ESTABLISHMENT OF A COMMERCIAL PROPERTY AND TRADING COMPANY

Cabinet Member(s)	Councillor Jonathan Bianco
Cabinet Portfolio(s)	Finance Property and Business Services
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Papers with report	Appendix 1 Outline Business Case

HEADLINES

Summary	This report sets out the business case for establishing a wholly owned Council property company including the key items for further consideration and authorisation from the relevant delegated authorities. The company's role will include the development of properties for market sale and rent to generate a commercial return from sale proceeds and rental income.
Putting our Residents First	This report supports the following Council objectives of: *Strong financial management and our Built Environment.* This report also contributes to the Council's Sustainable Community Strategy 2011 and the delivery of Local Plan part 2 - housing targets.
Financial Cost	There are no direct financial implications arising from the recommendations of this report.
Relevant Policy Overview Committee	Corporate Services and Partnerships Policy Overview Committee
Relevant Ward(s)	All

RECOMMENDATIONS

That the Cabinet:

1. **Approve the business case attached as Appendix 1 and resolve to establish and incorporate of a property company (the Property Company) to build, sell and manage houses for market sale and market rent.**

/continued…

2. **Delegate all necessary decisions regarding the detailed arrangements (including the completion of such legal documentation as is necessary) to allow the establishment of the Property Company, to the Leader of Council and Cabinet Member for Finance, Property and Business Services, in consultation with the Deputy Chief Executive and Corporate Director of Residents Services and the Borough Solicitor, including the agreement of the:**
   a. **details of the Articles of Association and the shareholder agreement between the Council and the Property Company (having regard to the need to ensure that the Council's interests are safeguarded)**
   b. **name of the Property Company,**
   c. **heads of Terms for the Facility Agreement;**
   d. **process of incorporation of the Property Company; and**
   e. **governance arrangements including who shall be the directors and the representative for the Council as the sole shareholder; and**

3. **to then commission the Borough Solicitor to complete the appropriate legal documentation.**

4. **Delegate to the Leader of Council and Cabinet Member for Finance, Property and Business Services, in consultation with the Deputy Chief Executive and Corporate Director of Residents Services, approval of the detailed business plan for the Property Company, once finalised.**

Reasons for recommendation

The Council's Sustainable Community Strategy 2011 and more recently the Hillingdon Local Plan (and London Plan) have identified the need for new homes (including affordable homes) for residents and to support the Borough's economy within the Council's role as a strategic housing authority.

The establishment of a Property Company for Hillingdon would contribute to delivering more quality housing to meet the needs of Hillingdon's residents and towards generating long term revenue income, which it is anticipated would be at a greater level than can be achieved by disposal of surplus land.

The Council has taken legal advice from Trowers & Hamlins LLP to ensure that it has the powers and capability to create the Property Company in line with legislation, and utilised KPMG to develop a financial model and overarching business case, given their previous experience in this field.

Alternative options considered / risk management

1. **Do nothing.** This would reduce the options available to the Council to create new housing supply and generate revenue.

2. **A Joint Venture model**. A Joint Venture could be entered into with a private developer, however, this option is likely to take a significant time to establish, mutual agreement will be needed for decision making, and revenue income would have to be shared.

3. **Sell existing sites.** The Council could sell its land and sites to private developers but this would general capital receipts only and would not offer the scope to generate a revenue income for the Company when suitable sites are identified.

Policy Overview Committee comments

None at this stage.

SUPPORTING INFORMATION

The Property Company would provide a delivery mechanism for developing new homes and will be designed to initially focus on the development of housing within the Borough for market rent and / or market sale. This will increase investment in regeneration whilst creating capital assets for the Council and enable the Council to control housing mix through the planning and design process. The objectives of the Property Company will complement other Housing initiatives that the Council is already undertaking, including the development and acquisition of properties within the Housing Revenue Account (HRA).

The Property Company would be a limited company, with all shares owned by the Council and would operate with a small board of Directors. Initially it is not anticipated that it would employ staff directly, with operational requirements largely expected to be met through existing Council staff resources, with appropriate recharge of costs.

The Property Company must be financially viable, operate in accordance with an agreed business plan and meet all its statutory obligations. It should be noted that the Housing White Paper, published on 7 February 2017 “welcomes” innovative models to provide more housing by local authorities and specifically references local housing companies and joint venture models as examples.

Financial Implications

There are no direct financial implications arising from the recommendations of this report. There may be some minor costs associated with the establishment of the company, which together with the costs of the specialist advice obtained from Trowers & Hamlins LLP and KPMG, can be contained within existing budgets.

An Outline Business Case is attached at Appendix 1 containing the overarching financial considerations and rationale for establishing the company. The key issues include:

- The opportunity to undertake commercial development of housing and generate a long-term revenue income stream,
- The investment into the company would be at market rates to ensure State Aid issues are avoided adhering to the Market Economy Investment Principle (MEIP).
- The Council is expected to provide funds to the company through a mix of loans and investments utilising the Public Works Loan Board facility and reserves. The initial modelling suggested an approximately 70:30 debt equity split could offer best value and represents a level of Gearing is similar to that of a commercial investment.
- Risk assessment and mitigating actions associated with undertaking commercial property developments.
- The tax regime that applies to limited companies including the potential for Group relief for Stamp Duty Land Tax and treatment of VAT in the context of the operations and activities of the company. The anticipated Corporation Tax liabilities in the context of land acquisitions and property holdings.

A detailed financial model has been developed and some initial land holdings have been evaluated for transfer. This analysis indicated an internal rate of return (IRR) of at least 6%, with further benefits from indirect income from the New Homes Bonus funding that the Council would gain.

The specific sites and detailed financial modelling work for their development and tenure will be the basis of a business plan which will inform the operations of the company after it has been constituted. The decisions on the transfer of any sites will be subject to separate Cabinet decision.

RESIDENT BENEFIT & CONSULTATION

The benefit or impact upon Hillingdon residents, service users and communities?

Hillingdon residents will benefit from the new homes developed for sale and rent together with the additional revenue generation.

Consultation carried out or required

Local residents will be statutorily consulted through the Planning process.

CORPORATE CONSIDERATIONS

Corporate Finance

Corporate Finance has reviewed this report and the associated financial modelling, which demonstrates that there is scope for the Council to secure both a sustainable revenue stream and directly contribute towards the delivery of high quality housing for residents. Creation of a wholly-owned property company will enable the Council to effectively capture the developer's' profit margin on residential developments and re-invest this in the provision of local services. This additional value is expected to be returned to the Council through a combination of interest on lending to company and dividends on equity holdings, which would be captured in future iterations of the Council's Medium Term Financial Forecast as appropriate.

As outlined within the body of this report, the initial creation of a property company has no material financial implications but any subsequent decisions to invest in specific developments would require a range of factors to be considered. Future recommendations to invest in the property company will be subject to approval by Cabinet, and will be accompanied by a comprehensive financial appraisal of the site-specific business case and associated risks - where appropriate in house expertise is not available, any such appraisal will take account of relevant third party professional advice.

Legal Implications

The Council has taken legal advice from Trowers and Hamlins solicitors who have detailed knowledge and experience of advising councils on the formation and management of commercial housing companies.

The power of general competence under section 1 of the Localism Act 2011 enables the Council to establish a company for a commercial purpose. Under section 4 of the Act all trading must be carried out through a company.

Prior to deciding to establish a company, Cabinet is required to approve the Business Case in accordance with regulation 2 of the Local Government (Best Value Authorities (Power to Trade) (England) Order 2009. Cabinet must be satisfied that the Business Case is a comprehensive statement of the objectives of the business, the investment and other resources required to achieve those objectives, any risks that the business might face, how significant those risks are and the expected financial results of the business, together with any other relevant outcomes that the business is expected to achieve.

Cabinet must also have regard to the Council's fiduciary duty in acting as a trustee on behalf of its rate and taxpayers. The Council holds and spends money on behalf of its Business Rate and Council Tax payers and in making decisions concerning the formation of the Company and any associated investment, Cabinet must give proper consideration to the risks and rewards that might arise.

Cabinet must also consider whether the Council's involvement in the Company is proportionate and properly balanced against the anticipated benefits as well as the wider interests of its local business rate and taxpayers. On a practical basis this means Cabinet should consider whether the monies they are requested to approve for investment /lending to the Company could be better used by the Council in the wider interests of its local taxpayers. This should include considering the impact on the Council and its local taxpayers should the Company became insolvent or default on any loans it has taken from the Council.

If Cabinet approves the creation of the Property Company, a further detailed report will be submitted to the Leader of the Council and Cabinet Member for Finance, Property and Business

Services, detailing the structure, working and financial arrangements of the Company together with the potential risks and benefits for the Council. This report will include detailed legal advice to ensure that the Council's interests are protected.

Infrastructure / Asset Management

Infrastructure / Asset Management has authored this report.

BACKGROUND PAPERS

NIL

APPENDIX 1 - OUTLINE BUSINESS CASE

(a) The objectives of the business:

- Generate long term revenue income; and
- Deliver high quality housing to meet the needs of Hillingdon's residents.

(b) Investment and other Resources

The Council has access to low cost borrowing, from the Public Works Loan Board (the "PWLB") amongst other potential sources, that can be used to finance the land acquisition and property development through equity injections into or loans to the Project Company.

The current 30 year (as a proxy for long term rates applicable to market rental properties) PWLB rates are 2.69% and short term rates (as a proxy for lending against market sale developments) are 1.42%.

The Council also has the option to use some of its own reserves to invest into the company. This will likely be necessary in the first few years of the company's existence as loans will typically require interest and capital payments to be made following drawdown and the Project Company will not be able to contribute to these payments until an initial development is completed.

Investing in the Project Company

The form of investment into The Project Company must be made at a market rate to avoid potential State Aid issues. The Company must also have sufficient equity held to avoid transfer pricing issues (i.e. interest on loans being disallowable for tax deductions). This means that some of the profits of The Project Company will be subject to Corporation Tax.

The approach to assessing whether the proposed debt structure and pricing constitute State Aid is underpinned by the principles of Market Economy Investor Principle (MEIP). The MEIP assessment involves an assessment of an appropriate rate range based on actual investment returns demanded by private investors in similar investment loan opportunities, operating under normal market economy conditions.

The investment into the property company, therefore, also needs to be at a level of gearing consistent with a commercial investment. The financial modelling that has been undertaken suggests that is likely to be an approximately 70:30 debt/equity split which is in line with commercial gearing levels for similar investments.

Similarly on pricing, a conservative margin needs to be applied to Gilt rates on loans provided by the Council to the project company. 180 Bps margin to Gilt rates which is comfortably higher than the equivalent market average spread for investment grade bonds (BBB and upward) has been tested in the financial modelling.

Securing a return on Investment

The Council would expect to secure a return on any investment in the property company through a combination of dividends on any equity holdings and in the case of lending to the company through the differential between the lower cost of borrowing for the Council and the higher rate of interest on lending to the company.

(c) Risk assessment:

The table below identifies the key risks associated with the proposed property company. ***These risks only emerge once the company commences trading. Up until this point the only risk associated with the creation of the company will be any costs incurred in setup and development.***

Risk area	Description	Mitigating action
Design	Risk that the design of the developments and homes is subsequently determined to be unsuitable for the intended market and users.	This risk can be mitigated through comprehensive market and qualitative research, as well as pre-application planning advice.
Planning	Risk of not obtaining planning permissions or that delays in obtaining such permissions significantly impact the project. Planning permissions may also require a greater level of affordable housing than currently modelled.	Pre-application planning advice should be sought and the Council plans to work closely with displaced tenants to identify suitable alternative accommodation. s106 payments will be factored into the Council's plans.
Delivery	Risk that there is a failure to invest funds and execute the project as planned. In addition to the wider failure of the project, there is a risk that the Council does not receive the planned income from the Company that allows it to make its own scheduled debt service payments.	This risk can be mitigated through the detailed planning and governance arrangements for the project. It will also important for the Council to have sufficient working capital to meet PWLB debt service requirements in the short term should difficulties be encountered through its own reserves.
Construction	Related to delivery risk but includes the possibility of cost overruns and delays.	This can be mitigated by thorough investigations into ground conditions (a key cause of overruns and delays) being planned prior to detailed design work. Alongside this the agreement of appropriate performance and delay penalties with contractors for delays and/or cost overruns.

Maintenance	Risk that in adequate maintenance is performed or that it proves more expensive than planned.	In general, residential property maintenance is well understood and so this risk is considered manageable. One option would be to carry out an annual rolling programme of "stock condition surveys" on rental properties and maintenance spend could be reviewed by the Property Company Board.
Rental price growth	Risk that rental price growth is not in line with projected rates.	The level of rental income that can be achieved will be driven largely by trends in the broader property market over the investment period, so there is limited scope to mitigate this broader risk beyond developing good quality housing in desirable locations and conducting research in housing demand and affordability in the local area..
Demand/voids	Risk that properties take longer than expected to sell or that rentals are left void due to insufficient demand.	We recommend that the Council undertake market research to understand the scale of this risk, recognising a key premise of the project is the evident lack of supply of suitable homes at present. We have considered the risk as part our sensitivity analysis, illustrating a risk of an increase in voids over a 30 year period.
Sales price	Risk that expected sales prices are not achieved.	The sales values achieved will reflect conditions in the broader housing market at the time. As with rental price growth The Council should ensure it is developing good quality housing in desirable locations and conducting research in housing demand and affordability in the local area. We have illustrated the impact of this risk in our sensitivity analysis on page 17.

(d) Tax implications:

As a limited company there will be a range of tax considerations:

1. **Stamp duty land tax (SDLT):** On the basis that no SDLT reliefs were claimed by the Council when it acquired these properties, we would expect that SDLT group relief should be available to relieve the SDLT charge otherwise due. Thus, no SDLT will be due on the acquisition of the land by the Property Company. The Council will need to ensure that chargeable consideration for the transfers will be taken to be no less than their market value
2. **VAT:** The short term letting of residential property will be exempt from VAT and any VAT incurred on related costs will be irrecoverable. The first grant of a major interest in residential property will be treated as a zero rated taxable supply and any VAT incurred on related costs will be recoverable.

   It should be possible to mitigate VAT incurred on the construction of the residential units by procuring construction and professional services under a single 'design and build' contract. VAT at the standard rate will be incurred on the acquisition of the land if The

Council has made or will make an option to tax prior to the sale. This VAT will only be recoverable to the extent it relates to the grant of a major interest in the land.

3. **Corporation Tax:** As a limited company, the Property Company will be subject to corporation tax on its tax adjusted profits. Corporation tax is payable on the profits from the company's rental business and on any gains made on the sale of investment properties.

   Based on the proposed structure, the Property Company could potentially incur significant additional tax costs when it disposes of the land it acquires from The Council. If the current market value of the land exceeds the original price paid by The Council (as adjusted by inflation), the inherent gain would effectively transfer with the property from The Council (where no tax is due) to Property Company (where it would be taxed).

   It may be possible to prevent the tax charge from crystallising by retaining the properties in the Property Company for long term rental; or, to mitigate the additional tax due by adopting alternative structures (but additional SDLT costs and legal implications would need to be considered), or by agreement with HMRC. Developing properties with the intention to sell or with a main aim of realising a gain will need to consider this implication.

Detailed tax advice will be sought as required once the company is established and projects are being considered and developed.