Appendix A

Sutton Living Limited

Review of Business Plan Assumptions

Sutton Shareholdings Board

4th January 2017

Review of Business Plan Assumptions Sutton Living Limited

1.0. Summary

1.1 In February 2016, the Sutton Shareholdings Board agreed a Revised Business Plan which set out a number of development assumptions relating to rents, the development process, and rates of return. The intention is that these assumptions will be reviewed annually in association with a review of the company's business plan

1.2 It is proposed to undertake a two stage review in 2017, firstly, to review the business plan assumptions, which is the subject of this report, and secondly, to review the Sutton Living Business Plan for the 8th March meeting of the Sutton Shareholdings Board.

1.3 This report recommends a streamlining of the development assumptions used in order to concentrate on key areas relating to scheme viability, and use industry accepted standards to avoid the need of the Shareholding Board's approval of individual assumptions each year to ensure the company remains competitive and responsive in the market place.

2.0 Background to February 2016 report

2.1 The assumptions are set in para. 3 onwards in this report and summarised in Appendix 1

2.2 The Business Plan Model assumed the delivery of 250 dwellings specifying the numbers to be market sales, market rent, affordable rent and shared ownership. The Business Plan itself assumed 225 dwellings in ownership after market sales through development of Council and privately purchased land as well as "off the shelf" acquisitions from private developers. Each development opportunity would be the subject of a development appraisal seeking set returns. It was assumed that some of the appraisals would have negative outcomes but that schemes in total would balance or outweigh any negative ones so creating an internal subsidy for future developments.

2.3 It was recognised that operating a development company was a high risk operation and that a risk register would accompany each project and a programme register would be reported regularly to the OSL Board and Sutton Shareholdings Board. An update in the Programme Risk Register will be reported to 8th March meeting of the Sutton Shareholdings Board.

2.4 The starting point for the Business Plan were the financial assumptions prepared by Grant Thornton using illustrative schemes and various funding assumptions. These are set out as the "Core Assumptions". It should be noted that as Sutton Living Limited is 100% owned by the Council the company will be funded by the Council from its own borrowing and other resources. The Council's own funding assumptions are not considered as part of this report but similarly require annual review.

3.0 Core Assumptions

3.1 These were set having regard to prevailing market conditions and industry wide norms, although further consideration has been that these are too specific and should be more generic;

(i) Opening year of the model – year 1 being 2015/16, and for a term of 50 years based on cash flows (including initial 5 year development period). This might imply that, taking away the initial development period, a scheme has to repay between 45-50 years. Normally the appraisal model would have an initial development period followed by a timescale during which the scheme is expected to repay. A repayment period of around 50 years would equate to the norm for many Registered Providers (RPs or Housing Associations) with the assumption that several schemes would payback in a shorter period so allowing for some strategic important projects to take a take slightly longer assumed to be in line with the CPI, they were assumed to cancel each other period (noting para.2.1 above).

(ii) Inflation – the Model currently assumes 2% based upon the Consumer Price index (CPI). It is proposed that this figure will be reviewed annually, as will the impact on those on how rents are set.

(iii) Real growth –where all increases/decreases in costs and income are excluded, except if rents and service charges were for example assumed to increase say 1% above the rate of inflation as this would have the effect of improving scheme viability over time. The level of rents charged has to reflect local market conditions (and these should be established at both borough level and individual post codes). The effect of the recently announced London Living Rent, and the difference between this and the Local Housing Allowance, will need to be considered as part of the affordable element of schemes.

(iv) Property growth – the Model assumed property inflation at 3% (CPI+1%), and was assumed only to have a positive impact on the cash flow on future stair-casing of shared ownership sales. This property inflation figure is an under-estimate of current house price inflation in Sutton (in the 12 month period from September 2015 to September 2016 the average selling price of property increased by 13% - *Source* home.co.uk/guide house prices –Sutton). Property price inflation can have a positive impact on scheme viability, for instance, where retained rental properties increase in value over time, they provide the option of introducing or increasing sales to reduce the loan, or allow an existing loan to be re-negotiated. It is proposed that the development model should allow for at least a 3% property growth on all units (a figure to be reviewed annually at Borough and post code level) with a *five yearly* review on each developed scheme where appropriate to test current scheme viability levels.

(v) Voids/bad debts – this was assumed at 4% for affordable rent and shared ownership and 6% for market rented. The figure for market rent is unduly pessimistic and it is important that Sutton Living and its agents see itself as a commercial operation minimising voids, bad debts and rent loss. It is therefore proposed to use a standard figure of 4%. The figure set for following years schemes could be based on the current year's performance, thus giving an incentive to minimise this figure otherwise it will impact on scheme viability

(vi) Management & maintenance costs - these were assumed as £1100 per dwelling for affordable and market rent, and £500 per shared ownership dwelling. This is now likely to be an underestimate of costs which could be in the order of £1000 for management costs and £600 for maintenance, but actual management costs would be agreed with the managing agent prior to letting, and these would be applied to new schemes probably in the form of a letting fee. Rather than set a defined figure, it is proposed to cap these for business planning purposes at £2000 for both and if actual costs are greater than this, the Shareholdings Board will be provided with an explanation of why this figure has been exceeded

(vii) Lifecycle allowances – there is also currently an assumption of £1100 per dwelling for major elemental repairs and start in the 6 year after practical completion of the scheme (which is the RP norm). This also assumes that property defects insurance is also taken out before practical completion of the project. The actual rate of lifecycle allowances will depend on the dwelling size and an average rate would currently be in the region of £1222 per dwelling from year 6. In addition, a major repairs sinking fund would be put in place, and a sinking fund to replace individual items such as lifts. Items such as lift replacement will be charged to occupiers in the form of a service charge, so it is important to closely review the design of the scheme to ensure that capital replacement items are reduced to a minimum. In considering Lifecycle and other costs the Shareholdings Board needs to be aware that provision has been put in place with an explanation of the rationale of the level of costs, rather than approve actual amounts set aside. A more detailed explanation will always be provided if these costs are greater than £2000 per annum.

(viii) Set up costs – an appropriate amount needs to be set aside for staffing, accommodation and other central overheads, and money to undertake feasibilities and project development at risk prior to individual project approval. This sum should also include an amount for abortive costs where schemes do not proceed.

(ix) Interest costs on borrowing – this is based on money lent by the Council through the Public Works Loan Board (PWLB) rate plus a margin to satisfy "State Aid rules". The margin needs to be high enough to avoid claims of "unfair" competition by competitors if loans are considered too cheap, but also to avoid charging too high a rate that this is at a level that a return greater than the market expectation is received by the Council. The rate of return needs also to reflect current market conditions and the position with appropriate comparators in the market.

4.0 Rent assumptions

4.1 Sutton Living will be striking a balance between providing homes for an appropriate range of tenures and being commercially viable.

4.2 The Council's new build programme seeks to develop housing for what was known as general needs rented housing including what is now defined in the recently published Mayor of London's Affordable Homes programme as affordable rent (which is defined by benchmarks to reflect the formula rent cap figures for social rents uprated by CPI for September 2016 plus one per cent) and London Living rent (or intermediate rent, ward-specific rent levels for London Living Rent homes based on one-third of median gross household income for the local borough. The level is based on the borough median, but varies by up to 20 per cent in line with house prices for the ward). It will also include some shared ownership in order to help scheme viability and give an opportunity for those to get on the property ladder who could not afford to buy outright.

4.3 Sutton Living's focus should be to provide market rented housing as well as intermediate rented housing in order to maintain commercial viability as well as seeking recognition of being a provider of good quality market housing and acting as a responsible landlord in the Borough. In order to be planning policy compliant the target for affordable provision would be that set out in local plan policy i.e. that 40% of the scheme should be affordable. However, for Sutton Living, affordable housing should focus on intermediate rent and shared ownership (where sales are considered), with the mix on each scheme dependent upon scheme viability appraisal.

4.4 Service charges will be included within the rent and be levied to fully recover costs.

4.5 Property ground rents are normally payable at nominal amounts (e.g. £100 pa) on leasehold schemes. Other Councils are reviewing ground rents and how these might be offered at a higher level, balanced by a lower acquisition figure as being more tax efficient. This will be reviewed and reported to the Shareholdings Board.

5.0 Development assumptions

5.1 The Business Plan of February 2016 gave cost assumptions for site acquisition and development costs for each dwelling. These figures will be a consequence of land values in the borough and build cost. Build cost will be determined by the works specification, form of contract and build and material cost inflation. For acquisition costs the market value will be defined by the RICs Red Book – Professional Standards – January 2014 Edition. For construction costs these will be based upon obtaining current building regulations approval, and minimum planning standards, using a form of building contract (e.g. JCT Design & Build or JCT Intermediate Form of Contract) as set out by the appointed cost consultant and employer's agent, and tested by competitive tender. The actual unit purchase and development cost will be reported annually for information. Similarly, the cost of refurbishing individual acquisitions will be reported annually.

5.2 A developer's profit should be added for each project where the development and disposal of assets in being considered and this would normally be set between 20 and 25% of total costs, depending upon the complexity of the scheme and perceived development and sales risk.

5.3 The developer's or Required Profit would be factored into the "Gross Development Value" (GDV) of the scheme and would determine the amount to be paid for the land where:

Amount available for land purchase=GDV- (Build/development cost + Fees+ Required Profit)

6.0 Sales assumptions

6.1 Initially sales may relate to shared ownership where a proportion of the property is sold. The Business Plan of February 2016 assumed a sale of 35% of the equity with the remaining 65% retained by Sutton Living. Shared ownership purchasers have to purchase the share they can afford which on average for affordable housing has been 35%. In addition to a capital receipt Sutton Living would also be able to charge rent on the "retained" equity of 2.75%. This is already factored into scheme income and will be the maximum amount charged. A small reduction may be considered on a scheme by scheme basis if this affects affordability.

6.2 Future sales of shared ownership tranches through "stair-casing" was assumed in the previous Business Plan as 1% of equity sold on average per property per year. Normally, no allowance is made for stair-casing in project appraisals. As with property growth a review of shared ownership stair-casing should be included as part of the five year review of the scheme.

6.3 No assumptions have been made for grant from the GLA. However, Sutton Living may consider registering as a Bidder for Grant through the GLA Affordable Homes Programme 2016-21.

7.0 Fees and other on-costs

7.1 The February Business Plan made an assumption that professional fees of up to 10% would be added to acquisition and construction costs, and a further development allowance of 6% to cover staff working on the project. This figure should also cover the cost of survey reports and planning fees. This sum should be viewed as a maximum figure, with ideally these combined costs be kept to 15% except for more complex projects.

7.2 A contingency of 3% was proposed to add to construction costs. A higher figure could be added upon the recommendation of the cost consultant for example to refurbishment costs which are more difficult to predict.

7.3 An additional cost of 1½% should be added for sales schemes to cover additional marketing costs and legal fees.

8.0 Tax

8.1 Stamp Duty Land Tax (SDLT), Corporation Tax and VAT will be charged as applicable. The amount of VAT payable on professional fees could be reduced if these fees were capitalised as part of the building contract. Conversely if the building contract was for refurbishment Vat would be payable on the works contract as well as professional fees

9.0 Financial Performance Measures

9.1 The Business Plan identified a range of methods to assess individual scheme viability. In addition to schemes obtaining a cumulative Internal Rate of Return (IRR) of 4%; a positive Net Present Value (NPV); and loan repayment within 50 years, six other potential measures of efficiency were listed:

- Profit On Cost (POC) ratio between scheme profit and development cost
- Profit on Value (POV) ratio scheme profit and total market value of the scheme
- Return On Equity (ROC) profit as a proportion of the equity capital invested in the scheme
- Return on Capital employed (ROCE) profit against combined equity and debt capital invested
- Rental Yield –gross and net yield
- Price to Earnings (PE) measure in commercial finance in relation to share value

9.2 Achievement of all these additional measures appear to put unnecessary requirements in terms of scheme efficiency and complexity beyond what a developer would normally be seeking and some (such as Price to Earnings) are not relevant to Sutton Living as an evaluation tool.

9.3 Consequently, in addition to IRR; a positive NPV, and loan repayment within an acceptable period, a developer’s profit of between 20 and 25% should be sought *before* a value is estimated for land acquisition. The acquisition price is a residual calculation worked from the Gross Development Value of the scheme

10.0 Conclusion

10.1 This report recommends the streamlining of development assumptions for the development of schemes by Sutton Living Limited, based upon agreed industry standards and actual projects, now that Sutton Living is more actively involved in the development process. The report does not discuss the funding assumptions used by the Council for Sutton Living, and these will separately need to be reviewed in order that Sutton Living remains competitive in the market place.

10.2 This report deals with the review of development assumptions. At the next meeting of the Sutton Shareholdings Board on 8th March, the Business Plan itself and Risk Register will be reviewed

11.0 Recommendation

11.1 This report is for noting

Mike Kirk
Managing Director Sutton Living Limited

Appendix 1 Summary of Business Plan Assumptions

Parameters	New Terms	Current Terms	Comments
Core Assumptions para.3.0			
Term of the Model	Unamended	50 Years (Year 1 2015/6)	
Scheme payback	Unamended	Within 50 years	
Inflation	To be reviewed annually linked to CPI	2%	
Real growth	1% above inflation	Consumer Prices Index	
Property Growth	3% in appraisals, five-yearly reviews for each developed scheme	3%	Property inflation figure is an under-estimate of current house price inflation in Sutton
Voids & Bad debts	4% for voids and bad debts	4% for affordable rent and shared ownership, 6% for market rent	A higher provision may be made for high rent schemes. More than 10% would be reported to the Shareholdings Board
Management costs	£1000 per dwelling	Management and maintenance costs assumed at £1100 for affordable and market rented housing, £600 for shared ownership	Review annually against actual scheme costs. Costs exceeding £2000 for management and maintenance to be explained to Shareholdings Board in further detail.
Managing Agent's Fee	An agreed sum to be paid to agents managing on behalf of SLL		To follow market rates and instead of a management cost
Maintenance costs	£600 average: but will vary according to unit size and whether units new build or refurbished	Management and maintenance costs assumed at £1100 for affordable and market rented housing, £600 for shared ownership	Review annually against actual scheme costs. Costs exceeding £2000 for management and maintenance to be explained to Shareholdings Board in further detail.
Lifecycle costs	£1222 average commencing year 6: will vary against unit	£1100 per dwelling from year 6	Monitor against actual costs. Costs exceeding £2000 to be explained to

Appendix A

	size. Usually 0.6% for new build and 0.8% for refurbishment		Shareholdings Board in further detail
Set up and fixed costs	No change proposed at present, but costs to be kept under review	£60k year 1, £50k p.a thereafter	Actual costs to be reported in annual business plan review
Interest costs	To reflect current market conditions		Actual rate charged to be reviewed on a scheme-by scheme basis
Rent assumptions para. 4.0	**New Terms**	**Current Terms**	**Comments**
Market rents	Review annually and set for each scheme using RICS accredited Valuer using local comparables	LHA level for Worcester Park (Outer South West Broad Rental Market Area)	Valuations to reflect unit size by post code
Affordable rents	To be linked to Mayor of London affordable rent benchmarks	80% of market rents for 1 bed flats, 69% for 2 bed flats, 66% for 3 bed flats	
London Living Rent (Intermediate Rent)	To be linked to Mayor of London's London Living Rents (ward-specific rent levels for London Living Rent homes based on one-third of median gross household income for the local borough. The level is based on the borough median, but varies by up to 20 per cent in line with house prices for the ward).		
Service charges	Those applicable to scheme and based on recovering expenditure	Service charges levied to recover costs	Service charges form part of the market rent
Property ground rent	May merit consideration to offer increased ground rent	Currently considered as nominal	To be reviewed (see para. 4.5)

	and lower acquisition figure as being more tax efficient		
Development assumptions para. 5			
Acquisition land/buildings	Based on RICs Red Book	Various estimates made based on local knowledge and research	
Build cost and build cost inflation	Based on BCIS and cost consultant review of relevant tender prices	Construction costs based on market intelligence (@Feb 15, £115k to £140k per dwelling)	Costs of refurbishment of individual acquisitions to be kept under review and reported annually to Shareholdings Board
Developer's profit	Target between 20-25% of total costs depending upon scheme risk	No specific assumption made	May not be applicable where all units are retained in management
Establishing scheme profit	Residual from scheme GDV		
Business Plan parameters	**New terms**	**Current Terms**	**Comments**
Sales Assumptions	Market sales based on RICs valuation	Estimates based on local knowledge and research	Sales estimate valid three months
Shared equity	No change	Shared ownership assumes average initial tranche of 35%	Current stair-casing assumption 1% additional equity sold each year
Rent on retained equity	No change on maximum amount applied	2.75%	Balance to be achieved with affordability
Grant from GLA	No change currently – but note comment in para.6.3	No assumptions on receipt of grant in current Business Plan	Reviewing bid documents for GLA Affordable Homes Programme to decide whether to become a registered provider
Fees & other on-costs para 7.0			
Fees and allowance	15% for professional fees and SLL development allowance	10% fees, 6% SLL development allowance	Additional fee of 1½ % for marketing in schemes with outright/shared ownership

Appendix A

Works contingency	To reflect works risk and should be in the range of 5% to 10%	3%	Retained by client so not added to the contractor's contract sum. May be higher in more complex schemes
Tax para 8.0			
VAT	To be charged on all fees, and refurbishment works costs	Costs liable for VAT quoted inclusive of this	Awareness of different rates e.g. refurbishment where there is a change of use from commercial to residential is a lower rate
SDLT	Allowance to be made for SDLT where applicable	SDLT built in based on current thresholds	
Financial Performance para 9.0			
Internal Rate of Return (IRR)	Schemes cumulatively to achieve 4%	Schemes cumulatively to achieve 4%	
Net Present Value	Scheme to achieve +NPV	NPV referenced as part of assessment process	Where evaluating multiple projects NPV can be used to prioritise one scheme over another
Repayment of loan	No change	Within 50 years	Standard assumption

This page is intentionally left blank