



## **Appendix 1**

### **Sutton Living Limited Interim Review of the Business Plan May 2019**

**Report by the Managing Director  
Sutton Shareholdings Board Meeting 1<sup>st</sup> May 2019**

## 1.0 Executive Summary

- 1.1 Sutton Living Limited (SLL) is now in its fourth year of operation and while much preparatory work has been undertaken, the Company has still to enter its development phase with the start on site of its first major scheme, Wallington Public Hall. It has appointed staff with more experience of commercial development and adopted appraisal tools and bought in development finance experience in order to focus on more viable developments. Uncertainty from the Council on funding projects still remain and this is a result of developing schemes that require long-term funding with no immediate prospect on return on Council investment, albeit they do increase the long-term assets for the Council. The conclusion is consideration of a mixed programme of encouraging asset growth by developing and retaining units for private and intermediate rent and a sales programme promoting both affordable and open market sales and using the receipts to reduce the Company's debt.
- 1.2 The Company and Council has agreed to an external review of its objectives and financing, and this will feed into a full update of the Business Plan in September. This report is an interim review.
- 1.3 It is hoped that this review and the start on site for Wallington Public Hall can be used to re-launch the company within the Council and form a clearer understanding of the Company and its objectives.

## 2.0 Goals for 2019/20

- 2.1 The following Goals are proposed for 2019/20

(1) Forge a clearer understanding and agreement of the Company's aims and objectives

By holding a seminar with key stakeholders within the Council following the external review of the Company's aims and business planning objectives.

(2) Development & Procurement

Rebalance SLL's future programme by undertaking a development for sales programme covering both outright and affordable sales to enable income to reduce the funding deficit of the Company.

(3) Draw up a three-year development programme with the aim of achieving a surplus in 2021/22

The identification of sites, securing purchase and planning will take a minimum of 18 months and development at sales at least another 18 months before surpluses are realised. Further income could be obtained by securing grant aid from the GLA to develop schemes for affordable rent and then selling these units onto the Council to manage long-term.

(4) Secure progress for a range of development projects

A start on site for Wallington Public Hall site; planning consent and start on site for Alexandra Gardens; and agreement to purchase and letting of building contracts for the Old Rectory, and The Grove.

(5) To draw up future management and maintenance strategies to put in place for completed projects

Schemes will be delivered in the next 18 months and management arrangements need to be agreed before that date in order that they are ready to be implemented prior to completion of letting of private units that will need to be marketed at least 6 months prior to completion.

(6) Put together a list of projects to match sale units with numbers of affordable and market rent in order to balance the existing programme

This requires the identification of a minimum programme of 80 units in 2019/20.

(7) Continue to work to secure the position of Sutton Living as the preferred development partner in the Council's Estate's Regeneration Programme

This remains a long-term goal of Sutton Living, but it is unlikely to generate any significant income for at least the next three years, other than developing off-site affordable and sales opportunities for existing estate residents. Consequently, expenditure short-term has to be limited to avoid building up more accumulated debt.

(8) Future funding

To continue to investigate access to private funding and private site opportunities to augment the development programme and bring additional investment into the Borough. These goals will be challenging to fulfil until the Company has built up a development track record, and is involved in projects of sufficient scale to be attractive to external funding. The Council would need to support such moves as the sole shareholder.

(9) Publicity and Marketing

To continue to develop the web-site as schemes progress, and use the start on site for a relaunch of Sutton Living linked to (1) above

(10) Governance

To appoint non-executive directors from outside the Council to secure expertise from outside the Council and independence of the Company, consistent with the reserved matters retained by the Council.

### **3.0 Background to Business Plan**

- 3.1 The Business Plan for Sutton Living Limited was approved by Opportunity Sutton Limited (the precursor to the Shareholdings Board) in August 2015).

#### **4.0 Sutton Living Objectives**

##### **4.1 Three key objectives were to:**

- (1) To deliver new housing in the Borough across a range of tenures;
- (2) To contribute towards meeting existing and forecast demand for housing for both through development of sites already identified and through development on new sites, yet unidentified;
- (3) To contribute to the General Fund through surpluses generated from housing developed.

##### **4.2 Implicit in all three of these key objectives is that Sutton Living must operate in a way that is financially responsible and follows company law, and this duty is imposed on its directors. It has to make a long-term profit in order to repay its funding from the Council. This means that while a desirable objective is to provide the maximum amount of affordable housing possible, and in the case of both Wallington Public Hall and Alexandra Gardens 35% has been proposed, this can only be done long-term if schemes are viable. Key components to costs are what Sutton Living has to pay for the land; how it controls development costs; and what it has to be provided in terms of planning gain. While Sutton Living cannot expect favourable treatment from the Council, under EU, UK, and Council procurement rules neither should it expect to be an “exemplar” of offering more than can reasonably be expected from the private sector.**

#### **5.0 Goals for 2018/19**

##### **5.1 The Business Plan in 2018/19 set some modest targets for achievement by the year ending 31<sup>st</sup> March 2019. These related to:**

- (1) Securing planning consent for Wallington, site purchase and letting of a building contract. Planning consent has been obtained and site purchase and letting of a building contract is pending.
- (2) Development of a scheme in Alexandra Gardens in partnership with Sutton Housing Partnership. Terms have been agreed with the Council to purchase the site subject to planning, but to date the scheme has been awaiting determination since July 2018.
- (3) To become a development partner on the Council’s Elm Grove Regeneration project. While Sutton Living has contributed towards this project, the timeframe is at least three years before any development project secures income to the Company. This is a long-term rather short-term project.
- (4) To investigate private funding and private site development. This first requires a track record and a sizable programme to attract outside investors.

- (5) Hold a mini-relaunch of Sutton Living at the start on site of Wallington Public Hall. This is intended, but the start in site is now anticipated in May 2019.
  - (6) To advertise and appoint independent non-executive directors. This is currently in hand.
- 5.2 In addition to the above goals, Sutton Living set up a Design & Build Subsidiary through which to let design and build contracts in order to recover Vat from schemes.

## **6.0 Current Sutton Living Development Programme**

- 6.1 The first development programme identified a number of sites delivering 273 units over a minimum 5 year term for a mixture of market rent, shared ownership and market sales and affordable homes for rent. Approximately 270 homes were identified on eight Council and private sites, and after sales it was assumed around 220 homes would be left in management at the end of the first funding term. While this programme was costed by Grant Thornton, some of the sites were notional, and the works costs on others were underestimated.
- 6.2 The Business Plan in 2018/19 identified a revised programme of between 230 and 250 units in sixteen Council and private sites. These included the Elm Grove Regeneration Project with an estimated output of 65 units, Ludlow Lodge a Council development which Sutton Living was to acquire of 11 units; a Council garages scheme, and a single property acquisition totalling 13 units. While Elm Grove remains a long-term ambition, this will not happen for three years; Ludlow Lodge has now received GLA grant and has been withdrawn, as has the garages site, and the single property acquisition is no longer viable. This reduces the programme to around 150 units (with 16 units shown on a site in Sutton Town Centre still not secured for development by Sutton Living). The only sales income comes from the sale of the affordable at Wallington where GLA grant and additional HRA borrowing has been secured.
- 6.3 The revised development programme set out in Confidential Annex A includes some Council owned sites where it is proposed that Sutton Living develops for sale on a “risk sharing” basis, in order to balance the programme. Using identified sites and based on capacity studies undertaken for the Company this takes the identified programme back to around 234 units. The inclusion of most of these sites is subject to Council approval, but all would meet the objectives of the Company agreed by the Council.
- 6.4 Work on the Company’s third goal (Draw up a three-year development programme with the aim of achieving a surplus in 2021/22) is underway at the time of writing. This will be available to be circulated to the Shareholdings Board before the end of May.

- 6.5 The programme set out in Annex A assumes a different working relationship can be forged between the Council and Company (see below)

## **7.0 Requirements for Sutton Living to successfully achieved its targets**

### **7.1 A collaborative working arrangement with the Council**

The initial approach to the acquisition of the Wallington site was adversarial, based on the premise that the Council needed to treat Sutton Living as any other private developer and so have a commercial relationship between the parties. With both Council and Sutton Living engaging their own lawyers it became a very expensive exercise and succeeded in delaying the process as every point became the subject of detailed discussion. Moving forward it has been agreed a better approach is to set down clear parameters at the outset and possibly use the same lawyers in order to streamline the process while still protecting the independence of both parties

### **7.2 A clear approach to Planning**

Planning has to act independently of the Council, but sometimes there has been a confusion of roles with Sutton Living been seen as a part of the Council and having requirements set that would not be acceptable to the private sector. While it would not be in Sutton Living's interest to appeal against planning decisions, it does need to have a robust and professional view towards Planning, and the approach adopted by Sutton Living is to appoint planning consultants where necessary to argue the planning merits of each scheme.

### **7.3 An understanding of the funding requirements of the Council and Sutton Living**

From detailed funding discussions held on Wallington, a misunderstanding of the funding needs emerged, with a misconception on Sutton Living's part that the Council's equity did not need to be covered by long-term borrowing by the Council. This added to the scheme costs and made the project initially unviable. On Wallington the Company appointed consultants with development experience and this helped the scheme and provided reassurance to the Council. The securing of grant from the GLA significantly helped the viability of the scheme, as has the agreement on using more competitive interest rates, and a blended rate between different housing tenures. As a consequence of discussions on Wallington a number of business plan assumptions are altered (see Appendix 2).

### **7.4 Agreeing an overall programme with the funder**

Rather than deal with schemes on a one-off basis, discussions are proposed with the funder (the Council) on agreeing an overall programme, balancing retention and sale of units so that funding can be put in place in advance. A

series of quarterly meetings already take place between Sutton Living and Finance and it is proposed these are used for programme planning.

7.5 Confirmation of the tenures to be developed

The current tenures being delivered by Sutton Living, according to its current objectives, are units for intermediate and market rent; outright, and low cost (affordable) sale. At Wallington an opportunity was taken to secure GLA grant to provide London Affordable Rent, and the grant helped secure scheme viability. Section 106 planning requirements may insist on the provision of affordable rent, and some wholly owned companies have taken the decision to set up registered subsidiaries to manage rented affordable housing. This was discussed at the Shareholdings Board in 2017, but it was decided not to go down this route given the requirements of the GLA and extra level of bureaucracy. It might also prove a diversion from the Company's main objective of developing a range of housing types and lead it to become a housing manager. Consequently, where affordable rented housing is provided, the intention will be to secure grant for its development where possible, and then on completion sell on long leases to the Council for Sutton Housing Partnership.

7.6 Simplifying the complexity of agreements between the Council and Company

The Company has to enter a number of complex funding agreements in order to borrow to develop, and this brings potential delays in the process, and in the acquisition and development of private sites would rule out the ability of Sutton Living to respond quickly. A number of items are "reserved matters" to the Council and also brings the potential for delay. In addition, the Council has sought a number of warranties from the Company. In the case of Wallington, the Council sought a collateral warranty in order to agree the site purchase, a separate one to cover the leaseback of the commercial unit, and third one to cover funding. Technically all three maybe required, and reports that the Company is acting with due diligence. In time, with more sites being secured a better understanding will be developed and a less risk adverse approach may be adopted.

7.7 Funding and development opportunities outside the Council

This remains an objective of the Company, but as reported earlier, until a development track record is built up, and the scale of the programme is attractive to funders such as Pension Funds, this remains a medium-term objective.

**8.0 Governance & Operations**

8.1 The Governance arrangements are set out in the Shareholder Agreement and clear fiduciary duties set out for company directors.

8.2 In order to bring in the widest experience into the Company, Sutton Living is appointing non-executive director with commercial and finance experience from outside the Council.

## **9.0 Core Development Assumptions**

- 9.1 The core development assumptions were reviewed of the 2018/19 Business Plan. They are attached as Appendix 1.
- 9.2 The main change relates to the need to have interest cover of more than 110% (i.e. the long-term loan starts to repay from year 1. This is a challenge as most RP developers for instance do not have this requirement as they can borrow against a substantial uncharged stock and can afford not to repay to the loan until year 7 onwards. Sutton Living has nor stock to borrow against and so has to make the scheme pay from the outset. This is likely to restrict the capacity of Sutton Living to develop, and to programme sales in future schemes in order to reduce the loan debt. It also requires the Council to take a view on when it receives a capital receipt for land, as receiving a residual payment after development reduces the cost of development to the Company.
- 9.3 Minor changes relate to management costs for Wallington being more realistic at £500 per unit per annum, and the inclusion of a standard sinking fund provision, previously omitted of 0.6% of build costs (for new build) from Year 11, and 1% in refurbishment schemes.
- 9.4 There has been discussion with Council colleagues in estates regeneration as to how low the developer's profit could be set by Sutton Living. Currently, the business plan assumptions are that it should not fall below 15%, a figure used by developers who are building range of tenures but where grant has been secured on the affordable housing element so the development risk, and rate of return can be reduced. The Company also aims to deliver 35% affordable housing on schemes which potentially eats into the profit margin. Maximising the amount of affordable housing is an aspiration and may not be achieved if land acquisition costs are high. In disposing of land, the Council has to decide whether it is seeking to maximise land value or the provision of affordable housing. Ultimately the Company has to cover its costs and is able to recover some of its abortive costs which inevitably flow from development. All schemes have to show a positive residual valuation.
- 9.5 Confidential Annex A updates the review of sites carried out in 2018/19.

## **10.0 Sensitivity Testing & Risk Register**

- 10.1 As was stated in the last Business Plan, each scheme will be the subject of sensitivity testing to allow for a variety of scenarios using the Proval Appraisal system and core development assumptions, and also now look at the return of the Council's equity share, which is has to borrow.
- 10.2 The summary of the key strengths, weaknesses, opportunities, and threats to Sutton Living were set out in the February 2018 Business Plan and is restated in Appendix 2 with minor changes.

- 10.3 Sutton Living's Risk Register is kept under review and presented to each meeting of the Shareholdings Board. Principal risks remain around scheme viability; the level of interest rates, and reliance on Council land and funding. Proposals to mitigate these risks are contained in the risk register. In addition, the major risk now identified is the uncertainty created by the UK's decision to leave the European Union, given that most materials, and a substantial part of the building labour force comes from the EU or elsewhere from outside the UK. This creates major uncertainty on future costs.

## **11.0 Conclusion**

- 11.1 This review of the Business Plan is interim giving the current review of Sutton Living. A further review will be submitted to the Shareholdings Board in September. The objectives of Sutton Living are likely to remain unchanged, but the programme is required to be more balanced with a greater proportion of sales (both affordable and outright) in order to reduce the Company's funding debt and put in profit within three years. The Company will still be able to particular opportunities to the Council as diverse such as restoring and managing the Old Rectory, and The Grove Carshalton, and becoming the Council's partner in estate regeneration projects. Some of these opportunities are long-term. The immediate priority is to ensure that the schemes it delivers are viable and the Company acts in a commercially prudent manner.

## **12.0 Recommendation**

- 12.1 That the Interim Review of the 2019/20 Business Plan, and goals set out in para. 2.1 are agreed.

Mike Kirk Managing Director – Sutton Living Limited 1<sup>st</sup> April 2019

### Appendix 2 Summary of Business Plan Assumptions

Parameters	Terms	Comments updated 01/05/18
<b>Core Assumptions para.3.0</b>		
Term of the Model	50 Years (Year 1 2015/16)	
Scheme payback	Within 50 years	
Inflation	2%	Annually to CPI
Real growth	1% above inflation	
Property Growth	3% in appraisals	
Void & Bad debts	4% for voids and all tenures	
Management costs	£1000 per dwelling (to be reviewed annually)	The review of Wallington Feb 2019 considered that £500 per unit per annum was more realistic for this scheme
Maintenance costs	£600 average: but will vary according to unit size and whether units new build or refurbished	Review annually against actual scheme costs
Lifecycle costs	£1222 average commencing year 6: will vary against unit size	Monitor against actual costs
Property building insurance costs	£315 per unit per annum	An assumption previously not included
Interest costs	To reflect current market conditions	Interest rates have been agreed for both the development phase and long-term loan
<b>Rent assumptions para. 4.0</b>		
Market rents	By unit size by post code	Review annually and set for each scheme using RICS accredited Valuer
Affordable rents	To be linked to Mayor of London affordable rent benchmarks	Affordable units in terms of SLL have previously been those with rents at 80% of market value or shared ownership units
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.	Affordable units in terms of SLL have previously been those with rents at 80% of market value or shared ownership units

Service charges	Those applicable to scheme and based on recovering expenditure	Service charges form part of the market rent. Charges should recover costs
<b>Development assumptions para. 5.0</b>		
Acquisition land/buildings	Based on RICs Red Book	
Build cost inflation	Based on BCIS and cost consultant review of relevant tender prices	
Sinking fund	0.6% of build costs for new build, and 1% for refurbishment from Year 11	Standard development assumption, not previously stated
Developer's profit	Target between 15-20% of total costs depending upon scheme risk	May not be applicable where all units are retained in management Previously adjusted (down from 20-25%) in the light of market trends
Establishing scheme profit	Residual from scheme Gross Development Value	
Sales Assumptions para.	Market sales based on RICs valuation	Validity three months
	Shared ownership assume average initial tranche of 35%	Current stair-casing assumption 1% additional equity sold each year
Rent on retained equity	2.75%	
Grant from GLA	No assumptions on receipt of grant in current Business Plan	Reviewed following the 2017/18 Business Plan and decision taken not to apply for grant at the present time
Affordable housing	To seek 35% (subject to viability) on public land in either intermediate rent, or shared ownership	'Affordable' rented housing will be delivered where it is feasible to seek GLA grant and stock managed by Sutton Housing Partnership
Fees & other on-costs para 7.0	15% for professional fees and SLL development allowance	Additional fee of 1½ % for marketing in schemes with outright/shared ownership
Works contingency	3%	Retained by client so not added to the contractor's contract sum. Maybe higher in more complex schemes
<b>Tax para 8.0</b>		
VAT	To be charged on all fees, and refurbishment works costs	Awareness of different rates (e.g. refurbishment where there is a change of use from commercial to residential). Sutton Living has set up a subsidiary Sutton Living D & B in order to recover VAT

SDLT	Allowance to be made for SDLT where applicable	
<b>Financial Performance para 9.0</b>		
Internal Rate of Return (IRR)	Schemes cumulatively to achieve 4%	
Net Present Value	Scheme to achieve +NPV	Where evaluating multiple projects NPV can be used to prioritise one scheme over another
Repayment of loan	Within 50 years	No change in 2018/19 for new build schemes. Refurbishment should repay in 35 years
Interest Cover	Minimum of 110% from Year 1	This is a previously unstated requirement (see para.9.2)

### Appendix 3

The following SWOT analysis is a summary and update of the key strengths, weaknesses, opportunities and threats to Sutton Living Limited referred to in the March 2017 Plan with changes updated in 2018 (*indicated thus*):

#### Strengths:

- Supporting the Council in maximising housing development in the borough;
- Ability to use internal skills and resources within the Council;
- Knowledge of the borough and its development opportunities;
- Ability to secure funding at competitive rates;
- Council and Senior Councillor support;
- Long term capital growth and scope to repay loans in longer term;
- Intention to hold assets seen as important to the community long-term.

#### Weaknesses:

- Current higher funding rates reflect a company with no current assets;
- Lack of developable land;
- Low land values compared to much of London;
- *Relative lack of experience of housing development/construction (now addressed by the appointment of experienced staff)*
- Being associated with the perception of the Council as not being 'commercial', while at the same time wishing SLL to be an "exemplar" developer;
- *Long drawn out process to secure planning and borrowing approvals resulting in lengthy timescale before significant numbers of homes are available;*
- Lack of scalability to develop economies of scale;
- Potential for conflicting objectives particularly in early stages e.g. on the true value of land and property disposals.

#### Opportunities:

- To increase the supply of high quality housing in the borough;
- Ability to assist the Council in supporting its Regeneration initiatives, and in the retention of important buildings by investing in their refurbishment;
- Increasing the range of tenures to help local people to rent or buy a home;
- Ability to bring in suitably skilled external non-executive directors and staff;
- Capacity for increased growth in housing prices from low base;
- Long-term income generation for the general fund.

## Threats:

- *The external threat of Brexit on future build cost inflation*
- Development opportunities taken by private sector, especially in the early years until a credible track record is achieved;
- *Council tempted to sell sites to private developers who are able to pay more as they can take planning risks, unlike Sutton Living, and who can develop schemes with no commitment to long-term management*
- Competition from RPs or PRS providers who are providing for similar client groups;
- Inability to attract suitable staff;
- Challenge from private sector over 'state aid' (low);
- The 'not in my backyard' syndrome and other adverse publicity;
- Land values increase and make development unviable;
- Government clampdown on Council companies/prudential borrowing;
- Impact of Right To Buy extension on new rented housing if provided with grant funding (*decision taken not to register for grant aid in 2017*)
- Increase in interest rates;
- Sustained low period of inflation;
- Inaccurate development appraisal assumptions (*mitigated by use of agreed development assumptions underwritten with updated specialist cost and marketing advice*)

**Annex A Confidential Sites Programme**

(separately listed)

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