

Commercial Investment Strategy: Establishment of a Housing Development Company

Cabinet

Date: 15th March 2017

Author:	Deputy Leader and Cabinet Member for Finance and Corporate Services and Interim Corporate Director Resources (Section 151 Officer)
Wards:	All
Locality Affected:	All
Parishes Affected:	All

1. Purpose and Reasons

- 1.1 The purpose of this report is to agree the setting up of a wholly owned trading company limited by shares, through which the Council will design and construct housing on a commercial basis for sale or private market rent, and to approve the first 6 schemes to be developed for private sale.
- 1.2 The report's recommendations would support achievement of the Council's Vision Priority: "to improve infrastructure and housing to support a growing, low-carbon economy" and contribute to delivering pledge 9: "to develop Council-owned brownfield sites..."

2. Recommendations

Cabinet is recommended to:

- 2.1 Approve the establishment of a housing development company, limited by shares and wholly owned by the Council, pursuant to the Council's powers under the Local Government Act 2003 and the Localism Act 2011 and any other relevant enabling statutory powers, for the purpose of developing on a commercial basis housing for market sale and/or private market rent.
 - 2.2 Authorise the Director of Law and Democratic Services to complete all associated legal documentation necessary to establish the company, and transfer land to the company, including, *inter alia*:
 - 2.2.1 Companies House registration.
 - 2.2.2 Memorandum of Association and Articles – setting out the remit and rules governing the running of the company.
 - 2.2.3 Shareholder Agreement – this will be a key document as it will capture how the Council/Shareholder will exercise its control over the housing company.
 - 2.2.4 Appointment of Company Secretary and Directors (including non-executive Directors)
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Further information on the subject of this report can be obtained from Jan L Willis, 01793 463976, jan.willis@swindon.gov.uk.

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- 2.2.5 Insurances including Directors insurance.
- 2.3 Delegate responsibility for agreeing governance arrangements including the shareholder agreement and Board membership for the new company to the Director of Law and Democratic Services in consultation with the Cabinet Member for Finance and Corporate Services, the Cabinet Member for Strategic Planning and Sustainability and the Cabinet Member for Housing and Homelessness, and report to the Council's Special Committee as appropriate.
- 2.4 Authorise the Council's Section 151 Officer to draft Heads of Terms for a Facility Agreement for the Council to provide loan and equity finance of up to £15m to the Housing Company to fund working capital plus construction and other development costs associated with the sites listed at paragraph 3.12 with such terms to be approved by the Cabinet Member for Finance and Corporate Services on the advice of the Council's Commercial Investment Board, and in consultation with the Commercialisation CMAG, such funding to be provided from the Commercial Investment Fund.
- 2.5 Authorise the Head of Property and Assets to agree terms for the transfer of the sites listed at 3.12 (with the exception of Euclid Street) to the housing company.
- 2.6 Instruct officers to bring a further report to Cabinet setting out the business plan for the same company to deliver market rent homes and any additional financing requirements for the Company to deliver this.

3. Detail

Background: Commercial Investment Strategy

- 3.1 Over the next three years, the Council faces a challenging financial environment as a result of reduced Government funding and increasing demand. The ability to innovate and invest wisely on a commercial basis, taking advantage of opportunities as they present themselves, will be key to achieving a balanced budget position and securing a sustainable financial future for the Council.
- 3.2 Accordingly, in December 2016 Cabinet adopted a Commercial Investment Strategy and agreed to establish a Commercial Investment Fund as a vehicle for investment in schemes that will support the Council's wider economic and regeneration objectives and generate income for the Council to help deliver long-term financial resilience (Cabinet Minute 70 and Council Minutes 73(1) and 91(2) 2016/17 refer). This includes the development of housing for sale on Council owned land and the development of private rented sector housing.
- 3.3 The publication of the Housing White Paper "Fixing our broken housing market", on 7th February 2017, continues to signal the Government's support for Councils

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setting up local housing companies. This includes developing new homes for market sale and private market rent.

- 3.4 The Council's Housing Strategy 2014-2026 sets out 4 key priorities:
1. Supporting economic growth- increasing the quality and diversity of our housing stock
 2. Responding to the changing housing market- improving standards in private rented housing
 3. Affordability- improving the offer
 4. Managing demand – promoting and maintaining independence
- 3.5 The Housing Company would assist priorities 1 and 2 of the Housing Strategy, complementing the work already achieved in the early years of the strategy in priorities 3 and 4 and the work of the Housing Revenue Account which would remain focused on developing affordable housing within its existing powers.

Legal Powers to Establish a Housing Development Company

- 3.6 Local authorities are empowered to trade through a number of pieces of legislation. The relevant powers for this project are the powers contained in the Local Government Act 2003 and the Localism Act 2011. Section 95 of the Local Government Act 2003 enables local authorities to do for a commercial purpose anything which they are authorised to do for the purpose of carrying on their ordinary functions provided that that power is only exercised through a company.
- 3.7 Section 1 of the Localism Act 2011 provides local authorities with a general power of competence to do anything that an individual generally may do, including doing so for a commercial purpose. The general power of competence is limited by any other statutory prohibitions, restrictions or limitations that might apply to the action that the local authority is proposing to take. As with the section 95 power, the local authority's ability to exercise its general power of competence to trade is again subject to the requirement that that power is exercised through a company.
- 3.8 A Wholly Owned Company ("WOC") is not subject to the same accounting regulations as a Local Authority and any profits can be recycled back to the Council in the form of Dividends which are classed as revenue receipts and can therefore be used in a much more flexible way, and more importantly used to support the Medium Term Financial Plan. Sales of property directly by the Council would typically have been classed as Capital Receipts, which are restricted in terms of their use.

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- 3.9 As a wholly owned subsidiary of the Council, the housing company would be able to apply the 'Teckal' exemption in terms of any contracts between the Council and the housing company, therefore these contracts would not be subject to the EU procurement regime.
- 3.10 For state aid compliance reasons local authority loans to a company for commercial activities must be provided on market terms. If the Council does opt to provide loans to the company then it is likely to require appropriate security through a fixed charge over the company's assets and/or a floating charge. The Heads of Terms would be drafted by the Council's Section 151 Officer and approved by the Cabinet Member for Finance and Corporate Services on the advice of the Council's Commercial Investment Board, and in consultation with the Commercialisation CMAG, such funding to be provided from the Commercial Investment Fund.

Phase 1 Housing Development Programme – Build for Sale

- 3.11 Cabinet previously approved the establishment of a rolling capital fund of up to £15m, funded from the Council's cash balances and / or Prudential Borrowing, to fund small scale housing development by the Council on Council-owned land. (Cabinet minute 42(5) 2016/17 refers).
- 3.12 Since September 2016, work has progressed to identify the sites that will comprise phase 1 of the programme and to complete detailed cost modelling. These sites are detailed below together with the expected development timescale and funding requirement for each.

Site	Units	Expected Sales	Funding £m
Euclid Street	7	From October 2017	£1.243m
Shaw Ridge	5	From September 2018	£3.174m
Shaw Village	16	From July 2018	£2.854m
Windmill Hill	21	From March 2018	£4.227m
Sparcells	5	From February 2018	£1.334m
Idovers Drive	8	From November 2018	£1.547m
Total	62		£14.381m

- 3.13 Euclid Street is to be delivered through the Council's capital programme rather than through the company as the first pilot development and will be used to refine

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the development process on the other 5 schemes and to test overall programme viability. Approval for this scheme has been provided through a separate Cabinet Member Decision Note, but is included in the above table for completeness.

- 3.14 For the purposes of viability testing a target rate of return across the whole programme of 20% of Gross Development Value (before tax) has been applied. This is in line with the industry standard for commercial housing development. However, the return will vary from site to site depending on factors such as land valuation, any specific design or access requirements and market conditions at the point of sale. The Council will have the flexibility to retain units for private market rental where this would provide a better return, albeit over a longer timescale, than selling on the open market.
- 3.15 These 6 sites are expected to generate profits totalling around £3.5m before Corporation Tax (19% in 2017/18 and 18% in 2018/19), which will be distributed to the Council in the form of dividends. In addition the sites are expected to generate a land payment to the Council (from the trading company) totalling in the region of £494k which will be classed as a capital receipt. VAT on any new build developments is zero rated and therefore recoverable by the Company.
- 3.16 The exact profits made by the company and the value of the land receipt will depend on land valuations at point of transfer to the Company, cash flow requirements (which will affect financing costs) and Corporation Tax payable on the profit. It is recommended that the land be transferred to the company on terms that satisfy the Council's duty to demonstrate best consideration under Section 123 of the Local Government Act 1972.
- 3.17 Advice received from the Council's external tax advisers PWC is that stamp duty liability would be removed on sale of land from SBC to the housing company due to group relief which applies where the company is at least 75% owned. Further detailed advice is being sought on this and a number of other tax issues.
- 3.18 Finance costs are modelled simply at this stage on the basis of a 6.25% cost of capital (an assumed commercial rate) on construction costs assuming an average 12 month build out. These costs will be refined as the business plan and cash flow forecast is developed. In addition, the land value is derived from a residual land value calculation (income less costs less profit) and may differ from the market valuation at the point of transfer. The costs detailed at Appendix 1 include a 10% risk contingency and Council staffing costs for specific schemes but exclude general company overheads.
- 3.19 Apart from Euclid Street, development of each of the sites would be subject to planning consent and further feasibility work to firm up the cost and risks. Should there be a significant variation from the business case this will be reported to the Commercial Investment Board for approval before proceeding. Each scheme will

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be monitored and reported through the officer Programme Board and CMAG as well as forming part of the Councils capital programme which is reported quarterly to Cabinet.

Business Case for Development of Housing for Private Market Rent

- 3.20 A business plan is being developed by an officer project team with the support of Altair, a housing consultancy with financial experience in this sector. The scope of work commissioned is to set out a 30 year business plan using the initial costings from the build for sale work stream in order to test and understand the financial sustainability of the market rent model. Specialist legal advice is being provided by Trowers and Hamlins on a range of issues associated with the development and running of a wholly owned company for these purposes.
- 3.21 Once the business plan for market rent has been finalised, a further report will be brought to Cabinet for approval which sets out the financial and resourcing implications should Cabinet wish to proceed. Consideration will also be given at that time to the merits of establishing a second wholly owned company to market and manage the private rented stock.

Governance Arrangements

- 3.22 The Council will own 100% of the shares in the housing company and as such will have full ownership. As sole shareholder the Council would appoint the company directors and approve key decisions and the company's business plan.
- 3.23 It is imperative that an appropriate governance structure is put in place to ensure the sound and robust management of the company and protect the Council's reputation and financial investment.
- 3.24 The Board of Directors will be responsible for providing strategic direction and setting operational parameters, as well as overseeing and scrutinising operational and financial performance to ensure that business plan targets are met, within the parameters agreed with the Council as shareholder. To ensure accountability, a clear decision making framework will be required that sets out matters which will be determined by the Board of Directors and delegated authority which will allow the Managing Director to make decisions in relation to the day to day activities of the company. A performance and financial management framework with clear targets and milestones will also need to be developed.
- 3.25 To ensure that the housing company can operate efficiently and effectively it will be important to have the appropriate balance of skills and experience and, in particular, the right business and commercial financial acumen. This can be achieved through the appointment of non-executive directors with appropriate industry experience.

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- 3.26 It is proposed that the Housing Company Board of Directors will consist of a minimum of the following:
- 3 elected members, to include one representative from the Opposition Group,
 - The Managing Director of the housing company,
 - 2 senior officers of the Council, and
 - 2 independent Non-Executive Directors.
- 3.27 There will undoubtedly be a number of decisions required that will involve a conflict of interest for any Council officer or Member appointed to the Board. Members or officers who might be expected to make the above decisions may find it extremely difficult to undertake these roles if they are also a Director of the Company.
- 3.28 Cabinet are requested to authorise the Director of Law and Democratic Services to agree governance arrangements including the shareholder agreement and Board membership for the new company, in consultation with the Cabinet Member for Strategic Planning and Sustainability and the Cabinet Member for Housing and Homelessness, and report to the Council's Special Committee as appropriate.
- 3.29 The Board of Directors would delegate some functions to an operational management team that would include the Managing Director and officer representatives on the board. At least one director needs to be appointed in order to enable the company to be registered and basics to be established (such as setting up banking arrangements).
- 3.30 Any elected member or Council officer appointed as a company director would not normally be remunerated (although it may be appropriate for Non-Executive Directors to receive modest remuneration). There will need to be clear separation between all officers on the Board of Directors and officers providing advice to the Council as shareholder. Consideration will need to be given to ensuring that key expertise (such as Financial and Legal advice) is available to advise both the Council as shareholder and the company.
- 3.31 An officer Housing Development Programme Board forms part of the wider governance structure around the wider housing development programme and this Board will continue to scrutinise proposals to bring Council owned sites forward for development prior to Cabinet approval. A CMAG has also been formed to which the Programme Board reports regularly. The Council's Commercial Investment Board oversees commercial investments in consultation with a Commercialisation CMAG.
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Company Resources

- 3.32 It is anticipated that many of the services that will be required for the delivery of housing development projects will be contracted out (construction, sales and marketing) or provided by local authority staff and re-charged to the company at commercial rates (for example planning and design, site investigation surveys and ecology). The detailed costings include an allowance to cover project management costs which are the costs of the Councils design and architecture team. There will not be any requirement to transfer staff to the Company and therefore no TUPE issues apply.
- 3.33 To avoid the burden and costs of setting up systems for the company to employ staff directly (for example payroll, pension etc.), it is proposed that an appropriate Council officer be seconded in the first instance on a part-time basis to manage the company. As the scope of development activity undertaken by the company increases over time additional staffing will be required, as well as other internal staff support. These costs and general company overheads are currently not included within the figures at Appendix 1 but a detailed staffing profile and operational budget will be developed after March Cabinet that reflects the agreed remit and scope of activity of the company.

Business Plan

- 3.34 One of the first tasks for the company Managing Director will be to develop a detailed business plan covering a rolling 5-year period of investment activity and operational policies. The Business Plan will be reviewed and agreed annually by the Commercial Investment Board and covers the following: -
- Company objectives (as established in the Shareholder Agreement)
 - Operational plans
 - Financial model and assumptions
 - Operational budget and working capital requirements
 - Fees, interest and loan repayments, on-costs and tax
 - Funding profile and sensitivity analysis

4. Alternative Options

- 4.1 The Council does not have the legal powers to build and sell property for a commercial purpose directly and therefore this activity must be carried out through a company. If Cabinet does not agree to set up a housing development

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company, there will be a direct impact on the Councils budget as this proposal contributes to the Medium Term Financial Plan position.

4.2 The alternatives to setting up a single company to design, construct and manage housing for sale and private rent are as follows:

4.2.1 Set up separate companies to design and build housing for sale and private rent. This option is not recommended on the basis that it would limit flexibility in terms of deciding the appropriate route to market for each scheme, would increase the complexity of the governance arrangements and would incur additional overhead costs, this reducing the amount of dividends that would be returned to the Council.

4.2.2 Set up a separate company to manage housing built for private rent (in effect a Council owned lettings agency and property management company). This would have the advantage of insulating risk associated with the distinct activities of design and construction on the one hand and lettings and property management on the other. The merits of this alternative will be considered in the light of legal and tax advice received when the detailed business plan for housing for private rent is brought back to Cabinet.

4.2.3 Set up the housing company as a subsidiary of Forward Swindon Limited. This option has been discounted for the reasons set out in a separate report on Cabinet's agenda on the Council's forward strategy for delivering economic development and regeneration in Swindon elsewhere on Cabinet's agenda.

4.2.4 A Joint Venture model with a private developer is another option, however, this option would necessitate an EU compliant procurement process and take significant time to establish. Whilst a JV would allow the Council to access commercial and housing development expertise and share risk the downside is a loss of control and flexibility as well as a requirement to share revenue income.

5. Implications, Diversity Impact Assessment and Risk Management

Financial and Procurement Implications

5.1 These are detailed in the body of the report

Legal and Human Rights Implications

5.2 Legal implications are set out within the report. Legal and human rights considerations have been taken fully into account in compiling this report. It is

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considered that the proposals within this report are compatible with Convention Rights.

All Other Implications (including Staff, Sustainability, Health, Rural, Crime and Disorder)

5.3 No specific implications have been identified at this time.

Diversity Impact Assessment

5.4 A Diversity Impact Assessment was not undertaken as it is considered that there are no direct impacts from this decision. A Diversity Impact Assessment consideration would be expected as part of the Cabinet Member Decision note process for developing future sites.

Risk Management

5.5 The following table sets out the key risks identified and key controls to mitigate these risks.

Risk Area	Inherent Risk	Mitigation	Residual Risk
Business case insufficiently robust/not tested	Medium	i) Employment of specialist financial consultants ii) Sensitivity analysis carried out to test impact of negative movement on key assumptions iii) Scrutiny of external modelling by in house Finance staff	Low
Insufficient expertise to ensure achievement of best value in property construction	Medium/High	i) Include within the business modelling the costs of an Employer's Agent to oversee the development process ii) Provision for recruiting Company directors with background in development	Low/ Medium
Adverse movements in the housing market, such as property sales and/or rental price deflation, higher than anticipated building cost inflation, leaving the Company committed to unviable	High	i) Consideration of viability on a site-by-site basis so that if a scheme is not modelled to be viable, commencement is delayed or cancelled ii) Flexibility to determine the optimal route to market (sale or private rental) for each scheme in the light of	Medium

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schemes		prevailing market conditions.	
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6. Consultees

- 6.1 The Interim Head of Finance (Section 151 Officer) and Director of Law and Democratic Services (Monitoring Officer) are consulted in respect of all reports.

7. Background Papers

- 7.1 None

8. Appendices

- 8.1 None

9. Key Decision/Decision in Cabinet Work Programme and Forward Plan

- 9.1 This is a Key Decision and is included in the Cabinet Work Programme and Forward Plan for March 2017.