AGENDA ITEM 5

CRAVEN
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DISTRICT

Asset Based Income Streams

Report of the Select Committee

Policy Committee

22 July 2014

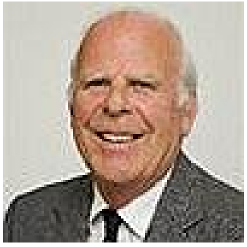
FOREWORD

On behalf of the Select Committee I am pleased to present this report.

The Council's long term financial strategy indicates that income to support services and priorities will continue to remain under pressure. It is in a position whereby it needs to consider means of maximising or deriving where possible a return on its assets, and establishing new income streams. Developing asset based income streams presents one such opportunity which the Committee was pleased to scrutinise.

It is with some regret that for reasons explained within this report that the Committee has only reached an in principle view as there are many as yet unanswered questions particularly with regard to issues of finance and governance. The Committee remains available to consider any or all outstanding issues should that be the wish of Policy Committee or Council.

The Committee is appreciative of the support provided by David Smurthwaite, Strategic Manager for Planning and Regeneration and Jenny Wood, Affordable Housing Development Officer.



Councillor John Roberts,
Chairman, Select Committee.

1 Introduction

At the meeting of Policy Committee held on 11th February 2014 Members' attention was drawn to work undertaken by Daventry District Council in using its assets and capital to develop new income streams, in particular the building of homes to rent in the private sector market. It was subsequently agreed that Select Committee would conduct a review of the potential for this Council using the same powers under the Localism Act to progress a similar initiative(s).

The Localism Act contains a number of proposals to give local authorities new freedoms and flexibility including a 'general power of competence' which gives a Council the legal capacity to do anything that an individual can do that is not specifically prohibited. In effect the new, general power gives councils more freedom to work together with others in new ways to drive down costs and gives them increased freedom to do creative and innovative things.

On 12th March 2014, the Committee met to progress its review.

2 Consideration of the Issues

Having received a presentation summarising

a. why it would be appropriate for the Council to consider developing a new asset base to generate income.
b. the experience and approach taken by Daventry District Council, and
c. the range of asset based projects undertaken by other local authorities, including land banking, building hotels, industrial units, houses and multi storey car parks.

the Committee identified the key elements and areas of risk as being the financial and legal implications / arrangements associated with the proposed delivery model, namely a third party company, means of resourcing and governance arrangements.

Outline business cases for each of the following asset based initiatives, including an indication of potential viability and return were considered. Where possible the scenarios were based on actual local purchase prices and rental costs, or where necessary national guideline build costs.

- **Buy empty homes for market rent** : buy empty homes to provide a strong and diverse portfolio that generates rental income.

- **Buy empty homes for intermediate rent** : purchase empty homes on the open market and rent for 80% of market rent without the requirement to nominate so possible to target newly formed households.

- **Buy empty houses for shared equity** : purchase empty homes using commuted sums, 50% stake then sold to a purchaser who pays a small rent on the unsold equity.

- **Build new homes for intermediate rent** : build homes to rent for 80% of market rent without requirement to nominate, so it is possible to target newly forming households.

- **Build new homes for market rent (large sites)** : build houses on own large sites to rent to private sector tenants.

- **Build new homes for market rent (small sites)** : build houses on own land and then rent to private sector tenants.

- **Acquire Section106 affordable homes (shared ownership houses)** : transfer Section 106 shared equity affordable houses from developers to the Council; 50% stake sold to a purchaser who pays a rent on the unsold equity.

- **Shops** : buy or develop retail units with flats across Craven.

- **Decked car park** : additional car parking by decking with retail wrapped around.

In considering which option or options may be most appropriate for the Council to pursue at this time, if any, the following points were made which may be of relevance to Policy Committee's future deliberations

i. It was not currently possible to use both grant assistance and commuted sums to build new homes, but it was understood the ability to do so was under consideration.

ii. There was no requirement to provide affordable housing if smaller sites were developed.

iii. The number of homes across the District known to be empty for more than six months totalled 160, generally speaking registered social landlords were not interested in acquiring empty homes, but there could be potential if applying market rents.

iv. The possible use of commuted sums was a concern as to do so would take funding away from another part of the housing sector and was it appropriate for the Council to take advantage of commuted monies in this way.

v. It was a complex subject, external advice / input from relevant external parties, would be helpful, as would financial and legal advice.

vi. It was questionable whether the Council had all the necessary expertise in house and as such it may be wise to start with a small development and then make an assessment on how to move forward, perhaps the Council's staff could be trained as necessary. If a larger site was to be developed / the Council established a larger asset base / portfolio would additional staff be required.

vii. There were a lot of issues to consider, for example who would manage the assets and the cost of management in-house compared to external.

viii. Renovating and maintaining older property could be expensive, new build may be preferable, although in areas where it was difficult to build such as the Dales, acquiring property may help to provide sustainable homes in those areas.

ix. Clarity on costs and tax implications would be required, the figures presented in respect of each of the above options did not include finance or long term maintenance costs / estimates. A fund for maintenance would need to be established from the outset.

x. If the Council was to develop its own property, consideration should be given to taking advantage of feed-in tariffs from solar panels.

xi. There would be little risk in developing a small site, if rental became problematic the dwellings could be sold.

xii. A smaller development could probably be funded from within the Council's existing reserves, whereas a development of perhaps ten units would require borrowing.

xiii. The Council could simply build house for sale, ie rental based on a 5% return represented a 20 year payback period, whereas the sale of property increased the Council's capital position for reinvestment.

xiv. A mixed portfolio could be considered, for example, acquiring Section 106 affordable homes for intermediate rent as well as building to rent; 106 homes could be acquired significantly cheaper than building new.

xv. The Council currently had sites with planning consent and should consider taking advantage of one or more of those sites for build to rent.

Having concluded that there may be some merit in taking a stepped approach commencing with small scale development, the Strategic Manager for Planning and Regeneration was asked to work up and present a model build to rent scheme based on development of a Council site for presentation to this Committee's next meeting; the model to include estimated development costs, return and projected rental income. A copy of the amended model discussed in the meeting is appended to this report at Appendix A. A briefing paper was also requested on Section 106 Shared Equity Homes. A copy of the briefing paper is attached at Appendix B.

Building Homes for Rent : Using Building Cost Information Service (BCIS) cost estimates, excluding the value of the land, total development and build costs for a pair of semi-detached houses in Craven would cost an estimated sum of £207,650. When using the BCIS estimates for a site of more than 15 houses the costs fell dramatically from £1,230 per sq metres to only £1061 per sq metres, however developing larger sites was significantly more complex. .After taking account of costs associated with management, maintenance and voids the estimated net operating profit on two dwellings would start at £10,600 per annum. Over a 25 year period it was estimated that the build to rent model for two dwellings would be expected to achieve up to £112,000 greater value in income and asset value when compared to investment return based on an average interest rate of 3%.

From discussions with locally based estate agents the Committee was advised that there is a demand across the District for two to three bedroom houses, although within rural parts demand was lower the further a location is from amenities. Approximate rental income on a three bedroom house ranged from £500 to £650 per calendar month.

Section 106 Shared Equity Homes : Under current planning policy, all new housing sites of five dwellings and above must include an element of affordable housing, currently 40%, subject to financial viability, with 75% of that figure being for affordable rental and 25% for intermediate sale or rent, otherwise known as shared ownership housing. On completion, affordable homes built by private developers were sold to one of the Council's housing association partners at approved prices substantially less than market value. So far as possible all partners were offered an equal share of Section 106 houses with sites 'allocated' on a rota basis, taking account of the location of existing stock, financial capacity and development programmes. If the Council was minded to adopt this approach it could participate in the rota arrangement without the need to establish a housing revenue account, provided it acquired no more than 50 rented or 100 shared ownership houses. The Affordable Housing Development Officer advised that the Council should focus on urban shared ownership property for sale not intermediate rental units.

By way of example, a new build affordable two bed house of 70 sq.m could be bought by the Council from a developer at £66,500, representing 42% of market value. Retaining the freehold, the property could then be sold at the same price to a first time buyer who would then pay 2.75% rent (£214 per month) on the unsold equity (£93,500) to the Council. The Council retained the 58% of the equity in the house which appreciated or depreciated according to the prevailing market conditions with the occupier having the right to buy further shares of the house at market value until it was owned outright.

The ability to transfer Section 106 property purchased by the Council to a third party company would need to be established.

3 Outstanding Issues

Workloads and competing pressures within the finance and legal services teams has meant that the Committee has not progressed its review to a satisfactory conclusion in terms of the the financial and legal implications associated with the possible adoption of a housing based approach to generating new streams of revenue generation. This should not be seen as a criticism of either service area, simply a product of the time in the municipal and financial years and related work commitments.

Having heard that advice may not be available before September 2014 Committee Members were concerned that, should this Committee seek the necessary legal and financial advice before submitting its findings to Policy Committee, Council may not be in a position to reach a decision until the end of the Autumn cycle. To facilitate an earlier decision by Council it was concluded that the Committee should reach an in principle view, and advise Policy Committee to satisfy itself as to all relevant financial, legal and governance issues. An indication as to some of the numerous questions and issues on which the Committee would have been seeking to satisfy itself or form a view are listed within Pages 5 and 6 above, others would have included the following

- Is a third party company the best delivery model available to the Council and if yes

    a. How should it be made up ie structure and Council representation.
    b. What governance arrangements would be put in place.

c. What control would the Council have ie how autonomous.
d. What would the liability be, if any, of those appointed to it.
e. Should external persons with appropriate skills be appointed to the board?

- the acquisition by the Council of Section 106 Agreement properties built by developers as a requirement of a planning consent raises a question as to the roles of members serving on the Policy and Planning Committee and whether members of Policy Committee should continue sit on planning committee ie would there be an actual or perceived conflict between the two roles?

- what is the vision, if any, as to the size of the portfolio the Council is seeking to establish and what would be the mechanism for agreeing to acquire Section 106 Agreement properties under the rota system, by a decision of Policy Committee on each occasion or under some form delegated authority?

4 Conclusion and Recommendations

There is a need given the financial climate in which local government now finds itself for the Council to seek new and possibly innovative ways of generating revenue to support the budget and longer term financial strategy. Using assets to generate new revenue streams has been successfully applied by a number of Councils. Whilst recognising that those Council's may well be structured differently and have greater capacity in terms of resources, both human and financial, there appears to be no reason in principle why this Council should not be able to pursue a similar strategy. There is a question mark as to how representative small schemes are in terms of the issues that could be encountered in developing larger sites and managing a larger property portfolio, however, adopting a relatively cautious approach in the first instance should mean that the exposure to any significant risks would be low. Whilst in the first instance it is felt Council should pursue a housing based approach, the mind should not be closed to other alternative means of using the Council's assets to generate additional income. It is recommended that

(1) In principle Policy Committee progress a housing based approach to revenue generation by acquiring Section 106 Affordable Homes for intermediate sale and utilising existing Council assets to build four or less houses per site for market rent.

(2) That, the recommendation at (1) above is subject to Policy Committee being satisfied on the financial and legal implications / arrangements associated with the delivery model, namely a third party company, means of resourcing and governance arrangements.

(3) That, bearing in mind the greater complexity that would be involved in developing larger sites, Policy Committee is advised that greater scrutiny will be required should it be minded to consider that scale of development(s).

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Appendix A

Build to Rent Model
Outline Business Case

Introduction

This paper looks at the business case behind the building and renting out of two houses on Burnroyd Drive, Glusburn. The site is in Craven Dc's ownership and has outline planning permission. The business case looks at the costs of building the houses, the rental income and management and maintenance costs over a 25 year period. Also the paper looks at the possible value of the asset after 25 years and finally a comparison between of the build to rent model and placing the start- up funding in a long term high interest savings account.

Build Costs

Using the BCIS cost estimates to build a pair of semi-detached houses in Craven would be approximately £1230 per m2, so two 80 m2 three bedroom houses would equate to £196,000. Once the architects fees and permissions are included the estimated cost to build the houses would be almost £208,000.

Cost Items	£
Architects fees	£6,000
Surveys	£3,000
Build Costs	£196,800
Planning permission	£770
Building regulations	£1,080
Total build costs	£207,650

In is interesting to note that when using the BCIS estimates for a site of more than 15 houses the costs would fall from £1,230 per m2 to only £1061 per m2. For a three bedroom semi-detached house this is a saving of £13,500 per house. Clear the more houses on a site the further the overheads can be shared between the houses so a large terrace would be cheaper per m2 than a short terrace.

Different design types and scale would cost:

One off pair of semis	£1230 per m2
Estate housing	£1061 per m2
Flats/apartments	£1274 per m2
Terraced housing	£1076 per m2

Value of the Assets

Current forecasts for house price change outside of London and the South East is 5.8% per year but longer term (5 years) forecasts vary for Yorkshire from 4% to 5% per year. In order to be cautious we have used +3% as the average annual change in value. This takes the original value of a three bedroom semi-detached house in Glusburn at £150,000 to an eventual value of £305,000 over a 25 year period. It is important to note that this does not take into account the effects of inflation.

Year	Value of asset (3% annual appreciation)
2015	300000
2020	347782
2025	403175
2030	467390
2035	541833
2039	609838

Rental income

Following discussions with local agents and reviewing the rentals on Rightmove.co.uk a monthly rental of £600 is appropriate. In order to reflect the change in rental prices we have increased rental income by forecast inflation (2% pa) although currently rents appear to be rising by 7% pa outside of London. Over the 25 year period it is estimated that £461,000 of rental income will be received.

One caution is that the further into the future the assumptions go, the greater risk there is in predicting future rents and costs and if carrying out a formal valuation then the rental income in the far future would be regarded as less valuable.

Year	Rent	
	Monthly	Annual
2015	£1200	£14400
2020	£1325	£15899
2025	£1463	£17554
2030	£1615	£19381
2035	£1783	£21398
2039	£1930	£23161
Total (25 years)		£461,236

When accounting for potential void rates at 1 month per year the income over 25 years would reduce to £424,337

Management and Maintenance Costs

Maintenance costs – the costs of maintenance are calculated at £750 per year and then increased each year by 2% to cover inflation.

Management costs – the management costs are calculated at 8% of the rental income. This is an appropriate benchmark as it is using private sector rates as a comparison. The actual management model has not been considered at this stage but there will be clearly a cost that needs to be considered.

After taking into account management and maintenance costs the net operating profit after voids on the two dwellings would start at an estimated £10,600 pa.

It will also be necessary to carry out a mid-life refurbishment of the properties which has been assumed to be £20,000 per dwelling.

Year	Maintenance	Management	Total
2015	£1500	£1152	£2652
2020	£1656	£1272	£2928
2025	£1828	£1404	£3233
2030	£2019	£1550	£3569
2035	£2229	£1712	£3941
2039	£2413	£1853	£4266
Total 25 years	£48,045	£36,899	£84,944

Investment Test

It is important to compare the financial outcomes of the model with a comparison of investing the build costs into long term savings account to understand if the business model is financially beneficial. The table below adds the net rental income and the asset value after 25 years minus the build costs to understand the full value of the development. In comparison three scenarios are used to assess the value of an investment after 25 years if a sum equivalent to the build costs plus land value (£257,650) is placed into long term savings. The three scenarios assume interest rates at 1%, 3% and 5%. To better understand the realism of the three scenarios currently the 12 months savings rate from Barclays for Craven DC is 0.91%.

Taking an average interest rate at 3% the build to rent model would be expected to achieve £112,000 greater value in asset value and income over the final lump sum achieved from making the investment for 25 years.

Comparison between income and capital value versus investment rates		
Build To Rent Model		
Net rental income		339,393
Refurbishment		- 40,000
Land value		- 50,000
Asset value (2039)		609,838
Build cost		- 207,650
Value and income (25 years)		651,581
Investment test		
Initial investment		257,650
Av. 1% pa interest rate	0.01	330,419
Av. 3% pa interest rate	0.03	539,462
Av. 5% pa interest rate	0.05	872,494

It is important to note that the value to the average investor is not worth more than the current capital value; any investor will only pay “one bid above” anyone else. However, value to an investor is not necessarily the same as value to the Council e.g. long term income stream, so the value in the table above is the value to the Council not the value to the market.

Appendix B

MIXED TENURE DEVELOPMENTS DISCUSSION PAPER

THE POTENTIAL FOR THE COUNCIL TO BUY NEW BUILD AFFORDABLE HOMES

SUMMARY

It is possible for the Council to buy new affordable homes built by private developers on mixed tenure sites, for less than build cost. The sale of these homes to affordable housing providers is a requirement of planning policy on sites of 5 dwellings and above, with homes available to buy at £900 - £1,000 per m2. These homes are then rented to local people at subsidised rents or sold on a shared ownership basis. To date, private developers have sold them to housing association partners. There is no reason however, why the Council should not buy some of these homes itself to make available as affordable housing, in accordance with the National Planning Policy Framework definition. This could be accommodated within existing arrangements with housing association partners (summarised below).

Background

Under current planning policy, all new housing sites of 5 dwellings and above must include an element of affordable housing. These are called s106 sites. The Council's target is currently 40%, subject to financial viability. Affordable homes are built by private developers and sold on completion to one of the Council's housing association partners at approved prices. Size and quality standards apply.

The SHMA 2011 identifies a shortfall of 218 affordable homes per year in Craven. The need is mostly for good sized 1-bed and 2-bed homes; with 75% being affordable rented and 25% for intermediate sale or rent. Intermediate homes are typically for local working households who cannot afford market housing. They can either be for sale (shared ownership) or for rent, at a maximum of 80% of market rents. A local authority can own 100 shared ownership houses, or 50 rented ones, without the need to establish a HRA.

Existing Housing Association Partnering Arrangements

The Council works closely with its partner associations to ensure that good quality affordable housing is delivered in a cost effective way. Approved transfer prices mean that sites are not touted round by developers; avoiding abortive work and maximising affordable housing without unnecessary cost to the public purse. Transfer prices also give certainty to developers and minimise risk. The same process operates in Harrogate.

The Council tries to make sure that all partners are offered an equal share of s106 sites, with sites 'allocated' on a rota basis, taking account of the location of existing stock, financial capacity and development programmes. Recently, the number of s106 opportunities across Craven and Harrogate has escalated as increases in permissions across both districts have meant that many more affordable homes are in the offing.

In April 2014 an indicative total of 1202 affordable homes on s106 sites across Craven and Harrogate were allocated to the ten housing association partners operating in one or both areas. Of these, 383 have planning permission, with 105 (Harrogate) subject to appeal. The rest are planning applications, the majority on a few large draft site allocations in Harrogate and therefore expected to be approved.

These sites have recently been allocated to partners so that they can work up development programmes and set resources aside. All are aware that the timing of development is not within the control of the Council and that the forecast number of affordable homes could reduce if viability challenges are made by private developers.

Proposal

It is proposed that all Craven sites available for allocation from 1 April 2014 be distributed amongst association partners as currently, but with the inclusion of the Council in future. RP partners are aware and have made no objection.

Initially, it is proposed that the Council consider acquiring affordable homes for intermediate sale (shared ownership) only. This is because a local authority can only grant secure tenancies for rented housing. With that comes the Right to Buy, which means that significant discounts will apply to market value if the property is sold. The affordable home will be lost with limited proceeds having to be used to provide replacement affordable housing.

Although purchasers of shared ownership housing may buy further 'tranches' until they own it outright, this must be at full market value. This means there should be sufficient funding from the sale of a shared ownership dwelling to be able to replace it. Until and unless that happens, the purchaser will pay a subsidised rent on the unsold equity.

Normally 25% of the affordable housing proposed on qualifying sites will be shared ownership or intermediate rent.

Approach 1 - Example
A new build 2 bed house of 70 m2 is bought by an RP/CDC at £66,500. The RP/CDC retains the freehold and sells the property at the same price to a first time buyer. This represents 42% of market value (£160,000). The purchaser pays 2.75% rent on the unsold equity (£93,500) to the RP/CDC. This equates to £214 per month or £2,568 per year. The RP/CDC would therefore retain the 58% of the equity in the house which will appreciate or depreciate according to the prevailing market conditions. The occupier can buy further shares of the house (at market value), until it is owned outright.

Approach 2 - Example
A new build 2 bed house of 70 m2 is built by the developer who then sells a share in the equity equal to the transfer price (£66,500) to a first time buyer. This represents 42% of market value (£160,000). The developer then transfers the remaining equity to an RP/CDC to whom the first time buyer pays 2.75% rent on the unsold equity (£93,500).This equates to £214 per month or £2,568 per year. The RP/CDC would therefore retain the 58% of the equity in the house which will appreciate or depreciate according to the prevailing market conditions. This approach would not require any up front funding. The occupier can buy further shares of the house (at market value), until it is owned outright.

Legislative Background

Legal issues regarding the powers to act and the establishment of a company will be dealt with in a report to Select Committee in July.

Finance

Using the above Approach 1, the RP/CDC will require upfront funding of £66,500 per unit until 42% of the equity in the dwelling can be sold. Therefore the funding requirements are short term and fully recoverable. As the purchase costs are at a fixed price the RP/CDC does not carry any risks of cost overruns etc. There are a number of financing options that will be considered more fully at the July Select Committee.

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