

Appendix A - Financial Business Case Ravelin Property Limited

1. Background

- 1.1 The City Council are looking to set up an arms-length development company that will deliver housing within the City and surrounding areas.
- 1.2. Ravelin Group will deliver sustainable growth in a commercial manner through the development of Council owned (and other) lands. Through its development, it will prioritise the creation of balanced communities, delivering a range of homes people can afford (in line with City's housing need) and other products to enable economic growth in and around the City of Portsmouth.
- 1.3. All profits generated will be paid back to the Council in the form of Dividends.
 - 1.3.1. The revenue income source will be used to fund, sustain and improve council run services.
 - 1.3.2. Capital profits from development schemes could be paid as dividends to the Council to be invested into future projects, including building further homes that local people can afford by Ravelin.
- 1.4. The Business case objectives will include but not be limited to the following:
 - 1.4.1. Ravelin Group recognises that the need for affordable sub-market rents will largely be met within the HRA and thus Ravelin Group will work with the HRA to support and deliver these new homes on behalf of the HRA, where appropriate.
 - 1.4.2. The Council will expect Ravelin Group to develop new homes that people can afford to support low income working families, like homes for key workers to rent and shared ownership products to buy in and around Portsmouth, in line with the city's housing need.
 - 1.4.3. Ravelin Group will support the Economic Growth and Inward investment ambitions of the city with its development pipeline. By creating new jobs in property development and offering apprenticeships and training opportunities all with the aim of deriving long term benefits for the City.
 - 1.4.4. Work with Portsmouth City Council employees through Service Level Agreement (SLA) wherever possible.

1.4.5. Work with the Councils procurement, property and economic growth teams to support the delivery of a range of social value outcomes, as defined by the Council's policies.

1.5. The Council, through its Strategic Development Team (but not limited to) will identify land within the Council ownership and consider options for development that will be tested through the Councils current cross directorate clearance process Development Programme Enabling Board (DPEB) to identify if any alternative land uses should be considered .

1.6. The Strategic Development team will work with relevant Council departments and members to design developments that meet the Council core principles and accommodation strategies.

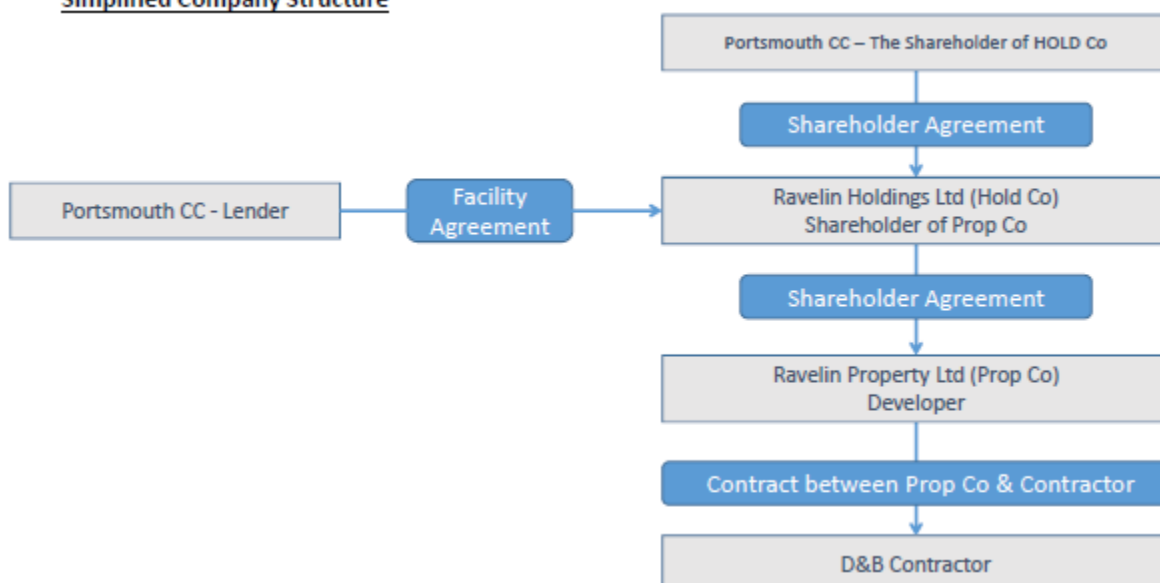
1.7. Once agreed by DPEB and with Cabinet member support the Council will commission Ravelin to deliver these developments in a staged manner as noted in appendix D.

2. Structure and Roles

2.1 The Diagram below sets out the proposed company structure for the Development Company.

Figure 1 - Outline Structure

Simplified Company Structure



- 2.2 The Council has two main role's within the delivery structure both allow it control the vehicle:
- 2.2.1 the first is as the 100% shareholder, this relationship will be governed by a shareholders agreement that allows the Council to set out any reserved matters that will allow the Council to exercise a certain amount of Control of the company, this could be linked to future lending and the type and nature of future developments, and the distribution or reinvestment of profits.
 - 2.2.2 The other role the Council will have is as the primary lender to Ravelin via a facility agreement. Within this agreement the Council can attach conditions to any lending that it may give to Ravelin. This could be in its simplest form that no lending will be granted until a business justification case is presented to the Council. This will ensure that the Council's risk is kept to a minimum.
- 2.3 Ravelin Holdings Ltd will be the Company that has legal title of the land and properties built by its subordinate Company Ravelin Property Ltd. It will be responsible for all land assembly and sales, where required.
- 2.4 Ravelin Property Ltd will be the company that contracts with companies to carry out works, to deliver new homes and will be responsible for the delivery of developments. Ravelin Property Ltd will invoice its Parent company whilst delivering the developments.
- 2.5 Subject to independent legal advice, Hold Co may see fit to setup a further subsidiary Prop Co or DevMan Co specifically to provide to Development Management service to the HRA on sites like Southsea Community Centre where no land transfer is required.

3. Taxation

- 3.1 As Ravelin will be trading as a Commercial entity it will need to bear in mind the taxation regime within the UK, something that the City Council has previously not had to consider. The main issues are of Corporation Tax and Value Added Tax (VAT).

Corporation Tax

- 3.2 Any profits made by the Company will be subject to Corporation tax at 19% (Reducing to 17% from April 2020). The Council will need to ensure that it plans its operations so that it is most tax effective. The Council may need to seek specialist advice before it starts trading as this experience is not held currently within the Council.

VAT

- 3.3 The Council will seek specialist taxation advice as part of the due diligence process prior to trading.
- 3.4 In order for the Ravelin to be able to recover VAT that it incurs on its expenditure it will need to ensure that it registers for VAT. The sale of new homes is zero rated which means that it should be able to recover 100% of its VAT on purchases.

Income Tax

- 3.5 Ravelin will operate in a way that any employees that it has are employed on a Service Level agreement between the Council and the Company and therefore will be employed by the City Council, no Income tax will be paid by the Company itself. However the supply of staff by the Council will be a vatable supply of staff and therefore VAT will be payable on this supply.

4. Working Capital

- 4.1 The Council will need to ensure that the Company has enough Working Capital to operate. This could mean that a mixture of equity and debt funding is required in the early part of the company's history is required. The Company will not start to see any income until it starts to sell properties. This could mean that the Council will need to lend for a year or more before Ravelin is able to repay its loans. As soon as the company starts to borrow from the Council it will need to be able to pay the interest Payments on this, this could mean that initially the Council needs to invest equity finance in the company to ensure that it can meet it borrowing requirement and other out goings initially.
- 4.2 A Cash flow forecast will need to constructed to ensure that this initial equity investment is enough for the company to be able to meet its working capital obligations, whilst also ensuring that the Council are not tying up money that could be used elsewhere earning a higher return.

5. Operating Costs

- 5.1 The Ravelin Board will primarily be made up of a mixture of Council employees and other external property specialists. To this aim the company will not require its own premises but the cost of premises will be charged to it via an agreed hourly rate for Council employees through a Service level agreement with the Company.

5.2 The Company is likely to require support primarily from Finance, Legal and Procurement and a large amount of support from the Strategic Projects team will be required. It will also require support from Architects and planning consultants.

5.3 These costs will be dependent on the level of activity carried out by it.

6. Board Composition

6.1 Refer to the main paper and cost

6.2 The Council will need to recruit 2 to 3 non-executive directors who have experience of delivering housing so as to ensure that the board has a sufficient level of skill in order to be able to deliver viable schemes, this could cost up to £30,000 per annum.

7. PCC Support

7.1 Legal

7.1.1 The initial support from legal will be in incorporating the company and setting up the various legal instruments as set out but not limited to figure 1 above in the company structure.

7.1.2 Much of this advice will need to be commissioned from specialist companies in the first year and could cost as much as £150,000.

7.1.3 Ongoing support will be required to support the contract between Ravelin Property Ltd and the construction companies, the land assembly for various developments and for the sales of the units built amongst other things. This support could cost £100,000 ongoing.

7.2 Finance

7.2.1 Finance support will be required in the form of preparing the initial business case for developments and the initial business case for incorporation.

7.2.2 Ongoing the Council will provide transactional accounting services for Ravelin as well as Payroll. The Council will also prepare the companies statutory return and accounts. The Council will also file all Corporation Tax and VAT returns.

7.2.3 There may also be other advice from a cash flow and taxation point of view, this could cost as much as £75,000 per annum.

7.3 Procurement

7.3.1 It is envisaged that after incorporation the Council will offer Procurement and Commercial advice and support to the company when engaging with construction companies as well as other strategic advice. This is envisaged to cost around £50,000 per annum but is dependent on the number and size of developments.

7.4 Strategic Developments Team

7.4.1 The Strategic Developments team will work with Ravelin to identify potential development sites and will assist with the design of schemes on behalf of Ravelin, as well as facilitating the relationship between Ravelin and the support services, this could cost around £250,000 per annum however this rather depends on the number of schemes that come forward.

8. Relationship with the Housing Revenue Account

8.1 The budget delivered by the Government in the autumn of 2018 came with an announcement that the borrowing cap that was previously in place for the HRA had been abolished. That meant that Councils are now able to borrow in line with the prudential code, which ensures that any borrowing should be affordable, sustainable and prudent.

8.2 This means that if that the Council must ensure that any borrowing it takes on will generate a revenue stream that will meet the ongoing cost of servicing its debt and maintaining the asset, that the scheme is viable. A viability assessment this is backed up by a set of assumptions which are not always predictable i.e. the Governments policy to freeze rents¹ in social housing.

¹ The HRA is now in the final year of the Welfare reform act that mandated that the Council had to reduce all housing rents by 1% a year for four years. The latest guidance is that once this ends the HRA will be able to set rents at CPI +1% for the following five years. What happens to rental growth after that time period is uncertain.

- 8.3 The Council also needs to consider the effect the reinvigoration of the right to buy scheme and how the receipts could be used by Ravelin.
- 8.4 It also is worth bearing in mind that Ravelin would not have the benefit of using 1-for-1 receipts if it were to build Social Housing and therefore this is another reason why the Council may wish to consider a commercial arrangement with the HRA to enable the delivery of both social rented and private for sale housing on HRA land.
- 8.5 It is noted that the HRA can deliver private housing so long as any proceeds are then reinvested into the HRA. The HRA however are unable to provide products such as part rent part buy which would fall into the suite of affordable products based on the Governments definition.²
- 8.6 Any transfer of HRA land will be based on a current use and follow the principles of a Red Book valuation.

9. The Developments

- 9.1 Initially Ravelin will be working on the first five development sites in their role as a developer, partner and/or development manager with the HRA.
- 9.2 For the purposes of this first financial business case to establish the budgets for Ravelin, the size of development and mix of tenure to be developed is as set out in the previous Cabinet report for the Five Sites. This report was heard in October 2018 and contained indicative unit numbers which will change once the team has completed the detailed design and the schemes have been considered and agreed by the planning committee.
- 9.3 Based on these development sizes and the proposed tenure mix the overall return on investment is around 15% (or £4.8m), excluding operating costs and Corporation Tax. This return does not include the cost of operating costs and Corporation Tax once these are taken into account the return is around 5% (or £1.7m) as a proportion of Gross Sales (see table 1 below).

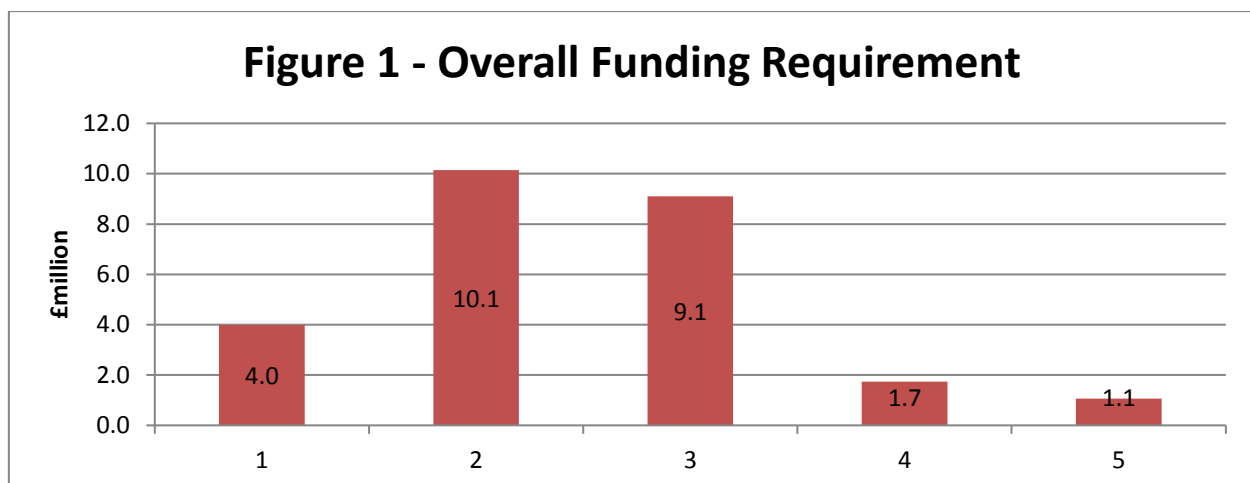
² See legal advice

Table 1 - Return on Development Investment

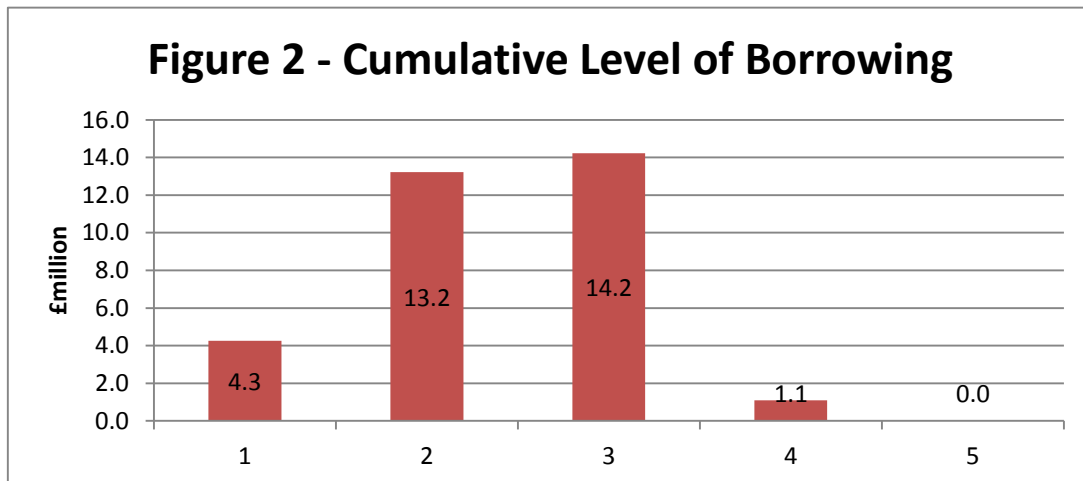
Activity	Planned Expenditure	% Return
Land Costs	£1,837,000	
Construction Costs	£22,319,000	
Interest on Borrowing	£3,664,000	
Property Sales	(£32,674,000)	
Development Profit	(£4,854,000)	15%
Operating Costs	£2,500,000	
Corporation Tax	£660,000	
Total Return	(£1,694,000)	5%

9.4 As stated in paragraph 1.3 all profits generated are paid back to the Council as dividends to support Council run services or reinvested into future capital projects.

9.5 For the purpose of budget modelling the business case assumes that all of the developments in this appraisal will be built within the first three years with completed units being sold within a year of completion of construction. This means that the Ravelin will have a £4m cash funding requirement in year 1, £10.1m in year two and £9.1m in year 3. This includes the cost of construction, operating costs and borrowing.

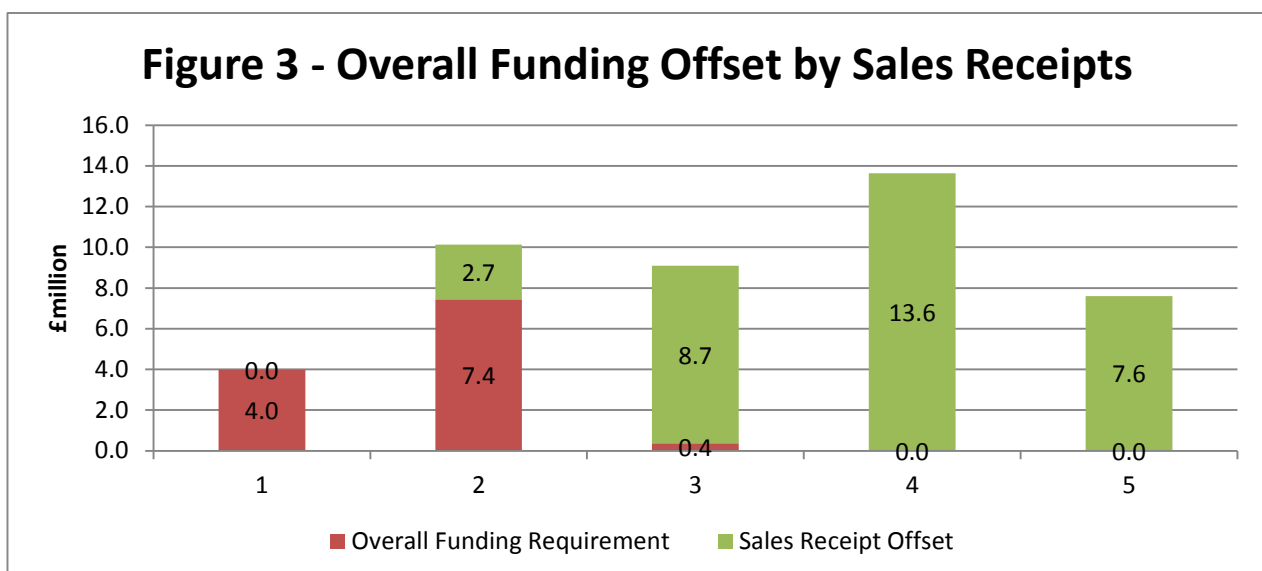


9.6 Ravelin would hope to start selling private properties off plan but for the purpose of this financial business it has been assumed that receipts will not be received until after completion. This suggests that average borrowing requirement will be £4.3m in year 1, £13.2m in year 2 and £14.2m in year 3. In reality the company would seek to reduce its reliance on borrowing by maximising its working capital management.



9.7 The maximum amount the Council would need to lend Ravelin in a year would be somewhere around £14m, this lending would be secured against the Land and Work in progress and would be dependent on the size and phasing of developments.

9.8 Figure 3 below shows the net cash flows for years 1 - 5 and shows that year's one and two are where the Companies net outflows are greater than their income.



10. Profit and Loss Account

10.1 Based on the 5 development sites a forecast profit and loss account has been constructed for the first 5 years of operation. This shows that Ravelin could make a profit of £3.5m after taking account of all borrowing costs, operating costs and

taxation. Loss relief from Corporation Tax has not been taken into account at this time and is subject to independent tax advice.

Table 2 - Forecast Profit and Loss Account

<u>Ravelin Forecast Profit & Loss Account Years 1-5</u>	Year					
	1	2	3	4	5	Total
Sales of Property	£0	(£2,695,000)	(£8,729,400)	(£13,642,000)	(£7,607,600)	(£32,674,000)
Income from Building Operations	£0	£0	£0	£0	£0	£0
Cost of Sales						
Construction Costs	£1,923,075	£11,159,715	£9,236,640	£0	£0	£22,319,431
Operating Costs	£500,000	£500,000	£500,000	£500,000	£500,000	£2,500,000
Impairment	£0	£0	£0	£0	£0	£0
Interest Borrowing	£216,854	£810,333	£1,305,928	£1,331,378	£0	£3,664,494
Total Costs	£2,639,929	£12,470,049	£11,042,569	£1,831,378	£500,000	£28,483,925
Gross Margin (positive)/negative	£1,923,075	£8,464,715	£507,240	(£13,642,000)	(£7,607,600)	(£10,354,569)
Net Margin Before Tax (positive)/negative	£2,639,929	£9,775,049	£2,313,169	(£11,810,622)	(£7,107,600)	(£4,190,075)
Cumulative Deficit / (Surplus)	£2,639,929	£12,414,978	£14,728,146	£2,917,525	(£4,190,075)	
Taxation (19% - reducing to 17% 2020)	£0	£0	£0	£0	£659,514	£659,514
Net Margin After Tax (positive)/negative	£2,639,929	£9,775,049	£2,313,169	(£11,810,622)	(£6,448,086)	(£3,530,561)

10.2 The exact amount of operating costs is also not yet known and more work would need to be done to ensure that this is properly quantified. The majority of this cost is actually in the form of recharges back to the local authority as detailed earlier in the report.

11. Financial Impact to the Council

Land Holdings

11.1 The Council is a significant land owner and has, in the past, moth balled sites that were not financially viable because they were looked at as community or social housing projects. The use of the Ravelin will give the Council the ability to offer homes for sale.

11.2 The Council has land holdings in both the GF and the HRA, with a mix of both considered in this report. For the purpose of this business case and in line with current Council financial guidance, it has been assumed that the capital receipts from any land transfers will be held centrally by the Council. The use of these receipts will be decided by the S151 officer.

- 11.3 Any land disposed of to Ravelin must be transferred at the current market value. Valuations are carried out based on current use and in line with the principles of a Red Book Valuation and not at a discount that would give it an advantage over the market.
- 11.4 In the cases where a development is via a joint venture (or similar commercial structure) between the HRA and Ravelin. Ravelin will pay a residual land value which will be a proportion of the land based on the mix of tenure within that development. As a rough example, in the case where a development has 30% affordable Housing, Ravelin will pay a land value for the 70% that contains the Market sale units. If applicable the HRA would pay a value in line with the 30% but only in the instances where it is not already the land owner.
- 11.5 The developments considered in this business case would provide the Council with a capital receipt of nearly £2m, however a formal valuation of the land involved needs to be undertaken prior to any sale to Ravelin.

Income from Lending

- 11.6 The facility agreement that governs how the Council lends money to Ravelin and on what terms is a key document that supports the financial case for setting Ravelin up.
- 11.7 Under the proposed model, in this business case, the Council will lend Ravelin money at a Commercial rate of 5.09% at the time of writing this report, whilst the cost of City Council borrowing will be around 2.57%, this means that the Council will benefit from an income stream from the Company.
- 11.8 Based on the developments in this report the Council would generate £1.3m in net interest earned on lending to Ravelin over the next two years. The income has the effect of reducing the amount of corporation tax that the Ravelin needs to pay as well as giving the Council a return on its investment prior to any sales.

Table 3 - Income from Lending

	Borrowing Cost	Income from Ravelin	Net Income from Lending Activities
Arundel Street	£176,628	(£349,820)	(£173,192)
Hambrook Street	£118,661	(£235,013)	(£116,352)
Doyle Avenue	£165,539	(£327,858)	(£162,319)
Museum Road	£865,138	(£1,713,444)	(£848,306)
Total	£1,325,966	(£2,276,316)	(£1,300,169)

11.9 Initially the Company will need to be able to service this debt through some form of working capital loan or equity investment. The exact amount is not yet known and this rather depends on the speed at which the operations of the company start. This will need to be modelled in detail so as to optimise the amount of equity funding required to meet these obligations.

12. How will Projects be brought forward?

12.1 On a project by project basis Ravelin Property (or any further company subsidiary incorporated) will submit a business justification case (BJC) in 3 key stages. This allows the S151 officer to scrutinise and review these BJC's as the project develops to better manage the risks and ensure the direction of travel remains within the agreed Ravelin Group business case as signed off by Cabinet.

12.2 This approach allows the S151 officer to fund progress with the early feasibility works in a controlled manner and ensures that capital funding and land only pass to Ravelin at the appropriate time with some conditionality and claw back in place.

12.3 Ravelin Property will be funded in the form of a commercial loan in line with state aid rules and the land offered for development under a long lease or agreement to lease.

Example:-

Stage 0 (Options)

- Officers from Strategic Developments (or other departments) will identify land within the Council ownership and consider options for development.
- Options for development will be tested through the Councils current cross directorate clearance process Development Programme Enabling Board (DPEB) to identify if any alternative land uses should be considered.

- Following approval by DPEB and agreement with the relevant Cabinet Member, Ravelin can be instructed to take forward a specific project.
- Note there is an option for Ravelin to be instructed to bring options forward to DPEB but this will be on client request only.

Stage 1 (Concept & early design - RIBA 1-2)

- Ravelin applies to the Council to bring forward a project (or group of projects) and it is agreed that these will be funded.
- Ravelin application to include - high level costings for this stage of work.
- Project Board & S151 officer review - if in agreement a loan on commercial terms to support the design and feasibility work (stage 1) is approved.
- Ravelin proceeds to complete stage 1.
- Once Stage 1 is complete Ravelin presents to the client project board & S151 officer.
- The Board needs to formally agree that Stage 1 is accepted and that Ravelin should progress to stage 2.

Stage 2 (Planning & Design development, procurement soft marketing - Riba 3-4)

- Ravelin applies stage 2 costs and an agreement to lease the land subject to conditions including the planning decision.
- Ravelin confirms costs for stage 2 and reviews estimates costs for the whole development project, including land transfer costs etc.
- Council agrees loan on commercial terms to support stage 2.
- Council agrees conditional Agreement to Lease.
- Ravelin secures planning and demonstrates preferred procurement route.
- Council confirms that it is supportive of the approved planning.
- Council confirms that the conditionality of the AFL has been met and the land can transfer (note this stage can take place later but prior to construction is preferred).

Stage 3 (delivery)

- Council agrees loan on commercial terms to support the projects delivery as per the approved planning.
- Conditionality is cleared and the transfer of land to Ravelin is completed to facilitate the development.
- Ravelin completes the project.