

Ex-Ante Block 1: Market Assessment

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# **Contents Page**

Rep	ort Summary	3
	Rationale for Urban Development Funds	3
	Ex-ante Assessment Method	4
	Research Findings	5
1.	Purpose of this Report	9
	Overview of the Ex-ante Assessment	9
	Structure of the report	10
2.	Block 1 Market Assessment Methodology	11
	Rationale for Urban Development Funds	11
	Overview of Design Principles for UDFs	13
	Block 1 Market Assessment Methodology	15
3.	Strategic Priorities for Investment	19
4.	Supply of Development Finance	36
5.	Performance of Development Markets	42
	Development Activity	42
	Office Market	44
	Industrial Markets	50
6.	Review and Implications of the Development Pipeline	55
	Identifying Market Failure and Sub-optimal Investment	55
	Market Issues in the WWV Programme Area	57
	The Potential Role of a UDF	59
7.	Assessment of the Value Added of a UDF	63
8.	Review of Lessons Learnt	66
	Key Lessons	66
9.	Conclusions and Next Steps	70



# Appendix A - Pipeline Assessment Framework



# **Report Summary**

- i. Regeneris Consulting was commissioned by WEFO to undertake an ex-ante assessment for ERDF backed infrastructure financial instruments (FIs). An initial screening assessment concluded that there was potentially only scope to use FIs to deliver investments related to business sites and premises.
- ii. This report provides the Block 1 market assessment element of the ex-ante assessment. It seeks to provide an objective assessment of the current market conditions affecting the provision of sites and premises in the WWV programme area and determine whether market failures that give rise to sub-optimal investment conditions are present. Building upon this, the market assessment seeks to identify investment needs that are not being met by the market and consider the extent to which a financial instrument would be an appropriate mechanism to provide this finance.

# **Rationale for Urban Development Funds**

- iii. An Urban Development Fund (UDF) is a long-term investment fund, typically with a horizon of up to 10-20 years. The UDF's investments are targeted at commercial property and regeneration schemes that can provide a financial return which enables monies to be recycled into other schemes until the closure of the fund.
- iv. As with all public sector backed financial instruments, UDFs need to make investments based on various types of market failure, sub-optimal investment situations and unmet investment needs. The main factors that give rise to these conditions for business sites and premises projects are:
  - Viability Gaps: Factors specific to individual developments and wider structural and cyclical features of a development market can result in a viability gap which might discourage private sector involvement or give rise to situations where a developer is unable to secure finance for a particular development in light of the returns it offers and the associated risks. Factors which contribute to the existence of viability gaps include excessive or abnormal site costs, poor market conditions and associated low, or uncertain projected revenues. The existence of a viability gap does not, of itself, constitute a market failure or justify public sector intervention. The case for public sector intervention can usually only be made on the basis that the investment would give rise to economic development spillover benefits that have value to the public sector.
  - Supply of Finance: Market failures in the provision of development finance can arise when
    providers of finance are discouraged from making particular types of investment as they
    cannot easily or cost-effectively determine the risks and returns due to imperfect
    information. The cost of establishing these risks and returns for the class of investment
    might be too high given the size of the proposed investment or the developer might lack
    the necessary collateral to help the lender to mitigate their risks.
- v. In practice, UDFs need to target their investment towards schemes that are marginally viable (i.e. projects should be close to commercial viability, with the provision of finance through the UDF either providing advantage through more flexible terms, offering rates just below commercial rates or helping to mitigate risk through first loss protection). The focus on marginally viable schemes ensures that investments provide a financial return for the UDF but avoid displacing commercial lending activity.



vi. Although UDFs need to create a financial return, their primary purpose is to secure economic spillover benefits. This means that the overall financial rate of return for a UDF will be lower than for a commercial investment fund (and hence it is more appropriate to judge the overall performance on the basis of the economic rate of return).

## **Ex-ante Assessment Method**

- vii. The objectives of the block 1 market assessment are to:
  - determine whether market failures are present, if there are sub-optimal investment conditions and investment needs that are not being met by the market
  - provide well evidenced conclusions about the size of the investment gap, the justification for public sector intervention and, if relevant, the form of finance needed to address it.
  - where there is evidence of an investment gap, determine the appropriateness of a UDF as
    the mechanisms for addressing this gap (bearing in mind that it isn't just through the cost
    of the finance provided, but also its associated terms and conditions).
- viii. In the context of a UDF, the investment gap relates to schemes that would not come forward through the market mechanism alone but which can improve overall economic welfare if they were to proceed.
- ix. Guidance on the preparation of ex-ante assessments for UDFs recommends that the scale of the investment gap should be quantified, although it notes various challenges in achieving this, not least the challenges raised by shortcomings in available data and intelligence to support this analysis.
- x. Ideally, the investment gap would be calculated using a systematic, bottom-up method to identify specific viability and financing constraints affecting each site, the specific market failures which are contributing to these constraints and the nature and extent of the viability or investment gap on each site. This site-by-site pipeline analysis would provide the basis for an aggregated estimate of the total investment gap across all the pipeline projects.
- xi. A systematic assessment such as this needs to capture the influence of both:
  - Development Site Specific Factors: these factors influence the cost and potential revenues
    associated with developing out a particular site and the scale of any viability gaps that affect
    the development.
  - External factors: structural and cyclical factors including economic and market conditions
    or the supply of finance also have an influence on the viability of development on particular
    sites and the ability of developers to secure finance.
- xii. These factors are interrelated and influence three overlapping determinants of the investment gap (i) development viability and the size of the viability gap (ii) willingness of developers to invest in a particular site; and (iii) the ability of developers to access finance to fund development activity.
- xiii. The availability of information relating to development-specific factors is patchy. This is partly because the development pipeline encompasses sites at various stages in their development and there is not always an active developer on site or a clear plan in place for how the site will be developed. Where plans are in place, developers are often not willing to share information on the viability of their sites.



- xiv. This means that there are gaps in the availability of information about the development pipeline and it has not been possible to identify the specific viability and financing issues on a site-by-site basis. The assessment has therefore drawn heavily upon a broader but less site-specific evidence base relating to external factors (such as the supply of finance and market conditions) to draw conclusions about viability and market failure.
- xv. This approach reflects the FI Compass guidance which highlights the inherent challenges in capturing systematic quantitative information about these aspects of the investment gap and recommends triangulating insights from literature reviews, data gathering, interviews and surveys.

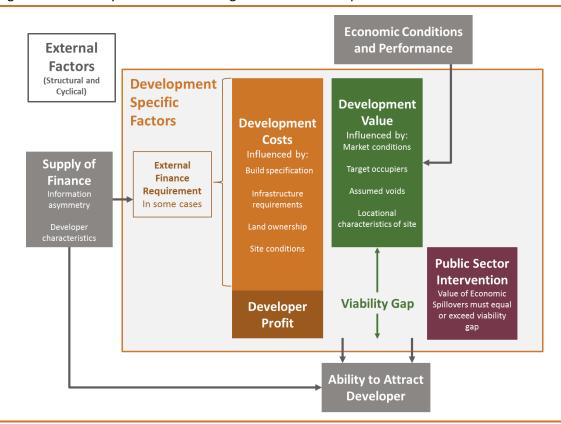


Figure 1.1 Summary of Factors Affecting the Investment Gap

Source: Regeneris Consulting

# **Research Findings**

- xvi. **WWV** is an area of low economic density. Whilst the WWV programme area is diverse in its economic character, it is an area of low business and employment density. Business and employment density is low in comparison to Wales overall and the UK average. The economy is also weighted towards lower value industries, such as land based industries and food production and processing, where employment is declining. These features of the programme area's economy have resulted in low levels of productivity, a below average employment rate and the outmigration of working age residents (particularly those with higher level skills).
- xvii. **Economic development policy is focused on economic growth and employment creation.** The Welsh Government's economic development strategy has a clear focus on economic growth and its central priority is to create employment. Many parts of the West Wales and the Valleys 2014-20 ERDF Programme echo this focus on employment creation. Priority 4 is expected to play a major



supporting role in realising the aspiration set out in the Operational Programme. The Specific Objectives under this priority will give rise to a range of supporting investments to improve transport networks, digital infrastructure and enable greater labour mobility.

- xviii. The property market in the WWV programme area is un-dynamic and characterised by a low volume of transactions, poor rental yields and hence a low level of development activity. The following points are particularly important in understanding the existence of market failure and sub-optimal investment situations in the WWV programme area. They apply equally to office and industrial developments and fairly consistently across the WWV area:
  - Rental values are low across the programme area, reflecting generally low levels of
    economic growth and a resultant low level of demand for both office and industrial space.
    The low rental levels partly reflect the poor quality of much of the office and industrial
    stock which has arisen because of low levels of development activity.
  - Low expected rental values mean that **large viability gaps** exist even when there are no abnormal site conditions to address.
  - Viability gaps affect sites in all parts of the programme area although there is some
    evidence to suggest that viability gaps could be slightly smaller in more buoyant parts of
    the programme area which are closer to areas of economic opportunity (i.e. the SE and
    NE).
  - These market characteristics mean that developers lack confidence in market conditions and this is discouraging speculative development, even where grant funding is available to address viability gaps.
  - Larger sites which are un-infrastructured or facing other constraints will not come forward without substantial grant funding.
- xix. The market assessment has highlighted evidence of market failure which provides a clear rationale for intervention in the development market to bring forward unviable or marginally viable sites across the WWV programme area. There is an element of path dependency which cannot be overcome without public sector investments, as developers and their investors do not value the benefits of sectoral change and economic restructuring in the same way that the public sector does. Similarly, the range of positive and negative externalities associated with bringing development activity forward on unviable sites are not factors in developer and investor decisions.
- xx. There is some evidence of finance market failure but viability related barriers to development are more widespread. The evidence suggests that finance market failures might exist where developments are viable or marginally viable, or where developers have particular characteristics. However, many of the active developers in the WWV programme area report being fairly well capitalised and highlight that it is issues related to site viability that are the more important consideration.
- xxi. The evidence suggests that the scope to address market failure using a UDF mechanism is limited in the WWV programme area. In most cases the viability gap will be of a scale that makes a UDF financing mechanism inappropriate, given its scope to offer developers benefits through access to cheaper or more flexible finance or to mitigate risk for other investors. Repayable finance, even where provided below commercial rates and on flexible terms will not fill the viability gap.



- xxii. The assessment suggests that there could be circumstances where viability gaps are smaller and potentially in the marginal territory that is suitable for UDF investment. These instances of marginal viability are more likely to occur in buoyant and dynamic markets (where confidence and rental values are a little higher) and where development-specific factors give rise to lower risk, greater rental values and more certainty around income streams. However, the assessment has not identified any specific instances in which these factors are aligned in such a way that sites which could be eligible for funding through the WWV programme have the marginal viability suitable for funding through a UDF mechanism.
- xxiii. The assessment has not provided the certainty required, in any regard, that there is a suitable pipeline of development projects in the WWV programme area. As noted in the following section, an important lesson of the UDFs funded through the previous programmes was the need for a reasonable degree of certainty that there is a sufficient number of development sites which could be appropriate (and eligible) for a UDF financing mechanism, which are development ready and hence that there is a realistic project pipeline. It is worth noting the stronger market conditions in the East Wales programme area may provide the circumstances in which a suitable pipeline of development schemes for financing through a UDF mechanism may exist.
- **xxiv.** Given the lack of evidence of a suitable pipeline, investment in a UDF for WWV would contradict the good practice lessons drawn from other schemes. Although it is based upon a limited evidence base, the review of lessons learned points strongly to the importance of scale in UDFs and suggests that fund value should be at least £50m. This review underlines the importance of a suitable pipeline of projects (both in volume and delivery readiness) to prevent delays between setting up the fund and making investments. In considering whether a suitable pipeline exists, it is important to bear in mind that not all projects which are identified as potentially suitable for UDF funding would go on to receive investment. As the assessment has not identified a strong pipeline of potential investments for a UDF, it is unlikely that either of these important criteria could be met.
- xxv. While there are good reasons to believe that UDFs provide a sensible basis on which to secure various forms of value added, the potential to achieve these in WWV is limited. Although evidence relating to the value added of UDFs is limited it highlights various forms of value added including providing finance to unlock stalled and marginal development, to drive the achievement of a range of important economic benefits, stimulating a more active developer and development finance market, as well as the recycling of investment returns. However, the scope to secure these forms of value added will not be uniform across areas with different characteristics. In the case of the WWV programme area, there might be less potential to achieve both demand and supply side related forms of value added due to the underlying weakness of the economy and property market. This suggests that UDFs are unlikely to be appropriate here.
- xxvi. These findings indicate that **UDF** would not be an appropriate mechanism to bring forward development of business sites and premises in **WWV**. The clear evidence of viability gaps indicates that there is a **continued case for grant funding** to bring forward sites which would be unviable without public sector intervention. The evidence from the market assessment, as well as wider best practice from evaluations suggests that any grant intervention should be designed and operated with the following principles in mind:
  - Clear Logic Model Underpinned by Comprehensive Evidence: the design of interventions
    which provide grants should be informed by a clear and comprehensive evidence base and
    evidence of market conditions to justify the specific focus of the fund and set the
    investment strategy. Clarity on the specific objectives that a fund is seeking to create is
    essential given that the existence of a viability gap does not itself constitute a market failure



or justify public sector intervention. The market is acting rationally by not investing in unviable propositions and the case for public sector intervention can only be made on the basis that an investment would give rise to economic development spillover benefits that have value to the economy and which result in an acceptable return for the public sector's investment. In light of this, grant provision should be underpinned by a clear logic model which identifies the rationale for and specific objectives of any grant provision.

- Careful Consideration of Delivery Mechanisms: there are a variety of delivery mechanisms
  which could be suitable for a grant fund. These include Feasibility Grants, Gap-Funding
  Development Activity, Repayable Grant and Local Authority Guarantees These various
  mechanisms need to be carefully considered in light of the specific policy objectives that a
  fund is seeking to contribute to.
- Robust Project Appraisal: Irrespective of the delivery mechanism (or mechanisms) used, any grant fund needs to be underpinned by a clear and transparent appraisal process to guide investment activity. The timing of development and the scale of benefits that a scheme will deliver are central to the grant funding decision and these expectations should be stated clearly in grant funding agreements to ensure that funds deliver the expected scale of benefit in timescales that are appropriate to the fund.



# 1. Purpose of this Report

## Overview of the Ex-ante Assessment

- 1.1 Regeneris Consulting and Oldbell3 were commissioned by WEFO to undertake an ex-ante assessment for ERDF backed infrastructure financial instruments (FIs). The overall assessment encompasses three phases of research:
  - A screening exercise to determine the thematic focus of the ex-ante assessment
  - A market assessment to explore the evidence of market demand, economic need and value added of using FIs (Block 1 of the ex-ante assessment); and
  - Subject to the outcome of the market assessment, the development of a **delivery and investment strategy** for any proposed FI (Block 2 of the ex-ante assessment).
- 1.2 We provide further detail below on the nature of each of these elements of the assessment.

## 1 – Screening Exercise

- 1.3 An initial screening assessment was undertaken to consider the underpinning market failure rationale and economic case for FIs in four areas, namely:
  - research and innovation infrastructure across the whole of Wales
  - marine energy infrastructure (technology and / or test sites) in West Wales and the Valleys
  - broadband infrastructure in 'white areas' across the whole of Wales
  - business sites and premises developments in West Wales and the Valleys.
- 1.4 The screening exercise considered the case for the use of FIs in the four thematic areas on an inprinciple basis, with reference to three separate criteria:
  - The **contribution** to the Welsh programme strategies for smart, sustainable and inclusive growth. The screening exercise considered, for each theme, whether there are specific programme objectives and interventions that could be addressed in principle through the use of FIs, whether there is an in-principle market failure in the provision of finance that could lead to sub-optimal investment and whether additional investment through a financial instrument could reduce an identified finance gap.
  - The value-add of using an FI to meet policy objectives and in particular whether a financial
    instrument might provide benefits over and above traditional grant (both direct and wider
    benefits) and could an FI, in-principle, be delivered in a cost effective manner.
  - The track record of using FIs in the intervention area and whether there is a track record
    of FIs being used successfully to achieve policy objectives in the thematic area and if there
    are any key lessons that might be used to inform the decision to use an FI one way or the
    other.
- 1.5 The screening process concluded that there are relevant investments which can support the Specific Objectives set out in the Operational Programmes in all four of the thematic areas. Although there are many instances in which there could be a case for public sector investment, there are just a few instances in which FIs are the most appropriate funding and delivery mechanisms to overcome market failure. In other cases, traditional forms of grant funding remain the most suitable form of support. In light of this the Research and Innovation, Marine Energy and Broadband Infrastructure themes were scoped out of the ex-ante assessment.



The assessment concluded that there is most scope to use FIs to deliver investments related to business sites and premises (SO4.4), which is only covered in the West Wales and the Valleys ERDF programme. The analysis concluded that while many proposed investments in this area may be subject to a viability gap, there could be scope to use repayable finance in its own right at sub-commercial rates in instances where returns are positive but marginal or in conjunction with grant assistance where there are more substantial viability gaps. There is a track record across the UK (including around eight JESSICA schemes in the 2007-13 programme) and the rest of the EU of effective use of FIs in these instances, often referred to as Urban Development Funds. In light of this, the main recommendation from the Screening Exercise was that the business sites and premises theme should be taken forward for a fuller market assessment (i.e. block 1).

#### 2 - Block 1 Market Assessment

1.7 This report provides the Block 1 market assessment element of the ex-ante assessment. It seeks to provide an objective assessment of the current market conditions affecting the provision of sites and premises in the WWV programme area and determine whether market failures that give rise to sub-optimal investment conditions are present. Building upon this, the market assessment seeks to identify investment needs that are not being met in the market and consider the extent to which an FI would be an appropriate mechanism to provide this finance. The methodology for the Block 1 market assessment is set out in more detail in Section 2 of this report.

# Structure of the report

- 1.8 As outlined above, this report focuses on the first block of the ex-ante assessment. It is structured as follows:
  - Section 2 outlines the methodology and data sources that have informed the market assessment
  - Section 3 provides an analysis of the market failures, sub-optimal investment situations and an assessment of the investment needs
  - Section 4 provides an assessment of the value added of a FI in light of the findings relating to market failures, sub-optimal investment situations and assessment of the investment needs
  - Section 5 addresses the additional resources that could potentially be raised by a financial instrument
  - Section 6 presents a summary of relevant **lessons learned** from similar instruments and exante assessment carried out in the past.
  - Section 7 summarises the conclusions and recommendations from the first block of the ex-ante assessment.



# 2. Block 1 Market Assessment Methodology

- 2.1 The European Commission is eager to see greater use of Financial Instruments (FIs) which provide repayable finance in place of traditional forms of grant, across a wide range of priority areas within the ERDF programmes. FIs offer various benefits to programme authorities including the scope to:
  - better meet the need of investors
  - secure greater private sector leverage
  - secure greater economic benefit, financial returns which can be recycled in the future and overall value for money
  - secure behavioural change and develop financial markets.
- 2.2 FIs which are focused on business sites and premises and the regeneration of urban areas such as town centres are typically known as Urban Development Funds (UDFs). This section sets out the rationale for the use of UDFs and the design principles underpinning FIs of this type. It then sets out the methodology for the Block 1 market assessment in light of the rationale for the use of UDFs.

# **Rationale for Urban Development Funds**

2.3 As with all public sector interventions, UDFs need to make investments on the basis of various types of market failure, sub-optimal investment situations and unmet investment needs. The main factors that give rise to these conditions are summarised below.

#### Market Failures

2.4 The causes of market failures that give rise to sub-optimal investment situations and unmet investment needs may be both structural and cyclical. Market failures can occur at the level of individual projects or at a wider spatial level, as shown in the table below.

	Structural	Cyclical		
Programme Area	<ul> <li>Information Asymmetry: whereby developers and investors are not fully aware of the risks and potential returns of investment opportunities in the programme area. Lack of full information could allow perceptions of the area (eg as being one of low or no opportunity) to dominate decision making and resultant investor and development activity.</li> <li>Path dependency: developers and investors are unlikely to value the benefits of sectoral change and economic restructuring in the same way as the public sector. They might therefore be unwilling to take additional risk or bear extra cost to develop a specific sites and premises offer to support the development of sectors with particular property needs or which are at a nascent stage in their growth.</li> </ul>	Economic Cycle: the impact downturns in economic activity have on investment and risk appetite amongst finance providers and the associated effects on this on the ability of developments to secure finance.		



#### Project Level

- Coordination failures: the time and cost required to assemble larger sites will not readily be borne by the private sector.
- Positive externalities: some of the benefits associated with bringing development forward which are valuable to the public sector (eg job creation) have no bearing on decisions made by developers and investors.
- Negative externalities: benefits of removal of negative externalities such as dereliction or land contamination are not valued by developers or their investors. Many contribute to site viability problems and act as barriers to investment.
- Information asymmetries in the supply of finance: these affect particular classes of investment (to greater and lesser extents according to the timing in the economic cycle). Where information asymmetries exist it is not possible for lenders to cost effectively ascertain the costs and potential returns of a particular investment.

### Viability Gaps

- 2.5 Factors specific to individual developments as well as wider structural features of a development market can result in a financial viability gap, whereby a particular investment is unable to achieve the financial returns needed to attract the necessary funding at market terms. A viability gap could arise for a particular site as a result of various factors, namely:
  - Excessive or abnormal site costs: site or development-specific factors that add to the cost of a development and make it unviable. These factors commonly include the need for major site clearance and remediation (often an issue in former industrial areas, such as the South Wales Valleys), site access and other forms of site infrastructure (often an issue for larger sites which lack existing infrastructure or which need to provide a high-quality environment to attract specific types of users such as on science and business parks).
  - Market conditions and projected revenues: whilst the characteristics of a particular development (eg target occupiers or sectors) can have an effect on projected revenues but more often it is wider structural factors that give rise to poor yields in particular areas or for particular development types. The nature and existing performance of the economy and underlying development market in a particular location (underpinned by the area's economic structure and performance) is a major consideration here. The process of economic and sector change is a key consideration for many parts of the West Wales and the Valley programme area, with the sites and property offer often not matching the needs of growing sectors. Where market conditions are poor, the low yields and associated risks can make certain types of development unviable on normal commercial terms or of marginal viability and hence unattractive to risk adverse developers.
- 2.6 The existence of a viability gap can discourage private sector involvement or give rise to situations where a developer is unable to secure finance for a particular development in light of the returns it offers and associated risks.
- 2.7 It is important to note that **the existence of a viability gap does not, of itself, necessarily constitute a market failure or justify public sector intervention**. By not investing in unviable propositions, the market is acting rationally. The case for public sector intervention can usually only be made on the basis that an investment would give rise to economic development spillover benefits that have value to the public sector.
- 2.8 In these circumstances it needs to be clear that a particular investment would result in the creation of positive externalities or the removal of negative externalities. Positive externalities (such as encouraging enterprise, job creation or sector development) are not specifically valued by commercial developers or investors and therefore have no bearing on investment decisions. Similarly, the existence of negative externalities (such as dereliction and contamination) will not



influence commercial decision making. Public sector intervention can be justified where the value of economic spin-off benefits results in an acceptable return on investment for the public sector.

### Supply of Finance

- 2.9 Market failures in the provision of development finance can arise when providers of finance are discouraged from making particular types of investment as they cannot easily or cost-effectively determine the risks and returns due to imperfect information. The costs of establishing these risks and returns for the class of investment may be too high given the size of the proposed investment, or the developer may lack the necessary collateral to help the lender mitigate their risks.
- 2.10 The economic recession and the financial crisis left lenders (and banks in particular) exposed to bad debt on commercial property which accounted for a significant proportion of their losses in subsequent years. As evidenced in the Bank of England Financial Stability Report¹ major UK bank's exposure to commercial real assets has declined since the crisis. This, combined with a general requirement for banks to rebuild their balance sheets in compliance with Basel 3 led to a slowdown in activity in commercial real estate lending from the main UK banks.
- 2.11 Whilst the high street banks have started to provide higher levels of debt and other forms of structured finance to the commercial real estate market, they are nevertheless cautious in their investment strategies avoiding higher risk schemes or developers with no track record or insufficient collateral.

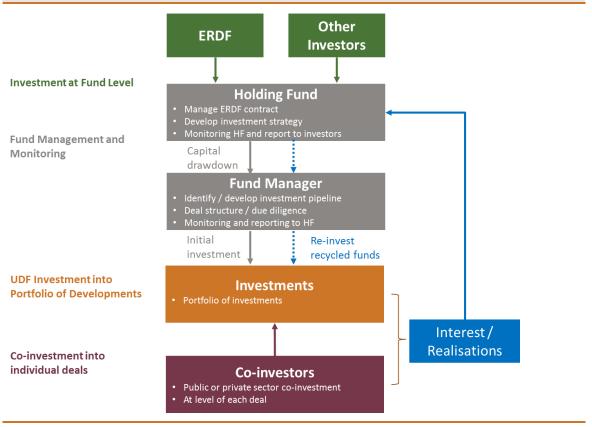
# **Overview of Design Principles for UDFs**

- 2.12 A UDF is a long-term investment fund, typically with a horizon of up to 10-20 years. Whilst it is established by the public sector which sets its overall priorities in line with public policy objectives and determining the operational model, the investment activity is managed at arm's length by a private sector fund manager. The fund manager may also have a specific role in securing additional private sector level investment at a fund level. The UDF's investments are targeted at commercial property schemes, but only those which have marginal viability. In this way the investments provide a financial return which enables the recycling of monies into other schemes until the closure of the fund.
- 2.13 However, the investment focus of UDFs and the emphasis on securing economic spillovers means that the overall rate of return for the fund would most likely be much less than a commercial investment fund would expect to achieve. Indeed, in determining the investment strategy for the UDF there is likely to be trade-off between the overall expected financial return and the economic spillover benefits.
- 2.14 UDFs are able to lever in additional funding to the ERDF contribution at both the fund and investment level, helping to ensure additional resources provide the benefits of scale and breadth of investment provided by a portfolio approach. The ERDF contribution to the UDF will typically be matched by other public or private organisations at the fund level (including Welsh Government, the EIB or potentially private institutions such as banks and pension funds), as well as private sector co-investment investment at the project level.



<sup>&</sup>lt;sup>1</sup> Financial Stability Report, July 2016, Bank of England

Figure 2.1 Illustrative Fund Structure



Source: Regeneris Consulting

- 2.15 Recent guidance<sup>2</sup> on the design of UDFs outline various principles which underpin their design. The most important of these and the implications for the ex-ante assessment are outlined below. In particular:
  - Investments made by UDFs must be into projects that are part of an integrated approach
    for a sustainable urban development strategy. This means that the fit of potential projects
    or developments with thematic and spatial priorities in the programme is particularly
    important as part of the ex-ante assessment.
  - UDF investment must take the form of a repayable loan. The use of repayable debt finance
    provided on commercial or quasi-commercial terms (where the IRR is insufficient to secure
    finance) with projects able to demonstrate a revenue stream which will enable repayment.
    The regulations allow for the use of sub-commercial interest rates on the provision of debt
    in Assisted Areas such as the WWV programme area.
  - **UDF investment should not crowd out private sector investment**. As with all public sector backed interventions, UDFs must operate in an area of clearly defined and well-evidenced market failure. Projects supported by UDFs must have an IRR which is not sufficient to attract finance on a purely commercial basis.
  - UDF supported projects must have potential to attract additional funding from other
    public and private investors. To maximise the value added of UDF investment, the FI
    cannot cover full development costs and requires a major funding contribution from the
    private sector.



<sup>&</sup>lt;sup>2</sup> Annex Vi Urban Development Fund

- Scope to combine repayable finance with traditional grant finance. There is scope to combine the provision of repayable commercial or quasi-commercial finance with grant where there is the need for the public sector assistance to address substantial upfront site preparation or infrastructure costs that the private sector would not be able to meet in its own right given the economics of the scheme.
- 2.16 These principles relate to the off the shelf instrument design from the July 2016 implementation regulation. There are various other investment model approaches (such as those including equity investment or some element of grant). The appropriateness of these models to meeting the type of demand identified in the market assessment was considered as part of the assessment.

# **Block 1 Market Assessment Methodology**

- 2.17 The objective of the market assessment is to determine whether market failures are present and if there are sub-optimal investment conditions and investment needs that are not being met in the market. The assessment therefore aims to provide well evidenced conclusions about the size of the investment gap, the justification for public sector intervention and, if relevant, the form of finance required to address it. The market assessment will therefore determine the appropriateness of an Urban Development Fund as the mechanism for addressing this gap.
- 2.18 The assessment methodology has been designed to respond to each aspect of the ex-ante assessment guidance and is structured as follows.
  - Establish Strategic Priorities for Investment
- 2.19 The assessment needs to be informed by a clear understanding of the strategic priorities for public sector investment in sites and premises and potentially urban centres across the programme area. This insight has been provided through the following tasks.
  - Analysis of the performance of the economy in the WWV programme area, including the identification of the key trends and economic drivers.
  - A review of relevant economic policy to identify the nature and focus of thematic and spatial policy responses to the socio-economic conditions in the programme area.

### Performance of Development Markets

- 2.20 The assessment needs to be underpinned by a clear understanding of how development markets are performing in terms of development activity, including the demand for and supply of sites and premises, and the viability of development. The desk-based elements of the review have explored:
  - General market evidence for Wales as a whole and its regions
  - Specific commercial development activity in the programme area, covering the quantity and value of development, types of commercial development (ie office, industrial etc), business sectors and key locations.
  - Market indicators for the programme area such as rental values and yields.
  - The level of development funding including the values of investment as far as this is possible and the investors (public and private) active across the programme area.
- 2.21 There are some limitations to the available property market data. In particular, the timeliness and coverage of the available datasets is constrained and it is not always possible to draw firm conclusions from the data in isolation. To help address these shortcomings the desk-based analysis has been supplemented by consultations with developers (5), property agents (6), members of the



development finance community (5) and other stakeholders including members of the Welsh Government's Property and Regional Engagement Teams to draw out more detailed insight into the market conditions, the extent to which the market is meeting business requirements and the reasons for sub-optimal investment.

2.22 The assessment has also been informed by how effectively the supply of development finance operating across the programme areas and if there are any particular gaps in the supply of finance or what circumstances there are problems in obtaining finance.

#### Assessment of the Development Pipeline

- 2.23 Testing for market failures in commercial development can be a complex exercise but it is important in establishing a robust case for UDF investment. A detailed analysis of the pipeline of potential projects should identify a broad range of potential sites and developments, the range of relevant characteristics and consider the extent to which they offer some fit within the requirements of a potential UDF funded through the WWV programme (see Appendix A).
- 2.24 Our identification of the project pipeline drew heavily upon earlier market assessment work commissioned by the Welsh Government. The composition of this pipeline was tested with Welsh Government's Area Managers who have an up to date view of the pipeline.
- 2.25 The market assessment sought to assess the extent to which each site fits with the criteria of the WWV programme and a potential UDF, using a two staged approach. The **first stage** was based on summary information about each site and analysis of some of the more objective criteria which determine whether or not a particular site could fit within the criteria for a UDF. These criteria included:
  - Whether the site can be considered to be part of a strategic, area-based approach to regeneration
  - If the site, or the proposed activities upon it will be eligible for ERDF support
  - The size of the site / proposed premises
  - The nature of the site's location and particularly whether it is close or well linked to deprived communities or urban locations.
- 2.26 After the sites which did not meet these criteria were eliminated, the second stage involved a detailed analysis of the barriers to site development, including viability and financing issues and the evidence of associated market failures. This analysis has been informed by desk-based research around the performance of development markets and supply of finance, consultations with relevant developers and site owners, as well as Welsh Government and selected local authority officers.
- 2.27 However, our ability to undertake the assessment in this manner has been constrained by the limited information which is readily and publicly available for many of these sites, as well as a reluctance on the part of some developers/owners to participate in this exercise. In the absence of detailed bottom-up information, the assessment has had to rely more heavily on more general information about the performance and prospects of the local economies of the WWV area and the associated property markets.

#### Assessment of the value added of the FI

2.28 The assessment of value added covers both the quantitative and qualitative dimensions of a proposed UDF, as well as its fit with other forms of public sector intervention and the consistency with State Aid provisions. Its primary purpose is to determine why a UDF approach is the



- appropriate response to meeting the investment need identified in the programme area and the advantages in opting for this mechanism compared to a traditional grant approach.
- 2.29 The task has been informed by a review of the available evaluation evidence of similar types of FIs (including FI Compass evidence and specialist task groups), a mapping of the FI interventions alongside other policies and discussions of the State Aid advisors. However, there is limited publicly available information on the implementation, performance and impact of UDFs at the current time.

Lessons Learnt

2.30 The consideration of the lessons learned from similar instruments has again drawn on the review and evaluation evidence available through FI Compass, as well as other published reviews. However, it needs to be noted that there is limited evidence in the public domain currently. Subject to this important limitation, the analysis has sought to identify success factors and pitfalls and identify how these lessons learned could be applied to proposed UDF funded through the WWV programme.

#### **Ex-Ante Assessment Guidance**

- 2.31 FI Compass Guidance relating to the ex-ante assessment for UDFs provides comprehensive instruction relating to the required focus and content of the market assessment for UDFs. Although the guidance provides a clear structure for the ex-ante assessment, it does not reflect all the complexities of undertaking market assessment for potential UDFs. In particular, the guidance would benefit from more detail relating to:
  - Market Failure: The FI Compass Guidance makes it clear that the ex-ante assessment needs to identify the specific market failure rationale for UDF investment but it does not fully describe the range of market failures, sub-optimal investment situations and unmet investment needs that can justify investment in a UDF. This is an important omission; as Table 2.1 in this section illustrates, there are numerous causes of market failure to consider in the ex-ante assessment and these can be both structural or cyclical and might occur at the level of individual projects or the programme area. The guidance does not fully reflect this complexity. In particular, it does not adequately differentiate between finance market failures and viability gaps or consider the implication of this for the case for investment in a UDF.
  - Investment Gap: The guidance clearly states that the ex-ante assessment needs to determine the size of the investment gap and the description of methods suggests that this can be achieved using top-down methods. The guidance does not recognise the need for bottom-up (ie site-by-site) analysis to explore the development specific factors which influence the scale of the investment gap in a particular area nor the challenges of accessing this type of information in practice. This is an important omission as this development level information is not always available (as we explore elsewhere in this report). As information on development-specific factors is usually incomplete or commercial in its nature, an exante assessment for UDFs cannot provide a full a quantitative assessment of the investment gap. This is not reflected in the FI Compass guidance and there is no instruction about how to address the lack of complete information, or where compromises should be made
  - Importance of the Pipeline: Although the guidance notes the importance of identifying a
    pipeline of potential investments for a UDF it does not make it clear that the ex-ante
    assessment needs to identify a sufficient pipeline to justify investment in the UDF and
    provide certainty about the ability of the UDF to make its investments. The guidance does



not explicitly highlight the need to consider the scale of the pipeline in relation to the size of the fund (and the extent to which one should inform the other), or assess the strength of the pipeline in terms of the certainty that the projects will come forward and the likely timing, or the ability to balance risk within the portfolio of UDF investments.



# 3. Strategic Priorities for Investment

- 3.1 This section identifies the main strategic priorities for investment in the West Wales and the Valleys Programme area. It draws upon:
  - analysis of the socio-economic characteristics of the programme area which informed the
     West Wales and the Valley ERDF Operational Programme
  - published data sources related to trends in economic activity and employment in the programme area
  - economic development and regeneration policy in the programme area.

# **The Programme Area**

3.2 West Wales and the Valleys covers an area of 1.24m hectares and has a population of c.1.9 million people, 64% of Wales' total population. The 15 local authorities in the programme area encompass a diverse mix of urban and rural communities. The programme area is predominantly rural with concentrations of population in the more urbanised South and along the north coast.

West Wales & The Valleys Boundary
North Wales
South Wales Valleys
South Wales Valleys

Ceredigion

Ceredigion

Renthyr Tydfil
Blaenau Gwent

Swansea

Rhondda Cynon Taf

Figure 3.1 West Wales and the Valleys Programme Area

Source: Regeneris Consulting. Note: Enterprise Zones in WWV programme area marked in red



- 3.3 The programme area can be split into three broad areas, each with distinct economic structures and characteristics:
  - North Wales Programme Area: encompassing Anglesey, Gwynedd, Conwy and Denbighshire is home to 395,000 residents. The economy here has a strong focus on manufacturing and energy (the area has seen major investments in onshore wind, biomass, tidal and nuclear industries in recent years). Tourism is also an important part in the local economy.
  - South West Wales Programme Area: including Carmarthenshire, Pembrokeshire and Ceredigion where population density is much lower and the economy has a more rural nature. Employment here is dominated by land based industries, energy, food production and processing and tourism. There are some pockets of industrial and service focused activity related to the port at Milford Haven and energy related activity in Carmarthenshire.
  - South Wales Valleys Programme Area: this more urbanised part of the programme area encompasses eight local authority areas and is home to 1.1m people. To the east, the heads of the valleys was historically dependent on manufacturing, mining and engineering but as employment in these sectors has contracted, the service sector has grown in importance. Swansea is a major service centre and home to 233,000 people (and reflects its City Region status). Although Cardiff and Newport are outside of the WWV programme area, their influence extends into the programme area and both are major economic drivers here.

### **Socio-economic Characteristics**

- 3.4 The socio-economic analysis that underpins the WWV Operational Programme (OP)<sup>3</sup> identified various characteristics of the programme area which are relevant to the ex-ante assessment. This analysis represents a snapshot of economic performance at the time when the Operational Programme was published in 2014 to inform the Structural Funds programme for the subsequent 4 years through to 2020.
- 3.5 The underlying theme in the analysis is that WWV faces a range of long standing socio-economic challenges. The key findings are:
  - Low Business Density: at 435 businesses per 10,000 population, business density in WWV is far lower than elsewhere in Wales (456 per 10,000) and substantially behind the remainder of the UK (573 businesses per 10,000 population). The socio-economic analysis also highlights a large gap between enterprise birth rates in WWV and the UK, which suggests that this gap in business density could continue to widen. The relatively small business base in the programme area means that a large proportion of employment is dependent on the public sector. In 2011, 38% of employee jobs in the programme area were in the public admin, health and education sector, although we know that since 2011 there have been some significant declines in public sector employment in Wales.
  - Low levels of productivity: the Operational Programme notes that GVA per head in WWV was more than £7,000 lower than that of UK between 2009 and 2011. The Operational Programme's analysis of the components of this gap highlights low GVA per worker as the main driver of this GVA gap. This is a reflection of the area's unfavourable industrial structure, the rural nature of much of the programme area and the tendency for economic activity to be focused on lower productivity sectors such as accommodation, agriculture and food services, education, human health and social work activities. This picture varies across the programme area, and there are some concentrations of higher value economic



<sup>&</sup>lt;sup>3</sup> Socio-Economic Analysis of West Wales and The Valleys, August 2013

- activity in some of the southern parts of the programme area, although only Swansea has a GVA per head which exceeds the average for Wales as a whole.
- **High Levels of Out-Commuting**: although the analysis underpinning the OP suggests that the programme area's economic structure and lower levels of productivity account for the majority of the gap in GVA per head it also highlights high levels of out-commuting as a key factor. This reflects the proximity of major employment centres (Cardiff and Newport in the South and Wrexham in the North) to the programme area and the lower density of economic activity and relative sparsity of employment opportunities within WWV. This serves to further dampen GVA per head in the programme area.
- Below Average Employment Rate: the OP notes that the employment rate in WWV has been increasing steadily, it remains low in comparison to the rest of Wales and the UK at 70% of people aged 20 to 64 (compared to 72% for Wales as a whole and 74% for the UK) although the situation has improved over recent years. This is a reflection of the low business density, and it underlines a clear need to create employment opportunities in the programme area. Employment rates vary across the programme area with the lowest rates being found in the Welsh Valleys, where economic restructuring has had a marked effect on the number and range of employment opportunities. The comparatively low proportion of working age people in employment is highlighted as a further influence on the overall low levels of GVA per head in the programme area.
- Falling Working Age Population: working age people make up around 60% of the population in WWV, the concentration of economic activity and employment in the South has given rise to a slightly larger working age population in this area (64% of residents of the South are of working age). The overall composition of population in the South is in line with the UK while the North and South West compare unfavourably. Both of these areas have a lower proportion of the population of working age and a higher proportion aged 65+. Between 2001 and 2010 both of these areas experienced a fall in working age population and an increase in the proportion of population aged 65+. During the same period the South experienced an increase in its working age population which was large enough to offset the decline in the other two areas and the working age population for the programme area as a whole increased by 0.6 percentage points.
- Out-migration of Younger People: although the population for the whole of West Wales and the Valleys area increased by around 42,000 between 2001 and 2010 (+2%) this has been driven by net in-migration of people aged 45-64 age group. This masks a net out-migration by younger people in the 16-24 age group. The operational programme does not explain the factors behind the out migration of younger people although it is likely to be influenced by people leaving the area to pursue higher education and better job opportunities.



Figure 3.2 Population in Programme Area by Age Group, 2010

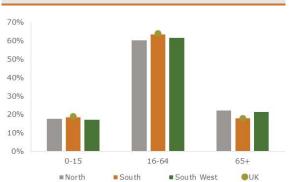
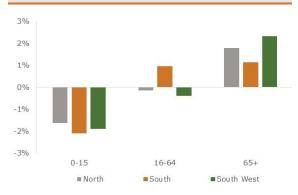


Figure 3.3 % Change in Population in Programme Area, 2001-2010



Source StatsWales and ONS

Source: StatsWales and ONS

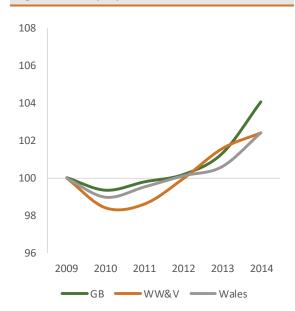
## **Recent Trends in Employment**

3.6 Before the recession, employment growth in the WWV programme area had been outstripping the Wales and national average, but employment in the programme area was more severely affected by the downturn than the rest of Wales and Great Britain. In terms of employment WWV has also recovered from the economic downturn at a slower pace than both Great Britain and Wales as a whole. Employment in Wales increased by 2% between 2009 and 2014 (equivalent to an increase of 16,800 jobs) but this was half the Great Britain rate of 4%.

108 106 104 100 98 96 2003 2004 2005 2006 2007 2008

**−**Wales

Figure 3.5 Employment Index, 2009-14



Source: Annual Business Inquiry

Source: Business Register and Employment Survey

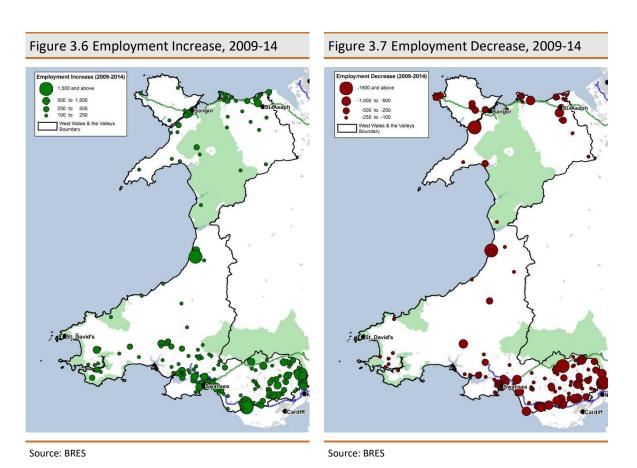
3.7 Recent employment growth in WWV has been heavily focused on the South of the programme area. The three southern local authorities of Carmarthenshire, Swansea and Neath Port Talbot

-WW&V



accounted for three quarters of all employment growth in the WWV to 2014. The spatial pattern of employment change (summarised in 1.1 and 1.1) highlights some interesting patterns:

- Existing urban centres appear to have been important drivers of growth: given the focus
  of economic activity in the South of the programme area, it is unsurprising that the majority
  of employment growth has occurred in the south of WWV. The clustering of employment
  growth in areas surrounding Cardiff and Newport and the growth experienced in Swansea
  illustrates the importance of existing urban centres as drivers of employment growth.
- Strategic transport corridors have been focal points for employment growth: the areas adjacent to or accessible from the M4, A465 and A40 routes in the south and the A55 in the north have seen a concentration of employment growth.
- There are some isolated pockets of growth outside of urban areas and strategic corridors: these appear to be related to the larger business centres and the presence of HEIs. This is particularly noticeable in the case of Bangor and Aberystwyth, where there has been a notable increase in employment in public administration and education in the areas around University campuses. There have also been increases around the southern ports of Milford Haven and Pembroke Dock.
- North West Wales has seen little growth in employment: the greatest reduction occurred in the local authority of Ceredigion in West Wales, with a loss of 1,400 jobs between 2009 and 2014. Denbighshire and Anglesey (both in North Wales) also suffered job losses of 1,100 and 800 jobs respectively, partly offset by jobs growth in Conwy of around 1,600 jobs.



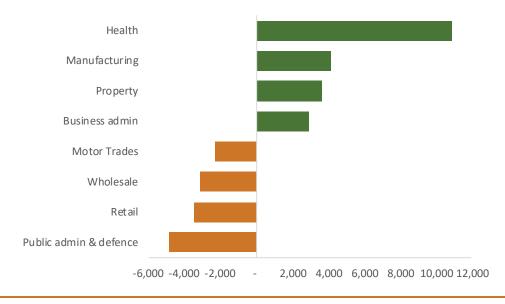
3.8 The fastest growing sector over this four-year period was the health sector, creating 10,900 jobs (a 10% increase). In absolute terms this is more than double the increase compared to any other



sector. The manufacturing sector has also increased over this period by around 4,100 jobs in contrast to the trend across Great Britain where it has fallen. This reflects the strength of the manufacturing sector in the WWV area, with its high location quotient of 1.4<sup>4</sup>. Growth in this sector has been concentrated in South Wales. This is likely to have resulted in increased demand for B2/B8 industrial space<sup>5</sup>. Conversely, there have been some major losses in public admin and defence, consistent with the trend across Great Britain. The wholesale and retail sectors have also experienced large falls in employment (-3,200 and -3,500 jobs respectively).

- 3.9 Overall, there has been little employment growth in North Wales (an increase of only 700 jobs between 2009 and 2014 equivalent to a less than 1% employment increase). Losses in the public sector and retail accounted for the majority of the job losses, which has been offset by growth in the health and the manufacturing sector.
- 3.10 In South West Wales, employment increased by 7,400 jobs between 2009 and 2014, although over 95% of this growth occurred in Carmarthenshire. Consistent with the trend in North Wales, the main job losses were in public administration and retail. These were offset by large increases in employment in manufacturing and health sector. The presence of HEIs (particularly in Aberystwyth) has meant that there has also been jobs growth in the education sector.
- 3.11 In South Wales, where the majority of jobs growth has occurred, employment has increased by 8,700 jobs between 2009 and 2014. Jobs growth has occurred in sectors similar to that across the WWV area (health and manufacturing). The greater presence of urban centres in South Wales has meant that there has been growth in sectors such as business administration (+4,100 jobs), IT and communication (+2,500 jobs) and property (+2,300 jobs).

Figure 3.8 Employment Change in West Wales & the Valleys, 2009-2014



Source: BRES



<sup>&</sup>lt;sup>4</sup> Location quotients quantifies how concentrated an industry is compared to a larger area used as a benchmark (in this case Great Brittan). A location quotient greater than 1 means the industry is more concentrated in the area compared to the average in terms of employment (Source=Business Register and Employment Survey).

<sup>&</sup>lt;sup>5</sup> B2 space refers to general industrial space, whereas B8 refers uses for storage or distribution.

## **Policy and Strategic Context**

### **Economic Development Policy**

- 3.12 Economic development policy in Wales over the past 5-6 years has been heavily focussed on delivering recovery from recession. In July 2010, the previous Welsh Government<sup>6</sup> published Economic Renewal: A New Direction (ERP). Although this policy is now dated, it provides useful context for the what the strategic priorities have been in Wales over this period and areas of investment.
- 3.13 The strategy centred on a vision "of a Welsh economy built upon the strengths and skills of its people and natural environment; recognised at home and abroad as confident, creative and ambitious; a great place to live and work" [page 3]. It refocused economic development activity around five priorities:
  - Investing in high quality and sustainable infrastructure
  - Making Wales a more attractive place to do business
  - Broadening and deepening the skills base
  - Encouraging innovation
  - Targeting the business support offer.
- 3.14 The strategy made a number of general commitments related to quality employment sites and infrastructure, including to 'invest in high quality and sustainable infrastructure'<sup>7</sup> and to 'take a more strategic approach to land management and premises for businesses'<sup>8</sup>. It also stated that the Welsh Government would 'develop our approach to premises for business to work with the market across Wales. In areas of high market demand we will seek to provide information rather than finance and be involved in joint ventures where necessary. In areas with low market offering we will provide a combination of gap funding (to the developer) and direct provision<sup>9</sup>.' The strategy also identified the (then) JESSICA Regeneration Investment Fund for Wales as one means of helping to finance the development of strategic employment sites and associated infrastructure.
- 3.15 The Economic Renewal strategy set the tone for the Welsh Government's sector based approach to economic development. The strategy identified a number of priority sectors based on their existing contribution to the Welsh economy and their growth potential. These were subsequently expanded to a broader list of nine sectors, which cover a substantial proportion of the economy<sup>10</sup>.
- 3.16 Each sector has its own private sector led panel which advises Ministers on the strategic priorities within each sector. These sector plans were devised at a time when the focus was on recovery from recession.
  - Recently, a new policy document has been published, Taking Wales Forward 2012-20. This sets out a high level aspiration for economic development activities over the next four years. As a recently

<sup>&</sup>lt;sup>10</sup> Priority sectors include ICT, energy and environment, advanced materials and manufacturing, creative industries, life sciences, professional services, construction, food and farming and tourism.



<sup>&</sup>lt;sup>6</sup> A coalition between the Labour and Plaid Cymru groups at the National Assembly for Wales.

<sup>&</sup>lt;sup>7</sup> Economic Renewal; A New Direction. Welsh Assembly Government. July 2010. Page 3.

<sup>8</sup> Ibid., Page 9.

<sup>&</sup>lt;sup>9</sup> Ibid., Page 12.

published strategy there are, as yet, no specific and detailed action plans in place but the following aspirations are notable and relevant for this study:

- The promotion of tech hubs in towns and cities, which could increase demand for employment land and office / incubator space.
- Promotion of inward investment, which could lead to increased land required for business space from businesses relocating to Wales.
- Delivering the Cardiff City Region Deal and the development of similar deals in Swansea and North Wales. This is considered in more detail within the spatial policy in this section of the report.

### Infrastructure Investment Strategy

- 3.17 The Wales Infrastructure Investment Plan is the main vehicle in Wales through which strategic capital investments are made. It emphasises both the need and importance of infrastructure investment in Wales for sustainable economic growth.
- 3.18 It should be noted that this document was produced in 2012 following the 2010 spending review which saw a stark reduction in Welsh Government funding budgets. This placed greater emphasis within the strategy to use more innovative and efficient ways to meet the continued infrastructure investment need. The most recent Spending Review and Autumn Statement delivered a 16% increase in real-terms to funding available for infrastructure investment through to 2020-21, however capital budgets are still much lower (in real-terms) than pre-recession levels. Therefore, there is still a requirement to maximise the use of available capital.
- 3.19 The document sets out the strategic investment priorities for £15 billion of funding by the Welsh Government over a ten-year period to 2022. It provides a detailed account of sectoral investment plans through to 2014-15 and outlines the key elements of a new approach to infrastructure investment. The sectoral approach is strongly aligned to the Welsh economic development policy with investments aligned to the priority sectors detailed above. The overall vision is to boost jobs and growth in Wales and infrastructure is seen as crucial to achieving this. Infrastructure is grouped into two categories, economic infrastructure which is physical networks such as roads, rail, ICT etc. and social infrastructure, which is physical assets such as housing, schools and hospitals.
- 3.20 The section of the infrastructure plan focussed on regeneration is most relevant to this assessment. "Regeneration covers a range of activities, from large-scale physical renewal projects that promote economic growth to neighbourhood interventions that improve quality of life." Within it, seven regeneration areas are identified as priority recipients of the regeneration budget (c.£60m per year), six of which fall into the programme area:
  - The Mon a Menai area covering Anglesey and part of Gwynedd
  - North Wales Coast which spans part of Conwy and Denbighshire
  - Aberystwyth in the local authority of Ceredigion
  - Western Valleys covering part of Swansea, Carmarthenshire, Neath Port Talbot, Rhondda Cynon Taff and Bridgend
  - Swansea
  - Heads of the Valley which covers a number of local authority areas including Merthyr Tydfil,
     Caerphilly and Blaenau Gwent.

regeneris
economics-research-analysis

<sup>&</sup>lt;sup>11</sup> Ibid., Page 73.

3.21 The latest project pipeline update<sup>12</sup> provides a summary of infrastructure investments and progress to date. Table 3.1 details the most relevant infrastructure investments in the programme area for the purpose of this assessment.

Table 3.1 WIIP Project Pipeline						
Area	Project	Value	Expected	Details		
	/Programme	of	Completion			
		scheme				
Carmarthenshire	County	£22m	2019-20	To deliver the economic		
	Regeneration			regeneration of the County's strategic		
	Fund			employment sites, primary town		
				centres, market towns, valley growth		
				zones and coastal belt.		
Ceredigion	Mill Street	£40m	2016	This development involving Council		
	Development,			owned land has long been a key		
	Aberystwyth			strategic aim for the authority.		
Pembrokeshire	Southern	£9.55	2016-17	Programme of highway improvement		
	Strategic			works to employment and energy sites		
	Route			south side of The Haven.		
	Bulford Road	£8.03	2016	Programme of highway improvement		
		m		works to energy sites north side of The		
				Haven.		

Source: Wales Infrastructure Investment Plan – Project Pipeline Update – February 2016

Regeneration and Development Policy

3.22 Regeneration and development activity in Wales is not currently guided by an active strategy but is supported by The Vibrant and Viable Places regeneration framework. In practice, this operates as a competitive fund to distribute regeneration funding to the most deprived parts of Wales. Local authorities were invited to bid into a £100m funding pot and this was allocated as shown in the table below.

Table 3.2 Allocation of Vibrant and Viable Places fund				
	Local Authority	Funded Area	Allocation	
	Bridgend	Bridgend Town Centre	£5.978m	
	Conwy	Colwyn Bay	£12.022m	
	Isle of Anglesey	Holyhead	£7.490m	
West Wales and the	Merthyr Tydfil	Merthyr Tydfil Town Centre	£12.873m	
Valleys	Neath Port Talbot	Port Talbot	£9.643m	
	Rhondda Cynon Taff	Pontypridd	£5.980m	
	Swansea	Swansea City Centre	£8.394m	
	Torfaen	Pontypool	£8.203m	

<sup>&</sup>lt;sup>12</sup> Wales Infrastructure Investment Plan – Project Pipeline Update – February 2016



	Flintshire	Deeside	£6.024m
East Wales	Newport	Newport City Centre	£14.988m
East wates	Wrexham	Wrexham Town Centre	£10.594m

3.23 Although the £100m has now been allocated, the Vibrant and Viable Places framework remains the overarching framework to guide investment in regeneration in deprived areas. However, it is not clear what resources are available to be invested through the framework.

## **Spatial Policy**

3.24 Welsh Government's Spatial Plan provides 'context and direction of travel for local development plans and the work of local service boards' 13. It was originally adopted in 2004 and updated in 2008 to reflect policy changes and work that had been undertaken around the plan. The overarching vision of the strategy is:

'We [the Welsh Government] will sustain our communities by tackling the challenges presented by population and economic change. We will grow in ways which will increase Wales' competitiveness while assisting less well-off areas to catch up on general prosperity levels and reducing negative environmental impacts. We will enhance the natural and built environment and we will sustain our distinctive identity'<sup>14</sup>.

- 3.25 The plan is built around several themes, including 'Promoting a Sustainable Economy'. It makes several recommendations in relation to new employment sites. These include locating development near to public transport and housing and infrastructure developments, and prioritising brownfield over greenfield sites where possible 15. The plan considers spatial plan areas separately and highlights the following priorities in each area:
  - Central Wales which includes the areas of Ceredigion, Carmarthenshire and Aberystwyth.
     The Plan acknowledges a need for interventions to provide infrastructure to broaden the economic base of this area.
  - The plan highlights limited availability of land in the North East Wales area (which includes Conwy and Denbighshire, part of the WWV area) and the need to preserve the distinctiveness and culture of the areas and indicates that large scale development is unlikely to be appropriate in this area.
  - In considering the North West Wales spatial plan area (which includes the areas of Gwynedd and Anglesey), the Plan identifies a need to enhance the quantity and quality of business premises provision and provide utility infrastructure to overcome constraints on some sites.
  - **Pembrokeshire** is considered as its own spatial area within the plan. It references 'Larger strategic employment sites will be key investment and employment locations in determining the future function and inter-relationship of settlements and will need excellent infrastructure and public transport links.' 16



<sup>&</sup>lt;sup>13</sup> People, Places, Futures – The Wales Spatial Plan 2008 Update. Welsh Assembly Government. 2008. Page 1.

<sup>&</sup>lt;sup>14</sup> Ibid., Page 20.

<sup>15</sup> Ibid., Page 26.

<sup>&</sup>lt;sup>16</sup> Ibid., Page 92.

- South East Wales Capital Region spatial plan area includes the valleys as well as Cardiff and Newport which are outside of the programme area. The Spatial Plan acknowledges that most private sector development will take place around the cities of Cardiff and Newport, and 'public sector strategic interventions' will be required in the mid-and upper valley areas as a counter-balance to growth in the cities. It also states that strategic regeneration interventions in the most deprived areas should be along sustainable transport corridors and support the key settlements.
- The waterfront of Swansea Bay in the **Waterfront and Western Valleys** spatial plan area, is identified as a priority. Regeneration and development activity is mentioned but the emphasis here is on facilitating the growth of the knowledge economy.
- 3.26 Whilst providing useful context, the Wales Spatial Plan is perhaps less useful in guiding investment decisions within the programme area given that it was last updated in 2008. Despite this, it has provided the foundation for various other spatial initiatives that will steer future investment. The most relevant are Enterprise Zones, City Regions and Strategic Corridors.

### **Enterprise Zones**

- 3.27 Enterprise Zones have become an important element of spatial policy in Wales. Businesses located in enterprise zones can benefit from business rate relief, capital allowances, preferential access to loans from Finance Wales alongside other business support services. Five of the eight EZs in Wales are located in the West Wales and the Valleys programme area and each are aligned to one or more of Wales' priority sectors. These are:
  - Anglesey: the rationale for assigning Enterprise Zone status to Anglesey is to aid the establishment of the island as a centre of excellence in low carbon energy regeneration to accelerate the investment required to achieve this. There are several major strategic investment projects planned within Anglesey many of which are related to energy infrastructure. The island is an attractive location for businesses in the energy sector supply chain and there is opportunity for the development of employment sites to support these. Ten strategic sites have been identified within the EZ<sup>17</sup>
  - **Ebbw Vale:** is focussed around advanced manufacturing, building on its manufacturing heritage it has a good supply of skilled labour and good links to other manufacturing hubs such as the West Midlands. There is 40 hectares of development land available within the EZ. Infrastructure investment will be focussed on five key sites within the Enterprise Zone<sup>18</sup>.
  - Haven Waterway has access to energy infrastructure and deep water port facilities and sea conditions which have shaped its focus towards wave and tidal energy and make it particularly suited to port related development. Within the EZ there is also a growing number of businesses within the supply chain including suppliers of raw materials, engineering expertise and professional services. There is a new wave energy demonstration zone as well as the availability of tidal stream technologies and electricity grid access could make EZ attractive to research intensive industries in the marine energy sector. There is 58 hectares of development land within the Enterprise Zone and four main strategic sites have been identified<sup>19</sup>.

<sup>&</sup>lt;sup>19</sup> The four main sites in Haven Waterway are, Goodwick, Haven Waterway, Haverfordwest Airport / Withybush Industrial Park, Trecwn.



<sup>&</sup>lt;sup>17</sup> The strategic sites in Anglesey are, Anglesey Aluminium, Bryn Cefni Industrial Estate, Creamery Land, Gaerwen Industrial Estate, Marine Zone, Menai Science Park, Parc Cybi, Penrhos Industrial Estate, Port of Holyhead and Rhosgoch.

<sup>&</sup>lt;sup>18</sup> The Ebbw Vale strategic sites are, Bryn Serth, Rassau Industrial Estate. Rhyd-y-Blew, The Works, Tradegar Business Park.

- Snowdonia: is aligned to multiple priority sectors; digital, low carbon and advanced manufacturing. There are two sites in the EZ with slightly different aims. The Trawsfynydd Site contains nationally important energy infrastructure and intends to become a hub for innovative low carbon technology and R&D enterprises. The site is also targeting ICT and digital enterprises and has the potential to become a data centre location. The second site, Snowdonia Aerospace Centre, at Llanbedr contains Llanbedr Aviation Centre and Enterprise Park which currently accommodates a number of businesses. The rest of the site is made up of predominantly unused land. Given the aerospace centre within the zone and its access to segregated airspace, it is hoped that the EZ will specialise in aviation, the Unmanned Air Vehicle sector and the development of related engineering skills.
- Port Talbot: is the newest EZ in Wales and is in a much more nascent stage of development.
   The Enterprise Zone will be based around established employment sites and land suited for further development. These sites are Baglan Energy Park, Baglan Industrial Estate and Harbourside and Port Talbot Docks.
- 3.28 Recently some rural alternatives to EZs have been developed. One of these (Teifi Valley) is in the programme area but it is not yet clear what form interventions might take. Given the rural nature it is not expected that this would have any major implications for the ex-ante assessment.

#### City Regions

- 3.29 Two city regions have been established in Wales following a feasibility report<sup>20</sup> commissioned by the Welsh Government in 2011. The two city regions are the Cardiff Capital Region, covering Cardiff and other areas in South East Wales, and the Swansea Bay City Region.
- 3.30 The Cardiff Capital Region includes the Blaenau Gwent, Bridgend, Caerphilly, Merthyr Tydfil, Rhondda Cynon Taff and Torfaen within the programme area. £1.2bn of investment is being channelled into the Cardiff Capital Region which is expected to create up to 25,000 jobs by 2036. The main investment priority within the city region is the South East Wales Metro which is looking to significantly improve public transport within the region. The remaining investments will be channelled into a number of projects centred around wider priorities.
- 3.31 The Swansea Bay City Region encompasses Neath Port Talbot, Swansea, Carmarthenshire and Pembrokeshire. The City Region has an Economic Regeneration Strategy<sup>21</sup> which provides a framework through to 2030.
- 3.32 In the context of land and premises the framework recognises that 'despite the significant investment that has gone into the physical fabric of the City Region over the past decade, major challenges remain, and our infrastructure is not currently meeting the needs of modern businesses, and communities.'22

### Strategic Corridors

3.33 The transport section within the Welsh Infrastructure Investment Plan details the investment approach to transport infrastructure across Wales. Investments into road and rail infrastructure will be prioritised around key strategic corridors and are centred on addressing issues surrounding congestion in urban areas, improving access to key areas and making important east to west routes more reliable.



<sup>&</sup>lt;sup>20</sup> City Regions Final Report, July 2012

 $<sup>^{21}</sup>$  Swansea Bay City Region Economic Regeneration Strategy 2013-2030

<sup>&</sup>lt;sup>22</sup> Ibid., Page 12.

- 3.34 Individual schemes were prioritised in the first National Transport Policy published in 2010 outlining the timing for delivery of each investment. Once expired in 2015, this was replaced by the National Transport Finance Plan. Although not a policy document, the plan sets out priority transport schemes either under construction or under development in the period up to 2020.
- 3.35 The prioritised schemes echo the investment priorities as set out in WIIP and are focussed around a more integrated transport system across Wales. This involves investment into transport corridors along the M4, strategically important A roads including the A55, A40, and A470 and TEN-T routes.

### The 2014-20 ERDF Operational Programme

- 3.36 The 2014-20 ERDF Operational Programme for West Wales and the Valleys seeks to guide the investment of ERDF funds to ensure that they contribute to the creation of sustainable jobs and economic growth. It sets the specific role that the ERDF Programme can play within the wider investment context and in doing so positions the ERDF Programme as having a role in unlocking opportunities for economic growth alongside potentially larger investments of the private, public and third sectors.
- 3.37 The aim of the programme is therefore to improve the conditions for wider investment that other actors (particularly the private sector) make through addressing bottlenecks and barriers to growth and helping to de-risk investment opportunities.
- 3.38 The ex-ante assessment is focused on the potential use of a UDF as part of the implementation of Specific Objective 4.4 within the Connectivity and Urban Development Priority. This objective seeks to increase employment through investment in prioritised local or regional infrastructure to support regional or urban economic strategy. This Specific Objective (SO) will focus on the following types of activity:
  - Support for a limited number of spatially prioritised schemes. Focus to be on regional or urban growth opportunities.
  - Business sites and premises in strategic sites including property development and land remediation.
  - Economically significant investments in physical infrastructure particularly integrated regeneration and economic development schemes such as tourism, culture or heritage assets.
  - Enabling infrastructure (eg site access) where an essential part of an integrated scheme.
  - Infrastructure investments to encourage business investment and employment growth (eg Enterprise Zones highlighted as an important consideration in spatial targeting).
- 3.39 The Operational Programme sets out an expectation that this SO might align with investments under SO4.1 (TEN-T) and deliver regeneration of strategic sites linked to these routes. It also highlights strategic sites for business clusters and manufacturing as a result of complementary investments in manufacturing and low carbon energy in Anglesey and North Wales ports.
- 3.40 It is important to recognise that investments under other parts of the programme could have an impact on the supply of and demand for business sites and premises in the programme area. This is set out in the table overleaf.



Priority	Specific Objective	Focus	Potential Impacts on Supply of and Demand for Sites and Premises
Priority 1: Research and Innovation	SO1.1: Increase the success of Welsh research institutions in attracting competitive and private research funding	<ul> <li>Addressing challenges of innovative and research intensive businesses</li> <li>Specific research infrastructure investments designed to improve capacity of research institutions to carry out internationally recognised collaborative research</li> <li>Support continued development of the Welsh research base and development of research intensive clusters (including encouragement of inward investment)</li> </ul>	Pipeline is unclear but would expect to see investments in specialised research infrastructure such as Centres of Excellence and infrastructure to support cluster development. Implications for the market assessment likely to be modest in the short to medium term, given the strategic nature of investment.
	SO1.2: Increase the successful translation of research and innovation processes into new and improved commercial products, processes and services, in particular through improved technology transfer from HEIs	<ul> <li>Focused on supporting SMEs to improve innovation and collaboration performance</li> <li>Address barriers to SMEs carrying out innovative and research focused activities and increasing their use of research</li> <li>Initiatives to support knowledge transfer, dissemination of new technologies and commercialisation of research</li> <li>Increase investment in applied research of experimental development with a clear link to economic outcomes</li> </ul>	OP highlights a desire to invest in the development of low-cost hubs or clusters for innovative businesses and sectors. Nature of investment here is not clear but this could influence the pattern of demand for office and industrial space and, for example, lead to a clustering of demand around key KBIs with an active or successful hub.
Priority 2: SME Competitive ness	SO2.1: Increase the amount of finance available to SMEs for both business start-up and for business expansion	<ul> <li>Focused on provision of different types of SME and start-up finance</li> <li>Includes micro-finance, debt, equity and mezzanine</li> <li>Potential for sector specific or geographically based approaches</li> </ul>	Potential to see isolated impacts on demand (associated with individual beneficiaries in receipt of larger amounts of finance). Would not expect a major impact on overall trends in demand and supply for business sites and premises.
	SO2.2: Increase the number of SME start-ups through the provision of information, advice and guidance and support for entrepreneurship	<ul> <li>Advice and mentoring services for start-ups and potential start-ups</li> <li>Some scope to focus support services towards creation of social enterprises</li> </ul>	Likely to contribute to business start-up and growth but would not expect a major impact on overall trends in demand and supply for business sites and premises.
	SO2.3: Increase the take up and exploitation of NGA networks and ICT infrastructure by SMEs	<ul> <li>Advice and guidance services to improve awareness of benefits, address barriers to take up and encourage connection to NGA</li> </ul>	Would not expect a major impact on overall trends in demand and supply for business sites and premises.



	SO2.4: Increase the growth of those SMEs with growth potential, in particular through accessing new markets (both domestic and international)	<ul> <li>Advice and guidance services of varying intensities to assist in removing barriers to growth</li> <li>Light touch and universally available advice and guidance</li> <li>Tailored and more intensive support to assist in overcoming barriers to growth, build capacity, internationalisation and resource efficiency improvements</li> </ul>	Likely to contribute to business growth but would not expect a major impact on overall trends in demand and supply for business sites and premises.
	SO2.5: Address market failures in the availability of finance, in particular risk capital for Welsh SMEs to undertake innovation and commercialise R&D	<ul> <li>Grants for proof of concept</li> <li>Possible FI for early stage seed and follow on (likely to provide debt, equity and mezzanine)</li> <li>Possible tailored business support services alongside finance</li> </ul>	Potential to see isolated impacts on demand (associated with individual beneficiaries in receipt of larger amounts of finance). Would not expect a major impact on overall trends in demand and supply for business sites and premises.
Priority 3: Renewable Energy and Energy Efficiency	SO3.1: Increase the number of wave and tidal energy devices being tested in Welsh waters and off the Welsh coast, including multi-device array deployments, thereby establishing Wales as a centre for marine energy production.	<ul> <li>Focus on developing the emerging marine energy sector in Wales</li> <li>Aim to attract major private sector investment into the programme area</li> <li>Investment in applied research, design and manufacture and targeted infrastructure and preparatory work</li> <li>Part-finance for test and demonstration devices and arrays</li> </ul>	Dependent on success could give rise to increase in demand for business sites and premises in areas close to the two demonstration areas (north and south coast).  Would not expect to see major shift in demand quickly.
	SO3.2: Increase the number of small scale renewable energy schemes established	<ul> <li>Advice and guidance to community groups to help address pre-consent barriers. Could include capacity development, advice and guidance services, support for collaborative working with developers, or investments to remove barriers to finance for community schemes (mostly pre-consent)</li> <li>Activities to help to demonstrate viability of mature technologies on a smaller scale</li> </ul>	Would not expect to see an impact on trends in demand for business sites and premises.
	SO3.3: To increase the energy efficiency of the existing Welsh housing stock, particularly in areas of fuel poverty.	<ul> <li>Energy conservation and efficiency measures in existing housing.</li> </ul>	Would not expect to see an impact on trends in demand for business sites and premises.



Priority 4: Connectivit y and Urban Developme nt	SO4.1: Address issues of peripherally and improve private investment in local areas through improvements to the functioning of the Trans-European Transport Network.	<ul> <li>Targeted investment in the road network along the A40 and A55 to alleviate congestion at identified bottlenecks</li> <li>Complementary measures to improve accessibility along TEN-T routes by public transport</li> </ul>	•	Would expect to see a direct impact on the demand for sites and premises along these strategic corridors.
	SO4.2: Increase urban and labour mobility to and from key European and employment centres	<ul> <li>Intermodal and sustainable transport facilities to improve access to employment and education</li> <li>Potentially some rail improvements specifically where these can connect growth areas to areas of unemployment (includes station improvements, new lines and electrification)</li> <li>Traffic management, new transport systems and strategies to improve urban congestion</li> <li>Smart ticketing and intelligent transport systems</li> </ul>	•	Plans for the metro in particular likely to result in direct impacts on the demand for sites and premises along route ways, although more likely in longer term.
	SO4.3: Contribute to Digital Agenda for Europe targets I Wales for 100% access to next generation broadband (30 mbps and above) and 50% access to 100 mbps	<ul> <li>Infrastructure improvements to improve connectivity to 30 mbps</li> <li>Targeted investments eg vouchers for 100 mbps</li> <li>Operational Programme references strategic sites such as Enterprise Zones but expectation that investments likely to be wider than this</li> </ul>	•	There is potential to assist with the viability / desirability of some sites although this depends on the target occupiers and their needs.



#### Implications for the Assessment

- **WWV** is an area of low economic density. Whilst the WWV programme area is diverse in its economic character, it is an area of low economic density. Business and employment density is low in comparison to the remainder of Wales and the UK average. The economy is also weighted towards lower value industries where employment is declining. These features of the programme area's economy have resulted in low levels of productivity, a low employment rate in comparison to Wales and the UK and the loss of working age residents (particularly those with higher level skills).
- The south of the programme area has seen employment growth. The recent pattern of employment change suggests that the south of the programme area, particularly Swansea, has been the main focal point for growth. In the South of the programme area, growth in employment has been largely driven by increases in manufacturing employment (focused on the Valleys in particular) and office based employment in business administration, IT and communications and property.
- The employment base in the north of the programme area continues to decline. In contrast to the employment growth in the south, the north has seen a continued trends towards a shrinking employment base. The overall contraction masks growth in some particular economic sectors including the health and some manufacturing sectors.
- Economic development policy reflects the socio-economic challenges and trends. Spatial interventions seem to be the main focal points. CRs, strategic corridors and EZs are the key instruments here and these are likely to be the focal points for growth in employment and demand for sites and premises. While it is still relevant, much of the policy is now dated, which makes it difficult to predict what the implications of this could be for demand / supply of premises.



# 4. Supply of Development Finance

## **Overall State of Development Finance**

- 4.1 It is a requirement of the ex-ante assessment to consider finance market conditions in the proposed intervention area, to assess the ability of private sector finance providers to meet developers needs and to identify any subsequent areas of market failure.
- 4.2 It is important to note that the supply of development finance varies substantially across different types of developments, locations and borrowers. In some of these areas the market works efficiently and developers have been able to satisfy all their funding needs through commercial lending. However, there are areas of the market that are seemingly underserved commercially and as such there is a potential role for the public sector to intervene should the evidence suggest there is excess demand for finance.
- 4.3 Pre EU Referendum, there were signs that the supply of finance was improving and returning to a healthier state following the recession and the financial crisis of 2008-10 after which commercial lenders started to withdraw from the development finance market. UK banks had a high level of commercial property exposure on their loan books and focus was put on carefully managing their positions, disposing of these risky assets and more generally rebuilding their balance sheets (in line with the requirements of Basel III).
- 4.4 Regulatory changes acted as a further disincentive for banks to lend. The Financial Services Authority (FSA) changed how property assets were classified which increased capital charges for banks and made it much more expensive for them to engage in development finance lending activity. As a result of this, appetite for new lending fell from its 2007 peak across all types of developments as demonstrated in 0.
- 4.5 Indeed, post Referendum, the outlook for the economy is much less clear, the latest Financial Stability Report recognises that the UK will be subject to 'a period of uncertainty and adjustment' and this has been evidenced by the changes in numerous market indicators such as exchange rates and the equity prices of UK banks.<sup>23</sup> In the immediate aftermath of the referendum result, a number of high profile investors, this includes Henderson Global Investors, Canada Life, Threadneedle, M&G Investments, AVIVA and Standard Life who all suspended trading in their property funds following the BREXIT referendum. More recently, Equilibrium (a North West England based wealth and investment firm) sold all of its commercial property investments.
- 4.6 The most recent UK Commercial Property Market Survey<sup>24</sup> also presents a negative outlook showing 'a significant deterioration in market sentiment following the Brexit vote. The heightened sense of caution is visible across both investment and occupier sides of the market, with uncertainty pushing rental and capital value projections into negative territory.'<sup>25</sup>
- 4.7 More recent evidence points to some stabilisation in the market, a number of investors are beginning to re-open funds and believe the market is starting to correct itself and opinion remains mixed on the full scale of impact the referendum result will have on the market.

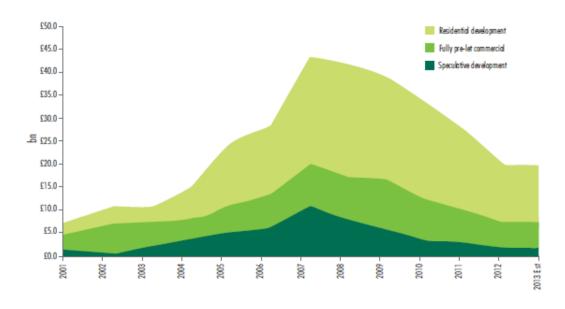


<sup>&</sup>lt;sup>23</sup> Financial Stability Report, July 2016, Bank of England

<sup>&</sup>lt;sup>24</sup> Q2 2016: UK Commercial Property Market Survey, RICS

<sup>&</sup>lt;sup>25</sup> Ibid., Page 1

Figure 4.1 Bank Loan Book Allocations



Source DeMontfort and CBRE

#### Sources of Finance

- 4.8 A simple commercial property finance deal is made up of debt usually provided by a bank or alternative lender and equity which is either wholly met by the developer or made up of developer contributions in addition to equity or mezzanine finance which is usually provided by property funds or alternative lenders. Consultation with banks suggest that when bank finance is used this is typically in the range of 40-50% of the gross development value of the site. Insurance companies are also heavily involved in commercial development. However, the extent of this is usually limited to lending on income-producing properties as opposed to providing funds to finance a development.
- 4.9 Each finance provider operates in different areas of the market, depending upon their investment strategies. Banks hold a dominant position in the provision of senior secured lending, usually in the form of revolving credit facilities<sup>26</sup>. However, such facilities are usually reserved for pre-let and pre-sold development activity.
- 4.10 Large established developers can also access capital markets through issuing corporate bonds, convertible bonds and private placements. Institutional investors such as pension funds and mutual funds will typically purchase the bonds, providing capital to the borrower. This source of finance is only available for developers with a strong balance sheet, seeking high levels of debt (the minimum amount of debt that can be raised on the wholesale bond market is typically £200m).
- 4.11 Alternative finance providers such as debt funds and unregulated lending platforms are more active in the provision of leveraged loans, mezzanine and equity finance as well as lending for speculative developments due to their appetite for yield placing them higher up the risk curve.
- 4.12 Evidence from our consultation suggests sources of finance in the WWV programme area are more limited than what is available in the larger cities. The main banks have a lot less local resource in

<sup>&</sup>lt;sup>26</sup> A revolving credit facility (RCF) is a line of credit where the borrower will pay a commitment fee and can draw down funds as and when required. The balance of the RCF will fluctuate with the lenders cash flow position and can go up as well as down. It operates in a similar way to a personal overdraft.



the programme area and larger developments are generally funded out of London. Where banks are active in these markets locally, they tend to be so with a bias towards relationship banking and predominantly lend to those customers with whom they have an established relationship with little appetite for new business.

- 4.13 This has constrained the supply of finance to SME developers in Wales, some of the challenger banks such as Aldermore and Shawbrook becoming more active in the programme area. However, it was suggested that they are not completely filling the gap that has been left by the withdrawal of major lenders from the sector. Additionally, the investment strategy of challenger banks is focused on retail development and they will only fund commercial development if it is a small part of a larger residential scheme and do not tend to look at industrial developments.
- 4.14 Finance Wales currently has a £10m property development fund which aims to provide an additional source of finance to property developers with viable non speculative schemes. The fund is available to developers across Wales and while we have not had oversight of specific deal information, we are aware that there has been a number of successfully executed deals (both residential and industrial) in the programme area.
- 4.15 Consultation with Finance Wales suggested this fund is performing well and has seen enquiries for good quality deals as well as received a good level of demand from developers. Since inception, the fund has invested in more residential than commercial developments (this is driven by demand and does not reflect the strategy of the fund) and has set thresholds for required pre lets / sales on developments.

## Trends in lending

4.16 The availability of finance is somewhat dictated by the characteristics of the borrower, the stage of development and the location and end use of the site. The following considers trends that were emerging pre-Brexit. Given current market uncertainty it is unclear how these trends will evolve in the next couple of years.

Size of developer

- 4.17 Large listed property developers with a good track record are able to obtain finance much easier than their smaller counterparts and experience fewer constraints in accessing the finance they need. Those able to access capital markets can obtain large amounts of debt at a cheaper cost to a senior secured facility and for longer tenors.
- 4.18 These developers are able to fund activities via the capital markets due to their size, the strength of their balance sheets and their track record which all provide investors with the confidence they need to invest. Pre Brexit, there was a compression of bond yields which was an indicator of rising investor appetite and suggested that there was a healthy amount of capital market funding available for the right type of developer.
- 4.19 Large developers are also able to use corporate facilities from UK and overseas banks to fund development activities (although overseas banks tend to focus their activity in London). As previously noted this is usually in the form of senior secured Revolving Credit Facilities although some banks will also provide mezzanine finance.
- 4.20 There is evidence of this in the programme area. For example, Conygar is one of the larger active developers in the programme area who are able to cover their funding needs through commercial lenders. They have a multi-bank relationship and multiple senior debt facilities of different maturities.
- 4.21 On the other hand, smaller developers are generally underserved for three key reasons:



- Smaller debt requirements: SME developers will generally need (and only have the capacity for) less debt to fund developments. The complexity involved in setting up development finance facilities makes it both time consuming and costly to lenders. Therefore, there is less appetite to lend at smaller debt levels.
- Track record: Smaller developers do not usually benefit from the same track record as larger more established developers. As such they are considered to be riskier which will impact the supply of finance available to them. An SME developer that does not have a spotless track record is unlikely to be able to obtain development finance easily.
- Credit worthiness: SME developers cannot offer the same level of security or collateral to lenders as their larger counterparts, as such providing finance is a lot riskier which limits appetite from banks to lend to these developers.
- 4.22 Consultees suggest that this issue is prevalent in the programme area and SME developers, especially those without an existing strong banking relationship will face access to finance issues predominantly for the reasons discussed. It was suggested that within the programme area the main high street banks generally do not get involved in deals below £5million.

## Type of development

- 4.23 As the real estate market recovered from the financial crisis, lenders returned to funding developments although bank lending is still largely restricted to pre-let or pre-sold developments. Activity is strongest for residential development in good locations were property is expected to sell reasonably quickly, and large scale, city central commercial developments such as prime office space and hotels. There is much less information on supply of finance in the industrial space, however, evidence in a study by the International Property Forum points towards more lenders being active in the supply of finance for industrial developments than that seen over the last five years (albeit this evidence is based on a small sample of lenders)<sup>27</sup>
- 4.24 The Bank of England's summary of business conditions for the UK as a whole<sup>28</sup> noted that despite robust occupier demand and rising rents in the commercial real estate market, they had not yet reached levels high enough to encourage funding for speculative development. Where such activity is taking place it is generally funded by overseas investors or specialist property funds.
- 4.25 In light of recent events, the outlook for speculative development is likely to be even more bleak. According to the UK Commercial Property Market Survey, 'On a UK-wide basis, occupier demand failed to rise for the first time since 2012. The headline net balance fell from +21% previously to a reading of zero in Q2'.<sup>29</sup>
- 4.26 As 0 above demonstrates, loan book allocations for speculative development is much lower than for commercial or residential developments. However, we cannot infer from the data whether this is due to supply constraints, lack of demand, lower debt requirements or a combination of these factors. Nevertheless, this is a market most UK banks have withdrawn from completely, or where they do lend it is restricted to low risk residential developments or office space in a prime location, preferably with evidence of strong potential occupier demand.
- 4.27 Alternative lenders are more active in the speculative development space as they are not subject to the same regulation as banks (which provides disincentives to lend in riskier areas) and tend to be much less conservative given their appetite for higher yields on lending.



<sup>&</sup>lt;sup>27</sup> UK Development Finance Review 2015, International Property Forum

<sup>&</sup>lt;sup>28</sup> The Bank of England Agents' summary of business conditions 2016 Q2

<sup>&</sup>lt;sup>29</sup> Q2 2016: UK Commercial Property Market Survey, RICS, Page 1

- 4.28 The recent rise of Peer-to-Peer lenders is a positive development for the outlook of speculative development. These lenders are much more willing to lend speculatively and also have a particular focus on smaller schemes. Having said this, it is unclear what appetite these lenders will have following the referendum announcement.
- 4.29 Evidence from local consultation supports this analysis. In recent years, there has been minimal speculative development in the programme area and banks are generally unwilling to fund this. While there is an undersupply of finance for speculative development in the programme area, public resource should only be used to fill this gap when there is a clear case that economic development benefits will arise. This is explored in more detail in Section 6 of this report.
- 4.30 There has also been more activity in the residential development space as opposed to commercial development, which inevitably diverts much of the available capital to this form of development. The reasons consultees gave for this were very much centred around the risk appetite of commercial lenders. Many banks were negatively impacted during the recession due to their exposure to speculative development and were left with a lot of vacant or unfinished land on their balance sheet. Moreover, consultation suggested that developers in the programme area focussed efforts where funding was more readily available and hence were more active in the residential space where they could achieve a high degree of pre lets / sales and go on to secure funding.
- 4.31 Whilst consultees suggested that the right commercial / industrial development can offer better returns than residential due to the higher risk premium attached to it, this also acted as a disincentive to lend in this sector. Commercial and industrial developments are more sensitive to business cycles and uncertainty, and tend to have shorter leases. As such, lenders are more comfortable operating in the residential space which has a higher degree of long term viability attached to it.

#### Location of the development

- 4.32 Following the recession, development finance became much more concentrated in London and the South East given that the property market in these areas were much less impacted by the financial crisis. Lenders had little appetite to fund developments in other parts of the UK outside of the major cities. According to a report by CBRE<sup>30</sup>, more recently lenders have shown an increased appetite for funding more regional developments, however, this is usually restricted to fully-let schemes. Despite this, London and the South East still dominate funding activity due to its underlying economic strength and growth in demand for both residential and commercial property.
- 4.33 Consultees suggested that despite the growth in lending outside of London, this is still very much constricted to major cities and most of the activity in Wales is centred around Cardiff. Investors are much less active in the more peripheral areas of Wales that lie within the programme area.
- 4.34 This is thought to be due to the information failures that exist in these areas. Lenders have much less local knowledge of the area and as such have difficulty making lending decisions due to their inability to confidently calculate expected returns.
- 4.35 There is additional information failure on a sectoral basis. The enterprise zones in Wales each have a defined sector focus and policy encourages growth within these. Developers and private investors do not have the same economic development aspirations as the public sector and given the market uncertainties that exist may not want to invest in areas with a confined sectoral focus.



<sup>&</sup>lt;sup>30</sup> Development Funding – Is it available? CBRE, 2014

### Implications for the Assessment:

In light of the uncertainty about the impact of the UK's departure from the EU on commercial finance provision, the analysis of the supply of commercial finance has focused on trends that were emerging pre-Brexit. This suggests that:

- Smaller developers tend to be underserved by commercial finance provision. This is partly
  because there is little appetite to lend at the smaller debt levels they require, due to the large
  fixed overhead associated with setting up development finance facilities. Smaller developers
  also tend to be considered riskier than their larger counterparts in part as they lack the track
  record of larger developers.
- Speculative developments find it very difficult to attract finance. Bank lending is restricted
  to pre-let or pre-sold developments and speculative developments need access to alternative
  lenders. For smaller speculative developments, peer to peer lending seems to have increased
  the supply of finance although it is not clear what appetite these lenders will have following
  the referendum result.
- Funding is concentrated in major cities. Post-recession development finance activity was
  contained to London and the South East. More recently there is evidence of increased
  appetite to fund more regional developments. Despite this growth in regional areas this is
  seemingly less prevalent in the programme area and information failures are still apparent
  among investors.

The analysis supports the existence of finance market failure for some types of developer and development.



# 5. Performance of Development Markets

- 5.1 This section provides an overview of the key indicators relating to the performance of development markets in the WWV programme area. It draws upon the following data sources:
  - Estates Gazette Interactive (EGI): This data source provides data on deals and availability for commercial property. It records useful information such as the use class, the total floorspace, the date of the deal and the postcode of the site. EGI data is based upon information collected directly from property agents. It therefore offers only partial coverage of property market activity as it reflects only the activity of agents that have participated, rather than of the property market as a whole. This makes it difficult to interpret some of the trends that this dataset highlights.
  - Business Wales Property Market Database: this provides data on the availability of commercial property in Wales. Similar to EGI, it relies on the information provided from property agents, and so only provides partial coverage of the property market. We have used this alongside EGI, to look at the spatial pattern of availability in Wales and sense check the data from EGI for consistency.
  - Wales Commercial and Office Market Assessments: JLL (and a number of other property
    agents) produced a range of reports in early 2015 which look at the commercial property
    market across Wales. These reports draw upon market analysis and consultations and
    provide headline analysis of the balance between demand for and supply of different types
    of property in Wales. The analysis within these reports has been used to supplement our
    analysis of the key property market datasets.
  - **Consultations:** this desk-based analysis has been supplemented with insights from consultations with members of the Welsh Government Property Team, property agents and developers that are active in different market areas in Wales. These consultations have been used to interpret the trends highlighted in the desk-based analysis.

# **Development Activity**

- 5.2 There is no data source which provides a comprehensive analysis of the total rate of development activity for business sites and premises in the WWV programme area. Consultations with property agents, developers and landowners point towards a very slow rate of development of business sites and premises across the WWV programme area and a limited number of active developers.
- 5.3 The Welsh Government has historically been active in supporting development activity and their experiences help to illustrate some of the characteristics of the development market in WWV. Much of the Welsh Government's investment into sites and premises has been focused on preparing sites for development by dealing with remediation, site access and servicing issues to bring sites closer to market.
- 5.4 In some instances, this activity has been closely tied to property development and has directly led to the construction of new floorspace (eg Amazon Way) but there are numerous examples where investment in strategic sites has not yet resulted in the construction of new floorspace. For example, Parc Cybi in Anglesey received in excess of £20m public sector investment to provide access and servicing. The site is now fully prepared and ready for development but there has, so far, been only limited development activity on this site. The development of the site is moving forward, albeit slowly, some of the plots have been purchased and appear to be moving towards development. In addition to examples of sites which are moving forwards very slowly, there are numerous examples of sites (eg Rhyd y Blew) which have been fully prepared for development but



which have not yet seen any development activity. These experiences underline the slow moving nature of the development market in WWV.

	Status	Number Approx		Examples
		of Sites	Number of Acres	·
	Ready for Development (infrastructure, connectivity and remediation all addressed)	6	>600	<ul> <li>Parc Cybi</li> <li>Bryn Serth</li> <li>Felindre Llangyfelach</li> <li>J38 Margam</li> <li>Pencoed</li> <li>Swansea Waterfront</li> <li>Rhyd y Blew</li> </ul>
	Further Preparation Needed (some servicing, connectivity or site abnormals to address)	4	>200	<ul> <li>The Works</li> <li>Port of Holyhead</li> <li>Fishguard Ferry Port</li> </ul>
Development Site	No (or limited) Site Preparation (investment in servicing, connectivity or site abnormals required)	5	>500	<ul> <li>TyDu</li> <li>Brocastle</li> <li>Rhosgoch</li> <li>Creamery Land North of Lledwigan Farm</li> <li>Land adjacent to Gaerwen Industrial Estat</li> </ul>
De	Unknown  Total Development Sites	9	>700	<ul> <li>Parc Aberporth</li> <li>Trecwyn</li> <li>Delta Crompton</li> <li>Park Avenue Development Site</li> <li>Snowdonia Aerospace Centre</li> <li>Pembrokeshire Science and Technology Park</li> <li>Priority Park Industrial Estate</li> <li>Menai Science Park</li> <li>Withybush Industrial Park</li> </ul>
Site on Existing Industrial Park	Ready for Development (infrastructure, connectivity and remediation all addressed)	6	>400	<ul> <li>Waterton Industrial Estate</li> <li>Parc Bryn Cegin</li> <li>St Asaph Business Park</li> <li>Bryn Cefni Industrial Park</li> <li>Parc Menai</li> <li>Penhros Industrial Estate</li> </ul>
	Further Preparation Needed (some servicing, connectivity or site abnormals to address)	4	>200	<ul> <li>Baglan Industrial Park</li> <li>Baglan Energy Park</li> <li>Rassau Industrial Estate</li> <li>Waterston</li> </ul>
	No (or limited) Site Preparation (investment in servicing, connectivity or site abnormals required)	0	0	
	Unknown	4	>100	<ul> <li>Snowdonia Business Park</li> <li>Coed Ely</li> <li>Glynneath Business Park</li> <li>Tredegar Business Park</li> </ul>
	Total Sites on Existing	1		

Source: information compiled for pipeline sites using a combination of web research and consultation evidence. Note: this does not provide a comprehensive analysis of the total developable land in the programme area. It focuses on strategic sites which have been included in the pipeline assessment (see Section 2 for methodology)

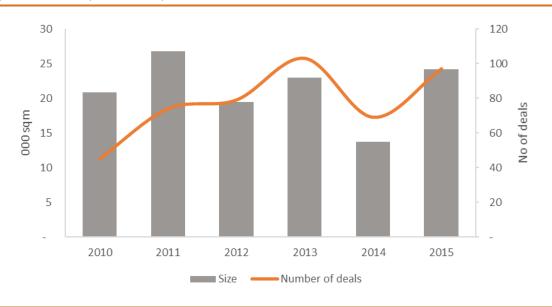


5.5 The history of investment into strategic sites has provided a mixed pipeline of sites which are at various stages of development, as summarised in the table below. Information available suggests that there is in excess of 2,000 acres of land at various stages of development. Information about site conditions is patchy but suggests that there are at least six sites which are ready for development. The Welsh Government view this to be a narrow pipeline of readily developable sites.

## **Office Market**

5.6 Figure 5.1 summarises EGI data relating to the take-up of office space (the total quantity of floor space which has been transacted). This suggests that annual take up has fluctuated each year between 2010 and 2015. On average, take up across these five years was 21,000 sqm per year.

Figure 5.1 Take up of Office Space, 2010-2015



Source: EGi

5.7 Smaller deals make up the majority of this take up, with just over two thirds of office deals completed since 2012 being for floorplates of less than 250 sqm. There appears to be a trend towards diminishing deal size: over the past 5 years, average deal size has reduced by around 50%, standing at around 210 sqm in 2015. However, this may be influenced by data coverage, as EGI recorded fewer deals in previous years.

## The office market reflects concentrations of economic activity...

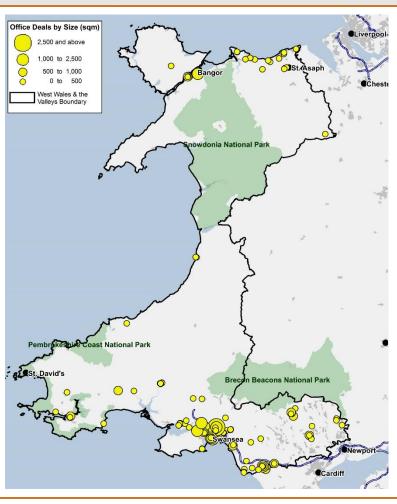
- 5.8 O shows that take up of office space has been focused upon areas where there is a greater concentration of economic activity and where the service sector is strongest. The vast majority of deals have been in the south of the WWV programme area, particularly clustered around the major service centre of Swansea, which accounts for just under half of all take up in the programme area since 2012. Bridgend and Carmarthenshire, located adjacent to Swansea, account for around a fifth of all take up. The majority of deals for larger floorplates have been in the south, where economic activity is more concentrated.
- 5.9 The maps indicate that there is a small amount of office market activity in the north of Wales, largely focused upon the A55 corridor and clustered around Bangor.



## Take up is focused on Grade B office space...

- 5.10 Data relating to the grade of office space is only available for around a quarter of all deals between 2012 and 2016 (covering around 12% of total take-up of office space). This partial coverage suggests that deals have been predominantly grade B space<sup>31</sup>. 88% of all deals (for which information on grade of space is available) were for grade B space, however the partial coverage of the data needs to be borne in mind when drawing conclusions from this.
- 5.11 Given that the data covers only a small number of deals, drawing conclusions from the spatial pattern of deals could potentially be misleading. Nevertheless this data does show that the pattern of grade A<sup>32</sup> deals is similar to that of large office deals, with most occurring in the south where economic activity is concentrated. The majority of this take-up of Grade A space is for smaller office space of less than 100 sqm.

Figure 5.2 Location of Office Deals, 2012-16



Source: EGi

<sup>32</sup> Grade A space is defined as newly built and refurbished space, and very high quality second hand space



<sup>&</sup>lt;sup>31</sup> Grade B space is defined as second hand space (but is not newly refurbished or of very high quality)

## Rental values have stagnated at a low level...

- 5.12 Rental values are recorded in EGi for fewer than half of the deals between 2012 and 2016. This makes it difficult to draw firm conclusions but the data suggests that rental values are low overall. Rental values are a little higher in the south of the programme area (most likely reflecting greater levels of demand here in light of the concentration of economic activity) and there has been very little change over recent years, in contrast to the trend across the UK. Deals completed in 2015 indicate that rental values for office deals were in the region of £9.80 per square foot. The data does show that there are exceptions where rental values higher than this have been achieved (although this relates to very few deals). These are mainly in South Wales in Swansea, Neath Port Talbot and Caerphilly where rents higher than £15 per sqft have been achieved.
- 5.13 There has been little change in rental values since 2012, which goes against the national trend where rental values have steadily increased by around 3% year on year<sup>33</sup>.

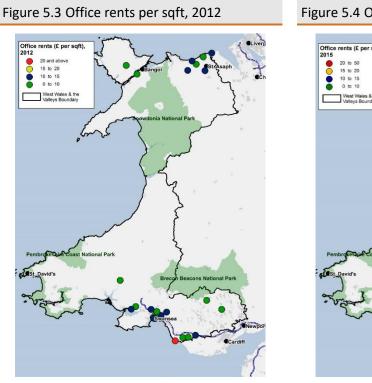
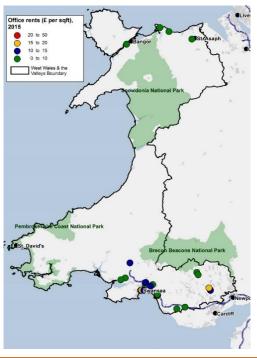


Figure 5.4 Office rents per sqft, 2015



Source: EGi Source: EGi

# Limited supply of high quality office space...

5.14 As of June 2016, there was around 160,700 sqm of vacant office space in the programme area. Interestingly, vacant office space is heavily concentrated in South Wales; only around 10% of total vacant office space is in North Wales. Although this is based on partial data, it points to limited supply of office space in North Wales. The JLL market analysis concludes that there is a limited supply of quality office space in weaker markets which have seen little or no speculative development. Anglesey and the upper valleys are highlighted as examples where the lack of speculative development has resulted in poor supply of quality office space.



<sup>33</sup> Colliers International, Report of Lancashire County Council

## ... and an oversupply of lower quality office space

- 5.15 The chart in 1.1 provides a local authority breakdown of vacant office space. This indicates that the majority of vacant space (around three quarters) is lower quality grade B space although there are some areas where concentrations of vacant Grade B space exist. The amount of vacant Grade A space in Swansea most likely reflects the volume of public sector backed development that has taken place here. Torfean is notable here too. The development market here is probably more active due to the area's proximity to Newport and the eastern part of the M4 corridor.
- 5.16 In spite of the vacant Grade A space in Swansea, the overarching picture is one of high vacancy in Grade B office space. The analysis in the JLL report echoes this finding. It points to an oversupply of lower quality office space as a major challenge in the programme area and a factor which has contributed to the stagnation in office rental values.

Grade A Grade B

Grade A Grade B

Grade B

Grade B

Grade B

Grade B

Grade B

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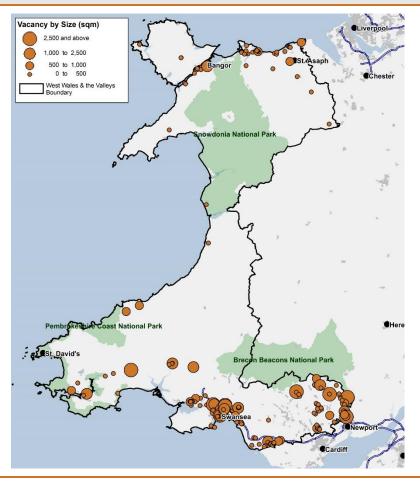
Figure 5.5 Vacant Office Space by Grade of Space, June 2016

Source: EGi

5.17 The map below highlights concentrations of vacant office space in various parts of the programme area.



Figure 5.6 Vacant Office Space, June 2016



Source: EGi

The following in particular are notable:

- **Swansea:** There is in the region of 55,300 sqm of vacant office space in and around Swansea in a mixture of large and small units. The JLL report highlights a particular concentration of vacant space is located in on the outskirts of Swansea, most likely as a result of speculative development of small unit office schemes in the mid-2000s.
- East Valleys: a concentration of vacant office space in Torfaen, Blaenau Gwent and Caerphilly. These are mainly business parks located along major transport routes such the M4 and on A roads just outside of Newport.
- Along strategic routes: there are some large vacant premises along the A40 in Pembrokeshire (around 4,000 sqm) and much smaller vacant sites along the A55 in the north.
- 5.18 The JLL report also states that close proximity to Newport and Cardiff means that as the supply of sites (Grade A in particular) in these city centres has reduced, developers have resorted to out of town sites that are still in close proximity to these urban centres.



#### **Implications for the Assessment:**

- Office rental values are low and have stagnated between 2012-16. On average, rental values
  are £9.80 per square foot. Rental values are expected to remain stable for the foreseeable
  future. Values are higher towards the south of the programme area, reflecting the
  concentration of economic activity and demand for office floorspace in this part of the
  programme area.
- There is an over-supply of grade B office space (only around a quarter of vacant space is Grade A). This oversupply of poor quality office space could explain the stagnant rental levels.
   Data is incomplete but it seems to point towards low levels of take up of grade A office space inside the programme area. It is not clear if this reflects lack of demand or lack of supply.
- Data analysis and consultations paint a picture of a relatively weak office market in North Wales. The low level of demand for office space in North Wales reflects the economic structure and performance of the area's economy. This has made the area unattractive as a location for speculative development and as a result the area has a limited and ageing supply of office stock. The ageing and low grade stock has contributed to low and stagnating rental levels data suggests the majority of recent deals have been below £10/sq ft. These low rental values have served to further constrain development activity. This has led to a situation where supply is quite constrained but demand is not sufficient to increase rental values and catalyse development activity. The indicators appear to point to a low supply-low demand equilibrium which could mask some shortages in North Wales.
- In the South East and the Valleys, the office market is slightly more buoyant and is largely focused on Swansea where there is a greater concentration of service sector activities. Although demand is generally higher, rental values here again are relatively low (there are few deals above £15 per square foot). This reflects the lack of speculative development and generally poor quality stock that is available in the city centre. Newer stock that has been developed is out of town, where rents tend to be lower.



## **Industrial Markets**

5.19 The industrial market includes both warehousing (B8), light industrial and manufacturing space (B1c and B2). Although the requirements of occupiers of these different types of space may differ, the data on deals does not distinguish between them, meaning it is not possible to analyse demand for each type separately.

## Falling take up of industrial space since 2010...

5.20 Data from EGI suggests that take-up of industrial space has fallen notably since 2010, although it is difficult to draw firm conclusions as this could simply reflect a lower number of deals being recorded by EGi, rather than an actual falling trend. Take up in 2015 stood at 150,000 sqm and this appears to be primarily made up of smaller deals (84% of deals in this year were smaller than 1,000 sqm). The data suggests that the average deal size has fallen from 1,760 sqm in 2010 to 925 sqm in 2015. However this is skewed by a few large deals that occurred in 2010. Compared to the previous year, take-up has reduced slightly. This trend is also reflected in the analysis underpinning the JLL report. Their consultation evidence suggests that the relatively low level of take up reflects a lack of available modern buildings.

of deals 300 sqm Number of deals Size

Figure 5.7 Take-up of Industrial Space, 2010-15

Source: EGi

## Take up is focused on lower grade space...

5.21 The grade of space for industrial deals is only recorded for around 40% of the deals. This partial coverage shows that the vast majority of take-up has been for grade B space (around 93% of all take-up). Although this is based on partial data coverage, other evidence also shows a lack of quality industrial floorspace in Wales overall. Analysis done by DTZ in 2004 shows that approximately half of all accommodation in Wales was built prior to 1970, whilst only 10% was newly constructed floorspace. Although this analysis was undertaken several years ago, the picture remains relatively similar given the lack of modern industrial accommodation that has been developed in the interim.



## Market activity is concentrated along strategic corridors...

- 5.22 Wales' prime industrial locations are outside of the WWV programme area (South East Wales and North East Wales) although their influence extends into corners of the programme area.
- 5.23 The map below highlights some key concentrations of market activity in areas with good access to the strategic road network. In the South, the Newport Bridgend M4 corridor is a key industrial location although there are also clusters of activity in the Valleys. JLL's analysis indicates that demand for industrial space has improved in line with investment in transport infrastructure (dualling of the A465).
- 5.24 In the North, the main industrial sites are positioned along the A55. There are some clusters of activity in the north of the programme area and some particularly large deals taking place around St Asaph and Llandudno and pockets of activity around Bangor and on Anglesey. This largely reflects the pattern of employment growth in the north of Wales.
- 5.25 Consultation evidence also suggests that there has been a growth in demand for larger distribution units arising from internet retail. This has been focused along the M4 and A55 corridors.

Industrial Deals by Size (sqm)

10,000 and above

5,000 to 10,000

1,000 to 2,500

500 to 1,000

0 to 500

West Wales and the Valleys Boundary

Snowdonia National Park

Figure 5.8 Location of Industrial Deals

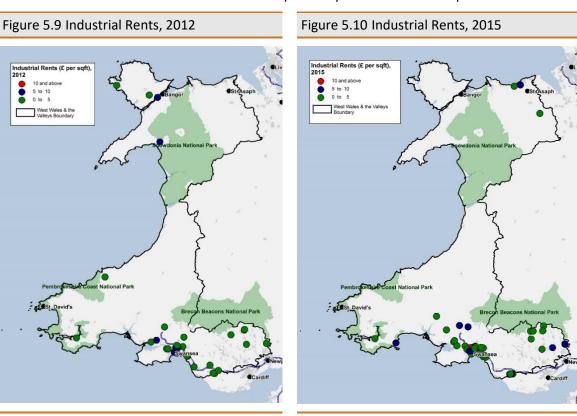
St. David's

Source: EGi



## Industrial rents have stagnated at a low level...

- 5.26 EGI data suggests that industrial rents have remained stagnant in recent years. The average rent in 2015 was £4.50 per sqft. This echoes consultation evidence which suggests that industrial rents have remained low for a number of years and are currently in the region of £4-5 per square foot depending on the quality and location. While rental levels have been stagnating in Wales, industrial rents have been increasing nationally by around 1% per annum<sup>34</sup>. Consultations suggest that the lack of industrial Grade A space and high proportion of secondary stock is likely to have constrained rental growth over this period.
- 5.27 Gaps in the data make it very difficult to draw conclusions about the geographical differences between industrial rents. The figure below suggests that there are no major differences between the rents commanded for industrial space between the north and south. Consultations suggest that rental values tend to be slightly higher in the North East increasing with proximity to the eastern end of the A55. Similarly, in the South East, rental values tend to be higher close to the eastern reaches of the M4 corridor and in close proximity of Cardiff and Newport.



5.28 Vacant industrial space is fairly well distributed across West Wales and the Valleys, although the majority of the vacant industrial space (around 85%) is concentrated in South Wales, particularly in the East Valleys area. The EGI data indicates that the vast majority of this vacant space is lower quality Grade B space. Only Tofraen has any vacant Grade A space (a very large site providing 8,900 sqm of grade A industrial floorspace). This echoes the findings of JLL's study which highlighted a trend of rising availability of second hand stock and limited supply of high quality industrial floorspace across Wales.

Source: EGi

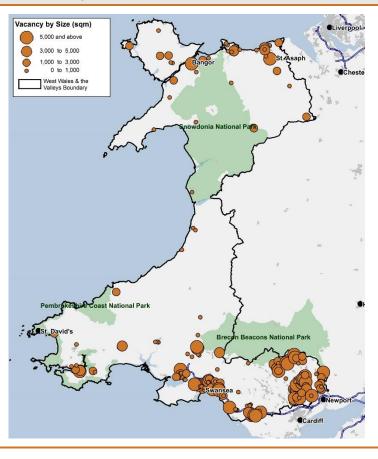
Source: FGi



<sup>&</sup>lt;sup>34</sup> Colliers International, Report for Lancashire County Council

- 5.29 The JLL report highlights a particular shortage of higher quality industrial floorspace along the Newport Bridgend M4 corridor. This area remains a prime industrial location but supply of new floorspace is currently very constrained.
- 5.30 The analysis highlights in particular a lack of supply for smaller starter units (< 5,000 square feet). The report cites evidence that the smaller starter schemes that exist across Wales are experiencing high occupancy rates, typically in excess of 90%. The high occupancy levels are related to a lack of supply caused by lack of speculative development in this part of the market, which has arisen due to viability issues associated with the letting profile of industrial incubators.

Figure 5.11 Vacant Industrial Space, June

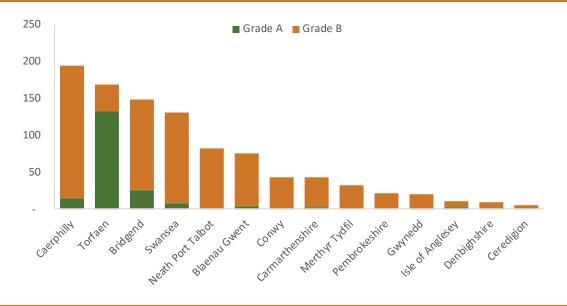


Source

5.31 The JLL report further concludes that the lack of high quality industrial space has acted as a constraint on the take-up of industrial space in prime locations across Wales, and has meant that some occupiers are taking space with a view to refurbishing property.



Figure 5.12 Vacant Industrial Space by Grade of Space, June 2016



Source: EGi

5.32 This view is also reflected in consultations with agents and developers, who have reported that low rental values, over supply of low grade space and high construction costs have led to a situation where it is more cost effective to acquire and refurbish second hand stock than to build new bespoke units.

#### Implications for the Assessment:

- Rental values for industrial floorspace are low across the programme area. Data and consultations suggest that average industrial rents have stagnated in the region of £4.50 per square foot for a number of years. The prime industrial locations in Wales are outside of the WWV programme area (in the more accessible North East and South East parts of Wales).
- There is a severe shortage of new industrial floorspace in the WWV programme area. The stock is generally ageing and of low quality and the lack of Grade A space has contributed to stagnating rental values.



# 6. Review and Implications of the Development Pipeline

- The Welsh Government's economic development strategy has a clear focus on economic growth and its central priority is to create employment. The West Wales and the Valleys 2014-20 ERDF Programme echoes this focus on employment creation. Priority 4 is expected to play a major supporting role in realising the aspiration set out in the Operational Programme. The Specific Objectives under this priority will give rise to a range of supporting investments to improve transport networks, digital infrastructure and enable greater labour mobility.
- 6.2 Specific Objective 4.4 is focused explicitly on investments in infrastructure to support a regional or urban economic strategy and to enable and encourage business investment and employment growth in the region. The Operational Programme states that this Specific Objective can make investments into site preparation, property development or enabling infrastructure on both strategic business sites and integrated regeneration and economic development schemes (including town centre regeneration schemes). Although the Operational Programme does not state it explicitly, investments will need to be tied closely to property development activity to ensure that the Specific Objective is able to create employment and directly deliver against its Claimant Count result indicator.

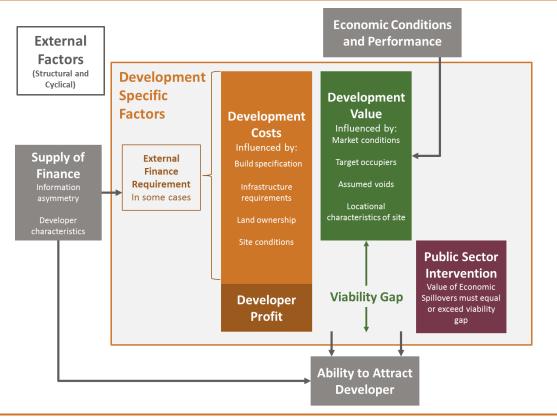
# **Identifying Market Failure and Sub-optimal Investment**

- 6.3 FI Compass guidance relating to the ex-ante assessment methodology for financial instruments in the 2014-20 programming period states that, irrespective of the investment model, public sector intervention must be justified by evidence of market failures and sub-optimal investment situations. Ideally, this will culminate in a quantitative estimate of the investment gap, subject to the challenges of doing this in a robust and reliable manner.
- In the context of an Urban Development Fund, the investment gap relates schemes that would not come forward through the market mechanism alone but which can improve overall economic welfare if they were to proceed. Although the guidance recommends that an ex-ante assessment should quantify the scale of the investment gap, it also notes various challenges in achieving this, not least the challenges raised by shortcomings in available data and intelligence to support this analysis.
- 6.5 Ideally, the investment gap would be calculated using a systematic, bottom-up method which identifies the specific viability and financing constraints affecting each site, the specific market failures which are contributing to these constraints and the extent of the viability or investment gap on each site. This site-by-site pipeline analysis would provide the basis for an aggregated estimate of the total investment gap across all of the pipeline projects.
- A systematic assessment such as this needs to capture the influence of two types of factors which are summarised in 1.1. These factors include:
  - Development Site-specific Factors: these factors influence the cost and potential revenues
    associated with developing out a particular site and the scale of any viability gaps that affect
    the development. A variety of factors influence the cost and value of the development.
    These are related to
    - Site conditions: the presence of any abnormal site conditions or infrastructure requirements will have an effect on development costs.



- Development model: whether the development is pre-let or speculative and the influence this has on assumed vacancy rates and yields.
- Target occupiers: this influences assumed void rates and rental values.
- External factors: structural and cyclical factors including economic and market conditions, supply of finance etc also have an influence on the viability of development on particular sites and the ability of developers to secure finance.

Figure 6.1 Summary of Factors Affecting the Investment Gap



Source: Regeneris Consulting

- 6.7 These development-specific and external factors are interrelated and they influence three overlapping determinants of the investment gap:
  - development viability and the size of the viability gap
  - willingness of developers to invest in a particular site; and
  - the ability of developers to access finance to fund development activity.
- 6.8 Although the assessment has sought to develop an evidence base which captures the influence of both development-specific and external factors, the information available on development-specific factors is patchy. The is largely because the development pipeline encompasses sites at various stages in their development. While some sites are fully serviced and prepared, others still require investment to bring them closer to market. Even on the fully prepared sites, there is not always an active developer on site or a clear plan in place for how the site will be developed out. Also developers are often not willing to share information on the viability of their sites. As plans or the development viability for many of the sites are not clear, this means that it is not possible to compile the specific information needed to understand the development-specific factors and their influence on site and development viability.



- 6.9 On the sites where development plans are more clear and developers are active, the assessment would ideally draw upon insights from the development appraisals that have been undertaken. However, this information is typically commercially confidential and is rarely openly available for an assessment of this type.
- 6.10 In light of these gaps in information, intelligence about site-specific factors has been compiled through a combination of desk-based research and consultations with selected land owners, active agents and developers in the programme area. The upshot of this is that there are gaps in the availability of information about each site and it has not been possible to identify the specific viability and financing issues on a site-by-site basis.
- 6.11 This means that the assessment has needed to draw heavily upon a broader but less site-specific evidence base relating to external factors (such as the supply of finance and market conditions) to draw conclusions about viability and market failure. This approach reflects the FI Compass guidance which highlights the inherent challenges in capturing systematic quantitative information about these aspects of the investment gap and recommends triangulating insights from literature reviews and data gathering, interviews and surveys.

# Market Issues in the WWV Programme Area

- 6.12 The assessment of the performance of development markets presented earlier in this report paints a picture of a fairly undynamic property market across the area which is characterised by a low volume of transactions, poor rental yields and hence a low level of development activity. The following points are particularly important in understanding the existence of market failure and sub-optimal investment situations in the WWV programme area. They apply fairly consistently across the WWV area to both office and industrial developments:
  - Rental values are consistently low across the programme area: Rental values for both
    office and industrial space have stagnated at a low level. This is in part a function of the
    generally poor (albeit improving) economic performance across the programme area and
    the resultant low level of demand for both office and industrial space. Low rental values
    also reflect the generally poor condition of much of the stock of office and industrial land
    and the apparent oversupply of Grade B office and industrial space.
  - Large viability gaps exist even where there are no abnormal site conditions to address:
    the low rental values dampen projected development values and serve to constrain
    development activity. Consultations evidence suggests that both office and industrial
    rental values are substantially below the level required for development to become viable.
  - Viability gaps affect sites in all parts of the programme area: particularly in the more remote parts of Wales where construction costs tend to be higher and rental values lower but even in more buoyant parts of the programme area which are closer to areas of economic opportunity (i.e. the SE and NE), consultees report that rental values are too low for development activity to stack up.
  - Developers lack confidence in market conditions: Welsh Government officers report that it is challenging to stimulate development activity, even when they are able to grant-fund viability gaps. Dealing with site viability issues is not a purely arithmetic exercise: developers and their investors need confidence that they will be able to secure the projected revenue streams. In practice, this means that there is little appetite for speculative development, even when grant funding is available. Most of the recent development activity has taken place on a pre-let basis or has been led by owner occupiers.
  - Larger sites which are un-infrastructured or which face other constraints will not come forward without substantial grant funding: Low rental values means that the public sector



will need to continue to grant-fund the development of infrastructure to serve strategic sites.

- Culture of grant funding: the conditions outlined above have created a situation where
  developers in the programme area expect grant funding to be made available to them to
  deal with development viability issues. This is understandable in light of market conditions
  but it is worth noting that alternative forms of finance would represent a major departure
  from the approach that has historically been taken.
- 6.13 The lack of development activity in WWV does not, of itself, constitute a market failure. In light of market conditions, the lack of development activity may well point towards a development market that is acting rationally. Similarly, any inability of developers to access finance via commercial means may reflect investors acting rationally in the face of market conditions and poor returns.
- 6.14 The market assessment has however highlighted evidence of market failure which provides a clear rationale for intervention in the development market to bring forward unviable or marginally viable sites. The main types of market failure are:
  - There is a range of positive externalities associated with bringing development activity forward (either speculatively or through pre-let agreements) on unviable sites in WWV. For example, once occupied, business sites and premises play an important role in supporting employment creation. Benefits such as this are highly valued by the public sector but have no bearing on investment decisions made by developers.
  - Removal of negative externalities associated with vacant sites (eg dereliction, blight) that
    are not being developed out by the private sector. The benefits of removing these negative
    externalities are not valued by developers. In fact, they add to development costs and
    contribute to viability gaps which discourage development activity.
  - The existing sites and premises offer in WWV is not suitable to support growth in the sectors that the Welsh Government is seeking to grow. Developers are unlikely to take the additional risk or bear extra costs needed to develop the specific sites and premises offer to support the development of sectors that have specific property needs or which are at a nascent stage in their growth. There is an element of path dependency which cannot be overcome without public sector investment, as developers and their investors do not value the benefits of sectoral change and economic restructure in the same way that public sector does.
  - There are circumstances where finance market failure could exist where development activity is viable or marginally viable (or has been made viable via grant funding). Here, information asymmetries might exist where developments (or developers) are small and the costs of securing information needed to understand risks / rewards is disproportionate to the potential returns to the investor or as a result of poor perceptions of the programme are as a location for investment. The evidence suggests that such instances of finance market failure could exist but are unlikely to be widespread given the tendency for active developers in WWV to be large and well capitalised.



## The Potential Role of a UDF

- 6.15 The evidence base points clearly to the existence of market failure in the provision of business sites and premises in WWV. The key question for the ex-ante assessment is whether a UDF investment model is suitable to address the market failures that exist.
- 6.16 As outlined in Section 2, UDF investment needs to be targeted towards developments which have marginal viability. This is primarily to ensure that the investments that a UDF makes provide a financial return which enables the recycling of monies into other schemes until the closure of the fund. In addition, the requirement to target marginal schemes also reflects the fact that repayable finance will be unsuitable to address large viability gaps.
- 6.17 The evidence base points clearly towards a conclusion that most development activity (with the exception of development being led by owner occupiers or associated with major inward investors) is likely to be subject to substantial viability gaps, even on fully prepared sites. The evidence suggests that, in most cases, the viability gap will be of a scale that makes a UDF financing mechanism inappropriate (i.e. repayable finance, even where provided below commercial rates and on flexible terms, does not fill the viability gap). This has been confirmed by our consultations with developers and property agents.
- 6.18 It is clear however that the scale of the viability gap is likely to differ according to various development-specific and external factors. The assessment has not identified any sites or development opportunities that appear to be marginally viable and therefore potentially suitable for UDF investment. This does not mean that there are no marginal developments the evidence suggests that there could be circumstances where viability gaps will be smaller and potentially within the marginal territory that is suitable for a UDF mechanism. The table overleaf illustrates this point by highlighting the circumstances in which, according to the market assessment evidence, viability gaps could be smaller.
- 6.19 Generally speaking, instances of marginal viability are more likely to occur in buoyant and dynamic markets (where confidence and rental values are a little higher) and where development-specific factors give rise to lower risk, greater rental values and more certainty around income streams. However, the assessment has not identified any specific instances in which these factors are aligned in such a way that sites which could be eligible for funding through the WWV programme have the marginal viability suitable for funding through a UDF mechanism.
- 6.20 As noted in the following section, an important lesson of the UDFs funded through the previous programmes was the need for a reasonable degree of certainty that there is a sufficient number of development sites which could be appropriate (and eligible) for a UDF financing mechanism, which are development ready and hence that there is a realistic project pipeline. The assessment has not provided the certainty required, in any regard, that there is this pipeline in the WWV programme area.
- 6.21 However, it is worth noting the stronger market conditions in the East Wales programme area may provide the circumstances in which a suitable pipeline of development schemes for financing through a UDF mechanism may exist.



## **Implications for the Assessment**

- There is evidence of market failure in the provision of business sites and premises of all types across the WWV programme area
- Scope to address this market failure using a UDF mechanism is limited in the programme area.
   This is largely because there are very few sites or development opportunities which fall into the marginal viability category.
- There might be opportunities to use UDF investment alongside grant funding where finance market failures exist, although this would require further investigation on a site-by-site basis.
- To proceed with a UDF there is need for a reasonable degree of certainty that there is a sufficient number of development sites which could be appropriate (and eligible) for a UDF financing mechanism, which are development ready and hence presents a realistic project pipeline. The assessment has not provided the certainty required, in any regard, that there is this pipeline in the WWV programme area.
- It is worth noting the stronger market conditions in the East Wales programme area may provide the circumstances in which a suitable pipeline of development schemes for financing through a UDF mechanism may exist.



Tuno of	Characteristics of	Unviable Schemes	Characteristics of Marginal Schemes		
Type of Development	Development Specific Factors	Market Conditions and Example Locations	Development Specific Factors	Market Conditions and Example Locations in WWV	
Small Offices (up to 5,000 sq ft)	Speculative development would need to assume high levels of vacancy and a void period, resulting in a lower development value.  Specialist market offer eg incubator space would dampen rental income projections. Would need to assume higher turnover of tenants, conservative void periods and a requirement for easy-in / easy-out tenancies. This would reduce development value.	Areas which lack critical mass of service activities and where the office market is not particularly well developed.  More peripheral locations which are less accessible from key strategic routes  This applies to much of the West Wales and the Valleys programme area.	Assumed void rates for multi- occupier schemes have a major impact on viability. Any developer would need to pre-let a large proportion of units to reduce uncertainty and risk. This would contribute to improving viability but might not eliminate viability gaps in isolation.  Higher specification development in response to demand, to command above average rents and compete effectively with oversupply of lower grade office space.  Generic floorspace offer to maximise potential market size	Developments located in areas with a stronger office market and current undersupply of Grade A space would command higher rents.  There is limited evidence that such areas exist in the WWV programme area. Anecdotally, demand and rents for office space might be higher in central Swansea and this could lead to improvements in site viability.  Site located in an Enterprise Zone where various incentives and tax reliefs available could, along with other factors, contribute to closing the viability gap.	
Larger Offices (> 5,000 sq ft)	Speculative development would need to assume high levels of vacancy and a void period, resulting in a lower development value.  Tailored or niche property offer eg sector specific facilities (such as tailored accommodation for Life Sciences businesses). This would		All or a large proportion pre-let (ideally on long lease) to reduce uncertainty  Generic floorspace offer to maximise potential market size for non pre-let floorspace	Urban location (eg central Swansea) where office market is more buoyant.  It is possible that development could be more viable in out of town locations where land values are lower but well connected to service centre (eg immediate	



	reduce market size and increase risk, especially if the sector was at a nascent stage of development.			hinterland of Cardiff), although this is doubtful. Site located in an Enterprise Zone where various incentives and tax reliefs available could, along with other factors, contribute to closing the viability gap.
Small Industrial eg starter units	Speculative development would need to assume high levels of vacancy and a void period, resulting in a lower development value.  As for office space, incubator or starter units would require more considerate assumptions about vacancy and revenues, which would dampen development value.	More remote locations, distant from the strategic transport network <b>eg Aberystwyth</b>	Assumed void rates for multi- occupier schemes will have major impact on viability. Developer would need to <b>pre- let</b> a significant proportion of units to reduce uncertainty and risk.	More buoyant industrial locations in the north east eg <b>Denbighshire</b> and adjacent to <b>A55</b> and very accessible from the east.  Similarly in the south, would need to be accessible from the east and easily accessible for A465 (eg <b>Ebbw Vale</b> ) or M4 (eg <b>Baglan</b> )  Site adjacent, or in close proximity to large upper tier
Large Industrial	Speculative development would need to assume high levels of vacancy and a void period, resulting in a lower development value.  Sector specific offers would be subject to higher level of risk, particularly if the target sector was at a nascent stage of development.			supply company or area of existing or projected opportunity (eg Wylfa Nuclear Power Station)  Site located in an Enterprise Zone where various incentives and tax reliefs available could, along with other factors, contribute to closing the viability gap.



# 7. Assessment of the Value Added of a UDF

7.1 Although there is a fairly comprehensive collection of ex-ante assessments of UDFs publicly available, there is very limited evidence of the actual experience of implementing these instruments including the value they add in practice and the lessons which have been learnt. The discussion set out in section 7 and 8 is therefore based on the limited published evidence, as well as a small number of discussions with organisations that have been involved in the design, implementation and delivery of these financial instruments.

Providing Finance to Unlock Development

- 7.2 The fundamental objective of an ERDF backed UDF is to provide the finance necessary to ensure developments whose viability and fundability is affected by market failures can proceed. The developments are affected by a complex mix of structural and cyclical economic, development and finance market failures. This mix and scale of constraints can and often does vary between location, type of property and business sector, as well as according to the characteristics of the site itself. The economic recession and financial crisis of the late 2000s has arguably extended these markets failures, certainly in terms of its impact upon the economy and property market alongside the availability of development finance.
- 7.3 Given the focus of UDFs on developments with marginal viability and the strict rules under which they operate, this raises a particular challenge in terms of targeting particular types of development that meet eligibility, viability and investment criteria. Providing these conditions are met, the UDFs should be playing a key role in unlocking development. It is not clear from the published evidence the extent to which the UDFs funded through the 2007-13 ERDF programmes have been successful in meeting these conditions, although anecdotal evidence suggests that funds such as Evergreen in the North West of England and Chrysalis on Merseyside have faced challenges in achieving their lifetime investment targets.

High Levels of Leverage

- 7.4 A feature of the design of ERDF backed FIs is their ability to lever in substantial additional investment, both at the fund and at the deal level. Securing match funding at the level of the fund for UDFs can be challenging, as the instruments are less well established in the UK and have lacked a demonstrable track record. Nevertheless, a number of these have secured EIB fund level investment in the form of debt finance, as well as asset backed investment from public sector partners through the inclusion of land and property (although this has raised a number of issues). Ideally, ERDF will be no more than 30-40% of the total funding package, but this might be challenging to secure in practice.
- 7.5 More importantly, the UDF model involves the fund investing alongside site owners, developers and other funding partners such as banks, specialist property funds and potentially institutional investors. The contribution of a UDF should be no more than 20-25% of any specific investment given the role in targeting schemes with marginal viability, supporting leverage of 4-5%. This would appear to be the main source of good leverage that UDFs have achieved.

Stimulating a More Active Development Market Locally

7.6 If UDFs are successful in unlocking development schemes with marginal viability, then it should help to stimulate economic activity, which in turn contributes indirectly to more active and viable development markets. They can also play role in demonstrating the returns which



can be secured in this part of the market, encouraging more developers and investors to be active in these market areas. It can further help to mitigate the risks borne by these investors, either through the sharing of risk or through first loss arrangements (whereby the public sector bears initial losses if these were to occur, although the ability to do this is influenced by the FI and specific UDF regulations). This could draw in finance and expertise in the area.

7.7 Whilst these are factors worth considering, it is not clear from the available evidence to what extent these are forms of value added that could realistically be secured in economies such as in the WWV programme area, with face significant economic and locational challenges.

## Securing Specialist Expertise

7.8 UDFs require a great deal of expertise and professionalism in designing and delivering these complex public sector backed instruments. The fund managers who manage UDFs may bring expertise which is not available or is limited locally. The involvement of the private sector investors (including the EIB), where this has occurred, also helps to ensure more rigour in design and delivery.

## **Driving Economic Impacts**

- 7.9 ERDF backed UDFs can be used to achieve a range of desirable economic development impacts through addressing market failure affecting the delivering of sites and premises to meet the current and future needs of the WWV economy. The provision of an appropriate mix of sites and premises plays a critical role in stimulating enterprise in general, supporting the process of sectoral change, as well as generating higher value jobs which provide skill development and employment opportunities for local people.
- 7.10 Whilst the evidence on the importance of the availability of sites and premises is clear, the available evidence of the extent to which UDFs are successful and provide value for money in achieving these economic benefits is currently limited.

#### Recycling of Investment Returns

- 7.11 One of the key strengths of using ERDF backed FIs to provide finance rather than grant mechanisms is the potential to secure returns which can be reinvested (after the operational costs of the UDF are covered, depending on how these are funded). However, the ability to secure these returns for reinvestment will depend upon the nature of the UDF model, the underpinning investment strategy, the economic cycle in which investment occurs and the effectiveness of fund management activity.
- 7.12 There is very limited information on the rates of return and hence recyclable monies which the existing UDFs are securing. We are not aware of any publically available projects of the expected financial returns for the UDFs in the UK which have operated under the 2007-13 ERDF programme. The experience from the SME business finance FIs suggest that whilst the earlier funds operating in previous programming periods have been criticised by the modest or lack of legacies, the more recent funds have been or are expected to be more successful in this regard.



### Implications for the Assessment

- The publicly available evidence examining the experience of implementing UDFs, their
  impact and the forms of value added they provide is limited. The assessment of value
  added therefore needs to be treated with a degree of caution until more evidence is
  made available and tested.
- There are good reasons to believe that UDFs provide a sensible basis on which to secure
  various forms of value added including providing finance to unlock stalled and marginal
  development, to drive the achievement of a range of important economic benefits,
  stimulating a more active developer and development finance market, as well as the
  recycling of investment returns.
- The scope to secure these forms of value added will not be uniform across areas with different characteristics. In the case of the WWV programme area, the potential to achieve both demand and supply side related forms of value added may be less due to the underlying weakness of the economy and property market and hence the appropriateness of UDFs.



# 8. Review of Lessons Learnt

- 8.1 We have reviewed the available evidence from the evaluation and review of FIs used both generally in economic development and more specifically in terms of the types of interventions being considered as part of Block 1. As noted above, the evidence currently available on the development, delivery and impact of UDFs either in the UK or elsewhere in the EU is limited. We have also considered more general lessons for the use of FIs that do not have a focus on urban development such as the evaluation of the four UK JEREMIE funds and other business finance funds. Where appropriate we have substantiated this through key messages that have come from consultations we have completed.
- 8.2 The lessons have been organised in terms of: the evidence base; the design and approval process; the procurement and delivery; the monitoring, reporting and evaluation; and management and governance.

# **Key Lessons**

Area	Lesson	Implications for the study
Evidence to Support Use of UDFs	Financial instruments are amongst the most complex ERDF backed instruments, with significant risks if not implemented in a well-planned and delivered in an appropriate manner. There needs to be robust evidence that they can be effective and efficient instruments in achieving their underlying goals and provide better value for money than the use of traditional grant mechanisms. Importantly, this evidence needs to be considered in the local context, which may differ significantly from that of other UDFs.	We have noted elsewhere that the evidence in the public domain about the impact and effectiveness and efficiency of UDFs is currently limited. This is a significant gap in our knowledge which needs to be carefully considered.
Design and Approval Process	Need for robust business planning There are few ERDF backed projects where the robustness of the market assessment and business planning is so important to successful delivery. The ex-ante assessment will provide some but by no means all of the information that partners require. The gaps in the information about the market and the viability need to be carefully considered as part of the decision-making process, with appropriate weight given to gaps in information and aspects of risks and uncertainty.	There is the need for partners to fil any key gaps which persist following the completion of the assessment and which have a direct bearing in the design of the investment strategy. The market assessment can only be a guide to the gap which public sector should be using ERDF to address and it is important for flexibility to be built into the design and delivery of the FIs which enable delivery to be adjusted if circumstances change over time.
	The size of the fund The optimum size of a UDF varies across the evidence base. A review of UDFs in the UK <sup>35</sup> suggests that UDFs should be at least £60m in total if they are to invest in projects of sufficient scale and have	The total size of the UDF should be determined by the project pipeline and investment requirements, available public resources and the amount of matched funding that can be

<sup>&</sup>lt;sup>35</sup> Developing Interest: The Future of Urban Development Funds in the UK, Centre for Cities, March 2013



significant impact. Despite this, the majority of UDF's in the UK do not come close to this kind of scale, for example, the East Midlands UDF established in 2009 has a total fund size of just £15m. What is clear from the evidence is that the size of the fund should be sufficient enough to have the required impact while also being able to justify the high level of start-up costs that will be incurred. Nevertheless, this needs to be balanced against the need for realism in terms of the time it takes to set-up schemes and commence investment, as well as the scale of potential demand which exists.

secured at the fund level.
However, scale of operation is an important factor in the operational efficiency of the UDF, the scope to secure the necessary expertise and hence its ability to provide VFM. UDFs with overall fund sizes of less than £50m would need to be fully justified on the basis of their ability to address these factors.

Balancing financial and economic returns
For a UDF to be effective it must generate
financial returns while also addressing
market failure and producing economic
and regeneration benefits. Evidence from
the final evaluation of JEREMIE in Wales
suggests that the original economic
development targets were set
unrealistically high and quite often
achieving financial returns took
precedence when making investment
decisions.

The UDF needs to set realistic targets and be clear on priorities for intervention. It is important that the relationship between both types of returns is understood and there is a clear investment strategy that reflects this.

# Procurement and Delivery

Procuring an external fund manager Evidence suggests that there are significant benefits in using established fund managers in terms of efficiency gains, skills and expertise, and profile in the market. In order to have more credibility among private investors and to be operated with the required financial acumen, fund management is more effective when procured to an experienced fund manager rather than being public sector led. Evidence used in the JESSICA North West of England exante assessment<sup>36</sup> suggested that in order to attract interest from commercial fund managers, the public sector should not put in place too many restrictions during the procurement process.

It will be important for the potential interest from specialist fund managers to be market tested. Given the potential for a WWV supported UDF to be fairly modest in size, this could reduce interest amongst the fund management community.

#### The project pipeline

A pipeline of viable projects will allow the fund to be more effective from inception. A key message from the Centre for Cities report is the need for a suitable pipeline of projects for the UDF to prevent delays between setting up the fund and making investments. Despite this, UDFs to date have often found this to be more difficult

The assessment has not identified an adequate pipeline of development schemes which are likely to address the specific viability conditions which would underpin a UDF. The fundamental suitability of a UDF for the WWV programme is questioned on this basis.



<sup>36</sup> Reference

than expected due to the limited number of shovel-ready projects to invest in.

#### A flexible investment strategy

UDFs are most effective when they can be flexible in their investment approach and have a range of financing tools to address different challenges property developers face such as access to capital, cash constraints or high upfront costs. A UDF that can make use of debt, equity and deferred consideration on land assets will be most effective and will be able to fund a wider scope of projects. Not only should a UDF be flexible in the types of finance it can deploy but also in its investment strategy. One of the successes of the Welsh JEREMIE fund was its ability to adjust its strategy to reflect changing market conditions during the lifetime of the fund. This success factor is also identified in the EU ex-ante guidance methodology for Urban Development Funds and will be increasingly prevalent given the uncertainty within the property market that has emerged post-Brexit.

What market failures are present in the identified pipeline projects. What types of finance are required? Presumably, recommendation will be for a flexible fund providing debt, equity and mezzanine finance.

#### Timeline for delivery

The timing of the ERDF funding programme may cause difficulty in fully investing the fund and realising returns. The funding programme finishes in 2020 although a UDF could potentially continue to operate until the end of 2023. This means that while a UDF would have seven years to make all of its investments, in practice the investment period would need to be shortened as all outcomes would need to be reported by the end of 2023

Do the number of projects suggest that this will be achievable? How viable are the identified pipeline projects— will they be able to deliver returns in the short to medium term

# Use of Remuneration to Drive Performance

A key lesson from SME finance FIs has been the need to use a remuneration strategy for the appointed fund managers which includes a performance related component in order to drive good performance. However, this needs to be structured in an appropriate and realistic way in order to achieve the desired outcomes for the public sector, whilst being set at a level and form which attracts high calibre fund managers and motivates them to achieve.

Designing and setting performance frameworks for fund managers is a specialist area which typically needs expert guidance both at the procurement, contracting and delivery phases of a UDF

Monitoring, Reporting and Evaluation Regularly monitor KPIs that cover investment, financial and economic development targets

It is essential that a UDF is able to generate investment, financial and economic returns and robust monitoring

The investment, financial and economic targets need to be clearly set out in the underpinning investment strategy and supporting analysis. The assumptions which have



	systems should be in place in order to	been used to derive these targets
	keep check of progress towards these.	should be fully documented and
		justified through appropriate
		benchmarking.
	Information reporting should be	The format, scope and timing of
	transparent and easy to understand	monitoring reports should be
	Evidence suggests that investors will seek	agreed with the range of
	clear, regular information on investment	stakeholders. These will need to
	performance that will be easy to compare	reflect the reporting and
	to other forms of investment information.	decision-making timescales of
		the respective investors.
Management	An investment committee should be	The membership of board and
and	established with both private and public	investment committee should
Governance	sector representatives	balance the interests and
	Governance that is partnered by both the	expertise that the groups require
	public and private sector is essential in	to fulfil their governance
	order to ensure that the UDF strikes the	responsibilities.
	right balance between investing for	
	economic development benefits with a	
	commercial ethos. Private sector	
	governance will also enhance the	
	credibility of the fund and maintain	
	engagement with the private sector.	



# 9. Conclusions and Next Steps

- 9.1 The market assessment has highlighted evidence of market failure which provides a clear rationale for intervention in the development market to bring forward unviable or marginally viable sites across the WWV programme area. There is an element of path dependency which cannot be overcome without public sector investment, as developers and their investors do not value the benefits of sectoral change and economic restructuring in the same way that the public sector does. Similarly, the range of positive and negative externalities associated with bringing development activity forward on unviable or marginally viable sites are not a factor in developer and investor decisions.
- 9.2 The assessment has highlighted some evidence of finance market failure but viability related barriers to development are more widespread for strategic speculative development. The evidence suggests that finance market failures might exist where developments are viable or marginally viable, or where developers have particular characteristics. However, many of the active developers in the WWV programme area report being fairly well capitalised and highlight that issues related to site viability are much more important considerations. This is linked to a combination of low demand (and hence rental values) as well as in some instances abnormal development costs (linked to remediation and infrastructure issues).
- 9.3 The evidence suggests that the scope to address market failure using a UDF mechanism is limited in the WWV programme area. In most cases the viability gap will be of a scale that makes a UDF financing mechanism inappropriate, given its limited scope to offer developers benefits through access to cheaper or more flexible finance or to mitigate risk for other investors. Repayable finance, even where provided below commercial rates and on flexible terms will not fill the scale of viability gaps that exist for the types of strategic sites that are relevant to the WWV programme.
- 9.4 The assessment suggests that there could be circumstances where viability gaps are smaller and potentially in the marginal territory that is suitable for UDF investment. These instances of marginal viability are more likely to occur in buoyant and dynamic markets (where confidence and rental values are a little higher) and where development-specific factors give rise to lower risk, greater rental values and more certainty around income streams. However, the assessment has not identified any specific instances in which these factors are aligned in such a way that sites which could be eligible for funding through the WWV programme have the marginal viability suitable for funding through a UDF mechanism.
- 9.5 The assessment has not provided the certainty required around a suitable pipeline of development projects in the WWV programme area. The review of lessons from UDFs funded through the previous programmes illustrates that there is a need for certainty that there are enough development sites which could be appropriate (and eligible) for a UDF financing mechanism, which are development ready (and hence that there is a realistic project pipeline). This does not appear to be the case in the WWV programme area although it is worth noting the stronger market conditions in the East Wales programme area may provide circumstances in which a suitable pipeline of development schemes for financing through a UDF mechanism could exist.
- 9.6 While there are good reasons to believe that UDFs provide a sensible basis on which to secure various forms of value added, the potential to achieve these in WWV is limited. Although evidence relating to the value added of UDFs is limited, it highlights various forms of value added including providing finance to unlock stalled and marginal development, to drive the achievement of a range of important economic benefits, stimulating a more active developer and development finance market, as well as the recycling of investment returns. However, the scope to secure these forms of value added will not be uniform across areas with different characteristics. In the case of the WWV programme area, there might be less



- potential to achieve both demand and supply side related forms of value added due to the underlying weakness of the economy and property market. This suggests that UDFs are unlikely to be appropriate here.
- 9.7 These findings indicate that **UDF** would not be an appropriate mechanism to bring forward development of business sites and premises in **WWV**. The clear evidence of viability gaps indicates that there is a **continued case for grant funding** to bring forward sites which would be unviable without public sector intervention.
- 9.8 The evidence from the market assessment, as well as wider best practice from evaluations suggests that any grant intervention should be designed and operated with the following principles in mind:

## 1 - Clear Logic Model Underpinned by Comprehensive Evidence

- 9.9 The design of interventions which provide grants should be informed by a clear and comprehensive evidence base and evidence of market conditions to justify the specific focus of the fund and set the investment strategy. Clarity on the specific objectives that a fund is seeking to create is essential given that the existence of a viability gap does not itself constitute a market failure or justify public sector intervention.
- 9.10 The market is acting rationally by not investing in unviable propositions and the case for public sector intervention can only be made on the basis that an investment would give rise to economic development spillover benefits that have value to the economy and which result in an acceptable return for the public sector's investment. In light of this, grant provision should be underpinned by a clear logic model which identifies:
  - The rationale for the grant provision: The specific economic development benefits that investments will seek to create and how these link to wider strategic aspirations in the programme area. This needs to clearly set out how grant provision contributes to strategic economic development aspirations as well as setting out how grant intervention will fit within the wider business sites and premises, sector development and property strategies.
  - The objectives of the grant provision: linked to the fund rationale, the logic model should set out specifically what type of business sites and premises are needed to deliver the desired strategic benefits. For example, any specialist premises needed to support development of particular sectors.

## 2 - Careful Consideration of Delivery Mechanisms

9.11 There are a variety of delivery mechanisms which could be suitable for a grant fund. These are summarised in the table below. These various mechanisms need to be carefully considered in light of the specific policy objectives that a fund is seeking to contribute to.

Table 9.1 Possible Delivery Mechanisms for Grant Funds					
Mechanism	Overview	Considerations			
	<ul> <li>Funding for developers to de-risk early stage development appraisal</li> <li>Help to move specific sites forward and create a project pipeline</li> <li>Would also contribute to developing the evidence base relating to barriers on particular sites</li> </ul>	<ul> <li>Careful application and appraisal process needed to select recipients and ensure that grants do not fund core developer activities</li> <li>Work with local authorities to identify target sites which have not seen any exploration / appraisal activity</li> </ul>			



		<ul> <li>Likely to need to be backed up with additional sources of funding to fill viability gaps and bring development activity forwards</li> </ul>
Gap Funding Development Activity	<ul> <li>Traditional gap-funding in which developers apply for grant to fill an identified viability gap affecting a particular development</li> </ul>	<ul> <li>Fund objectives need to be well specified to ensure grants are targeted towards development activity that will support policy objectives</li> </ul>
Developer Guarantees	<ul> <li>Guarantees alongside grant for developers</li> <li>De-risk development activity and reduce the amount of grant required</li> </ul>	<ul> <li>Need to carefully consider the overall cost and public sector return on investment under a worst-case scenario (ie if the guarantee is needed)</li> </ul>
Local Authority Guarantees	<ul> <li>Guarantees to local authorities to enable direct development</li> <li>De-risk direct development activity for local authorities whilst providing full control over the nature of development</li> </ul>	<ul> <li>Assume local authorities will be able to access required capital</li> <li>Need to consider appetite of local authorities to get involved in development activity in this way.</li> </ul>
Repayable Finance Component	<ul> <li>Maintain ability to offer repayable finance for marginally viable schemes that are identified</li> </ul>	<ul> <li>Helpful flexibility</li> <li>Finance pricing and terms would need to be carefully considered in light of development specific barriers and market failures.</li> </ul>

## 3 - Robust Project Appraisal

- 9.12 Irrespective of the delivery mechanism (or mechanisms) used, any grant fund needs to be underpinned by a clear and transparent appraisal process to guide investment activity. This needs to provide an assessment of:
  - The justification for public sector investment in each scheme and the specific market failure / viability gap affecting each development
  - The specific economic development benefits that the scheme will offer and the extent to which these contribute to the grant programme's objectives
  - The manner in which each investment would support particular types of economic benefit. For example, whether the project is seeking to support inward investment or growth of indigenous businesses.
  - Use project Benefit Cost Ratio (BCR) as a tool to value the scale of economic spillover benefits and assist with investment decision making and project prioritisation
  - The period over which development activity will take place and economic development benefits will be realised
  - The risks affecting the delivery of each project and the vulnerability of the development (and realisation of benefits) to external circumstances.
  - The extent to which the project is responding to market demand.
- 9.13 The timing of development and the scale of benefits that a scheme will deliver are central to the grant funding decision and these expectations should be stated clearly in grant funding agreements to ensure that funds deliver the expected scale of benefit in timescales that are appropriate to the fund.



# Appendix A - Pipeline Assessment Framework



	Name of Site		
	Site Location		
<b>.</b>	Site Ownership		
Background to Site and Nature of Development	Type of Development		
Opportunity	Any specific end-user focus at	eg sector, business lifecycle stage, R&D intensity etc	
Оррогиппту	this time		
	Any previous public sector	Brief details of any previous grants/ loans to unlock the site	
	investment		
	Total Scale of Investment	Private sector investment -	
		Any grant already committed -	
		Potential investment from a UDF -	
Initial Assessment Criteria:	Criteria	Site Fit	Suitable /
			Unsuitable
Is the site location	Close or well connected to	Yes/No (include brief detail)	
consistent with the	deprived communities		
aspirations of the OP	Near or well connected to	Yes/No (include brief detail)	
	urban location		
	Strong road / rail access	Yes/No (include brief detail)	
_	Within EZ	Yes/No (include brief detail)	
s the site part of a strategic	Within CR	Yes/No (include brief detail)	
approach?	Within Strategic Corridor	Yes/No (include brief detail)	
	Fit with SO4.4	Yes/No (include brief detail)	
	Any focus on ERDF ineligible	Yes / No (include brief detail)	
Is the site eligible for ERDF	sectors expected		
support?	Any likelihood of ERDF	Yes / No (include brief detail)	
	ineligible activities		
Is the site large enough to	Site > 1-2 Ha	Thresholds to be discussed / agreed	
	Elegranaco	Thresholds to be discussed / agreed	
be considered strategic?	Floorspace Overall Conclusion	Brief justification for why excluded / included in full assessment	



Full Assessment	Criteria	Important Points	Conclusion about Strength of the Case
Rationale for Public Sector Intervention	Nature of the Site / Development	<ul> <li>What is the nature of the property offer expected on the site?</li> <li>What specific development activity is being proposed (i.e. site infrastructure, site assembly, remediation, construction of premises)</li> </ul>	Strong/ Moderate/ Weak
	Site Viability	<ul> <li>Are there site preparation or infrastructure requirements or abnormal costs which could make the site unviable?</li> <li>What is the approximate size of the viability gap?</li> <li>Is any grant funding expected to go into the site?</li> </ul>	Strong/ Moderate/ Weak
	Market Demand	<ul> <li>Is there evidence of market demand for the proposed offer?</li> <li>Would the site owner / developer be able or willing to implement the proposed activity in the absence of public sector funding?</li> </ul>	Strong/ Moderate/ Weak
	Finance Market Failure	<ul> <li>Is there a finance market failure and hence finance gap?</li> <li>What is the strength of the evidence base for this?</li> </ul>	Strong/ Moderate/ Weak
	Economic Development Benefits	<ul> <li>What are the potential economic development spin offs associated with the site's development?</li> <li>What evidence is there that these benefits could provide value for money to justify public sector investment?</li> </ul>	Strong/ Moderate/ Weak
Deliverability of the Project	Current Status	<ul> <li>Is the site allocated?</li> <li>Is the project established in the planning system? Outline or full?</li> <li>Are there any ownership issues?</li> <li>Has any site infrastructure been completed?</li> <li>Has any development already taken place on the site?</li> </ul>	Strong/ Moderate/ Weak
	Ability to Proceed within Programme Period	<ul> <li>Is any other finance in place?</li> <li>Are there any other barriers to the development proceeding?</li> <li>Any other risks? Eg flooding, development-specific issues</li> <li>Can they be mitigated?</li> </ul>	Strong/ Moderate/ Weak
Overall Suitability	Conclusion		Strong/ Moderate/ Weak



