Appendix 1

London Borough of Croydon

Independent strategic review of Brick by Brick Croydon Ltd, Growth Zone, Croydon Affordable Homes LLP, the Revolving Investment Fund and the Asset Investment Fund

13 November 2020

pwc

Guidance

To navigate this report on-screen (in PDF format)

From the Contents page – click on the title of the section

Copyright notice

London Borough of Croydon Council
Bernard Weatherill House
8 Mint Walk
Croydon
CR0 1EA

We report on London Borough of Croydon Council ("LBC") and its subsidiaries, Brick by Brick Ltd ("BBB") and Croydon Affordable Homes LLP ("CAH") (together, the "group")) in accordance with our engagement contract dated 5 October 2020.

This report has been prepared in connection with the purpose as stated in the engagement contract. This review was carried out for LBC only.

We draw your attention to important comments regarding the scope and process of our work, set out in the appendices.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

Yours faithfully

PricewaterhouseCoopers LLP

Damien Ashford
Partner
damien.j.ashford@pwc.com

Jonathan House
Partner
jonathan.r.house@pwc.com

Matthew Lynn
Director
matthew.r.lynn@pwc.com

James Bailey
Director
james.s.bailey@pwc.com

Contents

PwC scope and limitations of our work

Scope of our work

The London Borough of Croydon Council (“LBC” / ”the Council”) has engaged PwC to carry out an independent review of its property development related subsidiaries/funding vehicles (“the entities”).

The scope of our engagement specified that c.75% of time should be spent on the review of Brick by Brick Croydon Limited (“BBB”) with the balance spent on the remaining entities. Accordingly, the depth of analysis on BBB is greater than that delivered on Croydon Affordable Homes LLP (“CAH”); Growth Zone (“GZ”); the Revolving Investment Fund (“RIF”); or the Asset Investment Fund (“AIF”). We have taken a prioritised approach to this review given the finite amount of time and resource available.

Key parts of our review work:

- Rapid financial and operational review of BBB;
- Strategic options review of BBB;
- Review of governance arrangements between LBC and BBB plus desktop review of governance arrangements with the other subsidiaries/funding vehicles;
- Current performance, Value for money and Governance arrangements of CAH, GZ, RIF and AIF.

Due to Government mandated Covid-19 travel restrictions, all meetings were held by video conference or telephone call with correspondence via email.

Approach to our review

We have taken a prioritised approach to this review given the short timeframe (four weeks). Whilst information was provided quickly by LBC, some financial information from BBB took over two weeks to be provided, limiting our ability to undertake analysis.

We have carried out initial and follow-up reviews of documentation provided by BBB and LBC to build understanding of the BBB financial position and performance including detailed Board, committee and other working papers for FY19/20 and FY20/21, plus any other available and relevant supporting documentation (including governance structures, loan agreements and detailed development site reporting where available).

We held initial and follow-up interviews with the Board and key staff members of BBB as well as key Council personnel, to form a view on performance, operations, governance and strategic options.

A similar approach was adopted for the other entities within scope albeit on a reduced scale due to the agreed focus of review work toward BBB.

Limitations in relation to our work

Our work commenced on 5 October 2020 with a first draft reporting deadline of 3 November 2020.

It was recognised that this short time frame of four weeks would require prioritisation of work, and that this would result in a high level of review across a large number of complex issues.

The full details required by the Council in respect to certain matters will require further work up, using information that has not been available to us during the course of our review.

In particular, in respect to BBB, delays in receiving information and the quality of information received have impacted the depth of review analysis we have been able to perform, in particular in relation to the current financial position and forecast performance of BBB.

Additional time would be required to refine the analysis, particularly regarding the strategic options available to the Council. Therefore the options set out should be considered indicative. We would recommend further work before a final decision is made by LBC on the future of its investments.

We also bring attention to the following:

- There are several examples of information provided not reconciling with information held by the Council (e.g. loan amounts and drawdown amounts) and we have had to work through these on a line by line basis to understand the correct current position;
- Audited FY19/20 accounts for BBB were outstanding during our review and accordingly we have based our analysis on the draft 2019/20 accounts provided to us by BBB;
- We have not conducted scenario modelling to assess the likely impact of COVID-19 or Brexit on the future performance of the entities or the Council's requirements.

Brick by Brick - operational review

Section two

2a

At a glance

1 LBC created BBB in FY15/16 to increase the quantity and quality of affordable housing available and deliver a positive contribution.

Against a backdrop of a nationwide shortage of social housing and affordable homes, with particular acuity felt in London, London Borough of Croydon ("LBC") established a commercial subsidiary, Brick by Brick Croydon Limited ("BBB") in FY15/16 to support an increase in the pace and quality of affordable housing being brought to market in the borough.

Delays in development timelines together with market uncertainty created by COVID and Brexit have impaired BBB's performance against plan and resulted in significant delays to LBC's return on investment.

BBB's draft accounts for the year ended 31 March 2020 (FY19/20) suggest a small profit before tax against LBC's cumulative lending of £199.5m and £14.4m of interest due.

LBC has proactively sought to gain a better understanding of the current and future performance of BBB and strategic options by commissioning this independent review of BBB.

2 The depth of our work has been limited by unavailability of robust financial information from BBB. The lack of management accounts and a 13 week rolling cash flow is concerning.

- We have been asked to perform a rapid review of BBB finances, operations and governance and identify strategic options for LBC.
- Our review and analysis has been limited by the absence of BBB financial documents, such as up to date management accounts, forecast financial performance for the Company and a 13 week rolling cash flow. The business keeps a detailed summary of incoming and outgoing funds, but this does not give the Board, shareholders or lenders an up to date overview of Company performance, profitability or cash requirements. This lack of financial oversight is concerning.
- Our review has been limited by the time in which to conduct the fieldwork, analyse and prepare outputs. It was agreed with LBC that a prioritised approach should be taken. Further detailed work is required in a number of areas.

3 We have completed our work through a combination of interviews and review of documentary evidence.

Our independent review has been conducted through the following:

- Initial and follow-up review of documentation provided by BBB and LBC to build understanding of the BBB financial position and performance including detailed Board, committee and other working papers for FY19/20 and FY20/21 plus any other available and relevant supporting documentation (including governance structures, loan agreements and detailed development site reporting where available);
- Initial and follow-up interviews with the Board and key staff members of BBB as well as key Council personnel to form a view on performance, operations, governance and strategic options.
- Council and BBB staff have been supportive of this process however there have been delays and limitations to the information available, that have impeded the ability to meet the scope in the timeframe available.

4 BBB has significantly underperformed against the FY19/20 business plan.

- Since its inception in 2015, BBB has been entirely dependent on funding from LBC and to date (September 2020) has total borrowings of £214m, comprising loans of £199.5m plus interest payable of £14.4m.
- In its FY19/20 business case, BBB ambitiously stated an ambition to deliver c.500 residential units per annum, targeting the completion of 14 sites already in development (307 units). Planned sales of £132.3m and a profit of £10.3m (7.8%) should have allowed the commencement of repayment of debt to LBC. No interest or loan capital was repaid to LBC in FY19/20.
- BBB attributes this to a number of factors including delays due to COVID, development issues and delays with actions sat with Council departments (such as Planning). We believe COVID was a relatively minor causal factor given the year ended on 31 March 2020. We note there is no reference to a FY19/20 impact in BBB's March or April Board minutes.

At a glance

5 BBB's governance requires significant strengthening at Board level with a need for substantially improved financial oversight. LBC also needs to enhance oversight of BBB.

- BBB's governance structure and practices require significant improvement. In particular there is a need for greater financial stewardship and assurance to both the Board and its shareholder (LBC).
- The Board lacks a qualified Finance Director. In addition, the business' in-year financial reporting processes have significant gaps and must improve substantially.
- The appointment of a suitably qualified Director of Finance to strengthen the Board is essential. BBB should prepare monthly management accounts including both year to date overall performance versus plan and forecast outturn for the year, with narrative against any variance. This will provide increased Board oversight of BBB's financial performance and allow it to provide greater assurance to its shareholder and lender, LBC.
- LBC's shareholder oversight of BBB must improve. We recommend rapid appointment of suitable LBC representatives to the BBB Shareholder and Investment Board.

6 BBB's loan portfolio has not been properly managed by LBC or BBB, and several of the Company's loans are technically in default as a result.

- BBB and LBC put in place loan agreements which cover the lending against specific developments. We have had sight of 30 of these documents.
- In many of the documents we have reviewed, the loans have breached their final repayment dates, and as a result BBB is technically in default on those loans. This is despite the fact that BBB continues to request further drawdowns against the loans.
- We understand that the loans were treated as extended by virtue of discussion of BBB's business plans but have seen no documentary evidence of Board or Cabinet discussions in this respect. This has resulted in loans not defaulting, due to an informal renegotiation apparently endorsed by LBC's lack of action in this respect.
- The loan drawdown process has not operated as stipulated in the loan agreements. The appropriate controls have not been applied by LBC to the LBC lending to the Company.

7 Land transfers have been conducted in a way which appears to be s123 compliant, but the method used has been inconsistent.

- The Council has sought to comply with obligations under s123 of the Local Government Act 1972 in relation to best consideration for any land which transfers to BBB. However, there are inconsistencies and differences in the approach that the Council and BBB have used in valuing the land, and where there are material valuation differences these should be better understood and resolved;
- There has been no previous formal documentation or agreement on the 'high' value of affordable housing units to be acquired from BBB which underpinned the valuation BBB has ascribed to the land acquired from the Council;
- The Council and BBB should ensure that all commercial arrangements between them are comprehensively documented going forward.

8 BBB's ambitious strategy of developing large numbers of small, complex and more risky sites has led to significant delays. This strategy has put LBC's investment at risk.

The 2016 Cabinet proposal for the establishment of BBB included the following:

1. Maximise the use of the Council's assets to deliver new homes;
2. Enable an innovative commercial model which will benefit the Council financially and help meet savings targets;
3. Bring forward the development of key sites across the borough;
4. Secure improved community facilities.

As of October 2020, the delays in bringing new homes to the market has put the Council at serious financial risk and resulted in only a handful of new homes being available. As a consequence, savings have not been made. The severity of this situation has not been exposed until late in 2020, as the formal controls that should have been in place were absent.

At a glance

9 Next steps

- As BBB's sole funder, LBC has a number of options in respect to how to address this situation and maximise potential value from BBB. We have set these out for LBC in section 2b.
- Irrespective of the options, LBC should:
  - Review the governance and management of BBB, tightening controls around loan funding in particular;
  - Improve capacity and capability of the teams that interact with BBB on a daily basis including in finance and planning;
  - Require BBB to improve its financial oversight by producing a 13 week rolling cash flow forecast and integrated forecast profit & loss and balance sheet statements; and
  - Require BBB to appoint a sufficiently qualified Director of Finance.

Brick by Brick -
Strategic options

Section two

2b

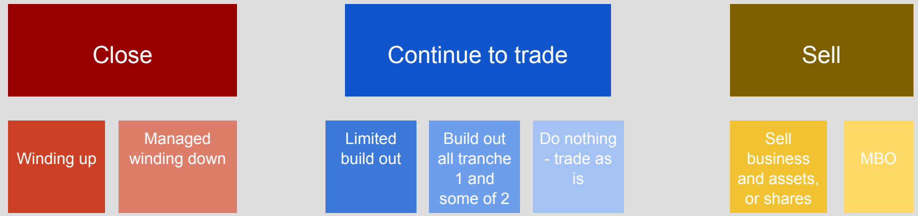
At a glance: Options available to the Council regarding BBB

1 We have set out what we consider to be the options available to the Council at this point in time.

- We have used the available information to assess the options in respect to BBB, taking into account:
  - The likely costs and potential revenue from BBB's development activities;
  - Further funding required (noting that LBC's financial position is extremely challenged);
  - The status of BBB's developments, and known problem areas;
  - The potential impact on LBC's loan funding to BBB, and interest accrued;
  - The impact of insolvency on BBB's assets;
  - The likely challenges in implementing the options;
  - The likely time requirement to deliver the options.

2 Seven options are available to the Council under three categories: Close, Continue to trade or Sell

- We have assessed the options available to LBC having considered the available limited information, and have classified seven options under three categories:



3 The options that present the best financial outcomes for the Council are continuing to trade: Limited build out or build out tranche 1 and some of 2.

- We believe, based on the available information and our discussions to date, that continuing to trade the business while further examping build out or sales options but they do require continued investment in BBB before a cash return is generated.
- Please note that our ability to assess the future costs, future sales and impact on the assets values has been extremely limited. LBC should undertake further work in respect to the detail on these options.
- All of the options result in the Council writing off substantial loan funding and accrued interest.

4 There is a significant amount of detailed work still to do, to firm up the options, the financial impact of each and their viability

- At this time, we do not believe BBB's information (i.e. lack of company level financial forecasts) is robust enough for the Council to make a strategic decision in respect of these options.
- As a result, the following actions should be immediately taken, to ensure that the Council is able to make a fully informed decision about the best option to select:
  - The appointment of a Director of Finance;
  - The rapid work up of robust BBB financial (P&L) forecasts; and
  - Further asset review work to test asset values.

Growth Zone - review

Section four

3

At a glance

1 Growth Zone is LBC's funding vehicle for investment regeneration in Croydon and is set up to retain and invest business rate increases.

Growth Zone was set up to provide LBC with a vehicle to coordinate its regeneration funding. The original business plan included £309m of Council and £209m of partner funding (GLA, TfL and others) and was predicated on the building of a Westfield retail centre in Croydon.

- Since the submission of the final business model in 2018 the economic climate has changed substantially and the planned scope has been greatly reduced.
- An original £167.8m of approved spend was reduced to £78m by LBC in February 2020, with FY20/21 planned spend reduced from an initial £21m to £6.7m.
- Of an initial 100 projects, 35 are paused and 15 have been stopped.

2 Given the ongoing COVID-19 pandemic and economic uncertainty, reducing planned funding in FY20/21 to £6.7m was a sensible step as the original business plan is no longer fit for purpose and requires revision.

- Further to the case by case COVID-19 review undertaken by LBC that resulted in the pausing of 35 projects and the cessation of 15, we recommend a project by project review of the remaining 47 projects be made to assess the return on investment (financial and non-financial) be undertaken to ensure further investment still delivers value.
- This review should also consider if the £6.7m currently forecast in FY20/21 should continue. We understand LBC are in the process of reviewing this.
- Reappraisal may enable LBC to pause further investment. However, we would not recommend closing down the GZ programme as this provides LBC with a vehicle to focus any recovery investment required of it and (dependent on central government policy) does provide LBC with the ability to use Business rates that it may otherwise have to return to central government.

3 The impact of COVID-19 on the Council and its partners presents a significant risk to fund planned investments and a future business rates receipts on which the model relies.

- There is a significant risk that the parties involved in GZ will have a reduced scope to invest in the near future given the competing demands and costs of the COVID-19 response to date and the potential reduction in forecast business rate increases on which GZ is reliant for future investment.
- Furthermore any increase in lockdown measures may adversely impacted existing project timescales and/or increase the costs of delivery.
- We recommend that LBC continues to communicate clearly with its GZ partners and seeks assurance from each on the forecast ability to fund existing projects to support its own investment decisions and before committing to fund any projects that have not yet commenced.
- A revised business case is recommended to adequately reflect changes in current and future population behaviours and requirements. This should come back to the LBC's cabinet in light of the severity of the cash issue in LBC.

4 Governance structures appear reasonable but the frequency of meetings with partners may need to increase to provide more assurance to LBC in the current climate.

- The monthly suite of meetings including the GZ Steering committee and subgroups seems appropriate in terms of membership and frequency, but the frequency of meetings with key stakeholders may need to increase in particular with GLA given current uncertainty.
- Processes for risk assessment of ongoing projects gives a means of exception reporting but should be completed consistently in order to give a complete picture.

At a glance

5 There are a number of key next steps LBC should consider in relation to Growth Zone

Given the current economic uncertainty, the steps the Council have taken to review and revise down the ambitious investment plan for Growth Zone are sensible.

There will be a continuing need for some investment in Croydon, particularly in light of the need to generate growth after the pandemic, and so switching off all planned investment would be unwise.

Any subsequent increase in planned investment should be supported by a business case and taken through robust governance and sign off processes for full scrutiny.

Croydon Affordable Homes LLP - review

Section five

4

At a glance

1 The LLPs were created as commercial entities to provide affordable housing and generate a positive contribution to the LBC general fund of £1.4m per annum.

- The LLPs are jointly owned by LBC (10%) and Croydon Affordable Housing LLP (90%) which is a registered charity.
- They currently lease 344 properties (248 in CAT and 96 in CAH) from the Council on 80 year leases with a 40 year Council break clause. These properties were purchased through sale and lease back to two funders.
- The LLPs' structure has enabled LBC to utilise right to buy receipts previously not permitted through the housing revenue account allowing investment in Croydon Borough rather than releasing these funds to central government.
- The transfer of assets to LBC's Pension Fund is outside of our review, however we note that the Council is planning to transfer the properties to LBC's pension fund at the 40 year lease break clause to reduce the annual LBC pension contributions.

2 The LLPs' latest financial statements were not available for review, but the FY19/20 forecast outturn was £317k (68% behind target) behind plan, due to bad debts and voids.

- Detailed financial information regarding the group's financial performance in 2019/20 was not available, nor was any record of FY20/21 financial performance in the year to date. We understand that 2019/20 accounts are currently with the external auditors but have not received these. This is a clear shortcoming in the LLP's financial monitoring and governance, given the value and significance of the assets held.
- The forecast outturn as at Q3 FY19/20 indicated the LLPs expected to deliver a combined surplus in 2019/20 of £148k against a budget of £465k. This shortfall in performance was attributed to higher than budgeted voids in CAH (12%) in year, reducing income by £108k and a growing bad debt provision in CAT (£127k over budget). Lettings management performance may also be a factor.
- We note that in Q4 a further 81 homes were transferred but these would not be reflected in the Q3 figures.

3 The life cycle costs of maintenance and repair do not appear to be reserved for in the LBC accounts. This must be addressed and may create an additional increasing annual liability.

- We understand that reserves for life cycle costs for the leased properties are currently not being made in the accounts of LBC. We understand that legal advice suggests the LLPs cannot make the provision in their own accounts.
- We note that the model used for CAH's development included average lifecycle costs of c.£1.4k per property per annum based on 8% of rental income. RICS life cycle costing guidance suggests that provision should be made of c.3% of the asset value per annum. The CAH approach is significantly lower than this but we note that 3% of asset value may be excessive for affordable housing and a tailored approach may be required.
- Immediate steps should be taken by LBC and CAH to assure the Board and Cabinet that suitable provisions for life cycle costs are being made. The amount not reserved may need to be backdated.
- This is particularly important given the planned transfer of the benefit of the properties to LBC's pension fund and reliance on the future rental revenues.

4 The governance arrangements of the CAH LLPs require significant strengthening, as they have been run with insufficient financial oversight.

- Our desktop review of Board and other papers plus interviews with CAH personnel suggests that the quality of financial reporting internally and externally needs to improve. Board papers suggest the last detailed financial update was in February 2020 (in the previous financial year) but only gave a forecast outturn and there is no evidence of the Board receiving a final 2019/20 position or update on FY20/21 trading performance.
- LBC's holding company was dissolved as Companies House filing deadlines were not met. We understand this position is being addressed by LBC, but indicates a need to significantly improve corporate governance and administration.
- We recommend LBC puts in place robust governance around the LLPs given the value of the assets held, with dedicated team resource aligned to the funding that the LLPs provide.

At a glance

5 CAH and CAT have partially met their purpose of increasing affordable housing available to Croydon residents, however we understand there is an ongoing mismatch of tenants to appropriate properties, resulting in the increase in rent arrears.

- We note that whilst the LLPs have increased the affordable housing available to Croydon residents, they are not forecast to deliver the surplus in line with business plans.
- If the 2019/20 Q3 forecast outturn was accurate, small cost increases or reductions in rental income would result in a failure to breakeven. This would trigger a waterfall payments model that may result in the Council not receiving its full management fee. The Council's overall position would be exacerbated by the need to increase lifecycle reserves.
- Properties are not generating rents in line with plan and costs of chasing rent arrears and increasing bad debt provision are driving financial underperformance.
- Better matching of tenants to appropriate properties is required if the LLP model is to deliver returns in line with the business plan.

6 The operational and business model for the CAH group of LLPs requires detailed review before further investment is made by LBC, and dedicated oversight of the LLPs should be established.

- Before LBC invests any further funds in properties via the CAH LLPs, it should undertake a detailed review of the businesses to ensure:
  - The full future cost of the properties is understood and accounted for appropriately, including lifecycle reserves.
  - There is a clearly understood cash impact for LBC in terms of forecast flow of funds from the LLPs.
  - There is a clear strategy on the use of homes in terms of tenant type and affordability.
  - The quality of financial reporting LBC receives from the LLPs improves, so that LBC has a detailed monthly phased financial plan at the start of each year with monthly progress reports against this at an income and expenditure level, with variance analysis and narrative plus a revised forecast outturn for the year.

Revolving investment fund - review

Section six

5

At a glance

1 The RIF was set up in 2014 to increase the amount of funding available to drive growth. Loans totalling £269.7m have been provided through the RIF, mainly to BBB. Many are in default.

- The RIF was set up with Cabinet approval on 29 September 2014, to accelerate the provision of homes, fund development projects, drive growth and sustainable employment opportunities. The RIF was explicitly intended to deliver capital and revenue returns for the Council.
- Since inception, RIF has provided loans totalling £269.7m to Council initiatives and subsidiary companies owned by LBC.
- The main areas of lending are to BBB (£208.8m*), Real letting property investments - relating to a management property fund providing housing to homeless individuals (£45m), and CAH (£8.4m).
- As at July 2020, the outstanding balances against loans, including accrued interest, provided through the RIF totalled £269.7m.
- No BBB loans have been repaid as a consequence of the lending, in direct contravention of multiple loan agreements which are technically in default.

2 A limit of £272.2m was placed on lending by RIF in the 2018-22 Medium Term Financial Strategy. The RIF has loaned £17.5m more to date than budgeted, in contravention of the Strategy.

- The 2018/22 Medium Term Financial Strategy (“MTFS”) noted that total RIF borrowing from 2018 to 2022 would be £272.2m.
- However, the scale of the funding through the RIF suggests that no cap has been exercised on the funding that the RIF has provided per annum to the extent that in FY20/21 the RIF can currently only lend a further £2.5m before reaching the £272.2m limit stated in the MTFS.
- Since there was an expectation that funding provided would revolve back from BBB to the Council to reinvest, there may have been an expectation that funding would not become excessive. However since the majority of funding to date (£208.8m to BBB*) has not delivered returns, any further investment represents an increased borrowing requirement for the Council.

3 Governance around the Loans provided has been informal and is not in line with the plan agreed by Cabinet, or best practice.

- The RIF fund was intended to be ring-fenced and have clear governance and decision making. Neither of these stated intentions have been put into place.
- There is no robust treasury plan for management of these loans, or set of standard operating procedures in relation to the management of RIF loans and loan management is not in keeping with industry best practice in relation to management of loans of this size.
- Changes in personnel have left a lack of corporate memory in relation to the RIF loans. It has been particularly challenging to locate copies of loan documentation for the purposes of this review.
- Management of the RIF’s loan book has been left to the LBC finance team, but up until mid-October 2020 there was no individual within LBC who had current active oversight of the RIF loan portfolio.

4 RIF lending is currently invested in 23 development projects, several of which are not performing as planned.

- Key investments are not performing as intended. Indeed, many BBB loans are overdue with no evidence of having been renegotiated or interest paid to date.
- The risk profile of the RIF loan book is therefore much higher than planned.
- The RIF has not been revolving, because very few of the loans have repaid with £208.8m* tied up in BBB loans with no interest received to date.
- The Council has not operated a balanced lending approach in contradiction to the careful analysis set out in the 2018 MTFS paper, with the majority on RIF investment focused on residential development.

** Note: £208.8m as at July 2020. Total funding as at 30 September is £214m.*

Asset Investment Fund (“AIF”) - review

Section six

6

At a glance

1 The AIF was set up in 2018 as part of LBC's investment strategy, to fund non-residential property investments. LBC has made investments of £98.8m through the AIF.

- The AIS was designed to group Council investments in commercial property as a vehicle to deliver revenue returns. The fund created is referred to as the Asset Investment Fund ("AIF") and was capped at £100m. The purchase of Croydon Park Hotel ("CPH") at £31.3m was completed before the AIF's inception but is accounted for in the AIF, bringing the fund limit to £131.3m.
- Based on the latest LBC documentation, the AIF has spent £98.8m on £93.5m of assets plus £4.9m of purchase costs, funded through general LBC borrowing.
- Assets purchased (including purchase costs) are: Croydon Park Hotel (£31.3m), Colonnades phases 1 & 2 (£53.5m), 60 Vulcan way (£7.4m); and 37-39 Imperial Way (£6.6m.)

2 LBC is forecasting significant AIF underperformance in FY20/21, with a £82k forecast net return against a budget of c.£2.4m. We think the actual return could be a loss of £(0.5m).

- The AIF is forecast to deliver a £82k net return to the Council in FY20/21 against a FY20/21 budget net return of c.£2.4m. The target return based on 2% of total investment of £131.3m is £2.6m.
- Forecast underperformance is driven by two key factors:
  - Croydon Park Hotel ("CPH"). This was expected to deliver rents of £1.7m p.a. but the tenant trading company went into administration in June 2020 in part due to COVID-19 trading pressures with no rent expected in FY20/21.
  - Colonnades leisure & retail park - COVID-19 restrictions have impacted several tenants, leading to rent deferrals and reduced interest in vacant slots, all reducing in year rent receipts.
- The forecast net return of £82k is predicated on an assumed 2.44% rate of interest on borrowing. The current average borrowing rate for LBC is 3.15% which equates to an additional c.£0.6m cost per annum. Adjusting the forecast £82k net return for this additional interest cost would result in a net loss to LBC of c.£0.5m.

3 Croydon Park Hotel and the Colonnade leisure and retail park both present significant financial risks to LBC that need to be addressed.

- The closure of CPH creates a £1.7m shortfall in FY20/21 rent receipts and exposes the Council to unbudgeted costs for the vacant property including maintenance, repairs, security and insurance.
- LBC currently estimates CPH is worth less than the purchase price. The asset should be appropriately impaired following external valuation, with the corresponding impact reflected in the income and expenditure statement.
- To mitigate this LBC are in the process of assessing alternative uses for the site with a view to generating income and currently expect to retain the property until the market recovers. This process should be prioritised.
- The Colonnades leisure & retail park has a number of tenants that have and will continue to be impacted by COVID-19 restrictions. Rents have underperformed and there is further risk of rent default. LBC should monitor this investment closely and plan for a downside scenario on rent receipts.
- The forecast net return on investment may be overstated by up to £0.6m as described in point 2. LBC should review and agree on the appropriate rate at which the AIF interest is calculated.

4 The monitoring and governance of AIF investments is very limited, and should be strengthened with clear Cabinet scrutiny.

- The process by which assets were acquired is clearly documented and followed LBC policy in terms of formal notices, recorded decisions and supporting documentation.
- The timeframes around making offers for the assets were short and delegated authority was used to make offers, but the commercial rationale behind this was documented.
- However, ongoing monitoring of the AIF portfolio and governance is very limited. AIF performance is not discussed at any formal board, with reporting confined to within the Asset and Estates team and Place directorate. AIF is covered by general financial monitoring on a monthly (previously quarterly) basis.
- The current underperformance of investments, in part due to COVID-19, underlines the importance of the AIF receiving suitable and regular executive oversight. Given the issues regarding Croydon Park Hotel and the need to quickly address these, we recommend higher levels of Cabinet scrutiny going forward.

5 The Council will need to make a strategic decision on the future of the AIF, considering current financial pressures vs long term investment. Immediate sales are likely to reduce value achieved.

- Given the the Council's financial pressures and the current economic uncertainty in the UK due to COVID-19, we agree with the decision to not pursue any further investment in the AIF.
- Making strategic decisions on asset realisation at a time of uncertainty may impact value and therefore disposals in the immediate term are currently unlikely to realise best value.
- We believe the best course of action at present is to seek to maximise returns on the existing investments and undertake annual strategic reviews of the AIF to assess if/when disposals will result in best value.
- However, if LBC needs to release cash to mitigate financial pressures in year, the AIF does represent significant potential for unlocking cash.

Recommendations and next steps

Section six

7

Key observations and recommendations

Priority

The actions have been given a ‘Priority’ rating from high to low. This reflects the degree of urgency with which we believe the actions should be addressed.

High	This is critical to progress.
Medium	This is important to progress.
Low	This is least important to progress.

Ease of implementation

The ‘Ease of implementation’ rating in the final column indicates the level of difficulty of implementation, taking into account any work already undertaken

R	Hardest to implement in the available time period.
A	Can be implemented in short to medium term.
G	Easiest to implement in the available time period.

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
1	BBB - Financial planning	The Company does not currently produce a consolidated phased plan against which to assess year to date financial performance, nor does it produce consolidated forecasts in terms of cash flow, profit and loss or financial position. We recommend that BBB should improve its financial oversight by producing: A 13 week rolling cash flow forecast; and integrated forecast profit and loss and balance sheet statements.	BBB	High	A
2	BBB - Financial governance	There is currently no financially qualified member of the Board to provide challenge to BBB's reported performance or forecasts. BBB should ensure that there is a sufficiently qualified Director of Finance in post to increase the internal financial scrutiny and challenge and support the Shareholder Board to improve its understanding of the business's finances.	BBB	High	A
3	BBB - Financial Governance - reporting	BBB does not currently have any integrated company-wide financial monitoring or forecast and therefore it is challenging for the Board to make effective decisions on the basis of Company financial performance. Whilst we understand there is an ambition to produce monthly management accounts moving forward, BBB should integrate development, sales and financial projections into a monthly reporting cycle to provide visibility to the Board on the Company's financial position.	BBB	High	R
4	BBB - Financial Governance	There is a lack of financial capacity and capability within BBB. In addition to the appointment of a qualified Director of Finance we expect there to be at least one additional suitably qualified member of staff who can support the development of robust financial information to proactively manage the BBB business.	BBB	High	A
5	BBB - State aid	Improve documentation of arrangements for the subsequent sale of assets by BBB, particularly where this has a direct influence on the valuation of land to be acquired / transferred.	LBC	Med	A

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
6	LBC - Purchase of BBB properties	The Cabinet has approved in July the further purchase of 231 BBB properties, but has not yet entered into contract for any of these. We understand that the status of these property purchases is pending, subject to review. The Council will need to decision on a site by site basis whether to pursue this option and notify BBB accordingly immediately prior to the practical completion of the schemes. LBC should review the proposed purchases of these properties in light of current market conditions, so that it does not exceed these thus exposing the Council to risk under S123.	LBC	High	A
7	LBC - BBB developments	LBC has not created sufficient capacity in its own teams (such as planning) to allow for the increased demand for services that its drive to create affordable homes is generating. There is evidence that some of the delays experienced on BBB development sites are being driven by longer than normal process time in the Council's operational teams. Since the Council must avoid preferential treatment to BBB, it may wish to consider general additional capacity in these teams to support quicker processing across the board. This will support quicker resolution for all developer delays including BBB.	LBC	High	A
8	LBC - BBB - State aid	The Council should regularly review the financing and operational arrangements of BBB for ongoing compliance with State Aid requirements, particularly in the context of: ● Maintaining a state aid compliant capital structure including the equity loan debt model ● Pricing loans on a state aid compliant basis which reflect the risk associated with investing in BBB specifically.	LBC	High	A

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
9	LBC - Governance	There are significant concerns around the adherence to governance procedures within LBC and its subsidiaries. LBC should consider commissioning a wider and thorough governance review of the organisation.	LBC	High	A
10	LBC - Governance	There is insufficient capacity within the LBC corporate governance team to appropriately oversee the application of governance across the organisation. LBC should review its governance team structure and ensure it has the required level of capacity and capability along with senior input to ensure best practice governance procedures are adhered to.	LBC	High	A
11	LBC - Governance	It has proven difficult to obtain a complete set of documentation in relation to loans and other agreements between LBC and its subsidiaries. LBC should ensure that it collates and maintains a complete central repository of all commercial arrangements between itself and its subsidiaries,	LBC	Med	G
12	LBC - Governance	Given the level of risk associated with BBB, the Council should consider reviewing the BBB risk entry on the central risk register and reflect the risk outside of general governance matters.	LBC	Med	G
13	LBC - Disposals	Where analysis and calculations are undertaken with regard the allocation of negative land value across sites, greater levels of clarity and explanation as to the process undertaken should be developed and retained for future audit trail purposes.	LBC	Med	G
14	LBC - Disposals	Consider the greater use of third party external valuers for all future site disposals, transferso or acquisitions.	LBC	Med	G
15	LBC - Disposals	Maintain an audit trail or log of key assumptions employed in developing valuations and analyses related to land transfers, disposals and acquisitions, particularly where this is performed in house (external valuers typically provide detailed reports on valuation, including assumptions employed).	LBC	Med	G

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
16	GZ - Business case	The assumptions on which the original business case was based (forecast business rates increases and the development of a Westfield retail complex) are no longer valid and the business case should be revised. This should be done building on the COVID-19 impact review already completed and must consider the change in the economic forecast for the duration of the proposed investment period and the changes in the requirements of Croydon's population and behaviours following COVID-19 and any associated downturn.	LBC	High	A
17	GZ - Governance	Annual and quarterly review meetings with GLA and the Mayor of London's office: Frequency of governance meetings with stakeholders may not be sufficient in light of ongoing economic uncertainty. LBC may wish to consider increasing frequency until such time as a revised GZ business plan is agreed including the underpinning assumptions over funding - i.e. business rate increases and the Councils ongoing ability to utilise these.	LBC	High	A
18	GZ - Governance	Any subsequent increase in planned investment should be supported by a business case and taken through robust governance and sign off processes for full scrutiny.	LBC	Low	A

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
19	RIF	The RIF fund was intended to be ring-fenced and have clear governance and decision making. Neither of these stated intentions have been put into place. Cabinet should urgently revisit the purpose of the RIF fund, and set clear lending controls with well enforced drawdown requirements to prevent any further loss of control.	LBC	High	A
20	RIF	Management of the RIF's loan book has been left to the LBC finance team, but up until mid-October 2020 there was no individual within LBC who had current active oversight of the RIF loan portfolio. Changes in personnel have left a lack of corporate memory in relation to the RIF loans. It has been particularly challenging to locate copies of loan documentation for the purposes of this review. Loan documents should all be properly archived and filed so that they can be easily located. An automated reminder and alert system should be established so that Loans are properly managed.	LBC	High	A
21	RIF	There is no robust treasury plan for management of these loans, or set of standard operating procedures in relation to the management of RIF loans and loan management is not in keeping with industry best practice in relation to management of loans of this size. A robust set of operating procedures should now be put into place with immediate effect.	LBC	High	A

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
22	CAH - Life cycle cost provision	We understand that there should be a provision in the LBC accounts for the life cycle costs of the lease properties managed by the CAH group of LLPs. There is no evidence that this provision exists suggesting there is a risk that the true future costs of the leases through to the planned transfers to the Pension Scheme are not recognised. CAH should recognise a liability in their accounts to address this, and funds should be ring fenced to reflect this future cost.	CAH	High	G
23	CAH - State aid	A more consistent approach to agreeing land value between the Council and its wholly owned subsidiary: It does not appear to be logical for the two related entities to have materially different views on land valuation.	LBC	Med	G
24	CAH	There is a lack of clarity on whether or not life cycle costs are being appropriately recognised. Immediate steps should be taken by LBC and CAH to assure the Board and Cabinet that suitable provisions for life cycle costs are being made. The amount not reserved may need to be backdated.	LBC	High	G
25	CAH	We recommend LBC puts in place robust governance around CAH given the value of the assets held, with dedicated team resource including a company secretary function to oversee general CAH LLP group companies house filing and require improved financial reporting from the LLPs.	LBC	Med	G
26	CAH	LBC should formulate a clear strategy on the use of homes in terms of tenant type to understand the impact of suggested rent levels and the ability to pay these.	LBC	Med	G

Key observations and recommendations

Ref.	Area	Observation and action	Responsible Organisation	Priority (High / Med / Low)	Ease of implementation (Red / Amber / Green)
27	AIF	Monitoring of the AIF portfolio and governance is very limited. AIF performance is not discussed at any formal board, with reporting confined to within the Asset and Estates team and Place directorate. AIF is covered by general financial monitoring on a monthly (previously quarterly) basis. The governance of AIF should be formalised with a clear regular review with reports to Cabinet on status.	LBC	Med	G
28	AIF	Making strategic decisions on asset realisation at a time of uncertainty may impact value and therefore disposals in the immediate term are currently unlikely to realise best value. We believe the best course of action at present is to seek to maximise returns on the existing investments and undertake annual strategic reviews of the AIF to assess if/when disposals will result in best value.	LBC	Med	G
29	AIF	If LBC needs to release cash to mitigate financial pressures in year, the AIF does represent significant potential for unlocking cash. Assess if there is a need for cash. If there is, then undertake a more detailed review of each asset for suitability to meet this need. This could include a detailed valuation exercise.	LBC	High	A

Appendices

Section eight

8

Scope and process

Scope	Process
Purpose	The report was produced for LBC only and is a confidential document.
Access to management	In general, we have had reasonable access to LBC staff and directors, the Board and staff of BBB, personnel linked to the CAH group, RIF and AIF.
Management representation	We have shown sections of this draft report (excluding section 3 - strategic options), plus supporting appendices to: BBB's CEO (sections related to BBB), the former LBC Section 151 officer (historical pages only); a Trustee of CAH LLP and the Head of Asset Management and Estates (the AIF and RIF sections). They have confirmed that, to the best of their knowledge and belief, the report does not contain any material error of fact, there has been no material omission and it fairly sets out the recent results, state of affairs and (where relevant prospects of the subjects of this review. To the extent that we consider appropriate, we have incorporated their comments in this report.
Access to information	Our work has comprised a review and analysis of the financial and other information provided to us by LBC, BBB, the Trustee of Croydon Affordable Housing LLP and other individuals, plus discussions with individuals related to each of the entities that form the subject of our report. We have assumed that this information and management's explanations and representations are complete, accurate and reliable. The quality and availability of financial information available from BBB has impacted the level of detail we have been able to provide in our strategic options analysis. Further work would be required to deliver more detailed modelling of the proposed options.
Clarity of information	The information provided to us, together with our access to management, has allowed us to gain insight and understanding into some of the more significant risks, trends and issues faced by each of the entities.
Review process	Our work was performed over a 4 week period commencing 5 October 2020. We had access to LBC officers. We also had access to the CEO, BBB and the BBB senior management team and other staff.
Exclusions from scope	LBC should consider our recommendations in the light of its own assessment of the security position. We point out that the scope of our work did not include a detailed review of the Croydon Housing market BBBs competitive position in this markets. Furthermore, our work did not include a review of any of the entities tax affairs or its pension arrangements.
Financial projections and short-term cash flow forecast: Prospective Financial Information ("PFI")	Any underlying PFI referred to in this report was not prepared or developed by us and we have not restated any PFI or made assumptions or projections relating to PFI. Management has full responsibility for the judgements involved in, and results of, its PFI preparation processes. While we may have performed sensitivity analyses on PFI and underlying assumptions, any tables aggregating our comments or observations of vulnerabilities and sensitivities do not represent restatements of or revisions to PFI; they are only a summary of our analysis to assist you with your evaluation of PFI. It is your responsibility to consider our analysis and make your own decisions. As events and circumstances frequently do not occur as expected, there may be material differences between PFI and actual results and cash flows. See also our comment below re BREXIT. We take no responsibility for the achievement of predicted results.
BREXIT	Given the UK referendum result and the subsequent triggering of Article 50 there is uncertainty, which could persist for some time, as to what this may mean for businesses, whether in the UK or outside it but with trading or other connections with the UK. As a result, our work may not have identified, or reliably quantified the impact of, all such uncertainties and implications.
COVID-19	It is not possible for LBC, its subsidiaries or us to assess with any certainty the implications of COVID-19, either in terms of how long the current crisis may continue or in terms of its impact, potential or actual, on LBC or subsidiary business. For example, BBB may face significant supply issues if its supply chain includes entities in regions where the authorities have implemented, or may implement, measures to contain and/or prevent the spread of COVID-19. Similarly, demand for products and services may be significantly impacted. BBB has modified its projections to try and show a possible outcome. It has not considered the potential impact on balance sheet items (such as impairment to assets (such as fixed assets, investments, inventory, receivables), or liabilities and provisions (including potential claims)). BBB has not implemented contingency measures. We note that the potential variation between projected and actual results is likely to be materially greater than it might otherwise have been. We take no responsibility for the achievement of projected or predicted results or balances."

PwC scope and limitations

Interviews conducted

Key individuals we have interviewed:

BBB

- CEO
- Chair
- Financial Controller
- Head of Operations
- Head of Delivery
- Head of Property & Engagement,
- Head of Design
- 4x Development managers

LBC

- Interim CEO
- Director of Growth Zone
- Executive Director of place
- Executive Director of resources and monitoring officer
- Head of Asset Management and Estates
- Head of Growth Zone
- Head of Internal Audit
- Interim Director of Law & Governance
- Risk and Corporate Programme Officer
- S151 Officer and Director of Finance

Others

- External Auditors of the Council and former auditors of BBB
- Former S151 Officer at LBC
- Trustee of Croydon Affordable Housing LLP

Glossary

Our report includes a number of terms and short descriptions, which we define alongside:

Term	Definition
AR	Affordable rent
BBB	Brick by Brick Croydon Ltd
BTR	Built to rent
CAH	Croydon Affordable Homes LLP
CAT	Croydon Affordable Tenures LLP
CEO	Chief Executive Officer
CGA	Common Ground Architecture
Company	Brick by Brick Limited
Council	London Borough of Croydon
CT	Corporation tax
EBIT/ EBITDA	Earnings before interest and tax/ Earnings before interest, tax, depreciation and amortisation
EUV	Existing use value
FOT	Forecast outturn
FY19/20, FY20/21, FY21/22	Financial years ending March 2019, March 2020 and March 2021
GLA	Greater London Authority
Group	LBC's subsidiaries, Brick by Brick Ltd and Croydon Affordable Homes Ltd.
GZ	Growth Zone
HMRC	Her Majesty's Revenue & Customs
HTB	Help to buy
LBC	London Borough of Croydon Council
LLP	Limited liability partnership

Term	Definition
Ltd	Private limited company
M6	Month 6 financial period, ending 30 September 2020
MBO	Management buy out
MEIP	Market Economy Investor Principle
MTFS	Medium term financial strategy
MVL	Members voluntary liquidation
NED	Non-executive director
P&L	Statement of profit and loss
p.a.	Per annum
PAYE	Pay as you earn
PC	Practical completion
PFI	Prospective financial information
PwC	PricewaterhouseCoopers LLP
Q1, 2, 3, 4	Quarters ended/ending June, September, December, March
RIF	Revolving Investment Fund
S/O	Shared ownership
S106	Section 106 - the legal agreement between a developer seeking planning permission and the council
S125	Legal agreement between tenant and landlord when tenant is eligible for the Right to Buy to Right to Acquire
Sensitivity	The estimated illustrative financial effect of a change to a key assumption, to reflect either a vulnerability or an upside
SME	Small and medium enterprises
SWOT	Strengths, weaknesses, Opportunities, Threats
TFL	Transport for London
Tranche 1	Site developments in construction

Term	Definition
Tranche 2	Site developments with approved / submitted planning applications
TUPER	Transfer of Undertakings (Protection of Employment) Regulations
VAT	Value added tax
VFM	Value for money
Vulnerability	An unquantifiable sensitivity that may present upside or downside risk
YTD	Year to date

pwc.com