Land and Property Committee

Date: **16 January 2023**

Item: **Build to Rent Programme Update**

This paper will be considered in public

1 Summary

1.1 TTL Properties Limited (TTLP) has made good progress in its Connected Living London (CLL) joint venture with Grainger plc to develop and manage a portfolio of Build to Rent homes, such that it is now ready to start construction at four sites at Arnos Grove, Montford Place, Nine Elms and Southall that will see 1,240 homes come forward.

1.2 The investment partnership with Grainger plc was initially approved by the Finance Committee on 4 July 2019. In July 2022, TfL's Chief Finance Officer (CFO) used delegated authority to approve an additional Land Authority, reflecting an increase in the estimated peak equity requirement resulting from increased construction cost inflation. Since then, market conditions have worsened further. Despite a rebasing of the appraisals to take account of realistic upside and downside assumptions, there is now a risk that, on the basis of the existing growth assumptions, some of the financial metrics set out in the TTLP Investment Strategy will not be met.

1.3 The Committee is asked to increase the Land Authority to reflect the market conditions and, while acknowledging that there remains risk to the financial performance of these developments, approve a course of action that will mitigate the risks whilst allowing the developments to progress to help meet the need for housing, including affordable housing, in London.

1.4 A paper is included on the Part 2 agenda which contains supplementary information that is exempt from publication by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the business affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendations

2.1 **The Committee is asked to note the paper and the exempt supplementary information on Part 2 of the agenda and approve additional Land Authority across four of the sites, as set out in paper on Part 2 of the agenda.**

3 Background

3.1 In July 2019, the Finance Committee approved the investment sum and Land Authority necessary to deliver a portfolio of Build to Rent development sites through TTL Build to Rent Limited which is a 49 per cent shareholder in the CLL joint venture. The CFO was authorised to approve the disposal of sites and the investment into the joint venture, subject to certain investment metrics being met.

3.2 The CFO approved Agreements for Lease and Land Authority for four sites at Southall, Arnos Grove, Montford Place and Nine Elms between November 2019 and November 2021. CLL plans to commence enabling works on these sites in the first quarter of 2023, with main contracts following later in 2023.

3.3 The four approved sites are set out below.

Site	Total Homes	Affordable Homes	Land Disposal	Start Enabling Works
Montford Place	139	56	Jan 2023	Jan 2023
Arnos Grove	162	65	Jan 2023	Mar 2023
Nine Elms	479	190	Jan 2023	Jan 2023
Southall	460	184	Feb 2023	Feb 2023
Total	**1,240**	**495**		

3.4 Cockfosters, which provides a further 351 homes, is awaiting planning consent and a Section 163 consent to dispose of operational land (notwithstanding a resolution to grant planning permission from the local planning committee). Consequently, it does not form part of this approval request.

3.5 In July 2022, additional Land Authority was approved by the CFO, reflecting an increase in the estimated peak equity requirement resulting from increased construction cost inflation.

3.6 Since the July 2022 paper, market conditions have worsened further following the market reaction to the September 2022 mini-budget. The site appraisals have been impacted by further increases to construction cost, increased financing costs, reduced debt availability and weakening sentiment in respect of investment yields. Within the updated base case, these negative factors are partially offset by favourable short-term rental growth and other revised assumptions on inflation and affordable rents.

3.7 However, these market factors have two key impacts:

(a) increasing the level of shareholder equity required; and

(b) a requirement for construction cost moderation and other changes to appraisal inputs to enable the project metrics to be achieved.

3.8 The effect of these two factors means that further equity is needed to complete the schemes and there is a risk that the original TTLP metrics may not be met.

3.9 TTLP could pause activity until market sentiment improves. This, however, would delay the delivery of 1,240 homes, including 495 affordable homes. It would also lead to a loss of affordable housing grant, making viability more challenging. The CLL schemes are using grant funding from the existing Affordable Housing Programme (AHP), which covers projects that start on site prior to March 2023. Under the replacement AHP scheme (funded by Central Government), the discounted market rent (DMR) product that forms part of the Build to Rent model does not qualify for grant assistance. The schemes will therefore lose their grant funding allocation unless they start on site by March 2023.

3.10 TTLP's Investment Strategy states that TTLP will aim to deliver throughout the property cycle, accepting that its returns will not always be as high as would otherwise have been the case. If a decision is taken to proceed, there are actions that CLL can take to mitigate the impact of the market conditions. These cannot however guarantee that the investment metrics will be achieved.

4 Market Context

4.1 CLL has recently received proposed terms from four potential lenders. The large increase in base bank rates, from 1.25 per cent in July 2022 to 3.5 per cent in December 2022, has increased the overall debt needed to develop the four sites. In addition, banks are being more cautious, and the amount of interest cover and therefore debt that can be supported by rental cashflows has reduced. In a Build to Rent model, the increased cost of long-term investment stage debt negatively impacts investment returns.

4.2 CLL employs three cost consultants across the portfolio of sites, and monitors forecasts from the rest of the market. Quantity surveyors' inflation projections vary considerably, from two per cent to five per cent in 2023 and from two per cent to four per cent in 2024/25. Whilst there is a growing consensus that construction market inflation has peaked, the quantity surveyors are predicting an easing of inflationary pressure rather than a significant deflationary event. On average, forecasts suggest an expectation of 3.2 per cent inflation per annum over the next three years, down from four per cent per annum six months ago.

4.3 Whilst the economic circumstances are different to the 2008 position, it is worth noting that the global financial crisis led to a 16.7 per cent price construction cost deflation between 2008 and 2010.

4.4 Given the public sector drive for residential starts on site by March 2023, there is an expectation of continued construction demand in the short-term. There is, however, an increasing expectation from developers that projects will be paused beyond this date, given the higher interest rate environment and the increased yield expectations across all sectors of the property market. Registered providers are also reducing output, given their need to focus on maintenance and improvement of existing stock. Total construction orders fell by 10.4 per cent in Quarter 2 (Q2) 2022 on the previous three months, the largest quarterly fall since Q4 2020 (Office for National Statistics, 2022).

4.5 These factors may lead to a repositioning of the contractor supply chain as order book forecasts reduce, with potentially a more pronounced deflationary movement than cost consultants are currently suggesting.

4.6 Despite the above, there is a risk that international cost factors including energy pricing, currency volatility and the Ukraine war, could continue to impact material prices in the short term and drive continued inflationary pressure.

4.7 Notwithstanding the market challenges, a record £2.5bn was invested into UK Build to Rent in the first six months of 2022. Given the weight of money seeking to secure institutional residential investments, prime yields have reached 3.25 per cent for stabilised assets. While there is very limited transactional evidence demonstrating an outward yield movement, agents are indicating a pause in activity during Q3, weakening market sentiment and an expectation of downwards yield movement in response to rising interest rates and funding costs, and the increase in 10-year gilt rates.

4.8 Conversely, with mortgages being harder and more costly to obtain and with private rented sector (PRS) landlords seeking to exit the sector, annual London PRS rental growth reached 16.1 per cent in Q3 2022, according to Rightmove. Tenant demand has increased by 20 per cent compared with last year, available properties to rent have reduced by nine per cent and consequently, occupancy levels remain strong.

4.9 The market continues to be underpinned by strong fundamentals of tight supply, high demand and a robust outlook for earnings growth – all reasons why TTLP saw Build to Rent as its most important medium to long-term investment class. This should allow for good rental growth prospects and constrain any outward yield movement.

5 Proposed Next Steps

5.1 There is a strong rationale to maintain momentum on the CLL sites and progress the delivery of much-needed private and affordable homes, in accordance with the Mayor’s Transport Strategy. For the reasons set out in paragraph 3.9 above, the programme will also lose affordable housing grant funding unless it starts on site by March 2023. The financial risk of the current market, however, needs to be managed effectively.

5.2 Sensitivity analysis and scenario analysis on key appraisal inputs including construction cost, rental growth and finance swap rates have been assessed to demonstrate the market adjustments that would be needed in order to allow the TTLP investment metrics to be achieved. Given the current market context, it is considered that there is a realistic prospect of these market adjustments taking place. A strategy has therefore been developed that enables the CLL leases to complete and allows enabling works to progress, subject to a maximum initial commitment as set out in the exempt paper on Part 2 of the agenda.

5.3 The strategy allows CLL to retain the affordable housing grant, progress schemes within the current building regulations framework and put itself in the best position to deliver homes as quickly as possible, subject to market conditions. The enabling works capital is also accretive to value, i.e. would make the sites more valuable if disposed of.

5.4 Progressing to main contracts and committing further capital would then be dependent on achieving the investment metrics or achieving a new Committee approval.

5.5 Assuming that the projects can proceed to the main construction contracts, the equity requirements for the programme within the development phase will increase, based on the increase in rolled up interest and the reduction in loan to cost funding ratios. Consequently, this paper requests an overall increase in Land Authority as set out within the exempt paper on Part 2 of the agenda.

5.6 Following a detailed review of the site appraisals and market conditions, Grainger's Investment Committee has approved in principle the proposed strategy, subject to this Committee's approval.

6 TTLP Business Plan and Debt Funding

6.1 The previous levels of equity are included within the TTLP Business Plan. While the additional requirements are not currently included in the TTLP Business Plan, TTLP has sufficient financial resources available to enable the projects to proceed at these levels of equity, without impacting the capital programme for other projects across TTLP. The updated equity requirements will be included in the current Business Plan process.

List of appendices to this report:

Exempt supplementary information is contained in a paper on Part 2 of the agenda.

List of background papers:

Funding Update on TTL Properties Limited, Finance Committee, 22 June 2022

Financial Framework for TTL Properties Limited, Land and Property Committee 30 June 2022

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