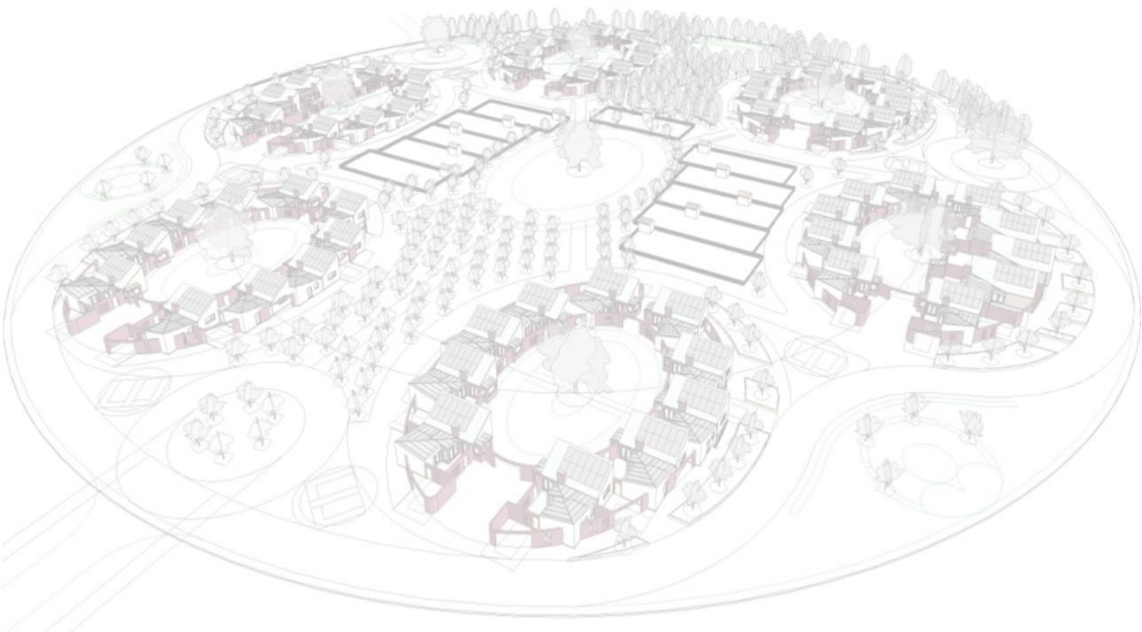
Shropshire Council

Local Housing Company

Outline Business Case



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savills

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Introduction

This Outline Business Case (OBC) has been prepared in relation to proposals to create a Local Housing Company (LHC) to help address Shropshire's unmet housing and development needs.

The OBC has been prepared using the principles of HM Treasury Green Book Five Cases Model. These are that the business case in support of a new policy, new strategy, new programme or new project must evidence:

- That the intervention is supported by a compelling **case for change** that provides holistic fit with other parts of the organisation and public sector – the "strategic case";
- That the intervention represents best **public value** – the "economic case";
- That the proposed Deal is attractive to the market place, can be procured and is **commercially viable** – the "commercial case";
- That the proposed spend is **affordable** – the "financial case";
- That what is required from all parties is **achievable** – "the management case".

As a part of the OBC, the options for alternative ways of addressing the needs have been examined, including the delivery of housing by the Council itself.

1. Strategic case

Shropshire housing market
The Local Plan Review of 2017 identified the need to build 28,750 new homes by 2036. Whilst in 2017/18 1,876 new homes were built, private sector developers are focussed on profit maximisation in the 3-5 bed 'for sale' market. The evidence is that the market is not, and will not, build the housing needed to meet the broad future needs of communities.

By way of illustration, roughly one third of new household formation is due to the growth in older population. By 2030, Shropshire will comprise of almost 33% people aged over 65. There is a wealth of research that demonstrates how developing purpose designed housing promotes longer and more productive independent living which is better for residents and helps offset growing pressures in local health and care systems.

Local Authority led property development can target where the market is under-performing or failing to provide sufficient housing supply to meet demand. The local context can be evidenced from the sub-regional Strategic Housing Market Assessment which summarises projected levels of housing need and demand, including the required mix between property sizes, bedroom numbers, tenure types and rent levels versus incomes.

Research conducted by the Smith Institute carried out in 2017 discovered that in excess of 150 council owned local housing companies were in existence and that they expected there to be over 200 by 2020.

As well as helping to meet housing need in Shropshire, Council intervention in the market is likely to increase overall economic activity, supporting the delivery of investment in new homes. This has a multiplier effect in the local economy, with residents working in local businesses and spending in local shops and on local services. It also provides an opportunity to adopt key worker policies to encourage key workers in health, education, social care and other public services to remain or move to the county.

The Council's primary aim is to address market failure, increase the availability of affordable rented and for-sale housing and to develop housing types that the private sector developers are not building.

Fit with other Council objectives and priorities

The quality of housing greatly affects the health and wellbeing of residents. Inadequate housing can cause many preventable diseases and injuries, including respiratory diseases such as asthma and bronchitis, nervous system and cardiovascular diseases and cancer.

Over 25,000 people die each year in the UK because of living in cold temperatures and much of this is due to living in poorly heated homes. Living in cold homes can worsen arthritis and increase risk of falls and other accidents through stiffening and tightening of the joints. It can also have a detrimental impact on mental health. Overcrowded homes can contribute to mental stress and reduce general wellbeing. Poor housing is estimated to cost the NHS at least £2.5 billion a year in treating people with illnesses directly linked to living in cold, damp and dangerous homes.

As an example, research by colleagues in the Council's Adult Services reveals that a Shropshire resident who is over 80 years of age, who lives alone and in a thermally inefficient house has an 80% chance of being admitted to hospital within the next 12 months.

The link between housing and healthcare costs is now well established, with sizeable savings achievable in the costs of hospital beds and residential care through the provision of suitable housing. This would be likely to include delivering housing to support and empower independence. For example; younger and older people, disabled people, wheelchair users, people with a learning disability, people with a mental health condition, and people with an impairment.

Examples of types of housing which may help to address the needs of Shropshire include:

- Housing for Health / Social Care Clients - Step-Down Beds
- More Affordable Housing (to buy, rent or shared ownership)
- Later Living
- Key Worker Housing in Proximity to Workplace
- Housing to support potential growth in Student Numbers
- Starter homes

In addition to new housing being brought forward on green, vacant or re-designated land we recognise the opportunity to redevelop and repurpose abandoned, derelict or long term vacant properties. For example, this could be a long-term empty former public house on the high street of a small market town which has the potential for housing development on the upper floors and commercial or community use on the ground floor.

2. Economic case

The likely benefits of the delivery of more housing of the right type to address Shropshire's housing and development needs are outlined above.

Having established that the market is not delivering, and that intervention in the market by the Council in the delivery of new housing is likely to provide benefits, the next question is – what options exist to generate these benefits?

Council delivery without a separate vehicle

The Council commissioned a report from Savills and Trowers & Hamlins, which set out the key financial and legal issues to consider, to inform the development of a business case for a new housing company / vehicle. This report examined the financial and legal issues around the option of delivery by the Council without a separate vehicle.

From a purely financial point of view a new vehicle would present several other financial, accounting and commercial benefits, and greater ability to generate a revenue return for the Council, but also does attract corporation tax on any declared operational profits. In the case of retaining ownership of properties for rental, then the use of a separate vehicle would be recommended as it eliminates a number of financial risks. Such capacities do exist within the Council's ALMO (STAR Housing) and could be secured through a simple management arrangement.

The legal advice from Trowers & Hamlins, considers whether it would be possible to undertake the activities of development or property investment itself, without the use of a separate vehicle. This concludes that if the Council relies on Section 1 of the Localism Act 2011 ("the general power of competence") to undertake an activity for "a commercial purpose", it must do this through a company. Whilst the Council could seek to undertake development itself using different powers, this approach would carry a number of legal risks, and be far more burdensome in terms of administration such that it would hinder its ability to act efficiently in addressing housing market needs.

As a result, based on their understanding of the circumstances of the Council, Savills have recommended that a separate vehicle is created.

New vehicle options

Options for the ownership, structure and control of a new vehicle range from a simple wholly owned Council Company through to complex structures involving multiple vehicles with interlinked ownership and funding arrangements.

In simple terms, the options for ownership (and control) of a vehicle are:

- Wholly owned by the Council
- Partly owned by the Council
- No Council ownership

For property investment activity, a wholly owned Company is by far the most common model being pursued by local authorities, as it allows both control and retention of the long-term value of the housing. For property development, there can be a stronger case for third party involvement, either through contractual arrangements or as part owner in a vehicle. The 2017 research conducted by the Smith Institute revealed that the vast majority of the circa 150 existing LHC's are set up as 'for profit' organisations.

In the case of a partly owned Company (in practice a joint venture), an element of control would be ceded to a third party, who would also look to secure a return on its investment, in line with its risk exposure. Whilst the introduction of third party capital would involve some spreading of risk, this would lower the return achievable by the Council. A joint venture option would almost certainly be more complex and costly to deliver.

Form of vehicle

If the new vehicle is established as a wholly owned vehicle, subject to the legal power used by the Council, the vehicle could be established as either:

- Company limited by shares (CLS)
- Company limited by guarantee (CLG)
- Limited liability partnership (LLP)
- Community Benefit Society (CBS)

A decision on the form of the vehicle would need to take account of a number of issues, such as the costs and complexity of each option, and the future flexibilities they will provide.

The legal advice to this OBC and concludes that based on the circumstances of the Council, their recommendation is that the LHC be established as a Company limited by shares (CLS), as a direct subsidiary of the Council.

A CLS is by far the most common commercial form of Company. It is well known and recognised in the market, and is the option typically pursued by local authorities. There is also the advantage that a CLS wholly owned by the Council would be exempt from Stamp Duty Land Tax (SDLT) on any property transfers between it and the Council.

A CLG is nearly always set up as a not for profit vehicle, and unlike a CLS does not have the same commercial flexibility, i.e. it is not a Company that can be sold through its shares and without property transfer complications.

Unlike a Company which is a separate tax paying entity, an LLP is “tax transparent”, meaning that the tax treatment of the LLP follows the tax treatment of its members. This would have the advantage of preserving the Council’s favourable tax position for any commercial activity undertaken by the LLP, with a result that (unlike a Company) there would be no corporation tax liability on any of the LLP’s profits.

However, an LLP must also be established with at least two members - meaning an LLP cannot be a wholly owned vehicle. There a number of potential legal obstacles to the Council setting up an LLP, not limited to the fact that the Council would be unable to use an LLP if it were acting in accordance with its General Power of Competence for a commercial purpose.

A CBS could be used and is a corporate vehicle for the purposes of satisfying the restrictions attached to using the General Power of Competence. However, a CBS is a vehicle that must be established for the community benefit and is restricted in respect of profit distribution and therefore is unlikely to be suitable for the Council's objectives at this stage.

3. Commercial case

There are a number of legal considerations in the business case for a new vehicle. A high-level summary is set out below and should be read in conjunction with Trowers & Hamlins' detailed legal report.

Establishing a local housing company
The Council has the ability to establish a Local Housing Company to both develop new housing on land acquired or owned by the Council, for sale or rent. The Council may utilise Section 1 of the Localism Act 2011 to do so - using the "General Power of Competence". If the Council is using this power for a commercial purpose, then it can only exercise this power using a company - but it is not precluded from using one otherwise.

Development
Once the vehicle had been established, the Council would need to consider its powers in relation to disposing of land to the vehicle, whether this is General Fund or Housing Revenue Account. The Council would also need to consider how it can fund the vehicle to undertake development, which is likely to be by way of on-lending funds.

It should be noted that the Council has powers to undertake development itself, for example it may rely on Section 2 of the Local Authorities (Land) Act 1963 (the 1963 Act) to erect any building and construct or carry out works on land. However, this power may only be used where the development of buildings/works is objectively for the benefit or improvement of the Council's area (and not - for example - simply to provide a financial return to the Council).

Whilst the Council is potentially able to develop itself, the Council needs to be mindful of the fact that it would need to ensure that it was acting in accordance with its powers for each development.

Rental properties for investment purposes
The LHC, if established, could also provide properties for rental purpose with any surplus being returned to the Council by way of dividend. The LHC would not be restricted in the types of tenancies that it provided.

If the Council were to hold properties itself for rent the tenancies would have limited flexibility as they would automatically be secure tenancies in accordance with Section 80 of the Housing Act 1985.

Set up and governance arrangements
The company will be set up in accordance with the Companies Act 2006, including the appointment to the Board of the company. The Memorandum and Articles of Association and any other documentation required will be written under professional advisement from Savills and Trowers & Hamlins. The Council will hold 100% of the shares in the Company and have full ownership. This provides the Council with full control.

The Council and Company will ensure that appropriate governance arrangements are put in place to enable the Council, as the sole shareholder to set and oversee the strategic direction of the company whilst allowing the Directors of the company discretion to carry out the operational management effectively, efficiently and with clear targets and milestones. This will require a clear decision-making framework to ensure the Council as sole shareholder makes the appropriate decisions reserved for them; and give sufficient authority to the Directors to make decisions in relation to the day to day activities of the company.

Costs to establish the company are minimal. Ongoing operating costs will be determined by its ambition and scope of development.

It should be noted that establishment of the company in itself, does not create risks or commit the Council / LHC to undertake any development projects.

4. Financial case

The Council owns allocated and unallocated land (within the Local Plan) primarily in the north and centrally. Development in the south is likely to require acquisitions.

Analysis suggests, that depending upon future scope and ambition for the Company, development of 700 dwellings across 9 sites is possible in the first 5 years and 1,300 plus dwellings across 12 sites from year 5 onwards, just on Council owned land. Further work on other potential development sites is ongoing.

This OBC has been prepared to consider the establishment of a LHC to help address Shropshire's unmet housing and development needs. Once established, the intention would be for the LHC to undertake a number of housing development projects. It is important to note that the balance of affordable housing to market housing built will affect potential income generation, as will the scale of any building programme on revenue costs for staffing and support services. However, these should be considered alongside the wider benefits.

The full business case will be based upon detailed assumptions on housing numbers, percentage of affordable housing, number of properties retained for open market rent, and numbers of sales. The financial modelling will also take into consideration land values, construction costs, potential rents and house sales.

Strategic aims, revenue forecasts, savings, cashflow and portfolio growth estimations will all be used to assess how best to viably meet the County's needs. Savings opportunities to Council departments such as Adult Social Care and Children's Services budgets will be a major factor for consideration.

Whilst these potential development projects are not the subject of this OBC, financial illustrations of 3 such projects have been prepared to examine whether and how they could be undertaken within the LHC, and what the financial implications for both the LHC and Council would be.

Development illustrations

To illustrate the financial implications of a housing development project on both the LHC and the Council, 3 examples of development projects have been prepared, in Ellesmere, Oswestry and Shrewsbury areas, based on the following property values:

Ellesmere	Sale £000
4 bed	320
3 bed	260
2 bed	200
1 bed	160

Oswestry	Sale £000
4 bed	280
3 bed	220
2 bed	175

Shrewsbury	Sale £000
4 bed	465
3 bed	370
2 bed	260

In each case, the working assumption is:

- Land is bought by the LHC from the Council
- LHC procures contractors / developers to develop out the sites, and suitable professional services to support the process
- Development and the sale of properties is over a 2 ½ year period
- LHC is funded entirely by the Council, repaying all funding from sales
- LHC pays a commercial rate of interest on funding provided to it

The table below summarises the forecast financial impact of the developments on the LHC.

	Ellesmere	Oswestry	Shrewsbury
Properties developed			
Private	54	45	40
Affordable	6	5	10
	60	50	50
Property types	1 and 2 bed apartments	2, 3 and 4 bed houses	2, 3 and 4 bed houses
Financial summary	**£000**	**£000**	**£000**
Sales receipts	10,260	10,240	15,301
Development costs	-7,200	-7,000	-8,000
Land cost	-1,200	-1,250	-4,000
Profit before interest and tax	1,860	1,990	3,301
Interest	-404	-397	-691
	1,456	1,593	2,610
Tax	-291	-319	-522
Profit after tax	**1,165**	**1,275**	**2,088**
Peak funding requirement	**5,397**	**5,309**	**8,437**

It should be noted that these forecasts are based on a number of high level assumptions regarding the likely development costs and values of properties on typical sites in these areas. The financial forecasts have been prepared to illustrate the likely financial implications of undertaking such projects through the LHC. It is anticipated that any decision to proceed with a particular project will be subject to a separate development appraisal, financial assessment and decision-making process.

In each case, the profit before tax represents some 15% of sales, which is at the low end of market norms, and reflects the fact that the mix of properties developed is not aimed solely at maximising profit.

For each project, it is assumed that the LHC pays for the land up front, immediately starts to develop and that sales proceeds start to be received a year later. This leads to a peak funding requirement for the LHC for each project, which is slightly below the total delivery costs, and which is then repaid fully out of sales.

From the perspective of the Council, it is assumed that funding required by the LHC (in excess of the land receipt) is borrowed on a short-term basis (repaid from sales), leading to an interest cost. However, this is more than covered by the interest receipt from the LHC, and in addition the Council receives the profit after tax by way of a dividend receipt.

	Ellesmere	Oswestry	Shrewsbury
Council financial impact			
Land receipt	1,200	1,250	4,000
Short term borrowing	4,197	4,059	4,437
Peak LHC fundign requirement	**5,397**	**5,309**	**8,437**
Interest receipt	404	397	691
Interest cost	-130	-123	-106
	274	273	586
Dividend receipt	1,165	1,275	2,088
Total revenue	**1,713**	**1,821**	**3,259**

In summary, each project is forecast to deliver a revenue return for the Council which is over and above the land value receipt.

Retention of properties to rent

The financial illustrations above are based on development of properties for sale – either private sales, or affordable sales to an RP. As an alternative, some of the properties which would have been sold privately could be retained for rent by the LHC.

Such a decision would provide the Council with an option to make an additional financial return in a number of different ways, such as:

- A regular direct revenue return from the rental income generated by the properties.
- Based on the future capital growth of the properties, either a revenue or capital return, or re-investment into future property development/investment.
- An indirect revenue return through development and letting of properties which would produce revenue savings to existing Council budgets such as Adult Services.

Options for securing a return in these ways are illustrated below. These are based on the assumption that 20 properties which would otherwise have been sold privately for £250,000 each (i.e. a total receipt of £5m) are instead “sold” by the LHC development business to the LHC property investment business for £5m, with the LHC borrowing £5m from the Council.

Direct revenue return

Based on a typical gross rental yield of 4%, each of the £250,000 properties could be let at a rent of £10,000 pa, or £833 per month. Setting aside 20% of this (£2,000 pa) for the cost of managing and maintaining the properties, each property would generate £8,000 pa in net rental income – a total of £160,000 in the first year.

This would firstly be used to pay interest on the £5m borrowed by the LHC to buy the properties (3% finance cost assumed), with the surplus available to be paid to the Council as a dividend. Over time, as rental income increased by inflation the net profit each year would increase. The overall financial impact on the LHC is:

Financial return £000	**Year 1**	**10 Year total**
Gross rent	200	2,190
Costs	-40	-438
Net rental income	160	1,752
Finance cost	150	1,500
Profit	**10**	**252**

This profit shown above, is over and above the finance cost which the LHC pays to the Council of £150,000 pa.

Capital growth

As well as generating a direct revenue return from the rental income, as with any other property investment business, the LHC would also benefit from the capital growth of its properties. Based on average growth in value of 2.0% pa, the £5m property portfolio would be worth £6.095m after 10 years. The Council / LHC would have the option to realise this growth in value at any time, to repay loans to the Council and / or invest in additional properties.

The table below summarises the additional returns which would be generated by a property investment business over 10 years, based on the above assumptions (note that corporation tax has been ignored for these illustrations, but in practice it would probably lead to a reduction in the additional returns.)

£000 return	**Develop for sale**	**Retain for rent**
Sales receipt	5,000	5,000
10 year revenue receipt		252
10 year capital growth		1,095

This shows that with the rental yield assumptions outlined above, retaining properties for rental would create a viable property rental and investment business plan, allowing the Council (through the LHC) to cover its additional loan finance costs, to benefit from additional dividends and from longer term capital growth.

Indirect revenue returns

The illustrations above, take no account of any additional financial returns which may arise to the Council, from savings in its existing budgets such as Adult Services. However, by controlling the nature of any properties developed, the Council / LHC has the opportunity to direct investment into properties which could meet needs unmet by the market, and provide additional savings – for example, housing which keeps individuals out of residential care for a period of time.

LHC funding arrangements

Whilst it may be possible to source funding for the LHC from third party providers, the working assumption is that the Council provides funding for the LHC. This is the option which is being pursued by almost all local authorities setting up new housing companies, largely based on simplicity and value for money, and the flexibility it provides to return surpluses to the Council as revenue.

Funding structure and costs

The overriding principle which lies behind decisions on development and investment projects carried out by the LHC is that they need to be viable and generate a return in the context of the Council's cost of funding. Within this, it needs to be recognised that:

- The LHC is a separate legal entity which needs to operate with a financially viable business plan
- The Council will need to have a sound business case for investing in and lending to the LHC and, at worst, cover its revenue costs of funding
- The funding arrangements between the Council and LHC will need to be set up so that they satisfy HMRC and state aid concerns (see below and legal appendix)

The funding arrangements will need to take account of each of these issues.

State aid and HMRC

As a lender, the Council can properly charge interest on its loan funding to the LHC, in accordance with the terms of its funding agreement. This provides a convenient and tax efficient way of generating a revenue return for the Council. However, there are two main constraints on the nature and terms of the funding arrangement, and underlying interest payments:

- **State aid –** If it is considered that the Council is providing funding on terms which are considered to give it an unfair advantage over competition (for example if interest charges are unduly low), then a state aid challenge is possible.

- **HMRC –** Interest payments made by the LHC are likely to be tax deductible in the LHC, and not taxable in the Council. However, as the LHC is controlled by the Council, then the terms of its funding will need to satisfy HMRC that the interest charges are not unduly high.

To address both state aid and HMRC issues, the way in which the LHC is funded by the Council will need to reflect a normal commercial arrangement, with the Council acting in a way in which a private lender and / or investor would in similar circumstances in a market economy.

Under the market economy investor (or lender) principle, if the Council is acting in a way that a private lender and / or investor would in similar circumstances in a market economy then the Council's investment is considered a market activity and not state aid. For example, if the Council provided a loan on commercial terms and at a commercial interest rate, properly taking into account risks and / or made an equity investment on terms and for the return which a private investor would do, then such activity would not constitute unlawful state aid. Similarly, funding arrangements which reflect those of a normal commercial arrangement are likely to provide protection from any HMRC challenge.

Whilst there are a number of variations, in most cases the simplest way to address this issue is for funding to be provided from the Council to the LHC as a combination of equity and debt:

Equity – investment (by shareholders) in the share capital of the LHC. There is no automatic right to any interest or financial return. In the event that the LHC has sufficient profits, the payment of a dividend to the shareholders could be made.

Debt – loans to the LHC, on which interest would be paid under the terms of the loan agreement.

Whilst the reality is that the Council is borrowing to lend to the LHC (and receiving a margin on its lending), for state aid and HMRC reasons the funding would be classed as a mix of equity and debt. There are now a number of reasonably well-established principles, and examples at other local authorities of such state aid compliant funding arrangements.

5. Management case

Many councils wishing to have greater place shaping control, and in response to financial pressures, have in recent years sought an alternative solution by creating Local Housing Companies. In effect to attempt to take the best operational elements from the private and public sectors and integrate them. It is currently estimated that over half of all local authorities have either set up or are in the process of creating their own Local Housing Company.

Whilst council companies have existed for many years, with trading powers set out in Section 93 of the Local Government Act 2003, the recent diversification of new companies was prompted by the General Power of Competence introduced in the Localism Act 2011.

Whereas councils could previously only trade their existing activities, this legislation enables a local council to undertake any commercial activity that an individual or private company can lawfully undertake, provided this activity is not explicitly ruled out or constrained for councils by another piece of legislation. This provides for purely commercial trading in services not previously provided by councils, such as building homes for market sale and rent.

Savills and Trowers & Hamlins have, in the past few years, been involved in the establishment of more than 50 local authority housing companies. Whilst many of the issues which arise were new several years ago, they have now been successfully addressed by these and many other local authorities, so that the risks of not being able to set up a LHC to provide benefits to the Council are now very low.

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