

# LONDON BOROUGH OF BARKING AND DAGENHAM

## INVESTMENT AND ACQUISITION STRATEGY 2019 TO 2024

### Barking & Dagenham



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**Appendix 1: Investment and Financial Modelling Assumptions 2019/20**

## **1. Introduction**

- 1.1 The Council's first Investment and Acquisition Strategy (IAS) was agreed by Members in November 2016 as part of the Council's response to the unprecedented challenges it faced from Government cuts to public sector spending. The strategy has been subsequently reviewed in October 2018.
- 1.2 The purpose of the IAS is to support the Borough's growth opportunities and to ensure that the Council, and future generations, benefit by increasing the Council's ownership of long-term income producing assets. It is also the intention for the strategy to be relatively low risk, with borrowing used to fund in-borough regeneration, with income generated to cover borrowing costs, debt repayment, lifecycle and management and maintenance costs.
- 1.3 The scale of investment opportunity within the Borough is significant with in excess of 50,000 new homes to be built over the next twenty years. This will be accompanied by increased demand for employment space and sustainable energy providing the Council with a key leadership and investment opportunity.
- 1.4 The IAS provides the Council with the ability to make investments that have the potential to support economic growth and / or deliver economic regeneration within the borough. In some cases, schemes with lower returns may be considered for strategic reasons.
- 1.5 A four-year net interest forecast has been established by the Council within the Medium-Term Finance Strategy, which will support the IAS but also at times may act as a limiter to the Council's investment activities. The IAS will increase significantly the level of debt the Council holds as well as the amount of interest the Council pays over the coming years.
- 1.6 To ensure that the level of borrowing is sustainable, the Council will invest in schemes that provide a positive return after all costs and will ensure that it invests in a number of different asset classes and assets with different cash flows requirements.
- 1.7 It is inevitable that the IAS will change over time as schemes are accelerated, delayed, amended or removed. In addition, new investment opportunities to support both the IAS and the wider Council objectives and funding requirements will be considered. Each investment will be agreed and monitored by an Investment Panel, which is chaired by the Council's Chief Operating Officer.
- 1.8 The IAS has an income objective and a target of delivering £5.12m by 2020/21 and £5.89m in 2021/22. The IAS assets will be delivered primarily by the Council's development vehicle, Be First, and it is expected that Be First will accelerate the regeneration of the borough. It is important, however, that Be First manages the various scheme developments and puts forward investment schemes that are within the IAS budget limitations.
- 1.9 As the Council's investment portfolio grows, more regular reporting will be produced to provide Members with updates on performance and the Council's

borrowing position. It is also important to keep the investment criteria, guidelines and investment portfolio under regular review. A failure to do so could result in acquisitions and developments being made which do not reflect current market conditions and which could increase risks that operational assets under-perform relative to the market and each projects risk profile.

## **2. IAS Governance**

2.1 The Investment Panel (IP) was constituted by the Chief Operating Officer (COO) using authority delegated by the Constitution of the Council. the IP exists to advise the COO on the implementation of the IAS by appraising individual investment decisions and development schemes.

The IP aims to ensure that the opportunities for the IAS undergo appropriate consideration and robust challenge, and that proposed returns are in line with the expectations set out in the IAS. The IP is comprised of representatives from core areas of the Council as members of the panel and where necessary, appropriate 3<sup>rd</sup> party expertise acting as advisors to the panel who can be called upon as the need arises.

### **2.2 Role of the IP**

The IP has a responsibility for advising the COO on the approval or otherwise of the implementation of the IAS and the schemes/development opportunities detailed therein. In particular, it is expected that the IP will exercise its expertise to advise the COO on the appropriateness of the investment opportunity, specifically:

- i. the appropriate sources of funding for each development proposal;
- ii. any significant risks or implications arising from the approval or otherwise of schemes;
- iii. the impact of the approval or otherwise of schemes on Council resources, assets, or ability of the Council to provide key services;
- iv. any subject specific papers or questions, as requested by the COO; and
- v. ongoing monitoring of investments delivered under the IAS, or as requested by the COO.

Other opportunities for investment may be presented to the Council which are not listed in the IAS. In those instances, it is the role of the IP to consider and where necessary challenge the detail of such opportunities for investment and make a recommendation on the viability of those schemes to the COO for their consideration.

The COO may then choose to present the recommendation of the IP to the appropriate forum for formal approval, or where delegation exists outside of the current IAS, exercise their authority in respect of the proposed scheme.

It is the responsibility of the IP to monitor the expected and actual financial returns from schemes on a regular basis, to ensure that those schemes are in line with the expectations set out in the IAS, the MTFS, or previously agreed returns (if the scheme does not currently feature in either document).

Any significant delays or alterations to schemes which may impact the expected financial return to the Council will be brought to the attention of the IP.

Where a planned or unplanned change has or will need to take place relating to a scheme which has yet to be delivered but has already been approved by the IP, that scheme must be considered for a return to the IP for further approval if:

- i. the total variance is greater than £1m, or 5% of current total scheme cost - whichever is smaller;
- ii. the change will impact the expected financial return to the proposal as agreed at Investment Panel;
- iii. the change could result in the reputational risk to the Council;
- iv. the change represents a significant deviation to the proposal agreed at Investment Panel (10% variance of any metric) or represents a fundamental change to the structural makeup of the building or its intended uses; and
- v. the change will result in a significant slippage in the estimated delivery of the scheme (three months or greater from the date originally agreed).

The details of such a change should be summarised in a change control form and submitted to the COO. The COO will decide if the threshold has been met for reconsideration by IP (in consultation with members of the IP, or if necessary, by way of a virtual IP) and if so, the format such reconsideration should be presented in. These forms will be retained by the Council along with minutes of the discussion and the advice provided to the COO for IP.

### 3. Council's Control Approach

- 3.1 Prior to any investment decision, investment proposals need to go through a number of Gateways, including 6 project stages and 6 control points; the system covers the full project Lifecycle; from inception to completion and operation.
- 3.2 The system provides a proportionate level of project appraisal and assurance to the scale and risk associated with projects and with Be First's overall portfolio.
- 3.3 It is comprised of two types of control point:
- Gateway – a strategic decision to proceed with an investment;
  - Milestone – a reporting point to validate outcomes.
- 3.4 Scrutiny at each control point will include consideration of the following:
1. **Financial Value** – a project's Investment Value (Return on Investment), Be First revenue potential and new income for the borough (council tax etc.).
  2. **Deliverability** - a project's buildability, risks, ability to achieve planning, dependencies and required resourcing.
  3. **Social & Regeneration Value** – the likely contribution of a project to Be First contractual objectives and KPIs including wider regeneration impact.
- 3.5 A project must gain approval at each point before moving forward to the next stage. There are various approval bodies depending upon the control point.
- 3.6 The system is supported by a set of common tools and templates which are to be used throughout the project lifecycle. These tools include;
- Site Viability Appraisal
  - Project Programme
  - Risk Register.
  - Gateway Assurance Checklist
  - Construction Monitoring; and
  - Planning Monitoring
- 3.7 These tools ensure each project follows and achieves the Council's high-quality standards and presents information in a standardised way which allows effective portfolio monitoring.
- 3.8 As outlined in section 2, the IP will discuss and agree investments. The IP does not have to agree all investments. Some investments are rejected, and some are agreed but do not progress. Most new investments agreed by IP will still need to be agreed by Cabinet.

## 4. Investment Objectives

### 4.1 Strategic Objectives

The purpose of the strategy is to enable the delivery of the following key investment aims:

- To unlock regeneration and economic growth opportunities within the borough; and
- To establish a property portfolio to generate long-term revenue and capital growth, targeting an initial revenue return of £5.125m by 20/21.

### 4.2 Return Objectives

The allocation of investment funds will be guided by the following investment objectives. These objectives frame the evaluation, management and monitoring of all investment and funding opportunities considered by the Council.

- **Security:** ability of assets to hold and increase their capital value in line with inflation;
- **Liquidity:** ability of invested funds to be realised through the sale or refinancing of the asset reflecting the illiquid nature of direct property ownership; and
- **Yield:** ability of assets to generate positive Net Operating Income and positive net returns after debt service within market normative ranges.

### 4.3 Risk Management Objectives

The real estate portfolio will be managed over the long-term to achieve the following goals:

- a) Maintain an appropriate level of investment diversification across the following key factors:
  - (i). investment strategy for each asset class;
  - (ii). asset class diversification;
  - (iii). investment lifecycle; and
  - (iv). development period and stabilisation period risks.
- b) Work toward and maintain an appropriate level of leverage once assets are developed and stabilised. Consideration shall be given to the impact of third-party debt financing obligations and guarantees for the risk and return characteristics of levered assets.

## 5. The Council's Borrowing Strategy

- 5.1 All borrowing decisions to support the IAS are taken by the COO under delegated powers of the Council's constitution and after consultation with the Investment Fund Manager and the Director of Finance. The borrowing restrictions are reviewed each year and are included in the Treasury Management Strategy Statement (TMSS).
- 5.2 The borrowing limits set as part of the 2019/20 TMSS are £1.0bn for the Operational Boundary Limit and £1.1bn for the Authorised Borrowing Limit, representing the statutory limit determined by the Council pursuant to section 3(1) of the Local Government Act 2003. The borrowing includes IAS borrowing and wider Council capital borrowing.
- 5.3 The key objective of the Council's borrowing strategy is to secure long term funding at rates that match or are below the target borrowing rate. The Council's strategy also seeks to reduce the cost of carry to within budget limits. Currently the Council has a holistic approach to borrowing, taking into account cashflows, borrowing costs and investment returns to reduce the cost of carry. The Council will incur cost of carry costs while funding developments as income is only generated when the schemes are operational or if an income generating asset is purchased.
- 5.4 The Council can borrow funds from the Public Works Loans Board (PWLB), from capital markets, from bond issuance and from other local authorities. The Council would look to borrow for several purposes, including:
- (i) *Short term temporary* borrowing for day to day cash flow purposes.
  - (ii) *Medium term borrowing* to cover construction and development costs.
  - (iii) *Long term borrowing* to finance the capital and IAS programme.
- 5.5 Funding the IAS will require a significant amount of borrowing over the next four years and is in addition to borrowing already taken for current operational schemes. The COO and treasury section will monitor interest rates and, where possible, make borrowing decisions when rates are low, while taking into account the Council's debt repayment profile and cashflow requirements. The Council's borrowing strategy will give consideration to the following when deciding to take-up new loans:
- Use internal cash balances;
  - Using PWLB, the EIB or Local Authorities for fixed term loans;
  - Using Institutional investors (Pension Funds and Insurance Companies);
  - Ensure new borrowings are drawn at suitable rates and periods; and
  - Consider the issue of stocks and bonds if appropriate.
- 5.7 Although the borrowing is long-term, a part of the Council's debt is repaid each year through either an annuity repayment or equal instalment repayment. As a result, the Council's debt repayment profile is relatively smooth. Future borrowing will be mapped against this repayment profile and the forecast cashflows to help refinancing risk but also allow a steady reduction in the Council's debt exposure.



## 6. Funding the IAS (Proportionality)

- 6.1 As the Council starts to depend on profit generating investment activity to achieve a balanced revenue budget, an assessment of its dependence on profit generating investments and borrowing capacity allocated to funding these, is considered against the lifecycle of the Medium-Term Financial Plan.
- 6.2 A four-year net interest forecast has been established by the Council within the Medium-Term Finance Strategy (MTFS), which will support the Council's investments but also at times may act as a limiter to its investment activities. To ensure that the level of borrowing is sustainable, the Council will invest in schemes that provide a positive return after all costs and will also ensure that it invests in a number of different asset classes and assets with different cash flows requirements.
- 6.3 Table 1 summarise the current net income arising from the IAS and the interest requirement to support the strategy. The net interest requirement does increase from £1m in 2019/20 to £2.2m and this reflects the cost during a significant part of the development stage. Overall the IAS is expected to outperform the net investment cost and to provide significant surpluses in 2023/24 onwards.

**Table 1: Investment and Acquisitions Forecast 2019/20 to 2022/23**

MTFS Budget	2019/20	2020/21	2021/22	2022/23
	Forecast	Forecast	Forecast	Forecast
	£'000s	£'000s	£'000s	£'000s
General Fund Interest Payable	12,500	15,600	21,071	24,513
Interest Receivable	-7,674	-8,374	-13,395	-16,387
<b>Net Interest Required</b>	<b>4,826</b>	<b>7,226</b>	<b>7,676</b>	<b>8,126</b>
<b>Investment Income</b>	<b>-3,733</b>	<b>-5,125</b>	<b>-5,891</b>	<b>-5,891</b>
<b>Net Cost</b>	<b>1,093</b>	<b>2,101</b>	<b>1,785</b>	<b>2,235</b>

- 6.4 It must be highlighted that there is much greater certainty over the interest payable requirement, with a borrowing strategy in place to fund schemes and therefore the level of the interest payable is very likely to be achieved. There is greater uncertainty over the Interest Receivable and Investment Income targets but there is also the greater potential to outperform the current forecasts.
- 6.5 The IAS provides a framework for the investment restrictions for any given year. Pressure on the investment budget could be from a:
- i. delay in developments becoming operational, which delays investment income and interest receivable;
  - ii. significant increase in borrowing requiring more interest payable than forecast;
  - iii. A significant drop in treasury returns either through lower returns or lower investible cash balances; and
  - iv. The proportion of assets bringing in income being lower than expected or the proportion of assets that require development finance being higher than expected.

6.6 Although the Council will increase its debt, it will also increase its asset base and will receive income from its investments. In the event that there is a significant downturn in the housing market then the Council's strategy will come under pressure, either from a reduction in income from rental or from a reduction in asset values. To reduce these risks the Council has a number of approaches.

- i) Each investment includes a profit margin based on normal market conditions. If rental is reduced, then profit will reduce but the interest and debt repayment obligations will still be met. This will place pressure on the MTFs and to minimise this pressure a reserve has been established to smooth out cashflows.
- ii) If conditions deteriorate to a level that profit is wiped out and there is insufficient income to cover debt and borrowing positions, then adjustments can be made to the level of return that is set aside to meet the debt repayment. This is because some of the Council's borrowing only needs to be paid back at maturity (some loans have maturities of up to 50 years) but currently debt repayment provision is still made to repay the debt (i.e. each year money is set aside to repay the debt even though the debt is repaid at maturity). This is not the case for all the Council's debt, but it is a portion and provide a buffer to manage potential issues.
- iii) The Council, in more extreme cases, can reduce its investment activity and focus on the more profitable assets and/ or sell or refinance assets.

6.7 Most of the increase in General Fund interest payable shown in table 1 is to fund the Be First Business Plan, which was agreed by Cabinet on 21 May 2019, a summary of the development requirements, the Be First Total Annual Return and units built are provided in table 2 below.

**Table 2: Be First Business Plan Summary 2019/20 to 2022/23**

<b>Year</b>	<b>Development Requirements</b>	<b>Be First Total Annual Return</b>	
	<b>£000s</b>	<b>£000s</b>	<b>Units</b>
2019/20	79,794	5,622	112
2020/21	220,325	10,835	208
2021/22	216,504	11,070	790
2022/23	148,695	10,710	823
<b>Total</b>	<b>665,318</b>	<b>38,237</b>	<b>1,933</b>

6.8 The funding requirements of Be First are significant and will require the Council to borrow and additional £300m of long-term debt over the next four year. The amount required to borrow is lower than the Be First borrowing requirement in table 2 above as the Council, as at 31 March 2019, already borrowed £220m of this requirement.

6.9 In delivering its plan, Be First will work closely with the Council, Reside and My Place, drawing on the Growth Commission Stocktake published in 2016 and the progress review due to be published soon. A key part of this will be the publication of the draft Local Plan for consultation later this year.

## 7. Ownership of Investment Funding

7.1 Investment assets will be financed and owned by the Council directly, indirectly or through the provision of loan finance and/or guarantees to development and ownership entities. Ownership structures will reflect the regeneration and commercial purposes of investments and will be held in the most tax efficient structure(s) consistent with Local Authority powers as follows:

- Directly held investment assets (e.g. commercial property):  
*Direct General Fund borrowing through the PWLB, institutional funders or bonds as may be most advantageous from time to time.*
- Investment assets held by wholly owned vehicles (e.g. Reside vehicles and BSF joint venture company):  
*Debt finance provided by the Council to project entities; project finance provided by third party funders and co-investment between the Council and third-party investors. Funds may be provided as senior debt, junior debt or equity dependent on the requirements and commercial arrangements of schemes*
- Investment assets owned by Joint Ventures vehicles (e.g. co-investment development vehicles):  
*Debt finance provided by the Council to project entities; project finance provided by third party funders and co-investment between the Council and third-party investors. [Funds may be provided as senior debt, junior debt or equity dependent on the requirements and commercial arrangements of schemes.]*
- Equity and debt financing (e.g. development period loans to private developers and Be First):  
*Funded by direct General Fund borrowing, and on-lending on commercial terms, through the PWLB, institutional funders or bonds as may be most advantageous from time to time. Financing may be provided as senior debt, junior debt or equity dependent on the requirements and commercial arrangements of schemes.*
- Credit enhancement (e.g. provision of Council performance guarantees):  
*The Council may also provide credit enhancement through the provision of development and operational guarantees where this secures efficient finance for projects funded with third party debt.*
- Lease and Lease Back Funding:  
*Forward funding deals where the Council provides a guaranteed income stream to a funder, usually a pension fund, while subleasing the building to an operator. The Council commits to the development by agreeing to take possession, on practical completion being achieved, tied into a long lease for usually between 35 and 50 years on a non-assignable basis. Rents are fixed and subject to annual increases linked to RPI, often with a cap and collar arrangement.*

## **8. Investment Assets**

### **8.1 Eligible Assets**

The acquisition and development of financial and non-financial assets held to generate income and capital growth not held as part of normal treasury management. This includes:

- real estate assets, including residential, commercial and industrial
- loan debt, with the option for equity, provided to wholly owned companies
- ownership and financial interests in joint venture partnerships and loans to third-party entities where this supports the key investment objectives

### **8.2 Geographical Investment Parameters**

The focus of investment activities will primarily be to support the regeneration of Barking and Dagenham. Where investment opportunities arise outside of the borough these will be considered on a case by case basis where they are clearly linked to the direct achievement of Council regeneration objectives.

### **8.3 Investment Selection and Monitoring**

Investment schemes proposed to the Council will be required to satisfactorily meet the following investment criteria as appropriate to the assessment of each scheme. Asset selection should be guided by the Prudent Expert standard in the areas of acquisitions, development, operations, disposals and portfolio management.

### **8.4 Strategies**

The real estate investment portfolio will be diversified across property types appropriate for each eligible asset class. The strategy for each asset class will be consistent with institutional investment in real estate including:

- a) Property type diversification with asset classes
- b) Location and connectivity
- c) Design quality to maximise and retain asset value
- d) Tenancy and leasing occupation levels
- e) Return requirements: income return emphasis

### **8.5 Investment Life Cycle**

Considering that the investment portfolio is in the early stages of being created the medium-term aim is to limit development exposure to 30% of the market value of operational schemes.

## 9. Asset Classes and Investment Returns

9.1 The IAS investment pipeline consists of a number of difference asset classes, including residential, commercial, commercial loans and lease and lease back. A breakdown of each asset class, the various investments that fall under the asset class, the current gross cost and its completion date is provided below.

### 9.2 Residential Investments

Most of the current residential schemes were part of the original 44 schemes agreed by Members in 2016. These schemes formed the basis around the original Be First business plan. Over time the number of schemes has reduced and a number of them have changed significantly. The current pipeline of schemes, number of units, net cost after grants and sales and target date for completion is provided in table 3 and are based on the Current Be First Business Plan (2019/20) and other Council investments:

**Table 3: Pipeline of Residential Investment Schemes**

<b>Scheme</b>	<b>Units</b>	<b>Long-term Borrowing Requirement £000s</b>	<b>Target Date</b>
Weighbridge Modular	92	10,716	Nov-19
Wivenhoe Modular	20	2,853	Dec-19
Becontree Heath	87	18,328	Apr-20
Melish Close & Sugden Way	19	4,886	Apr-20
Limbourne Avenue	26	4,845	Aug-20
Margaret Bondfield	16	2,993	Aug-20
A House for Artists	12	3,036	Sep-20
Sacred Heart	29	8,672	Sep-20
Becontree Avenue 200	19	6,416	Dec-20
Sebastian Court	95	15,450	Apr-21
Gascoigne East Phase 2	526	55,792	Sep-21
Crown House	169	39,532	Dec-21
Gascoigne West P1	210	44,314	Jul-22
12 Thames Road	150	49,793	Aug-22
Gascoigne East Phase 3	250	31,257	Dec-22
Marks Gate Phase 1	150	13,586	Dec-22
Woodward Road	63	14,308	Dec-22
Stour Road 90	290	28,516	Jun-23
Oxlow Lane	60	10,763	Dec-23
Rainham Road South	64	10,363	Dec-23
Roxwell Road	82	14,295	Dec-23
Royal British Legion	56	13,402	Dec-23
Gascoigne West Phase 2	471	31,979	Dec-23
<b>Post 19-24 Business Plan</b>			
Marks Gate P2	288	14,746	Jul-25
Gascoigne West Phase 3	248	56,582	Aug-26
Marks Gate P3	288	15,422	Jul-27
<b>Total</b>	<b>3,761</b>	<b>522,845</b>	

- 9.3 Residential investments include a number of sectors, namely Social and Affordable Rent, Shared Ownership, Market Rent and Market Sale. Each scheme will include a mix of these sectors and it is the role of the IP, in consultation with Be First and Reside, to ensure that the correct mix is agreed and built. Each scheme needs to meet a number of minimum criteria, including:
- i. Operational Surplus at year 1 and year 6 (year 6 is when all costs, including debt, interest, management and maintenance and life cycle costs are incurred).
  - ii. A yield on cost of at least 4.0%.
  - iii. A positive net present value based on a discount rate of 5.0%.

The minimum return criteria is produced after a financial appraisal and needs to be met at each Gateway for a scheme to be agreed. It is therefore essential that the assumptions included in any appraisal are consistent, prudent and regularly reviewed. The assumptions used in the financial models are included as appendix 1 of the IAS. These will be reviewed at least annually and will be agreed by Cabinet, the Reside Board and the Be First Board.

- 9.4 As all the residential schemes are development schemes, there is a significant cost of borrowing incurred by the Council. It is therefore essential that the development programme includes a mix of larger schemes, which normally have fairly lengthy development periods, with smaller schemes that can become operational sooner. It is only when a scheme is operational that income is received by the Council and this income will cover interest costs, debt repayment and provide the Council with a return.

## 9.5 Commercial Investments

The Council's commercial investments are split into four different elements, including Commercial Activity, Commercial Lending, Lease and lease back; and Energy Company. Be First have requested that the Commercial Activity and Commercial Lending budgets are combined into one Commercial Investments budget to, which totals £322.2m. Combining the budgets will allow Be First greater flexibility to move between different types of commercial investments.

### 9.5.1 **Commercial Activity**

A budget of £122.2m has been set established by the Council to fund commercial investments, which are predominantly identified by Be First. The £122.2m includes £15m to purchase Welbeck Wharf and £7.2m to build the Dagenham East Travelodge (£7.2m). Commercial schemes are predominantly identified by Be First.

Be First will identify investment opportunities and bring these to IP then Cabinet for agreement. Currently one scheme, Welbeck Wharf, has been purchased, and one, Travelodge, is under construction. Table 4 provides a summary of commercial lending activities included in the Be First Business Plan and the remaining commercial budget agreed by Cabinet.

**Table 4: Commercial Activity**

<b>Development Project</b>	<b>Agreed £000s</b>	<b>Potential Funding Required £000s</b>
<b>Commercial Budget</b>	<b>122,200</b>	<b>122,200</b>
Travelodge	-7,166	-7,000
Welbeck	-17,765	-37,000
Unite Building	-	-1,500
<b>Remaining Commercial Budget</b>	<b>97,269</b>	<b>76,700</b>

9.5.2 The commercial investments will need to meet a net yields criterion, which is based on a blend of yields from CBRE and Knight Franks. Net return is net of all costs, including:

- Borrowing costs (interest and debt repayment);
- Stamp Duty;
- Agent and Legal Fees;
- Planning Costs;
- Management and Maintenance Costs;
- Letting Fees; and
- Any other costs associated with each proposal.

All costs should be fully disclosed and prudently included in the any supporting financial appraisal calculation.

The net yield after all costs, assuming interest costs at 3.25% and debt repayment for the various commercial sectors are:

1.5%	Offices (good secondary)
4.0%	Retail (Good Secondary)
1.0%	Industrial (Good Secondary)
1.0%	Hotel and Leisure

### 9.5.3 Commercial Lending

In order to progress stalled private developments, it is possible for the Council to provide financing to a developer. Commercial lending gives the Council greater control to ensure the development is completed within the proposed timescale alongside a short-term revenue return on its investment. Table 5 summarises the agreed schemes and two options included in the Be First Business Plan.

**Table 5: Commercial Lending**

<b>Development Project</b>	<b>Agreed £000s</b>	<b>Funding Required £000s</b>
Commercial Lending Budget	200,000	200,000
London Road	-35,000	-35,000
Axe Street	-28,000	-28,000
Option 1 &2	-	-25,000
<b>Remaining Commercial Budget</b>	<b>137,000</b>	<b>112,000</b>

Prior to any Commercial Lending proposal expert external advice will be obtained and will cover the following key areas of commercial loan underwriting:

- i. Commercial lending due diligence: key commercial, legal and accounting information requirements;
- ii. Interest rate setting process: process to determine commercially appropriate contract interest rate reflecting borrower, project and market risks;
- iii. Loan agreement;
- iv. Security; and
- v. Risk Management;

#### 9.5.4 ***Lease and Lease Back***

Previously, Cabinet have agreed to invest in two Lease and Lease back arrangements subject to finalisation of due diligence. These deals involve a lease and lease back arrangement with an Institutional Investor as the long leaseholder, the Council as the intermediate lessee and a hotel or aparthotel operator as tenant.

In these deals the Council is contractually required to enter into the Head lease and commence obligations with the Institutional Investor including paying the rent payments.

The lease agreements are usually between 35 years and 50 years, with rent subject to 5-year rent reviews and usually have a cap and collar arrangements to keep the rental increases within a set margin.

These deals will be agreed on an adhoc basis as and when they arise, with each deal having its own unique set of requirements and cashflows. The current deals have not been provided by Be First. Prior to each deal due diligence will be undertaken, covering:

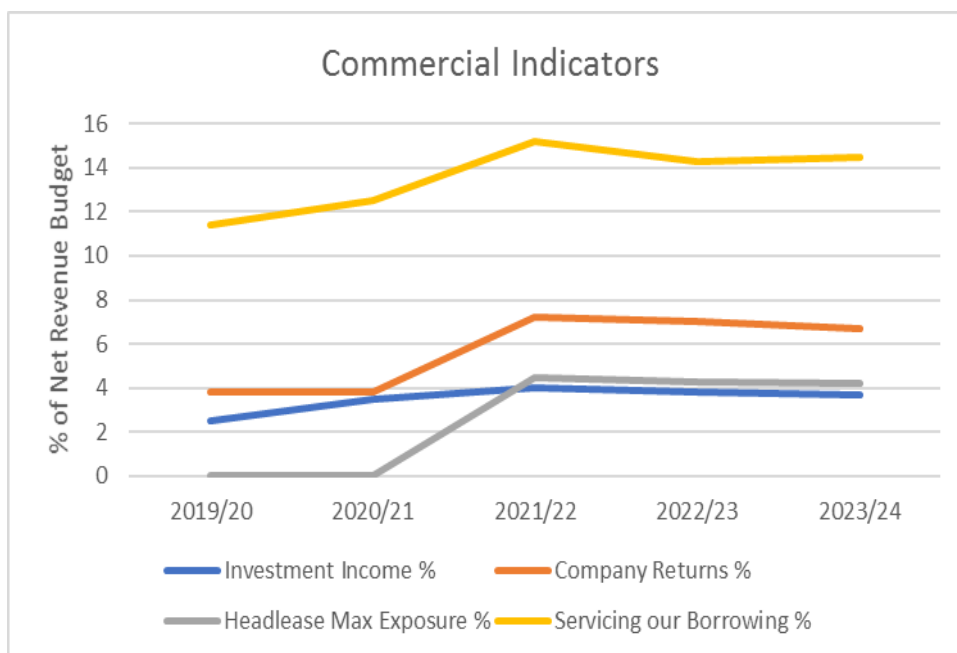
- transaction documents;
- asset management, construction and development aspects of the transaction; and
- financial advice on the transaction including cash flows.

The Council will seek to mitigate against commercial risk by creating an investment risk reserve, which will be proportionate to the extent of risk and possible loss on returns or head lease arrangements. Each Lease and Lease back arrangement will seek to help grow business rates for business rates pool, help with jobs within the area and support inclusive growth.



## 10. IAS Indicators

- 10.1 In recent years, and in responding to government funding reductions, some authorities have sought to replace lost revenues by taking a more commercial approach defined as “undertaking activities which involve risk with the expectation of generating additional income or capital gain.”
- 10.2 As a result, there has been some concern nationally by government over the extent to which councils are taking long term risks and whether the extent of commercial activity is proportionate. In response, the government revised its guidance to local authorities on investments in early 2018.
- 10.3 Concerns over local authorities’ extent of borrowing in advance of need to invest into property for commercial gain has prompted a National Audit Office inquiry into local government practice.
- 10.4 The Council understands these concerns and recognises the need to put in place additional controls and indicators that complement the existing prudential indicators contained with the TMSS and reported in the IAS going forward. These provide extra safeguards and inform the extent of stress on the revenue budget. These new metrics will be factored into a revised TMSS and are intended to support an overall judgement on the balance of risks, they include:
- The proportionality test of how much commercial income the Council receives from IAS in relation to other income;
  - The maximum risk exposure arising from lease and lease back deals;
  - The cost of servicing borrowing levels. This includes the Minimum Revenue Provision and interest payable for the debt in relation to general fund activity.
- 10.5 The current trajectory of the Council’s commercial activities, including company returns, investment income, head lease exposure (lease and leaseback) and borrowing costs; suggests the impact on the revenue budget as shown in the chart below. The biggest impact is the overall level of borrowing, which is expected to peak at 15% in 2021/22:



10.6 To mitigate against commercial risk, the council will be creating a new investment risk reserve, which will be proportionate to the extent of risk and possible loss on returns or head lease arrangements.

10.7 In addition, to further understand the extent of borrowing in relation to revenue budget, the non HRA Capital Financing Requirement is shown below:

<b>Non HRA</b>	<b>2019/20</b>	<b>2020/21</b>	<b>2021/22</b>	<b>2022/23</b>
CFR £m	488	480	468	652
Ratio of CFR to NRE	3.3	3.2	3.1	4.4

## Appendix 1 - Investment and Financial Modelling Assumptions – 2019/20

<b>Investment and Financial Modelling Assumptions – 2019/20</b>			
<b>Category</b>	<b>Current Metric Agreed</b>	<b>Date and source of current metric</b>	<b>Comments</b>
Council short-term Interest rate	1.5%	LBBB Finance Q1 – 2019	
Council long-term interest rate	3.0% for current schemes 3.25% for new schemes, commercial and commercial loans	LBBB Finance Q1 – 2019	
Market interest rate	6.0%	31ten Industry Standard	Updated value to be provided by third party
SDLT	4%		
MRP Repayment Period	50 years	LBBB Finance Q1 – 2019	2 years stabilisation at the commencement where MRP isn't charged
MRP Start Date	Year 2	LBBB Finance Q1 – 2019	
Cashflow Period	50 years	LBBB Finance Q1 – 2019	
Cashflow Period for TA schemes	40 years	LBBB Finance Q1 – 2019	
Cost inflation (development)	3.5%	BCIS and CPI Q1 2019	
Cost inflation (operational – management, repairs and maintenance)	19/20 - 1.9% 20/21 to 22/23 - 2.1% 2023/24 onwards 2%	CPI Q1 2019	Unit costs for Reside need to include VAT
Income inflation	CPI for 80% rents CPI+1% up to and including 1st April 2024 and then CPI thereafter for 65% and 50% rents (and any social rent).  Peppercorn rent for Community facilities	CPI Q1 2019	
Housing Price Inflation (above standard inflation)	Scheme specific based on valuer input. Most schemes assume 0% as conservative position.	LBBB Finance and external advisor Q1 – 2019	Updated value to be provided by third party
Initial Equity Tranche	30%	LBBB Finance and external advisor Q1 – 2019	
Rent on unsold equity	2.75% Share Ownership, lets base on a CPI + 1%	LBBB Finance and external advisor Q1 – 2019	No change

Staircasing	1.5% p.a.	LBBB Finance and external advisor Q1 – 2019	Update to a more gradual staircasing up to 60%
Unsold equity at end of appraisal term	20% assumed unsold equity at year 50	LBBB (Andrew Sivess & external advisors) Q4 2018	
Year 1 Surplus/Deficit	Year 1 positive	LBBB Finance Q1 – 2019	
Year 6 Surplus/Deficit	Year 6 positive	LBBB Finance Q1 – 2019	
IRR – Private Sale	15%	LBBB Finance Q1 – 2019	
IRR – Private Rent	7%	LBBB Finance Q1 – 2019	
IRR – Shared Ownership	7%	LBBB Finance Q1 – 2019	
IRR – Affordable Rent	6.1%	LBBB Finance Q1 – 2019	
IRR – London Affordable Rent	5%	LBBB Finance Q1 – 2019	
IRR – Extra Care Private	7%	LBBB Finance Q1 – 2019	
IRR – Extra Care Affordable	6.1%	LBBB Finance Q1 – 2019	
IRR – Student Private	7%	LBBB Finance Q1 – 2019	
IRR – Student Affordable	6.1%	LBBB Finance Q1 – 2019	
Yield on Cost	4%	LBBB Finance Q1 – 2019	
Profit on Cost Private	15%	LBBB Finance Q1 – 2019	
Profit on Cost Affordable	5%	LBBB Finance Q1 – 2019	
NPV Discount Rate	5.0%	LBBB Finance Q1 – 2019	
New Homes Bonus Rate	£1,200 per unit per year blended rate	LBBB Finance Q1 – 2019	
Council Tax Rate	£1,200 per unit per year blended rate	LBBB Finance Q1 – 2019	
Management and Maintenance costs	£1,528 per unit per year for all affordable rent stock Private and SO full repairing leases and service chargeable	LBBB Finance Q1 – 2019	MyPlace cost to be benchmarked and costs to be split into component parts.
Voids	1.5% of rent	LBBB Finance Q1 – 2019	Suggested no change
Bad debt	1.5% of rent	LBBB Finance Q1 – 2019	Suggested no change
Lifecycle costs	£1,440 per unit per year from YR5 after PC.	LBBB Finance Q1 – 2019	Work to be carried out to smooth the payments across

			the full life of the asset
Service charge as income	£20-£25 per unit per week for private and SO tenure. No service charge income for affordable rental tenure	LBBB Finance Q1 – 2019	To be reviewed
B&D Energy Charges	£260 unit per year	B&D Energy	
Reside Operational unit costs	£395 currently	Reside	