July 24th 2017

To: Castleforge Friends and Investors

Re: U.K. Planning System Pitfalls and Opportunities

Dear All,

Given the substantial attention dedicated to a market update at our recent Annual Meeting, we thought that rather than a letter about the market, it would be more interesting to put together a one-off discussion piece focused on the U.K. planning system.

It has occurred to us that planning risk can act as a blind spot for some investors who are not as familiar with the U.K. system. When these investors use heuristics from other markets or work with a partial understanding of U.K. idiosyncrasies only, they risk investing in projects where the risk profile is misunderstood and inappropriately priced. They may also avoid areas that present a considerable opportunity due to greater planning-related supply constraints than would have otherwise been assumed. Therefore, it is a useful exercise to run through a brief summary of the U.K. planning system and identify some areas where pitfalls and opportunities are created. For those of you who would like a more market-focused update, we will follow on with one of these in the near future and are available for direct discussion in the interim.

Overall, we will show the U.K. planning system as relatively inflexible and slow to react compared with other systems in well-established real estate markets, which has meant that supply is relatively inelastic in its response to changing demand across a number of sectors. This supply inefficiency embeds consistent pricing distortions that can help or hinder real estate investors. Due to these supply constraints, the government has periodically been obliged to intervene, normally because of a perceived crisis following a period of undersupply. Even then, most measures we have seen are not highly impactful in their creation of new supply in the near term. By way of example, in response to a perceived housing affordability crisis today, the government has only intervened directly on a limited case-by-case basis to overturn specific planning refusals, while broader measures have typically targeted the demand side of the equation (e.g. providing artificial "preferred equity" to buyers of houses under a certain price threshold under legislation known as "Help to Buy"). To date it has proved a highly difficult and politically challenging task to systemically improve planning efficiency and so for the foreseeable future these supply imbalances should continue.

In general, the U.K. planning systems are relatively unique in that each local authority must approve each new development within its remit. Many other countries, including the U.S., operate under various zoning regimes with differing levels of implied permission to develop within parameters. The fact that U.K. planning decisions occur at the local level in such a reactive manner is one of the primary reasons why it is difficult for supply to react to demand, which we will discuss in more detail after describing how the system works.

U.K. Planning Process Overview

In the U.K., each component country (England, Scotland, Wales and Northern Ireland) has its own planning system, but here we only focus on the English system for simplicity. In England, a system of "use classes" puts uses of land and buildings into various categories. Planning permission is typically required for all new construction, changes of use between

certain general use classes and certain changes of sub-use within the same general use class. English planning decisions are generally implemented at a local level, with primary planning decision-making resting with local government authorities (known as the "local planning authority" or "**LPA**"), which decides on planning applications. In Greater London for example, the Mayor has powers to determine certain planning applications of potential strategic importance but overall it is local councils making most planning decisions.

All applications for planning permission must be determined by the LPA in accordance with the relevant Local Plan and neighbourhood plans. These plans should, amongst other things, identify sites to be used to satisfy five-year housing needs across all tenures and define the boundaries of local Green Belts (protected land). Local and neighbourhood plans, in turn, must be made considering the National Planning Policy Framework and requirements of neighbouring local councils. In Greater London, Local Plans must also be in general conformity with the London Plan.

Local Plans are formulated and developed by the LPA (a time and resource intensive process) and then submitted to the Secretary of State for Communities and Local Government for approval. Following submission, a planning inspector assesses whether the Local Plan has been prepared in line with the relevant legal requirements (including the duty to cooperate with surrounding councils) and whether it meets the tests of "soundness" contained in the National Planning Policy Framework. This larger framework is how the national government ensures consistency in planning decisions across the country, even if decisions over applications are themselves left to the LPA. The Local Plan can be refused or modified in this process, forcing the LPA to prepare an entirely new Local Plan and submit this in some cases. In the event of a refusal, the LPA considers planning applications by relying either on the historic Local Plan (if one is in place), or considers applications on the basis of their ability to fulfill five-year housing requirements in absence of any Local Plan.

Certain Permitted Development Rights are now provided in England by which specific use changes can be made to buildings within their existing structure without the need to obtain planning permission. These rights are typically subject to conditions and limitations that control development impacts. Notably, buildings in use as offices or light industrial can be converted to residential use within their existing envelope except in certain exempted areas, which typically comprise the main commercial districts of LPAs.

The statutory time limit for an LPA to determine major new applications (large housing or commercial sites) is 13 weeks, and for applications subject to an environmental impact analysis, 16 weeks. The Government's "planning guarantee" is that all decisions, including any appeal, should take no longer than one year in total: 26 weeks for the application and 26 weeks for any appeal. Procedures exist for agreeing longer timelines in the event an application is expected to take longer than 26 weeks to decide. There is also a procedure for appeal if planning permission is refused, is granted subject to onerous conditions or if an application is not dealt with within the statutory time periods. Once planning permission is granted development must begin within three years, else new planning permission will be required.

Difficulties of Implementation

Application Process - Despite this government timing guarantee, planning applications often do not get decided in a timely fashion. According to a recent survey by the British Property Federation, the average time for a determination of a major planning application across London, Manchester and Bristol is 28 to 32 weeks (and up to 34 in London) and many other councils can take significantly longer. We believe a few issues are responsible for this slow process: First, if a Local Plan is rejected, is undergoing change or is challenged, this creates confusion on the part of the LPA as to their planning guidance at the time of an

application and confusion over what is an acceptable project. This can also put a pause on the submission of new applications because prospective developers are guided to wait until either a new Local Plan is adopted or the LPA confirms the type and scale of development that would likely avoid a refusal based on the five-year housing need. Second, planning applications are exposed to community objections that must be taken into account, and this is another major cause for refusals. Third, if and when planning applications are granted, they are granted for a specific project and design (not simply, for example, a stated Floor to Area ratio), providing little flexibility for the developer to change elements of the design without applying for an amendment. Fourth, planning departments can be significantly understaffed – a recent example is the City of Glasgow, which we understand has seen its number of planning officers reduce by nearly 75% over the past ten years. Fifth, in many cases the same officer is responsible for both large commercial projects and minor private amendments (such as a single residential unit basement extension), which hinders their ability to be responsive to large applications. These staffing problems can also lead to undesirable behavior. We have been aware (anecdotally) of applications refused by planning officers after 26 weeks simply to gain more time by pushing the application to appeal. Overall, a number of factors can contribute to a project's delay or rejection, and these cannot easily be predicted a priori.

Rights to Light – This is not part of the planning process itself, but is a separate legal right (equivalent to an easement). A right to light is the right of a property owner to prevent a neighbour from obstructing the light to the property owner's window. A homeowner with a right to light may seek injunctive relief against any development that infringes materially upon this right at any time. The impact of injunctive relief may be large, including cutting back the scope of the development or halting the development altogether. Although courts normally rely on injunctive relief as a last resort, developers nonetheless run a large financial risk in relation to these issues. Rights to light represent a particularly insidious risk factor for developments in densely populated areas.

Community Obligations – To mitigate the impact of proposed developments, Section 106 planning obligations are commonly used by LPAs to require developers to undertake works, provide affordable housing or provide funding for services (amongst other things). The specifics of these obligations require a separate negotiation between the developer and the local authority planners that must be undertaken for every new development after gaining planning consent. In addition to Section 106 planning obligations, LPAs have the right to put in place a Community Infrastructure Levy (**"CIL"**), a charge paid by new developments based on the area, type and scale of development. The CIL must be charged based on a "charging schedule" created by the LPA. While the CIL itself represents a predictable cost for a development in a given LPA, developers are still subject to varied Section 106 obligations in each instance. Planning obligations negotiated in better economic conditions can further reduce the viability of projects during a market correction. If a developer is unable to renegotiate these terms, the project is likely to stall and planning consent can eventually lapse if development is not begun within the three-year window.

Example: Change of Use Between Agricultural and Residential

Navigating this array of planning rules and legal rights makes obtaining a buildable planning permission in the U.K. a particularly complicated and time-intensive proposition. By way of illustration, we will use one example of a full change of use from land to residential consent.

CFP is aware of a 180-acre greenfield site on the edge of a major U.K. town which began the process of planning promotion in 2002 by lobbying to obtain an allocation in the Council's Local Plan for a residential development of 500 houses and a school. It all seemed relatively innocuous to us – who wouldn't want a free school for the local community plus 500 good quality single-family homes in a London commuter location?

Since 2002, the Council has consulted on three proposed Local Plans, however two of these (which were consulted on for a total of eight years) were never adopted due to objections by neighboring local authorities on various grounds. Only in 2010 did the Council propose a third Local Plan and the site in question received a draft allocation for the residential development which enabled the sponsor to begin design and subsequently apply for a full planning consent. However, this Local Plan was also rejected in 2015 because neighbouring local authorities claimed that it had not appropriately considered the impact on their Local Plans.

At this point, the Council encouraged the sponsor to enter into a Planning Performance Agreement (**"PPA"**) to bring forward the site with a planning application based on an argument that the Council would need this site to fulfill its intended five-year housing supply need. This PPA sets out the parameters, reports and surveys required as well as the time frame for the site to achieve a consent. It took the sponsors nine months to agree this document and a further 15 months to submit the application (at significant expense) due to the process and overall lack of Council responsiveness. The application is due for determination by planning committee in September this year, 15 years from the initial lobbying date for planning allocation. Further, assuming consent is granted it should take at least two years for the first units to be completed on the site due to the onerous Section 106 conditions and required CIL attached to the consent. In total, it will have taken 20 years to get London commuter belt housing approved, and all in the midst of a national cry for housing due to a perceived crisis over affordability and availability.

This example clearly has some idiosyncrasies but is not entirely unusual. The spectrum of planning risk generally lies in the scale of the change of use (in this case Agricultural to Residential is a complex change), the type of local authority (some councils can be less difficult and more responsive than others) and the complexity of the work involved (less contentious work involves primarily internal refurbishments within an envelope, while more extensive or visible works like ground up development require more consideration).

Where Does the Opportunity Set Lie?

As we have set out above, there are a range of risks to consider relating to the nature of planning consents, and the timing uncertainty and likelihood of success in light of these risks must be considered for each project. Entering into a short lifespan transaction that is heavily reliant on gaining planning consent as the driver of returns presents considerable downside risk unless the case in which planning consent is not obtained is still defensible.

However, given the time commitment and the equity investment required in order to obtain a buildable consent, it is possible to structure certain transactions where the initial equity outlay is small relative to the overall transaction size once the consent is obtained. Effectively options, these can be created to purchase a designed, buildable site at a given price only once consent is achieved. Given the small initial equity requirement, the time required, the specialist experience needed, and a lack of development finance until the project is consented, designed and construction is priced, we find that some of these transactions have a limited set of potential buyers and are significantly underpriced. If appropriately structured, these allow access to larger development projects at a highly attractive land basis with minimal equity outlay prior to consent. Here consideration must be paid to both the anticipated equity deployment timeline and the ability to recoup equity if planning is not achieved. The exit strategy post planning consent is important and in our experience it is necessary to analyze any transaction on the basis that one would develop the project upon gaining buildable consent as a base case driver of returns.

The relatively recent introduction of Permitted Development Rights legislation is also important. In areas where the value of exercising Permitted Development Rights is high (for

example cities that have high residential values versus office values), large amounts of space can be converted to a new use, thereby creating a supply shortfall in the prior use type. For example we have identified this dynamic playing out in Bristol where residential values are significantly higher than office, which caused a considerable amount of space to be taken out of the office market and converted to residential through Permitted Development Rights. This exacerbated the supply shortfall in an already supply-constrained office market while limiting the universe of potentially competitive buildings that could be refurbished quickly to return supply to the market in the near future, thereby providing strong tailwinds for our Bristol office refurbishment projects.

More broadly, we see certain trends such as changing demographics, increased in-migration and urbanization creating longer term surges of demand for particular types of real estate. However, the supply of relevant real estate typically fails to respond to the speed and level of demand, creating eventual upward momentum on pricing. We believe the nature of the U.K. planning system means these shortfalls should develop time and time again. Eventually shortfalls may be rectified once the perception of a crisis causes responses such as direct and large-scale government intervention, enforced amendments to Local Plans that specify creation of a particular product or loosening of formal (or perceptual) restrictions by councils. A recent example of this easing is the increased acceptance of skyscrapers (outside of Canary Wharf) by a number of LPAs in London as an appropriate part of the London skyline. Of course, easing of specific planning restrictions can lead to its own set of issues down the road. Although LPAs generally relaxed the supply constraints to high rise office building, many developers still proceeded with these developments because they were still operating within the old paradigm that perceived a structural limit on new supply. The failure of developers to recognize an easing of longer term office supply constraints in central London may now be creating a market with too much office space.

From our thematic perspective therefore, we can look at transactions within submarkets that are fundamentally supply-constrained due to the failure of the planning system to react to changes in demand in the short to medium term, while being ready to move the other way if we see planning constraints loosen. While all transactions need to be defensible on their own, we keep in mind the potential upside impacts created by these supply lags, or conversely the risks of entering into a “popular” asset class that has historically been supply-constrained but is no longer going forward.

I am going to stop here at risk of running long, but we hope you have found this an informative note, and please feel free to be in touch if you would like to discuss anything in more detail with our team. Meanwhile for those of you who would like a market update, please give us a ring at any time and look out for the next letter. Mike and I wish you all a wonderful summer and look forward to speaking with you in the near future.

Best Regards,

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Brandon Hollihan