Council and RSL housing stock in Scotland

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Social Housing in Scotland

i.s.4 report to Audit Scotland

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INTRODUCTION AND BACKGROUND

About this report

Audit Scotland commissioned i.s.4 housing and regeneration limited (i.s.4) in August 2012 to conduct an independent assessment of the relative performance of social housing stock in Local Authority and RSL ownership in Scotland using publicly available data. This was to inform Audit Scotland's national performance audit report *Housing in Scotland*. This short report summarises the methodology applied and the key findings of our analysis.

Scope of our work

Our analysis focussed on a sector-wide assessment of social housing in Scotland at the LA and RSL level. The emphasis in our analysis was on comparability and relative performance over the longer term (the next 30 years).

Our analysis did not include a detailed examination of, or commentary on, the financial performance of individual RSLs. The performance of individual RSLs and their social housing stock is regulated in Scotland by the Scottish Housing Regulator (SHR). It should however be noted that in appraising sector-wide performance the data has been built up from published data sources at the organisation level.

Some additional analysis on individual LAs was undertaken and is included in this report.

Limitations

The report was based on the specific instructions of Audit Scotland. Reliance has been placed on the published data and, other than general reasonableness checks, i.s.4 has not sought to verify the accuracy of that data, information and explanations provided as would be the case during an external audit or due diligence exercise. A list of the published data sources used is provided in Appendix I.

It should be noted that the estimates provided by i.s.4 for the purposes of this report do not constitute a formal valuation of Scotland's housing stock. A formal valuation would require a more detailed examination of the financial plans and cash flow forecasts of each landlord as well as the long term investment requirements of the housing stock. This information is not currently published. Actual valuations are therefore expected to vary considerably when based on more specific and detailed information.

As cash flow data is not published our analysis was based on Income and Expenditure (I&E) data. As we have adjusted for non-cash flow items, namely depreciation, using this data is not likely to provide a materially different picture. Our assessment has been made before funding cash flows, as per standard investment appraisal practice.

Acknowledgements

As part of our analysis, we worked closely with the performance audit team in Audit Scotland and assisted in the consultation with the Advisory Group. We would therefore like to acknowledge the contribution of those involved who provided their time and experience.

METHODOLOGY APPLIED

Our analysis was focussed on assessing the relative performance, effective use of resources and financial capacity of Scotland's social housing stock at the LA and RSL sub sector.

We applied Net Present Valuation (NPV) methodology to the net rental income stream (NRI) of each property and compared the results at the sub sector level. We then also compared the NPV estimates to the published net debt per unit to give a reasonable proxy of long term capacity.

NPV appraisals are widely used in social housing for a variety of purposes including for balance sheet valuation (where the landlord is not carrying assets at cost), for lender's security valuations where private finance is being borrowed and for individual projects to inform the decision on whether a project is worth investing in or not. It is also often used to assess the level of public sector subsidy required (or not). We applied a discount rate of 3.5% to the base estimates and performed a range of sensitivity analysis.

NPV measurement is particularly useful where a longer term view is required, as in the case of long life assets such as social housing. Essentially the NPV represents the value or financial strength today of the NRI of each property.

- **A positive NPV** suggests that the rents collected from tenants are sufficient, over the longer term, to cover the costs associated with management and maintaining the social housing stock.

- **A negative NPV** suggests that, other things remaining equal, the rents collected from tenants are not likely to be sufficient, over the longer term, to cover the on-going management and maintenance of the social housing stock. A negative NPV identifies those landlords where change should be considered.

In order to ensure comparability across all sizes of organisation in both the LA and RSL sub-sectors the NPV has been assessed mainly on a per unit basis. Comparability is an important consideration as LA landlords and RSLs operate in completely different contexts. They have different legal, financial and funding regimes all of which impact on their financial performance as our analysis will illustrate. Acknowledging this in any analysis between the two is therefore important.

That said, the core landlord role, involving the management and maintenance of the social housing stock, is the same and the nature of the financial relationship between the rents charged and expenditure incurred, which is the substance of the financial plan of every landlord in Scotland, is directly comparable.

The NPV appraisal was supported by a review of housing management indicators across the sectors. However, only 4 indicators in the published data sets were found to be directly comparable and complete. Further detail on our methodology and the assumptions applied is provided in Appendix I.

OUR KEY FINDINGS

The key messages arising from our analysis are detailed below.

RSLs and LA social housing stock can be compared

The context in which LAs and RSLs operate in terms of the legal, financial and funding frameworks is different. However, the nature of the key financial relationship between the rents charged to tenants and the expenditure incurred in managing and maintaining tenant's homes is the same and therefore comparable.

Relative financial performance varies significantly

It may come as no surprise that there are significant variations between the LA and RSL sectors in terms of the strength of their current financial performance and the NPVs. From the published data sources, the performance of RSL NPVs is higher at an estimated £21,282 per unit compared to the £4,306 per unit in the LA sub-sector.

There are many possible explanations for the difference and we would like to make it clear that our analysis does not suggest that the NPV of both sub-sectors should be the same or even similar as this would not reflect the different risk profiles of each. However, at a factor of almost 5:1 it does raise questions. Within the sub-sectors we estimated that 3 RSLs out of more than 140 analysed have a negative NPV (less than 2%). By contrast, 5 LA landlords (or almost 20%) have a negative NPV.

Negative NPVs should be examined further as it can raise doubts about the long term ability of a landlord to invest in tenant's properties and to continue with current services over the long run. Assurance would have to be sought that either a more detailed NPV appraisal yields a positive position or that corrective actions/appropriate plans are in place by that landlord. Our sensitivity analysis suggests that the LA sector has a number of options for improving on their currently weaker financial performance if desired.

There are Value For Money considerations regarding some of the expenditure patterns

Looking beyond the single high level NPV to the detail of the relationship between the rents tenants are paying and what that rent is being spent on to examine the use of scarce public resources highlights a number of VFM concerns. Our analysis suggests that there are clear disparities in the LA and RSL sector, not all of which are explained by the rent differentials between the sub-sectors. This is summarised below.

Table 1: Breakdown of 30 year NPV

	Per social housing unit		Per unit % terms	
NPV at discount of 3.5%	**RSL £**	**LA £**	**RSL**	**LA**
Rents	62,816	53,067	100%	100%
Service Charges	0	729	0%	1%
Void rent loss	-432	-879	-1%	-2%
Housing Management	-19167	-13829	-31%	-26%
Repairs	-8296	-19245	-13%	-36%
Property investment	-13,640	-15,536	-22%	-29%

NPV	21,282	4,306	34%	8%

This confirms that the lower NPVs for the local authority housing stock are partly a result of historically lower rent levels in this sector and higher voids but are also a direct consequence of higher expenditure particularly in respect of reactive repairs.

Whilst on the face of it housing management costs are reported as higher in RSLs than in LAs, it is worth noting that we have not adjusted the published data for any VAT equalisation which may in part account for some of the difference. There are classification differences. However, even taking the management costs and repairs cost together (to address classification inconsistencies) there is still a disproportionate spend by Local Authorities compared to RSLs. Local Authorities spend nearly 2 pounds out of every 3 pounds of tenants' rents on management and repairs. This merits further examination.

We also examined the historical trend in LA spend from 2004 to ensure that the base year used in our analysis (2011-12) was not reflecting a different spend pattern from that generally observed. This illustrated that the VFM concerns raised are representative of a long term historical trend.

It also highlighted that across Scotland, LA rent increases in the each of the years since 2004 have been used to fund increased overheads (management costs) and reactive repairs. From the published data analysed, there has been no significant increase, or apparent attempt to increase, planned maintenance spend. It also illustrates a clear imbalance of reactive versus planned maintenance of the housing stock in the LA sector. Our analysis therefore raises questions about the approach to investment planning and the competitiveness of existing repairs contracts within the LA sector.

Financial capacity varies widely

When compared against the net debt the NPV is a reasonable proxy of the financial value of that asset relative to the borrowings that are secured against it or are being paid for from tenants' rents in the absence of any other income or subsidy.

Ideally therefore, the NPV should be higher than the debt, but this is not always the case, sometimes for very good reasons, such as a Large Scale Voluntary Transfer which has not yet reached peak debt. However, it could also be an early indication of issues with financial viability and sustainability if the expenditure levels or borrowings being met from rents are not likely to be affordable over the longer term. Table 2 provides an overview for each sub-sector.

Table 2: Debt Levels relative to NPV (as already shown previously)

	Per social housing unit		All social housing	
NPV at discount of 3.5%	**RSL**	**LA**	**RSL £M**	**LA £M**
NPV	£21,611	£3,392	£6,106	£1,083
Net Debt	£7,923	£9,621	£2,239	£3,073
NPV less net debt (Net asset/liability)	£13,688	-£6,229	£3,868	-£1,989

As noted before, and highlighted here, the NPV per unit in the RSL sector is considerably higher than that of the stock in LA ownership. It also shows that the net debt per unit in the RSL sector is also slightly lower than in the LA sector.

Generally speaking, landlords with a positive NPV and Debt which is lower than the asset valuation/NPV provide a Net Asset position and will have financial capacity either for direct spending or for further borrowing. Those with a negative NPV or where the Debt exceeds the NPV would be described as being currently financially constrained.

On the face of it therefore the financial capacity of RSL social housing stock in Scotland is positive (ie the NPV of the NRI exceeds the debt) and the LA housing stock is negative (ie the NPV of the NRI is lower than the debt secured against the property) and under normal circumstances would be seen as being financially constrained.

The excess debt over property value across all LAs in Scotland is estimated on this basis as negative £1.9 billion. This compares with the RSL sector's positive valuation in excess of debt of £3.9 billion.

RSLs have positive NPV. However, it is not evenly spread and the reality is that RSLs may be reluctant to use it.

Analysis of published data suggests that RSLs in Scotland have surplus financial capacity. In practice, this capacity will be constrained by lenders covenants, especially those agreed since 2007 and the availability of long term finance at a realistic price. In addition, it is capacity that RSLs may be reluctant to use in the current climate and given that RSLs only relatively recently have come out of a period of artificially high grant levels.

This is particularly the case in the current climate when there are already adverse financial pressures known to be facing landlords. For example, downward pressures on income and upward pressures as a result of welfare reform and pensions issues which will result in lower NPVs sector wide over the longer term.

The long term financial issue in the LA sector is two-fold

The long term issue in the LA sector appears, on the basis of our analysis, to be two fold. There are weak underlying NPVs (due to lower rents and higher repairs spend) and higher, on average, debt levels. Put simply today's approach to pricing and the application of resources is creating a gap in long term financial capacity of the social housing stock in Local Authority ownership. Both indicators are pulling in the wrong direction. This contrasts starkly with RSLs who in the main appear to have capacity.

On this basis, the majority of LA's in Scotland (21 out of the 26 owning social housing) would be described as being financially constrained in terms of the ability of their existing rental income to meet the long term management and maintenance needs in their properties, without some of the following significant changes including for example, improvements in housing management performance, a reduction in expenditure levels or rent increases. Whilst some LAs may have decided to keep rents low for tenants, continued low rents in the long-term may require further subsidy to fund the gap.

Decisions and actions today have long-term financial implications

Our analysis demonstrates clearly that in social housing, decisions taken today and current performance levels will have long term financial consequences which will either enhance and maintain the financial value of our social housing stock or erode it. In other words, there is a direct relationship between today's housing management performance and tomorrow's financial capacity. Across the sector we must understand, plan, manage and monitor this relationship better. An emphasis on forward and long term financial planning is necessary.

The analysis in this report provides a baseline, using the latest available published data which is for the financial year 2011-2012. This provides a reasonable platform which can be updated and progressed as more of the right data is made available.

Our analysis highlights the importance of taking a longer term view of the sector, of understanding value as opposed to just cost and of considering not only past financial performance.

Whilst our analysis does not constitute a formal valuation, it does however, illustrate that some landlords are much better equipped to address the adverse financial pressures which they are likely to face in future. Conversely, some landlords are not well equipped currently. These pressures are well documented and include:

- downward pressure on annual rental increases (business plans which are based on RPI + real growth, year on year, may require significant review)
- funding pension service deficits and future increases in pension contributions,
- the impact of welfare reform and increasing investment costs arising from for example, the cost of EESH (Energy efficiency standard for housing).

The best performance is sometimes in the most challenging areas

Interestingly, our supporting analysis of housing management indicators also suggests that the most difficult areas do not automatically result in poorer performance. Our analysis has highlighted that there are a range of performance differences, some of which can be explained by the geographic and socio-economic profile of the local area but many have no obvious explanation.

Summary and conclusions

Our analysis has further shown that the LA sector has, on the face of it, options for improving its weaker financial performance in the management and maintenance of Scotland's social housing assets. However, this involves some significant change, including performance improvements and considering rent levels. Both LA rent policy and the management of responsive repairs are key issues which have to be examined further.

APPENDIX I

Published Data Sources

The data used in our analysis includes the Scottish Government's National Housing Statistics, the Scottish Housing Regulator's APSR and the Scottish Housing Regulator's SHQS published spend estimates to 2015. Data was extracted and collated for the two financial years 2010-11 and 2011-12. The analysis was further informed by SFHA research studies including notably their 2012 reports on Rent Affordability in Scotland (by Mandy Littlewood), Long Term Funding options (by Murja) and the Impact of Welfare Reform on Housing Associations and Housing Co-operatives Welfare reform (by i.s.4). These reports are available in full on the Scottish Federation of Housing Association's website www.sfha.co.uk

Performance Appraisal Model

The modelling was performed in i.s.4's performance appraisal tool on the basis that the current data remains constant for 30 years, except for the investment programme which is based on delivery of the SHQS by 2015 and then an average capital spend of £900 per property annually thereafter. Some sensitivity analysis is also included and the limitations of the underlying assumption that future years are similar to 2011-12 are fully acknowledged and discussed in the report.

It should also be noted that as the published data is only available on an income and expenditure basis it was not been possible to calculate the NPVs directly from published cash flow estimates. For the purposes of this report we therefore derived the NPV estimates from unitised income and expenditure statistics adjusted for known differences in accounting and cash flow measurement (the treatment of depreciation for example). Over the long run the difference between the adjusted income and expenditure and cash flow basis is unlikely to be material, however it is a limitation which we have noted in working with secondary/published data only.

Summary of the key financial assumptions used in the appraisal

In summary the key assumptions and specific sources are as follows:

- **Rents** at published 11-12 levels from the SHR for RSLs and Housing Statistics from the Scottish Government for LAs. The impact of real growth on rents is examined in the sensitivity analysis but does not form part of the baseline calculation. This was considered a more prudent assumption given the current climate.

- **Management costs** at 11-12 levels from the SHR for RSLs and Housing Statistics from the Scottish Government for LAs. Again no real growth on costs was assumed.

- **Repairs** at 11-12 levels from the SHR for RSLs and Housing Statistics from the Scottish Government for LAs. Again no real growth on costs was assumed.

- **Capital investment** – actual spend on SHQS for 11-12 and the anticipated spend for 12-13 until delivery of SHQS 2015 from the SHR's published tables. Thereafter, £900 per unit per year for the next 25 years has been assumed in the absence of any published data on the longer term investment needs of the stock.

- **RPI and real growth** – the appraisal has been performed on cashflows excluding RPI. No real growth on income or expenditure has been assumed although our analysis does consider the sensitivity of the NPVs to movements in real growth on income and costs.

- **Discount rate** – we have analysed the NPVs using 3.5%, applied over a 30 year period, which we understand is the Treasury's published discount rate. Again our analysis considers the sensitivity of the NPVs to movements in discount rate.

- **Appraisal period** – for the purposes of this report we have used an appraisal period of 30 years from 2011-12.

In order to confirm that 11-12 is a fair reflection of performance we also examined the 10-11 data and this is also discussed in the report.

An audit file of the source data used is available with this report. This provides full detail on the source data used.

Financial data exclusions

The local authority HRA data included the two categories **Other costs** and **Other income** which have been excluded from the NPV evaluation. Further work would need to be done to establish to what extent these are dwelling cash flows and to what extent they relate to non-housing activities. It has therefore not formed part of our analysis.

The Local Authority statistics also separate out **Service Charges**. These have been included in the analysis as it was not clear whether this was included in the RSL rental income stream or not. It is not a material factor at less than 0.01% and has not impact on the overall analysis and conclusions drawn.

All 26 Local Authorities in Scotland with a landlord function have been analysed in this report. The RSL population includes a more varied list of organisations. A total of 149 RSLs were analysed for the purposes of this report.

In 2011-12, the SHR published results on 161 landlords. This report has therefore analysed 92.5% of the landlords in Scotland. The 12 RSLs not analysed were identified as "outlying" in terms of their published data where a fuller examination would be required before the data could be used and commented on. The 12 RSLs excluded from the analysis in this report include:

1	20	Abbeyfield Scotland Ltd	LT 1,000	General
3	62	Aberdeen Soroptimist Housing Society Ltd	LT 1,000	Supported Accommodation
13	66	Ark Housing Association Ltd	LT 1,000	Supported Accommodation
17	69	Barony Housing Association Ltd	LT 1,000	Supported Accommodation
24	72	Blue Triangle (Glasgow) Housing Association Ltd	LT 1,000	Supported Accommodation
86	141	Key Housing Association Ltd	LT 1,000	Supported Accommodation
101	154	Loretto Housing Association Ltd	LT 1,000	Supported Accommodation
103	158	Margaret Blackwood Housing Association Ltd	1,000-4,99	Supported Accommodation
111	144	Next Step Homes Ltd	LT 1,000	General
136	180	Scottish Veterans Housing Association Ltd	LT 1,000	Supported Accommodation
141	190	Strathclyde (Camphill) Housing Society Ltd	LT 1,000	General
147	143	Trust Housing Association Ltd	1,000-4,99	Older Clients

The above lists illustrates that each of the organisations is a specialist, rather than a general needs provider and will therefore have a different income and cost structure. Whilst not forming part of this study, these organisations will no doubt be of further interest given the known issues in funding supported accommodation.