Housing Select Committee		
Report Title	Newham Private Rented Sector Vehicle – Red Door Ventures	
Contributors	Head of Strategic Finance, London Borough of Newham	Item: 4
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Purpose of Report

Newham Council established a wholly owned Company (Red Door Ventures) the purpose of which is to commercially develop and deliver homes which will be let on affordable rent and market rent terms. The Company will manage the properties and grow a portfolio over time, providing a return to the Council.

This report sets out the rationale, process and business case for the creation of the Newham Private Rented Vehicle - Red Door Ventures (RDV) as a wholly owned Local Authority Trading Company.

1 Introduction and Background

1.1 In December 2012 Newham's Mayor and Cabinet received a report on a proposal for the establishment of a Private Rented Company and resolved to move to a full business case and plan on the company (subsequently known as RDV).

1.2 The aim was to create a wholly owned company with the objective of operating a business to let homes for market rent which would purchase land and develop/purchase housing for rent from which the Council would receive a return on its investment as well as re-payment on any loans over a set period.

1.3 The company would operate in the same manner as any other private sector company, driven by the requirement to produce profits and to operate in a commercial manner. The Council's rights as a shareholder in RDV would be set out in RDV's Articles of Association and the proposed Shareholder's Agreement.

1.4 The Council had identified an opportunity in the residential market rental sector caused by the lack of sufficient activity by developers & other providers.

1.5 The establishment of RDV was proposed to deliver returns to the Council, through the commercial nature of the loan agreements.

1.6 The business case was developed following a review of market conditions within the private rented market in Newham, market and property considerations and rationale for the vehicle.

1.7 The business case was supported by a strategic financial forecast model [SFFM], developed by the project team's external advisers to demonstrate a viable scheme and the scale of development that could be supported by an approximate level of investment. The Council's external financial advisers also carried out due diligence on the business case.

1.8 The concept for the pilot scheme at Leather Gardens commenced in early 2013 and was approved at Strategic Planning Committee on 11th February 2014. The initial scheme was prepared on the basis of 36 x 2 bed affordable flats.

1.9 The design development, market feedback and assessment of rents achievable for this project, led to an increased specification including the creation of duplex flats at ground/first floor, additional private amenity space, all flats with 2 bathrooms, a lift in each core and enhanced external design to accommodate feedback through the planning process. However, irrespective of the increased costs, market advice strongly indicated that removing these key elements would have a significant reduction in the rents. These modifications uplifted the estimated rents by 26%.

2 Rationale

2.1 The business case recommended that the Council establish a company, the purpose of which would be to operate a business commercially developing and delivering homes on market rent terms. The company like any other would be subject to planning law and policies. The business case therefore included an estimate of affordable homes which would be required to be developed by RDV to comply with planning requirements The Company would manage the properties and grow a portfolio over time.

2.2 The following summarises the rationale for establishing the vehicle and other operational information:-

(1) The Council will establish RDV as a company. The RDV's business plan is to build 3000 properties and acquire 518 street properties. As RDV is subject to planning policy its business plan anticipates that these new homes will be a mixed portfolio of market rent and affordable homes. It is projected that 39% of these properties will be family units of three bedrooms.

(2) The majority of homes will be let at full market rent. These will form the core of RDV's business.

(3) RDV will act commercially as a developer and may sell units from developments as part of its business operations if it believes that is in its best interests, which is likely to arise with variations in market demand, avoid over concentration of a particular type or tenure on a specific site, achieve scheme viability and enable churn of units so that income is maximised and expenditure controlled.

(4) Value will be returned to LBN through dividends, the margin it may make on any loan to RDV and the increase in the value of its interest in RDV if the values of RDV's property assets increase.

(5) RDV's business case envisages that it will at least initially sub-contract its housing management & maintenance services as this is likely to be the most efficient option at the commencement of its business.

(6) Affordable Rent homes will be let in compliance with state aid requirements and in accordance with planning policy. It is therefore anticipated (based on current requirements) that the affordable homes will be let at up to 80% of market rent.

(7) The Council may provide state aid compliant loan finance to the company. RDV could also access private loan finance from third parties, subject to the Shareholder's Agreement.

(8) The affordable homes will be delivered as a planning obligation and it is not thought likely that RDV will obtain social housing grant, but the Council will have the option of providing state aid compliant support

(9) This will not be Council housing and the homes are not intended for households towards whom the Council owes a housing duty. RDV will adopt an affordable lettings strategy that complies with UK and state aid requirements. The Council's funding agreements with RDV will require it to comply with these legal obligations.

(10) The Council's funding will be repaid within the period, evidencing a viable project based on the assumptions utilised

2.3 In the longer term, the Council may seek a partner to invest in RDV once the company's business includes an attractive number of homes in its portfolio and that it has demonstrated itself as a sustainable business. It is more likely to be successful in attracting private sector investment then, and to secure a better return for the public sector.

3 The Business Case

3.1 The overarching business case is based on delivering a market rent product. To do this, the business case assumes that the Council or third parties provides funding in both the development and subsequent phases that is market comparable (in respect of the market rent homes) while it adopts a different funding regime for the affordable homes, which will be delivered to comply with planning policy requirements.

3.2 A base case has now been set on the basis of a 69% market, and 31% affordable split as this delivers an outcome which realistically reflects planning requirements. The exact split will depend on the financial viability of the various schemes and will be subject to agreement with the Planning Authority.

3.3 The Business Case projects a level of affordable housing on the basis that this is all at Affordable Rent – set at 80% of market rent.

3.4 The model and business plan has been developed to comply with state aid requirements, achieved by separating the Market and Affordable rent activities within the same company, with funding provided from the Council (and any other public sector lender) to the company on a commercial basis for the market rent properties and at subsidy rates (compared to market) for the affordable rent properties.

3.5 Value is returned to the Council through dividends, the margin it may make on any loan to RDV and the increase in the value of its shareholding in RDV if the value of RDV's property assets increases. Sensitivities and scenarios have been modelled evidencing the impact of various accommodation types and new build/property acquisition mixes. Profit generated from the company will be a revenue income to the Council.

4 Land Disposal by the Council to the Company

4.1 The Council will dispose of its land to the company on the basis of open market valuation and in line with Council obligations in respect of land disposals to secure best value.

4.2 The Company will only complete the transaction to purchase the land once it is satisfied that scheme is viable as evidenced by the Scheme Viability Appraisal (SVA).

4.3 The SVA calculates the residual land value based on a purchase for investment model rather than a development for sale basis.

5 Governance

5.1 The Council and RDV entered into a Shareholder's Agreement. This is, amongst other things, designed to ensure that the Company complies with good private sector governance practice.

5.2 Once the company became operational a Board oversaw the company’s formation to the early development stages.

5.3 The Articles of Association were agreed by the Council as the sole shareholder.

5.4 The Board approves the Company’s Annual Plan.

6 Risk Management

6.1 A risk register is maintained in relation to the business case and strategic financial forecast model (SFFM). The company is responsible for ensuring that a risk register is maintained for the individual and global development appraisals.

6.2 The key risks identified relate specifically to the sensitivity scenarios that may affect the SFFM and business case:

- Increased cost of funding which is not offset by an increase in income
- Longer turn-around of voids or re-let times than that assumed in the SFFM
- Land costs significantly higher than modelled
- Lack of available and/or suitable land
- Significant increase in development costs
- Reduction in market rents
- Significant reduction in property values
- LBN’s funding for affordable housing is less than modelled
- Portfolio size fails to meet required economies of scale
- Inability to compete equally in the private market: land purchase
- LBN unable to meet loan agreements

7 Finance Issues

7.1 During the life of the project, it is imperative that the Council's fiduciary duty is upheld. Whilst the project is predicated on a base case financial model using various assumptions, there needs to be recognition that the actual delivery of the project will differ from the base case because assumptions change and the returns will vary.

7.2 The Council put in place a control framework to ensure that the scheme remains viable in the long term, that loans can be repaid and that fiduciary duty is protected. This framework was developed as part of the agreements between the RDV and the Council and agreed prior to any drawdown of loan funding. Each project is assessed on an individual basis and also against the scheme as a whole to ensure that the Council's interests are protected. Any subsequent drawdown of funds will require compliance with that control framework.

7.3 The project is designed to secure long run returns for the Council in light of very significant reductions in Government grant funding but Members were asked to note the opportunity cost of investing land receipts in the RDV and be satisfied that these receipts would not be better used on alternative priorities that directly benefit the wider tax payers.

7.4 Members were asked to note the risks and mitigations outlined in the business case and the impact on the council tax payer if the RDV became insolvent or was unable to repay its loans. It was highlighted the company required a dedicated finance resource to ensure robust financial management.

7.5 The provision of a long term facility for funding was included in the Council's budget strategy and framework presented to Council on 24th February 2014. The expected capital expenditure in relation to potential expenditure in the first three years of the vehicle was included in the capital programme as required by the Council's constitution and financial regulations. Revenue expenditure through a working capital loan was also included in the budget framework.

8 Legal Issues

General

8.1 External solicitors provided advice on aspects of the Council's proposals. A QC of Counsel provided an opinion on a number of discrete matters

8.2 The Mayor in consultation with Cabinet agreed to establish a wholly owned local authority company limited by shares (RDV). Agreement was also sought to provide funding to the RDV in the form of loans and grants, and other support and to dispose of council land to it. Delegations to officers were sought to finalise the various agreements required to facilitate the above.

Finance

8.3 Section 24 LGA 88 provides the Council with the power to provide a wide range of financial assistance to RDV, including making a grant or loan to it and as RDV is a body corporate, the Council may under Section 24 (2)(d) acquire share or loan capital in it.

Land disposal and financial assistance

8.4 Section 32 of the Housing Act 1985 requires the Council to obtain the Secretary of State's consent for the disposal of land held under the Council's HRA. The Secretary of State has issued the General Housing Consents 2013 (the General Housing Consents) which set out circumstances in which he pre-approves/pre-consents to a local authority disposing of HRA land and property. Consent A 3.2 of the General Housing Consents permits the Council to dispose of vacant land. The Cabinet should note that vacant land means land where there are no dwellings and/or where any dwellings are no longer capable of human habitation and are due to be demolished.

8.5 The Council is entitled to dispose of land held by its General Fund (including buildings) to a third party provided it complies with Section 123 of the Local Government Act 1972. This requires it to obtain a consideration which is not less than the best it could reasonably obtain. If it disposes of a property at an "under-value" it does require the consent of the Secretary of State (except for limited circumstances such as short term leases).

8.6 When exercising its powers, the council must, as with any other power, have regard to its own procedural rules, the Wednesbury principles of reasonableness and its fiduciary duties. It must also ensure that its powers are used for the proper purpose.

Fiduciary Duties

8.7 The Council's fiduciary duties could be briefly summarised as it acting as a trustee of tax and public sector income on behalf of its rate and tax payers. The Council in effect holds money but does not own it; it spends money on behalf of its business rate and council tax payers.

8.8 The Mayor and Cabinet in making the decisions concerning the formation of RDV, investment and loans to that body (and similar activities) were asked to give proper consideration to the risks and rewards of approving the recommendations. In practice the Mayor and Cabinet will want to consider whether the Council will achieve an appropriate return for its risk and that the Council has minimised the risk and potential cost to it if RDV became insolvent and/or defaulted on its loan(s).

RDV as a company

8.9 The report proposed that RDV be created as a company (one limited by shares). There are other company structures but this was considered to be the most suitable vehicle for the Council under the current legislative framework. The Council is the only shareholder and the company's memorandum and articles reflect this. If Members and/or Officers are appointed to RDV's board of Directors they will in that role owe their principal duty to RDV.

State Aid

8.10 The Council is required to provide funding and ensure it and RDV operates in accordance with the state aid rules.

8.11 It is important that any loans/credit or other support provided to the RDV are state aid compliant. Loans/credit which the Council generally makes available to RDV must be made on commercial terms and at a commercial interest rate. If the Council subsequently chooses to make an equity investment into RDV it must ensure this is done on commercial terms. It will be necessary for the Council to obtain independent confirmation that such arrangements have been made on commercial terms prior to them being entered into.

Procurement

8.12 It is intended that RDV operates as a business and as such it is not intended for it to be a contracting authority nor subject to public contract procurement requirements.

8.13 Other things that needed to be considered when establishing the RDV were how Corporation and Value Added Tax affect trading and how any financial commitments to the company in terms of funding affect the Council's borrowing limits.

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