Subject: **HMOs and Guesthouse Purchase and Repair Scheme**

Report to: **Housing and Neighbourhoods Committee – 14th March 2019**
Policy and Resources Committee – 19th March 2019
Full Council – 23rd April 2019

Report by: **Anthony Moore, Housing Growth Manager**

RECOMMENDATIONS

That Policy and Resources Committee:

1. **Agree that the council progresses the HMO and Guesthouse purchase and repair scheme outlined in this report and recommend to Full Council for approval.**
2. **Recommend an initial £2m capital budget to be used to deliver the purchase and repair scheme and refer the approval of the initial £2m capital budget to the Full Council.**

1. INTRODUCTION

1.1. The council is seeking to build on the framework provided by the Acquisitions and Disposals Policy to acquire residential properties in order to provide better quality homes in the borough.

1.2. The housing market in parts of the town of Great Yarmouth has challenges including low property values, low rental income, economically unviable guesthouses, streets in conservation areas needing uplift and lack of private investment. Ultimately, this has led to attractive streets being converted into Houses of Multiple Occupation (HMOs) as their most or only profitable use. Many of these HMOs and guesthouses are often not well maintained and can bring an otherwise attractive area down, stalling regeneration and reducing the incentives of existing homeowners and landlords to improve their own properties.

1.3. This report explores opportunities for the council, like many other local authorities in coastal towns, to invest its own capital in purchasing carefully selected residential properties, renovating them and bringing them back into use as houses or flats in an improved condition. Case by case, this could be for sale, for an affordable rented home, or as a market rent scheme.

1.4 The council will need to establish a property development company to hold any properties outside of the HRA. Due diligence on this is nearing completion and is due to report ELT shortly. This will be reported to committee separately.

2. STRATEGY AND METHODOLOGY

2.1. The new HMO selective licensing scheme and the continuing changes in tax treatment of commercial home ownership means that some landlords are leaving the market. There is the potential for the council to play a role in filling that gap and making a positive intervention to improve the quality of rental property available in the town centre. Due to its ability to raise finance at a lower interest rate and over a longer period, the council has the potential to purchase HMO and guesthouse properties at a financially viable level.

2.1. The potential purchase of the property will be in line with the council's Acquisition and Disposal Policy. The policy provides the full detail of the process. A property may be suitable for a number of reasons:

- Size – a viable number of flats could be created from the property or it meets the need for larger housing;
- Value – it is priced to make it financially viable;
- Location – the properties are in areas which have regenerative potential;
- Condition – presents an opportunity to uplift the area;
- Suitable layout – they may have already had planning permission for conversion or been converted;
- Market failure – properties which have proved not viable for previous developers to build out or were failing businesses;

2.2. This report will take two case studies as **examples** of investment potential. The examples chosen have recently been on the market and represent two different examples within the above proposed investment strategy in order to establish the viability of the approach.

2.3. The council has modelled the financial parameters of the scheme. These have been set using data from Housing, Finance and estimated repair costs from the assets team. Property values and market rent information has been taken from existing data, including Hometrack. Build costs and professional fees are set at a cautious, yet evidenced level based on upper level market costs. The asking price is used as guidance for the purchase price. Please see Appendix 2 for assumptions.

2.4. As a scheme appears viable it will proceed for more detailed consideration and will begin to attract cost, for example, by undertaking a survey. The overall cost of the project will be refined through professional advice, for example, by engaging an architect. The principle will be to incur as little cost as possible to make an informed, proportionate decision at each stage. If a scheme fails to meet the criteria, this will be identified at the earliest possible stage.

2.5. The appraisal model shows an Internal Rate of Return (IRR), Net Present Value (NPV) and payback period as outputs of financial health. IRR is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project equal zero. IRR is used to evaluate the attractiveness of a project. NPV is a tool to determine whether a project will result in a net profit or a loss. A positive NPV results in profit, while a negative NPV results in a loss. The NPV measures the excess or shortfall of cash flows, in present value terms, above the cost of funds.

2.6. As the inputs change, so do these outputs. For example, the council may alter the build cost based on new information and the outputs will reflect this changed figure:

- An IRR of above 3% means the scheme has a higher yield than the interest rate on monies borrowed from the Public Works Loan Board
- A positive NPV shows the current value of the investment
- The payback period indicates whether the return covers the initial investment, management costs and interest over a set time period. Currently this is over a 30 appraisal period as per Capita's HRA model.

3. INDICATIVE SCHEMES

3.1. Two schemes have been chosen to model the principles of the approach. Both have been visited by officers to inform potential renovation costs.

<u>Opportunity 1</u>

3.2. A terrace of three 5 bed houses in a Victorian Square in central Great Yarmouth (photo attached as Appendix 1). The houses are in a dilapidated state, albeit two of the three are let at £600 pcm (we have subsequently served the owner with a notice regarding the condition). The middle house appears to have been started to be converted to 3 flats and there is an expired planning permission to convert all 3 houses to a total of 9 flats. The asking price, at the time or writing, is £375,000 and the properties have been advertised for nearly a whole year. This represents an example of an extremely poor condition property which would struggle to raise a profit yet could have a regenerative effect beyond the initial outlay.

<u>Opportunity 2</u>

3.3. A four storey house, again in a Victorian Square (photo attached as Appendix 1). The property has a modern rear extension and has been converted into 6 flats. The vendor has recently spent c.£40k renewing the properties to make them more attractive for a quick sale and a non-intrusive inspection showed a relatively good condition requiring relatively little investment required before letting the properties. The property was going to auction with a guide price of £350,000 but an informal chat with the vendor elicited his expectation of around £370,000. This represents an opportunity to take over a successful, good condition conversion in a target area; maintain or improve its appearance; and bring in a profitable yield to the council and, possibly, cross-subsidise less viable schemes in the proposed programme.

4. FINANCIAL APPRAISAL

4.1. The scheme is proposed to be at least cost-neutral with the potential to produce a profit for the council. The council will not pay above market rate for any property. The ultimate aim is to have a positive effect on the environs of the town centre, to reduce the number of poor condition HMOs and to provide a higher quality of accommodation in areas where the private market cannot afford to.

4.2. Both schemes have been modelled over a 30 year payback period. Both of the schemes have been appraised three times: as completely affordable rent, as completely market rent and as completely market sale. This enables a comparison between the options, to enable an informed decision as to the final mix. If the scheme fails to break even (IRR 3%), a final column indicates what purchase price the council would need to pay to meet a breakeven point.

4.3. Additionally, Opportunity 1 has been appraised as both 3 x 5 bed houses, meeting a definite need within the borough; and 9 flats (the expired planning permission). In both instances works costs have been provided by a Property Surveyor. The tables, below, show the headline figures:

<u>Opportunity 1</u>

30 year appraisal 3 houses.

Tenure	IRR (%)	NPV (£)	Upfront cost - net any grant	Payback period (yrs)	Break even price @3% IRR
Affordable Rent	0.5%	-£215,971	£750,628	not repaid	£150,000
Market Rent	1.59%	-£128,212	£750,628	39.7	£260,000
Outright Sale	-44.01%	-£322,312	£750,628	Not repaid	£40,000

30 year appraisal 9 flats

Tenure	IRR (%)	NPV (£)	Upfront cost - net any grant	Payback period (yrs)	Break even price @3% IRR/profit
Affordable Rent	-0.64%	-£306,996	£819,354	not repaid	£55,000
Market Rent	2.88%	-£12,430	£819,354	32.8	£360,000
Outright Sale	-22.41	-£197,754	£819,354	Not repaid	£170,000

Opportunity 2

30 year appraisal 6 flats

Tenure	IRR (%)	NPV (£)	Upfront cost - net any grant	Payback period (yrs)	Break even price @3% IRR
Affordable Rent	3.11%	£5,491	£408,975	32.5	Full asking price
Market Rent	6.21%	£172,221	£408,975	18.6	Full asking price
Outright Sale	-99.67%	£131,469	£408,975	0.4	Full asking price

5. FINANCIAL IMPLICATIONS

5.1. This report proposes the establishment of a new capital budget from the General Fund of, initially, £2m to fund the project.

5.2. The £2m will be funded from borrowing and the revenue implications (costs) of the borrowing will be mitigated by the revenue income stream from the proposals.

5.3. In principle the council aims to 'recycle' some of this funding through the sale of properties. Close monitoring of the capital fund will be required to track the use of funds for market rent properties which are retained as this will reduce the capital funding available for further property purchases.

5.4. The creation of a portfolio of housing assets will provide the council with a new independent stream of medium to longer term income. The council's exposure to debt will need to be considered as part of its Treasury Management function and will be reviewed annually. When assessing investment opportunities we will use the PWLB 30 year interest rate and payback period as per the Capita HRA model.

6. SENSITIVITY ANALYSIS

6.1. Some variables have been chosen for sensitivity analysis as an indication of how these risks may change financial outcomes and the results are shown in the table below:

6.1.1. 40 year payback period. There has been recent talk of Capita moving to a 40 year payback period to help finance HRA schemes whilst remaining well within a realistic timescale for building lifespan. Modelling in this way would help the viability of the scheme but would currently be different from how we appraise other comparable schemes.

6.1.2. Build costs. The most likely variable. Estimates are deliberately generous currently but with labour market forecasts suggesting a competitive labour market, these have been modelled at a 10% increase.

6.1.3. Market rents. Currently modelled against local comparables and would be backed up by a market valuation should we proceed to an exchange. These are unlikely to go down in the short term considering the shortage of good quality market rented units, however they have been modelled with a 10% decrease.

6.1.4. Void rates. The current allowance within the model is 6.7% of units being void for 35 days. This is cautious, being modelled on the average of both GYBC's regular and major voids figures. It is unlikely a good quality, recently refurbished unit would hold the same voids risk. It has been remodelled at 3.9% for 23 days, in line with 'regular' voids.

6.1.5. Not modelled: Contract length – most contracts have penalty clauses which indemnify the client against poor contractor performance being a long stop date; Sales prices - We are not looking to sell these units in the current model; purchase price – our purchase offer price is calculated on what GYBC could afford to pay, not on what is requested by the vendor; Affordable rents – these are set at Local Housing Allowances and increases have been set by HM Govt for the foreseeable future.

6.2. Results – as an example the Market Rent scenarios based on the 30yr Model, 9 flat scheme for Opportunity 1 show these changes in outputs:

Sensitivity variable.	IRR (%)	NPV (£)	Upfront cost - net any grant	Payback period (yrs)	Break even price @3% IRR inc. SDLT
Market Rent (original appraisal)	2.88%	-£12,430	£819,354	32.8	£360,000
40 yr Payback	4.35%	£192,683	£819,354	32.8	£525,000
10% increase in build costs	2.51%	-£51,069	£860,165	34.3	£320,000
10% drop in market rents	1.44%	-£145,976	£819,354	Not repaid	£220,000
Reducing Voids from 6.7% to 3.9% and the days from 35 to 23.	3.73%	£75,390	£819,354	28.4	£450,000

7. RISK IMPLICATIONS

7.1. Acquisition risk – there is always the potential for a downturn in the property market at some point in the future. Equally there may be signs of increased competitive activity from smaller property companies. This could result in the council being one of several bidders for any good quality properties. Just like any private sector bidder, it is likely that the council will be an unsuccessful bidder on occasions. Due to the nature of the property market, decisions may need to be taken quickly in order to put offers forward. Agility will need to be built into any request for authority to proceed. The council is seeking to mitigate this risk by having delegated authority to purchase properties to Strategic Directors and the 151 Officer as per the Acquisition and Disposal Policy.

7.2. Cost risk – legal costs, survey fees, and officer time may be incurred in potential purchases which do not proceed. The proposed process reduces these costs to the minimum for the longest possible period by seeking to identify issues at the earliest possible stage.

7.3. Property market risk – residential property is a riskier asset than other asset classes because of its physical characteristics, which need to be managed and maintained. This is often compensated by increased returns. However, the property market is not a certain market and the council may not achieve target returns if market conditions significantly worsen. This risk will be mitigated by regular reviews of market conditions.

7.4. Void risk - close management of the asset portfolio is critical to the success in delivering income. Long term voids will have an impact on the overall revenue budget with no income to offset the costs of owning a property. It is therefore important to monitor the level of voids over the entire portfolio, with an allowance being made for this within the financial modelling.

8. LEGAL

Section 123 of the Local Government Act (1972) creates a duty on the council to obtain the best consideration that can be reasonably obtained for the disposal of a property asset. This duty is subject to certain exceptions that are set out in the General Disposal Consent (England) 2003.

8. CONCLUSIONS

9.1. The council has an opportunity to play an active role in shaping the nature of residential communities in the town centre. Rather than simply leaving this to the open market the council can play a role by acquiring residential properties in order to provide a greater number of better quality homes in the borough. This should create a greater mix of properties in order to foster more sustainable communities.

9.2. Any proposal must be financially viable. Currently, the proposals have been modelled to payback over a 30 year period. The report models two different examples of the kinds of property which could be considered. The council anticipates these properties will require some degree of refurbishment. It has modelled conservative rates for costs, voids and property maintenance. Options exist for the properties to be either sold to generate a capital receipt or let to provide better quality rental accommodation for local people.

9.3. The council is well positioned to take advantage of borrowing facilities to achieve this at a time when some landlords are selling. Rigorous due diligence and market intelligence can mitigate most risks to the council. There is the possibility of flexibility of tenure to meet changing needs. The creation of a portfolio of housing assets will provide the council with a new independent stream of medium to longer term income.

10. RECOMMENDATIONS

That Policy and Resources Committee:

10.1. Agree that the council progresses the HMO and Guesthouse purchase and repair scheme outlined in this report and recommend to Full Council for approval.

10.2. Recommend an initial £2m capital budget to be used to deliver the purchase and repair scheme and refer the approval of the initial £2m capital budget to the Full Council.

BACKGROUND PAPERS

Acquisitions and Disposals Policy

Appendix 1 – example units under consideration

Appendix 2 – Financial Modelling assumptions.

Areas of consideration: e.g. does this report raise any of the following issues and if so how have these been considered/mitigated against?

Area for consideration	**Comment**
Monitoring Officer Consultation:	Yes
Section 151 Officer Consultation:	Yes
Existing Council Policies:	Yes
Financial Implications (including VAT and tax):	Yes
Legal Implications (including human rights):	Yes
Risk Implications:	Yes
Equality Issues/EQIA assessment:	No
Crime & Disorder:	No
Every Child Matters:	No