

SLOUGH BOROUGH COUNCIL

REPORT TO Cabinet **DATE:** 19 January 2015

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PART I **KEY DECISION**

SUBSIDIARY HOUSING COMPANY UPDATE

1. Purpose of Report

The purpose of this report is to update Cabinet on proposals to establish a commercial Subsidiary Housing Company (SHC) to develop high quality houses, initially for sale.

2. Recommendations

The Cabinet is requested to resolve:

- 2.1 That it be agreed in principle to implement the proposal to form a company (referred to as 'Herschel Homes' and 'HHL') as a business to be owned by the Council.

The aims of the company are:

- a) To acquire land, construct, sell and/or manage high quality housing.
- b) Efficiently manage its assets in a manner that reflects the organisational principles of its parent organisation.

The objectives of the company are to:

- a) Construct/acquire high quality properties for sale or rent in locations that provide the maximum financial return to the company,
- b) Provide excellent customer focussed services at a competitive price,
- c) Explore the potential for a programme of land acquisitions and site developments within Slough to maximise the business opportunities and profitability of the company; and
- d) Promote an organisational culture that balances business acumen and entrepreneurial flair with the requirement to operate within the policies adopted by the parent company.

- 2.2 That Herschel Homes be agreed as a company limited by shares with the Council being the sole shareholder.

- 2.3 That the commercial procurement strategy for Herschel Homes, in a structure that is not subject to public procurement requirements, be approved.
- 2.4 That a further report on Herschel Homes be made to Cabinet by April 2015 in order for the Cabinet to consider matters which it has resolved to be delegated to officers to develop and/or progress set out below..

Delegate to the Strategic Director Regeneration, Housing and Resources:

- the development of a detailed business plan for Herschel Homes to be submitted to Cabinet
 - Following consultation with the Head of Legal Services, the development of a Shareholder's Agreement for Herschel Homes which shall protect the interests of the Council as shareholder and also to enable Herschel Homes to operate commercially as a business,
 - Following consultation with the Head of Legal Services, the development of a draft Memorandum and Articles for Herschel Homes; and
 - Following consultation with the Head of Legal Services and the Assistant Director, Finance & Audit, the development of state aid compliant funding precedent agreements between the Council and Herschel Homes.
- 2.5 That the Assistant Director Finance & Audit, following consultation with the Strategic Director Regeneration, Housing and Resources, shall make proposals in the Council's next draft budget/capital programme a range of allocations of expenditure which takes into account: Herschel Homes' draft business plan (and its assumptions concerning Council funding to it) and also provides the Council with appropriate options to adopt those assumptions or agree a different allocation.
- 2.6 That the Head of Legal Services, following consultation with the Strategic Director Regeneration, Housing and Resources, be delegated to develop a protocol which shall set out how to manage and avoid potential conflicts of interests and commercial tensions due to:
- The Council's interests in Herschel Homes and similar organisations in which it has an interest;
 - Members and/or Officers sitting on the Board of Herschel and also as Council nominated Directors/representatives on other entities in which the Council has an ownership interest.
- 2.7 That the Head of Legal, following consultation with the Assistant Director Finance & Audit, be delegated the development of a protocol to set out good governance within the Council to avoid potential conflicts of interest between the functions of: making Council funding decisions to Herschel Homes; holding Herschel Homes financial performance to account;

exercising the Council's rights as shareholder; and Members and/or Officers being a Council nominated Director of that company.

- 2.8 That the sites specified in section 6.5 be held with the intention of a future disposal to Herschel Homes and that the Head of Asset Management should identify additional Council owned sites that could be incorporated into the update report by April 2015.

3. Corporate Plan

- 3.1 The Corporate Plan for the period 2014/15 highlights the necessity for the Council to develop new ways of working. The plan reaffirms the requirement to identify ways of gaining more value from the Council's assets to maximise income and offset reduced support from central government. The introduction of a SHC would provide a wholly owned vehicle that that will demonstrate positive financial outcomes and reflects the overall strategic vision for the Council now and in the future. This company could redevelop Council-owned sites in the traditional town centre and act as a catalyst for the longer-term centre of town strategy.

4. Joint Strategic Needs Assessment

- 4.1 The introduction of new high quality housing as described in this report will maximise the value of the Council's asset base and will provide an income stream that could contribute to the provision of front line services.

5. Other Implications

(a) Financial

This report comes with no immediate financial implications, however moving forward, these would be significant. In the event that this and subsequent reports are approved, the introduction of a SHC would have major capital, revenue and treasury management implications. Subject to the approval of the recommendations in this report, these issues will be the subject of a detailed business plan. Comprehensive financial comments can be found in section 6.3 and Appendix 1 and 2 of this report.

In addition to financial advantages considered in Appendices 1 and 2 bringing forward the sites for residential will also create additional council tax income in the region of £60k pa, which would be doubled for the first six years to £120k pa under the current central government New Homes Bonus scheme introduced in 2010.

(b) Risk Management

Risk	Mitigating action	Opportunities
Legal – Council is sued by creditors of the subsidiary	Establish clear firewalls between the Council and its subsidiary company	
Market Conditions – House prices could fall, resulting in anticipated sales values being unachievable.	The residential market will be monitored closely and if realisable values drop significantly viability will be reviewed.	The Council will benefit in any growth in value achieved during the construction period.
Finance – Exposure to increased risk due to activities of subsidiary and potential loss of temporary finance made available to the SHC.	The Councils liability for any debts of its subsidiary will be restricted in accordance with corporate law, other than in respect of any guarantees.	SBC will reduce its operating costs/overheads by providing services to the subsidiary company. Additionally SBC could generate additional income through providing loan finance and profits.
Finance - Lack of financial control	Ensure that any financial support (e.g. in the form of lending, guarantees, collateral securities, or indemnities), is formally documented; and recorded (as may be required) in SBC's Financial Plans, budgets and accounts.	Additional financial return to SBC from developing and selling properties at the agreed sites.
Governance – Poor performance	Ensure that the subsidiary has a board of directors that is competent to direct the subsidiary's business autonomously.	Board members of the subsidiary will be appointed by SBC and will consist of individuals with an expertise or interest in the business of the subsidiary.
Governance – Potential conflicts of interest with SRP and DISH	Take legal advice to ensure separation and documentation of roles.	
Performance – failure to develop land transferred to subsidiary	Impose a covenant on and/or a charge over any transfer of land to the company to ensure that the land would be transferred back to the Council at nil value.	Potential short-term appointment of external person with appropriate commercial skills and contacts to drive through the property developments on time and within budget.
Employment Issues	No risks identified	Potential to reduce existing staffing costs by SBC entering into a SLA with the SHC to provide management support services. The vehicle will aim to use local SME's as consultants/ contractors boosting local economic development.
Equalities Issues	No risks identified	
Human Rights	No risks identified	

(c) Human Rights Act and Other Legal Implications

None

(d) Equalities Impact Assessment (EIA)

There are no equalities issues associated with this report.

(e) Legal

General

Cabinet is requested to make an in principle decision to proceed with the formation of Herschel Homes. It will (if it approves this resolution) also request an update report by April 2015 with more detailed information. This will enable it to consider whether it is appropriate to resolve to make a final decision on the formation and operation of Herschel Homes. In the interim, Officers have investigated and are satisfied that the Council has the powers to implement the proposals concerning Herschel Homes. Legal comments will be tailored to (and set out in) the detailed proposals in the update report

At this point the Cabinet is not making an irrevocable resolution to form Herschel Homes. The legal implications which arise at this stage are therefore limited to those arising from the delegation to develop a detailed business plan for the Cabinet's further consideration and factors influencing the adoption of a company limited by shares for Herschel Homes.

Section 2 of the Localism Act 2011 limits the exercise of the new general power where it 'overlaps' with a power which predates it, such as Section 95 of the Local Government Act 2003. Whether the Council relies on the General Power and/or Section 95 it is prudent for it to comply with the requirements and limitations to which section 95 is subject. These are set out in Regulation 2 of The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 (the Order) which requires a business case to be prepared and approved by the Council before a company starts trading. Regulation 2(4) of the Order defines "business case" as a comprehensive statement of the objectives of the business; the investment and other resources required to achieve those objectives; any risks the business might face and the expected financial result of the business.

Relevant Finance Law

In accordance with the Council's constitution, any capital funding requirements for the HHL project will need to be allowed for in the council's budget strategy which needs to be approved by full Council.

HHL as a company

The report proposes that HHL be created as a company (limited by shares). There are other company structures but this is considered to be the most suitable vehicle for the Council under the current legislative framework. The Memorandum and Articles of Association need to be drafted. The Council is the

only shareholder and the company's memorandum and articles will need to reflect this. As the Company is operating as a business (and may be structured not to be subject to EU procurement requirements) Cabinet should consider requesting that the Strategic Director of Regeneration, Housing and Resource finalise a Shareholder Agreement between the Council and HHL. The purpose will be to protect the Council's interests, frame company governance and ensure compliance with the proposed procurement strategy for HLL (see 6.12 below).

Conflicts of interest

The Council has taken legal advice on potential conflicts of interest that may arise as a consequence of SBC introducing a SHC. A copy of the briefing note is attached (Appendix Three)

(f) Land and Property Implications

The property implications for this report are covered in Section 6 below.

6. Supporting Information

Background

- 6.1 In the previous report on the Subsidiary Housing Company, presented by the Assistant Director Housing & Environment on 14 July 2014, it was reported that the role of the company would be to develop, acquire, manage and/or sell properties. Subject to approval, it was noted that the company would be loaned the initial capital from the Council at market rates and with that money the company would buy the Council's land holdings and build residential housing developments in terms of the approved business plan.

The current recommended proposal is for a purely residential development company that aims to maximise short term development receipts assisting the Council's short term financial position and utilising it's skills and capital to realised the development profit in the land holdings.

The table below shows what the HRA is for, what the SRP is for, what the SHC is for and what the private market is for and where the SHC sits in the asset management framework.

	Large Mixed Tenure Sites	Small Private Sites	HRA Sites	Non Residential Sites
Housing Revenue Account	X	X	√	X
Slough Regeneration Partnership	√	X	X	X

Subsidiary Housing Company	X	√	X	X
Market Disposal	X	X	X	√

6.2 The operation of a business to develop homes for either private sale or market rental with the intention of making profits is a commercial purpose. Section 4 of the Localism Act 2011 requires that where a local authority exercises/uses the general power for a commercial purpose it must do this through a company.

6.3 Options Appraisal

6.3.1 Delivery

The Council is already a partner in a joint venture regeneration partnership, the Slough Regeneration Partnership (SRP), created in March 2013. The SRP housing supply chain has until very recently (December 2014) indicated that it would not wish to develop smaller housing sites (with a capacity for under 20 units) that are typical of the sites the Council has and are included in this report. Whilst correspondence has been received from SRP to confirm a broad willingness to review its position with smaller sites, this change in approach has not been substantiated. Discussions continue with our JV partner on this matter.

Including SRP, the Council has a variety of options available to it in respect of the disposal of surplus assets: These can be summarised as follows:

- Immediate disposal,
- Disposal subject to planning,
- Obtain planning and then dispose,
- Develop via a new Joint Venture Company,
- Develop via Slough Regeneration Partnership; and
- Develop via a Subsidiary Housing Company.

The advantages and disadvantage of each approach are highlighted in Appendix One. Having considered the available options, the preferred approach is to develop the sites via a Subsidiary Housing Company. This is on the basis that the SHC route maximises the value of the asset (the combination of land value and profit) to the Council.

6.3.2 Build to sell or build to rent?

Previous reports to Cabinet have commented on the potential for the company to either build to sell or build to rent. Having undertaken detailed financial analysis, it is clear that the build to rent option provides a greater

financial return over the long-term (a return on investment of 57% compared to 47%) and has the advantage of capturing the long-term residential value increases. However, the build to sell option would generate circa £1.68m in profit (in addition to capital receipts) and have a 2 year pay back period. In contrast, the build to rent option would take 14 years to break-even and a further 14 years (until 2043) to generate the equivalent present value of the £1.68m in profit realised almost immediately by the build to sell option.

	Disposal subject to planning			
	SHC - sale	SRP	SHC - rent	
	£	£	£	£
SBC income from sale of land to SHC	(£2,399,848)	(£2,399,848)	(£2,399,848)	(£2,399,848)
Income from sale of developments	n/a	(£10,426,720)	n/a	n/a
SBC share of SRP profit	n/a	n/a	(£1,031,153)	£0
Total purchase and development costs	n/a	£8,740,763	n/a	£8,740,763
Rental income (30 years) NPV at 3.5%	n/a	n/a	n/a	(£14,875,776)
Running costs (30 years) NPV at 3.5%	n/a	n/a	n/a	£3,577,921
NET RETAINED BY SBC	(£2,399,848)	(£4,085,805)	(£3,431,001)	(£4,956,940)

Payback period	1 year	2 years	2 years	14 years
Return on investment	n/a	47%	43%	57%
Return on investment per annum	n/a	23%	21%	4%

The return on investment per annum for the develop to sell option is 23% per annum compared to 4% pa for the build to rent option.

Taking the above into account, the develop for market sale option via a SHC is recommended as the most commercially beneficial approach. However, as the company evolves and subject to a robust business case, it may also develop/acquire properties for market rent.

6.4 Sections 6.5-6.12 will develop the SHC proposal and will provide clarity over the proposed:

- Development sites (and the approach for each site),
- Financial forecast for the early years of the company,
- Aims & Objectives of the Company
- Staffing arrangements
- Governance arrangements,
- Roles & responsibilities,
- Company model; and
- Procurement process.

6.5 Proposed Development Sites

6.5.1 For the purpose of this report, four sites previously identified as surplus have been appraised, as follows:

Site	Units	Description
Upton Road (former Gurney House)	10 four bedroom semi detached houses	This site will be marketed as Lascelles Place and is the location of a former care home that is now demolished. The development proposal is for a private gated scheme of high specification executive houses with south facing landscaped gardens backing onto Lascelles Park.
Alpha Street	14 one and two bedroom flats	This site is currently a town centre car park. The development proposals are for a high quality private flatted scheme
150-160 Bath Road	14 one and two bedroom flats or 4/5 town houses	This is a small cleared site on the Bath Road on the entrance into Slough with potential for a small private scheme of 14 flats.
83 Elliman Avenue	1 Detached House	This is a cleared site with planning permission for a private 4/5 bedroom detached house.

6.5.2 For the purposes of initial financial modelling, it has been assumed that the 4 sites will be practically complete within 3 years, with developments running concurrently.

6.6 Financial Forecast

6.6.1 As mentioned above, in order to determine the most advantageous approach, Asset Management and Finance have considered the impact of both developing and retaining the units for private rent and building and selling for short term profit. Detailed financial information is contained in Appendix 2.

6.7 Aims & Objectives

Companies no longer have to set out their detailed commercial objectives in their constitutional documents (Memorandum and Articles). The modern form of objectives can be summarised as a general power to do anything lawful to further their commercial objectives:

6.7.1 Aims

In broad terms it could be assumed that the Council is considering the introduction of a subsidiary company that aims to:

- a) Acquire land, construct, sell and/or manage high quality housing.
- b) Efficiently manage its assets in a manner that reflects the organisational principle of its parent organisation.

6.7.2 Objectives

The objectives of the company are to:

- a) Construct/acquire high quality properties for sale or rent in locations that provide the maximum financial return to the company,
- b) Provide excellent customer focussed services at a competitive price,
- c) Explore the potential for a programme of land acquisitions and site developments within Slough to maximise the business opportunities and profitability of the company; and
- d) Promote an organisational culture that balances business acumen and entrepreneurial flair with the requirement to operate within the policies adopted by the parent company.

6.8 Staffing Arrangements

The cash flows undertaken to date have assumed operating costs (including staff costs) of £350,000 per annum (for a breakdown see 7.3 of Appendix 1). Whilst external expertise will be required, the outline business plan makes the assumption that the Council will provide strategic, financial, technical and administrative support to the SHC, which will be set out in a Service Level Agreement (SLA). This would allow the new company to develop separate business plans, marketing plans, project development plans and board reports etc.

The underlying intent of a SLA is partly to provide reassurance that there is transparency in relation to the use of the Council's core staff and facilities for purposes which relate to the activities of the subsidiary, rather than the core Council activities and, similarly, that there is an appropriate mechanism for recovery by the Council of the associated costs.

The company will also have flexibility to appoint external expertise and consultants as required to assist with development management, sales and marketing, corporation tax and VAT. State Aid compliance means that HHL must pay a market fee for these services.

If staffing is wholly supplied by SBC via the SLA the sum of £350,000 per annum is over and above the amount that would otherwise be paid to SBC in relation to land receipt and profit. Costs have been assumed in relation to business and financial planning, corporate marketing, Asset Management, Project Management and Legal Services. This budget will

be used to backfill as required to ensure that business as usual is not affected by this additional work stream.

6.9 Proposed Governance Arrangements

- 6.9.1 As the sole shareholder the Council will appoint all of the company directors and the Shareholders Agreement (see below) will also provide the Council with the right to remove any Director. The Council should appoint directors in accordance with its constitution. The Council may elect to appoint some of the directors based on their commercial and sector experience, rather than their existing relationship with the Council. Some authorities have moved to selecting most directors on this basis in order to support the development of local authority owned businesses. Though such directors are 'independent' of a prior connection with the relevant council they are only appointed because that local authority has decided their skill and/or experience is an asset to the business. There is no requirement for the Council to include its method of selecting HHL's directors' within either the Shareholder's Agreement or the Company's Memorandum/Articles. This approach would provide flexibility for the Council to change its criteria for appointing HHL's directors as that company evolves.
- 6.9.2 Whoever is appointed as an HHL director will in that position have a primary duty to promote and advance HHL's business rather than the interests of other organisations (including the Council as HHL's shareholder).
- 6.9.3 In the event that Cabinet approves the introduction of a Group Structure, the governance and service delivery arrangements would be set out in a Shareholders Agreement (SA) and Service Level Agreement. The SA and SLA would establish the detailed arrangements within the group structure to demonstrate high levels of governance and operational effectiveness. The agreements will be required to demonstrate that:
- a) The group structure is established in a way that does not cause the Council as shareholder to breach its statutory obligations,
 - b) The Council holds HHL accountable for its financial and business performance and that it adopts good corporate governance standards,
 - c) That the Council's and its investment is not damaged by HHL delivering poor standards to the market and consumers,
 - d) That the Company has a board which: has a skillset to develop this type of business; is accountable to the Council as shareholder; and that it has at least one Member representative. All Directors will be appointed (and may be removed by the Council),
 - e) There are appropriate opportunities for Councillors to be involved in decision making at a strategic group level and ensure that appointments made to its subsidiary board is as transparent as possible,

- f) Costs are allocated correctly to the subsidiary in order to get an accurate assessment of the total costs incurred,
- g) Financial reporting to the Council, assessing results against target budgets and reviewing performance against key financial targets,
- h) A clear distinction is made between the organisations within the group to ensure that Councillors, staff and third parties are clear about which part of the group they are dealing with at any given time; and
- i) A clear governance distinction is made within the Council (by written protocol) which sets out and is clear about the Council's functions as Herschel Home's funder, its shareholder, holding its financial performance to account and a separation of decision making between individual Member's and Officers exercising those functions (including any role they may have as a Director of either Herschel Homes, Slough Regeneration Partnership or DISH).

6.10 Summary of Roles & Responsibilities

6.10.1 The Role & Responsibilities of each party will be set out in the SA and SLA. These will include but are not restricted to:

SBC	Subsidiary
<ul style="list-style-type: none"> • Approval of the overall strategy of the Group. • Approval of Corporate Plan. • Following sign-off by the Chairperson of the subsidiary, approval of the subsidiary's accounts. • Consideration and approval of subsidiary organisations' Business Plans and annual budgets. • Monitoring the performance of the subsidiary against financial and performance targets. • Consideration and approval of all constitutional changes. • The establishment of governance policies for the subsidiary, including standing orders and codes of conduct for board members. 	<ul style="list-style-type: none"> • Works within limits approved by SBC- but with operational independence from SBC. • Purchases staffing and other services from SBC. • Be tasked by SBC to develop housing and provide related services. • Provide high quality, effective and customer- focused developments that Comply with all the agreements in place between the subsidiary and the Council.

6.11 Proposed Company Model - Limited by Shares

6.11.1 Subsidiaries are separate, distinct legal entities for the purposes of taxation regulation and liability. The most common way that control of a subsidiary is achieved, is through the ownership of share in the subsidiary by the parent (SBC). These shares, along with governance measures described in section 6.8 and 6.9 give the parent the necessary means to exercise control.

- 6.11.2 The advantage of a Company Limited by Shares (CLS) is that it does not limit future options available to the Council. If the Council in future sought a private investor or wished to dispose of HHL then a CLS would be familiar to potential investors whereas a Company Limited by Guarantee may not be (as they are often associated with not for profit activity. HHL's commercial nature means a charitable or community structure would not be appropriate.
- 6.11.3 Whilst the Council could seek to enter into a partnership with an equity investor via some form of joint venture, the most effective way to control the company is to incorporate a wholly owned subsidiary. With such a model, the Council would have the maximum possible degree of control over the future activities of the subsidiary company and the Council (as sole shareholder) would have the ultimate sanction of either removing the Board Members and appointing replacements or, ultimately resolving to wind up the company. However, such a model means that the risks will not be shared and, however unlikely, creditors of an insolvent subsidiary may be able to obtain a judgment against the parent if they can prove that the parent and subsidiary are mere alter egos of one another.

6.12 The proposed procurement method

In developing the proposals for HHL a number of scenarios have been considered. When a report was last made to Cabinet in July 2014, the proposal was that HHL may have as an corporate objective the development of affordable homes. This would qualify as an objective in the general interest [of the community] and not one which an ordinary business would adopt. Based on that proposal HHL would have been a 'body governed by public law' under the control of the Council. As such it would have been subject to public procurement law and regulations. It is now proposed that HHL operates as a business developing market homes (and it will only provide affordable homes if this is required under planning law/policy). HHL will have a commercial nature and it will not be pursuing objectives in the general interest. As such it does not qualify as a body governed by public law and it will not be subject to public contract procurement requirements. This has a number of implications. Including that HHL should not promote public sector policies (including the Councils, adopt community or charitable objectives). For further information members are referred to Appendix 4.

7. Conclusion

- 7.1 This report updates Cabinet on the latest background work carried out on the feasibility of introducing a subsidiary company. It builds upon previous reports and provides confirmation that the company, if introduced, should focus on development and open market sale in its early years.

- 7.2 Whilst a detailed business case is still required, this report reiterates that the Council would maximise the value of its assets by benefitting from 100% of the net profit arising from each site.
- 7.3 The introduction of HHL would fit with the Council's ambition of making Slough a place where people want to live, work and do business, will help to deliver the Corporate theme of Using Resources Wisely and is an example of how the Council could maximise the value and use of its asset base, all of which are critical for success factors in the emerging 5 year plan.

8. Appendices (all contain exempt information)

- Appendix 1 - Options Appraisal
- Appendix 2 - SHC Options Appraisal – Financial modelling
- Appendix 3 - Paper on Council Governance for proposed SHC
- Appendix 4 - Paper on Procurement Process

9. Background Papers

None