

EAST HERTS COUNCIL

EXECUTIVE - 5 SEPTEMBER 2017

REPORT BY THE EXECUTIVE MEMBER FOR FINANCE AND
SUPPORT SERVICES

APPROVAL OF PROPERTY INVESTMENT COMPANY BUSINESS
CASE AND INCORPORATION OF THE COMPANY

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

- This report seeks approval of the strategic and financial business case for setting up a Property Investment Company wholly owned by East Herts Council with the initial remit to take on ownership of the council's existing five residential properties which it would then let out in the private rented sector.
- Approval is sought for the governance arrangements for the company, with approval for the necessary draft legal documentation for incorporation also being sought and delegated authority to finalise the documentation and proceed to incorporation of the company.
- The key revenue and capital outcomes of the draft initial business plan relating to the letting out of the five properties, developed following further specialist advice from external consultants, is included for noting with approval sought to recommend to full Council in due course the finalised initial business plan and that council monies be allocated in the form of a State Aid compliant loan and equity investment.
- It is drawn to members' attention that the recommendations in this report will enable the Property Investment Company to be incorporated and, in theory, commence trading. That said however, the company will only be able to commence trading in reality once resources have been made available by full Council at a later date.

RECOMMENDATIONS FOR EXECUTIVE: that:

(A)	the strategic and financial business case (presented in paragraphs 1.10 – 1.21) for the proposed Property Investment Company be approved;
(B)	the Memorandum and Articles of Association, appended in draft form to this report, be approved in principle with final approval delegated to the Executive Member for Finance and Support Services acting in consultation with the Head of Housing and Health and Head of Legal and Democratic Services;
(C)	the Shareholder Agreement, appended in draft form to this report, be approved in principle with final approval delegated to the Executive Member for Finance and Support Service acting in consultation with the Head of Housing and Health and Head of Legal and Democratic Services;
(D)	the Property Investment Company, to be called Millstream Property Investments Limited, be incorporated as a company limited by shares wholly owned by East Herts Council;
(E)	authority to complete and submit the necessary documentation for incorporation be delegated to the Head of Legal and Democratic Services;
(F)	East Herts Council's full Council assumes the role of Shareholder of the company;
(G)	authority to determine a Shareholder representative to attend general meetings or enter into communication with the company in place of such meetings be delegated to the Leader of East Herts Council;
(H)	a Shareholder Advisory Group of three elected members of East Herts Council be established with the purpose of advising the Council when exercising its role as Shareholder, with advice provided by senior officers of the council;

(I)	the identification of members of the Shareholder Advisory Group be delegated to the Leader of East Herts Council;
(J)	the composition of the company's Board of Directors to be, in the first instance, three Core Directors who shall be officers of East Herts Council, with up to an additional three directors appointed at any time in the future as Independent Directors selected for their relevant expertise and experience;
(K)	authority to nominate the Core Directors be delegated to the Leader of East Herts Council acting in consultation with the Chief Executive;
(L)	authority to nominate the Independent Directors be reserved by full Council acting in its role as Shareholder;
(M)	the key outputs of latest draft initial 30 year business plan, covering the purchase and management of the council's existing five residential properties, included in Essential Reference Paper 'D' be noted;
(N)	the initial 30 year business plan be finalised for presentation to full Council in due course in support of the allocation of capital resources;
(O)	the Executive recommends to full Council that the council provides the company with a State Aid compliant loan and equity investment in line with East Herts Council's existing financial policies, subject to Council's approval of the company's 30 year business plan;
(P)	the Executive recommends to full Council that the four council-owned properties in Bishop's Stortford known as 1 Old River Lane, 2 Old River Lane, 3 Old River Lane and Castle Bungalow, Castle Gardens and the council-owned property in Hertford known as 6 Water Lane are disposed of to the company, subject to full Council's approval to release capital for equity and loan funding; and
(Q)	once the company's initial 30 year business plan has been submitted to and approved by the Council, and subject to full Council's approval of funding, the company may start trading.

1.0 Background

- 1.1 This report and associated appendices present the strategic and financial business case for establishing a Property Investment Company, wholly owned by East Herts Council, for the purpose of generating revenue and capital income. At this time, it is proposed that the company would only be concerned with the purchase and letting of the council's five existing residential properties although the Articles of Association would enable the generation of revenue and capital income through the acquisition of residential properties for private rent and sale and commercial properties for lease and sale.
- 1.2 Earlier versions of the business case, business plan modelling and governance proposals have been considered by the erstwhile Corporate Business Scrutiny Committee on 30 August 2016 and 29 November 2016 and by the Joint Meeting of Scrutiny Committees on 17 January 2017 and 14 February 2017. Consideration by the scrutiny committees has been very helpful in refining the proposals, including focusing on transferring the council's five residential properties before considering further acquisitions. The proposals and recommendations in this report stem directly from member scrutiny.
- 1.3 At its meeting of 4 April 2017, the Executive approved:
- in principle... to develop a property investment company, the incorporation and trading of which is subject to future approval of a full financial business plan for the company.*
- 1.4 This report provides the strategic and financial business case for approval, along with key revenue and capital outputs from the latest business plan for noting.
- 1.5 At the same meeting, the Executive approved that:
- Memorandum and Articles of Association and a Shareholder Agreement are drafted for consideration alongside the business plan at a future date.*
- 1.6 Draft versions of these documents are included in **Essential Reference Papers 'B' and 'C'** respectively and are discussed in more detail in paragraphs 2.17 – 2.21 below.

The proposal

1.7 The proposal under consideration in this report is to establish a Property Investment Company wholly owned by East Herts Council to take on the ownership of five residential properties currently owned by the council and to rent these out in the private rental sector.

1.8 The five properties under consideration are:

- 1 Old River Lane, Bishop's Stortford
- 2 Old River Lane, Bishop's Stortford
- 3 Old River Lane, Bishop's Stortford
- Castle Bungalow, Castle Gardens, Bishop's Stortford
- 6 Water Lane, Hertford.

1.9 The reasons underlying the proposal have been considered at the various scrutiny meetings noted above and the Executive meeting in April 2017, namely, to:

- be able to operate the five properties in the private rental sector, that is, to use the council's 'general power of competence' to trade in a commercial setting. The context for use of the council's powers is covered in **Essential Reference Paper 'D'**. See paragraphs 2.2 – 2.7 for further details of the legal basis to trade
- provide a revenue income stream to support the council's activities and contribute to reducing the impact of financial pressures on existing services. See section 3 for a more detailed discussion of financial matters
- benefit from any uplift in property values over time
- diversify the council's investment portfolio. See paragraph 1.13 – 1.16 for more details of this.

Strategic business case

1.10 As noted by the Executive at its meeting on 4 April 2017, 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.

1.11 The Medium Term Financial Plan (MTFP) 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
- there is no long term certainty over the future of New Homes Bonus and already New Homes Bonus reforms have reduced the amount of grant received
- the Department for Communities and Local Government (DCLG) includes 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
- the introduction of the 100% Business Rate retention policy will be potentially delayed. The expected Finance Bill is not part of this parliament's legislative agenda.

1.12 Given the above, it is imperative that the council acts to secure other sources of income in the longer term to prepare for potential further reductions to these sources of funding.

1.13 To this end, the council has already made a number of investment decisions 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.

- 1.14 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. The aim is to avoid a concentration of risk.
- 1.15 Holding diversified forms of investment is a well-established way of mitigating risk.
- 1.16 The council already holds investments, such as property bonds, which do not of themselves directly providing a community benefit, but do create much needed revenue income with which to offset government funding reductions, maintain desired council tax levels and/or support the council's service development priorities.
- 1.17 The council's Corporate Strategic Plan includes prioritising work to "Undertake feasibility work on setting up a company to build new homes" as a means of meeting one of the council's key priorities, that is, to "enhance the quality of people's lives". While the proposal in this paper is simply to transfer the ownership of the council's five residential properties to a wholly owned company, this *could* provide 'proof of concept' for property development at a later stage should members wish to consider this approach. The matters under consideration in this paper neither prejudice nor fetter members' future decisions regarding housing development.

Commercial and financial business case

- 1.18 In order to assess the commercial and financial business case for establishing a company for the purpose of generating revenue income and capital growth through property investment, the council devised a 30 year business plan model, drawing on financial and tax advice from PWC. This model has been scrutinised internally, including by members of the Corporate Business Scrutiny Committee.
- 1.19 Savills, a leading specialist property and investment advice consultancy, was invited to scrutinise and review the model. Savills concluded:

The [council's] overall approach and business plan model is similar to those which we have seen at other local authorities. We have reviewed the workings of the business plan model, and successfully carried out sense checks, largely by mirroring the results in our own model...

The business plan is based on the company being entirely funded by the Council. This is the approach which is followed by almost all Councils looking to set up property investment companies in similar circumstances, due to simplicity and value for money.

1.20 Savills recommended a small number of amendments to the inputs and assumptions used in the model which have been incorporated and have informed the key revenue and capital cash flows presented in **Essential Reference Paper 'D'**. In summary, the amendments were:

- using the same inflation rate for all inputs, including rent and capital value increases and management and maintenance increases, and
- increasing the figures used for capital works and replacements.

1.21 Following Savills' commentary, bespoke tax advice was sought from PWC. This advice has confirmed officers' understanding of the tax position regarding the company and provides assurance that the proposed approach is sound – see section 3 for more discussion of this.

2. Report

2.1 As noted above, the proposal in this report is to set up a Property Investment Company wholly owned by East Herts Council to take on the ownership of five residential properties currently owned by the council and to rent these out in the private rental sector.

Legal basis of the company

2.2 Trowers and Hamblins has provided detailed advice on the legal aspects of establishing a company; the information in this section of the report has been taken from the advice provided.

2.3 Section 1 of the Localism Act 2011 provides local authorities with the power to do anything an individual may do, subject to a

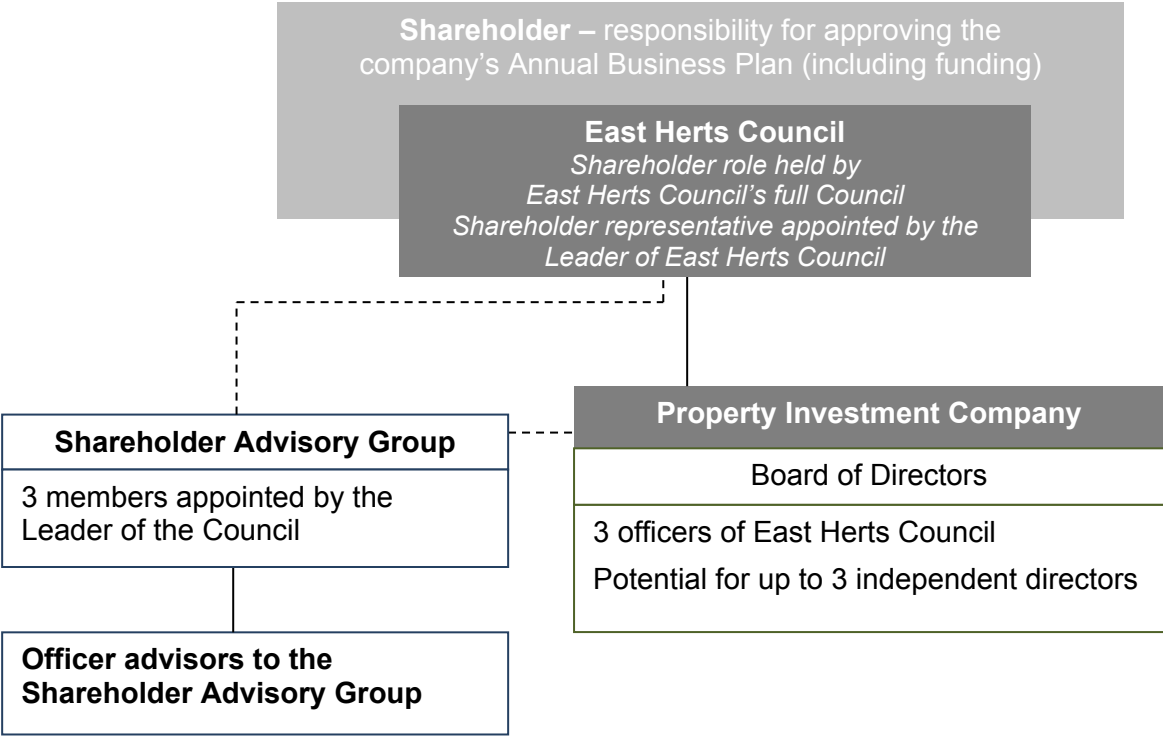
number of limitations. This is referred to as the 'general power of competence'. A local authority may exercise the general power of competence for its own purpose, for a commercial purpose and/or for the benefit of others.

- 2.4 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.
- 2.5 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.
- 2.6 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 constitutes consideration of the strategic and financial business case.

Form of company and proposed governance arrangements

- 2.7 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.
- 2.8 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.

2.9 It is proposed that the governance of the company would be as follows.



2.10 The respective roles of the constituent parts would be as follows.

Body	Role
East Herts Council would be the sole shareholder	Full Council, when meeting formally, would take decisions reserved for the shareholder in the company's Memorandum and Articles of Association and Shareholder Agreement. Such decisions would include the approval of the company's business plan on an annual basis
Shareholder representative	An individual, whether an elected member or officer of East Herts Council or another person, appointed by the Leader of the Council to represent the Shareholder at general meetings of the company or in other communications with the company if, as a single shareholder, the shareholder decides not to hold general

	meetings
A shareholder advisory group consisting of three elected members	Appointed by the Leader of the Council, this group would exercise oversight of the company's reports and performance on a regular basis, and provide strategic guidance and advice 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 would be provision for additional independent directors appointed in time for their expertise in regard to property management, finance and the like; independent directors would probably require some remuneration

2.11 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, signing off any changes to the company's 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. Note: the business case under consideration here is concerned only with the transfer of the council's existing five residential properties.

2.12 It is envisaged that the company would not employ its own staff unless at a later stage the council acting in its shareholder role approves a business plan including expansion of the company's operation. As council officers, with member oversight, are currently managing the five properties under consideration and a number hold directorships of commercial companies jointly owned by the council, notably the CCTV Partnership company and the Building Control company, it is believed that the necessary skills to deliver the proposed company are available in-house.

2.13 For avoidance of doubt, the company would only ever 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, should it wish:

- whether the company procures any properties in the forthcoming year, including perhaps setting minimum or maximum caps on the number of properties acquired. Note: only the council's five existing properties are currently proposed for acquisition by the company
- whether the company divests itself of any properties
- rental yields that would be acceptable to the shareholder
- the circumstances in which finance will be provided and the conditions attached to this.

2.14 The company's directors would, of course, be obliged under the Companies Act 2006 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, largely 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.

2.15 The roles and responsibilities of the council and the company are summarised in the following table:

	Council's responsibility	Company's responsibility
Sets up the company	✓	
Writes the initial business plan for member approval	✓	

Appoints directors	✓ <i>acting as the shareholder</i>	
Drafts annual business plan (once the company is trading) 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 investment, shareholder loans of similar	✓ <i>acting as the shareholder (for equity investment / shareholder loans)</i> <i>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	✓	

Incorporation of the company

- 2.16 It is proposed that the company be incorporated with the name Millstream Property Investments Limited.
- 2.17 The draft Memorandum and Articles of Association are included at **Essential Reference Paper ‘B’**.
- 2.18 The Articles of Association lay out how the company will operate. The Articles adopt the Model Articles of Association for Private Companies Limited by Shares as available on the ‘Starting a company’ pages on the gov.uk website. The Model Articles have been varied, deleted or replaced where appropriate to reflect the specific requirements of the council’s wholly-owned company.
- 2.19 Many Articles are procedural, however, of particular importance they make specific provision for:
- the governance arrangements proposed in this report
 - meetings of the Board of Directors will only be quorate if two of the Core Directors (that is, the officers appointed as directors, not the Independent Directors) are present
 - decisions *not reserved for the Shareholder* can only be made by the Board of Directors if a majority of the Core Directors (that is, the officers appointed as directors, not the Independent Directors) agree
 - the shareholder shall have the right to inspect any of the company’s accounting or other records or documents.
- 2.20 Although East Herts Council would be the sole shareholder, it is proposed to put in place a Shareholder Agreement between the council and the company covering how the two bodies will interact. Of particular note, the Shareholder Agreement will make explicit those matters over which decision-making is reserved for the Shareholder, that is the council, rather than the company. The draft Shareholder Agreement is included in **Essential Reference Paper ‘C’**.
- 2.21 The proposed full list of matters reserved for the shareholder to decide is included in section 11 of the Shareholder Agreement. Key reserved matters include:

- approving or varying the annual business plan
- as part of the annual business plan, determining the number and type of, and any associated conditions associated with, properties to be purchased in the coming financial year and any deviation from this
- appointment of directors
- changing the nature of the business in any way – for example deciding the company should do something different
- merging, selling or winding up the company or part of it
- borrowing money / offering guarantees outside of the business plan approved by the council
- deciding how any company profits are distributed.

3 Financial matters

3.1 There are a series of ways in which the council will be able to generate financial income through a wholly-owned company. Notably:

- **receipts from the properties sold by the council to the company.** The properties would be sold at market value, in line with State Aid regulations
- **interest on loans to the company.** The council has the power to make loans; commercial rates would need to be applied to be compliant with State Aid regulations. This would attract a margin over the interest accruing to the council on cash held on deposit and/or the council's own cost of borrowing
- **distributions of profit made by the company through dividends.** The company will derive an income from rental income, net of management and maintenance costs, and/or, in time, sales and uplift in the capital value of its assets. These profits, net of tax, would be distributed to the shareholder, that is, the council
- **purchase of services from the council.** The company may wish to purchase services such as housing management,

financial and legal support from the council at a market rate. At this stage the assumption has been made that the council would be able to support these services from within existing staff resources.

- 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, requires a business case to be prepared and approved by the council before a company starts trading. Approval of the recommendations contained in this report will satisfy this requirement.

Business plan

- 3.3 A draft initial business plan for the Property Investment Company based on the transfer for the council's five existing residential properties to the company has been drawn up.
- 3.4 As discussed above, the business plan model has been scrutinised and validated by Savills. Furthermore, the treatment of tax within the business plan and the metrics by which performance of the plan can be assessed have been informed by PWC's bespoke tax advice, tailored to the council's and proposed company's specific requirements and circumstances.
- 3.5 The key revenue and capital cash flows arising from this draft initial business plan along with the metrics by which to assess performance of the draft plan are given in **Essential Reference Paper 'D'**.
- 3.6 The draft initial business plan relates solely to the purchase and management of the council's five properties under consideration. The modelling indicates that the council would receive a revenue income each year for the 30 years of the plan. At the end of the 30 years, the plan assumes the properties are sold in order to pay off the loan to the council and give a return to the council on the equity deployed. It should be noted that disposal of the whole property portfolio has been assumed for modelling purposes only. Alternatives could include disposal of part of the portfolio and/or retention of the portfolio support by refinancing of the debt, whether from the council or another lender. All options would be kept under review.

- 3.7 Over the lifetime of the business plan, the company may recommend to its shareholder that one or more properties are disposed of and potentially replaced to retain the income stream. Decisions on disposal would be reserved for the shareholder.
- 3.8 Officers will continue to refine the business plan ready for submission to full Council in due course in support of a recommendation for the council to provide a State Aid compliant loan and equity investment.

4 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

Contact Member: Cllr Geoff Williamson – Executive Member
for Finance and Support Services
geoffrey.williamson@eastherts.gov.uk

Contact Officer: Jonathan Geall – Head of Housing and Health
and
Contact Tel No 01992 531594

Report Author: jonathan.geall@eastherts.gov.uk