Report for:	**Cabinet**
Date of meeting:	**23 May 2017**
PART:	**1**
If Part II, reason:	

Title of report:	**Development Company Update**
Contact:	Cllr Andrew Williams, Leader of the Council James Deane, Corporate Director (Finance & Operations) Mark Gaynor, Corporate Director (Housing & Regeneration)
Purpose of report:	To update Cabinet on work undertaken to date on the viability of the Council establishing a Development Company to develop the Civic centre site.
Recommendations	That Cabinet: 1. approve work to progress on the creation of a Devco based on Option 3b of the Cushman Wakefield model, i.e. to sell a portion of the units developed on the private market, and to retain a portion for private rental in order to generate a revenue stream for the Council; 2. recommend to Council the approval of a budget of £200k to progress Recommendation 1 of this report. This will cover the finalisation of design work, the finalisation of the business case, and consequent legal advice on the most appropriate tax and governance arrangements on creation of a Development Company.
Corporate objectives:	This project aligns with all of the Council's corporate objectives, as approved by Council in February 2016.
Implications:	Included in the body of the report.
Monitoring Officer/S.151 Officer Comments	**Monitoring Officer:** The Council has the power to establish a Development Company pursuant to provisions contained in the Local Government Act 1972, Local Government Act 2003 and the Localism Act 2011. As highlighted in the report, detailed legal advice will be obtained in relation to the governance arrangements, which will operate between the Council and the Development

	Company, the applicability of 'State Aid' rules (EU rules in place to prevent members states distorting cross boundary competition), and the Council's requirement to achieve 'best consideration' for any disposal/transfer of land to the Development Company. This further advice will be reported in forthcoming reports." **S.151 Officer** My comments are included in the body of the report.
Consultees	Portfolio Holders Chief Officers
Background papers	Report to Cabinet, May 2016: Agenda item 9; Proposals for a Development Company
Glossary of acronyms and any other abbreviations used in this report:	CW – Cushman Wakefield Devco – Development Company NPV – Net Present Value

Executive Summary

1. In May 2016, Cabinet approved the procurement of specialist technical expertise to advise on the viability of creating a Council-owned Development Company (Devco), based on two principle objectives:

   - To maximise revenue income to support provision of General Fund services; and,
   - To contribute to the delivery of local housing in a high-demand market

2. Following a procurement exercise, Capita Asset Services was appointed to produce a report on the viability of several Council-owned sites. This report identified the Civic Centre site as the most viable development opportunity. At a meeting in December 2016, Portfolio Holders agreed to commission more detailed modelling of the Civic Centre site in order to establish sufficient assurance of viability before investing further in the formation of a Devco.

3. Cushman Wakefield (CW) was appointed to undertake this detailed modelling based on previous knowledge of the site gained from a Feasibility Study they produced in 2016. The modelling was based on a 180-unit residential development, comprising one and two bedroom flats arranged over three blocks.

4. The table below provides an overview on the viability of a number of development options for the site based on a 30-year evaluation period. The Net Present Value column shows that the Council could make a financial return from all options other than Option 3a; the retention of all units for private rental.

Option		Net Present Value (loss)
1	Market sale of the land to a developer	£4.1m
2	Devco to develop the site and then sell all units on completion	£9.3m
3a	Devco to develop the site: retain **all** units for private rental	(£4m - £8m)
3b	Devco to develop the site: retain **50%** of non-affordable units for private rental	£7.5m - £8.6m
4	Joint Venture Devco to develop site and then sell	£5m

5. The NPV calculation does not differentiate between capital and revenue cash-flows. Of the profitable options, only Option 3b would give the Council the revenue stream previously approved by Cabinet as a key objective for the Devco. On this basis, pursuing this option would be justifiable despite its not generating the highest NPV.

6. Option 3b headlines based on currently modelled assumptions:

- 180 units – 60 sold as affordable; 60 sold private market; 60 rental units retained
- Net revenue stream – c£300k in first full year; inflationary increase up to c£400k by year 12
- Interest premium for Council lending to Devco not yet factored in (subject to legal advice)
- Debt profile (c£6.5m outstanding after sales) – interest only repayments
- Model assumes sale of units/refinancing in year 30

7. Some of the key risks and mitigations associated with Option 3b are summarised below (mitigations are subject to further legal advice as the company structure and tax position is further refined):

Number	Risk	Potential Mitigation
1.	The housing market collapses resulting in the Devco holding a number of unsold units, and missing out on the capital receipt that would bring the debt down to a serviceable level.	The Devco could convert some of the additional units intended for private sale to affordable housing, thereby securing a return and potentially allocating additional 1-4-1 receipts.
2.	The private rental sector collapses resulting in the Devco being unable to find tenants for the retained units and thereby unable to meet the financing costs.	The Devco could convert rental units to private sale, or convert to affordable housing, or use for temporary accommodation in the short-term.
3.	State Aid regulations require the Council to lend to the Devco at a higher interest rate than has been modelled. (This looks like a positive for the Council in terms of additional revenue, but it may pose a problem from a tax perspective if it renders the Devco unviable.)	Models have been run based on various different costs of financing, all of which, on current assumptions, show a positive NPV. The highest finance rate modelled is 8%, which, anecdotally, is a significantly higher rate than most Councils are lending to their Devcos. More legal advice is required on this point.

8. The CW financial modelling is based on prudent financial assumptions. However, the accuracy of the costing at this stage is inevitably limited by the fact

that the scheme design underpinning the financial model is very high level. Costs and receipts for the Council will be refined as the design work becomes more precise and the tax position is finalised. The outcome of the CW report provides the Council with assurance that a scheme could be sufficiently viable to justify further investment in a Devco.

9. It is recommended that Cabinet approve work on the Devco to progress on the basis of Option 3b, and that Officers, in consultation with Portfolio Holders, appoint professional advice to develop a more detailed scheme, and design the most appropriate governance and tax structures for the Devco to optimise Council returns.

The development plan used as a basis for the financial modelling

10. The scheme used by CW to model the costs and receipts consists of 180 residential units split between three blocks. The scheme would be delivered in two phases, with the capital receipts from the sale of units in the first phase being used to finance the costs associated with the second phase. This approach would minimise the borrowing costs incurred by the Council to finance the project. In accordance with the Council's planning policy, 35% of the units would be affordable.

11. This scheme was first proposed by CW as part of a Feasibility Study carried out on the Civic Centre site in summer 2016. The Study was produced in conjunction with Council Planning Officers and is indicative of what could be achieved on the site. Both the design and the attendant financial model are subject to change as the designs are progressed and become more precise.

The different delivery methods modelled

11. Appendix A shows a summary of the financial model produced by CW, for the delivery of the site using five different delivery methods. The delivery methods are described below:

    - **Market sale/disposal** – the Council sells the land on the open market and takes a financial return in the form of capital receipt. This option would not generate a revenue stream for the Council to support the provision of General Fund services in the future.

    - **Direct delivery, with sale of all units** – development delivered by Devco, with the Council providing the finance before recouping capital receipts from the sale of units. This option would not provide a revenue stream for the Council.

    - **Direct delivery, with retention of all non-affordable units** – development delivered by Devco, with the Council providing the finance before recovering an income stream from the letting or residential units.

    - **Direct delivery, with sale of 50% non-affordable units and retention of the remainder** – development delivered by Devco, with the Council providing the finance before taking returns in the form of capital receipts (for units privately sold) and revenue stream (for the rented units).

- **Joint venture delivery vehicle with all units for sale** – Devco funded 50:50 between the Council and an investment partner (with the value of the Council's land included within its 50% contribution). Returns from the Devco would be split 50:50 between the JV partners.

Key assumptions within the financial model

12. The model reflects cash inflows and outflows over an evaluation period over a 30-year period, with the key assumptions summarised below:

    - Scenarios in which units are retained by the Council for private rent:
        - Rental at £1,200 per calendar month, average
        - 25% holding costs, e.g. to reflect voids, maintenance, and marketing
        - Rental growth at 2.5% per annum
        - Units are sold in year 30 in order to reflect the retained asset value

    - Affordable units:
        - In all cases it has been assumed that affordable units are sold to a Housing Association on completion

    - Finance costs:
        - Finance costs of 6% for developer in baseline scenario
        - Evaluation period of 30 years for rental options
        - 3.5% discount rate to determine NPVs, as per HM Treasury recommendation

    - Sale values:
        - Capital growth assumed at 2.5% per annum, with 25% reduction of inflated values to account for major refurbishment and re-kitting of stock prior to open market sale.

13. The base case model shown in Appendix A is based on the Devco accessing finance at 6%, with scenarios also modelled at 4% and 8% financing. In all cases the recommended options, 3b, generated a positive NPV. The final financing rate will depend upon legal advice around state aid regulations, and will emerge during the next stage of works.

Financial Implications for the Council

14. It is likely that the primary source of funding for the Devco will be via the Council borrowing from PWLB and then on-lending to the Devco. This will require the Council to meet financing costs on its borrowing for a likely period of 2-3 years until the Devco is able to generate a capital receipt from those units earmarked for sale, and to generate a return on rental units.

15. In order to minimise financing risk and costs, the Council will seek to match the duration of the loans it takes from PWLB to the likely repayment timescale of the Devco. For example, if the Devco is forecasting a receipt of £12m in year 2 from the sale of the units in phase one, the Council would borrow £12m for two years, repay the loan to PWLB and then refinance as required to deliver subsequent phases. As a result of these timing considerations, the Council's borrowing structure cannot be finalised until the designs are more progressed.

16. However, the indicative position based on the assumptions within this model does not suggest a short-term revenue pressure on the Council sufficient to preclude the on-lending model. Current PWLB rates for 3 year borrowing are around 1.1% for DBC, which, based on peak debt for Option 3b, would result in the Council bearing short-term annual financing costs of c£250k per annum.

17. The short-term financing costs facing the Council in the delivery of the Devco will be considered as part of the current year-end process, and recommendations will be made to Members for the creation of an appropriate reserve.

Next Steps

18. Following the outcome of the CW report, it is recommended that Members approve officers to begin the following workstreams to run concurrently:

    a. Procurement of more detailed designs in conjunction with Planning officers and in consultation with Cabinet Members;
    b. Procurement of legal advice to establish and the most appropriate governance and tax structures for the delivery of this specific model;

    c. Contingent on the progress of the above two points, to create a Devco for the development of the Civic Centre site. A further report will come to Cabinet to formally approve the creation of the Devco, based on the refinement of the modelling as described in points one and two, above.

19. Officers will be working with colleagues from other Local Authorities across the county and beyond to ensure the sharing of best practice, and where appropriate, the sharing of costs via the One Public Estate forum.