

EAST HERTS COUNCIL

JOINT MEETING OF SCRUTINY COMMITTEES – 14 FEBRUARY 2017

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

DIVERSIFICATION OF INVESTMENTS: ESTABLISHMENT OF A PROPERTY INVESTMENT COMPANY

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

- This report discusses the case for diversifying East Herts Council's investment portfolio by establishing a property investment company, wholly owned by East Herts Council.
- The company would form part of the council's overall portfolio of investments aimed at generating a revenue income stream to fund the council's priorities in the context of diminishing subsidy and grants from government.
- A property investment company would act in the market place to acquire properties and let them at market rents. Although principally conceived of as a vehicle for renting out residential properties, the company could, if financially advantageous, acquire and let commercial properties.
- It is envisaged that while a commercial endeavour, investment in property could yield a number of wider community benefits, notably:
 - providing income to protect existing council services and/or fund emerging priorities
 - acting as a good private sector landlord, putting increasing pressure on poorer landlords to improve
 - providing a potential 'last resort' action to tackle poor standards in the private sector and/or remedy empty properties where both informal advice and enforcement have failed
 - increasing the availability of good quality private rented accommodation for those on short-term placements with local employers.

RECOMMENDATION FOR JOINT MEETING OF SCRUTINY:

That:

(A)	The case for establishing a property investment company be considered and Members' comments be forwarded to the Executive for when it considers the proposal to set up a company.
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1.0 Background: the financial challenges facing the council

1.1 East Herts Council, like many local authorities, is facing reductions in subsidy and grants from central government and so is finding it increasingly challenging to fund both existing services and emerging priorities.

1.2 The Medium Term Financial Plan has highlighted:

- Revenue Support Grant funding from central government reduces from £1,145k in 2016/17 to £351k in 2017/18 and then reduces to zero from 2018/19. This is a significant loss in funding within the MTFP.
- New Homes Bonus reforms have reduced the amount of grant received and have added a baseline amount which puts future funding at risk.
- DCLG include in their assumptions that Council Tax will be increased by at least the referendum limit amount, £5 for East Herts Council, each year until 2019/20
- The proposed move to 100% Business Rates Retention will place additional risk to the future funding of local government from 2019/20. The tariff/top-up system will remain in the reformed scheme limiting the amount of Business Rates income that East Herts Council retains.
- The funding formula which DCLG use to determine the baseline funding need for each Local Authority will also be revised significantly from 2019/20. This may also have a significant effect on the Business Rates income that East Herts Council retains.

1.3 Within this context, Officers will need to identify options to put to Members to increase returns on assets held and maximise the opportunities for revenue generation.

Investing to generate income

- 1.4 The council has made a number of investment decisions to date with the aim of securing a revenue return on assets held. The council's approach to investment is laid out in its Treasury Management Strategy, devised to be compliant with CIPFA's Prudential Code. CIPFA defines effective treasury management as:
- The management of the Local Authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.
- 1.5 The Council's Investment Strategy is contained within the Treasury Management Strategy. The Investment Strategy is set with regard to the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. The Council's investment priorities are security first, liquidity second, then return.
- 1.6 In accordance with the above guidance from the DCLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk, detailed in the Investment Strategy.
- 1.7 Holding diversified forms of investment is a well-established way of mitigating risk. At present, the council has deployed its resources in a number of ways, principally:
- holding cash on deposit in the bank/short term investments
 - investing in property funds
 - investing directly in commercial property.
- 1.8 Each form of investment has a different profile in terms of security, liquidity and yield offered. For example, holding money in the bank is both secure and liquid, but yields are currently extremely low. Property funds, on the other hand, are more volatile and less liquid but offer higher yields.
- 1.9 These investments provide revenue resources for the council to direct towards its priorities, rather than providing community benefits in themselves, as detailed in the MTFP.

Diversifying the council's investment portfolio further through investment in residential property

- 1.10 This paper proposes to further mitigate the inherent risk, however slender, associated with higher yield investments by investing in property, principally residential, through a wholly-owned company.
- 1.11 In the first instance, the company would receive five properties owned by the council. This would ensure these properties are held and managed on a sound footing avoiding any confusion as to whether they could be counted as 'council houses' subject to the various inherent controls and conditions this would imply. The company would then acquire residential properties on the open market and let them at market rents.
- 1.12 If financially advantageous, the company could propose to its shareholder, that is, the council, the acquisition of commercial property too.

2.0 A property investment company: how would it work?

- 2.1 The respective roles of the council and the company would be as follows.

	Council's responsibility	Company's responsibility
Sets up the company	✓	
Appoints directors	✓ <i>acting as the shareholder</i>	
Drafts annual business plan covering proposals for: <ul style="list-style-type: none"> • acquiring properties in the coming year • financial resources required from the council • use of profits within the company or paid as dividends to the shareholder 		✓
Approves (or otherwise) the annual business plan for the company	✓ <i>acting as the shareholder</i>	
Provides financial resources and defines the terms of loans, equity	✓ <i>acting as the</i>	

	Council's responsibility	Company's responsibility
investment, shareholder loans of similar	<i>shareholder (for equity investment / shareholder loans) acting as 'banker' (for commercial loans)</i>	
Negotiates property purchases		✓ <i>the company may purchase this service from the council</i>
Lets, manages and maintains properties on a day-to-day basis (through agents unless more cost-effective to do so directly)		✓
Determines whether / when to dispose of properties	✓ <i>acting as the shareholder based on recommendations from the company</i>	
Determines use of revenue income to the council stemming from lending and recharges to the company and dividends from the company	✓	

- 2.2 The table above indicates that although the company would be managed on a day-to-day basis by its board of directors, decisions on key aspects of the company's operations would be reserved for the shareholder, that is, the council.
- 2.3 The principle mechanism by which the shareholder would guide its company is through the approval, or otherwise, of the company's annual business plan. The exact contents and format of this business plan would be governed by the Articles of Association and Shareholder Agreement. Both are legal documents to which the council and company would adhere.

Potential community benefits derived from a property investment company

- 2.4 The primary role of a property investment company as proposed is to generate revenue income and capital growth. The nature of the company's operation would, however, also generate community benefits in the following ways:
- providing revenue income to combine with that from the council's property bonds and other investments to protect existing council services and/or fund emerging priorities
 - acting as a good landlord in the private housing rental market. East Herts is not immune to the activities of poor private landlords. For example, the Environmental Health team are currently dealing with 27 private sector housing complaints / cases of proactive action, including seven actions against houses in multiple occupation and four actions against particularly 'rogue' private landlords. This workload covers significant fire risks and instances of poor quality heating (excess cold risk). Anything to provide higher quality private rental alternatives is to be welcomed
 - providing a means of 'last resort' when working with poor private landlords and/or the owners of empty properties where engagement and enforcement action has failed to remedy the situation
 - providing good quality private lettings for professionals on short-term placement with East Herts' major employers, for example, GSK, Tesco and local hospitals.

- 2.5 The above community benefits would not, however, fetter the shareholder in using the company to acquire property outside of East Herts should this be considered financially beneficial for the council.

Legal basis of the company

- 2.6 Trowers and Hamlins provided detailed advice on the legal aspects of establishing a company as proposed; the information in this section of the report has been taken from the advice provided.
- 2.7 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.

- 2.8 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.
- 2.9 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.
- 2.10 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. The financial business case would form part of a future report seeking resources for the company. This is outside of the matter under consideration in this report, that is, the case for establishing a property investment company.

Form of company and proposed governance arrangements

- 2.11 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.
- 2.12 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 would own the entire share capital. There are certain requirements that would apply to the company, some of which are statutory such as the obligation to file annual returns and accounts, while others the council would be able to determine itself, including the governance arrangements.
- 2.13 It is proposed that the governance of the housing company would be as follows.

Body	Role
East Herts Council would be the sole	Full Council making decisions reserved for the shareholder in the company's articles of association and shareholder

Body	Role
shareholder	agreement. Such decisions would include the approval of the company's business plan on an annual basis
A group of three elected Members would form a shareholder advisory group	Appointed by the Leader of the Council acting in consultation with the Chief Executive, this group would exercise oversight of the company's reports and performance, provide strategic guidance and advise to full Council when it is exercising its rights and responsibilities as the shareholder
The company's Board of Directors	This body would manage the affairs of the company on a day-to-day basis. It is proposed that in the first instance all directors would 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 regard to property management, finance and the like; independent directors would probably require some remuneration

2.14 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 other decisions reserved for the shareholder in the articles and shareholder agreement
- as a funder – deciding whether or not to make loans to the company and setting the terms of these loans
- as an owner of properties and/or land – making available properties and/or land to the company.

2.15 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.

2.16 For avoidance of doubt, the company would only be able to purchase properties in line with the annual business plan approved by the shareholder, that is, the council. In this way, the shareholder has the ability to approve, or otherwise:

- whether the company procures any properties in the forthcoming year, including perhaps setting minimum or maximum caps on the number of properties acquired
- whether the company divests itself of any properties
- gross rental yields that would be acceptable to the shareholder
- the circumstances in which finance will be provided and the conditions attached to this.

2.17 The company's directors would, of course, be obliged under the Companies Act 2007 to ensure that the company's financial circumstances are sound. It is envisaged that through on-going dialogue between the directors of the company and the council, principally represented through the shareholder advisory group, the company would be able to frame its draft annual business plan in line with the aims of its shareholder.

3.0 Financial matters

3.1 Once established, a financial business case would need to be made to full Council to identify and allocate capital resources. This business case would form the company's first annual business plan. The scale of investment would be solely the decision of the shareholder (the Council).

3.2 As noted above, Section 95 of the Local Government Act 2003 and 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.

- 3.3 In pursuance of establishment of a property investment company, modelling by the Housing and Health and Finance services, acting on advice from PwC, indicates that property purchase and rental can generate revenue returns for the council from interest on loans from the council to the company, recharges to the company for Officer time and profits made available as dividends.
- 3.4 The future request for capital allocation will be subject to scrutiny and consideration at the time. The matter under consideration in this report, the case for establishing a property investment company, does not fetter Members later consideration of whether or not to provide funding and, if so, how much.

Financial viability

- 3.5 Initial modelling conducted by the Housing and Health and Finance departments indicates that a property investment company as proposed would be financially viable under a series of scenarios.
- 3.6 Financial viability details would be presented to Members, should the decision have first been taken to establish a company, at the time at which the company's first business plan is submitted for scrutiny and approval. See **Essential Reference Paper 'B'** for a summary of questions raised to date about financial viability and others issues along with answers.
- 3.7 For the avoidance of doubt, regular reviews of the company and the market would take place at which time the council (shareholder) could decide to invest more, invest less, diversify or sell the portfolio depending on the market conditions. The shareholder would retain full control with the ability to respond quickly to opportunities as they arose.

4.0 Implications/Consultations

- 4.1 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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