Urban Maestro

New governance strategies
for Urban Design

Innovative Financing models for Public Private Partnerships (PPPs) in Real Estate Development

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1. INTRODUCTION

There is a momentum for places to generate new initiatives to help leverage private sector finance for real estate development, as well as meet the increasing demand for modern communications and services. Moreover, from the public sector there has been a greater use of financial instruments and mechanisms globally. Innovative finance for real estate development involves non-traditional forms of funding through private mechanisms, solidarity mechanisms, public-private partnerships mechanisms, and catalytic mechanisms. However, innovative finance for real estate development is not to be viewed as an alternative to traditional forms of finance but should been seen as complementary. Furthermore, innovative financing of real estate development are those measures providing financial support to address one or more policy objectives through the use of loans, guarantees, equity or quasi-equity investment, or other risk-bearing tools – that can be combined with grants and involve risk-sharing with financial institutions to boost investment in large infrastructure projects. Innovative finance approaches to development and PPPs have been increasingly used in the real estate and property industry. Moreover, the intense pressures from accelerating growth worldwide require innovative funding mechanisms to support sustainable development. In real estate development, innovative financing mechanisms have often been used in PPPs that provide transport and energy infrastructure.

2. A Focus on Public Private Partnership (PPPs)

A Public Private Partnership (PPP) is a public service or private business venture that is funded and operated through a partnership between the public sector (either central or local government) and one or more private sector companies. PPPs are recognised as a key element in a government's strategy for delivering modern, high quality public services and promoting competitiveness. The use of private financing in public projects is one element of PPP business structures and partnership arrangements. Others include joint ventures, outsourcing, and the sale of equity stakes in state-owned businesses. The introduction of private sector ownership into state-owned businesses can have a full range of possible structures. The structure could for instance be brought into existence through floatation or the introduction of a strategic partner. Either public or private sector interests can hold major or minor stakes in the PPP. The importance of PPPs to development finance is the amount of funds and policy support that is directed at the real estate industry in using this model of partnership.

PPPs are therefore a particular type of contractual arrangement between the public sector and private sector firms. They give the private sector a greater role in financing, real estate and maintaining public sector facilities, although the government retains a stake in the PPP Company. Under public private partnership arrangements the government is not liable to a fixed stream of annual payments. PPP is therefore an arrangement that can be financed via both public sector and private company sources. For instance, a partnership contract can be drawn up that recognises agreed government funding and private developer contributions to a project.

With the introduction of the private sector in PPPs, advantages for the public interest are maintained if fundamental government roles are made responsible and held accountable for. Fundamental roles for the government include being the principal decision maker between different competing objectives. This then allows the government to retain authority as to whether the objectives are delivered to the standards required. Most importantly the fundamental government decision-making should in theory ensure that the wider public interests are safeguarded. Public interest issues would be those such as putting in place regulatory bodies that remain in the public sector, maintaining safety standards, and ensuring that any monopoly power is not abused.

Budget overspend is often a feature of large scale Public projects. PPPs often deal with the need for either more accurate projections or improved finance methods in such projects. This is not to say that initial budgets are initially kept artificially low, but budget are often projected low in the first instance to ensure projects using public money win the bid and get the go-ahead in the first instance.

With public criticism of public sector overspend, some recommendations in re-thinking finance are the introduction of equitable due diligence in public finance as is carried out in private business. Moreover, there is a call to involve rigorous expert scrutiny not just at the point of purchase, but also throughout the life cycle of public sector finance projects. The recommendation to incentivise finance in the public sector is especially significant. Particularly as it is stressed that finance should not just be a 'sell off' by emphasising that public sector parties benefit from the innovative approaches developed by private sector partners in deals.

The complexity and intricacies of integrating private sector risk into finance has meant that more sophisticated PPP design structures have come into existence. One example being the use of government backed bonds on projects and partnership organisations. This finance approach is held with caution as the raising of finance through bonds issued by state-owned businesses or bonds guaranteed by government does not always offer best value. It is more cost-effective for governments to issue (non-guaranteed) gilt-edged securities (or gilts) to directly finance projects as they offer less guarantee and more risk but as a result can offer greater reward – therefore generating greater initial funds to finance the project. Avoidance in increasing the public sector borrowing is also enabled through the direct issue of government gilts into the financial market – rather than state-owned businesses issuing bonds for the direct financing of its PPP projects.

More generally, partnering in any form of finance is an attractive idea and in economic terms it helps to eliminate inefficiency as costs per unit of output are reduced. Furthermore in partnering, the decisions of an individual public sector authority or an individual contractor are less likely to maximise the value of output. Particularly when applied to decisions chosen on what to build, how to build it, and how long to spend on the project. Partnering also improves the dynamics of the market by putting the client more in control and improving the flow of information between the participants. Partnerships can also provide the platform to provide greater incentives to complete the contract on time, to budget and to the expected quality.

Contemporary issues surrounding the partnership industry involve the reduction in credit available to finance projects and the subsequent programme delays and new deals being signed. Many deals take a fall in direct correlation to credit and economic cycles. For instance, in a downturn in credit available, banks no longer feel

able to take on large chunks of debt, and the cost of finance can sharply rise. For further discussion, against this backdrop of a shrinking public purse and a tight financial market, is a focus on the critical finance decisions made by both public and private stakeholder partners.

3. Public Private Partnerships (PPP) and Financing

Partnership collaborations can be one of the most effective ways of financing major infrastructure. PPPs relieve public budgetary constraints in addition to the improvement of the quality of public services, whilst encouraging innovation and optimising risk transfer. PPPs incorporate a range of arrangements, from joint ventures and concessions, to outsourcing, and equity stake sales. The type of agreement will determine the level of involvement of the private sector organisations or the public sector partner, including whether this will vary over time and the exact roles of the relevant parties to use real estate development finance for PPPs. The financing of PPPs is more commonly used in countries with significant private-sector schemes having long-term liabilities that need to be matched to long-term assets. PPP initiatives funded by bonds are often index-linked, known as index-linked debt, and expose procurers to potentially higher inflation risk.

With respect to financing real estate development and the legal ownership of PPPs project land to develop on, there has previously been an assumption that the involvement in land-based activities guarantees investor protection, regardless whether or not they own the land. If investment finance cannot guarantee land ownership rights, this increases insecurity and the potential for ownership disputes thereby acting as a disincentive to investment and decreasing the likelihood that prospective investors will finance land-based projects. For financial innovation in real estate development, land ownership rights as part of the finance mix can play a part. Discussions of land readjustment finance and re-parcelling of land by a municipality to unlock fragmented potential sites in deadlock can help in this regard.

Public sector finance issues cannot be ignored in financing the development process, indeed there needs to be a strategy appropriate to the project, and one that

satisfies the criteria of both the investors and partners. Current government guidance for the public sector and similar organisations may influence the finance route, particularly where there is substantial public sector funding involved. There are also barriers relating to scale in finance, as proposed developments can suffer from high bidding costs, borrowing costs, and the need to comply with finance directives. Financial innovation in real estate development therefore can have some opportunity in PPPs, where large-scale projects often prevail where the private market cannot succeed alone, and partnerships can gain advantages in the finance process.

4. The Intricate Design of Finance in Real Estate Development for PPPs

Effective utilisation of financing real estate development for PPPs is integral to successful outcomes, particularly in the present climate of limited resources where investors are likely to be cautious. To deal with a more complex economic condition, the reality in financing real estate development has typically been a blending of loans and grants. Innovative finance, in part by blending grants and loans, is intended to share risk, and potentially provides greater flexibility and innovation. This is not always realised, for example the inflexibility of the original contracts during the operational period can result in one sector being burdened with a greater share of risk, potentially resulting in the public sector paying a higher risk premium.

Value capture mechanisms that capture real estate value increases due to investment in nearby infrastructure are being increasingly adapted at the core of PPP delivery models. Land value capture finance is used to recover the capital cost of real estate development in PPPs by capturing some or all of the increments in land value resulting from the initial outlay. Land value capture finance, to fund public goods by capitalizing on land rents, has a long tradition in public finance, as infrastructure development can stimulate further land development, economic growth, and increasing property values. Specific policy instruments for tapping into the wealth generation capacity of places are those such as Tax Increment Financing (TIF) districts.

Loan and bond instruments, whether in value capture or otherwise, are more often used in PPP real estate development to attract private investment in well-functioning capital markets, with bonds providing institutional investors, such as pension funds with both limited risk and stable yields. Some government loans, such as the subordinated loan, can enable governments to fill financial gaps formed between loans and equity. Subordinated loans can be repaid where project performance is as expected, and the outcome empowers the government to receive a share of on-going revenues as interest on the loans.

Some tax incentives are viewed as innovative finance instruments, particularly if they progressively encourage PPPs as part of the finance mix in real estate development. Spatially targeted tax breaks can help start-up businesses and expand existing businesses. Financial incentives range from business rate discounts to simplified local authority planning to reduce costs. Many municipalities compete for new investment in development by keeping land use taxes artificially low. Furthermore, selective tax waivers and other incentives aimed at investors, developers, and residents - can have a pivotal role in improving a place's physical and economic environment. These fiscal-based measures must operate within clear planning, regulatory and budgetary frameworks, particularly as the ways in which these measures operate will vary depending upon national and local taxation structures.

5. Issues of Governance, and Planning in Real Estate Development for PPPs

Land ownership has been recognised as essential to real estate development in PPP finance, and indeed some authors argue that fragmented landownership hinders the development process. For example, there can be complications with the finance for large development PPPs projects due to the contestation over Compulsory Purchase Orders (CPO). Furthermore, the sale of surplus sites by the public sector to the private sector can be used to raise funds and fulfil other development objectives but will often be contested. Land with development potential can also be disposed of by issuing a public bond rather than for a direct payment. Where contaminated Brownfield land is present, particularly in prime locations without local government

ability to remediate it, the public sector can offer land to the private sector at below market rates or in conjunction with other incentives. This has given rise to 'brownfield entrepreneurs' who remediate such sites before they redevelop or market them for redevelopment.

Local authorities are well positioned to reduce risks and make projects more attractive for private investors to finance them, through locally relevant incentives; including development fees waivers, subsidized insurance, and property tax abatements. Real estate development finance for PPPs has seen some attempt at devolution of financial power from central to local government, and the decentralization of national development and related policies. Often, this devolved finance has involved more than the decentralization of the budget, by providing local authorities the capacity to engage in decentralized policies. As a result, rather than providing and regulating development, the public sector has increasingly become more central in enabling and stimulating development finance, changing its role from one of command to one of accommodation.

6. Sector Asset Preference in Real Estate Development for PPPs

The broader trend in real estate development PPPs is a shift in investor and developer preferences to mixed-use schemes. Such projects have been found to have lower levels of risk per unit of return and increased the opportunities for property portfolio diversification. As an asset, real estate has been recognised as potentially providing high rates of return on investment but poses high-risk due to the higher degree of uncertainty of property.

Real estate development in PPP projects are typically longer in duration and involve substantial amounts of capital. Consequently those investors that finance real estate PPP projects need an appropriate rate of return relative to the risks. Capital will be invested as the investor anticipates that the project will ultimately yield substantial returns and diversify risk. As institutional investors are often risk-adverse, they are likely to restrict their activities to places and sectors with which they are already familiar.

Despite the opportunities offered by innovative finance in real estate development for PPPs, it is clear that risk needs to be considered alongside the speculative financial returns on offer. Many financial tools in real estate development such as value capture bond mechanisms take on innovation risks with some sense of prudence. Although real estate development is generally perceived as high risk with low returns, it can provide an increased diversification thereby potentially enhancing returns. Furthermore, the developer profit motive will continue to drive development however the risk is managed. The result is long-term stable real estate development finance in PPPs that has the potential to benefit all stakeholders.

7. Conclusion: Policy Drivers, Barriers and Opportunities

In conclusion, agents for driving real estate development financial innovation in public private partnerships can be from key individuals and institutions. Financial leverage from public bodies, planning departments and entrepreneurial local authorities can all be substantial. Institutional financial leverage highlights the need for local authorities to work collaboratively to provide leadership in real estate development PPPs projects. For example, collaboration can aid real estate development finance for PPPs, by ensuring that resources are invested in such a way that they make the biggest impact. Furthermore, place based leaders can make a case to be awarded new powers to promote economic growth by setting policies to demonstrate that PPP initiatives and policy structures are sufficiently capable and ‘robust’ to deliver on their objectives. Innovative finance for PPPs in real estate development requires strong local and visible leaders in order to encourage independence and promote balanced and sustainable economic growth. The checks and balances that are promoted in the financial design beyond the tools and mechanisms will be critical to developing places of quality.

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