Committee: Cabinet

Date: 20 March 2016

Wards: All

Wholly Owned Local Authority Property Company (LAPC)

Lead officers:
Chris Lee – Director of Environment and Regeneration, Caroline Holland, Director of Corporate Services

Lead members:

Cllr Martin Whelton – Cabinet Member for Regeneration, Environment and Housing
Cllr Mark Allison – Deputy Leader and Cabinet Member for Finance

Contact officer:
James McGinlay – Assistant Director for Sustainable Communities

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Recommendations: That Cabinet

A. Note the work that has been carried out to date in relation to the setting up of a wholly-owned local authority property company ("LAPC").

B. Approve the setting up of a wholly owned local authority property company.

C. Approve the business case for the local authority property company.

D. Agree the proposed governance arrangement set out in this report.

E. Agree to:

(i) Establish a Sub-Committee of Cabinet and (subject to (iii) below) delegate to that Sub-Committee authority to exercise the Council's rights and responsibilities as shareholder of the company;

(ii) Nominate Members to sit on the Shareholder Cabinet Sub-Committee;

(iii) Delegate to the Director of Environment and Regeneration authority to take decisions on matters reserved to the Council in circumstances where the expenditure to be incurred in any one instance does not exceed two hundred and fifty thousand pounds (£250,000)

F. Delegate, to the Chief Executive and Monitoring Officer, authority to set up the company including finalisation and approval of all relevant documentation, and registration with the Registrar of companies.

G. Note that appropriate amendments will need to be made to the Council's constitution with respect to the Cabinet Sub-Committee and that Cabinet recommend to Full Council the appropriate amendments.

H. Recommend to Full Council, the capital investment funding of £13,022m for the first four sites plus working capital of up to £4m.

I. Delegate to the Director of Corporate Services the finalisation of the loan agreement between the Council and the LAPC .

J. Recommends to Council an allocation of a further £10 million in the capital programme for the strategic acquisition of sites, subject to the business case for each acquisition is agreed by the council's Property Asset Management Board.

K. That Cabinet (approval will also be required by full Council):

i) Approve the increase in the Capital Programme to reflect the proposals in this report, and

ii) Approve the revised Treasury Management Strategy inclusive of revised Prudential indicators

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1 PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1. To demonstrate to Cabinet a sound financial business case and governance structure for the establishment of a Local Authority Property Company.

1.2. To approve the setting up of a wholly owned Local Authority Property Company ("LAPC") with the purpose of generating revenue for the Council and increasing the supply of housing in Merton. Over 100 Local Authorities across the Country have established or are in the process of establishing LAPCs. These Councils, like Merton, have seen the real and significant financial benefits that can be realised through the use of a company structure alongside the powers of Local Authorities. This is in addition to the way companies can be used to accelerate and increase the supply of housing.

1.3. To approve the proposed structure, business plan, and the mechanics of how the company will operate and be governed (Appendices 1-4).

1.4. This report summarises the work which has been undertaken to develop the business case for setting up a wholly owned Local Authority Property Company ("LAPC") to develop housing and commercial property on Council owned land to generate income to the Council by way of finance charges and dividends to the Council as sole shareholder of the LAPC.

2 DETAILS

2.1. The Localism Act 2011, through the general power of competence introduced a power for local authorities to do anything that individuals generally, of full legal capacity, may do, subject to certain, specified, limitations and restrictions. A number of local authorities, most notably, Croydon, Sutton, Lambeth, Ealing, Thurrock, Enfield, Havering, and Newham have already used this power to establish subsidiary housing development companies. Across the country 110 local authorities have set up or in the process of setting up property companies.

2.2. A wholly owned Local Authority Property Company(LAPC) offers the opportunity to the council to develop its land holdings and utilise its capital borrowing facilities to develop housing and commercial property to generate an annual revenue return to the council. The company would develop

property in accordance with council planning policy; however the company intends to sell any affordable housing units developed to registered providers [Housing Associations] as the council does not have its own housing revenue account and the company is being set up purely for commercial purposes.

2.3. Principles / Set-up

i. The property company would be a private company limited by shares, wholly owned by the Council with the principle purpose of generating revenue to assist the council with its financial challenge. Developing housing as its key product will also assist in creating and accelerating housing supply (and where appropriate commercial units).

ii. The company would be commercially focused, with the objective of developing properties for rent but also as appropriate, for sale. Officers have identified that there is strong local housing demand in the area through on-going research with local agents and developers with gaps in the market for sale and for rent which the company could help to fill.

iii. The plan to build property for private rent, private sale, affordable rent, shared ownership etc. is in recognition of the role that the Council feels the Company could play in delivering housing supply within the Council's boundaries and maximising the income to the Council as its sole shareholder (see Business Plan Appendix 1). The establishment of the LAPC is not restricted to developing solely in Merton. The company will also have the flexibility of acquiring and developing sites outside the borough following the same principles as already stated.

iv. In order to comply with both State Aid rules and Her Majesty's Revenue & Customs (HMRC) requirements in relation to capitalisation the Council would fund the company through a mix of both equity and loan finance. In the initial business plan it is proposed that the Council would transfer the sites, as and when required, to the LAPC and take equity in the company through the acquisition of shares to the full value of the land consideration, thereby meeting the requirements of section123 of the Local Government Act 1972.

v. In addition, the Council would lend money to the company at a commercial lending rate, in order to provide the company with the finance required to plan, design, and construct the new properties (see Business Plan Appendix 1).

vi. The company could also purchase sites, land, or property, if the business case generates a good financial return and is in line with the company's memorandum and articles.

vii. The company may set up joint ventures with trusted partners for the

development of some larger sites that require specialist land assembly skills and larger sums of cash to assist with delivering the development if this is deemed to be appropriate and support the business case.

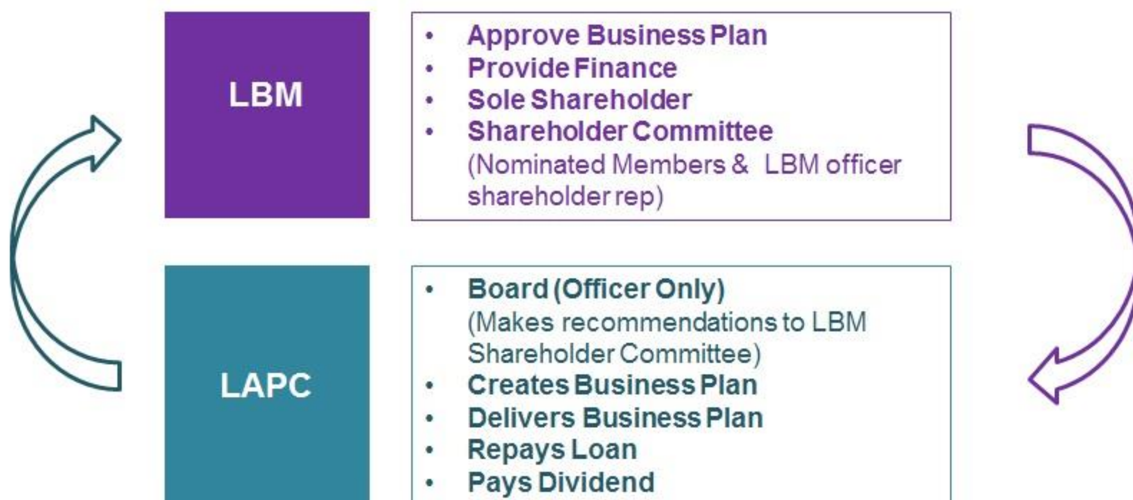
viii. The company would contract with construction specialists and construction companies for the development of sites.

ix. The developments will be planning policy compliant (subject to viability).

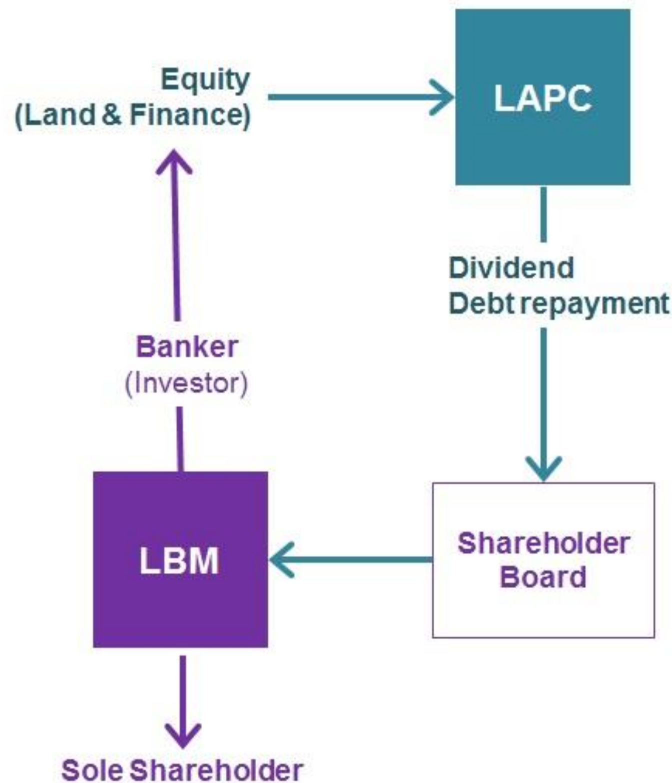
x. The return to its shareholder (the Council) would be in the form of –

- Dividends from profit
- Income from debt financing
- In the medium to long term, enhanced capital value growth of the assets.

The diagram below shows the, proposed, relationship between the council and the company.



The diagram below demonstrates the flow of money from the company to the council.



2.4. Sites

2.4.1 The Council's strategic property group PAMB (Property Asset Management Board) oversees the council's property portfolio and is the strategic decision making group for all land and property.

2.4.2 The Property and Asset Management Board list shows property and assets requiring strategic decisions (Please see Appendix 3 – Property List).The list identifies sites that the council owns and which have the potential to yield up to1500residential and commercial units.

2.4.3 Six sites were initially identified, surveyed and then modelled. After being independently surveyed and valued by BBP Regeneration, advisors to the Council, and the costs and values inputted in to an established housing model supplied by Price Waterhouse Coopers two sites were eliminated. One site was eliminated due to the council's corporate requirements and priorities changing during the process, and the second site, a very small and constrained site, did not meet the criteria of the company of generating a long term rental stream.

2.4.4 BBP Regeneration provided independent surveying and valuation advice as part of the site selection and modelling process. BPP assessed the shortlisted four sites and identified that 77 units could be built across the four sites and these were economically viable and would deliver an acceptable return to the company and council.

2.4.5 The four sites have been identified and selected, based on location, planning consideration, and market values. The sites have also been selected based on their availability for development e.g. land assembly not required. The planning designation and the financial modelling have been tested against theselected four sites. These four sites are:

- Farm Road Church, Morden
- Land at the Canons, Mitcham
- Raleigh Gardens, Mitcham
- Elm Nursery, Mitcham

2.4.6 The first four sites of the first tranche will deliver approximately 77 units. Two of the four sites have the potential to contain a mix of housing and ground floor retail; these two sites are Raleigh Gardens and Elm Nursery Car Park.

2.4.7 The company will sell affordable housing to registered providers and retain the private rented units within the company, seeking to establish a structure of 2-4 year assured short hold tenancies to give private renters more security, minimise void periods, and to stabilise revenue flow into the company. The company would either retain or sell the ground floor retail/commercial property depending on market conditions at the time of practical completion.

2.4.8 Council officers reviewed the opportunity at the P4 site, however the company's key purpose and principles is to specialise in developing housing as its product, with ground floor retail in some sites. The company at this point is not in a position to diversify and venture into developing high quality office accommodation.

2.5. Background / Market Conditions

2.5.1 The London property market over the past five years has seen strong growth in the numbers of properties developed for investment and private rent. This inward investment has pushed house prices up and seen rental values continuing to increase.

2.5.2 The following values in the table below are real rental values advertised on the website rightmove.co.uk during September 2016 for the London Borough of Merton area, i.e. Mitcham, Wimbledon etc.

2.5.3 Current Monthly Market Rents – Merton values compared to housing cap

Property Type	Range (Lowest)	Range (Highest)	Housing Cap
1 Bedroom	£825	£1,950	£724-£1,099
2 Bedroom	£1,000	£2,900	£912-£1310
3 Bedroom	£1,395	£3,400	£1,209-£1,535

2.5.4 The table shows a wide range of monthly rental levels across Merton, skewed by the higher value premium rentals in Wimbledon. The table shows the difference between market rent and the housing cap rent. The company will take advice from local agents to determine appropriate rent levels for each site after development.

2.5.5 Merton is one of the most expensive boroughs to rent, in outer London with the average 2 bedroom properties in the borough costing around £1,300 per month to rent.(www.london.gov.uk).

2.5.6 The cost of buying a home in London has risen on average by 11.2% since the start of 2015 according to the government's website www.gov.uk, with Merton rising by 10.6% with an average house price of £509,000. These high property values are making it increasingly difficult for first time buyers to get mortgages; with average deposits required starting at 10%, buying in Merton would require at least a £20,000 deposit for a studio or 1 bedroom flat in the east of the borough (www.rightmove.co.uk, 9/18/2016).

2.5.7 Due to the current market conditions, this has created what developers and government policy makers now know as "generation rent". According to research carried out by Price Waterhouse Coopers, by 2025, 60% of 25-39 year olds will be renting, with only 26% having joined the housing ladder.

2.5.8 These market conditions have created a strong rental market in London for now and the foreseeable future. This market segment of young renters has been relatively untapped by developers. However a few have started to change their business model to take advantage of this growth market.

2.5.9 PWC has advised that Brexit has not had much impact on the rental market which remains strong. PWC and RICS have however identified a slowdown in house sales and a softening of prices across London. Local agents in the borough have advised that there is a strong demand for rental properties in the borough despite Brexit.

2.6. Market Competitors

2.6.1 All though not currently in Merton, Fizzy Living and Grainger plc have already developed established Private Rental Sector (“PRS”) products in Newham and Kensington and Chelsea. The PRS product by Fizzy Living in Canning Town is a fully serviced apartment block, contains a concierge service, gym and dry cleaning services on the ground floor. Fizzy living offer a concierge service where there are developments of over 85 units on a single site, the number required to make the concierge system viable in the first instance.

2.6.2 The Fizzy Living and Grainger developments offer flexible rental terms, with renters able to have a bit more security (Commonly a 2 year assured short hold) around their tenancy. The developments also have an onsite building managers and a concierge service. The developments also have offers on a range of value added products to tenants such as free wifi, deals on TV and broadband packages etc

2.7. Private Rented Developments

2.7.1 Research around PRS developments has been undertaken, looking at housing developers to learn from their experience in the design and maintenance requirements specifically for privately rented stock. The market is now investing heavily in private rented developments as a long term income stream. Private rented developments have become increasingly attractive to investors who are prepared to purchase whole development sites for investment funds.

2.7.2 Some of the key aspects of optimised build to rent developments are:

- Maximised units per floor
- Highly efficient spatial planning
- Standardisation of components for all developments
- Whole life costings considered at the beginning
- Smaller unit sizes
- Specification driven by whole life costings, i.e. robust finishing, building fabric etc

2.7.3 Research with market specialists and discussions with other authorities also found that Private Rented Sector (PRS) Developments require a different approach in terms of assessing viability as part of seeking planning consent. Private Rented Developments unlike traditional developments carry debt and risk for a much longer period of time, and requires a flexible business model that includes a cash reserve to be retained in the company to weather market conditions and allow the company to stay solvent. Unlike traditional developments that are built for sale, building for rent presents more risk as the product is subject to market influence and pressure for up to 30 years.

3 ALTERNATIVE OPTIONS

3.1. Option 1:

An alternative option is that the council sells land to generate capital receipts (estimated at £8,413,000 for the four sites). This has been the practice historically, to leave it to the private market to build the housing. This delivers a one off receipt for the Council, rather than an on-going revenue stream back to the council. This short term gain approach results in a declining asset portfolio and also almost certainly less affordable housing being supplied year on year. The income generated from capital receipts would be interest earning only and result in a reduced financial return to the Council. Anticipated red book value £8,413,000 – Estimated Interest rate @ 0.55% = £46,271 per annum interest return.

3.2. Option 2:

Another option would be for the Council to partner with a developer to reduce its risk and exposure to the market. This option delivers less risk but also less of a return for the council, the proposed articles of the company allows for joint ventures as and when they are required. The developer will have a target margin to make it a viable investment as a small project, and will require units to be sold off earlier to get a return on their initial investment leaving the company with less rental properties, less affordable housing and a much lower annual income stream.

3.3. Option 3:

The Council could partner with a Registered Provider. This option is being considered for larger developments and is allowed for in the company's articles and business plan, however would impact on the level of return to the council. The council has a duty to get best value for the sites and would not be able to offer or sell any land to a registered provider less than this without secretary of state approval.

4 CONSULTATION UNDERTAKEN OR PROPOSED

4.1. The process of establishing the company has involved senior staff and council members to ensure the concept is acceptable and presents a sound case for council investment. The council has also sought legal advice from SLLP and Trowers&Hamlins, financial advice from the council's internal business model advisor, alongside Price Waterhouse Coopers (PWC), and Surveying advice from BBP Regeneration.

4.2. The team has also consulted and carried out research with local agents to ascertain the levels of demand in Merton.

4.3. The combination of professional advice and consultation with senior staff and members has helped develop the business model to ensure it represents a sound investment for the council, maximising the gain from some of the Council's land and asset portfolio.

4.4. The housing company has been discussed at the scrutiny task groups for housing supply and commercialisation as a method of assisting the council both with its financial challenge and creating additional housing supply. The proposals herein are consistent with the aims of these Task Groups particularly increasing revenue and accelerating housing supply utilising the Councils land and powers.

5 TIMETABLE

Cabinet Approval	March 2017
Full Council Approval	April2017
Company Set up and Land Transfer	June 2017
Procurement starts (Project Consultants/ Constructor)	July 2017
Procurement Completed	Nov 2017
Design Completed	Marc 2018
Planning Permission	June 2018
Construction Starts	July 2018
Construction Completed	Dec 2018
Properties Occupied	Feb 2019

6. RESOURCE AND PROPERTY IMPLICATION

6.1 Property

The Council's Property and Asset Management Board (PAMB) will agree sites that can be released to the company for the development. The objective of the LAPC will be to generate revenue stream to the council whilst providing housing and commercial property to maximise the value of the council's land and assets. A proposed pipeline can be found in the company business plan (Appendix 1).

7. FINANCIAL IMPLICATIONS

7.1 Financial projections have been modelled using software designed by Price Waterhouse Coopers (PwC) with assistance in compiling the data from the Councils development surveyors BBP Regeneration Ltd. The caveats and assumptions used within the model are provided within Appendices 5b and 5c.

7.2 The financial implications for the company and the Council are an integral part of the model and are summarised in the paragraphs below. Detailed consideration is given to the following within Appendix 5:

a) The use of Discounted Cash Flow (Net Present Value) for Evaluation
b) Caveats on the PwC Model
c) Assumptions within the PwC Model
d) Principal Repayment of Debt
(this is termed "Minimum Revenue Provision" within local authorities)
e) Sensitivity Analysis
f) Land Valuations
g) Tax and VAT Advice
h) The Council
i) The LAPC
j) Revised Treasury Management Strategy (including revised Prudential Indicators)

7.3 The Council

7.3.1 The proposed Local Authority Property Company (LAPC) structure involves the Council investing cash and available land as equity and providing loan finance sufficient to fund the company's development programme for an estimated 77 housing units including 20 affordable units.

The Table below also shows the provisional draw down of the funding required:

Financing Drawdown	£m	Year 1 £000s	Year 2 £000s	Year 3 £000s
Land as equity	8.413	8,413	0	0
Loan	13.022	620	6,480	5,922
Cash Equity Investment	3.256	155	1,620	1,480
Total	24.691	9,188	8,101	7,402

7.3.2 During Year 4 an estimated £2.707 million from the sale of the affordable housing to a registered provider, will be repaid by the company, reducing the funding requirement from that year to an estimated £10.315 million. The Loan repayment will be treated as capital; interest on the loan and dividends received by the Council are treated as revenue.

7.3.2 Land Equity – the land equity transferred to the company at market value to provide best consideration to the Council. The four sites are detailed within Appendix 5f.

7.3.3 Loan – The model assumes that the Council will borrow from the Public Works Loans Board to fund the loan for an estimated period of 22 years. This loan would be at an interest rate of 3.26% The Council will provide a loan to the LAPC at a rate of 6.5% a commercially competitive rate. The interest rate used within the model of 6.5% reflects the tailored repayment profile being provided to the company and Appendix 5h provides detail from the model of the estimated impact on the Council's balance sheet and income and expenditure account over the next 30 years. Officers are currently modelling how best to fund the loan from internal resources and would envisage that this would be achieved for the early part of the loan period. The longer the loan can be funded internally the greater the margin achieved from the loan to the housing company. However, care must be taken on the timing of any external loans and the interest rate that can be achieved from the market. The Authority would also be mindful of the maturity profile of its loan base.

7.3.4 Cash Equity – In addition to the land equity the Council will also be required to provide £3.256 million cash equity. This sum is required to provide an acceptable gearing ratio when equity is compared to loan capital. Including land equity the company will have a gearing ratio of 53%, excluding land this ratio increases to 80%.

7.3.5 Discounted Cash Flow - Officers have also undertaken a Discounted Cash Flow model to weight the flow of cash over time. The results of this analysis are detailed at Appendix 5a but show that the net anticipated cashflow from the company over the 30 years modelled is anticipated to be £53.704m, discounting these net cashflows by 3% per annum provides a net positive discounted cashflow of £16.906m.

7.3.6 Internal Rate of Return - The indicated internal rate of return of 6.48%(Blended 6.39%)will need to be re-visited following sensitivity analysis and adjusting the parameters to optimise the model's outputs.

7.3.6 Repayment of Debt - The proposed draw-down of funding and the repayment schedule along with proposed debt repayments (this is termed "Minimum Revenue Provision" MRP, within local authorities) adjustments are currently being fed into the Capital Programme Funding Model. At present debt repayments, if required, will be matched to loan repayments to minimise the impact on the Council. The financial impact from the capital model will then be fed into the Medium Term Financial Strategy (MTFS). The Council's approach to the treatment of MRP has already been clarified with PwC and our specialist financial advisors. It would be prudent to also discuss this approach with our external auditors.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 15	Year 20	Year 25	Year 30
Balances														
Council equity														
Cash equity in WOC	-155	-1,775	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256	-3,256
Land equity in WOC	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190	-8,190
Repaid share capital											0	0	0	11,446
	-8,345	-9,965	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	-11,446	0
Loan to WOC	-640	-7373	-13966	-10301	-10315	-10295	-10247	-10164	-10044	-9881	-8,298	-5,540	-905	0
Council loan from PWLB	788	9046	16864	12840	12603	12324	12009	11651	11250	10801	7,721	2,878	0	0
	-8,197	-8,292	-8,548	-8,907	-9,158	-9,417	-9,684	-9,959	-10,240	-10,526	-12,023	-14,108	-12,351	0

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Years 1 - 10	Years 11-15	Years 16-20	Years 21-25	Years 26-30	Cumulative
Gen Fund - I & E																
Dividends	0	0	0	0	0	0	-0	-0	-0	0	0	35	676	1,165	57,870	59,746
Interest receivable (if not rolled up)	20	252	672	908	670	670	669	666	661	653	5,841	3,042	2,373	1,257	59	12,572
Interest payable	-13	-158	-416	-550	-419	-411	-402	-391	-380	-367	-3,505	-1,581	-964	-161	0	-6,211
Net interest income	8	95	256	358	251	260	267	275	281	286	2,336	1,462	1,409	1,097	59	6,362
Total	8	95	256	358	251	260	267	275	281	286	2,336	1,497	2,085	2,262	57,929	66,108

The total reflects the annual return to the Council as shareholder

WOC – Wholly owned Company

7.3.7 By managing the cash required using the Council's own financial resources it will enable officers to provide some fine tuning the transfer of money to the LAPC. The level of flexibility offered will be contained within the loan agreement, and this will be reflected in the interest rate agreed, variation from this would be accommodated at a cost to the company within penalty clauses. The Council will also be able to optimise the external funding utilised to manage its cash flow position. Benefits to the Council will arise from the margin between any internal/external borrowing costs and the lending rates on loans to the company, and dividends payable from company profits

7.3.8 Council approval will be required for the loan, cash equity, land equity, and a budget for acquisitions. Council approval will be sought to provide cash and loan equity up to the figures detailed in this report. The company will have a £10million acquisitions budget approval in place to quickly take advantage of any market opportunities for land or assets.

7.3.9 Accounting Arrangements – The LAPC will need to be set up as a separate entity within Merton's accounts, with a separate bank account. Officers will draw on expertise developed when progressing CHAS arrangements. Officers will also be recommending that the LAPC uses the same external auditor.

7.3.10 Overheads – Overhead calculations and any recharges are based on the approach adopted for CHAS, the Council wholly owned company.

7.4 The Local Authority Property Company (LAPC)

7.4.1 The LAPC would be wholly owned by the Council. The company will plan to maximise profits and provide an ongoing income stream back to the council. Construction will be undertaken in the first 3 years and non-PRS properties will be sold when complete to Registered Providers, the remaining PRS properties will be rented at market rates.

7.4.2 The company reaches an in-year breakeven position in Year 5, however, the project as a whole breaks even in Year 15. This is reflected in the first dividends falling due in that year.

7.4.3 Appendix 5i details the output from the model in terms of the LAPC. The discounted cash flow shows a more modest return to the company.

7.4.4 Value Added – The flow of income and expenditure preclude effective calculation of a Discounted Cash Flow and Internal Rate of Return. However, it is possible to review the value added by the company – over the 30 year modelling period it is estimated that the LAPC will add £11.446 million value to the Council

7.4.5 It is envisaged that the company will adopt the CHAS support model mentioned in paragraph 7.3.9

7.4.6 Tax advice in respect of the company is contained in Appendix 5g

7.4.7 Insurance – The LAPC will need separate commercial insurance.

7.5 Sensitivity Analysis

7.5.1 Capital finance has undertaken four elements of sensitivity analysis on the model. Officers have:

1. Increased price inflation from 2.5% to 4.5%

2. Reduced income inflation from 4.5% and 4.3% to 2.5%
3. Varied the interest on the loan:
   a. Increasing the loan rate by 0.5% (i.e. increasing Merton's Margin)
   b. Increasing Merton's margin by 0.5% but reducing the PWLB loan Rate (Loan Rate is still 6.5%)

7.5.2 Analysis has shown that lower inflation levels in respect of selling prices and rentals will have a marked adverse impact on the profitability of the scheme for the Council when the timing of cash flows are analysed. This level of inflation would severely undermine the viability of the LAPC.

7.6 Review of Prudential Indicators

7.6.1 The financial proposals contained in this report will have a substantial impact on the Authority's Capital Programme 2017/21 and will require a revised Treasury Management Strategy (including revised prudential indicators) and this will require approval by both Cabinet and Council.

7.6.2 Loan and Cash Equity Investments, loan repayment and interest have been added to the capital funding model from information contained in the PWC model. In addition, it has been assumed that all the £10 million required for acquisitions will be utilised in 2017/18. As additional information becomes available financial planning documentation will be updated.

7.6.3 Impact on the Capital Programme - Allowing for slippage in the programme building in the proposals contained in this report will have the following impact on expenditure and funding:

Capital Expenditure	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Capital Expenditure	38,465	**50,316**	**41,305**	**23,478**	8,432
Slippage*	(6,698)	**(235)**	**2,323**	**664**	**475**
Leasing Budgets in Programme after Slippage	(223)	(125)	(45)	(572)	(29)
Total Capital Expenditure	31,544	**49,956**	**43,583**	**23,570**	**8,878**
Financed by:					
Capital Receipts	14,105	19,475	855	328	4,536
Capital Grants & Contributions	15,306	15,070	13,081	5,486	628
Capital Reserves	-	-	-	-	-
Revenue Provisions	2,061	6,959	61	4	0
Other Financing Sources	-	-	-	-	-
Net financing need for the year (a)	**72**	**8,452**	**29,586**	**17,753**	**3,714**

7.6.4 Whilst part of the additional expenditure is funded from the loan repayment, the bulk of the expenditure would be funded from internal borrowing. Based on current assumptions over the funding period this will just trigger the need to start to borrow externally in the financial year 2024/25.

7.6.5 The proposals contained in this report will result in the following revenue impact, interest on the loan has been included within investment interest netting off against the cost of borrowing:

Total Borrowing Costs Net of Investment interest

	2017/18 £000s	2018/19 £000s	2019/20 £000s	2020/21 £000s	2021/22 £000s
Original	12,229	10,917	12,290	12,917	13,114
Revised	12,229	11,195	13,161*	13,135	13,547**
Variance	0	278	871	218	433

* For the first three years of operation the Housing Company will capitalise the interest payable it impacts in this year as there is a large draw down of funding

** Assumes a lower rate of interest within the market – prior years have been adjusted for current performance

7.6.6 The main cause of the increase in borrowing costs is the £10 million acquisitions budget, this will cost an estimated £385k per annum. At present no income generation potential has been added for this scheme only the cost of servicing the debt.

7.6.7 Revising Prudential Indicators - The impact of the proposals in this report has been incorporated into the revised Treasury Management Strategy attached as Appendix 5j. All the prudential indicators have been reviewed and updated. The most pronounced impact is on the Authorised Limit for External Borrowing which has had to be increased by £20m in 2018/19 and £30m in 2019/20, because of the rise in the Capital Financing Requirement (CFR). The increase in the CFR is summarised in the table below:

Capital Financing Requirement	**2016/17 Estimate £'000**	**2017/18 Estimate £'000**	**2018/19 Estimate £'000**	**2019/20 Estimate £'000**
Original	189,978	181,644	192,997	193,274
Revised with Housing Company and Acquisitions Budget	189,978	189,864	211,412	219,158
Increase	0	8,220	18,415	25,883

8. LEGAL AND STATUTORY IMPLICATIONS

8.1 Legal advice has been provided by South London Legal Partnership (SLLP) and external lawyers Trowers&Hamlins. Legal advice has been sought on the type of company that is required, powers, ministerial statement, high level tax and VAT advice, the articles of the company (appendix 4), the shareholder agreement (Appendix 2), the governance arrangements and the contracting status of the company.

8.2 Powers

8.2.1 The council is able to use its general power of competence set out in section 1 of the Localism Act 2011 (the 2011 Act).

8.3 Ministerial Statement

8.3.1 Advice received from Trowers&Hamlins have given a clear steer that the Council is not currently at risk of contravening a Ministerial Statement, issued on 20 March 2015, which reviewed the progress made by Councils in increasing house-building and provided a warning that house-building by Councils should not be pursued in a way such as to undermine the Government's commitment to right-to-buy. The purpose of establishing the proposed company is what might be characterised as a commercial one. The Council wants to make the most of its assets and meet the potential for a return from its property-related activities.

8.4 Governance Arrangements

8.4.1 The company will be set up and governed as a wholly owned company of the Council. The company's day to day governance will be managed by a board of directors consisting of council nominated personnel, with a nominated shareholder representative present from time to time as part of the Council's governance arrangement.

8.4.2 As set out in the Recommendations a Sub-Committee of Cabinet will be established as the Council's shareholder board (See Appendix 2 – Shareholder Agreement) which will exercise the rights and responsibilities of the Council as shareholder (subject to paragraph 8.8 below) including, amongst other things agreeing and approving the company's annual business plan and funding arrangements and monitoring progress against the business plan on behalf of the council.

8.4.3 The sub-committee will also control "Reserved Matters", which are contained within the Shareholder Agreement; the list consists of decisions required from recruitment, acquisitions, and key financial decisions.

8.4.4 The Director of Environment and Regeneration will have delegated authority to take decisions on reserved matters in circumstances where the financial expenditure to be incurred, in any one instance, is below two hundred and fifty thousand pounds (£250,000).

8.5 Controlled Regulated Companies

8.5.1 The Local Government and Housing Act 1989 deals with companies: (a) under the control of local authorities; and (b) subject to local authority influence. The LAPC is likely to fall within one of these categories and will, therefore, be required to comply with the, relevant, provisions of the Local Authority (Companies) Order 1995.

8.6 Contracting Status and Procurement

8.6.1 The company will be wholly owned by the Council. It will be governed by the Council through a Cabinet Sub-Committee. For the purposes of European procurement rules it will be a 'contracting authority' and will, therefore, be required to comply with the public procurement regime in its procurement of goods, services and works which have contract values above the, relevant, threshold. This will include the procurement of contractors to develop out the sites.

8.6.2 However, the company will need to formulate its own procurement procedure for goods and services below the European threshold as it is a standalone commercially driven company, for example lettings, management and maintenance etc.

8.7 Land

8.7.1 In order to comply with both State Aid rules and HMRC requirements in relation to capitalisation the Council would fund the company through a mix of both equity and loan finance. The company would initially utilise sites from the Councils asset list (Appendix 3) paying the Council best consideration reasonably obtainable for the site as an equity stake in the company. The Council would transfer the sites, as and when required, to the LAPC and take equity in the company through the acquisition of shares to the full value of the land consideration. Transfer of the property at best consideration reasonably obtainable should satisfy the requirements of section123 of the Local Government Act 1972.

8.8 Staffing

8.8.1 In the initial set up stage council staff will be seconded to the company to carry out the work necessary to deliver the company's business plan, reviewed. Formal secondments agreements will be entered into between the Council and the LAPC in relation to such staff.

8.8.2 The seconded staff team would run the day to day management of the company; overseeing the design planning, procurement and construction process through strong project management processes and monitoring the performance of contracts such as letting and management agents.

8.8.3 The staff team would commission specialist consultants and contractors to undertake the detailed design, planning and implementations work.

8.9 The LAPC will contact with the Council through a series of SLAs for HR, finance, legal advice etc. The cost of staff and specialist support will be met by the LAPC.

8.10 Contracting Services from the Council

8.10.1 Any arrangement between the LAPC and the Council will need to be on commercial terms, so as not to contravene the rules on state aid, and to ensure that, in its interests, the company is not paying more for such services than it would have to pay on the open market.

8.11 Shareholder Agreement

8.11.1 A shareholder agreement usually regulates the relationship of shareholders with each other. In the case of the LAPC the shareholder agreement will be between the Council and the LAPC and will, amongst other things, identify those matters in respect of which the Council wishes to reserve decision-making and right of action to itself (See Appendix 2).

8.11.2 The Sub-Committee will control "Reserved Matters", which are contained within the Shareholder Agreement, the list consists of decisions required from recruitment, acquisitions, and key financial decisions. Please see Schedule 1 of the Shareholder agreement – Appendix 2 for the full list of reserved matters.

8.12 Articles

8.12.1 A company's Articles of Association (see Appendix 4 – Articles of Association), together with any special resolutions, comprise the company's constitution. The LAPC's articles will be based on the model set of Articles, for companies limited by shares, tailored to suit the LAPC. They will set out, amongst other things, the internal management structure of the LAPC; the procedures for appointing and removing directors and the conduct of meetings.

9. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

9.1 One of the key objectives of developing council owned sites is to increase the supply of housing to the market and support regeneration. The LAPC will generate a profit that will be returned back to the Council as revenue to fund much needed council services.

9.2 Although the LAPC's key objective is to generate a profit from professional segment in the rental market, the supply of affordable housing as part of the company's business plan is to assist the Council in meeting local housing needs.

10. CRIME AND DISORDER IMPLICATIONS

10.1 None for the purpose of this report.

11. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

11.1 The land value of the portfolio will inevitably change as the design develops from the current early stage, and the timing of any land transfer will be critical. Officers have therefore provided a more detailed commentary on how the financial performance of the portfolio can be improved and how development risk can be mitigated up to the construction phase, as well as beyond that.

Opportunities to improve financial performance

11.2 The success of any development project relies upon proactive development management throughout the programme. If the project is approved by the Council's officers and any development partner(s) will continue to refine the development schemes, providing opportunities to improve their financial performance. Such opportunities include:

- Increasing the quantum of development through more detailed design, with architect input.
- Optimising unit mix and sizing to maximise sales and rental values.
- Refining the specification to optimise sales and rental income relative to development cost.
- Adjusting tenures based on updated assumptions about the performance of the portfolio, changes in market conditions and consider introducing new affordable tenure types e.g. starter homes.
- Seeking cost savings, with input from quantity surveyors and engineers
- Adjusting contingencies to reflect the level of risk appropriate to each stage of development.
- Transferring risk to parties best placed to manage them – such as through use of contractors / development partners.

- Adjusting the timing of each stage of development based on market conditions.

Opportunities to address potential deterioration in financial performance

11.3 Even after Cabinet approval, the LAPC will have multiple opportunities to address potential deterioration in financial performance compared to its business plan, including through delegated powers.

11.4 Prior to planning permission:

- Disposal of the site without planning permission if, for example, sites with greater potential become available, or land values increase substantially in a certain part of the Borough

11.5 Between planning permission and construction:

- Delaying start on site if, for example, the relationship between sales values and build costs worsens
- Disposal of the site with planning permission if, for example, tender returns for the construction works are too high
- Revision to planning permissions to further optimise financial performance if, for example, another use becomes more viable
- Investigating alternative delivery structures, to reduce construction risk and lower construction costs
- Applying for affordable housing grant if, for example, the scheme can no longer support the level of affordable housing committed in a Section 106 agreement

11.6 Throughout construction:

- Early marketing / forward sales of units earmarked for disposal, to reduce sales risk in a declining market
- Ongoing value engineering and contract variations, including the phasing of site development so that the programme can be paused or terminated

11.7 Post-construction:

- Disposal of completed units if, for example, rental values decrease or sales values increase relative to rental values
- Negotiating rental guarantees / other risk-sharing management arrangements
- Negotiating a leasehold ‘income strip’ agreement with an institutional investor, to reduce holding risks
- Further investment to reduce management and maintenance liabilities
- Temporary or permanent change in tenure mix to manage letting voids

11.8 Throughout the life of the LAPC:

- Removal or addition of sites if, for example, sites with greater potential become available
- Renegotiation of finance arrangements if, for example, rates can be reduced through refinancing through alternative sources, or interest can be reduced by early repayment.

Appendices – the following documents are to be published with this report and form part of the report

Appendix 1: Company Business Plan

Appendix 2: Shareholder Agreement

Appendix 3: Property Asset Management Board Sites List

Appendix 4: Articles of Association

Appendix 5:
a) The use of Discounted Cash Flow (NPV) for Evaluation
b) Caveats on the PwC Model
c) Assumptions within the PwC Model
d) Principal Repayment of Debt (Termed "Minimum Revenue Provision" within local authorities)
e) Sensitivity Analysis
f) Land Valuations
g) Tax and VAT Advice
h) The Council
i) The Housing Company
j) Revised Treasury Management Strategy

The use of Discounted Cash Flow (Net Present Value)for Evaluation

The proposed Local Authority Property Company (LAPC) structure involves the Council investing cash and available land as equity and providing loan finance sufficient to fund the company's development programme.

Cash flows between the Council and the LAPC will include cash injections to the company (loan and equity) and payments (of interest and dividend) back to the Council. Forecasts are based on a 30 year programme, though there will be options to close the company before or after that time.

To evaluate the viability of the scheme Merton has utilised a Price Waterhouse Coopers (PWC) Financial Model. Financial officers have worked with PWC and BBP (specialist property and economic development consultants). Net Present Value calculations have been added to the original model.

When evaluating cashflows over such a long term time frame it is necessary to adjust the value of cash flows based on when it is anticipated that the money would be received. Net Present Value (NPV) is ideal for long term projects such as the Housing Company as it allows for the value of the cashflows to be weighted in accordance with when they occur e.g. £1million received today is worth more than £1 million received in a year's time. The results of this analysis are shown below:

Total Cashflows Over the 30 Year Modelling Period

Item	£000s
Equity land transfer	(8,190)
Equity cash injection	(3,256)
LAPC (Loans) & repayments*	0
PWLB Loans & (repayments)*	0
PWLB Loan interest (paid)	(6,211)
LAPC Loan interest received	11,614
Dividend & share cap repayment	59,746
Net Value (Paid)/Recd in year	53,704
Discount factor	3%
Discounted Cash Flow (Net Present Value)	16,906

*These items net to zero over the modelling period, however, annual discounting calculations would include movements.

This calculation demonstrates a reasonable return on the money invested. The PwC model calculates the internal rate of return of 6.48%(Blended 6.39%)with the inflation assumptions stated in Appendix 5c, this calculation will be re-visited following sensitivity analysis (Appendix 5e) and adjusting the parameters to optimise the model's outputs.

Caveats on the PwC Model

The assessment of the viability of the company has been undertaken utilising a Price Waterhouse Cooper developed model which forecasts activity over a 30 year time span. There will be options to close the company before or after that time. This software has previously been used with other Local Authorities including several London Boroughs. The model is based on a commercially driven, arm's length company, wholly owned by the Council. As with any future forecasts assumptions have been made and PWC have place the following caveat on the model:

"The Model has been developed using data and assumptions from a variety of sources. PwC have not sought to establish the reliability of those sources or verified the information so provided, nor has the Model been audited by PwC. Accordingly no representation or warranty of any kind (whether express or implied) is given by PwC to any person (other than the Council in accordance with the Engagement) as to the internal consistency or accuracy of the Model nor any output from it. Moreover the Model does not absolve any recipient from conducting its own audit in order to verify its functionality and/or performance.

PwC accepts no duty of care to any person (except to the Council under the relevant terms of the Engagement) for the development of the Model, its use, nor in respect of any output from it. Accordingly, regardless of the form of action, whether in contract, tort or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind and disclaims all responsibility for the consequences of any person (other than the Council on the above basis) acting or refraining to act in reliance on the Model and/or its output or for any decisions made or not made which are based upon such Model and/or its output"

The specialist property information/inputs and assumptions used to populate the model and generate the base financial case have been provided by BBP Regeneration. This has included the provision of up to date market rental and sales values, up to date build costs, and estimated contingencies required for each of the four sites. As part of this work their report lists several pages of assumptions and data sources used.

Assumptions within the PwC Model

The Housing Company will require the following funding to be made available for it to draw down on to progress the four sites:

Financing	£m	Description
Land as equity	8.413	Land is transferred from LBM to the company in exchange for equity in the company. Detailed in Appendix 5f
Loan	13.022	The Council provides a loan to the company to cover the majority of the costs of construction
Cash Equity investment	3.256	The Council provides sufficient additional cash equity to the company in order ensure that the company's loan to value ratios is maintained at or below 70%-75%. This level of lending complies with state aid rules
Total	**24.691**	

In addition the following assumptions have been made:

Input	Commentary
Land	The first four sites have been selected and nominated through the Property and Assets Management Board, as sites surplus to requirements that have no school requirements.
Tenure Mix	The company will take the approach of a private developer, allowing only for 70/30 split of private rent to affordable.
Land cost	The land in the model has a red book (RICS) estimated value that is retained within the company as an equity stake.
Construction costs	The model requires the BCIS figures to be inputted which are based on market rates for development per square foot. In version two of the financial business plan real costs will be entered into the model from constructors.
Rental Income	Rental income is based on today's estimate plus inflation of 4.3% p.a. This is considerably higher than widely available forecasts for general United Kingdom inflation which is generally expected to be circa 2% (CPI).
Operating costs	Management, maintenance and lifecycle costs reflect industry norms. It has been assumed that council officers will be seconded to the company at this point for part of their time, e.g. 0.4 FTE. (The charge to the company, in relation to this, will be at commercial rates.)
Bad debts and voids	An allowance for 3.5% for bad debt and voids on residential rental income has been inputted into the model. No allowance has been made for commercial voids.
Input	**Commentary**
Interest	The interest rate which the Council will pay on its borrowing reflects PWLB rates in May 2016 plus 0.5%.Since this date the rate has dropped considerably to 1.85% as at September 2016. Interest on the loan to the company will be at market rates to ensure state aid compliance. The model assumes 6.5%, which would not change, the reduction in the PWLB rate will provide a greater return to the Council.
Loans	It has been assumed for the purposes of modelling that the loan will only be drawn down when required. It is not envisaged that the practical

	application of this assumption is viable.
Inflation factors	The inflation indicators used are as follows: CPI 2.5% (used for calculation of construction and operating costs), HPI 4.5% and Rent 4.3%. The long term government target from CPI is 2%.
Tax and VAT	Corporation tax, Land tax and VAT are incorporated into the model.

<u>Principal Repayment of Debt (Minimum Revenue Provision (MRP))</u>

Local authorities are required to make a minimum revenue contribution to debt each financial year this is called the Minimum Revenue Provision (MRP). The MRP charge is the means by which capital expenditure which is financed by borrowing or credit arrangements is paid for by council tax payers. Local Authorities are required each year to set aside some of their revenues as provision for this debt, the sum is calculated taking into account the useful life of the asset.

An authority's duty under regulation 28 of the 2003 Capital Finance Regulations (as amended) is to determine for each year an amount of MRP which it considers to be prudent. This clearly would limit an authority from setting an MRP that is too low to be prudent, but the key question is then whether the duty stops an authority from determining an amount that is over-prudent. If this is the case, then an authority does not need to charge MRP in cases where no contribution towards prudence would be made.

This is particularly relevant to loans to other parties. Under proper accounting practices, loans are not expenditure and only become so when an allowance might need to be made where repayment becomes doubtful. From a financing point of view, it would be prudent not to set aside resources for capital loans – whilst the expectation remains that they will be repaid, an authority will just have exchanged one asset (cash) for another (debtor). However, as capital loans have the same effect on an authority's underlying need to borrow as its own capital expenditure, regulation 25(1)(b) of the 2003 Regulations brings them within the scope of the definition of capital expenditure, with the intention that capital loans will be limited in the same way as "normal" capital expenditure. The Statutory Guidance on MRP (here) then has an expectation in paragraphs 23 and 24 that if capital loans are not financed from capital receipts or grants MRP will be provided over the estimated life of the assets in relation to which the third party expenditure is incurred. When the loan is repaid, the repayments will be capital receipts, which are usually then applied to discharge the outstanding financing requirement and give a "refund" of the MRP made to date (albeit in the form of increases in capital receipts rather than a credit back to revenue).

The argument is how the Government expectation sits with an authority's over-riding duty. The Statutory Guidance is clearly intended to limit increases in an authority's borrowing by generating a revenue charge that wouldn't otherwise be needed, whereas the authority's duty is to manage its underlying need to borrow prudently (which does not require a revenue charge, except for doubtful debts). As the Government intention would lead to an authority setting aside more than it needs to maintain a prudent position, authorities have two options:

- Accept that the Statutory Guidance supplements the statutory duty and bring capital loans within the authority's MRP arrangements per the Statutory Guidance
- Reject the Statutory Guidance as being contrary to the statutory duty and not make MRP for capital loans

As the second of the options requires the Statutory Guidance to be disregarded, an authority taking it up would need to demonstrate that it had had regard to the Guidance but decided that it was not appropriate in this instance. The Informal Commentary on the Guidance acknowledges that departures may be justified. However, paragraph 14 does say that. Officers are seeking the advice of Legal Services and External Audit to determine acceptable treatment. Depending on the outcome of this consultation will determine whether or not the narrated approach to MRP will need to be amended.

In summary, there is a possibility that MRP does not have to be charged on capital loans, but in order to take up this option an authority must have assured itself that it would be reasonable to disregard the expectations of the Statutory Guidance in the light of the authority's duty to determine a prudent charge. There is anecdotal evidence to suggest a growing number of authorities are finding themselves able to take such a position.

Form of MRP

If the Council determines that it should make MRP for a capital loan, there is still flexibility to schedule how it might be made. The Statutory Guidance confirms an expectation that charges will be based on the period that the public will benefit from any assets acquired by the borrower as a result of the loan, not the repayments agreed. Under this expectation, there is no reason as to why MRP would match the profile of principal repayments by the borrower (especially as MRP will be a charge to revenue but the principal repayments will be credited to the Capital Receipts Reserve).

Deferring an MRP charge would be reasonable if the agreement with the company to repay principal reflected a situation that it will not be creating any substantial operational assets until after the first three years. Similarly, an MRP that is skewed to the later years of the loan may be appropriate if the benefits generated by the investment increase during the years that the loan is outstanding.

Investment in a Company

If the Council were to acquire an investment in the company rather than provide it with loans, the same discussions about the need for MRP apply as to capital loans. Regulation 25 defines the acquisition of share capital as capital expenditure, and paragraph 24 of the Statutory Guidance sets an expectation that MRP will be provided for the investment over a maximum of 20 years, despite the fact that under proper accounting practices no expenditure will have occurred (a cash asset being exchanged for an investment).

MRP and PWLB Repayments

PWLB repayments can be made at any time, provided that the Council has sufficient cash balances to meet the payment. When principal repayments are made under a capital loan, these will be capital receipts, to be paid into the Capital Receipts Reserve. If these receipts are posted into the Capital Adjustment Account, the cash that backed them will effectively become available to support cash out flows to the PWLB. There is not necessarily any direct connection, however. MRP reduces an authority's overall underlying need to borrow. Whether borrowing is actually reduced depends on wider consideration of the authority's treasury position.

MRP if applicable to the scheme

If MRP does apply the Council will need to make provision from revenue for the repayments of the loan principal and well as paying for the interest on the loan, however, the repayment of principal from the housing company will need to be treated as a capital receipt and therefore could not be used for this purpose as such if this is the case the Council would require income from the housing company of at least the interest rate changed by PWLB plus 5 percentage points.

It would be prudent to ensure that repayments to the Council on loan(s) taken out by the LAPC cover the repayments of Council borrowings from the PWLB to fund both the loan to the company and the cash equity invested in the company.

Loans made by PWLB and the Council can be structured on an annuity basis and satisfy this requirement. A Minimum Revenue Provision each year for the repayment of debt connected to PWLB loans would be based on a 20 year annuity loan. Interest at 6.5% on £13.022m loan to the LAPC covers the repayments of Council loans from the PWLB of £16.278m at 3.26%.

Sensitivity Analysis

Officers have received training on the PwC Model and received a final copy of the model on 1 December 2016. The model is similar to that developed in-house to model the funding scenarios for the capital programme. The following sensitivity analysis has been undertaken:

1. Increasing price inflation from 2.5% to 4.5%
2. Reducing income inflation from 4.5% and 4.3% to 2.5%
3. Varying the interest on the loan:
    a. Reducing the loan interest by 0.5%
    b. Increasing the loan interest by 0.5%

BBP information in respect of the selling and rental income for the 3Mitcham sites appear high when checking local property information, reducing this income will reduce the profitability of the company.

Land Valuation

The council is under an obligation under s123 of the Local Government Act 1972 when disposing of an interest in land to obtain best consideration reasonably obtainable. The Authority's valuer has valued the 4 sites being progressed by the Housing Company as:

Site	Market Value	Total Units	Affordable Housing	
	£000s		Number	%
Farm Road Church	553	9	4	44%
Land at the Canons	3,355	22	5	23%
Raleigh Gardens	2,453	22	2	9%
Elm Nursery Car Park	2,052	24	9	38%
Total	**8,413**	**77**	**20**	**26%**

Best consideration for these sites would be the market value. The valuation guidance provides no allowance for the impact of affordable housing on the site value.

Tax and VAT Advice in relation to the Housing Company

Generally, limited companies are considered not to be the most tax efficient vehicles for investment by local authorities, as local authorities do not pay corporation tax whilst a limited company pays corporation tax on its profits and can only declare dividends out of its net-of-tax profits.

However, the council will be able to make management charges, to the company, for staff time and costs and the company will be able to deduct such costs from profits before tax.

In terms of VAT, the company will be unable to recover VAT for repairs in the way the council does. Renting properties is an exempt activity for VAT purposes, however landlords pay VAT on repairs. The company would also be liable for council tax on any void periods.

Stamp Duty Land Tax ("SDLT") on land transfers: SDLT is payable on transfer/disposal of land. Where the purchaser of land is connected with the vendor SDLT is payable on the market value of the land (or the consideration given if higher).

The LAPC may well be "connected" with the Council on the basis that the Council controls the LAPC. However, it might be possible to obtain group relief from SDLT in respect of the land transferred to the LAPC from the Council. Two companies (or in this case the LAPC and a body corporate (the Council) will be in the same SDLT group if one is the parent of the other.

A company is the parent of another if it is the beneficial owner of at least 75 per cent of the ordinary share capital of the other and it is beneficially entitled to at least 75 per cent of any profits available for distribution. As the Council is proposed to be the sole shareholder of all of the paid up share capital, SDLT group relief should be available so there would be no SDLT payable on land transfer from the Council to the LAPC.

The Council

The council will receive the interest from the company on the loan and dividends from the company's profits from the cash equity investment. In order for the council to loan the £13.022m to the company and provide £3.256m cash equity, cash reserves maybe used or loan(s) of £16.278m would be required from the PWLB.Modelling has prudently assumed a PWLB Loan will be required. PWLB interest charges to the Council and interest receipts are set out in Tables over the page:

LBM Balance Sheet - Years 1 to 5 (£'000)

Item	Year 0 (£'000)	Year 1 (£'000)	Year 2 (£'000)	Year 3 (£'000)	Year 4 (£'000)	Year 5 (£'000)
Cash	0	(0)	0	0	0	0
Land	(8,413)	(8,190)	(8,190)	(8,190)	(8,190)	(8,190)
Investment	8,413	640	7,373	13,966	10,301	10,315
Long Term Debtor	0	8,345	9,965	11,446	11,446	11,446
Long Term Loan (LAPC)	0	(788)	(9,046)	(16,864)	(12,840)	(12,603)
Net Asset Impact (Surplus/(Deficit) excl MRP	0	8	102	358	716	968
Capital Receipt	0	0	0	0	2,707	0
NET ASSET IMPACT (Surplus/(Deficit) with MRP	0	8	102	358	3,424	968

LBM Balance Sheet Impact in 5 Years Periods

Item	Year 5 (£'000)	Year 10 (£'000)	Year 15 (£'000)	Year 20 (£'000)	Year 25 (£'000)	Year 30 (£'000)
Cash	0	0	0	0	4,018	74,298
Land	(8,190)	(8,190)	(8,190)	(8,190)	(8,190)	(8,190)
Investment	10,315	9,881	8,298	5,540	905	0
Long Term Debtor	11,446	11,446	11,446	11,446	11,446	0
Long Term Loan (LAPC)	(12,603)	(10,801)	(7,721)	(2,878)	0	0
Net Asset Impact (Surplus/(Deficit) excl MRP	968	2,336	3,832	5,917	8,179	66,108
Capital Receipt	2,708	434	1,583	2,758	4,634	905
NET ASSET IMPACT (Surplus/(Deficit) with MRP	3,676	2,770	5,416	8,675	12,813	67,013

The base model incorporates a repayment profile that prioritises early debt repayment starting in year 4 and covers 22 years. An annuity loan over 20 years is a preferred option as it involves simple, equal annual payments to the Council, meets statutory requirements and includes interest and principal.

Further guidance is being sort regarding whether Minimum Revenue Provision will apply to this type of investment. This is discussed in Appendix 5d. This would not undermine the viability of the scheme.

The Housing Company

The company will plan to maximise profits and provide an ongoing income stream back to the council. Construction will be undertaken in the first 3 years and non-PRS properties will be sold when complete to registered providers,the remaining PRS properties will be rented at market rates.

The forecasts show an in year deficit in the first 4 years, whilst the planning and construction work take place. Profits arise in year 3 when completed social housing is sold and increases steadily over the remaining years when PRS properties are rented. Distributions culminate in a final dividend of accumulated profits in year 30.Interest has been rolled up in the first years in the model, though immediate payment of interest could provide the Council with a margin on interest at the outset but will require high borrowing initially.

The tables below show income and expenditure for the proposed company over the first 5 years and in 5 year blocks over the modelled life of the company.

LAPC Income and Expenditure Impact - Years 1 to 5

Item	Year 0 (£'000)	Year 1 (£'000)	Year 2 (£'000)	Year 3 (£'000)	Year 4 (£'000)	Year 5 (£'000)
Profit on sales	0	(200)	0	(1,001)	(800)	0
Net rental income	0	0	120	723	622	655
Net Interest/(Cost)	0	(101)	(137)	(301)	(908)	(655)
Interest income on surplus cash balance	0	0	0	0	0	0
Profit/(Loss) before tax	0	(301)	(17)	(579)	(1,086)	(0)
Corporation tax	0	0	0	0	0	0
Profit/(Loss) after tax	0	(301)	(17)	(579)	(1,086)	(0)
Dividends	0	0	0	0	0	0

LAPC Income and Expenditure Impact in 5 Years Periods

Item	Year 0-5 (£'000)	Year 6-10 (£'000)	Year 11-15 (£'000)	Year 16-20 (£'000)	Year 21-25 (£'000)	Year 26-30 (£'000)
Profit on sales	(2,000)	0	0	0	0	51,126
Net rental income	1,581	3,838	4,949	6,350	8,110	10,343
Net Interest/(Cost)	(1,563)	(3,319)	(3,042)	(2,373)	(1,257)	(59)
Interest income on surplus cash balance	0	0	0	0	0	0
Profit before tax	(1,982)	518	1,908	3,977	6,852	61,410
Corporation tax	0	(85)	(324)	(676)	(1,165)	(10,687)
Profit after tax	(1,982)	434	1,583	3,301	5,687	50,723
Dividends	0	0	(35)	(676)	(1,165)	(69,316)

LAPC Balance Sheet - Years 1 to 5 (£'000)

Item	Year 0 (£'000)	Year 1 (£'000)	Year 2 (£'000)	Year 3 (£'000)	Year 4 (£'000)	Year 5 (£'000)
Land	0	8,190	4,074	0	0	0
Cash	0	(0)	(0)	(0)	(0)	(0)
Capitalised interest	0	20	272	851	668	682
WIP/Stock	0	136	3,379	4,567	0	0
Investment properties	0	337	9,295	19,097	19,097	19,097
Capitalised veh costs	0	0	0	0	0	0
Corp tax creditor	0	0	0	0	0	0
Long term loan	0	(640)	(7,373)	(13,966)	(10,301)	(10,315)
Equity cash element	0	155	1,775	3,256	3,256	3,256
Equity land element	0	8,190	8,190	8,190	8,190	8,190
P&L Reserve	0	(301)	(318)	(897)	(1,982)	(1,982)

Note: The loan from the Council is fully repaid after 20 years. Corporation tax is largely deferred until PRS stock is revalued at the end of the planned programme and therefore subject to the rates of corporation tax at that time.

LAPC Balance Sheet - Years 1 to 30 (£'000)

Item	Year 5 (£'000)	Year 10 (£'000)	Year 15 (£'000)	Year 20 (£'000)	Year 25 (£'000)	Year 30 (£'000)
Land	0	0	0	0	0	0
Cash	(0)	33	54	(0)	(0)	9,328
Capitalised interest	682	682	682	682	682	(0)
WIP/Stock	0	0	0	0	0	0
Investment properties	19,097	19,097	19,097	19,097	19,097	0
Capitalised veh costs	0	0	0	0	0	0
Corp tax creditor	0	(33)	(89)	(169)	(281)	(9,328)
Long term loan	(10,315)	(9,881)	(8,298)	(5,540)	(905)	0
Equity cash element	3,256	3,256	3,256	3,256	3,256	3,256
Equity land element	8,190	8,190	8,190	8,190	8,190	8,190
P&L Reserve	(1,982)	(1,548)	0	2,624	7,147	(11,446)

Note: The commercial lending rate for the loan to the company has been modelled at 6.5%.

Dividends become payable on realised profits and have been modelled to start in Year 15 in relation to PRS rental profits. There is a stepped increase in dividend in year 27 when all the debt has been repaid

Liquidity - The model assumes optimum cash flows, with no significant cash holdings. Working capital will be required but detailed drawdown arrangements for Council loans will enable this to be operated at an optimum level.

Advice from Price Waterhouse Coopers has been to agree a loan facility and draw down on a cash flow model ensuring that neither the company nor the council lends money before it's required and incur unnecessary interest charges. It is intended that advances and repayments will be implemented on a commercial basis and a cash balance will be maintained to ensure sufficient liquidity in the company. The loan percentage of 6.5% represents limited flexibility on drawn down arrangements which would be detailed in the loan agreement. Greater flexibility would trigger a higher interest rate. This will be considered as part of the sensitivity analysis.

Land values - The model has been based on land values calculated on a market value. It is recommended that an independent valuation of the four sites is obtained.