Shropshire Council
Local Housing Company

Business Plan – January 2019

Contents

1. Introduction

Introduction

1.1. Background

Shropshire Council ("the Council") has agreed in principle that a wholly owned local housing company be formed. This business plan for Shropshire Local Housing Company ("SLHC") has now been prepared to inform a decision on the final approval.

1.2. Initial development schemes

Whilst the Council owns a number of potential development sites, primarily in the north and centre of the County, this business plan is based on two indicative "initial development schemes" which have been worked up to illustrate the potential delivery of housing by SLHC and to show the likely financial impact on the Council. Every development undertaken by SLHC would be based on an agreed bespoke development appraisal for that site.

1.3. Scope of the business Plan

The outline business case ("OBC") included high level illustrations of three developments in different parts of Shropshire. These were based on realistic theoretical sites which were assumed to be of a good quality and ready for development, and incorporated very high level cost and value assumptions. The purpose of this presentation was to illustrate how the use of a separate company would work.

This business plan is now based on more specific local data, with the benefit of having undertaken development appraisals for two specific sites, one in the north of the County and one in the Shrewsbury area. As such, it takes into account a more detailed estimate of property values, land values, construction costs and other development costs which would be likely to apply in these areas.

Based on this data, the working assumption is that these two sites would have negligible land value and that they would generate insufficient profit to be delivered by the market. This business plan is based on SLHC taking forward two sites and delivering a higher level of affordable housing than the market would provide or conventionally be required by the Council's Local Plan policies.. It should be noted that the financial forecasts are indicative of what could be achieved on these sites using current market information, plus a range of realistic assumptions.

As well as showing the financial position of SLHC, the business plan addresses its funding requirements and the resultant financial impact on the Council.

The proposed governance and constitutional arrangements of SLHC are addressed in a separate paper.

1.4. Financial modelling principles

This financial modelling and presentation is centred on the development activity of SLHC, through the examples of acquiring two sites and developing a mix of market and affordable housing. The working assumption for the financial modelling is that SLHC would sell all the properties that it develops, either as market sales or as completed properties for rent or shared ownership to a Registered Provider.

Affordable housing developed with the benefit of Homes England grant would need to be sold to a Registered Provider, either the Council itself or a Private Registered Provider (ie a Housing Association). The business plan just makes the simple assumption that the affordable housing is sold by SLHC at its (affordable housing) value. The identity of the purchaser would make no difference to the business plan.

In terms of 'for sale' market housing, it is an option for the SLHC to retain some properties and let at a private market rent instead of being sold. To illustrate the impact of retaining a number of properties for rent, separate financial modelling of this "property investment and rental" activity has also been carried out (see section 3).

1.5. Company operation, administration and overheads

This business plan is centred on the financial modelling of two indicative development schemes, and as such includes an allowance for professional fees, which is designed to cover the full costs of taking those sites forward, both the costs of external support and advice and of internal staff costs.

However, in addition to these costs which are attributable to specific development schemes, it is likely that SLHC would incur additional costs in:

- Identifying new sites and in the preliminary stages of investigation on the feasibility of new developments
- Governance and oversight of the company
- Any additional administrative costs which are necessarily incurred in running a limited company, such as accounting, and the preparation and filing of tax returns and accounts.

At present these are not included within the business plan, however once the governance and administrative structure is in place, it is important that a full assessment of such costs is made, and that suitable provision is made.

1.6. Summary

In summary, this plan illustrates through the development of two typical sites, comprising a range of housing which the mainstream market has not previously been delivering, that affordable housing could be delivered (in line with the priorities of the Council), and that a positive financial return could also be achieved. Going forward the Business Plan for the SHLC as a company is comprised of a series of developments of this nature where each decision to invest is backed up by a detailed development appraisal using current market information plus an allowance for the full cost recovery of the company's operation.

2. Initial development schemes

Initial development schemes

2.1. Introduction

This business plan is based on two initial housing development schemes through which properties are developed by SLHC for sale or rent. It should be noted that the financial assumptions in this initial business plan are predicated on properties being developed for sale rather than for rent.

This section summarises the characteristics of each scheme, showing the housing delivery, their funding requirements and likely financial returns. With an objective of addressing unmet housing need, the two schemes modelled both look at housing developments which would not be delivered by the market because the likely level of profit is not sufficient (typical target profit of 20% on cost). As a result, the underlying land value is negligible. In addition, with the benefit of Homes England grant, they would also deliver a higher level of affordable housing than is required under planning policy.

This plan details two sites, one each in the North of the County and Shrewsbury area. To support the business plan financial forecasts, an assessment of typical current market rents, property values and construction costs for these areas has been undertaken, and other standard development cost allowances have also been included. However, the financial forecasts themselves are indicative of what could be achieved in these areas on such sites and do not necessarily reflect site specific financial forecasts, which would be completed following construction procurement.

2.2. Development financial summaries

Two similar sized sites have been used, capable of accommodating 26 new properties (mix of 2, 3 and 4 bed). Underlying property values in Shrewsbury have been assumed to be 5% higher than in the North. Under planning policy, the North site is assumed to require 10% affordable housing and the Shrewsbury site 20%, and in both examples, this has been increased to 40%, with an assumed Homes England grant of £30,000 (based on current grant programmes) per property supporting the additional provision. The table below summarises the number and value of properties delivered on each site.

	Site A North	Site B Shrewsbury
Number of properties developed		
Private	16	16
Affordable	10	10
	26	26
Average receipt per property £000		
Private	204	214
Affordable (inc grant)	120	119
Total receipts £000		
Private	3,263	3,427
Affordable	1,199	1,189
	4,462	4,615

Development costs for each site are based on the underlying assumption that each site is reasonably clear and ready for development, with no abnormal site preparation costs. Other development cost assumptions are:

- Construction costs are based on BCIS data, which is industry standard RICS construction data used to produce specific estimates for option appraisals, early cost advice and cost planning. For both sites this is a rate of £1,473 per sq.m. Moving to new 'precision engineered' off site construction models would reduce this rate.
- An additional contingency of 3% on construction costs has been added, and a further 8% for professional fees to cover the costs of design, planning, project management etc.
- Payment for CIL on these two schemes has been ignored on the basis that these sites have a high percentage of affordable homes which would not otherwise be deliverable by the market.
- Additional interest costs for the development funding at 4% pa will be incurred (see section 4)

Based on these assumptions, and assuming a tax rate of 20% on the resulting development profit (see section 5), the forecast profits for each development are:

	Site A North	**Site B Shrewsbury**
Financial summary	**£000**	**£000**
Sales receipts	4,462	4,615
Development costs	-4,293	-4,293
Profit before interest and tax	169	322
Interest	-74	-72
	96	250
Tax	-19	-50
Profit after tax	**76**	**200**

In summary, successful completion of these schemes would see developments, otherwise unprofitable to the market, taken forwards and delivering 20 affordable houses (compared to a policy requirement of 7), and a profit after tax of £276,000.

2.3. Scheme funding requirements

Delivery of each of these schemes is forecast to cross two financial years, with the quarterly funding requirements as summarised below.

Site A- Oswestry £000	Total	q1	q2	q3	q4	q5	q6	q7
Development Costs	-4,292	-311	-1,148	-1,326	-844	-552	-109	-2
Sales Revenue	4,462	0	433	329	437	1,627	1,431	205
Interest	-73	-3	-10	-20	-25	-14	-1	0
Closing balance	97	-314	-1,039	-2,056	-2,488	-1,427	-106	97

Site B- Shrewsbury £000	Total	q1	q2	q3	q4	q5	q6	q7
Development Costs	-4,292	-311	-1,148	-1,326	-844	-552	-109	-2
Sales Revenue	4,614	0	424	335	429	1,708	1,502	216
Interest	-72	-3	-10	-20	-25	-13	-1	0
Closing balance	250	-314	-1,048	-2,059	-2,499	-1,356	36	250

This model assumes that both developments would progress simultaneously the resulting quarterly funding requirement of SLHC for the two schemes combined would be:

Quarterly Funding Requirement								
SLHC £000		q1	q2	q3	q4	q5	q6	q7
Site A		-314	-1,039	-2,056	-2,488	-1,427	-106	0
Site B		-314	-1,048	-2,059	-2,499	-1,356	36	0
Total		-628	-2,087	-4,115	-4,987	-2,783	-70	0

This shows a funding requirement for SLHC over the 2 financial year period of delivering these schemes, of up to £4.99m, with funding being repaid in full by the end of this period.

2.4. Council funding and returns

Section 4 addresses the detailed funding arrangements, but in summary (as SLHC's owner and lender) the Council would need to access funding as set out above, to provide to SLHC. It is assumed that this would result in an interest cost to the Council of 3.0%, which would be more than covered by the interest payable by SLHC of 4.0%.

From the Council's perspective, the overall position would be:

3. Property investment and rental

Council Impact £000	**Total**	**q1**	**q2**	**q3**	**q4**	**q5**	**q6**	**q7**
Quarter end funding balance		-628	-2,087	-4,115	-4,987	-2,783	-70	0
Interest receipt from SLHC	147	6	20	40	50	29	2	0
Interest Cost	-93	-4	-13	-26	-32	-18	-0	
Net Interest Receipt	54	2	7	14	18	11	2	0
Dividend	347							347
Net Revenue Receipt	401	2	7	14	18	11	2	347

In summary, over the 2 year period, the Council would provide up to £4.99m to SLHC, with the balance fully repaid by the end of this period. During the period, the Council would receive interest (in excess of its finance costs) of £54,000, and further dividends based on the gross profits of the schemes of £347,000. The company will, however, have to make suitable provision for additional costs not directly attributable to the development of sites before determining the level of dividend to be paid to the Council.

Property investment and rental

3.1. Introduction

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 SLHC.
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 Social Care.

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 (ie a total receipt of £5m) are instead “sold” by SLHC development business to SLHC property investment business for £5m, with the LHC borrowing £5m from the Council.

3.2. 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 SLHC 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 SLHC 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. It would be subject to corporation tax at a current rate of 19%.

3.3. 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/SLHC 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.

3.4. Council financial impact

Whilst all funding provided to SLHC for its development (for sale) activity would be capable of being repaid out of sales proceeds, to the extent that properties were retained for rent, there would be a need for long term investment (as opposed to development) funding to be provided to SLHC.

Based on the illustration above, £5m of the development facility would be replaced by a £5m property investment facility, which would be secured against the value of the underlying properties. The Council would receive interest to cover its interest liabilities, and would have options to seek repayment of the loan at a future time in the knowledge that there were appreciating housing assets more than sufficient to cover it.

4. Funding Arrangements

Funding Arrangements

4.1. Introduction

Whilst it may be possible to source funding for SLHC from third party providers, the working assumption is that the Council would provide the funding for the SLHC. 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.

4.2. Funding Structure and Costs

The overriding principle which lies behind decisions on development and investment projects carried out by SLHC 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:

- SLHC 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 SLHC and, at worst, cover its revenue costs of funding
- The funding arrangements between the Council and SLHC 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.

4.2.1. State aid and HMRC

As a lender, the Council can properly charge interest on its loan funding to SLHC, 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 SLHC are likely to be tax deductible in the SLHC, and not taxable in the Council. However, as SLHC 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 SLHC 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 SLHC in the form of:

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

4.2.2. Funding assumptions

For the purposes of this financial modelling, it is assumed that the Council can borrow at 3% and that it receives a return on its funding to SLHC of 4%. This could potentially be achieved in a number of ways which would comply with state aid and tax regulations – for example each £100 of funding could be classed as £40 equity and £60 debt, with the debt bearing interest at 6.67%. In this way, for each £100 of funding provided, SLHC would pay £4 pa interest (6.67% of £60).

Before the funding agreement between the Council and SLHC is finalised it is recommended that the Council (and SLHC) receive independent confirmation that the funding arrangements reflect normal market conditions prevailing at that time.

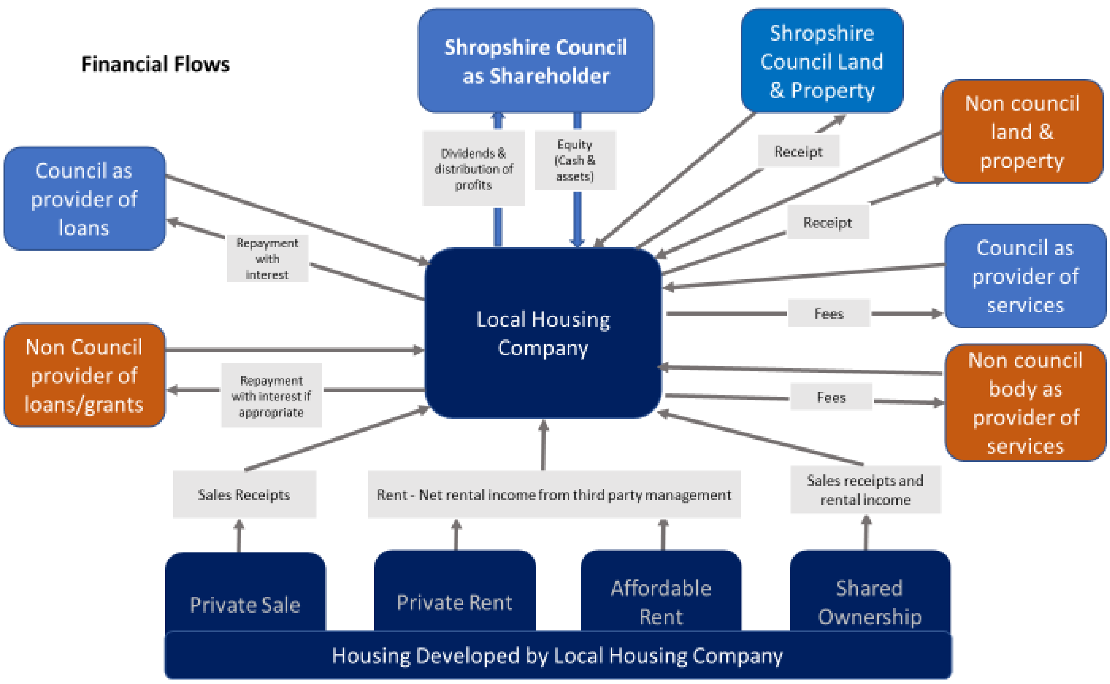
4.2.3. Capitalised interest

A further common feature of the funding arrangements for companies such as SLHC is the capitalisation of interest for the duration of a development schemes. Capitalising (or rolling up) interest means that interest due under the loan agreement is added to the capital amount of the loan. In practice, this is achieved by SLHC receiving an additional loan amount to allow it to meet its interest obligation to the Council. This results in the Council receiving interest it is due under the loan agreement.

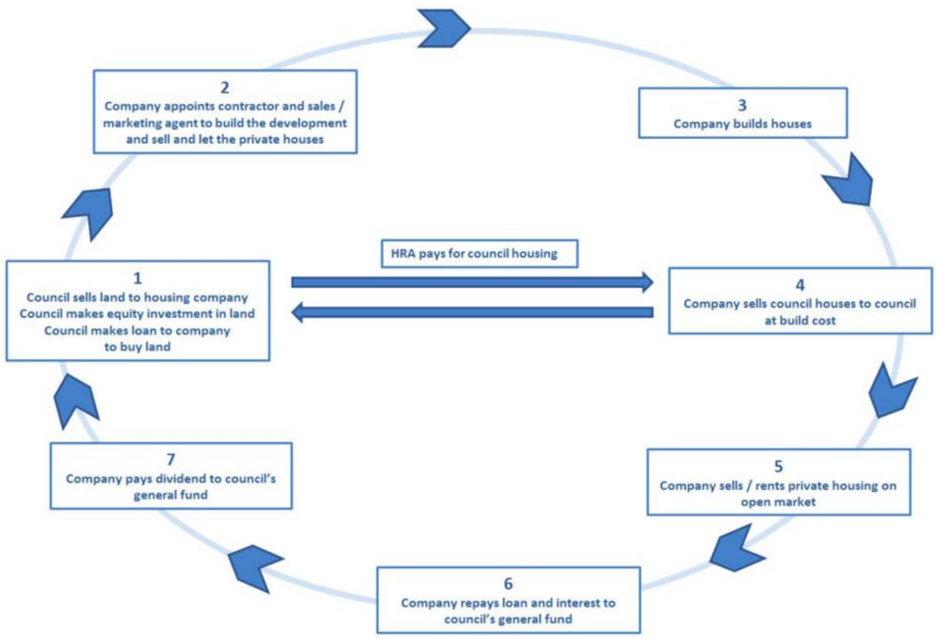
4.2.4 Financial Flows

The Company will receive equity and assets transferred from Shropshire Council plus it may receive loans or grants from bodies such as Marches LEP, Homes England, West Midlands Combined Authority or any other similar body. Any loans received from the Council will be repaid with an appropriate level of interest. In addition, the company will require a range of supporting services and capacities such as accountancy, HR, legal services etc. It is anticipated that these will be secured via a series of SLA’s with individual departments pending their capacity.

The below diagrams aim to illustrate the nature of the various relationships and flow of finance supporting them.



Development Model



5. Taxation

Taxation

5.1. Introduction

As a company, SLHC will potentially be liable for:

- VAT on operating costs which cannot be recovered
- Stamp Duty Land Tax (SDLT) on land and property acquisitions
- Corporation tax on profits.

The business plan includes provision for the likely liability for each of these taxes.

5.2. VAT

Whilst there is unlikely to be any VAT cost directly relating to the construction and sale of new houses, depending on the precise nature of the commissioning arrangements, it is possible that there could be a VAT liability relating to external professional services. At this stage it is assumed that any irrecoverable VAT is covered by the allowances for construction costs, contingencies and professional fees.

For the property rental and investment activity, it is likely that there will be some irrecoverable VAT costs relating to the management of the properties. At this stage it is assumed that the operating cost allowances would be sufficient to cover any irrecoverable VAT.

5.3. Stamp Duty Land Tax

The likelihood is that the Council and SLHC will form a tax group, so that there will be a SDLT exemption on property transfers between the Council and SLHC. However, SDLT would be payable on acquisitions of property from third parties by SLHC.

5.4. Corporation tax

The way in which a corporation tax liability arises for SLHC depends on the nature of the underlying activity. It is likely that SLHC will be classed as undertaking two separate activities:

- Trading (property development for sale)
- Property investment (rental)

5.4.1. Development

For the development of properties for sale, the corporation tax liability would be based on the profits of each scheme – broadly sale proceeds less development costs. In the calculation of development costs, the cost of land acquired for the development is typically deductible. However, in the event that the land is acquired from a group company (ie from the Council), there are additional provisions to consider which could reduce the amount of any deductible land cost.

5.4.2. Rental

For the rental business, corporation tax will be payable on profits, which are based on gross rental income received, less eligible costs:

- **Variable costs** – Whilst this will include property management and maintenance costs, it would not necessarily include major life cycle works. Depending on the precise nature of such works, they may not all be allowable as a tax deduction.
- **Interest payable** – Whilst there is some risk that interest would not be deductible if the funding arrangement was not a normal commercial arrangement (see section 4); the working assumption is that SLHC will be set up and funded so that interest costs will be tax deductible.

Corporation tax liability is payable 9 months after the end of the relevant year.