Annex C

Social Finance Report on Brent Property portfolio acquisition

Summary of Key points on setting up a council owned company

Executive Summary

- The Social Finance Report for Brent looks at the potential for Brent to acquire a portfolio of property, potentially across a number of geographic areas, to be used as accommodation for homeless households.
- Properties would be renovated to a good standard and let at Local Housing Allowance levels, either to prevent homelessness or to end a homelessness duty.
- Analysis of 13 geographic markets highlights that for Brent to acquire a significant number of units it will have to look outside of its home borough, even at lower target gross yields
- The number of properties that can be acquired is critically dependent on the target gross rental yield applied in the acquisition phase.
- A lowering of the target gross yield from 6% to 5% would increase the number of available properties by a factor of almost three. A reduction below 5% would make further substantial increases in the number of available properties. For any solution to reach a critical scale over the next few years, a gross yield below 6% would need to be considered for acquisitions.
- A decision will need to be made over whether the delivery route is required to achieve an income just to cover interest costs (plus a margin for safety) or whether it will also be required to generate additional cash to repay the principal on the loan. Debt structures which delay repayment of principal offer potential advantages in the early years of a scheme.
- Using shorter term finance could potentially help lower interest rates given the current yield curve, however this would leave the delivery vehicle facing refinancing risk. Longer term debt would address this issue, at the cost of higher initial interest rates, and would also protect against short term fluctuations in house prices.
- Since the accommodation will be providing “sub-market” housing, there is precedent to use existing Services of General Economic Interest State Aid exemptions, allowing Brent to on-lend from PWLB or other internal sources at no additional margin.
- There are two principal routes to mitigating the risk that the portfolio of properties does not deliver the financial returns expected. These are (1) selling units or (2)

converting the portfolio to market rent. A change of use for the properties, depending on the financing arrangement, potentially has State Aid considerations.

Number of properties available

The number of properties annually available for sale in the market is critically dependent on the gross yield required to be provided by Local Housing Allowance level rents.

Table 1. shows this in a number of potential target areas, which we expect would be compliant with the government's suitability order governing out of area placements of homeless households.

Table 1. Estimated number of properties available at different gross yields

Area	Estimated Annual No. of Properties Available at Gross Yield 6%	Estimated Annual No. of Properties Available at Gross Yield 5.5%	Estimated Annual No. of Properties Available at Gross Yield 5.0%	Estimated Annual No. of Properties Available at Gross Yield 4.5%	Estimated Annual No. of Properties Available at Gross Yield 4.0%
St. Albans	0	0	3	9	19
Three Rivers	3	6	6	6	25
Hertsmere	3	6	9	22	53
Harrow	6	11	26	53	115
Leighton Buzzard	3	6	28	53	84
Watford	16	22	31	53	87
Dunstable	28	31	43	68	93
Slough	12	28	53	118	248
Wycombe	19	43	68	146	270
Dacorum	19	47	71	130	236
Brent	29	43	90	195	368
Luton	56	102	152	239	388
Milton Keynes	133	211	335	508	744
Total	327	557	915	1600	2728

Brent could of course only purchase a proportion of available properties in any area without risking putting up prices. It should be noted, that there 5400 properties were available for sale in these combined locations, so any purchases would likely constitute only a small percentage of the overall market.

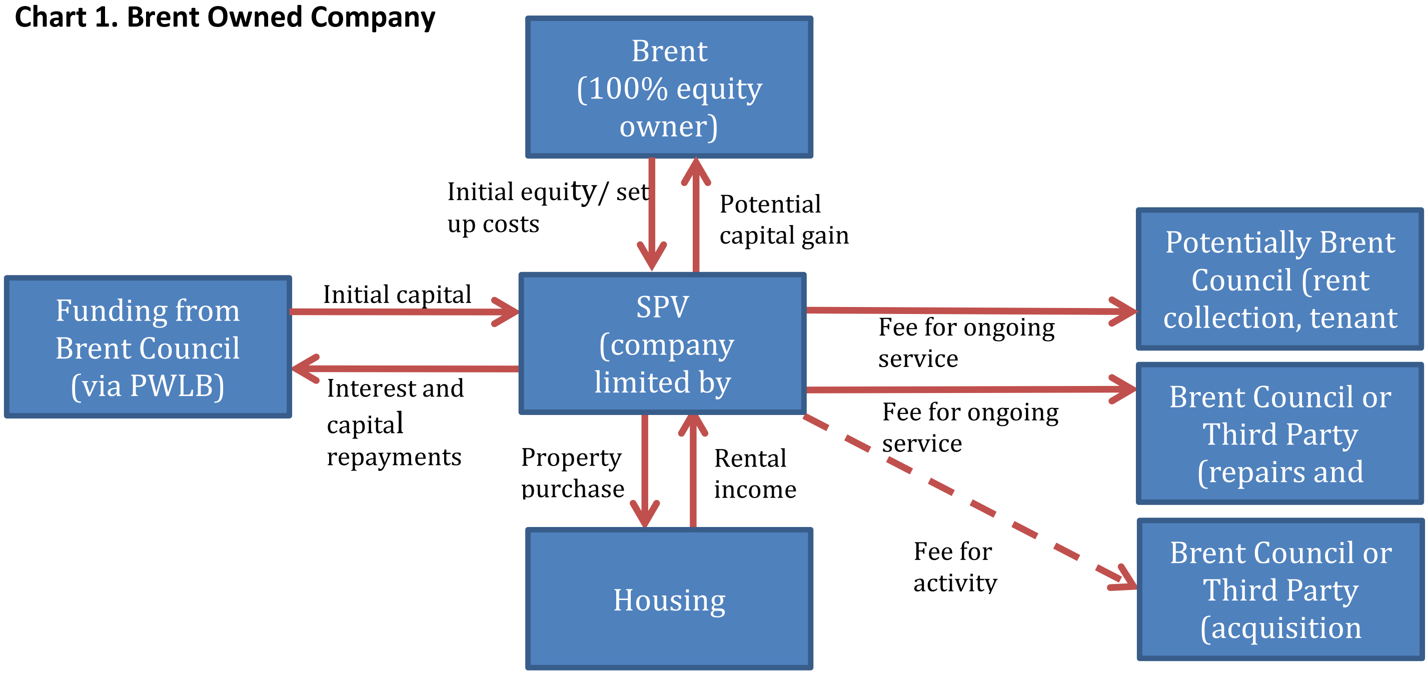
Sensitivity analysis of the above shows that a 10% increase in property prices reduces the number of available properties to purchase by around 40% given unchanged rental income. In other words if property prices rise by 10% in a year, then delaying acquisition of properties by a year would mean 40% less available properties on average.

Proposed Solution:

- Brent Council directly set up a local authority controlled housing company, which is a company limited by shares.
- The company would be established with the purpose of creating a portfolio of residential property which could offer households currently living in temporary accommodation a good quality, well managed private rented sector property, affordable at Local Housing Allowance rental levels.
- Tenants would enter into an Assured Shorthold Tenancy with LHC, and the accommodation would enable Brent Council to end a homelessness duty through a PRSO or prevent homelessness.
- The portfolio would be established through the purchase of existing street property in areas selected by Brent, which would be purchased and renovated.
- Tenancy management, maintenance and other on-going operations would be carried out by the company who could either enter into a Service Level Agreement with Brent Council for services or contract with a third party.
- The company could potentially be financed via PWLB (with Brent borrowing from PWLB and then lending on to the company).
- Since the principal activity of the company is the provision of housing at affordable levels, its activities would fall within the Services of General Economic Interest (SGEI) State Aid exemption, and as such there would be no requirement to add a margin to the on-lending.

The likely structure of relationships and transactions involved in the operation is summarised in Chart 1.

Chart 1. Brent Owned Company



Financial Viability

Chart 2., below, illustrates the net operating income yield before finance (NOI) under different rental inflation assumptions, (assuming a 6% gross rental yield). Costs are assumed to increase at 2.5% p.a in all cases. If rent is fixed for an extended period, the NOI yield declines due to cost pressures. If rent increases at a rate of more than 1.0% p.a. then NOI yield expands over time, as the rental income increases exceed the increases in costs. The extent and rate that NOI yield expands is critical in determining whether there is potential to repay principal as well as interest over the life of the scheme

Chart 2. Net operating income with varying rental inflation.

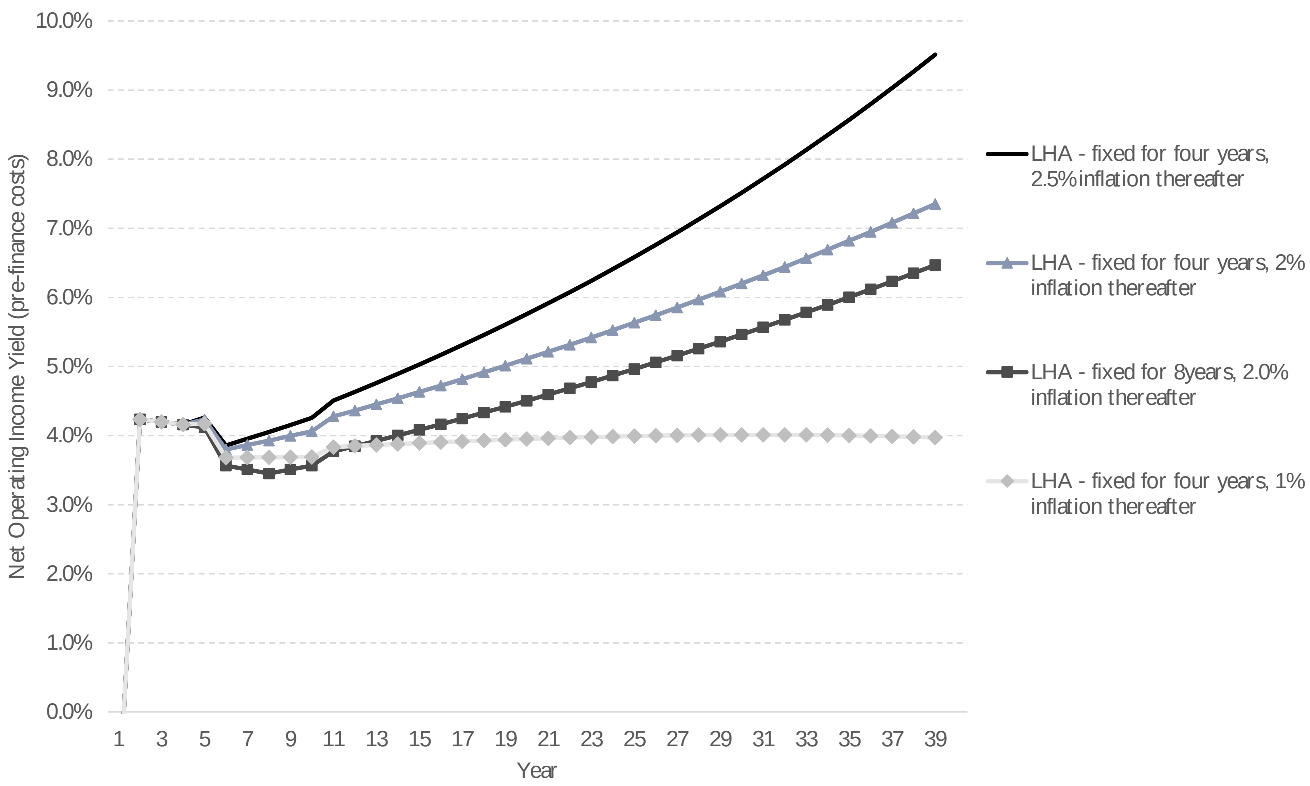
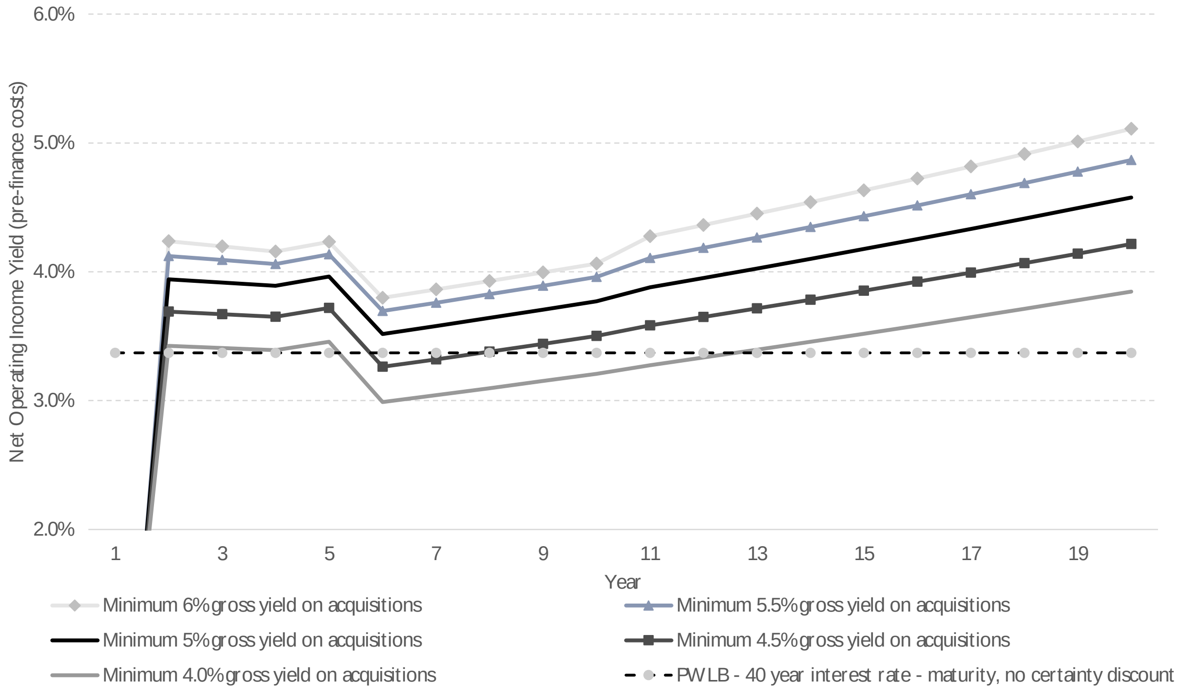


Chart 3., below, illustrates net operating income yield of a housing company under different target gross yields for portfolio acquisition. With a 5%+ target, there is potential to exceed the interest cost of long term finance (assuming PWLB interest rates) in every year of the loan. Rental inflation is assumed at 2% p.a. (post the four year LHA freeze) and cost inflation at 2.5%. p.a.

Chart 3. Net Operating Income compared to PWLB rates



Risk Management

There are numerous operational and financial risks associated with the creation of a housing delivery vehicle, irrespective of the delivery route. There are a number of methods by which internal risks can be managed on a day-to-day basis, but the provision of housing at Local Housing Allowance rates faces a number of potential external factors which may be outside the control of the delivery vehicle.

There are two key options for responding to an external shock 1) selling units to exit and/or repay principal of loans and 2) converting rental levels from sub-market to market levels to boost income mid-scheme.

1) **Selling Units** – the following charts highlight that the potential for this to be an effective risk mitigation depends on the timing of any sale and therefore the value realised, <u>assuming a long run nominal inflationary environment for house prices.</u> If units are purchased at the start of an up-cycle, there is potential over time for inflation to create a cushion, giving some degree of reassurance that a sale will recover sufficient capital to repay principal on loans. If units are bought later in the

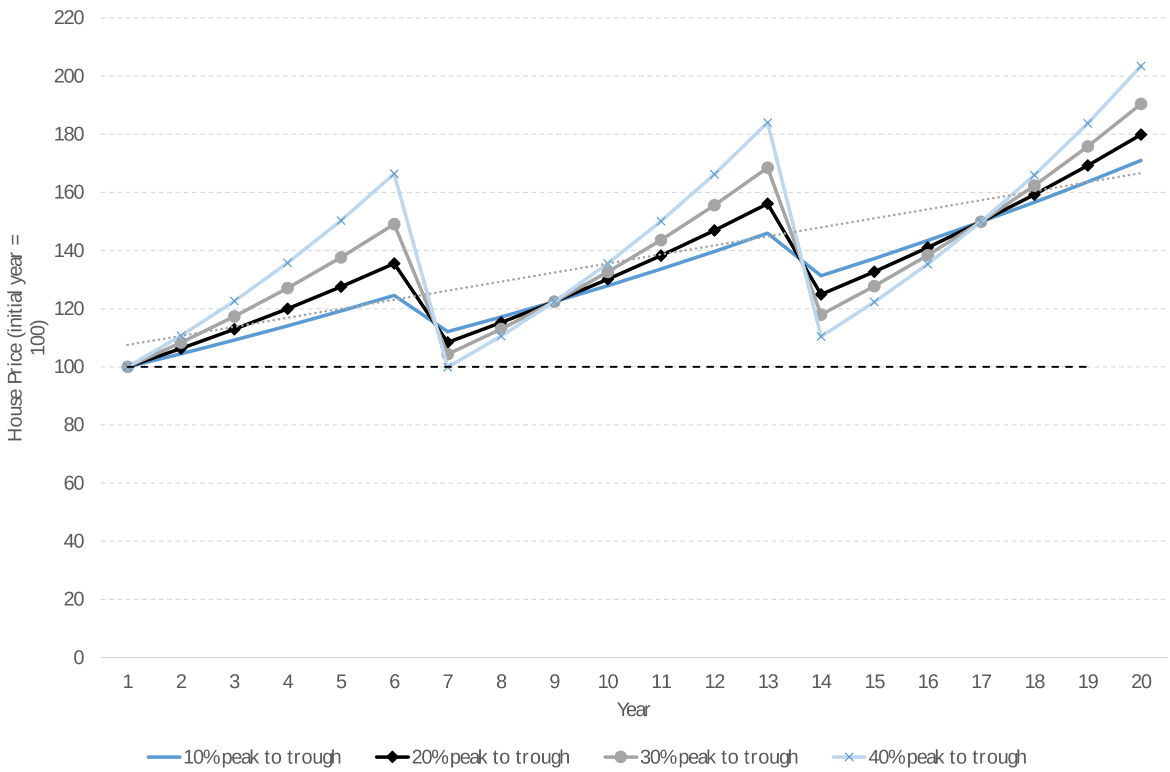
cycle, this cushion may take a number of years (cycles) to be achieved. Over a sufficiently long horizon, assuming positive house inflation, this route could give some comfort as a means to repay loan, particularly if structured as a maturity/bullet repayment.

2) **Converting to market rental** - median market rents are typically 15-50% above Local Housing Allowance levels. This offers the potential, dependent on the units acquired to convert from renting at sub-market to market levels, boosting gross rental income. This benefit however may be partially or wholly offset if this action requires a repricing of the interest rate on debt for State Aid reasons.

3) Chart 4. below illustrates the potential for house price inflation to provide a risk mitigation against the value of a loan, using a very simple model of house price inflation. This model assumes a 7 year cycle (6 up years and 1 down year), with a trend growth rate of 2.5%.

4) If units purchased at start of cycle, then by Year 6 (peak) value has increased to extent that can absorb up to a c. 40% peak to trough decline, and still meet initial value if sold.

Chart 4. Value of properties compared to purchase price if bought at the <u>bottom</u> of the cycle



The situation is very different if properties are purchased at the end of cycle (Year 1 is now 6th year of a 7 year cycle). In this scenario depending on where you buy in the cycle it can potentially take multiple cycles before the value of units would exceed initial purchase cost even in a down turn. For example if peak to trough decline is 30%, then it would take until year 22 before confidence that values in a downturn will exceed initial purchase cost.

Chart 5. Value of properties compared to purchase price if bought at the <u>top</u> of the cycle