Cabinet

18 December 2013

Proposals for the Development of Market Rent and Market Sale Housing in Durham

Key Decision R&ED/18/13

Report of Corporate Management Team

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Purpose of the Report

1. This report describes a proposal for the Council to develop its own market rent and market sale housing on County Council owned land and considers how best this can be delivered.

2. The report proposes the establishment of a new company that will help the Council achieve its growth ambitions through the delivery of both housing for rent and sale, offer an alternative route to that of the private sector and help to meet housing need and demand across the county.

3. It also offers an opportunity for the Council to generate capital receipts from the development and sale of housing and introduce a new source of revenue from rental income streams.

4. The proposals contained in the report relate solely to market housing, i.e. not social housing. The demand for social housing in the county is met by the development programmes of the Registered Providers, including the County Council's own landlords. Currently the Housing Revenue Account debt cap limits the amount of borrowing that is possible to sustain further development by the County Council, although the decision of Cabinet on October 30th to seek to transfer its homes to a group structure of the existing providers should enable opportunities to develop new social housing.

5. As well as providing a background to private renting in Durham and identifying other new build for rent initiatives (sections 2 & 3), the paper looks at the following key issues:

a) Meeting housing needs (see paras 6 - 14)
b) Costs and viability (see paras 18 – 38)
c) Development and delivery options (see paras 39 - 41)
d) Procurement and Soft Market testing (see paras 42 - 49)
e) Governance (see paras 50 - 58)
f) Staffing (see paras 59 – 62)
g) Sales and Marketing (see paras 63 - 66)
h) Other Issues (see paras 67 - 75)

Background

6. Following the recent economic downturn, there is an opportunity to assist the recovery of the housing market in County Durham by supporting investment that provides additional choice in housing tenure to meet the needs of some parts of the County's population.

7. We know that the private rented market has expanded significantly over the last 10 years (from 7.9% of the market in 2001 to 13.8% in 2011 (Census 2011)) and is now recognised as playing an important role in meeting people's housing needs as well as increasing mobility. It helps to stimulate and respond to economic growth.

8. In contrast, the proportion of houses in owner occupation has declined slightly.

9. Overall, housing completions are currently below 1,000 per annum. There is a need to increase delivery in order to meet identified need. The County Durham Plan identifies locations for this development to take place; this report identifies a way to deliver some of these housing units in locations that conform with the County Durham Plan and in forms of tenure that meet identified housing need.

10. The present government has encouraged growth in market rent housing. Its housing strategy 'Laying the Foundations' (2011) emphasized this and the 2012 Montague Report[1] (a government sponsored report looking at barriers to the delivery of private rented homes) recommended a series of initiatives to strengthen it further.

11. Durham's 2013 Strategic Housing Market Assessment (SHMA) identified that a high proportion of 'in migrants' (45.1%) chose the private rented sector for their first home in Durham. Over half of all households (50.2%) who had previously lived in Durham with family and friends (i.e. newly forming households) chose the private rented sector for their first home.

12. Whilst the Durham housing market has a strong supply of low value housing (often pre-1919 terraced housing), there is little rented housing in

[1] Review of the Barriers to Institutional Investment in Private Rented Homes' CLG August 2012

the private market that is of high quality and which matches the aspirational life styles of many newly forming households. There are relatively few examples of new build for rent in Durham (other than the affordable housing products provided by Registered Providers).

13. Furthermore, there are many newly forming and existing households who are seeking a home but who cannot access owner occupation at the present time and yet do not consider the social rented sector as an option either.

14. This group of households are at a disadvantage in that they are not able to easily identify any particular housing solution to meet their needs. They are usually economically active but may be on average or below average incomes.

New Build for Rent Initiatives

15. To date there have been relatively few examples of new build for rent in Durham (other than the affordable housing products provided by Registered Providers). Current examples of market rent development include:

a) **Prince Bishops Homes** (an arm of Derwentside Homes) which primarily provides miscellaneous properties bought ‘off the shelf’, although Derwentside Homes are about to embark on new build for rent properties with assistance from the HCA ‘Build to Rent’ programme. Derwentside Homes currently have 212 Prince Bishops Homes under their management with a further 100 in the development pipeline.

b) **Gentoo Genie** – strictly speaking this is a home ownership product but is based around a ‘purchaser’ buying shares of a house through regular monthly payments (similar to a rent). The unique selling point of the Gentoo Genie product is that it does not require a deposit. Launched in November 2011 in this region, Gentoo Genie now have 9 properties in the county and 64 across the North East – all purchased in conjunction with pre-existing new build schemes.

c) Many completed new build schemes include sales to investors as well as owner occupiers. Once purchased, investors let the homes out at market rents.

d) Some housing for rent has been built in Durham City specifically for the student market.

16. The County Council has an opportunity to develop its own land for a mix of both housing for market rent and sale. The Council’s land includes sites where the market is relatively strong, where people aspire to live and where there is a wide range of good quality services nearby. It is proposed that such sites would combine market rent housing with housing

for sale at a provisional ratio of 30% rent and 70% for sale. This ratio may be varied based on evidence from sales and lettings of any pilot site.

17. The proposals set out in this report demonstrate that subject to appropriate risk management and project management arrangements being put in place, more value can be secured from the same land through the Council facilitating development and being involved in the delivery of housing units on these sites than would be the case if the sites were simply sold on to the private sector. The form of that development and the way in which it is delivered is key to ensuring these returns are made.

Financial Viability

18. In examining the financial viability of these proposals, a financial modelling exercise has been undertaken using standard assumptions around management and maintenance costs. Detailed work will need to be undertaken in due course to prepare a fully developed business plan, but modelling to date has examined a programme of new build on a staged basis.

19. The overall proposal has assumed an indicative new build programme of 310 properties in total – 93 of which are for market rent.

20. Overall development costs for such a programme of sale and rent properties (including construction costs, fees, overheads and borrowing costs) amount to around £26m, (although it is estimated that peak borrowing will be significantly less than this sum).

21. This is because the private sales element of the programme will benefit from regular sales income once the first units are completed. This will help to cap overall debts at less than 30% of the total scheme costs of the housing for sale (depending on the size of the site). Debts will be repaid no later than immediately following the sale of the last unit.

22. When the sites are amalgamated into one programme of phased starts and completions, then the overall peak debt will reduce to a significantly lower figure. One of the challenges of the business planning process is to further reduce the peak debt figure to ensure that the project can be delivered as efficiently as possible.

23. It should be noted that borrowing for the market rent housing is profiled over the long term and repayments are based on 30 year net rental income streams (after taking into account voids, bad debts and management and maintenance costs). Maximum debt, equivalent to the total costs of the market rent housing, occurs on the date of practical completion of each phase.

Market Rent

24. Our initial development appraisals show that the programme would secure good returns on investment ranging from 8% to10.8% internal rate of return based on a 30 year annuity using a prudent interest rate of 6.5%.

25. The returns are derived from realistic assumptions based on evidenced comparable data on both expenditure and income.

26. The base development appraisal for the market rent units (using an interest rate of 6.5%) projects a surplus over 30 years ranging from around £152,000 per unit to £77,000 per unit . Surpluses are generated straightaway (ie from year 1) on high value sites but would be deferred on lower value sites.

27. A sensitivity test has been undertaken by applying assumptions that represent a 'worst case scenario' (increased management and maintenance costs of 20%; increased voids rate (from 2% to 4%); reduced sales and rental income of 10%). This scenario, which is considered to be a worst case situation, reveals an overall loss of £192,750 in year 1 but delivers cash returns in later years. In this latter scenario, no scheme generates a surplus in year 1, rather the year when a cumulative surplus is first achieved is extended to beyond year 17.

28. This sensitivity analysis represents an extreme set of assumptions. Nevertheless, it serves to illustrate how risks associated with this type of development need to be monitored and managed. Further work to understand alternative and more realistic scenarios will be undertaken as part of the business planning process.

Capital Returns

29. An assessment has been completed taking into account the estimated financial returns from the development of both rent and sale properties compared with the expected capital receipts for each site based on current market values.

30. This assessment showed that each site offers a significant capital surplus over and above that which can be achieved from a straightforward disposal on the private market.

31. Long term borrowing through PWLB is a key advantage to the authority. Whilst the HCA are also offering favourable loan rates for their Build to Rent programme, these rates are strictly short term loans and will be offered on the condition that the developer seeks refinancing of the developed scheme soon after completion (thus enabling the HCA loan to be repaid).

32. The preliminary conclusion from an assessment of financial viability is that the proposed schemes have the potential to release revenue streams back

to the Council almost immediately and would increase year on year as long as current assumptions remain valid. The programme will also provide healthy capital returns.

33. Further sensitivity analyses will be undertaken to satisfy the authority that risks and/or losses have been eliminated or mitigated.

Housing for Sale

34. The properties for sale demonstrate a strong positive return on investment. Total development costs are estimated at £18.4m compared with estimated sales values at nearly £31m. This means a surplus of over £12m could be generated. Both the initial business case and the soft market testing demonstrates a strong positive return on investment.

35. The viability of the sales units has been appraised using the same cost assumptions as the market rent units (it is expected that the building standards will be the same). The Council has the ability to secure acceptable profit margins in two ways:

(a) Profits from the sale of land will be secured on individual house sales

(b) Developer profit margins will be improved through procuring a building contractor rather than a volume house builder (whose profit margins tend to be much higher).

36. It should be noted that, in accordance with the requirements of the County Durham Plan, the Council will have to offer an agreed contribution to affordable housing either on or off site. This will reduce profit margins by the difference between the open value of a market sale unit and one that is sold to a Registered Provider for affordable rent multiplied by the number of affordable units being provided.

37. The affordable housing percentage prescribed by the draft Local Plan ranges from 10% to 15% on the available sites.

38. In addition to the evidence we have on housing demand and overall scheme viability; the following will also be required:

a) The appraisal of **development and delivery options** that will offer the best arrangements for delivering the product.
b) The implementation of rigorous **procurement arrangements**
c) The introduction of robust **governance arrangements**
d) The establishment of effective **staffing arrangements**
e) The development of an effective **sales and marketing strategy**

These issues are discussed below.

Development and Delivery Options

39. Several options for procuring a market rent and sale programme were considered including:

    a) the Council developing and managing the schemes itself
    b) the Council setting up its own arms-length company to develop and manage the schemes
    c) the Council setting up a joint venture with a developer to share risks and returns
    d) the Council being sole developer of the scheme but leasing the rental units on completion to a private provider

40. All four options can deliver housing units for market rent and market sale but with varying degrees of risk. The conclusion from the options appraisal is that option B, a form of 'arms-length' company offers opportunities to get the balance right between risks on the one hand and revenue streams and capital returns on the other. Conclusions from the options appraisal are set out in Appendix 2.

41. Where the Council retains control of land disposal, development and management, as in Option B, there are clear opportunities for maximising income streams and capital receipts.

Procurement of Development Services

42. The main services that will require procurement are those of a building contractor to deliver the houses and there may be other ancillary services that are also needed.

43. A range of procurement routes have been examined in order to identify a contractor who can deliver a cost effective and good quality product in the most appropriate way and within a reasonable timescale.

44. Options available to the Council include:

    (a) making use of an existing procurement framework. This could have the advantage of streamlining the process by taking advantage of previous OJEU processes. Examples of existing frameworks include:

    - the HCA's Delivery Partner Panel (DPP) commissioned by the Homes and Communities Agency. This is a panel of pre-qualified housing developers and contractors approved by the Homes and Communities Agency (HCA) for developing public land. This is ready to use and could streamline the procurement process.

    - DCC frameworks which include for example the Durham Local Education Partnerships BSF framework ("inspiredspaces"). Existing frameworks tend to be dedicated to specialist work so their flexibility to accommodate this type of house building work needs further consideration.

(b) proceeding with a new procurement process in compliance with OJEU requirements. This would ensure contractors are matched very closely to our specific requirements but does entail a much longer and more costly 'lead in' time.

45. Whilst the advantages of a new framework would need to be weighed up against potential time and cost savings of utilising an existing framework, it is clear that there are several robust options for procuring a suitable contractor. It is believed that the HCA Delivery Partner Panel could offer a route to speed up delivery and secure quicker development alongside earlier financial returns.

Soft Market Testing

46. We know that well established companies are active in the region and they would welcome the opportunity to tender for Council funded housing schemes.

47. A soft market testing exercise has been completed in order to test the appetite amongst building contractors. Interviews were arranged with three leading contractors; all of whom are on the HCA DPP and confirmed their strong interest in working with the Council as a contractor (rather than a developer) in delivering the identified schemes.

48. Their specialisms include not only offering design and build contracting services but also site investigation, planning application work and marketing. The Council is confident that a suitable building contract can be procured.

49. In addition, the market testing exercise has shown that the assumptions that the officer project team have used in terms of attractiveness of the sites chosen to the market, sales values and rental returns, contractor profit margins and timescales for delivery are all reasonably correct and provide a sound basis for moving forward to a detailed business plan, which subject to agreement, can then be quickly implemented.

Governance

50. The Localism Act 2011 requires a local authority to undertake commercial activities through a separate company. This company should either be one as defined by section 1(1) of the Companies Act 2006 or a society under the Co-operative and Community Benefit Societies and Credit Unions Act 1965. A final decision on the type of entity to be chosen will be required and will be considered as part of the detailed business plan.

51. Should the Council support the development of its own arms-length company, then there are 2 options:
    a) establishing a new company
    b) utilising an existing Council company

52. A new company can be established at relatively little cost and offers the advantage of having defined business activities tailored to specific aims and objectives. This is a cleaner solution and comes without any previous history, which makes the running of the company simpler and any future due diligence far more straightforward.

53. On the other hand, the Council already has other companies. These include Service Direct NewCo Ltd (a trading company with a wide remit but specialising in the purchase of IT hardware) and the County Durham Development Company Ltd (CDDC). Whilst these companies already exist, they are also focused on other activities, therefore for them to take on responsibility for these housing proposals may require amendments to their governance.

54. The simplicity of creating a 'tailor made' company relatively quickly and easily probably outweighs the advantages of using an existing company. It is therefore recommended that a new company is established dedicated to delivering a high quality product and providing management services for the market rent units.

55. Work on establishing appropriate financial arrangements between the Council and its subsidiary that offer tax efficient arrangements will also need to be undertaken. This will be considered within the detailed business plan.

56. Any disposal of land and buildings to the new company would be allowed under s2 Local Authorities Land Act 1963.

57. As the company will be a subsidiary of the Council, it is appropriate that the Council provides it with Directors to control its affairs. The likely mix of Directors will be considered further in the business plan.

58. Given the nature of the undertaking it is proposed that any member or officer Directors should not receive any separate payments for their services (although any personal liability should be mitigated through the provision of Director's indemnity insurance).

Staffing

59. The budgets identified in the development and management viability work would be utilised to cover the costs of staff required to successfully progress the model through its initial phases of development.

60. The range of skills, knowledge and experience can probably be sourced from existing staff resources, although consideration could also be given to

seconding staff to the new company as work expands. Ultimately the company may gain sufficient scale to employ its own staff.

61. Management services will include rent collection; lettings; maintenance; general management; miscellaneous financial management and accountancy services; company secretarial work; governance and personnel support; legal advice and IT support.

62. The company will need to establish clear service level agreements with Council services and plan to have effective arrangements for making changes to such agreements as and when required.

Sales and Marketing

63. All of the companies spoken to during the market testing exercise expressed a strong desire to be the party selling houses as part of this venture. This is considered to be the best way forward as relevant contractors have various brands that attract loyalty and familiarity in the market place that would support the selling of houses. The contractors themselves have the required skills to sell houses and through any commercial negotiations, could be incentivised to sell units to support the development programme.

64. The presence of empty homes for any length of time represents a particular financial and reputational risk to the Council and the contracting partner. The experience of the contractor in phasing; marketing and selling houses would be employed to minimise this risk and to ensure that both rental and sales units are reserved and occupied quickly.

65. The new subsidiary company will need to have an image (and associated branding) that is attractive to the market and will help to promote an exciting and dependable product to prospective renters.

66. The company brand name and image will set the tone for the company as a professional provider of high quality well managed rented accommodation.

Risks and Other Issues

67. The available sites are in popular neighbourhoods and are considered sustainable in the long term. Our proposals will be designed to be attractive to the market. However, as with other long term projects there will be risks and some of these are set out below.

68. A key risk is our dependence on the continued strength of the private rented market. Because relatively low interest rates and low house prices can make mortgage payments competitive with rental payments (after taking account of the cost of a deposit and mortgage arrangement fees), the private rented market may be seen as ‘second best’ to owner-occupation, although it is considered that the housing market will continue

to require various forms of tenure and housing products to meet the needs of the communities living and working in County Durham.

69. In addition, housing is often sold at below £100,000 across the county – generating mortgage repayment rates that are equivalent to renting.

70. Furthermore, the new ‘Help to Buy’ initiative (the government funded equity share and mortgage guarantee product) will allow first time buyers and others to either purchase new housing at 80% of market value (so allowing access to a mortgage at 75% of full market value once a 5% deposit has been paid) or to purchase existing housing through a 95% mortgage with the government under-writing any default risks.

71. Should ‘Help to Buy’ remain in place and continue to prove popular, it may have the effect of reducing demand for rented stock and this may impact on the county’s rental values.

72. However, overall there is enough evidence to show that in the short to medium term there will be a continuing shortfall in housing supply, regardless of tenure. Furthermore, the market for privately renting at market rent levels continues to be attractive to many households particularly if it is in the right location and offers good quality and well managed accommodation.

73. If we were to find demand for market renting was to reduce then the risk of void loss could be mitigated through placing extra emphasis on the sales element of each site. In particular, the Council will have the option to ‘fall back’ on selling the units at full market value.

74. The Council will need to demonstrate that it is not in contravention of ‘state aid’ rules in delivering this development of market rent and market sale housing programme. The funding arrangements (and the inapplicability for state aid) will need to be examined more fully by our legal and financial experts as part of the financial business case.

75. The HCA has a body of experience (and is also managing the nationwide Build to Rent scheme). The Council will maintain close links with the HCA to ensure their expertise and knowledge is utilised to the full.

Conclusions

76. In conclusion, whilst the Durham housing market has a strong supply of certain types of housing, there is very little rented housing in the private market that is of high quality and which matches the aspirational life styles of many newly forming households.

77. The County Council has the opportunity to use its own land to support the delivery of housing to meet identified need for market rent and housing for sale. The route described in the report is designed to maximise the

delivery of housing units in the shortest timeframe and deliver revenue income to the County Council.

78. Other local authorities such as Thurrock, Manchester, Daventry and Ealing are also developing in a similar way recognising the valuable role that local authorities can play in delivering housing units to meet local need using Council owned land.

79. Subject to agreement to proceed, a further report will be presented to Cabinet in Spring 2014 which will set out the detailed way forward, including proposals to ensure efficient delivery.

Recommendations and reasons

80. There is scope for the County Council to develop market housing for rent and sale in Durham and utilise the Council's land to pursue this objective. It has the potential to meet housing need and demand in County Durham whilst also providing a financial return.

81. It is recommended that Cabinet:

1. Agree to further exploration of the proposals for the development and management of market rent housing and housing for sale.
2. Agree to the commencement of procurement for technical advice and a contracting partner to aid the production of the Business Plan.
3. Agree to the establishment of a Project Board and delegate decision making on the project to the Corporate Director, Regeneration and Economic Development and the Corporate Director of Resources, in consultation with the Portfolio Holder for Housing and Rural Issues and the Portfolio Holder for Resources.
4. Receive a further report setting out a detailed Business Plan including project plan, a resource plan for the programme, governance and staffing arrangements and arrangements for the establishment of a new company.

Background papers
None

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APPENDIX 1: Implications

Finance –
The Council will need to borrow funds to deliver the proposed development and will need to establish an agreed repayment schedule with its subsidiary company for the rented units.

The development project would need to go through the Cabinet capital programme decision making process as a self-financing return on capital investment project.

Staffing –
In the short term existing staffing can be utilised to progress the scheme but ultimately dedicated staffing resources may be recruited to the workload contained within the detailed Business Plan.

Equality and Diversity –
None

Accommodation –
None

Crime and Disorder –
None

Human Rights –
None

Consultation –
None

Procurement –
Procurement of a suitable contractor will be required to progress this scheme.

Disability Discrimination Act –
None

Legal Implications –
The Council will either need to adapt an existing company or create a new one as it cannot itself be landlord on this project. The Council has authority under s123 of the Local Government Act 1972 to dispose of any development(s) and authority under s2 of the Local Authorities Land Act 1963 to build.

Appendix 2 : Options Appraisal

1. **Option A** – **the local authority is sole developer of scheme and manages the completed scheme directly** - gives the authority the greatest freedom to initiate; specify and control the development and offers the greatest opportunity for profit. But it also presents us with greater financial risks. In particular it may expose the Council to the very real risk of being required to charge rents at less than full market rent and the Council would also be subject to Right to Buy provisions (and the associated discounts).

2. **Option B** - **is a new 'arms-length' wholly owned company**. This would be set up by the Council, and would help mitigate risks in managing the properties. It provides sufficient independent rigour through the development of its own business plan to protect the Council from some of the risks associated with ongoing management. In particular, through being able to issue assured tenancies, it would allow market rents to be set and Right to Buy and rent setting provisions avoided.

3. **Option C – is a Joint Venture company** which would involve a more formal procurement process to establish who in the market is best equipped to deliver the required development and management services alongside the Council. It is possible that one partner may not have the skills and expertise to deliver both development and management services and so any joint venture may encompass more than one other partner. The procurement process is likely to be protracted. Furthermore, the financial returns would be shared with the JV partner, usually on a 50:50 basis. This would reduce the revenue return to the Council that Option B would safeguard.

4. **Option D – is a develop and lease arrangement;** which allows the management responsibilities to be tendered out to an independent specialist housing manager on a long lease but gives the Council sole responsibility for development work.

5. All four options can deliver housing units for market rent and market sale but with varying degrees of risk. The conclusion from the options appraisal is that option A places the project at risk from the Right to Buy provisions, option C reduces the opportunity to maximise capital receipts and revenue income streams; option D means that the rental income stream is shared but the County Council would also develop the houses, an area where our expertise and brand is limited. Option B, a form of 'arms-length' company offers opportunities to get the balance right between risks on the one hand and revenue streams and capital returns on the other.