Scheme Feasibility

Karen Hillhouse. Land and New Business Manager

2 July 2018

Hastoe Group

The following note presents the funding model for the delivery of **affordable rent homes** in the context of a **rural exception site**.

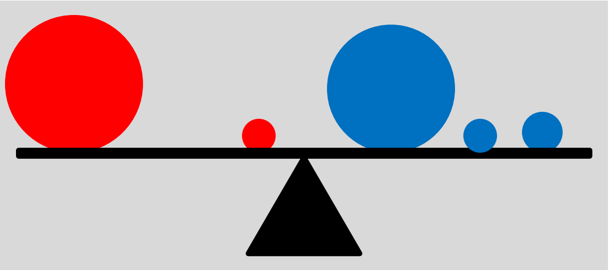
The development of new affordable rent homes requires large up front investment, primarily debt funded.

Contents:

- The cash flow balance of developing affordable rent.
- The costs of developing affordable rent.
- The income from developing affordable rent.
- Surpluses from existing rented stock to support the costs of developing new homes.
- Mixed affordable rent and shared ownership development.

Hastoe
Group

The cash flow balance of developing affordable rent



Costs – Short & Long-term

- **Land** – low, but significant and market influenced.
- **Abnormals** – preparing the site for development, can be material.
- **Build** – design, and contractor procurement
- **On-costs** – consultants, fees, professional services, development management, and financing.
- **Long-term maintenance & management**

Income – Long & short-term

- **Rental income** – below market rent, currently decreasing.
- **Grant** – relatively low and uncertain rates.
- **Subsidy** – additional cash flows from existing surpluses and commercial profits to reduce and support on-going debt.

Costs – Land & abnormals

- Land costs for affordable rent homes typically vary between £5k and £12k per plot.

- Whilst suppressed, land values for affordable rent have an intrinsic link to open market values, and the hope value land owners associate with their land.

- Land prices are defined by the value land owners are prepared to release land for affordable housing development.

- Works are required to land to make it suitable for housing development covering a broad range of areas, including, infrastructure, services, and land remediation.

Due diligence

Restrictive covenants

Services

Drainage

Highways

Hastoe Group

Costs - Build

- Housing associations typically procure construction contractors through a competitive tendering process. Build costs include a margin for contractors who manage the construction process, and assume many risks.

- Build cost variance is driven by:
  - Type of home built – i.e. house/flat, 2/3/4 bedrooms etc.
  - Quality of build – Building regulations, Passivhaus, Home Quality Mark. Housing associations build affordable rent homes based on a long-term view of managing and maintaining.
  - Aesthetic design – quality and appearance of design
  - Build methodology

Balancing build cost, design and sustainability

Choose the correct design team

Materials

Costs – on-costs, maintenance and management

- In addition to land, abnormals and build costs, developing new homes incurs further costs relating to a range of professional services covering design and development management, including:
  - Architects
  - Planning
  - Employers agents
  - Direct staff costs
  - Construction management
- The development of homes is largely debt funded, and interest incurred during the construction period.
- Once built and let, homes are managed by a dedicated housing management team, and homes are maintained to a decent standard.

Income – Rental income

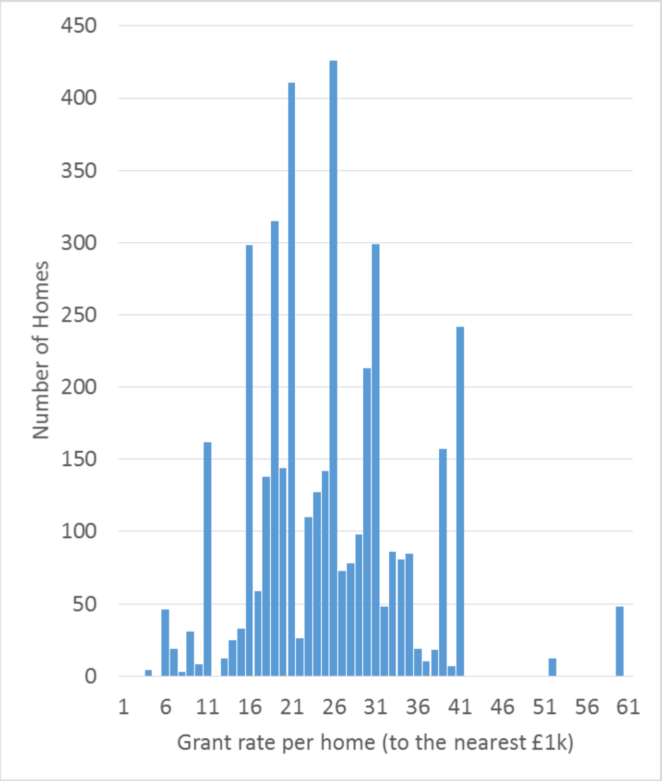
- Affordable rents are set at 80% of the open market value rent for that specific property (including service charges).
- Many housing associations cap rent at the Local Housing Allowance (LHA) levels. This is defined across Broad Rental Market Areas (BRMA), and is the capped level of housing benefit LA's will pay.
- LHA's are set by the number of rooms per property, and based on the 30th percentile of market sampling provided by the Valuation Office Agency (VOA).
- Example of 2 bedroom homes for Chichester's BRMA's

BRME	Chichester
Min rent	128.88
Max rent	471.78
80% of min. rent	103.10
80% of max rent	377.42
LHA (30th percentile)	**168.00**

Hastoe Group

Income – Grant

- Grant rates are at historically low rates, with the average grant awarded in the East and South East to grant funded affordable rent homes in the 2015/18 AHP at £24.3k per home. In the late stages of the 2008/11 NAHP grant was awarded at a rate of over 50% of the total cost of a new home.
- The distribution of grant rates in the East and South East is shown in the chart.
- For a time the HCA stated that no new grant would be made available for affordable rent homes, though grant is now slowly being made available.

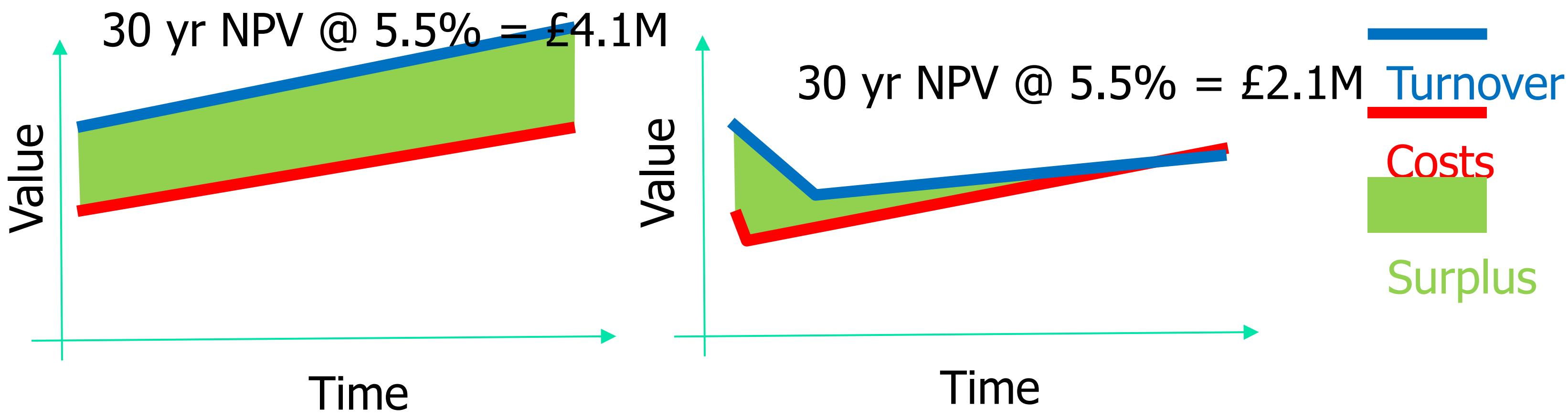


Income – subsidy (existing surpluses)

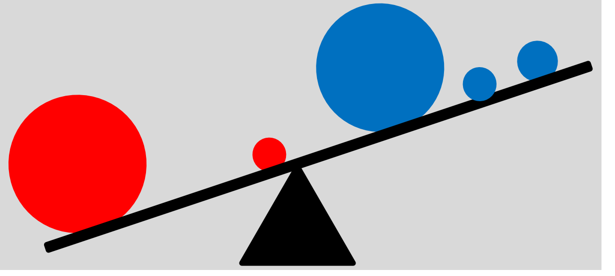
Well managed Housing associations generate surplus cash from their existing housing stock. These additional cash flows can support additional debt. The rent cut significantly reduced the forecast values of these cash flows.

The example below illustrates the impact of the rent cut on forecast surpluses based on a £1M turnover with a 25% margin prior to the rent cuts; and assumes an initial 10% cost saving is found in year 1 following the rent cuts.

The impact of the rent cuts in the below example, along with future rent growth uncertainty, halves the value of the surpluses generated. These surpluses are used to cross subsidise the development of new homes.



The cash flow balance of an affordable rent home



Applying Net Present Values to discount future cash flows to today's value. E.G. discounting 30 year cash flows at a rate of 5.5%, equivalent to average funding costs and periods.

	Costs	Income	Variance
Grant		30,000	
Land	10,000		
Abnormals	10,000		
Build	140,000		
On-costs	25,600		
Sub-total	**185,600**		
Management (NPV)	6,553		
Maintenance (NPV)	34,163		
Sub-total	**40,715**		
Rent (NPV)		136,575	
Total	**226,315**	**166,575**	**59,741**

Hastoe Group

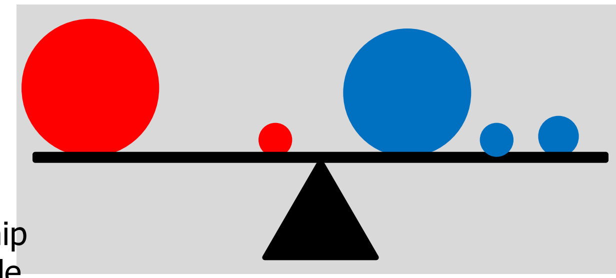
Subsidy - shared ownership & sale

- Many affordable developments provide a mix of affordable rent and shared ownership ownership. The overall returns on shared ownership are driven by a number of variables, most significantly the Open Market Value (OMV):Cost ratio, and the initial first tranche share sold. The table below illustrates the NPV (30 yrs @ 5.5%) of a home with a £300,000 OMV (rent charged at 2.75% of the unsold equity) across the two above variables:

		Initial first tranche sale			Open market sale
		30%	50%	70%	
OMV: Cost ratio	125%	(31,501)	(5,358)	20,785	60,000
	140%	(5,786)	20,357	46,500	85,714
	155%	14,951	41,094	67,237	106,452

- Many Rural Exception sites have a restriction on the level of stair-casing allowed on shared-ownership, typically not allowing stair-casing to exceed 80%. Whilst this retains the home as affordable shared ownership in perpetuity, it does restrict the saleability of the homes and so low initial first tranche shares are sold.

Balanced scheme (example)



Example
8 affordable rent
2 shared ownership
2 open market sale

	Costs	Income	Variance
Sales		780,000	
Grant		380,000	
Land	164,000		
Abnormals	120,000		
Build	1,680,000		
On-costs	373,160		
Sub-total	**2,337,160**		
Management (NPV)	56,788		
Maintenance (NPV)	273,302		
Sub-total	**330,090**		
Rent (NPV)		1,329,596	
Subsidy (existing)		177,654	
Total	**2,667,250**	**2,667,250**	**-**

- A mixed tenure scheme probably still requires subsidising from existing surpluses.
- Grant rates need to be higher than those currently being awarded.
- Land costs for shared ownership and open market sale tend to be high than affordable rent.
- On-costs slightly higher to allow for sales and marketing.
- Circa £180k of subsidy is required in this example to deliver 8 affordable rent homes (i.e. £22.5k per home), compared to £60k in earlier example.

Summary

- Affordable rented housing development is largely debt funded.
- On-going net rental cash flows will be used to service the debt, however they are not sufficient to service all the debt.
- Current low grant levels do not significantly reduce the opening debt.
- There are a number of major variables in the affordable rent development model, on both the sides of cost and income.
- Shared ownership can generate surpluses, but are not typically large enough at a low selling share to significantly subsidise affordable rent.
- The rent cut policy has significantly reduced the capacity for housing associations to subsidise new development from existing surpluses.
- The provision of open market sale can generate profits to reduce the long-term debt levels of affordable rent.