

Lincoln Quality Homes

Draft Business Plan

A City of Lincoln Council Company

Version 3.1: RL

October 2017

Executive summary

The City of Lincoln Council decided at its meeting on the 29th February 2016 to establish a wholly owned company to deliver new quality homes at private rent levels and for low cost home ownership.

The rationale for entering into this new area of work were several fold:

- The Council has almost exhausted its new build capacity in its more usual delivery mechanism, the Housing Revenue Account.
- A quarter of the total housing stock in the City is in the private rented sector and the overall quality is low with high levels of non-decency and category 1 hazards. By setting new quality standards in the sector the Council seeks to raise the overall standard and make it more difficult for bad landlords to find tenants.
- Through the local plan process it has been evidenced that there is a severe shortage of all tenures of housing in the City and the Council wants to do all it can, not just to facilitate others to build, but to directly intervene in the market when it doesn't deliver what the community needs.
- Additionally (not mentioned in the initial report) a company allows the opportunity to respond to other housing opportunities that would not be available within the HRA mechanism. Examples of this include becoming a letting agent of privately owned accommodation and to undertake a wider role in the Sincil Bank regeneration project.

At the time of making the decision to progress the wholly owned company option the governance and basic financing structures were agreed. The Company would be run operationally by a board of five, predominantly senior Council officers, but to include private sector expertise in relevant areas if it could be sourced at reasonable cost. A number of 'reserved' matters relating to policy and direction would need to be considered by an overseeing councillor committee. The only issue of policy requiring further agreement by the Executive following its February 2016 decision was a detailed financial plan now contained within this company Business Plan.

The initial target given by the Council was for the Company to build in the region of 150-200 units of quality accommodation for letting at private rent levels or for low cost for sale within 5 years. However given further discussions a phased approach was recommended and therefore this business plan now proposes the building of 53 homes as a first phase. These would be funded through borrowing in the General Fund and then on-lending to the company. The company, once established, would need to react to opportunities to build more and potentially different types of housing and therefore it is envisaged that plans would need to be flexible and open to change.

Properties owned by the Company will be managed and maintained by the Council through its comprehensive housing delivery function although a front of house initial

lettings arrangement will be used to attract initial tenants in the first years of operation until the public is used to the Council operating a Company arrangement.

A key part of this plan is the detailed financial projections at section 7 and Appendix 1. Initially, the company is projected to be managing 42 new, quality homes and have sold 11 homes by 2021.

In summary, the Company would:

- Increase the supply of homes within the City of Lincoln and meet wider housing demand
- Create realisable capital assets for the Council
- Enable the Council to control the housing mix and standards (where viable) through the design process
- Enable the Council to retain full control of the development and construction process, including the marketing of homes for rent and sale
- Generate long-term revenue for the Council
- Generate the potential for New Homes Bonus and actual additional Council Tax

1. The case for new quality homes for rent at both market and affordable levels

From the current Council tax roll we know that the number of homes within the City Boundaries is 45,201 and that 80% of these are in council tax bands A and B. This is markedly higher than the East Midlands average for those bands and reveals that the City's housing stock is lower in value than comparable areas. It is also a strong indicator of smaller and poorer quality housing.

In addition, the 2014 City wide stock condition study stated that of the 42,956 homes at that time, 23% or 9,632 were in the private rented sector (PRS). Again comparing this to the East Midlands average of 15%, and putting it alongside the overall low value of homes, reveals the unique housing tenure and value mix in Lincoln. The ready explanation of this characteristic is that the Lincoln figures are skewed by the no of students in the City and the demand is therefore for short term housing hence the large role of the PRS. This is certainly true but comparing the Lincoln percentage of 23% homes as PRS properties to the nearby cities of Sheffield (16%) and Nottingham (22%), both with two larger Universities, reinforces the point about the unique mix here. Private sector rented housing plays a much larger role in our housing mix than anywhere else within our region.

The private sector housing team, through the private sector stock condition survey of 2014, also estimate that of the 9,632 properties at least 36% of them don't meet the Government's Decent Homes standard of 2004 (as later amended) which means they lack one or more basic modern facilities. More worrying and of greater concern though is that the team also estimate that 21% of the properties in the PRS have category 1 hazards as defined under the Government's Housing Health and Safety

Rating System of 2006 which means they have a hazard that is potentially injurious to health such as dangerous wiring, significant dampness, etc.

The Council would like to see property standards across the private rented sector improve but there is little it can do with its own funds under the current financial constraints applying for local government. Traditional remedies of the past such as declaring a housing renewal initiative or a housing action area in specific parts of the City don't mean very much without funding to support and implement them i.e. significant funds are needed for property improvement and/or selective demolition.

The Council is committed to restricting the growth of Houses in Multiple Occupation (HMO) by its 2016 Article 4 directive which means planning permission is needed for each proposed new HMO.

One option open to the Council is to make investment in alternative private rented housing at a significantly higher quality threshold than that which currently blights the 'lower end' of the market. The increase in supply and effect of this may mean that landlords have to work harder to attract and retain the good tenants in the future.

The Strategic Housing Market Assessment (SHMA) prepared in 2015 for the Central Lincolnshire local plan process indicates that the City itself has an acute shortage of housing and that 374 new homes are needed each year across the tenures. The reality is that actual delivery lags significantly behind supply meaning that the shortage becomes more problematic for the City year on year. It's against this background that the Council has decided to do all it can to work alongside the market and directly intervene to provide new housing as well as facilitate development by others. Consequently, alongside this new build company initiative the council is also committed to developing 250 units for social and affordable rent in its Housing Revenue Account and supporting Housing Associations to deliver at least 150 new units in the same 5 year timeframe.

Other than at very low levels there is no current development activity around private homes for rent in the City. The Council's company model therefore is adding something new to overall provision. The background to this is that building homes in the local market is generally more expensive than buying and refurbishing existing homes. The private sector money invested in the PRS can therefore offer greater yields from existing housing rather than new. Private sector money is invested on the merits of each individual property and not in any strategic sense in relation to the shortfall in the overall property mix. Only the Council is willing to invest based on the wider strategic context.

The properties that this Company will build will not be at the expense of properties that could be built in the HRA as the capacity of the HRA to build beyond its current programme is very limited i.e. HRA new build resources are projected to be exhausted in that programme.

All of the rented homes in the Company will be let on assured shorthold tenancies or full assured tenancy agreements thus helping to meet different housing needs. The provision of a longer-term private rental offer will give households increased stability. At this stage neither tenancy would attract the ability for the tenant to exercise the

right to buy. A nomination/management agreement will be agreed between the Council and the Company.

There is certainly no question with regard to demand for affordable properties with over 1,800 separate applications for housing on the Council's waiting list with 600 applicants able to secure a property per year. This is against the backdrop of the HRA losing properties through the reinvigorated right to buy policy.

The addition of new homes through Council intervention in the market will assist with delivery of local plan targets. In 2016/17 188 homes of all tenures were delivered in the City against a local plan target of 374.

Rent levels have been carefully modelled to ensure that the market rents assumed are reasonable and will achieve quick letting times for a high standard of home. Market rents levels have been forecast to increase marginally above inflation (CPI).

2. Properties for market sale

In order for the company to be viable in providing market rent homes with a high percentage of borrowing and the requirement to make a return to the Council to cover their cost of equity a form of 'subsidy' is required.

This will come through the profits that can be made from building and selling-on at market values 21% of the properties built.

Research and analysis has been carried out by Messrs Cushman & Wakefield with advice on tenure mix for each site leading to the assumptions used for market sale numbers.

Recent announcements by the Government indicate their intention is to focus on increasing the supply and availability of homes for owner-occupation. Part of this will be achieved by the extension of right to buy to registered provider tenants.

3. Lincoln Homes – a quality standard

The Company will initially commit to building 53 quality homes with 42 at private sector rent levels and 11 for sale at market values. Borrowing to fund the rented units will need to be over 40 years as per the financial details later in this plan.

The homes themselves will be a mixture of 1 and 2 bed flats and 2 to 4 bedroom houses built as a mix of semi-detached and town house units.

The property mix for the Company has been informed by the current stock profile of the City and by specific research by specialists, Cushman & Wakefield, that evidences there is a strong market for the above portfolio mix of company products.

The company has been profiled and financially planned against these initial ambitions. However, the Company is also very much about a new, more flexible

approach to development and opportunities that are likely to arise and be taken up that mean the property mix and consequent financial modelling will change.

The company will build utilising modern construction techniques and to a high-energy efficiency levels (at least an energy efficient SAP rating of 89 – the Lincoln Private rented sector average is 58 as per a 2017 assessment). It will explore off site system build solutions and will utilise them if financially advantageous to do so. The build rates provided allow for similar build standard to that of registered providers (housing associations).

During construction, the Company will use external support with appropriate experience (known as employers agents) to manage the sites during development. They will liaise with the Housing Board directly.

The company will be responsible for obtaining planning consent, engaging with the contractors to build the properties and then managing the operation of the homes.

In order to progress each development, the following process is proposed:

1. Following identification of site opportunities, the Council will approve the principle of development on the land by the Company. This enables the Company to start incurring expenditure.
2. The Company approves designs and submission of a planning application together with seeking tenders for construction.
3. At this stage both the Company Board and the Council consider the final scheme proposal including construction cost estimates and funding arrangements. The proposal will then go forward to the Council's Company sub-Committee for final approval to draw down the land transfer and funding agreements.
4. Regular meetings will occur during and post the construction of the scheme and are undertaken by the directors of the company. They are designed to make sure that the scheme progresses as planned.
5. At any point, should a significant change occur this will be considered by both the Company Board and the sub-Committee to approve any variations.

The formation of this Company assists with meeting the Council's priorities in that;

- This company will enable the Council to access finance to increase the supply of good quality, value for money housing in the City, meeting the Housing Strategy. By increasing the supply of quality accommodation within the Council's control, this will widen the Council's options in discharging its statutory homelessness duties and secure accommodation for some of the most vulnerable residents in the City.
- The Company will provide access to good quality, stable housing which is a key aspect of a person's health and wellbeing.
- By using long-term finance the Council removes concerns over refinancing or having to sell properties. Furthermore, it will ensure properties are maintained at a good standard.

- By increasing the supply of quality homes that the Council can access within the City this will increase opportunities for local residents to access employment and education.
- The development activity will provide direct employment, jobs through the supply chain and the opportunity to grow local skills especially through apprenticeships.

4. Managing and maintaining the rented Housing stock

As construction is completed, the Company will use a mix of specialist advice and existing Council staff to organise the lettings and sale of the homes.

For the market sale properties it is envisaged that a local estate agent will be used, appointed through a procurement exercise. This is to ensure that the correct level of marketing and sales expertise is used to ensure quick sales. Conveyancing will be provided by the Council's legal team, who have the knowledge and experience through right to buy sales. Costs for these services have been provided for within the plan.

The management and letting of both the affordable and market rental properties will be provided by Council staff through a service level agreement. The Council's Housing department is the largest and most experienced comprehensive housing management and maintenance service in the area. The Company will employ the department to undertake all management and maintenance functions on its behalf.

Planned maintenance will be procured through the existing arrangements that work within the HRA and future investment programmes will be on a joint public procurement basis.

The initial marketing of the market rented housing will include using a third party for the first two years of operation whilst awareness is raised that the Council offers market housing products alongside its more usual submarket rent housing.

The Company will subsequently call upon other Council departments, such as legal services, finance and procurement for support as and when necessary and service level agreements will be put in place and have been factored for.

At this stage, it is not considered that any additional management or operational staff will be required to deal with the Company's requirements. Therefore, the above arrangements should lead to efficiency savings within the HRA, or assist with offsetting loss of income from right to buy sales. The General Fund may marginally benefit from this too.

Performance will be monitored by the Company Board, using key performance indicators in line with those presently gathered by the Housing department.

Core functions such as external audit and support to the Council's finance team will be directly procured. The Company will be required to produce accounts that follow the requirements of the Companies Act and will be consolidated with those of the

Council. There is also the requirement to perform corporation tax computations. Currently there is no knowledge or skills available with the Council's finance team to perform these so they will form part of the service that will be procured.

5. Developing and growing the Company

Initially the Company will not have directly employed staff. At initial low stock numbers such staff would be a relatively high cost burden. In its early stages the Company will be operated by Council staff working on the basis of recharging through service level agreements their time employed to the company. This may well be the long-term arrangement as well, but the option does exist to employ direct staff if this becomes more financially advantageous. The financial modelling, once beyond the initial set up phase, has been done on the basis of mirroring standard management and maintenance allowances as applied in the housing association sector i.e. standard average amounts for these functions based upon experience.

Formal decision making will be through a Company board of five. There will be three Council staff designated as board members from different professional disciplines namely, the Director of Housing and Regeneration, the Head of Finance and the Corporate Property Manager. There will be two members from the private sector on the Board, one with a financial background, preferably related to housing, and one with a private sector housing management or estate agency background. The three Council staff will receive no additional remuneration from the Company and the two private sector Board members will be paid an allowance based on attendance at Board meetings, policy and training days not to exceed 12 per year. These costs have been provided for.

A number of policy and governance matters will be reserved to a sub-Committee of the Council and these are listed as an appendix to this plan.

The company will act flexibly to maximise new build opportunities and to increase the overall quality of the housing stock within the city of Lincoln.

Through its experience of managing market rented properties the Company could look to expand into managing other private landlord properties within the City, therefore providing an additional income stream.

In the future, the Company could look to expand into regeneration and development of brownfield sites with the option of the purchase of existing properties and could seek to provide housing for:

- Essential key workers – discounted market rent, rent to buy, shared equity and starter homes
- Supported accommodation for those with special needs
- Retirement, extra care and sheltered accommodation
- Temporary accommodation for homeless households
- Student accommodation

The operation of a Company could also potentially ‘solve’ the issue of the HRA having to sell voids in order to fund the High Value Void policy which formed part of the 2016 Housing and Planning Act. Initial thoughts are that a number of properties per year could be purchased by the Company with the potential to retain them within the affordable housing sector within the City.

6. Financial modelling

Full details of the financial modelling undertaken can be found in Appendix 1.

The modelling has taken into account the very latest assessment of the Searby Road site that is ready to progress through design and planning.

In total 53 new homes have been modelled to deliver the following;

- 11 Properties for Market Sale
- 42 Properties for Rent at Market Levels

Extensive research has been commissioned and Messrs Cushman and Wakefield have identified valuations and rental levels for properties at the site. In addition, they have provided build rates for each property type which are in line with expected benchmarks. Additional on-costs have been modelled to allow for design, planning, abnormalities and management of scheme delivery.

The financing of the development costs for the schemes will be provided through the following;

75% Borrowing	25% Equity
<p>The Company will borrow via the Council's General Fund through a mixture of short and 40 year loans.</p> <p>The short-term loans will be repayable at maturity whilst the long-term loans will be on an annuity basis.</p> <p>The loans will be split between those providing finance for the market sale and market rented properties.</p> <p>The loans for market sale and market rented will be on a 'base rate plus a margin' basis (to which the Council will benefit) equivalent to market rates available for long-term development/acquisition loans to avoid state aid claims.</p>	<p>The Council will inject an initial 25% cash injection to the company as part of its shareholding.</p> <p>The Council will fund this via net land receipts and a mixture of short and long-term borrowing. The long-term borrowing is on an annuity basis and is for a maximum of 20 years in line with Government requirements.</p> <p>This demonstrates that there is a risk to the Council in that any loan premiums or dividends payable by the Company do not meet the cost of the loan financing therefore mitigating against any state aid claims.</p>

Additional short-term borrowing will be required by the Company to cover the interest costs and cash flow whilst the first schemes are developed out.

The modelling undertaken has been based on a series of assumptions (provided in Appendix 1 in more detail) agreed by officers and external advice and is summarised below:

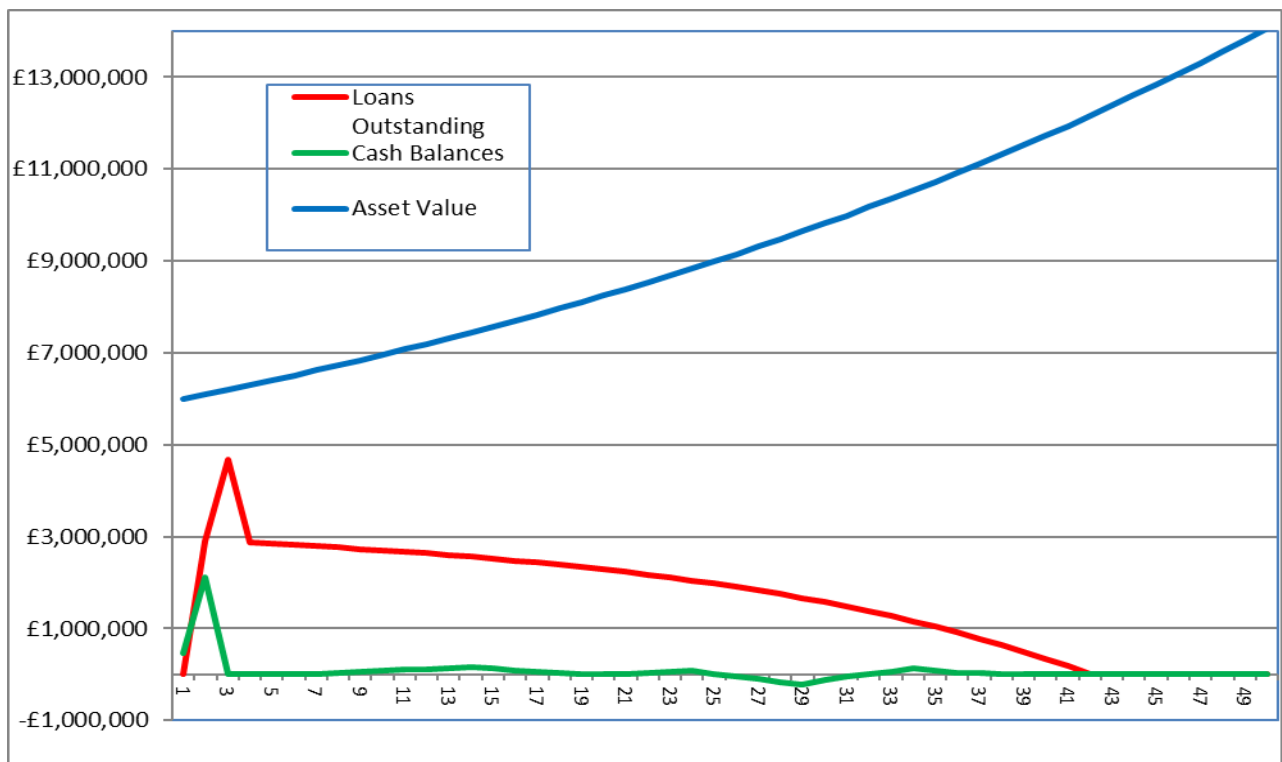
Input	Commentary
Sites	Searby Road site to be developed as a Company site.
Tenure Mix	A mix of 21% for market sale and 79% for rent at market levels.
Construction Programme	The site will take an estimated 12 months to build
Land Cost	An open market value has been attributed to the site
Construction Costs	These are based on external advice and in line with expected benchmarks with additional provision for on-costs by officers
Sales Profile	Sales occur 6 months after the site completion as a contingency
Sales Values	These are derived from external advice with allowances for discount and marketing and conveyancing costs
Rental Income	Market levels are derived from external advice
Management Costs	An allowance has been made for management, service costs, repairs and investment in the stock at appropriate levels
Bad Debts & Void Losses	Allowances have been made for these based on current HRA performance
Operating Costs	Allowances have been made for Board, external audit and accountancy services.
Inflation Factors	A full range of factors have been assumed in addition to a base CPI of 2% throughout
Interest Rates	A market rate has been determined based on 'base rate plus a margin'.. These rates are consistent with bank rate offerings for development and acquisitions

The key test for assessing viability is that:

- The Company can afford to meet its operational responsibilities in managing, maintaining and covering its financing costs for the loans provided by the Council. In addition, it should be able to create surpluses for redistribution through dividends to the Council as its sole shareholder.
- In-turn the dividend payments the Council receives and the premiums included within the loan interest payments the Company makes should be sufficient to cover the financing costs the Council incurs for providing the initial equity

The latest detailed modelling shows that the company can make dividends for the majority of years and that the Council will be always in a positive cumulative position in terms of the premiums and income it receives against its financing costs.

The graph below shows the projected borrowing that the Company would have in its own right, the cash balances and the projected net assets i.e. the market rented properties.

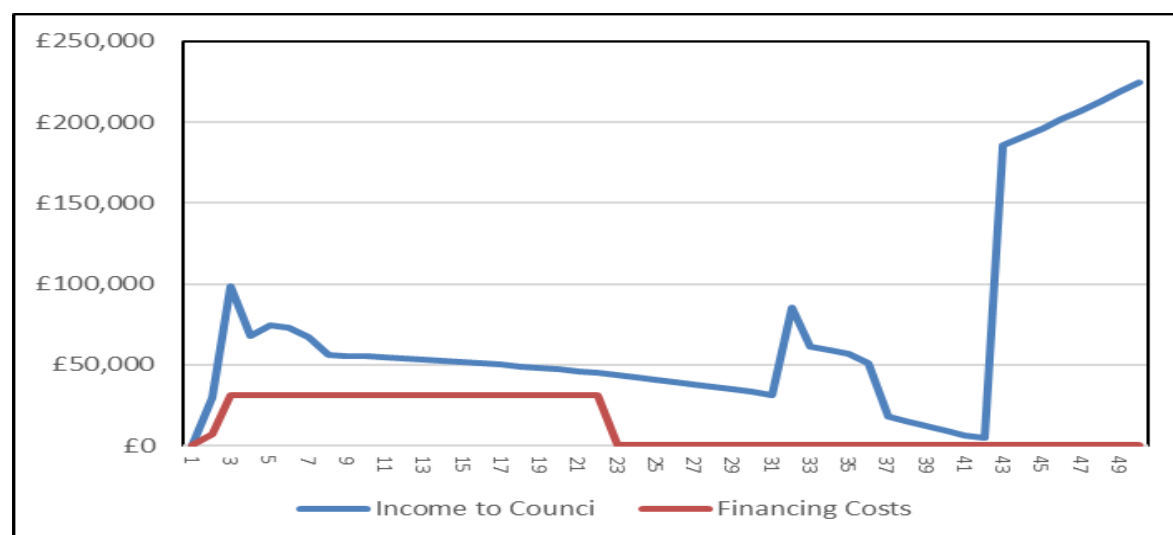


The above projections allow for the interest payments that the Company will make to the Council, but also dividend payments where possible. The premium element of the loan interest payments and dividends will cover the financing cost of the borrowing the Council undertakes to finance its equity injection.

Between years 25 and 32 the projected cash balances are below zero and the company may have to undertake an additional loan in order to cover this shortfall but the plan demonstrates that this can be financed.

As part of its long-term investment the Council will continue to receive dividend payments from a company that would be debt free and assets worth well in excess of the initial development costs.

The following graph shows the position for the Council in terms of the financing cost for the equity loans versus the net income it will receive from the Company by way of premiums on the loans charged and dividends received.



The above graph demonstrates that there are no years where the Council's cost of financing its equity loans is greater than the income from the company through loan premiums and dividends.

The Council hold the option to sell at anytime the market rental properties on the open market and the above graph for the Company demonstrates that the net value of properties remains significantly higher than the loan balances.

The intention is that the Company will be an investment company for tax purposes. However, to the extent that it will sell properties it could be regarded as a property trading company and the accounts will reflect this with differing treatment of tax for sales and for operating income.

The Business Plan modelling has been presented to the Council's General Fund financial advisors to provide an opinion with regards to best value and to the Council's treasury advisers to assess the borrowing requirements of the Company and impact to the General Fund. Comments made have been incorporated, where appropriate, in the Company's business planning process.

7. Risks

The table below identifies the key risks specifically associated with the Company. These risks will only emerge once the Company commences trading and development starts. Up until this point the only risk associated with the Company is the costs of set up and work to date.

Risk	Likelihood	Measures & Mitigation
The financial assumptions used to model the outputs prove to be materially different in practice	Low	The assumptions have been discussed internally and with external advice and are comparable with other similar products. Variations would be appraised by the Company Board for it to instigate compensatory changes elsewhere in the plan or to monitor the situation if considered marginal.
The site identified does not achieve planning permission	Low	The site selected is a prime development area. Alternative sites could be sought.
Land abnormalities are found on site	Low	Given the local knowledge of the area it is unlikely that anything will be found to prevent development. There is the outside possibility that the development could face delays through investigation or discoveries of archaeological interest.
Higher than anticipated build costs	Medium	This will be monitored and has a significant impact to the viability of the Company. Contracts could be let on the basis of risk transfer to the builders.
Rising Interest Rates	Low	Assumed increases have already been built into the model and further increases tested in the sensitivity section. In periods of higher inflation and interest rises market rents would expect to increase.
Ensuring that tax implications are minimised	Low	The model assumes full payment of corporation tax and non-recoverable VAT. Advice will be sought as part of the set up process to minimise future implications.
A Legal Challenge is made with regards to State Aid	Low	Expert opinion has been sought and informs the terms and interest rates offered on the loans by the Council. Rates modelled are equivalent to LIBOR rates plus uplifts to reflect market levels available to developers. The Council's equity investment at 25% has been used in similar scenarios and does not demonstrate a financial risk to the Council in terms of recovering its financing costs.
Properties prove difficult to sell	Medium	Research has shown that there is demand for homes for sale within the areas of development. Certain loans would have to be refinanced and properties let for short

		periods as market or affordable rent and then sold.
Properties prove difficult to let	Low	Research and known demand through the waiting list shows that this should not be problematic. Properties could be sold to mitigate this.
Demand for Certain Tenures Change	Low	The Company can seek to change market rented properties to affordable for a short or medium term though the impact to the business plan would be need to be assessed. The Company could seek to purchase homes on the open market if they prove viable.
Impact on staffing if the Company is wound up or does not progress	Low	The Company will not employ anyone directly and any services that cannot be provided by the Council internally will be outsourced. Any support from the Council will be using existing resources so there are no risks to current staff.
Perception and Reputation	Low	The Council's role as a housebuilder and operator in the private letting sector will need to be considered in the context of ensuring correct branding and marketing strategy.
Government Intervention	Medium	The creation of such a company is relatively new but over 50 local authorities have instigated or set up such organisations. Where local authorities are seeking to innovate there is always the risk through legal challenge and/or Government intervention.

The ultimate risk relates to the Company being at the mid-point in its development plans, having built some properties and committed to others, when one or more of the key financial assumptions change significantly to make the Company no longer viable, even with attempted compensatory changes elsewhere. In these circumstances the Company may need to be wound up and the assets would revert to the Council. It would then be up to the Council whether it wished to buy the assets and settle the liabilities or to sell the properties on the open market in order to pay off the debt. Much would depend on the financial market circumstances at the time and relative health of the HRA and General Fund.

If any loans for both the Company and Council were repaid in these circumstances, then a financial penalty for early redemption would apply.

8. Exit Strategies

There may come a point in the future when the Council no longer wishes to continue investing in the Company (e.g. if the target number of housing units has been delivered), or if the private sector is now building units at a sufficient rate. There may also come a point in the future when the Council doesn't wish to be the sole shareholder. In order to mitigate this a number of exit strategies would be available to the Company as follows:

- Secure alternative sources of finance from other lenders.
- Diversify into other areas of housing management or sell its services to others.
- Work in partnership with other organisations.
- Sell the Company as a 'going concern'.
- Dispose of the assets and wind up the company.