Portsmouth
CITY COUNCIL

Title of meeting:	Cabinet
Date of meeting:	26 July 2022
Subject:	Business Case for the establishment of a Council owned Subsidiary Company to own and operate the Old Brewery, Hambrook Street
Report by:	Director of Regeneration
Wards affected:	All
Key decision:	No
Full Council decision:	No

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1. Purpose of report

1.1. To set out and seek approval of the Business Case for the establishment of a subsidiary Company ("the Company") required for the operational phase of the Old Brewery, Hambrook Street ("**the Site**") redevelopment project being undertaken by Ravelin Housing Limited ("**RHL**").

2. Recommendations

2.1. It is recommended that Cabinet;

2.1.1. Approve the Business Case for the setting up of the Company.

2.1.2. Delegates authority to the Director of Regeneration, in consultation with the City Solicitor and S.151 Officer to set up the Company, appoint suitably qualified Directors and set up governance arrangements necessary for the Company to start trading with an obligation to report regularly to Cabinet on the Company's performance.

2.1.3. Delegate authority to the Director of Finance and S.151 Officer in consultation with the Directors of the Company to agree a mortgage lending agreement to fund the property transfer.

3. Background

3.1. On the 28 February 2019, Cabinet approved the Business Case for the establishment of Ravelin to act as a property development company for the Council.

3.2. On the 14 September 2020, the Leader approved the Business Justification Case to redevelop the Site, subject to the approval of the S.151 Officer and Director of France. This subsequently approved the transfer of the Site to RHL.

3.3. On the 10 August 2021 the S.151 Officer approved the Business Case from RHL to re-develop the Site. The Business Case worked on the assumption that upon practical completion of the development, a City Council wholly owned subsidiary company ("the Company") would be set up. The Company would itself borrow from the Council the cost of acquiring the developed Site from RHL. RHL could then re-pay its debt to the Council, whilst the Company would re-pay its debt to the Council over the long-term through rents and other costs reclaimed from residents purchasing or renting the residential units.

3.4. The Council obtained tax advice which provided advice that it would be more favourable for the Company to be directly owned by the Council, rather than indirectly as a subsidiary of either Ravelin Group Ltd or Ravelin Housing Limited.

3.5. For the Council to set up a trading company it must by law consider and approve a business case in relation to the specific subsidiary company. This paper therefore sets out the business case for the Company and seeks approval from Cabinet for its establishment.

4. Why the Company is needed

4.1. The proposed business case sets out the requirements for a new company to be formed called 'Hambrook Street Ltd'. The Company is to be a wholly owned company; limited by shares. Portsmouth City Council will be the sole shareholder owning 100% of the Company.

4.2. The Company will be established to hold and operate a single property 'The Brewery' of Hambrook Street, Southsea PO5 3BE.

4.3. An options appraisal has been undertaken to assess alternative options to setting up this company:

Option	Details	Pro's	Con's	Conclusion
Option One	Continue to hold and manage asset within Ravelin Housing Ltd	No costs associated with setting up new company, saving circa. £20k Maintains use of RHL as branding to build on reputation. Simpler and less administrative therefore more efficient.	Precludes RHL from being able to recover its VAT on construction costs which would be circa £700k+ additional unbudgeted cost to RHL as opposed to a cost of approx. £20k new company set up cost and property transfer.	Discounted
Option Two	Sell asset back to PCC	None	Would result in a financial loss to the Council in borrowing	Discounted

			receipts. The Council would take on the operational risks and acquire the property at higher market value than it originally sold it so would have a longer payback period. PCC would not be able to hold the asset for private rental purposes and income generation only and so would not see a return on the investment and the development would not meet its intended purposes.	
Option Three	Dispose of asset at on practical completion, do not hold	No operational risk to increases in management costs; income and profit and loss in the event of high inflation and recession. Early capital receipt to pay off loan to Council.	May not achieve value required to pay back debt and cost of development, RHL could be in a negative equity position. Would also not have proven the operational model to enable crystallisation of the developed asset value. Would still need to set up a separate holding company to enable marketing and contracts for the operational model to be established and negotiated.	Investment position to be reviewed at the end of the construction period, with updated valuation and investment analysis to assess viability before proceeding with any disposal to new Company

Option Four	Set up subsidiary company	Tax efficient for RHL. Enables RHL to pay off its debt to the Council and reduce its debt obligations to facilitate future pipeline of developments. Potential to sell the asset and the Company as a fully operational model to quickly leverage a capital receipt.	Duplication and additional cost of legal work to transfer the asset into a new company. Administrative, requiring additional reporting and management of another company. Does not utilise and develop the RHL brand.	Preferred option

5. The objectives of the Company

5.1. 'Hambrook Street Ltd' will own, operate and maintain the Site in accordance with the Hambrook Street Ltd Business Plan, **Appendix One**. It will explore the option of contracting out to third parties for the lettings management and maintenance/facilities management services required as part of the asset management against the option of direct employment to fulfil the functions required. However, the Company would enjoy all the risks and rewards of ownership in a tax efficient structure.

5.2. The Company will periodically assess and report on the investment performance to inform whether to continue to hold the Site for income generation and capital growth or dispose to realise the value and return a capital receipt and profit back to its Shareholder.

5.3. The Company expects to achieve a gross profit from year one, and a net profit in year 15.

5.4. The Company's objectives are:

5.4.1. To deliver a housing solution using an alternative delivery model focused on build to rent and affordable private rent markets. A key objective is to acquire the developed site and then hold, operate and maintain the asset;

5.4.2. To remain financially viable and commercially sustainable;

5.4.3. To ensure efficient landlord services are archived to include housing management and maintenance;

5.4.4. To maintain "The Brewery" to a standard that meets tenants' reasonable expectations, protects shareholder reputation and shareholder investment in the Company;

5.4.5. To be an example of how a Build to Rent product could operate in the City of Portsmouth to help attract further investors to the City;

5.4.6. To maximise capital value and create a saleable asset should the generation of a capital receipt become a priority for the Shareholder.

5.5. Performance against the Company's values and objectives will be monitored via periodic engagement surveys with key stakeholders.

5.6. Performance will be monitored through achieved occupancy rate, tenant turnover, waiting lists for accommodation and reviews. Periodic inspections and audits will be undertaken of the supply chain to ensure industry standards and contract obligations are being met.

5.7. The investment model requires periodic investment analysis, reporting and market engagement to inform any investment recommendation to dispose of the asset. This in turn will indicate whether the operational model has achieved its objectives and values based on its attractiveness to the market.

5.8. Furthermore, the Company targets to:

5.8.1. Let all 17 Units by June 2023;

5.8.2. Maintain a minimum 95% occupancy for the first 5 Years;

5.8.3. Be cash positive for the first 5 years;

5.8.4. Maintain the property with a view to maximising the capital value;

5.8.5. Periodically assess the investment value of the operated asset and crystallise the investment opportunity and dispose of the asset at the optimum time to give the maximum reward to the Company and its Shareholder;

5.8.6. Demonstrate best practice with tenants needs;

5.8.7. Be compliant with emerging residential management regulations and standards and strive to uphold best practice.

5.9. **Governance**

5.9.1. Governance of the Company will be detailed in the Articles of Association, of the Company. However, as a company wholly owned by the City Council there will likely be additional reporting requirements and restrictions placed on the Company Acts such as:

- A requirement to report quarterly on the performance of the Company to the Shareholder

- Restrictions on the appointment of Directors, require Shareholder approval, refer to Section 6 for further details on Directors.

5.9.2. Restrictions on the ability to borrow any money other than the City Council.

6. The investment and other resources needed from the Council for the Company

6.1. The Council must by law recover the costs of any accommodation, goods, services, staff or any other thing that it supplies to a company it sets up to trade.

6.2. The Company will be financed via a mortgage loan from Portsmouth City Council.

6.3. The Company will not employ direct employees.

6.4. The Company will be run by 3 Directors who will likely be Council employees at senior and Director level but could be external independent individuals. The skills required by the Directors should ideally include financial directorship, investment management experience and residential or facilities management experience. Further details relating to the company governance is set out in the Business Plan at **Appendix One**.

6.5. A further Council employee will perform the role of Company Secretary, undertaking statutory governance procedures and administration for the Company, to be appointed by the Company Directors once in post.

6.6. Additionally, the Company will require support from 2 further Council Officers to provide commercial property support and financial management accounting, which will be provided within existing team structures and will not generate new roles.

6.7. All Council employees performing functions for the Company will be engaged individually under a contract between the Council and the Company, where time related costs of the employee will be recovered from the Company.

6.8. The services of the Company include property management, facilities management, asset management, valuation, insurance, service charge management, legal advice and procurement will most likely be provided by third parties under contract and service level agreement. The option to directly employ will be considered as part of the assessment into the most cost-efficient way to operate the Site. The costs for the services engaged will be met by the Company in accordance with the agreed contractual terms. The costs for the services will be met from the income received from Tenants occupying the residential properties.

7. Any risks the business might face and how significant these risks are

7.1. **Funding Costs** - The UK is experiencing extremely high inflation costs currently and the Bank of England has indicated that they intend to use Interest rates to tackle inflation which means that potentially rates could increase to 3% to 4% in the short term. The Company has already agreed that any lending will be on fixed rate basis and will conclude the financing documents as soon as possible to ensure the lowest rates possible are secured.

7.2. **Funding Availability** - Changes to the PWLB and Treasury Management Rules could mean that the Council's ability to invest in the Company could be hindered if more draconian measures are put upon them. It is unlikely however that these new measures would come in prior to January 2023 when the loan is due to be taken.

7.3. **Rental Income** - The Company relies solely on rental income to raise revenue, changes in market forces and the introduction of a Government imposed rent cap could affect the ability of the Company to maintain this revenue. The Business Plan assumes a modest growth of 2% in rental value and as Hambrook will not be a registered social landlord it is in effect protected from the Government policy as a private company.

7.4. **Capital Growth** - At the moment, the UK has seen a significant increase in the value of both rental yields and sales growth. However, the UK house market is cyclical in nature and the market is just starting to see the value of house growth turn. In March 2022 house growth was 3%, in April prices reduced by 0.3%.

7.5. **Increased Costs** - Inflation is likely to top approximately 7% - 10% in autumn 2022 and this remains a significant risk to the Company business plan as could see increases to operational costs and overheads. The Company will seek to mitigate this through procurement.

7.6. **Capacity** - Hambrook Street Limited is unlikely to employ any staff directly and more likely to commission staff from the Council to manage the third-party contractors on the Company's behalf. However, this is a relatively new venture and the Company will need to be satisfied that the Council have sufficient skill and expertise to provide services to it and assess the most cost effective way of operating.

8. The expected financial results of the business, together with any other relevant outcomes that the business is expected to achieve

8.1. Taxation

8.1.1. Corporation Tax

- 'Hambrook Street Ltd' will pay Corporation Tax on any profits it makes. All operating and debt costs will be deductible for Corporation Tax Purposes.
- Repayment of Debt finance is not deductible for tax purposes.

8.1.2. Stamp Duty

- When the Site is acquired from RHL, no Stamp Duty will be payable by RHL or the Company as the transfer of the freehold is between two associated companies. This will be reassessed prior to any transaction in case of any changes to legislative position.
- Note: the companies (RHL and 'Hambrook Street Ltd) are not in the same group but are associated as they have the same Shareholder.

8.1.3. VAT

- When the property is acquired from RHL this will be the first transfer of a residential property and therefore will be treated as Zero Rated for Taxation purposes.
- The only income that the Company will receive is that of rental income from its tenants, this essentially means that it is unable to recover any input tax on its operating expenses.

- The Company will not need to register for VAT as its taxable turnover is below the £85,000 current annual threshold. This is on the assumption the Company turnover is achieved from VAT exempt rental income.

9. Reasons for recommendations

9.1. RHL will complete the conversion and achieve practical completion of the Site in March 2023. Ahead of this date it is critical to the business justification case and the financial modelling that the cost of the operational management for the asset is known. The asset will need to be revalued to obtain revised market rent information and revised freehold values to enable the cash flow for the development to be reforecast. A key component of the financial models is understanding how the asset will be managed from a lettings and facilities management perspective and under what terms those contracts will operate. In order to engage with the market and commence the procurement process for this, the appointing company needs to be confirmed. It is not possible to undertake procurement exercise for this work as RHL and then establish the contracts under a different company.

9.2. Additionally, in order to comply with the terms of the facilities agreement with the Council, RHL is expected to repay its loan as a single bullet payment at the end of the construction period on the basis that the asset will be transferred into another subsidiary Company. Should this not occur then RHL will need to obtain further funding to cover the VAT liability it would then incur and undertake a new application for funding at higher cost from the Council which will have a negative impact on the future lending ability for RHL and the business case the Council approved for the development as referred to in Section 3 of this report.

9.3. The establishment and registration for a new subsidiary company if approved by Cabinet in July will take 2 months to establish. It is anticipated that a 3-month procurement and tender programme will be undertaken for the operational contracts for the site. These will then be agreed and marketing campaign established to launch the asset for letting enquiries with the intention to secure pre-lets 3-months prior to the anticipated practical completion.

9.4. The completed asset will be re-valued by RHL for freehold sale prior to practical completion and the investment model re-run to assess and confirm that holding the asset and transferring to the Company provides the best financial return to the Council.

10. Integrated impact assessment

10.1. An integrated impact assessment has been completed and is at **Appendix Two.**

10.2. The assessment indicates that the proposed change will deliver good quality homes, will help to reduce energy and encourage businesses to invest in the city, supporting growth and regeneration.

11. Legal implications

<u>The power to trade - Council's ability to incorporate a company to trade</u>

11.1. The provision of property management services (as to be undertaken by the Company) can be undertaken by the Council as being incidental to its housing, regeneration or investment powers, or under the general power of competence under s1 of the Localism Act 2011.

11.2. Where the purpose of the activity is for commercial purposes, then the Council must do so through a Company (section 95 of the Local Government Act 2003) to ensure that the Council is not put in a more favourable position (for example in relation to taxes) than those with whom it is able to complete in the market.

11.3. Operating through a company is subject to conditions as set out in the *Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009* ("the Order"). The conditions are that the Council must;

11.3.1. prepare and approve a business case in support of the proposed exercise of that power; and

11.3.2. ensure that it recovers the costs of any accommodation, goods, services, staff or any other thing that it supplies to the company in pursuance of any agreement or arrangement to facilitate the exercise of the power conferred.

Ownership and Governance

11.4. The Company will be wholly owned by the Council. The executive function of "shareholder" in relation to the Company will be the responsibility of the Council's executive (i.e., cabinet), either to an individual portfolio holder or Cabinet collectively. In relation to the Council's other companies, responsibility sits with Cabinet collectively.

11.5. The Council will not run the Company, that will be the responsibility of the board of Directors. The Directors will run the Company in accordance with the powers granted to them through the company's constitution (for example its articles of association and shareholder agreement if required).

11.6. It is proposed that the Directors of the Company are Council Officers. Company Directors have statutory duties to act in the best interest of the Company (not the Council) and therefore the Council should be cogent of issues around conflict of interests concerning those officers who it appoints as Directors, to enable the Council, the Company and those Officers to address and manage any conflicts identified. Remuneration of Directors who are also Council Officers should not be through the Company due to the restrictions in s117 of the Local Government Act 1972 and so any additional duties the Council requires such Officers to undertake should be graded and remunerated through the ordinary Council job evaluation process.

11.7. The Council should also be satisfied that the Directors it appoints are suitably skilled and qualified with sufficient knowledge and training in relation to the role of a Company Director.

Holding the Directors to account

11.8. The Shareholder is responsible for holding the Directors of the Company to account, to ensure they are performing satisfactorily and protecting the investment of the Shareholder.

Portsmouth CITY COUNCIL

11.9. The Council should appoint a Shareholder representative who will act in effect as the client Officer to the Company to act as the conduit between the Council and the Company. To be clear, this role does not discharge the Shareholder function (unless such functions are delegated to the Officer by Cabinet, which it may wish to do in relation to certain minor, inconsequential or urgent decisions required of the Shareholder by the Company) but simply act as a conduit through which matters can be brought to the attention of the Shareholder for decision or oversight.

Subsidy control

11.10. The Council will need to ensure that the financing of the Company fits within the subsidy control (formally state aid) obligations on the Council.

12. Director of Finance's comments

12.1. The reasons for the Council establishing a Local Authority Company to operate The Brewery development are set out within the Business Plan attached at **Appendix One**.

12.2. The Council will, subject to an updated valuation at the time of purchase, through a mortgage loan agreement, lend to Hambrook Street Ltd to enable the Company to purchase the property from Ravelin Housing LTD, another Council owned Company.

12.3. In the event of Company failure, the Council's financial risk is limited to the Shareholding within the Company. The loan will be made to Hambrook Street Limited with a legal charge attached to the property ensuring that if the company defaulted on the loan, the property would revert back to the Council as primary creditor.

12.4. The establishment of this Company was always envisaged when the Council originally agreed to lend funding to Ravelin Housing LTD to purchase the property from the Council, develop and convert into residential flats. This report is merely allowing the next stage of that business case, in order that the Company, Hambrook Street LTD, can become incorporated.

Signed by:

Appendices:

- **Appendix One** - Business Plan - Hambrook Street Limited
- **Appendix Two -** Integrated impact assessment

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Portsmouth
CITY COUNCIL

Title of document	Location

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by ……………………………… on ………………………………

………………………………………………
Signed by: