

**CABINET
3 DECEMBER 2019**

**DELIVERY OF NEW HOMES PROGRAMME
JOINT VENTURE PROPOSAL**

**Responsible Cabinet Member -
Councillor Charles Johnson, Resources Portfolio**

Responsible Director - Paul Wildsmith, Managing Director

SUMMARY REPORT

Purpose of the Report

1. To approve the establishment of a Joint Venture Company which will provide the infrastructure build and sale of homes under an investment programme within the North East under the company name Esh DBC JV Limited.
2. To seek approval for the Council to invest in the company and to acquire land for schemes meeting *qualifying investment criteria* for residential development, through the Council's Joint Venture arrangements.

Summary

3. The Council issued an OJEU procurement exercise in July 2017 to seek a joint venture partner for residential development. Esh Homes Limited was the successful bidder and was appointed to the Council Joint Venture Framework Agreement ("the Framework").
4. To date four Joint Venture schemes have been arranged under separate joint venture companies and brought forward for development at Eastbourne, Middleton St George, Heighington, and West Park Garden Village.
5. Results to date have exceeded the investment outcomes reported to Cabinet and overall the four joint venture companies are projected to provide 388 new homes; estimated new homes bonus of £2.1m; a post-tax profit of over £3m and a surplus on loan interest payments of £1.1m from a maximum engaged investment of £24.3m.
6. The investment returns above will be substantially delivered out in the next two to three years and this report proposes a further investment subject to meeting equivalent *qualifying investment criteria* for residential development to deliver investment returns on a similar basis under a single joint venture company.
7. This will be more efficient in terms of administration and ensures that relevant opportunities can be delivered under the joint venture approach to offer continuing investment returns to the Council.

8. The Joint Venture Company will be based on a 50:50 split between the Council and Esh Homes Limited and the Company will return developer profits equally to the Council and Esh Homes Limited.
9. The Joint Venture Company will be funded by the Council and Esh Homes, the Council element will be funded via prudential borrowing of up to £9.5m at its peak.
10. Overall it is estimated the scheme will deliver an average 17% annual return on Capital with pre-tax profits averaging over £1m per annum, which in the first three years will be reinvested back into the venture with the first dividend of £0.5M payable in year four.
11. The average annual net interest surplus in the first four years on the commercial loan is anticipated at £0.180m charged at state aid compliant rate
12. Further documentation referred to by appendices to this report are as follows:-
 - (a) Appendix 1 (Part III) – Model Appraisal
 - (b) Appendix 2 (Part III) – JV Company Four Year Projection
 - (c) Appendix 3 – Shareholders Reserved Matters

Recommendation

13. It is recommended that :-
 - (a) Cabinet approve the establishment of the Joint Venture Company to acquire land, deliver, and build private sale and affordable homes over a nine year programme.
 - (b) Cabinet approve £9.5m from the Investment Fund to fund the Joint Venture Company financed by prudential borrowing subject to a first Legal Charge in favour of the Council over the Land acquired by the Joint Venture Company together with a Guarantee from the Joint Venture Partner in respect of 50% of the Senior Loan sum.
 - (c) That the Joint Venture Agreement be approved and delegated authority to the Assistant Director – Resources (Chief Finance Officer) be granted to finalise the establishment of the Joint Venture Company in line with the terms in this report.
 - (d) The Assistant Director – Resources (CFO), the Assistant Director Housing and Building Services and the Assistant Director - Law and Governance are appointed to act as directors in the Joint Venture Company as part of its Executive Board and to delegated approval to agree on acquisitions of land and development of sites on behalf of the Council as Shareholder.
 - (e) The Joint Venture to be funded from prudential borrowing from the Capital Investment Fund established by the report to Council dated November 2016.

Reasons

14. The recommendations are supported by the following reasons :-

- (a) To assist in the delivery of the Economic Strategy by speeding up the building of new homes.
- (b) To deliver income for the Council.

Paul Wildsmith
Managing Director

Background Papers

No background papers were used in the preparation of this report

Elizabeth Davison: 5830
Sarah Hutchinson: 5489

S17 Crime and Disorder	This report has no implications for crime and disorder
Health and Well Being	There are no Health and Well Being Issues
Carbon Impact and Climate Change	There are no sustainability issues
Diversity	There are no diversity issues
Wards Affected	All wards potentially
Groups Affected	Not Applicable
Budget and Policy Framework	This report does not represent a change to the budget and policy framework
Key Decision	This is a key decision
Urgent Decision	This is not an urgent decision
One Darlington: Perfectly Placed	There are no issues adversely affecting the Community Strategy
Efficiency	An investment return will help the Council's budget
Impact on Looked After Children and Care Leavers	This report has no impact on Looked After Children or Care Leavers

MAIN REPORT

Information and Analysis

- 15. The report recommends the establishment of a new Joint Venture Company between the Council and Esh Homes Limited to acquire the sites (yet to be identified) and to bring forward residential development of homes for private sale and affordable housing.
- 16. The Council has already established a number of Joint Venture Companies to build and sell homes with Esh Homes Ltd delivering meaningful investment returns.
- 17. Subject to approval and on the terms of this report, and subject to meeting *qualifying investment criteria* for residential development, and to the delegated approvals in this report, the Joint Venture Company will purchase the sites and procure infrastructure, including roads, sewers, drainage and services and

associated s.278 works to open up the sites and to deliver private and affordable housing.

18. The sites as selected will be subject to planning approval. It is envisaged that the sites may be outside of the borough of Darlington but within the north east region.

The Joint Venture Proposal

19. The Joint Venture Company will be based on a 50:50 split between the Council and Esh Homes Limited and the Company will return developer profits equally to the Council and Esh Homes Limited.
20. The Joint Venture Company will be funded by both parties. The Council funding for the programme will be via prudential borrowing of up to £9.5m secured primarily by legal charge on land to be acquired and by a floating charge on the company assets.
21. The Council will provide Senior Lending facility up to a maximum of £4.1m repayable in full over a year nine term and secured by a first legal charge on land acquisitions. Draw down of this facility will be subject to land security being in place. Interest will be charged at the State aid rate (as varied from time to time) and which provides an investment return to the Council.
22. The Repayment Date will be initially set at year nine (and set to be subject to interest payments re-payable over the term (monthly in arrears). There will be a provisional requirement for a capital repayment schedule over years four to nine (based on similar figures to expected dividends) to be waived at the Council's discretion if a dividend is agreed in its place, or otherwise subject to satisfactory progress of schemes.
23. The Senior lending facility drawn down from time to time will be subject to no less than 100% loan to value ratio (LTV) and secured by first senior and legal charge over the land and assets of the company.
24. Both parties will provide Junior Lending facilities in equal amounts up to a maximum of £5m each. Draw down of this facility will be subject to land and other security being in place subject to no less than 100% LTV ratio.
25. A smaller amount of funding will be made available for initial development costs and securing options up to a maximum sum of £0.250m each to be drawn down equally. Both parties will control cash at bank by bank mandate and both parties own the company jointly. This funding will be subject to an enhanced interest rate to meet with state aid requirements.
26. The loan will be repaid by the Joint Venture Company to the Council subject to sales progress over the loan term and is expected to generate a net income after taking into account any cost of borrowing undertaken by the authority.
27. The estimated average pre-tax profit share for the Council per year is projected to be £1m however cash flows will be recycled into new land and work in progress until year four when a dividend of £1.0 m is scheduled of which Darlington's share is £0.5m. See **Appendix 2 (Part III)**. Profits from year five onwards can be taken as dividend or used to repay the loan.

28. In addition, the net surplus on interest on the commercial loan to be repaid in year nine if not before will be approximately £0.180m per year charged at state aid compliant rate.
29. Based on the business plan the company activities are expected to generate enough profit to repay the loan in full from profits by the ninth anniversary of the scheme and (subject to sales outcomes) would then carry land and work in progress (WIP) to the value of c £14m to continue with the joint venture debt free.

Scheme Approval

30. The approval by the company to proceed with a scheme shall be a Shareholders Reserved Matter and brought forwards to the board for approval subject to a scheme meeting *the qualifying investment criteria*.
 - (a) This is that the investment will provide the expected investment return set out in the model investment appraisal in the form annexed at **Appendix 1 –(Part III)** adequately supported as follows;
 - (b) Independent land agent appraisal of disposal prices
 - (c) Independent SIs report
 - (d) Independent Title Report
 - (e) Independent QS Report (as applicable)
 - (f) Updated Legal and Audit advice
 - (g) That the development is to be delivered in the region
 - (h) That any land purchase or contract be at arms' length
 - (i) That (in accordance with the Joint Venture Agreement) all contracts have been competitively tendered in accordance with the Public Contracts Regulations 2015.

Building works

31. The Joint Venture Company will contract with building contractors in respect of the substantive works in accordance with the development appraisal agreed for each project.
32. It is a condition of the joint venture that all contracts with a value over £25,000 require the approval of the Council (and Esh Homes Limited) and it is a requirement that all contracted works are competitively tendered in compliance with the Public Contracts Regulations 2015

Joint Venture Agreement

33. The Joint Venture agreement has the following heads of terms :-
 - (a) The joint venture partner will deliver the overheads and sales services works and services as set out in the tender process (to include all necessary services and overheads)
 - (b) The costs and profits are split 50:50.

- (c) The number of homes built at any one time is limited to reduce risks associated with sales.
- (d) The maximum funding requested is £9.5m. Subject to sites brought forward the drawdown of funding will be subject to satisfactory progress of works on site and the pre conditions to loan security. The repayment profile will be set to allow for full loan repayment during the nine year loan term.
- (e) The making of a dividend to the shareholders for profit (over and above interest) will be agreed through the Joint Venture company. The joint venture partners have strictly equal voting rights (i.e. neither party can nominate a chairman to have a casting vote) and either party can if it wishes elect to exit the agreement and seek its dividend or continue the development arrangements, subject to a decision to be made by members at this time.
- (f) Each joint venture partner will nominate three directors to the Executive Board.
- (g) Decisions made by the Executive Board by simple majority will be binding on all partners save as to the shareholder reserved matters which must be agreed by both shareholders in writing.
- (h) A process to resolve disputes is included.
- (i) The Joint Venture will incur costs and execute sales in accordance with the Approved Appraisals (which will be produced on the model form to meet with the investment principles set out in the Model Appraisal).
- (j) Agreed scheme appraisals will be annexed to and form part of the Joint Venture Agreement on approval.
- (k) Sales may not be made at less than 95% of the appraisal value without the consent in writing of both shareholders.
- (l) The Agreement can be terminated under defined circumstances.
- (m) The Building contracts can be delayed or terminated under defined circumstances.

34. The principal elements of the Senior Loan Agreement are:

- (a) A Senior Loan facility from the Council to the Joint Venture Company in the sum of up to £4.1m to fund the Joint Venture development programme. The business case cashflow is attached with drawdowns subject to property acquisition and satisfactory progress on site.
- (b) Interest on the loan to be calculated at no less than the State Aid compliant rate, currently 4.9% and variable over the term.
- (c) Security on the land to the extent of the advanced sum from the Council.
- (d) Legal Charge over the land to secure the lending to be released as required for sales of housing units subject to satisfactory repayment of the loan and subject

to an administrative fee to cover the costs of removal of £25.

- (e) A final repayment date of 9 years from the date of the agreement unless otherwise approved by both parties in writing.
- (f) The whole of the advance will be repayable as a debt if any instalment is not paid when due or in the event of any insolvency action. The Council in such a case will rely on its first legal charge over the land and development.

35. The principal elements of the Junior Loan Agreement are:

- (a) A loan from each of the Joint Venture Partners to the Joint Venture on equivalent terms of up to £5.0m each to be drawn down in equal amounts on equal terms
- (b) Subject to a debenture/ floating charge ranking second to the Senior Debt.
- (c) Provision for an unsecured element at an enhanced state aid compliant interest rate

36. The principal elements of the Building contracts will be:

- (a) Contract between Joint Venture Company and building contractor which shall be procured in accordance with the requirements of the Public Contracts Regulations.
- (b) Defined CDM roles in accordance with the CDM Regulations 2015 and advice from the Council's Corporate Health and Safety Unit.
- (c) Based on formal tenders for the works in accordance with Public Contracts Regulations 2015.
- (d) Variations over £15,000 require consent in writing of both the Joint Venture parties; the Council and Esh Homes Limited.
- (e) Works can be delayed at the instance of the Joint Venture Company with agreed delay costs of £5,000 per week.
- (f) Terminable by the Joint Venture Company on notice with agreed termination payment for demobilisation costs of £25,000.

Risk Analysis and Valuation Comment

37. There are two main areas of risk on the expected return; *the cost of the build* (which if it increases will diminish profit) and the *achievement of the sales value*. Safeguards are in place on both elements as below:

Cost of the build

38. The Council's financial commitment is limited to the amount of the loan advance.

39. Over the course of a building project the building contracts allow for required variation instructions to be given. As increases to the Building contract costs affect

the profitability of the Council investment and financial risk these are managed in the joint venture agreement as follows;

- (a) Mechanism in the Building contracts that no variation with a value in excess of £15,000 can be made without the approval in writing of the contract administrator
- (b) Mechanism in the Joint Venture Agreement that no variation with a value in excess of £15,000 can be made by the Joint Venture Company save with the consent in writing of both the Council and Esh Homes Limited. This is recorded in the Joint Venture and in the Articles of Association of the Joint Venture Company as a shareholders reserved matter. A full list of the shareholders reserved matters is appended at **Appendix 3**
- (c) Mechanism in the Joint Venture that the building contracts cannot be varied with cumulative variations with a total value in excess of £50,000 save with the consent in writing of both the Council and Esh Homes Limited. This will be recorded in the Joint Venture and in the Articles of Association of the Joint Venture Company as a shareholders reserved matter.
- (d) A further mechanism in the building contracts provides that the works are released on a staged basis of five units at a time. These phased releases are to be approved by monthly governance meetings and the requirement for this is recorded in the Joint Venture. The approval for further releases shall not be given where the sales programme is behind targets to the extent that the Joint Venture Company does not have sufficient funds to meet the liability of the additional release.
- (e) The Joint Venture Agreement governs the situation where consent is sought to sell properties for less than 5% below the appraisal value, or where the sales programme is behind the projections in the cash flows requiring a further advance on the loan agreement to maintain liquidity of the Joint Venture Company. In such a case (on a case by case basis) the parties will not continue with the building contracts unless there is agreement in writing by both parties to do so.
- (f) The building contracts will contain express provision that delay payments of £5,000 per week are incurred for delay at the request of the Joint Venture Company.

Achievement of Sales Value

- 40. The expected sale values will be subject to a formal valuation exercise approved for each scheme as part of the qualifying investment criteria.
- 41. The sales values are further controlled through the risk mitigation processes below to ensure no disposal can be effected at less than 95% of the amount stated in the *Approved Development Appraisal*.

Financial Implications

- 42. The Joint Venture Company will be registered for VAT and the house sales will be zero rated any input tax on purchases paid by the Joint Venture will be able to be

claimed back from HMRC this is because new house sales are Zero rated rather than Exempt or Outside scope, the cash flow is net of VAT.

43. The sum of £9.5m allocated for the Joint Venture to be funded from the Capital Investment fund via prudential borrowing to be fully repaid by the Joint Venture Company.
44. After the finance costs and the Joint Venture Company costs of sale and professional costs, the pre-tax profit to each partner is estimated at an average £1m per year which will be reinvested in the company with the first dividend paid in year four of £0.5m. In addition the net surplus on loan interest payable on the Council lending is projected at £0.180m per year. Appendix 2 (Part III)

Mitigation of Risk

45. The Joint Venture will operate on a risk reward basis, and each parties risk share will be limited to half of the required lending to fund the scheme.
46. Approval of a scheme is subject to a meeting *qualifying investment criteria* with supporting due diligence on title and site condition to establish there are no title matters adversely affecting a development and the site investigation reports (SIs) do not indicate known issues with the land. The final approval of an *Approved Development Appraisal* will be a shareholders reserved matter.
47. Assistant Director – Resources (CFO), the Assistant Director Housing and Building Services and the Assistant Director Law and Governance are appointed to act as directors in the Joint Venture Company as part of its Executive Board which meets regularly monitor progress on the programme of investment and developments; this will include review of sales progress, expenditure, health and safety compliance, social value benefits and any matters requiring board approval.
48. Control and governance of the company will be equally shared and neither shareholder will have a casting vote. In the event the parties do not agree then the matter will be covered by deadlock provisions in the joint venture agreement.
49. The risk of non-payment of lending will be secured firstly against the land and assets of the Joint Venture Company, as well as by a guarantee from the Joint Venture Partner for their share of the project (in respect of 50% of the Senior Lending).
50. Additionally building contracts will be let on flexible terms to ensure that they can be terminated early if needed and offering the Joint Venture Partners the opportunity to slow or phase development as needed to reflect changes in the market.
51. The advance from the Council will be on the basis of the required state aid compliant interest rate required by the relevant EU legal communication notice. This is currently calculated at 4.9% per annum (variable upwards in accordance with changes to the Bank of England base rate).
52. Funds at the bank will be protected as follows:

- (a) Both of the Joint Venture members directors will be named on the company bank mandate have immediate direct access to account information.
- (b) Each of the Joint Venture members i.e. Esh Homes Limited and the Council will cross guarantee to the other over the conduct of the bank account by their employee directors in the Joint Venture Agreement.

53. The Joint Venture Agreement governs the situation where consent is sought to sell properties for less than 5% below the appraisal value, or where in any scheme the sales programme is more than five units behind the projections in the cash flows.

Outcome of Consultations

54. Internal consultations with Housing, Estates, Finance, Legal, Capital Projects and Procurement have not raised any objections to the proposals and the expectations are considered reasonably achievable at the present time.
55. The development of each site as brought forwards will be subject to full consultation with residents as part of the planning process.

Legal Advice

56. The Localism Act 2011 includes a 'general power of competence' which gives local authorities the legal capacity to do anything that an individual can do that is not specifically prohibited. This gives the powers to enter into prudential investment and in this context the investment provides a financial return along with ancillary benefits in terms of delivery of housing, new homes bonus.
57. The Joint Venture is to be delivered with the Joint Venture partner appointed following an OJEU tender process conducted in Summer 2017.
58. Under the provisions of the Local Government Act 1999 the Council is subject to a general duty to obtain 'best value' in the exercise of its functions. Cabinet should consider in making the recommendations of this report that the deal represents value for money which is supported by obtaining independent valuation comment on the terms of each land disposal the Council's professional appraisal of the sales values and by requiring that the engagement of the building contract be conducted in accordance with tendering processes on an arm's length basis in accordance with the Council's own tendering thresholds.
59. The Assistant Director, Law and Governance, will be required to document the Joint Venture on the basis set out in this report, specifically in the Joint Venture Agreement, the Loan Agreement, the Legal Charges, the Deed of Guarantee and register the necessary restrictions at the Land Registry and at Companies House to protect the Council's interest in the schemes and mitigate investment risk.