

EAST HERTS COUNCIL

CORPORATE BUSINESS SCRUTINY COMMITTEE – 29 NOVEMBER 2016

REPORT BY THE HEAD OF HOUSING AND HEALTH AND  
HEAD OF FINANCE AND PROPERTY

HOUSING COMPANY BUSINESS PLAN

WARD(S) AFFECTED: ALL

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**Purpose/Summary of Report**

- This report discusses how the establishment of a housing company, wholly owned by East Herts Council, would provide revenue income to offset diminishing government support and grants in order to meet the council's objectives while at the same time provide quality housing opportunities.
- The case is presented for taking the first step towards providing homes across all tenures for those on varying incomes, that is, to acquire properties to let in the private housing market. Detailed advice from Trowers and Hamlins legal practice has been drawn on which confirms the basis on which the council is able to set up such a company.
- The report includes a 30 year business plan for this first stage of the proposed company's operation drawing on external tax advice provided by PwC, and goes on to give a timetable for setting up the company and carrying the necessary work to then assessing the feasibility of building homes of different tenures.
- The report invites the Committee to scrutinise the business case and business plan.

**RECOMMENDATIONS FOR CORPORATE BUSINESS SCRUTINY:**

**That:**

|            |  |
|------------|--|
| <b>(A)</b> | <b>The full business case and 30 year business plan be endorsed; and</b>   |
| <b>(B)</b> | <b>The establishment of a housing company based on the business case and business plan be recommended to Executive for approval.</b> |

## 1.0 **Background: Why set up a housing company?**

1.1 East Herts Council's Corporate Strategic Plan 2016/17 – 2019/20 includes conducting feasibility work on the establishment of a housing company. In East Herts, a housing company could:

- create a revenue stream which members could use to deliver their priorities
- initially provide homes to buy or rent in the private market before moving on to develop new homes, including providing affordable housing in line with the council's planning policies, thus helping people on the council's housing register
- be designed to, as well as provide housing, acquire and/or develop commercial premises should this be financially attractive.

1.2 This report lays out the business case for the council setting up a housing company. The business plan, included in the exempt **Essential Reference Paper 'B'**, demonstrates the viability of the company, in the first instance, acquiring a portfolio of homes for rental in the private market.

1.3 The council is required to set a balanced budget each year. In light of changes to government funding the council will need to generate more income itself and/or make savings to achieve this from 2017/18 onwards. This business plan demonstrates a means by which the council can generate a new source of income to contribute to replacing diminishing government funding, thus providing members with supplementary resources to further the council's corporate priorities to improve the health and wellbeing of our communities, enhance the quality of people's lives and enable a flourishing local economy.

## 2.0 **Full Business Case for the Establishment of a Housing Company wholly-owned by East Herts Council**

2.1 As considered by the Corporate Business Scrutiny Committee in August, the first element of work on setting up a housing company is to establish a viable business case for the acquisition of residential properties, including those currently held directly by the council, for letting in the private market.

2.2 Taking this first step would enable the company to start trading quickly, thus rapidly building up a track record and resources to enable the council, pending member approval, to move on to housing development (via the proposed company or a new

company) so as to provide homes in all tenures in line with planning policies.

### ***Legal context***

- 2.3 Trowers and Hamlins has provided detailed advice on the legal aspects of establishing a housing company; the information in this section of the report has been taken from the advice provided.
- 2.4 Section 1 of the Localism Act 2011 provides local authorities with the power to do anything an individual may do, subject to a number of limitations. This is referred to as the 'general power of competence'. A local authority may exercise the general power of competence for its own purpose, for a commercial purpose and/or for the benefit of others.
- 2.5 In exercising this power, a local authority is still subject to its general duties, such as the fiduciary duties it owes to its rate and local tax payers and to the public law requirements to exercise the general power of competence for a proper purpose.
- 2.6 Section 4 of the Localism Act 2011 requires that where a local authority exercises the general power of competence for a commercial purpose it ***must*** do this through a company.
- 2.7 Section 95 of the Local Government Act 2003 is also of relevance. The associated regulations, Regulation 2 of the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009, require a business case to be prepared and approved by the Council before a company starts trading. This report forms the first draft of a business case with the associated financial business plan also covered.

### ***Provision of homes of different tenures***

- 2.8 While the initial operation of the company would solely see the provision of homes for rent in the private market, it is recognised that should, with member approval, the company move on to *build* properties, there would be a requirement to provide affordable homes in line with the council's planning policies. Under such circumstances, mixed tenure developments would be expected consisting of homes for rent and sale in the private sector, along with affordable rented and low cost home ownership homes in line with planning requirements.
- 2.9 Although the initial phase of the company is concerned with acquisition for private rent, the council asked Trowers and Hamlins to clarify the position of the company regarding the

provision of market versus affordable housing. Trowers and Hamlins drew particular attention to the Ministerial Statement about the establishment of local housing companies issued in March 2015 by the then Housing Minister. The Ministerial Statement stated, amongst other things, that the Government would not support local housing companies where such companies are established for the purposes of avoiding the right-to-buy or the borrowing restrictions imposed by Government on housing revenue accounts, that is, the accounts in which stock-holding authorities manage their council housing. Trowers and Hamlins advised that restrictions and requirements which are contained in any other legislation are not overridden by the council's reliance upon the general power of competence.

- 2.10 The housing company proposed in this report is *not* envisaged as a vehicle for circumventing the right-to-buy or borrowing caps placed on stock-holding councils. In connection with the Ministerial Statement, on the basis of the instructions given by the council, Trowers and Hamlins is comfortable that the council's rationale for establishing and participating in the proposed company is not for improper purposes and the clear intention to make a profit and provide market housing raises no cause for concern. Officers would add that, as is the case for all housing developers, any profit derived from housing development will need to take account of the provision of affordable housing required by East Herts Council's planning policies, which are, in part, predicated on meeting local need and demand for affordable housing.
- 2.11 In this way, the commercial focus of the company and the local need for affordable housing to be delivered through the planning process are not in conflict.

#### ***Form of company and proposed governance arrangements***

- 2.12 The Localism Act 2011 defines which forms of company a local authority can use to trade. These are; a company limited by shares, a company limited by guarantee and a community benefit society. Of note, a limited liability partnership is not an available legal structure.
- 2.13 The legal advice provided by Trowers and Hamlins is that the company should be a company limited by shares. This form of company complies with the ability to trade provisions set out within the Localism Act 2011. East Herts Council will own the entire share capital. There are certain requirements that will apply

to the company, some of which are statutory such as the obligation to file annual returns and accounts, while others the council will be able to determine itself, including the governance arrangements.

2.14 While yet to be determined, it is proposed that the governance of the housing company would include:

- East Herts Council being the sole shareholder, with full Council making decisions reserved for the shareholder in the company's articles of association and shareholder agreement. Such decision would include the approval of the company's business plan on an annual basis
- a group of three elected members forming a shareholder advisory group, appointed by the Leader of the Council acting in consultation with the Chief Executive, to exercise oversight of the company's reports and performance, provide strategic guidance and advise the full Council when it is exercising its rights and responsibilities as the shareholder
- the company's Board of Directors – the body which manages the affairs of the company on a day-to-day basis. It is proposed that in the first instance all directors shall be Officers of the council, who would not receive any additional remuneration for this role. In time, there may be provision for additional independent directors appointed for their expertise in regarding to housing, development, finance and the like; independent directors may require some remuneration.

2.15 While the company's Board of Directors would manage the company's affairs on a day-to-day basis, the council would have a number of ways in which it could legitimately guide the activity of the company, including:

- as the shareholder – appointing and removing directors, signing off the company's annual business plan, and signing off any changes to the company's Memorandum and Articles of Association, and making any offer decisions reserved for the shareholder in the article and shareholder agreement
- as a funder – deciding whether or not to make loans to the company. It is considered that it would be difficult for the newly formed company to secure affordable loans by any other means. Note: loans must be at commercial rates so as not to contravene State Aid regulations

- as an owner of properties and/or land owner – making available properties and/or land to the company. Note: disposal must be at market value so as not to contravene State Aid regulations and to satisfy the council’s Local Government Act 1972 Section 123 duty to obtain the best consideration that can be reasonably obtained
- as a planning authority – should the company build homes in the future, as with any housing developer, the council would assess whether a particular proposal by the company meets planning requirements including acceptable levels of affordable housing and/or other s106 contributions as required by the council’s planning policies
- as a strategic housing authority – again, should the company build homes in the future, as when working with any housing developer, the council would direct the required affordable housing mix and/or the need for specialist housing on sites in line with the relevant planning policies.

2.16 It is envisaged that the company would not employ its own staff during its early stages of operation, and indeed perhaps not unless approval is given in future to embark on housing development. It is believed that the necessary skills, at the initial stages, are available in-house or readily available in the local market, notably regarding property management.

***Would a holding company be beneficial?***

2.17 The report to Corporate Business Scrutiny in August raised the possibility of establishing a holding company to bring together the council’s interests in the various companies in which it currently has, or it anticipated to have, a share.

2.18 Trowers and Hamlins’ report observed that a holding company could possibly enable a more streamlined approach to governance within East Herts Council, however, the report went on to conclude that, *“we would advise that at this point there appears to us to be insufficient justification from a governance or legal perspective for the establishment of a holding company alongside the establishment of the Company (noting that we are not advising on tax matters).”*

2.19 From a tax point of view, PwC have brought to the council’s attention that the transfer of shares by the council to a holding company would incur Stamp Duty Reserve Tax at 0.5%.

2.20 Given this above advice, Officers believe there is not a compelling case for creating a holding company at this stage but that this should be kept under review.

### **3.0 Financial Business Plan**

3.1 A detailed 30 year business plan has been developed by the Heads of Housing and Health and Finance and Property. Assumptions regarding tax have been included based on advice from PwC. The model is based on the acquisition of 25 properties over the first five years of the company's operation, with each of these homes let out in the private rental market.

3.2 The full business plan is included at Essential Reference Paper B – this appendix is exempt from consideration in public because it contains commercially sensitive information regarding the assumed value of council assets and assumptions regarding costs that would be incurred in the open market.

3.3 The information presented in Essential Reference Paper B includes (a) income statement for the company showing income and expenditure, and profit and loss, and (b) the cash flows to and from the council.

#### ***Resources to be made available to the company***

3.4 The business plan is based on the following funding assumptions which have been considered as part of the external legal and tax advice received:

- equity provided by the council representing 35% of resources required by the company to acquire 25 properties. This amounts to £2.544m
- a loan from the council to the company for the remaining 65% of resources needed. This amounts to £4.724m The model assumes the loan is repayable at 4.25% above base rate on an interest only basis, with the principal repayable at year 30.

#### ***How does the company create an income stream for the council?***

3.5 In outline terms, East Herts Council would receive a revenue income stream from:

- **interest on loans to the company.** The council has the power to make loans; commercial rates would have to be

applied to be compliant with State Aid regulations. Commercial interest rates would be at a higher level of interest than the councils' own cost of borrowing and/or interest accruing on cash held on deposit by the council, thus a revenue stream flowing to the council is created

- **purchase of services from the council.** The company may wish to purchase services such as project management, legal, HR or IT support from the council. Regulation on 'transfer pricing' dictate that this should be a cost plus no more than 5%. At this stage the assumption has been made that the council would be able to support these services from within existing staff resources
- **distributions of profit made by the company through dividends.** The company will derive an income from (a) rental income, net of management and maintenance costs ground rents, and (b), in time, disposal of homes at an uplifted value. These profits, net of tax, would be distributed to the council as the sole shareholder. Note: subject to future member approval, the company could develop homes and thus make a profit on properties specifically developed for sale.

### ***Summary of outputs from the 30 year business plan***

3.6 In summary, the business plan demonstrates that (refer to Table 1 in Essential Reference Paper B for the assumptions used in the business plan):

- the company is able to make a profit from rental income net of running costs and taxes:
  - in years one and two the company's income essentially matches its outgoings. However, from year three, an annual profit after tax accrues, rising from £8,304 in year three, to £53,668 a year by year 15 and £152,308 a year by year 30 – see *Table 2(i) to (iii) 'Housing Company Income Statement' in Essential Reference Paper 'B'*.
- from year one, the council receives an income stream from interest on loans, recharges and receipt of dividends:
  - the annual income to the council rises from £53,977 in year one, to £268,432 a year by year 5, £323,710 a year by year 15 and £431,606 by year 30 – see *Table*



**3(i) to (iii) 'Cash Flows to East Herts Council' in Essential Reference Paper 'B'.**

- the income to the council offsets the opportunity cost lost to the council of investing a total of £7.768m (equity and loan) in term of interest foregone rising from £10,068 in year one to £51,598 a year from year five of the business plan onwards once the full equity and loan have been drawn done. This represents interest at 0.71% foregone (the rate of return between 1 April and 30 September 2016)
- revenue income to the council (assuming all profits after tax are paid as dividends to the council) over the 30 year lifetime of the business plan totals £9.5m.
- the value of the property portfolio of 25 homes rises over time such that:
  - the property portfolio is modelled to be worth £16.2m at year 30 given historic average property value appreciation rates
  - after repayment of the initial loan at year 30, the value of council's equity stake would have risen from £2.5m to £11.5m at year 30
- the total income to the council, that is, the annual revenue income over 30 years combined with the value of the equity stake at year 30 would be £20.9m.

***Sensitivity testing***

- 3.7 Prudent assumptions have been made in the base case modelling discussed above. Sensitivity testing has been conducted, however, to assess the impact of adverse inflationary movement over the lifetime of the plan. The assumptions used in sensitivity testing along with the impacts on key outputs from the business plan model are displayed in exempt Essential Reference Paper C.
- 3.8 In summary, the sensitivity testing shows that even in the most pessimistic scenario, that is, (a) if need for repairs increases by 50% over the base assumption and inflation on repairs costs runs as high as 5.3% a year and (b) rent inflation is capped at 0.65% a year over the full 30 years, the business plan is still viable with the council receiving an income of £53,977 in year one, rising to over £200,000 a year from year four onwards. The outputs are

included in **Essential Reference Paper ‘B’**.

3.9 This very pessimistic scenario also includes property value appreciation running at just 1.1% a year for the full the 30 years, yet the council’s equity still appreciates considerably from £2.5m to £4.8m. In this scenario, the full income to the council over the 30 years (revenue income and equity value appreciation combined) would be £11.6m as compared with £20.9m in the prudent base case scenario.

3.10 In summary, the sensitivity analysis indicates that the business plan is robust enough to cope with significant adverse changes in income and expenditure in that the company remains profitable under the circumstances modelled and income, albeit at a lower level, is maintained for the company.

#### **4.0 Proposed timetable for establishing a housing company**

4.1 The timetable below slightly amends the one considered by members at the Corporate Business Scrutiny meeting of 30 August 2016. Importantly, the proposed ‘go live’ date at the end of 2016/17 / beginning of 2017/18 remains unchanged. The timetable has been revised to maximise the time members have to consider the business case and business plan modelling.

| <b>Key action</b>  |   | <b>Date</b>       |
|--|---|-------------------|
| Consideration of full business case (including proposed governance arrangements) and 30 year business plan by: | Corporate Business Scrutiny                               | 29 Nov 2016       |
|  | <i>If required</i> , Joint Meeting of Scrutiny Committees | 17 Jan 2017       |
|  | Exec  | 7 Feb 2017        |
|  | Council   | 1 March 2017      |
| Articles of Association and Shareholder Agreement completed  |   | March 2017        |
| Housing Company incorporated   |   | March 2017        |
| Housing Company starts trading   |   | April 2017        |
| Assess viability of housing development by the company   |   | Mid 2017          |
| Consideration of the case for housing development,   |   | Late 2017 / early |

| <b>Key action</b>  | <b>Date</b>            |
|--|------------------------|
| <i>assuming a financial viable can be determined</i> , by Corporate Business Scrutiny Committee, Executive and Council   | 2018                   |
| <i>Subject to a viable business plan and member approval</i> , inclusion of work on housing development in the housing company's Annual Business Plan 2018/19 put to Council | Feb / March 2018       |
| <i>Subject to above</i> , commencement of housing development  | Late 2018 / early 2019 |

4.2 As noted in the table above, it is proposed that once the housing company is established, the focus of attention will turn to assessing the viability of housing development.

4.3 Housing development through a company would:

- see new homes built for market rent and sale
- include new affordable homes built and retained by the company (or a 'sister company' established for this purpose) as a requirement of East Herts Council's planning policies designed to meet local need and tackle demand on the housing register
- provide additional revenue streams for the council created in much the same way as discussed in this report.

4.4 The external advice provided to date by Trowers and Hamlins and PwC already covers a number of legal and tax issues related to housing development, hence Officers envisage the investigation of the viability of housing development will be able to proceed swiftly in the new financial year.

## **5.0 Implications/Consultations**

5.1 Information on corporate issues and consultation associated with this report can be found within **Essential Reference Paper 'A'**.

### Background Papers

None.

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