

SOUTH HOLLAND DISTRICT COUNCIL

Report of: Portfolio Holder – Finance and the Executive Director – Commercialisation

To: Cabinet – 14 February 2017

Author: Christine Marshall – Executive Director – Commercialisation

Subject: Welland Homes Financial Model

Purpose: To consider a financial model for Welland Homes Limited (Welland Homes).

Recommendations:

- 1) That the Capital Programme, included as Appendix E to the draft Budget, Medium Term Plan and Capital Strategy Report to Council on 22 February 2017, considered as Item 8 on this agenda, be amended to reflect the amended programme set out in paragraph 4.10.2.
- 2) That the 2017/18 Treasury Management Strategy, included as Appendix G to the draft Budget, Medium Term Plan and Capital Strategy Report to Council on 22 February 2017, considered as Item 8 on this agenda, be amended to reflect the changes set out in paragraph 4.13.3.

Recommendations to Council:

- 3) That the amendment to the Welland Homes Interim Business Case, as detailed in this report, be approved.
- 4) To reaffirm the delegated authority, granted by Council on 25 March 2015, to the Executive Director - Commercialisation (the S151 Officer), to approve the final mix of use of reserves and borrowing in line with the business plan and Council Treasury Management Strategy.
- 5) That delegated authority be granted to the Executive Director - Commercialisation (the S151 Officer), to approve the terms of any loan agreements required.
- 6) That the Council reverts back to the original 2016/17 Treasury Management Strategy approved by Council on 24 February 2016 with immediate effect but keeps the CCLA instant access money market fund counterparty limit at £10m rather than original £5m.

1.0 PURPOSE OF REPORT

- 1.1 To provide an update on the Welland Homes Business Case financial modelling. This update specifically relates to the acquisition of housing investment properties from 3rd parties for the purposes of market rent.
- 1.2 To approve the capitalisation and borrowing required and its structure so that the necessary loan agreements and supporting finance can then be progressed. This will support the proposed programme of acquisitions and enable the agreed rental schemes to proceed.
- 1.3 To provide an update on the state aid position and to give an informal position from our auditors on this.
- 1.4 To review the short term treasury management policy currently in place in light of clarity over this matter.

2.0 BACKGROUND

2.1 Welland Homes is the Council's wholly owned housing development company, established in July 2015 to support the delivery of a range of much needed housing solutions across the district. The original business plan for the company focuses on the following main strands of activity:

- **Holding private rented housing as an investment asset.** By utilising a company structure, the Council is able to invest in private rented housing through Welland Homes Ltd, the Council is able to help bridge a gap in the housing market and thereby help to meet local demand – whilst at the same time making effective use of capital to achieve better returns.
- **Building new homes for both market sale and rent.** In addition to being a holding vehicle, Welland Homes is also a delivery vehicle. Utilising a commissioning approach and 'design and build contracts' to bring about development, Welland Homes is presently taking forward two sites for market housing for sale and rent, totalling 34 homes (subject to planning).

2.2 An initial six sites were identified as the development focus for the company and these were centric to the initial business case approved by Council in 2014. However, a number of constraints around these sites subsequently emerged, resulting in an inability to deliver a number of the approved component parts of the original approved business plan.

2.3 In July 2016 an updated Interim Business Plan was approved by Cabinet. This identified that since the original business plan was approved, the Council's need for affordable rented stock had increased significantly due to:

- replacements needed as a result of a re-invigorated 'Right to Buy' programme, and
- changes to national government policy, which place an heightened need within stock holding local authorities to increase their asset base.

2.4 Given the uncertainty around the scale of the future housing delivery requirement for the district, the Interim Business Plan was developed to enable "us to focus on what we do know" and fast track delivery of some new housing whilst the emerging details of future development requirements are understood.

2.5 The interim business plan proposed agreement for the development and/or acquisition of a total of 82 homes across four sites with:

- Two site to be developed by Welland Homes for market sale and rent, subject to planning,
- The acquisition of £3m in new build units 'off plan' for market rent, and
- A new approach to development on behalf of the Council's HRA to be achieved via a delivery arrangement where the Council commissions the work (for its HRA) directly from Welland Homes; whilst retaining directly the ownership of land and associated uplifts in land values as a result of any planning approvals which may be secured. This gives the Council a route to increase its HRA stock at lower cost than the alternative acquisition at open market value. The first such development proposed for this route is the redevelopment of council owned land and assets at Small Drove, Weston with a view to facilitate a development of between 25 and 35 new affordable homes (subject to planning) for the benefit of the Council's Housing Revenue Account.

- 2.6 The interim business plan also provided an opportunity to test the various development activity streams within the company. The individual streams were to be the focus of the company in the immediate future following July 2016 to allow separate projects to run in parallel providing a fast tracked mechanism for delivery in a risk managed controlled and structured way.
- 2.7 The activity identified for the period of this Interim Business Plan is summarised by project below:
- Site 1 (Severn Road Spalding) – 24 homes, 12 HRA, 12 retained by Welland Homes for market sale/rent,
 - Site 2 (Parkside Crescent, Spalding) – 9 homes retained by Welland Homes for market sale/rent,
 - Site 3 (Small Drove Weston,) - 34 homes phased development on behalf of the Council, and
 - Site 4 (Green Lane Spalding) – 15 market rent homes acquired and retained by Welland Homes.
- 2.8 To support this activity the Interim Business Plan proposed that the initial allocation of £2.5million for the acquisition and holding of residential investment property be increased to a maximum of £3million.

3. CURRENT ISSUES

- 3.1 Since the approval of the Interim Business Case significant progress has been made, although a number of immediate issues now need to be addressed:
- the role of Welland Homes as part of the Council's need to increase the delivery of appropriate affordable housing,
 - the need to ensure that the Welland Homes Business Plan is sustainable, and
 - that contractual arrangements between the Council and Welland Homes are compliant with State Aid Regulations.
- 3.2 **State Aid**
- 3.2.1 In establishing contractual arrangements with Welland Homes the Council needs to ensure that both parties are compliant with the relevant legislation and regulations.
- 3.2.2 The provision of a loan by the Council to a wholly owned housing subsidiary may constitute State Aid according to Article 107 of the Treaty on the Function of the European Union (TFEU) if as a result of this; the Company obtains an economic advantage.
- 3.2.3 However, if the terms of the loan are comparable to terms that would be offered by a private investor, operating under normal market economy conditions, such a loan would be in line with the Market Economy Investor Principle (MEIP) and would not constitute State Aid.
- 3.2.4 The Interim Business Plan assumes that all Welland Homes Investments would be funded through 100% borrowing.
- 3.2.5 The Council has sought advice from external lawyers and from KPMG on this subject based on the Interim Business Plan. It is clear that, in order to maintain the assumed interest rate level in the current Business Plan, there needs to a gearing of equity investment to lending. KPMG advise that the equity element of capital funding should equate to around 35%.

3.2.6 The proposals set out in this report therefore seek to implement funding arrangements that will ensure that the Council and the Company are State Aid compliant.

3.3 **Green Lane, Spalding**

3.3.1 Welland Homes Limited is contractually committed to purchase 15 properties in Green Lane Spalding in March 2017. In view of this fast approaching deadline, to which the Company is contractually committed, an urgent decision is required to enable capitalisation of the company.

4. **INTERIM BUSINESS PLAN - UPDATE**

4.1 Given the uncertainty over the future delivery vehicle(s) for housing in South Holland, the need to ensure State Aid compliance and the imminent purchase of properties within Green Lane the whole Welland Homes business case needs to be reviewed.

4.2 Going forward, it is assumed that a substantial component of the business activity of Welland Homes will be that as a holding and investment vehicle for private rented housing. This revenue generating activity will be central to covering core costs and allowing the company to trade, in addition to providing a sustainable platform from which other housing-related opportunities can be pursued (e.g. housing development activity etc.).

4.3 In the immediate short term clarity around the sustainability of Welland Homes is required. This update therefore sets out the level of investment necessary to sustain Welland Homes as a holding vehicle under terms compliant with State Aid regulations.

4.4 In order to determine the updated baseline business case, a revised model has been created. The model is based on the core costs of the business and has been used to determine the level of activity required to generate the required returns.

4.5 The investment proposed will deliver approximately 60 additional properties by 31st March 2022:

- Completion of Green Lane (15 units) in March 2017,
- Completion of Long Sutton (5 Units) by March 2018, and
- 4 additional schemes of 10 units, with 1 completed each year up to 2021/22.

4.6 The model is based on a number of assumptions which are set out in detail in Confidential Appendix 1. Key assumptions are that the Council will provide equity in respect of set up costs/cash flow and 35% of the cost of individual schemes with the balance (65%) funded by Welland Homes borrowing from the Council (with the interest rate in the current model then being unchanged).

4.7 The assumptions built into the model are prudent and are designed to ensure a sustainable business model. In particular:

- annual repairs and maintenance costs are assumed at £750 per property from year one, and
- no assumption has been made about rent increases outstripping cost inflation.

4.8 All assumptions regarding costs and income will be reviewed on an ongoing basis as schemes are completed and units let. If actual costs are lower than current projections and rental returns improve this will improve the overall yield. In particular, assumptions around rent levels will be reviewed following the completion and letting of the Green Lane Scheme as there is initial evidence that it may be possible to overachieve the rents assumed,

4.9 Welland Homes Impact

4.9.1 The projected impact on Welland Homes is set out in Confidential Appendix 2.

4.10 Council Impact

4.10.1 The property numbers and financial implications reflected within this paragraph only include properties purchased by the Company and held for Private Rented Housing. The detailed projected financial impact on the Council is set out in Confidential Appendix 3 with key elements summarised below.

4.10.2 Based on 65% gearing the total Council Capital Programme Investment required to deliver 6 schemes (60 properties) is estimated at £3.007m over the period 2016-17 to 2021-22, an increase of £0.956m over the draft capital programme included within the Draft Medium Term Financial Plan (Item 8 on this agenda):

	Current Programme £000	Amended Programme £000
2016-17	931	858
2017-18	1,120	241
2018-19	-	477
2019-20	-	477
2020-21	-	477
2021-22	-	477
	2,051	3,007

4.10.3 The current modelling assumes that the Council's Equity Investment in Welland Homes will be funded through internal borrowing. While the base rate is so low this will mean that the Council can achieve a higher rate of interest from Welland Homes than by investing elsewhere. However, as this is a long term investment there is a risk that if the base rate increases the opportunity cost of this internal borrowing could increase. To mitigate this risk the Council could choose to fund this investment through a long term PWLB loan.

4.10.4 The original business plan was approved by the Council on 25th March 2015 with delegated authority to the S151 Officer to approve the final mix of use of reserves and borrowing in line with the business plan and Council Treasury Management Strategy. This delegation now needs to be re-affirmed to reflect this update to the Interim Business Plan.

4.10.5 Revenue savings of over £0.325m per year will be achieved by 2021-22 as a result of this investment.

4.10.6 The Council will also receive indirect contributions through New Homes Bonus and as a result of an increased Council Tax Base.

4.11 Loan Notes

4.11.1 The element of funding that comprises a loan or loans will be subject a formal loan agreement or agreements which may be protected by way of a charge against the company's assets generally (a floating charge) or against specific assets. It is suggested that the s151 Officer be authorised to approve the terms of any such agreement.

4.12 External Evaluation of Business Model

4.12.1 The updated Interim Business Plan has been developed taking into account informal advice received from our external auditors. However, the legislation and regulations applying to areas such as State Aid, Corporation Tax and Value Added Tax are extremely complex. The modelling completed and assumptions made will therefore be subject to external evaluation before any loan agreements are completed.

4.13 Treasury Management Implications

4.13.1 No borrowing has been undertaken since the business plan was approved and the updated interim business plan assumes all funding will be from existing council reserves.

4.13.2 The current lack of clarity over the level and timing of future investment requirements has led to a position where the Council's Interim Treasury Management Strategy for 2016/17 only allows short term lending for up to a month at a time – so that cash flow resources are available if required for Welland Homes. The rates of interest receivable on this basis tend to be uncompetitive (usually less than 0.25%) leading to a shortfall in interest earned against budget in 2016/17.

4.13.3 To reflect the recommendations set out within this report the Council's 2017/18 Treasury Management Strategy, included as Appendix G to Item 8 on this agenda (The Council's Budget and Medium Term Financial Plan) now needs to be updated to reflect the change in the capital programme set out in para 4.10.2 and the subsequent impact on capital financing and expected investment levels.

4.13.4 It is also recommended that the Council reverts back to the original 2016/17 Treasury Management Strategy approved by Council on 24th February 2016 with immediate effect but keeps the CCLA instant access money market fund counterparty limit at £10m rather than original £5m.

4.14 Wider Business Case Review

4.14.1 In addition to the 60 investment properties addressed in this update, the 2 development schemes being pursued by Welland Homes are now moving through the planning process. These schemes will be subject to a detailed financial viability appraisal when a competitive tendering exercise has been completed. Pending the outcome of this exercise it may be necessary to revisit the overall Business Case.

5. OPTIONS

5.1 Do Nothing

5.1.1 Whilst this option would provide time to consider the Business Case, it would in the meantime limit the delivery of housing from Welland Homes under the existing business plan and leave the Company unable to meet its contractual commitments re Green Lane.

5.2 Agree an update to the Interim Business Case

5.2.1 This has the advantage of securing quick delivery of some important projects, enabling further consideration of a longer term business case for the company once detailed analyses of the impact of imminent changes to the housing landscape have been considered alongside all options for securing delivery of housing in greater numbers.

6. REASONS FOR RECOMMENDATIONS

- 6.1 An update to the interim business plan provides the best delivery option during a period of uncertainty in relation to the future scale of development required.

7. EXPECTED BENEFITS

- 7.1 This update to the amended business case will deliver 60 private rented properties by 2021/22 and support the delivery of savings targets set out in the Councils Medium Term Financial Plan.

8. IMPLICATIONS

8.1 Constitution & Legal

- 8.1.1 Whilst operational matters in respect of the company are executive functions, the changes proposed to the business plan result in a need to change the budget. As a result, the final decision is reserved to Council.
- 8.1.2 The key legal issues have been considered at each stage of the project, and have been reported to the Cabinet and Council previously. The key legal issue affecting this report is of state aid, and that issue is dealt with in the body of the report.
- 8.1.3 The proposed interim business plan is consistent with the agreed objectives of the development company.

8.2 Contracts

- 8.2.1 There will be a number of contractual arrangements between the Council and the Company – examples being in terms of services delivered to the Company by the Council, to the Council by the Company and in terms of the loan agreement(s).

8.3 Corporate Priorities

- 8.3.1 This update to the interim business plan meets the council's medium term financial plan and commitment to housing and growth in the district.

8.4 Financial

- 8.4.1 This is a financial report with detailed financial implications set out in the body of the report.

8.5 Reputational

- 8.5.1 Successful delivery of properties through Welland Homes Limited is very important to the Council not only in terms of its corporate objectives, but also reputationally.

8.6 Risk Management

- 8.6.1 The approach set out in the interim business plan will be underpinned by strong risk management. The interim business plan provides reduced risk to the council that the original business plan by giving greater certainty and increased contributions to the council.

8.6.2 It should be noted that the value of the residential assets held may go up or down in line with market forces.

8.7 Stakeholders / Consultation / Timescales

8.7.1 All housing development will be subject to the appropriate consultation processes

9. WARDS/COMMUNITIES AFFECTED

9.1 All as the Growth agenda is extended

10. ACRONYMS

TFEU - Treaty on the Function of the European Union

MEIP - Market Economy Investor Principle

CCLA – Churches, Charities & Local Authorities

HRA – Housing Revenue Account

PWLB – Public Works Loan Board

GF – General Fund

NHB – New Homes Bonus

Background papers:-

Draft Housing Company Business Plan

Interim Business Case

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Key Decision: No

Exempt Decision: No

Confidential Appendices attached to this report:

Appendix 1 - Key assumptions supporting financial modelling

Appendix 2 - Financial Impact on Welland Homes Limited

Appendix 3 - Financial impact on the Council