be more complex. While a top-down perspective is warranted, the role of governance in urban regeneration also requires cooperation at various levels across jurisdictions. Otherwise, policymakers may end up simply moving problems from one area to another.

Investors must assess the long-term viability of any redevelopment project carefully, including the financial position of the council, potential risks of the project and the ability of local authorities to partner with regional and national policymakers to enhance growth. A clear and nuanced understanding of the risks and rewards helps to protect all stakeholders.

## The 'E' in ESG

Long overlooked, investors and broader stakeholders are starting to consider the longer-term impact of their actions on health and the environment far more carefully. While many UK cities have generally committed to decarbonising, the threat to the environment tends to increase with economic growth through higher demand for services such as transport, energy and waste management.

The European Commission, in its annual EU Environmental Implementation Review, singled out air quality as a major concern for the UK. In 2017, 37 out of 43 urban zones – including London, Glasgow and Birmingham – exceeded their annual limit value for nitrogen dioxide, which can cause respiratory problems.<sup>9</sup>

For regeneration developments, with their longer time horizon and increased public scrutiny, the stakes are even higher to mitigate any environmental impact. To help future proof assets, energy sustainability and pollution control strategies may help, as does reducing the construction impact to the area.

Among those projects taking the environmental impact into consideration from the planning stages to execution is the urban renewal of St. George's in Gravesend. Policymakers plan to include low-carbon public transportation, electric-vehicle charging stations and recycling programme improvements. The development itself will aim to limit the use of new concrete and steel structures to reduce costs and the environmental impact, while new green spaces will enhance biodiversity.



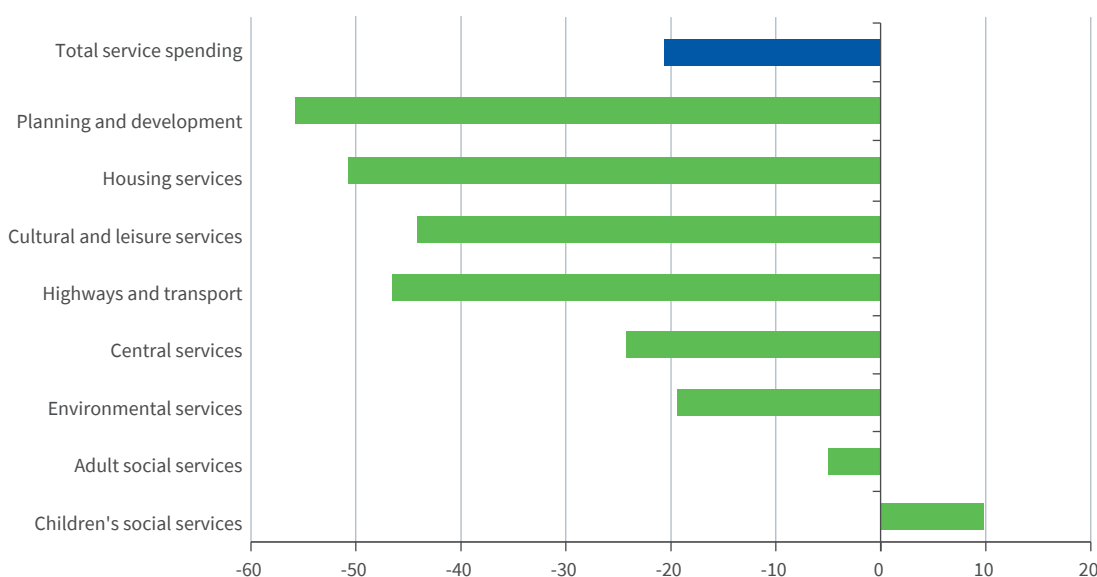
9. 'The EU Environmental Implementation Review 2019 Country Report – United Kingdom', European Commission, April 2019. [https://ec.europa.eu/environment/eir/pdf/report\\_uk\\_en.pdf](https://ec.europa.eu/environment/eir/pdf/report_uk_en.pdf)

## Plugging the funding gap: The role of institutional capital

While regeneration schemes are becoming more complex, the financial barriers for local authorities are rising. Annual budgets for UK local authorities, on average, have fallen by 21 per cent in real terms between the 2009-2010 fiscal year and 2017-2018. See Figure 3. This gap is expected to widen, potentially creating opportunities for investors to step in.

Local authorities primarily depend on three major sources of funding – council tax, business rates and central government grants. All are under pressure and are unlikely to keep pace with the rising costs of public services, according to the Institute for Fiscal Studies.<sup>10</sup>

**Figure 3. Change in local government service spending, 2009-2010 to 2017-2018 fiscal years (per cent)**



Source: Institute for Fiscal Studies calculations using MHCLG local authority revenue expenditure and financing statistics.

Government funding has fallen around 49 per cent in real terms between the 2010-2011 and 2017-2018 fiscal years. According to the IFS, the reduction “is without parallel in modern times,” and disproportionately impacts councils serving more deprived communities highly dependent on national government funding.

The UK government also plans to eliminate general-purpose grant funding next year and increase the proportion of business rates retained by councils. The latter should offset some of the losses from the former, but the shift puts more pressure on policymakers to expand their sources of funding. Regeneration can help unleash the potential of local assets, but it will require new sources of private funding to complement public capital,

particularly since the government in October increased the interest rate it charges local authorities to borrow.

Many are reviving existing assets such as government buildings, empty offices or underused town centres to promote economic activities, ease budgetary constraints and improve the environment without having to hit taxpayers.

The types of developments vary widely, ranging from a single-building conversion or land purchase to mixed-used multiplexes.

Consistent with traditional regeneration developments, retail brands may form part of the renewal. But some, including St. George's in Gravesend, account for consumer trends such as a shift towards experiences.

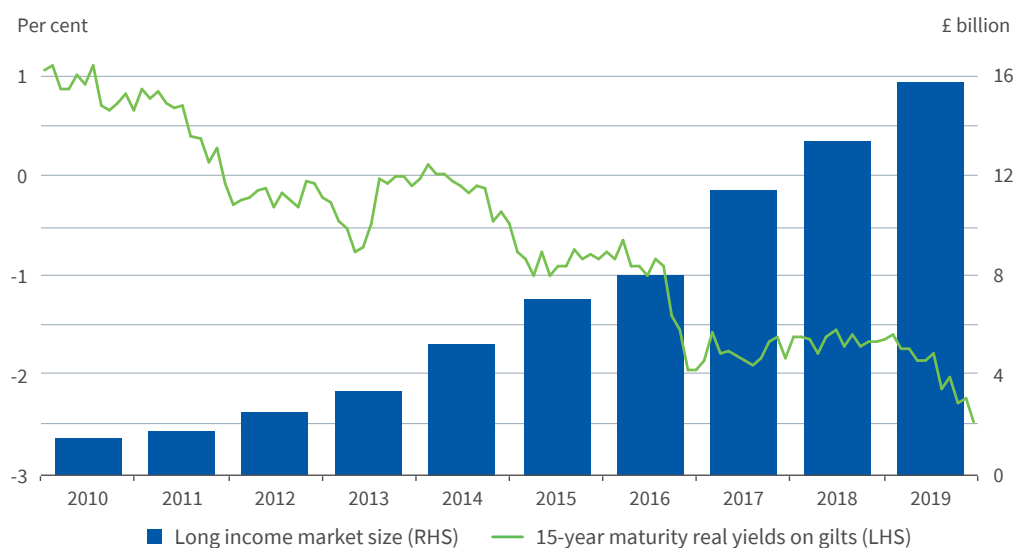
10. Neil Amin Smith and David Phillips, ‘English council funding: what’s happened and what’s next?’, Institute for Fiscal Studies, 29 May 2019. <https://www.ifs.org.uk/publications/14133>

Therefore, restaurants, hotels and other leisure services are also included. Housing – including affordable units – is another major consideration.

The flip side of the regeneration coin is how best to marry the projects that can help deliver such outcomes with investment

capital looking for reliable income streams. Financing approaches are evolving, partly as a response to councils' budgetary challenges but also because of the lower-for-longer interest rate environment, which is driving investors to seek long-term secure income from real assets. See Figure 4.

**Figure 4. Growth of long income real estate vs. gilt yields**



Source: CBRE, data as at 30 June 2019.

Long income real estate financing solutions generally fall into three categories: sale-and-leaseback arrangements, ground rents and amortising leases. Sale-and-leaseback and ground rent strategies have been employed by institutional investors for some time.

The third – amortising leases – was less common but is increasingly seen as a preferred funding option for regeneration projects in the UK.

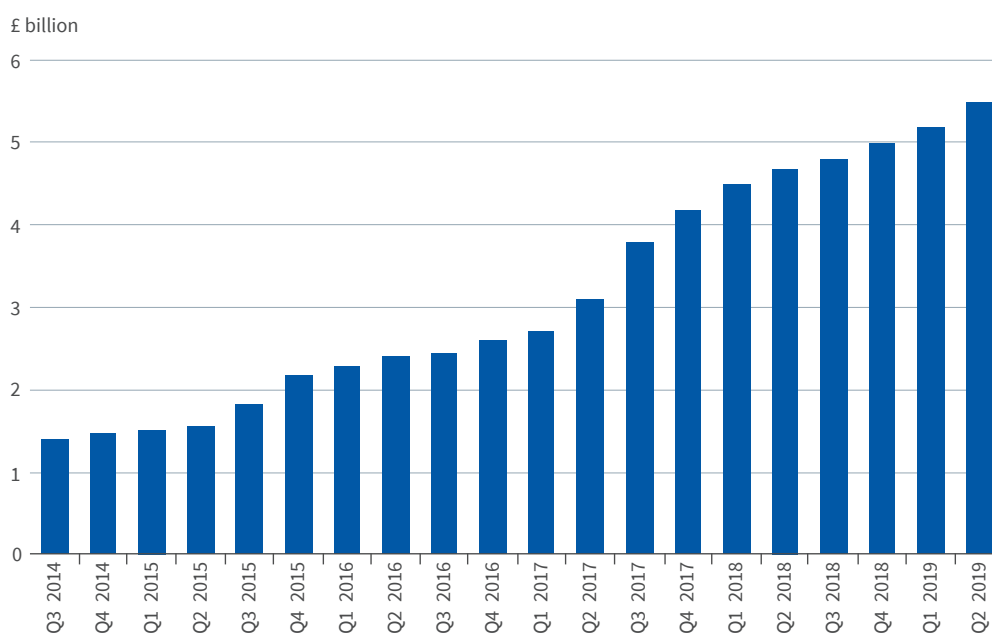
### How amortising leases work

Effectively, these are income-strip transactions, allowing local authorities to retain control of the assets at the end of the term and investors to access a secure, long-term income stream.

Typically, amortising leases include the option for the council to repurchase the asset for a nominal £1, assuming rent payments and other obligations in the terms of the contracts have been met. For many local authorities, the ability to retain long-term control of their town centres is particularly attractive, as indicated by the increasing prevalence of amortising leases. Between July 2014 and June 2019, the value of the income strip market increased threefold, as shown in Figure 5.



**Figure 5. Capital value of the income strip market**



Source: CBRE, data as at 30 June 2019.

Lease financing can also provide more flexibility compared to other forms of debt, such as government loans or bonds, potentially resulting in more efficient use of capital and more certainty on funding costs. Traditional borrowing generally requires the council to immediately draw down the entire funding amount, or otherwise take additional risks because the cost of funds can vary if drawn over time.

An amortising lease, however, can be structured to allow funds to be drawn down as and when work is completed. Interest rates on the rental payments are fixed from day one, giving both investor and borrower more certainty during the development period.

Construction risks can be structured so that both the fund provider and developer are liable for the delivery of the project. Afterwards, local authorities take on all the liabilities relating to leasing out the underlying assets, the administrative responsibilities and the day-to-day operational duties.

In return, the rent – or income – paid to investors for the long lease is significantly discounted, up to around a third below market rates, allowing the council to sublet at a profit. The strategy offers several potential sources of much-needed revenues to support social services and reinvest in urban areas. See Figure 6.

For investors, the predictable, inflation-linked and relatively low-risk income generated from amortising leases can help meet pension liabilities, making them an increasingly attractive option with a

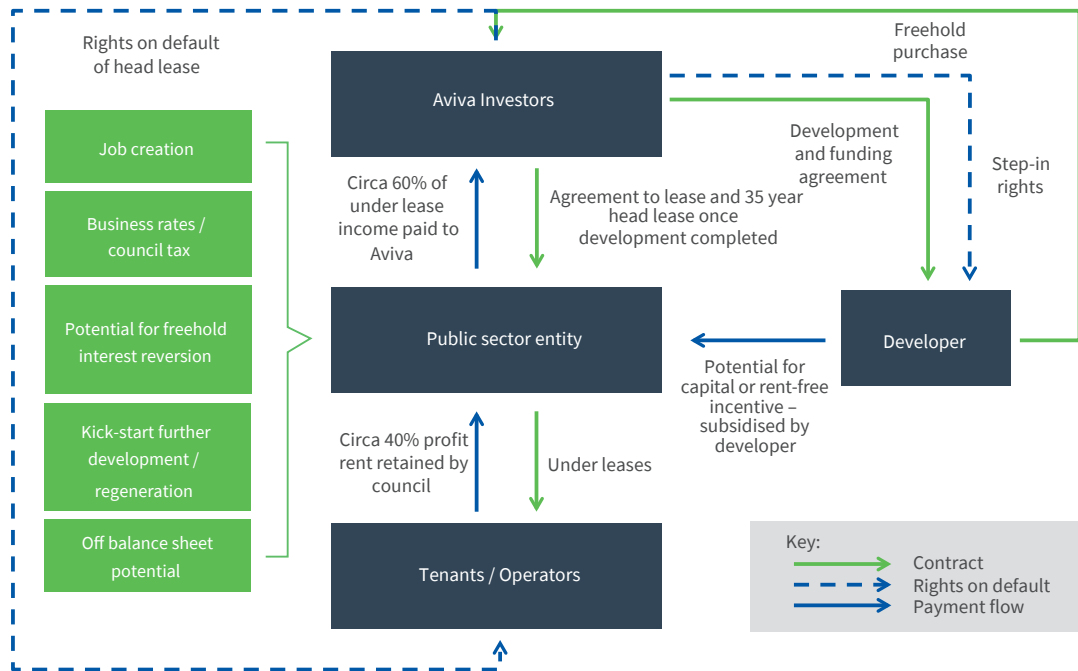
long-term view. The cash flows are backed by high-quality tenants such as local authorities, other government entities, quasi-government organisations and investment-grade companies, so cashflow certainty is high given the strong tenant covenant strength.

Since the economic value of the transaction expires at the end of the lease term when it is returned to the council, the cash flows may provide a more precise tool to match pension liabilities than traditional bonds or other forms of long-lease real estate. In the case of bonds, investors receive principal in a single payment at maturity. For sale-and-leaseback transactions, investors will continue to own the underlying asset at the end of the lease, which could add uncertainty in the asset valuation and operational risks at the end of the cashflow.

Another advantage of amortising leases is their ultra-long nature, which typically range between 30 and 50 years; this aligns well with the time horizon of pension liabilities. Lastly, yields tend to be more attractive than government bonds without a lot of additional risk, with spreads of between two and three per cent above gilts as of 31 October, depending on tenant covenant strength.

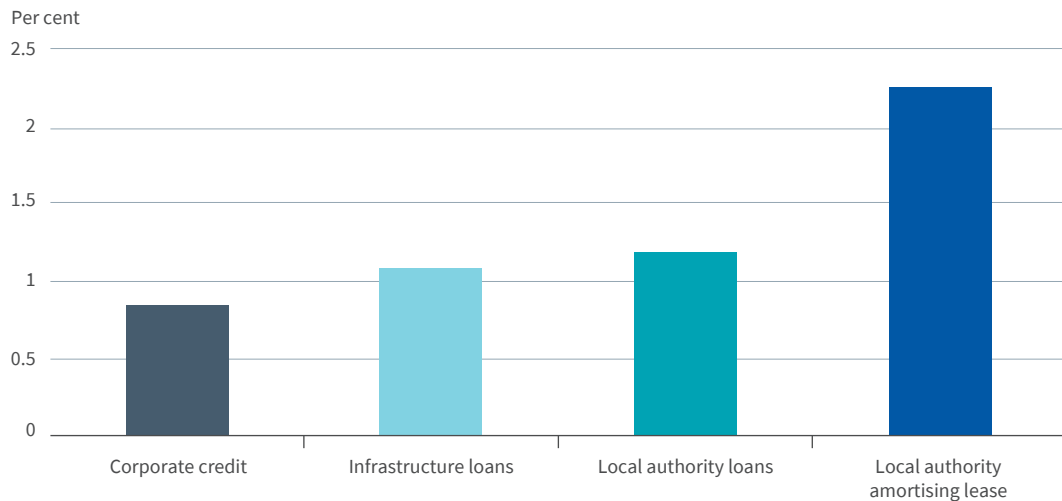
Amortising leases have the potential to outperform assets of comparable credit quality and duration to reward investors for illiquidity risk – a premium that is particularly suited to the long-term nature of pension schemes. See Figure 7.

**Figure 6. Additional characteristics of amortising leases**



Source: Aviva Investors, 2019.

**Figure 7. Return premium over gilts of amortising leases vs. comparable assets**



Source: Bloomberg, Aviva Investors, based on yields for comparable duration (about 17 years) and credit quality (AA-) investments as at 4 November 2019.

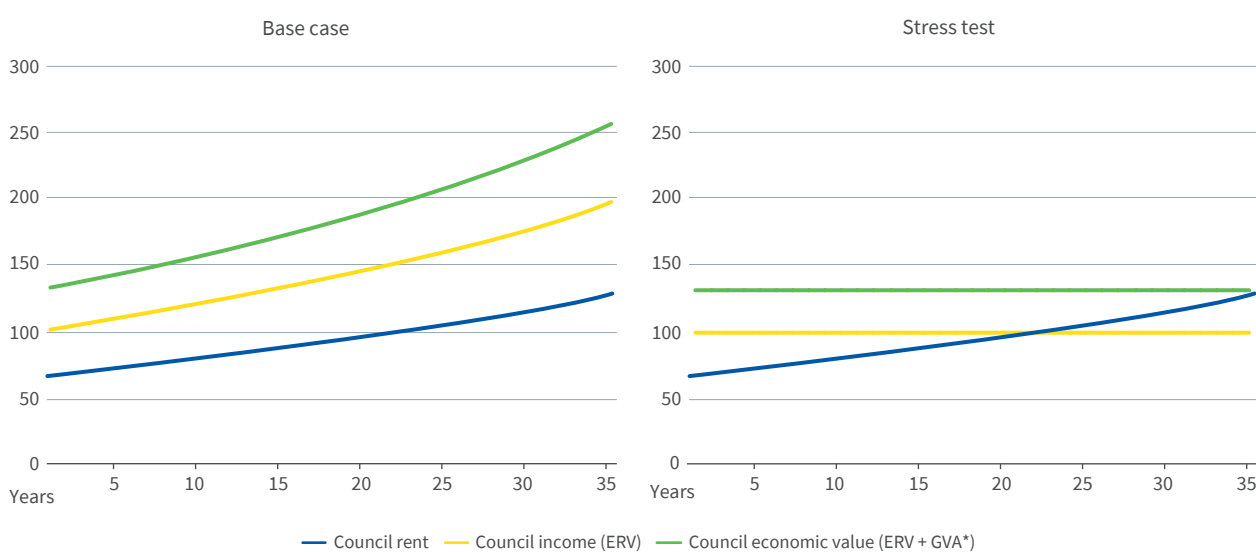
Portfolio diversification is another potential advantage, particularly versus equities. According to estimates by Aviva Investors, the correlation between amortising leases and UK equities is -0.17 based on quarterly returns between September 2011 and 30 September 2019. (The correlation coefficient indicates a measure of the relationship between the two asset classes, with 1 indicating a perfect positive correlation and -1 a perfect negative correlation.)

However, the complexities of amortising leases require a robust due-diligence process. Not every regeneration project will be successful. Having strong origination capabilities and a rigorous risk management process can help decipher which projects will meet investment goals. One of the main differences between amortising leases and traditional real estate investments is the focus on income continuity. Unlike typical development projects in which a major focus is on the underlying real estate value, investors in amortising leases are usually more concerned about interruptions to cash flows.

Risk scenario analysis, therefore, needs to prioritise the downside. Economic growth assumptions may change, for example due to Brexit uncertainties. Rent may be below expectation, impacting the cash flows generated for local authorities to pay investors. Core retail tenants could experience financial pressure from increased online competition and may not fulfil the terms of their lease contracts. The long-term viability of any project also depends on careful assessments of the financial position of local authorities to determine whether they are likely to meet their obligations in a stressed scenario.

Structured prudently, however, amortising leases can endure decades of negative performance before the project's total income falls short of the rent payments. As shown in Figure 8, investors can still benefit even in downside risk scenarios. Importantly, additional revenues from economic activities associated with the project can strengthen the council's financial position. If there is a shortfall towards the end of the lease term when local authorities are closer to owning the assets, the incentives are even stronger for them to meet rental obligations, helping to reduce investment risk at a crucial time.

**Figure 8. Amortising lease rent obligation vs. income**

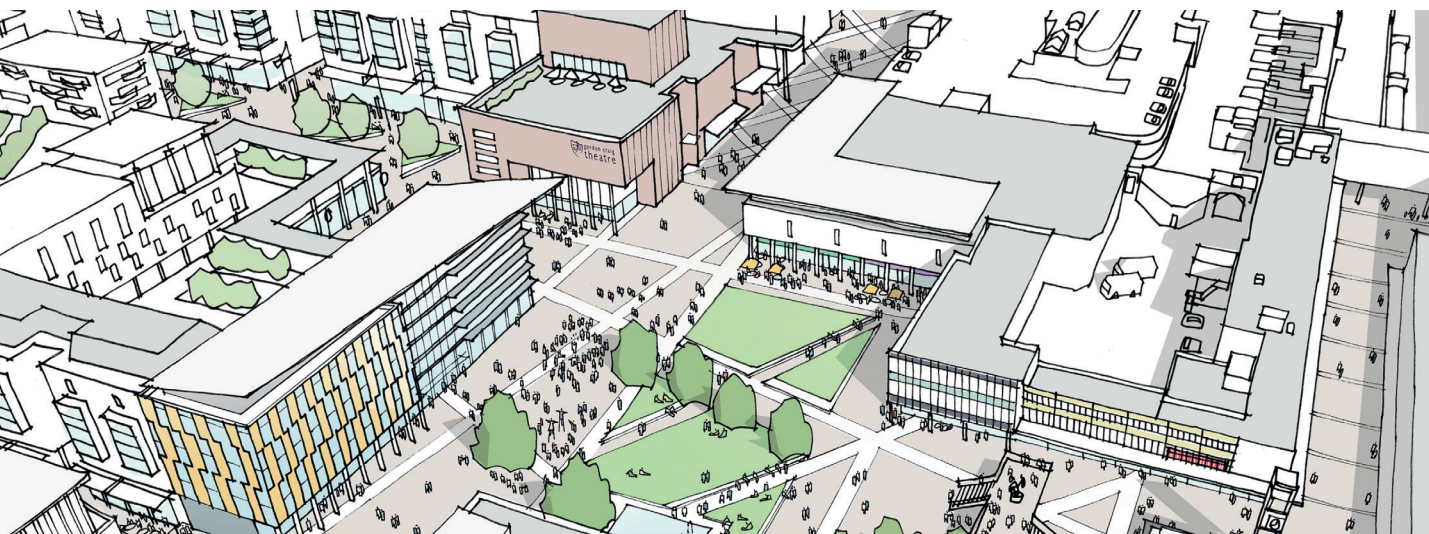


Source: Aviva Investors, 2019.

For illustration purposes only. \*ERV = Estimated Rental Value, set to 100 in year one. \*\*GVA = Gross Value Add to the local area through the creation of economic activity (jobs, business rates, council tax, etc).



## Regeneration: Lessons from Stevenage



How financial and economic factors are weighed against ESG considerations can be demonstrated in our funding of the regeneration of Stevenage, the first post-war 'New Town'. Located about 30 miles from London, it was designed and built from scratch. Though it succeeded in attracting a commuter population earning more than the national average, the town centre became increasingly blighted after the global financial crisis. Big chains including Marks & Spencer pulled up stakes in 2015,<sup>11</sup> a consequence of the shift of retail online.

Stevenage Borough Council spent years developing a regeneration framework, underpinned by an evidence-based research.<sup>12</sup> The Queensway shopping parade alone will add 116 residential units as part of a wider 20-year regeneration programme to revive the town centre. Even though retail spaces will still include typical high street brands, the focus has shifted towards leisure and entertainment. Around 200 jobs will be created during the construction phase, with about 80 to be added post-construction.

Funding was structured to minimise financial risk to the local authority while avoiding turning to taxpayers. Under the terms of the 35-year amortising lease agreement, the council pays 77 per cent of the improved scheme's estimated rental value (ERV), allowing for a significant profit if the property is sublet at market rates.

Besides the direct economic value added, Stevenage Borough Council will potentially benefit from the social revitalisation of having more footfall into the town centre, and the related council tax and business rates generated. In case the local economy is negatively impacted by Brexit or a global downturn, there is a margin of safety as a result of the reduced rent, which acts as built-in downside protection.

From an ESG perspective, the development should have a positive social impact by improving the work-life balance, health and skills of residents while also helping to meet housing needs, with 20 per cent of the new stock to be classified as affordable. In addition, the local authority benefits from an increase in revenues to meet rising demand for services, including social care.

Similar to St. George's Shopping Centre in Gravesend, Stevenage's Queensway shopping parade is more of a refurbishment of existing structures to preserve the area's history (the first traffic-free shopping centre was opened in Stevenage in 1959) and minimise the environmental impact. The project is also part of Stevenage's wider plans to improve low-carbon transport links.

Stevenage is also collaborating with other local authorities within the 'Innovation Corridor', stretching from London, through Stevenage, Cambridge and Peterborough. The multi-borough digital strategy aims to reinvigorate nearby communities by focusing on issues such as smart city technology, flexible workspaces and knowledge-based skillsets. Within this corridor, for example, is GlaxoSmithKline's bioscience campus in Stevenage.



11. Graham Ruddick, 'Marks & Spencer triggers local anger after confirming store closures', The Guardian, 29 July 2015. <https://www.theguardian.com/business/2015/jul/29/marks-spencer-local-anger-confirming-store-closures-nine-shops>.

12. 'Stevenage Central', Stevenage Borough Council, Summer 2017.



## Concrete advantages

The divide between thriving cities and the regions left behind has often resulted in physical and often political scars. There is some evidence this gap may widen in the new economy, while dwindling financial resources from central government will make it even tougher for smaller cities and town centres.

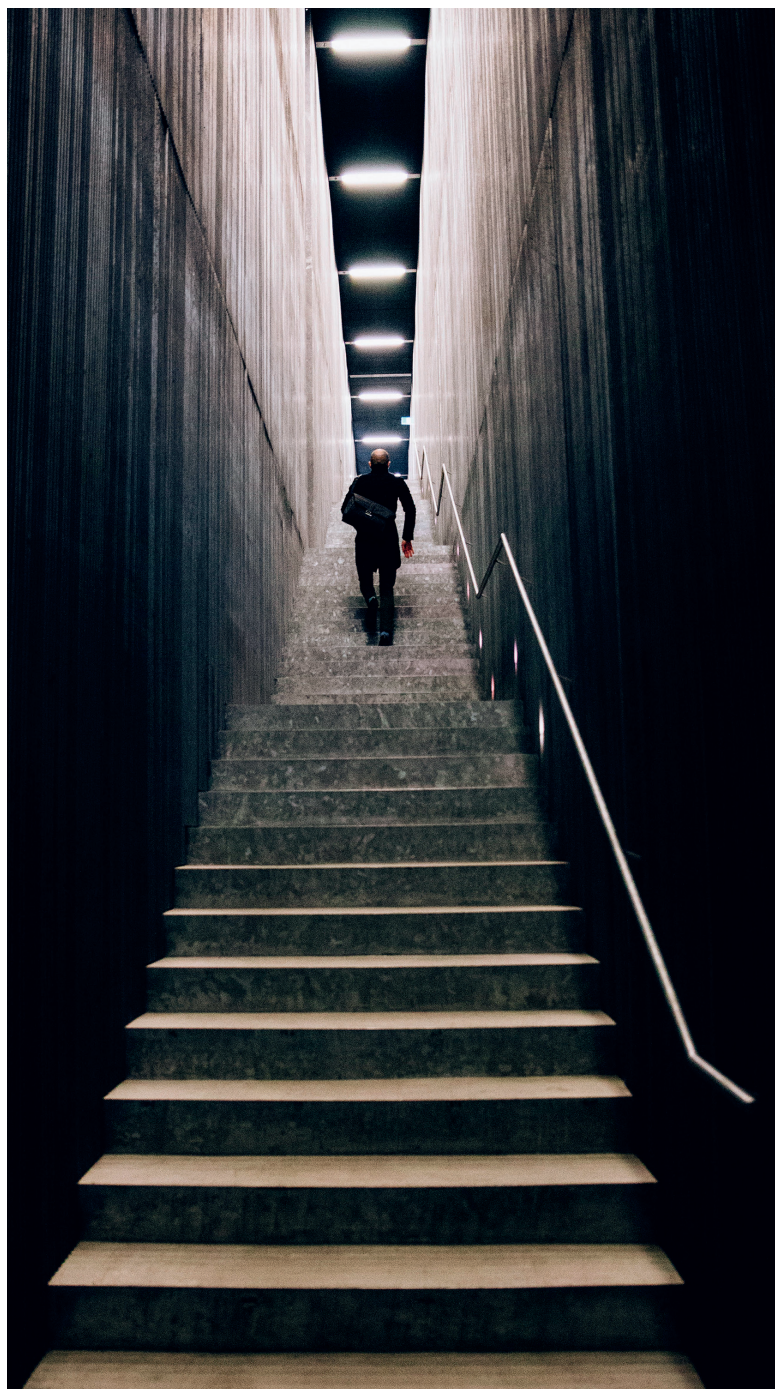
But success does not have to be so unevenly spread geographically, with larger cities gaining the competitive edge. To thrive in the knowledge-based era, local authorities will need to find new paths to generate growth, and they can't do it alone.

Pension schemes and other institutional investors may feel a social responsibility to help communities evolve through regeneration. But these also need to align with the responsibilities they have to their own constituent members. Therefore, it is important to scrutinise regeneration plans through a risk-return lens, partnering with local authorities with a clear understanding of the ties between financial opportunities and ESG risks, and between local developments and major city hubs. The notion of a self-contained community may have worked when manufacturing dominated the economy, but not when information – and connectivity – is king.

The UK is at a critical junction. From a political perspective, Brexit-related uncertainty is weighing on economic growth and access to central government funding, with the British economy shrinking for the first time since 2012. In the second quarter this year, the UK's gross domestic product (GDP) contracted by 0.2 per cent, according to the Office for National Statistics.

Globally, economic growth is moderating, partly due to US-China trade tensions but also long-term structural factors. Central banks are responding by loosening monetary policies, with the US Federal Reserve cutting rates in October for the third time in 2019. The Bank of England also signalled that interest rate cuts may be needed if economic weakness persists. The uncertainty has led investors to seek safer assets. In the UK, for example, 10-year gilt yields fell sharply in the third quarter of 2019 to less than 0.40 per cent in September, a level not seen since the aftermath of the UK referendum on its membership of the European Union.

At a time when many pension schemes are de-risking but reluctant to add government bond exposures, the built-in cashflows from amortising leases could help schemes meet member benefits without taking on a lot of additional risk. More than that, they can help save the communities that those members depend upon for a better retirement.



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