Appendix 4 (Cabinet March 2022)– SQW review of the financial viability of the Merton Estate Regeneration Project provided by Clarion.

February 2022

1. Background context

1.1. A full Financial Viability Assessment was provided by Savills, on behalf of Clarion Housing Group, for all of the estates comprising the Merton Estate Regeneration Programme in addition to the overall programme in April 2020. This was reviewed by SQW, on behalf of Merton Council, who reported in June 2020 following dialogue with Savills and CHG to test and update particular assumptions and inputs. Recommendations were made regarding potential options to optimise viability and reduce the deficit position, which following this process stood at -£235m.

1.2. Constructive workshops and dialogue took place between Clarion and Merton Council and their respective advisers, between October 2020 and February 2021 to explore how to optimise the viability of the scheme and reduce the deficit position. Importantly, due to the number of variables being tested relating to aspects such as additional densification, tenure splits, phasing and programme, key inputs including sales values, commercial values, valuation methodology and finance rates were kept 'fixed' to simplify the variable testing process. Following this dialogue, the viability position was reduced significantly from -£238m to -£65m. The updated and significantly reduced deficit position and the 'key moves' required to achieve this – including the suspension of Clawback - were reported to Cabinet in September 2021, with subsequent scrutiny and review taking place at the Overview and Scrutiny Commission on 19 October 2021.

1.3. The deficit position for the Merton Estate Regeneration Programme reported in October 2021, based on February 2021 figures (including assumptions and inputs dating from before February 2021), was significantly financially unviable. However, despite the significant financial viability deficit identified CHG has made a commitment to delivering the regeneration programme. This is not justified on financial viability grounds but is a function of their wider priorities and commitments as a Registered Provider and is a commitment made at their discretion. The basis or rationale for their commitment is not commented on in this appendix.

1.4. Importantly, the Supplemental Deed includes a range of enhanced provisions, which are not repeated here, to allow for more transparent and accountable risk management and programme monitoring arrangements to ensure Clarion keep the council abreast of the viability position, programme risks and mitigation strategy on a rolling basis. Protections are also in place to ensure reversion to Decent Homes Standards should significant delays occur, irrespective of Clarion's delivery of the full regeneration programme.

Conversely, in the event that the financial viability position significantly improves across the life of the programme there are mechanisms already included in the S106 Agreement, and now proposed in the Supplemental Deed, relating to affordable housing and recouping of Clawback, to ensure LBM captures any ‘upside’. For the avoidance of doubt, all reviews will be undertaken at a point in time, on the basis of actual evidence, incurred costs and sales receipts whereas the current baseline position is inevitably undertaken on a forward looking, growth model forecasted basis.

1.5. Given the scale and duration of the programme, there are clear development risks which could impact on its viability – both downside and upside – and Clarion, in committing to delivery is indicating it is willing to absorb and mitigate these risks. It is acknowledged by both Merton Council and Clarion that the financial model even in its updated form is dynamic and the viability position will shift over the course of the delivery programme, not least in response to market cycles and wider factors, for instance the wider economic inflationary context. Clarion’s commitment to delivery takes this into account. This was all set out previously in the Cabinet Report (September 2021)

1.6. The latest reported viability position therefore represents an appraisal at a specific point in time and will be the basis for subsequent business plan viability monitoring, review and risk management – the details of which are set out in the Supplemental Deed.

1.7. Whilst recognising the dynamic nature of financial viability of the Merton Estate Regeneration Programme across the life of the programme, both the council and Clarion acknowledged that as a consequence of the duration of this review process inclusive of the September 2021 Cabinet Reporting and the subsequent period taken to negotiate the Supplemental Agreement, a period which included the Covid-19 pandemic and ongoing impacts of Brexit, there was a need to refresh the financial viability appraisal prior to entering into any contractual commitments to ensure the reported baseline deficit position is based on current assumptions and inputs with particular reference to costs and values.

1.8. Accordingly, Paragraph 2.110 of the LBM Cabinet Report (6 September 2021) made the following statement with regard to the required update of the baseline viability position:

> “*There will also be attached to the deed, a revised iteration of the financial viability appraisal that is currently run and reviewed under the section 106 agreement for the three estates. That will establish a baseline position (which is currently acknowledged to be unviable*).”

1.9. The council therefore instructed SQW to undertake a review of the Savills, (February 2022) updated financial viability model completed on behalf of

Clarion for the Merton Estate Regeneration Programme.

1.10. The scope of this review was focused on testing the robustness of principal inputs and assumptions. The model itself was not interrogated as this had been agreed previously via provisions contained within the S106 Agreement. A significant amount of analysis had also taken place over the preceding two years so the scope of this review was focused on a comparative analysis of the principal revenue and cost side assumptions and inputs and their corresponding impact on the viability position.

2. Overview of approach

2.1. Annex 4.1 includes a side-by-side analysis of the overall Merton Estate Regeneration Programme financial viability position comparing the February 2021 position (which informed the Cabinet Report, October 2021) and the updated February 2022 position, as reported by Savills on behalf of Clarion.

2.2. Savills prepared full Financial Viability Appraisals for all three estates and at programme-level for the Merton Estate Regeneration Programme, on the basis that the agreed financial model links all three estates. For the avoidance of doubt the rationale for this interlinked model has been established and agreed previously: it was a fundamental principal of the original scheme that the surplus generated by the High Path estate could cross-subsidise the significantly less financially viable Eastfields and Ravensbury estates.

2.3. The Financial Viability Appraisals prepared by Savills included evidence provided by Knight Frank and Mace to support some of the principal assumptions including residential sales values and construction costs, respectively.

2.4. SQW's review of the Financial Viability Appraisals provided by Savills is contained at Confidential Annex 4.1.

2.5. Fundamentally Savills has reported that the overall Merton Estate Regeneration Programme viability deficit positioned has worsened slightly, but not materially, from c. -£65m to c -£68.1m.

2.6. Whilst the overall deficit position has not moved significantly between the position reported in February 2021, there have been some slightly more significant movements within individual revenue and cost lines. The rationale for these movements is considered reasonable. For information, a high-level summary is provided below regarding the key areas: private sales income and private rental income which make up c. 83% of all revenue; and construction costs which make up c. 67% of all costs. A summary is provided of the latest reported position, including assumptions regarding future inflation, and SQW's view of the current stated position.

2.7. All other revenue and cost lines have been reviewed in full (see Confidential Annex 4.1) and overall the position is considered to be robust. For the avoidance of doubt it is worth acknowledging that Merton Estate Regeneration Programme relies on c. £56.4m of GLA grant to support the affordable tenure homes (c. 3.5% of income); there is a significant risk attached to this assumed level of grant based on grant funding criteria which Clarion acknowledges but has confirmed it will absorb this risk and has a strategy in place to secure the required grant.

3. Summary of private sales and rental income position

3.1. The financial viability model for Merton Estate Regeneration Programme is predicated on blended sales rates for private sales on a per sq ft basis, applied to the proposed floorspace (Net Internal Area) and derived from more granular analysis of sales values for different size homes. This is an appropriate methodology for a large-scale scheme approved in outline, subject to detailed Reserved Matters applications coming forwards in due course and has been a key assumption inherent to the model since the original granting of planning permission in 2019.

3.2. The resilience of the housing market and sales values across the UK throughout the Covid-19 pandemic has been notable and this issue was raised by Members at the Overview and Scrutiny Meeting in October 2021. The sales values underpinning the model and reported to Cabinet at this point relied on sales values dated April 2020. Savills provided supplementary evidence at the time of September 2021 Cabinet and subsequent October 2021 Overview and Scrutiny meeting to substantiate this previously reported position on the basis that house price growth widely reported in the media was, in fact, highly specific to context and in practice it was important to consider factors including location, typology (i.e. flats vs house) and age of property (new build vs second hand stock). Looked at from this perspective, sales values of new build flats in the London Borough of Merton had not increased significantly during this time. In support of this updated Financial Viability Appraisal, a bespoke residential market and pricing report was undertaken by Knight Frank (November 2021) including extensive comparable analysis and market commentary. The previous and updated sales value positions on a blended rate basis are provided in SQW’s Financial Viability Appraisal review. Fundamentally, the present-day blended sales value on a per sq ft basis has increased slightly at the High Path Estate and remained unchanged for the Ravensbury Estate and Eastfields Estates.

3.3. In general, Knight Frank reported that there is a relative lack of comparable evidence from large-scale, high-quality new build schemes in this area of LB Merton, particularly in proximity to the Eastfields and Ravensbury Estates. Additionally, as Savills further report, reported increases in sales values for flats in LB Merton over the last two years have been relatively modest relative to England, and even more modest for flats compared to houses (noting that available data does not distinguish between new builds and second-hand stock).

3.4. SQW has reviewed the identified comparables and market analysis and undertaken their own research, including utilising a tool which collates information and comparable evidence from the Land Registry, EPC certificates and property marketing websites. Following this review – the results of which are appended to the full Financial Viability Appraisal review provided at Confidential Annex 4.1 – SQW are of the view that the sales values currently assumed within the Merton Estate Regeneration Project model for the three estates, on a present-day basis, are robust, defensible and within appropriate ranges identified.

3.5. It is important to note that whilst sales values have slightly increased on a February 2022 position compared with the previously reported position for the High Path Estates (although not for Eastfields or Ravensbury) overall the total income across the Merton Estate Regeneration Programme for private market sales has actually reduced by -£18.6m. This is explained, despite the proposed increase in the number of homes, by the fact that the proposed average unit sizes on a net internal area basis have actually reduced, reducing the total proposed net internal area – this has generated reduced total income and is a function of the balance between seeking to increase revenue vs construction costs.

3.6. Regarding proposed forecast sales inflation looking ahead beyond 2022, SQW has reviewed the assumptions presented by Savills and considered the forecast value inflation in the context of other forecasts including Savills own published research and inflation forecasts from the Office for Budget Responsibility. There is a significant amount of variation in sales value inflation forecasts and it is important to consider the specific variables of location (UK vs London vs borough) and the inevitable significant uncertainty regarding the macro-economic context which has a significant influence on house prices. The assumptions made by Savills in the financial model are not unreasonable given the review of the available evidence, but it is recommended that this should be kept under close review as part of the ongoing business plan monitoring process. This has previously been identified a key sensitivity and ‘risk factor’ of the financial model and this remains the case. This applies to the Merton Estate Regeneration Programme as it would any major, long-term regeneration programme.

3.7. In relation to the projected private rented sector income, the key assumptions (sales values and net investment yield) made by Savills appear broadly robust, in the opinion of SQW. Fundamentally purpose-built Build for Rent schemes typically command a premium rent, particularly relative to second hand rental stock and the rental assumptions made by Savills reflect this. There is little comparable local evidence in terms of purpose built Build to Rent schemes to benchmark this scheme against but the rental assumptions do appear broadly sensible relative to local rents; much will depend on the nature of the proposed Build to Rent scheme and the nature of the amenity and service offer which will support this premium. Evidence will be required to substantiate this position as the detailed scheme design and Build to Rent proposals materialise in due course. The net investment yield assumed is arguably slightly conservative given wider market evidence of yields in a Zone 3-4 / Greater London location but, again, the level assumed could be justified on a current day basis in the absence of a designed scheme, operator or 'product'. Therefore the assumptions in the scheme are, in SQW's view, considered robust on a present day basis. Again, these assumptions should be refined, further evidenced and updated during the programme's development as greater certainty on the proposed Build to Rent scheme and market benchmarking takes place.

4. Summary of construction cost position

4.1. Construction cost inflation has been widely reported in the media, linked to a number of supply-chain inflationary pressures. Accordingly, Savills has provided, using costs provided by Mace, updated cost information to inform the February 2022 Financial Viability Appraisals, prepared on a 2022 basis.

4.2. Despite the wider inflationary context, Mace have reported that construction costs across the three estates – on a present day 2022 basis - have remained broadly consistent with the position reported in February 2021, albeit in the context of reported changes to the net:gross building efficiencies. Overall, a relatively minimal increase in costs is reported. This position has been tested by SQW with benchmarking against BCIS industry-standard metrics with relevant adjustments to ensure a like-for-like comparison, as far as is possible. The build costs reported by Savills, using cost information provided by Mace, are considered broadly robust and sit within a range of costs identified which could be considered reasonable.

4.3. With regard to forecast construction cost inflation, SQW has reviewed a range of industry-wide forecasts and publications including the industry standard BCIS forecasts along with those provided by specialist cost consultants. The construction growth assumptions adopted by Savills and Mace are, in the view of SQW, broadly consistent with industry-wide assumptions.

4.4. Clearly with a large-scale regeneration programme such as this, with the majority of phases yet to be designed in detail, the level of cost information will inevitably become more accurate as the programme progresses, not least as designs are developed and contracts tendered (noting that 'actual' costs for the early phases of Ravensbury and High Path have been inputted into the appraisal which provides further support to the present-day costs reported).

4.5. Fundamentally, it is not possible to precisely predict future construction cost inflation – as with house price inflation – which are influenced by a whole range of macro-economic factors. However, the assumptions made within the Merton Estate Regeneration Programme appraisal are, presently, considered reasonable. When considered in the round, the overall forecast increase in construction costs reported in February 2022 (on an inflationary basis) compared with February 2021 (also on an inflationary basis) is <1% which is considered reasonable.

4.6. As with sales values, it is recommended that construction costs should be monitored closely as part of the business plan process as the Merton Estate Regeneration Programme progresses with regular updates to be provided by Clarion and their cost consultants regarding outturn 'actual' costs as incurred and confirmed, along with identification of key shifts in their view regarding construction cost inflation and any mitigation strategies necessary. These provisions are already accounted for in the Supplemental Deed.

5. Conclusions

5.1. Fundamentally, the viability position reported by Savills, on behalf of Clarion, has not significantly changed since reported to Cabinet in September 2021. The overall reported deficit position has slightly worsened from c. -£65m to c. -£68.4m. This is not considered material in the overall scale of the Merton Estate Regeneration Programme.

5.2. SQW has reviewed the principal revenue and cost-side assumptions and movements, as justified by Savills on behalf of Clarion, on a February 2022 basis and is of the opinion that these are robust, within an acceptable tolerance. There is, inevitably with a programme of this scale, complexity and duration, a significant element of risk associated with the assumptions made within this growth model but based on the available evidence and information the current position reported by Savills, on behalf of Clarion, is considered to be reasonable.