EAST HERTS COUNCIL

COUNCIL – 18 OCTOBER 2017

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

APPROVAL OF PROPERTY INVESTMENT COMPANY BUSINESS PLAN AND ALLOCATION OF CAPITAL RESOURCES

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

- This report presents the first 30 year business plan for council's Property Investment Company. Approval of the plan is sought. This includes approval to sell, at open market value, the council's five existing residential properties – 1 to 3 Old River Lane, Bishop's Stortford, Castle Bungalow, Bishop's Stortford and 6 Water Lane, Hertford. The business plan indicates that the company is viable and creates a steady revenue income stream for the council as well as capital growth, predicated on modest property price inflation over the 30 years of the plan.

- The report seeks approval to make an equity investment in the company which would consist of part of the value of the properties being transferred, not a cash investment.

- The report also seeks approval to extend a loan to the company at commercial rates, thus being state aid compliant. This loan would be offered on an 'interest only' basis over 30 years with the principal repayable at the end of this period unless varied by the council in the meantime.

- Sensitivity testing, the outputs of which are presented in this report, indicates that even should inflation, interest rates and management and repairs increase, while rent inflation remains static and property price inflation reduces, the 30 year business plan is still viable, albeit the council would need to extend an overdraft facility to the company (at commercial interest rates) and revenue and capital growth returns would be lower than in the base case business plan.

- The report also points out that 6 Water Lane, Hertford requires significant investment to bring it up to a lettable standard. Approval is sought for capital resources to carry out these works prior to sale to the Property Investment Company as this is particularly tax efficient. The cost of the works will be reflected in the market value paid by the company.

RECOMMENDATIONS FOR COUNCIL: **That:**	
(A)	**the initial 30 year business plan for the Property Investment Company, to be named Millstream Property Investments Limited, presented in Essential Reference Paper B be approved;**
(B)	**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 be sold to the company at full market value;**
(C)	**the Council makes an equity investment in the company of £424k;**
(D)	**the Council makes a loan on commercial terms to the company of £787k;**
(E)	**authority be delegated to the Head of Finance and Property to increase the equity investment and loan by up to 2.5% should the property valuations at the time of sale be higher than assumed in the business plan, with any increase in excess of 2.5% to be brought back to full Council for consideration;**
(F)	**authority be delegated to the Head of Finance and Property to determine the terms of the loan to the company with due regard to state aid regulations;**
(G)	**a capital allocation of £85,000 is made to carry out essential capital works to 6 Water Lane, Hertford to bring it up to a lettable standard prior to disposal to the company, with these costs reflected in the market valuation; and**
(H)	**the company starts trading once it is incorporated.**

1.0 Background

1.1 At its meeting of 5 September 2017, the Executive approved the establishment of a property investment company, to be called Millstream Property Investments Limited, which will be wholly owned by East Herts Council. The purpose of establishing this company is to generate revenue and capital income. At the outset, the company will be solely concerned with the purchase and letting of the council's five existing residential properties although the Articles of Association will 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 This report presents to Council:

- the initial 30 year business plan for Millstream Property Investments Limited, referred to herein as the base case

- the outcome of downside and upside sensitivity testing based on assumptions that are, respectively, less and more favourable than the assumptions used in the base case 30 year business plan

- details of how the business plan will be kept under review and approved on an annual basis by full Council acting as the company's shareholder

- a recommendation to utilise the council's equity in the existing properties to constitute an equity investment in the company of 35% of the properties' value, equating to £424k in the business plan, and extend a loan to the company on commercial terms of 65% of the properties' value, equating to £787k plus a further 2.5% of this amount should the market valuation be higher than the business plan assumes. A valuation in excess of this uplifted figure would trigger a further report to full Council for member consideration

- a recommendation that the Council sells the following five properties to the company at market value:

    - 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, once works to bring the property up to a lettable standard have been completed by the council in line with recommendation G in this report.

The 30 year business plan

1.3 As discussed in the Executive report of 5 September 2017 and preceding scrutiny committees, there are a number of ways in which the council will generate **revenue income** through its wholly-owned company. These being:

- **interest on loans to the company**. The Council has the power to make loans; commercial rates will be applied to be compliant with State Aid regulations. This will attract a margin over the council's internal cost of borrowing

- **purchase of services from the Council**. The company may purchase services such financial and legal support from the council at a market rate. The business plan assumes this. Furthermore, given the scale of the proposals, it is assumed 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 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.

1.4 From the Council's point of view, of primary importance is the total income accruing to the council from these different sources, rather than the performance of any particular income stream.

1.5 In addition, so long as the value of the properties increases over time, the council will benefit from **capital growth** on the assets held by the company.

1.6 **Essential Reference Paper B** presents the detailed 30 year business plan for the company based on the acquisition and rental of the council's five existing residential properties.

1.7 **Essential Reference Paper C** presents the key revenue and capital outcomes of the business plan alongside the outcomes of sensitivity testing based on varying a number of key inputs to the model.

1.8 The modelling indicates that the company's business plan and the downside (based on more pessimistic assumptions) and upside (based on more optimistic assumptions) scenarios are all viable.

Revenue – base case business plan

1.9 The information in **Essential Reference Paper C** indicates that the 30 year business plan would give the Council a revenue income of £451k in the first ten years of operation, equating to around £45k a year. The revenue income would total £1.54m over the 30 years of the business plan.

1.10 Interest payments and income from services purchased from the council would accrue to the Council each year. In most years, the company would distribute its profits as a dividend to the shareholder (the Council). Because the business plan anticipates a planned programme of capital investment every five years from year 15, in some years the company would need to retain its profits to meet these costs.

Revenue – downside scenario

1.11 The downside scenario still provides revenue income to the council. Perhaps surprisingly, although over the first ten years of the business plan, it is projected that the income to the council would be lower than in the base case scenario, over the full 30 years a higher level of revenue income to the Council is projected. This is because the modelling assumes the interest rate applicable to loans made by the council will increase over the lifetime of the business plan, thus affording the council a higher return on its loans. This offsets the fact that the company will not be able to distribute dividends and will need to draw on an overdraft facility from the Council.

Revenue – upside scenario

1.12 As would be expected, the revenue income to the Council is higher under the upside scenario. Here, the more favourable operating climate boosts profits and the company is able to distribute profits to the shareholder (the Council).

Capital

1.13 As discussed in previous reports to the Executive and scrutiny committees, the Council will need to provide capital resources to the company in the form of an equity investment and loans at commercial interest rates.

1.14 Trowers and Hamlins and PWC have advised that equity funding of not less than 35% of the company's capital requirement would be in keeping with other wholly owned companies' approaches and market conditions.

1.15 The base case business plan along with the downside and upside scenarios all envisage the same equity investment and long term loan. This is because this funding relates to the company's initial purchase of the properties, the value of which does not vary under any of the scenarios.

1.16 An equity investment by the Council of £424k would be required. This would not be a cash payment, rather, the equity would take the form of part of the value of the properties being sold.

1.17 The remaining £787k to purchase the properties would take the form of a loan from the Council made on commercial terms and secured against the properties.

1.18 The business plan is predicated on the company disposing of the five properties at year 30. Given the assumptions in the business plan, all proceeds of disposal, net of chargeable gains tax, would revert to the Council as the shareholder (in the case of the equity) and as the banker (in the case of payment of the loan principal).

1.19 The model predicts that the Council's £1.21m (combined equity and loan value) would have risen in value by just over £820k to £2.03m in year 30 in the base case. This equates to an internal rate of return of 5.33%. This can be thought of as the average interest rate the Council earns each year on the capital it has used to fund the company.

1.20 Under the downside scenario, the business plan is still able to provide capital growth despite the more pessimistic assumptions. The key difference, however, is that the company would need to have access to an overdraft facility to meet its costs year-on-year. The modelling assumes the Council provides this facility at a commercial interest rate.

1.21 Under the downside scenario, it is predicted that the initial value of the assets acquired would appreciate to £1.75m net of taxes due at disposal, representing an internal rate of return of 4.79%. From this capital value, £156k would be needed to repay the overdraft in place at year 30.

1.22 The upside scenario is, of course, more favourable. The company does not require an overdraft facility. The asset value at year 30 is predicted to have risen to £2.67m, representing an internal rate of return on the council's capital of 6.52%.

Council's capital position before and after sale of the five properties

1.23 The business plan presented in this report would only see the Council's five existing properties sold to the company. The business plan in its current form does not envisage any further property purchases by the company. Any such decisions will be for the Council (as shareholder) to make in the future.

1.24 The capital position of the Council resulting from the property disposal is neutral and the Council's capital resources would remain as liquid as they are now because:

- the value held within the five residential properties can only be accessed by selling the properties or borrowing against them; this is equally true regardless of whether the Council or company owns them;
- in regard to the £787k loan:
- the Council would make a loan of £787k to the company
- the company would immediately use this £787k to buy the properties, that is, it would pay the Council because the Council is the vendor of the properties
- therefore, in reality, the £787k would remain as cash held by the Council.

__Capital requirements – equity and loan__

1.25 All figures quoted in this report are based on market value estimates provided by the Council's Property Team at the time of modelling with the addition of a 2% inflation uplift in recognition that the actual disposals are unlikely to occur before 2018, that is, around a year after the Property Team's valuations.

1.26 These values will need to be verified at the time of disposal.

1.27 There is no reason to believe these subsequent valuations will be significantly higher than the figures used in the business plan, however, to avoid the need to seek further full Council approval of slightly increased figures, the recommendations in this report seek approval of amounts up to 2.5% higher than the amounts assumed in the base case modelling. Should funding in excess of 2.5% above the assumption in the business plan be required, full Council approval will be sought.

1.28 This report also seeks approval of a capital allocation for essential works to 6 Water Lane, Hertford. This property is in a poor state of repair rendering it unlettable. Thus, regardless of whether the property is retained by the Council or sold to the company, capital works must be carried. The Property Team has estimated that these works plus fees will cost around £85,000, excluding VAT but including a potential for a 2.5% uplift in the original estimate.

1.29 It is assumed in the company's business plan that the Council will have carried out these works prior to disposal. This is reflected in the market value assumed. It is worth noting that PWC have confirmed that it is more advantageous in terms of tax for the Council to carry out the works as the Council can offset the VAT incurred on refurbishment, while the company could not as its income is derived from residential rents which are exempt from VAT.

__Review of the company's business plan__

1.30 While the 30 year business case is based on robust assumptions, it is, of course, to be expected that various factors, such as the rate of inflation, repairs costs, rent rises and the like, will soon begin to vary from the base case assumptions. The governance arrangements regarding the company and its interactions with the Council (its shareholder) have been designed to ensure full oversight by members – see **Essential Reference Paper D** for the governance structure approved by the Executive on 5 September 2017.

1.31 The business case will thus be kept under constant review in the following ways:

- the board of directors of the company will monitor the financial position of the company on at least a monthly basis. At its meeting of 5 September 2017, the Executive approved that in the first instance, three officers of the council will be appointed as directors by the Leader of the Council in consultation with the Chief Executive. These officer directors will be appointed prior to registration of the company at Companies House later this year. The Executive also approved that up to three independent directors can be selected in due course by full Council for their relevant expertise and experience

- the directors of the company will report to the Shareholder Advisory Group (consisting of three members) on a quarterly basis, giving full details of performance against the business plan. The Executive delegated authority to the Leader of the Council to nominate these members; this will be done prior to registration of the company

- the business plan will be thoroughly reviewed and recalibrated each year. That is, all the variables will be updated with the impact of the revised figure forecast over the coming 30 years. Full Council, acting as the company's shareholder, will be asked on an annual basis to sign off, or otherwise should they see fit, the updated business plan.

1.32 This approach is enshrined in the Shareholder Agreement that has been drafted. This will be signed by both the council, as shareholder, and the company itself before trading commences.

2 Financial matters

2.1 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. The Executive approved the business case for the company at its meeting on 5 September 2017. This report covers the detailed business plan for the company and as such fully satisfies the regulations.

2.2 Finance officers have been fully involved in the work to prepare the business plan and have liaised closely with the council's external financial consultants for this project, PWC and Savills. The inputs have been informed by advice from Savills, who also suggested sensitivity analysis which is included in this report. PWC have advised on taxation issues, notably VAT, corporation tax and chargeable gains tax. Their advice has been incorporated into the modelling of the business plan.

3 Implications/Consultations

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

<u>Background Papers</u>
None

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