

**SOUTH HOLLAND DISTRICT COUNCIL**

**Report of:** Portfolio Holder for Assets & Planning and Executive Director - Commercialisation (S151)

**To:** Cabinet Tuesday – 16<sup>th</sup> February 2021

**Author:** Katie Nicol, Housing Development Programme Manager

**Subject** Welland Homes Business Plan Update

**Purpose:** To present to the Council, as sole shareholder for Welland Homes Ltd, an updated Welland Homes Business Plan and a proposal from the Company to purchase four houses for the purposes of market rental investment.

**Recommendation(s) to Cabinet:**

- 1) To approve the business case for the acquisition by Welland Homes Ltd of four houses, for the purposes of a market rental investment.
- 2) That, subject to the refreshed business plan and budget being approved by the Council in accordance with recommendation 3 below, delegated authority be granted to the Executive Director - Commercialisation (the S151 Officer), to (i) approve the terms of any loan agreements required; (ii) approve the value and the profile of any periodic cash flow payments to be made to the Company; as required to support the Company in the acquisition of the proposed investment properties.

**Recommendation(s) to Council:**

- 3) That the updated Welland Homes Business Plan be approved, and included as an amendment in the SHDC Quarterly report to members for quarter 1 2021/22.
- 4) To reaffirm the delegated authority, granted by Council on 25<sup>th</sup> 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.

**1.0 BACKGROUND**

- 1.1 Welland Homes was established by SHDC in 2015. The principal objectives for setting up the Company were to increase housing supply to address demand; to boost the local economy; to improve the quality of rented sector accommodation; to set standards for good housing design; and to generate income for the Council.
- 1.2 The Council is the sole shareholder of the Company and the Company's business plan can only be amended with the approval of the shareholder. However, the Company has six nominated directors who oversee the activity of the Company. The current adopted business plan is predicated on the Company owning 60 homes by 2022/23.

- 1.3 The Company now owns 35 market rented homes across 4 sites as shown in the table below. All properties are let and the low void rates indicate that the properties are in demand.

Scheme name	Number of dwellings	Handover date	Development type
Walters Close, Spalding	15	2017/18	Acquisition of completed dwellings from developer, with discount on OMV
Tennants Close, Long Sutton	5	2018/19	Acquisition of completed dwellings from developer, with discount on OMV
Pankhurst Close, Spalding	10	2019/20	Welland Homes design and build contract.
Bentley Court	5	2019/20	Acquisition of completed dwellings from developer, with discount on OMV

- 1.4 The original Capital Program was, included as Appendix E to the Budget, Medium Term Plan and Capital Strategy Report to Council on 26<sup>th</sup> February 2020, as Item 10 on the agenda.
- 1.5 Capital funding for new schemes is financed through a mixture of loans (at commercial rates) and equity provided to the Company by the Council. Given the current Bank of England base rate, the Council earns a margin on the interest charged to the Company. Additionally, the council earns a return on the equity invested.
- 1.6 In return, the Company receives the rental income and pays interest on the loan.
- 1.7 By 31<sup>st</sup> March, the Company will be in a position to distribute profits.
- 1.8 The current portfolio of 35 homes is appreciating in value and the current asset value is significantly greater than the total investment required to deliver those homes.
- 1.9 The Company incurs Core Business (operating) costs such as insurance, accountancy services, legal expenses and reimbursement of SHDC staff time for administering board meetings, managing the property management contract and identifying new business opportunities.
- 1.10 Properties owned by Welland Homes are currently managed by Ark Property Services; a private letting agent with experience of operating in the market rented sector within the district.
- 1.11 The Welland Homes Business Plan was most recently updated in July 2019 when the Council approved funding for the acquisition of five completed dwellings at Bentley Court, Spalding.

## 2.0 NEW BUSINESS SCHEME

- 2.1 Welland Homes is continuing to pursue further investment activity for the purposes of market rent to comply with its Business Plan. This Business Plan assumes a further scheme of 15 dwellings will be secured by April 2021. Delivery of these units has been delayed by the impact on the construction sector, SHDC and the Company, of the Covid-19 pandemic.
- 2.2 The SHDC Housing Development Programme Manager recommenced seeking new development and acquisition opportunities in Summer 2020. This has involved approaching active developers in the district to seek out opportunities to be considered by the Company. Following this engagement, a number of potential schemes were identified and presented to Welland Homes Board. Welland Homes Board requested that officers explore the possibility of purchasing the four homes which are subject to this business case.
- 2.3 A heads of terms document was drawn up which included all relevant information relating to the scheme that was known at the initial stages. This was reviewed by the Welland Homes Board who unanimously agreed to make an offer for this scheme. Following negotiation between the company and developer, a price was negotiated and agreed 'subject to contract' between both parties.
- 2.4 This was presented to the Welland Homes board on 26<sup>th</sup> January 2021. The Company directors considered the business case relating to the proposed acquisition and the impact on the Company's Business Plan. The report indicated that the target date for acquisition of the dwellings was March/April 2021 but that this accelerated pace would be challenging to achieve. An occupation date of August 2021 was assumed as a mitigation against any delay to the programme, or in letting the units.
- 2.5 Following extensive consideration of the business case, the Board identified that the scheme met their objectives:
- The scheme will make an appropriate return to Welland Homes to enable the debt to be serviced.
  - The scheme is in Holbeach which is a location with good demand for private rented accommodation.
  - The size of the scheme is appropriate. Whilst the Business Plan had anticipated that 'scheme number 5' would provide fifteen dwellings, this proposal will add value to Welland Homes' property portfolio and additional units will be sought to fulfil the Business Plan target.
  - Whilst the acquisition of solely 3 bedroom houses is more expensive than a scheme including a mixture of different property types, the Board is satisfied, based on the current understanding of the rental market and advice from Ark Property Centre that the properties will be in demand for private rented accommodation.
  - The scheme will provide good quality accommodation.
- 2.6 The board also considered the scheme costs identified in the business case, details of which can be found in confidential Appendix 1:
- 2.7 Having regard for the business case, Welland Homes board identified that the scheme met their objectives in terms of size, location and property type and return on investment. The board resolved to agree the following:
- "That, subject to the approval of the sole shareholder, and the relevant legal due diligence and appropriate professional review, Welland Homes Ltd purchase 4 units, to be let as market rent properties, as per the Business Plan assumptions."

- 2.8 Following this board resolution of 26<sup>th</sup> January 2021, a deposit has been paid for the four properties.
- 2.9 A discount has been achieved on the individual asking prices of the units. This is in an unexpectedly strong sales market, where sector intelligence suggests that developers are seeking near-to-asking price offers, as demand is outstripping supply. This is enhanced by the 'race' to benefit from the pause on stamp duty in place until 31<sup>st</sup> March 2021.
- 2.10 Directors also noted that the project is located in an area which will have an un-adopted road and a management company in place. The Board discussed the implications of this and noted the risks associated with these facts and requested officers carry out additional due diligence on these elements as part of the conveyance process to mitigate any risk. This may include:
- Reviewing proposals for the technical construction of the road;
  - Review of the management company accounts forecast relating to future maintenance of the road; and
  - Monitoring the Planning condition relating to the road construction.

### **3 Financial Evaluation**

- 3.1 At the meeting of the 26<sup>th</sup> January 2021 Welland Homes reviewed the business case and assessed the impact of this scheme on a refreshed Business Plan.
- 3.2 Directors acknowledged the impact on the Business Plan of the more expensive acquisition as a result of the strong sales market but noted the positive return generated and the potential of the capital asset to appreciate over time. They were satisfied that this scheme meets their objectives and they agreed:
- That the scheme be presented to the Council, as Shareholder;
  - That officers proceed with payment of the partially non-refundable reservation fee of £500 per property to the developer, for the acquisition of the 4 dwellings in order to ensure the properties are taken off the open market.
  - That, subject to the approval of the sole shareholder, and the relevant legal due diligence and appropriate professional review, Welland Homes Ltd purchase 4 units, to be let as market rent properties, as per the Business Plan assumptions.
- 3.3 The financial appraisal of the scheme is summarised in confidential Appendix 1.
- 3.4 The projected impact on the overall Welland Homes Business Plan is set out in confidential Appendix 3.
- 3.5 In order to enable Welland Homes to proceed with this project, the Company is seeking approval from the shareholder to put into place all of the necessary arrangements to enable the Company to complete the proposed investment.
- 3.6 These arrangements include Cabinet approving the business case for the acquisition and recommending to Council that a loan and equity investment be made available to Welland Homes to acquire the units.
- 3.7 Approval will then be sought from Council to approve the changes to the Company's Business Plan (in its capacity as sole shareholder), and to make available all necessary finance to enable the Company to acquire the units.
- 3.8 A 'Proforma B' has been prepared to enable the authority to cover the costs associated with necessary due diligence. This includes the appointment of a solicitor to prepare a Report on Title to ensure the units have good and marketable title. These costs will

transfer to Welland Homes as part of the Total Commitment in the Loan agreement in the event that the scheme is approved by the shareholder.

- 3.9 Funding is also sought to appoint a formal valuation to agree the assumptions made within the appraisal of the opportunity. This will be carried out by a Royal Institute of Chartered Surveyors registered firm, in order to confirm the purchase achieves good value for money and that the rental level assumed for the units, is achievable. This will be reviewed by representatives of the Board, as part of the due diligence process prior to completion of the acquisition.

#### 4.0 RISK

- 4.1 Acquisition and development activity has within it inherent risks. These risks are sought to be identified and managed at each stage of the process of project consideration, and at regular points as opportunities progress through the governance process.

- 4.2 The risks associated with this project have been considered by the board and will be reviewed as the due diligence is undertaken. This project will be added into the risk register for the Company.

- 4.3 The key risks for the Company associated with this acquisition are identified below:

- **Exchange and Completion is not achieved within the required 6-week deadline.** This is being mitigated by ensuring a good relationship with the developer and establishing clear lines of communication. The developer has been made aware of the internal project timeline which already does not achieve these dates. Officers are however committing to best endeavours to ensure the acquisition is achieved in a timely manner. Regular updates will be provided to the developer to evidence that the scheme is progressing and not being held up unnecessarily.
- **Contract negotiations are unsuccessful.** Whilst key terms have been agreed, draft documentation has yet to be reviewed. Officers are seeking to protect the best interests of the Company and shareholders at all times and external legal specialists are being appointed to act on the Company's behalf in these negotiations.
- **Difficulties in letting the properties.** A professional marketing agent is in place to manage and market the dwellings early. As part of the contract negotiations officers will seek agreement from the developer to allow early generic advertising in advance of the acquisition. Financial modelling does include prudent assumptions around void rates. Additionally, advice on appropriate rental income has been provided by Ark Property Centre in order to safeguard the return expected and a prudent delay has been built in to the cash-flow expected before rent is assumed to be generated.
- **Quality is not as expected.** Financial modelling includes an allowance for a Buyer's Representative to carry out a purchasers snag prior to completion to ensure that units are handed over with a good standard of workmanship. Insurance documentation will be in place and units will have defects cover in place, for a minimum of a year by the developer.
- **Cost of Management Company Costs relating to the scheme increases at a faster rate than rental inflation.** Welland Homes will seek to have a representative on the management company board. Should the costs significantly compromise the investment long term, the asset has the benefit of being an asset with a greater degree of liquidity than other asset classes (e.g. commercial units) and so other exit strategies could be considered.

- 4.4 The key risks for the authority as sole shareholder are as follows:

- **Financial.** This risk is mitigated by the efficient running of the Company and the delivery of the Business Plan. The Council are prudent lenders and oversee their investment by regular involvement at Board Meetings and by the checks and balances required to progress Welland Homes investment activity.
- **Reputational.** As above, this risk is mitigated by efficient running of the Company. Professional advice and due diligence is sought at every stage of the process and effective governance processes are in place to review and monitor all activity. Officers review Welland Homes' activity with the shareholder's interests in mind, as well as that of the Company.

## 5.0 IMPACT ON THE BUSINESS PLAN

- 5.1 The detailed projected financial impact on the Council is set out in Appendix 4.
- 5.2 It demonstrates that with the benefit of this scheme, there continues to be a beneficial financial return to the Council from Welland Homes activity. This is forecasted to be revenue return of over £0.308m per year by 2022-23 comprising equity donations, loan interest and staff recharges.
- 5.3 The key changes to the Welland Homes Business Plan since it was last approved in July 2019 are summarised below:
- The proposed purchase of 4 additional units by March/April 2021.
  - The previous Business Plan assumed a Scheme 5 which would comprise 15 homes which would be in management by 31<sup>st</sup> March 2021 and a Scheme 6 which would comprise 10 homes which would be in management by 31<sup>st</sup> March 2022. However, this new Business Plan assumes the following:
    - Scheme 5A which will provide 4 homes to be in management by August 2021;
    - Scheme 5 B which comprises 6 homes to be in management by 1<sup>st</sup> April 2022;
    - Scheme 6 which comprises 15 homes which will be in management by 1<sup>st</sup> October 2022.
  - Welland Homes' overheads such as core costs and fees for audit, directors' insurance and legal services have increased since the original Business Plan was prepared. The latest Business Plan includes the actual costs for 2019/20 and assumes an inflated level of overheads for future years.
- 5.4 It should be noted that the capital costs for Schemes 5B and Scheme 6 reflect the current market costs and are considerably higher than those built into the original Business Plan which were based upon 2017 market prices.
- 5.5 The scheme gross return on equity has been compared to the rest of the Welland Homes programme and a summary table is attached at confidential Appendix 4. The comparison summary provided at Appendix 4 identifies that this scheme provides a lower 30 Year Return on Equity than the earlier schemes in the Welland Homes Business Plan, but is comparable to the margins on the Bentley Close scheme. This is attributed to the purchase price for these units being high compared to the previous schemes. This is due to a number of factors:
- The other acquisition schemes; Green Lane and Tennants Close were agreed in 2016 and 2017 respectively. Since these were agreed housing prices have continued to rise in the district, and the quantum of investment opportunities on the open market has decreased. This is evidenced by the significant increase in asset value of Welland Homes existing assets since the original purchases were completed.

- The scheme comprises all 3 bed properties rather than a mixture of 2 and 3 bed which would reduce the average cost per unit.
- The scheme is only 4 units and so it doesn't benefit from the same economies of scale as at Pankhurst Close and Walters Close.
- The scheme is located in Holbeach which is a popular residential location in the district and therefore prices are at a premium.
- The post Lockdown housing market saw unexpected growth and increased demand during 2020, meaning that developers are achieving near-to-asking price offers.
- Pankhurst Close was a development scheme as opposed to an acquisition. A development scheme balances higher risks (due the risks involved in constructing the properties as opposed to simply acquiring them) with potentially higher rewards (financial return), and therefore it is not directly comparable with an acquisition opportunity so needs to be considered separately.

5.6 However, although this Scheme 5A provides a lower 30 Year Return on Equity than the earlier schemes in the Welland Homes Business Plan it still provides a positive return and allows investment in a capital asset with scope for appreciation in value over time.

5.7 The Core Business (Operating) costs for Welland Homes from 2021/22 onwards are forecasts. They have been calculated based on the actual 2020/21 Company costs, but are slightly inflated to take account of rising costs. Accordingly, the Business Plan is predicated on forecasts only. It is possible that these forecasted Core Business (Operating) Costs could increase further. Gross Scheme Returns are based on accurate forecasts of likely rental income.

5.8 The total investment required to deliver 60 properties across six schemes is estimated at Appendix 3.

5.9 The current modelling assumes that the Council's investment in Welland Homes will be funded through internal borrowing. While the Bank of England 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, it should be noted that, as this is a long term investment, there is a risk that if the base rate increases there may be an 'opportunity cost' to the authority.

5.10 In line with the delegated authority granted by Council on 25<sup>th</sup> March 2015 and re-affirmed within the recommendations within this report, the Executive Director - Commercialisation (the S151 Officer) will approve the final mix of reserves and borrowing in line with the Business Plan and Council Treasury Management Strategy.

5.11 The element of funding that comprises a loan or loans will be subject to 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. Delegation to the Section 151 Officer is sought to approve the terms of any such agreements.

5.12 Delegation to the Section 151 Officer is also sought to approve the process required for the Company to draw down periodic cash flow payments if required.

5.13 The revised Business Plan was considered and agreed by the Welland Homes board at its meeting of the 26<sup>th</sup> January 2021, subject to approval by the shareholder.

## **6 OPTIONS**

Option 1 – To approve the business case for the acquisition by Welland Homes Ltd of four houses for the purposes of a market rental investment.

Option 2 – Do nothing. Without the approval of the shareholder, Welland Homes would be unable to proceed with the proposed investment. This in turn would limit the delivery of housing from Welland Homes under the existing Business Plan and leave the Company unable to deliver forecasted returns.

## **7 REASONS FOR RECOMMENDATION(S)**

7.1 To approve the business case for Welland Homes to acquire four homes in Holbeach in order to realise the expected benefits as detailed in Section 8 below.

## **8 EXPECTED BENEFITS**

8.1 The acquisition of four homes and delivery of this scheme will provide a number of benefits:

- Supports the delivery of the wider Welland Homes Business Plan, which will in turn support the delivery of savings targets set out in the Council's Medium Term Financial Plan
- Increases housing supply to address demand;
- Boosts to the local economy;
- Improves the quality of rented sector accommodation; and
- Generates income for the Council.

## **9 IMPLICATIONS**

### **9.1 Constitutional & Legal**

9.1.1 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 for Council.

9.1.2 The legal requirements for the acquisition by Welland Homes will be met by an external solicitor appointed by Welland Homes. Review of the loan agreement, drawn up by Eversheds on behalf of South Holland District Council, has been carried out by the Council's solicitors previously and the same template is proposed to be used for this acquisition.

9.1.3 The proposed revisions to the Business Plan are consistent with the agreed objectives of the Company.

### **9.2 Contracts**

9.2.1 In capitalising Welland Homes as a means to enable the Company to deliver the project, the Council will utilise a loan and equity agreement, prepared by external legal advisors. This loan and equity agreement will act as a contract between the Council and Welland Homes in relation to the financing arrangement between the two parties.

### **9.3 Corporate Priorities**

9.3.1 The recommendations contained within the report will make a notable contribution to the realisation of the Council's corporate priority around 'Your home' and supports the following priorities in the Corporate Plan 2019-2023:

- Enable effective planning and delivery of housing solutions to meet local needs and aspirations to ensure that our residents have access to a range of housing options in the district;
- Deliver new homes for our residents and provide a dividend to Council through our Welland Homes housing company; and
- Ensure that our residents are enabled to live in high quality housing no matter the tenure.

#### 9.4 **Financial**

9.4.1 There is a detailed financial report with financial implications set out in the confidential appendices attached. This includes a financial evaluation of this Business Case; a revised Welland Homes Business Plan; an assessment of the financial impact of the revised Welland Homes Business Plan on the Council; and a comparison of the financial return anticipated to be achieved on this scheme alongside forecasts for other approved Welland Homes projects.

#### 9.5 **Reputation**

9.5.1 In order to mitigate reputational risk, a robust risk management structure sits around the administration of Welland Homes as a Company. Reputational risk is a key consideration within this structure, and is being proactively managed by the project team.

9.5.2 In order to manage reputational risk in terms of the timeframe around the acquisition and the required governance, the project team have held discussions with the developer to clearly articulate the caveats within the offer, and the process surrounding the opportunity, so all parties have clear expectations.

#### 9.6 **Risk Management**

9.6.1 In order to mitigate risk, a robust risk management structure sits around the administration of Welland Homes as a Company. This risk management structure has been created to manage the financial, legal, delivery, strategic and reputation risks associated with the activity of the Company. A risk register for the Company is reviewed by the board and a separate risk register, from the perspective of the authority is reviewed at the internal project group meeting.

9.6.2 Risks around acquisition activity are sought to be mitigated through regular review and the appointment of professional expertise to provide legal due diligence, and accredited valuation advice to ensure value for money, in terms of the cost of the opportunity.

#### 9.7 **Stakeholders / Constitution / Timescales**

9.7.1 Welland Homes has an ambition to purchase the homes in March/April 2021. The financial modelling of the opportunity has assumptions around income generation and assumes the units are let from August 2021.

9.7.2 The acceptance of the offer from the developer subject to an accelerated timeframe is a challenge and officers have been clear of the internal steps required before any acquisition can take place. There is a risk however that if the 6 weeks lapse and the developer is not satisfied with progress on the project, that the units may return to the open market.

#### 9.8 **Transformation Programme**

9.8.1 Detailed revenue savings arising from the investment in Welland Homes are set out as part of Confidential Appendix 3. Forecast revenue return of over £0.308m per year comprising equity donations, loan interest and staff recharges will be achieved by 2022-23 as a result of this investment and the wider Business Plan. In addition, the Council will also receive indirect contributions through New Homes Bonus and as a result of an increased Council Tax base.

10 **WARDS/COMMUNITIES AFFECTED**

10.1 All

11 **ACRONYMS**

11.1 None

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**Lead Contact Officer:**

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**Key Decision:** Y

**Exempt Decision:** Partially exempt

**This report refers to a Discretionary Service**

**Confidential Appendices attached to this report:**

(Please note that the following appendices are not for publication by virtue of Paragraph 3 (Information relating to the financial or business affairs of any particular person (including the authority holding that information))

Appendix 1 –Financial Evaluation

Appendix 2 - Welland Homes Updated Business Plan

Appendix 3 – Financial Impact on Council

Appendix 4 – Comparison with approved Welland Homes Acquisition and Development Programme Returns.