Appendix 3

Capital Strategy 2019/20

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019-20, all local authorities to prepare an additional report, a capital strategy report, which will provide the following:

- a high-level long-term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed; and
- the implications for future financial sustainability.

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

This capital strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy includes the following and is outlined in the Council's Investment and Acquisition Strategy:

i. The corporate governance arrangements;
ii. Investment Objectives;
iii. Investment Policy; and
iv. The risks associated with each activity.

Where a physical asset is being bought, details of market research, advisers used, (and their monitoring), ongoing costs and investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash.

Where the Council has borrowed to fund any non-treasury investment, there should also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

If any non-treasury investment sustains a loss during the final accounts and audit process, the strategy and revenue implications will be reported through the same procedure as the capital strategy.

To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this report.

In addition to the Investment and Acquisitions Strategy, the Council's Minimum Revenue Provision Policy (MRP) includes the debt repayment policy the Council uses for its investments. The Council also has a borrowing strategy, which includes the debt repayment profile, the interest costs and outlines the various types of borrowing the Council has used for its investment strategy.

Investment and Acquisition Strategy

2018 to 2023

Contents

1. Introduction

1.1. The Council is facing unprecedented challenges and opportunities. The population of the borough is expected to increase to 220,000 by 2020 and rise further to 275,000 by 2037. Demand for Council services is increasing but budgets will fall leaving a cumulative shortfall of £63m by 2020.

1.2. However, the Borough's growth potential provides the opportunity to invest in Barking and Dagenham's future, supporting growth whilst generating a long-term financial return to support Council activities.

1.3. The scale of investment opportunity is immense. In excess of 50,000 new homes will 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. This paper updates the investment strategy approved by Cabinet in November 2017. The new strategy refreshes the eligible asset classes and sets out the framework for making investment decisions. The revised strategy reflects Government guidance on local authority investment activity.

2. Investment Objectives

2.1. 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
- To establish a property portfolio to generate long-term revenue and capital growth, targeting an initial revenue return of £5.2m by 20/21 and indexed at CPI thereafter

2.2. 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 to be realised through the sale or refinancing of the asset reflecting the illiquid nature of direct property ownership
- Yield: ability of assets to generate positive Net Operating Income and positive net returns after debt service within [market normative ranges]

2.3. 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 life-cycle;

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.

3. Investment Policy

3.1 Funding the Investment Strategy

The Council has currently acknowledged that to support the creation of the investment portfolio would require gross funding of £2.2bn (a net requirement of £0.85bn after sales and grant is taken into account). The level and sources of borrowing will be reviewed periodically. Borrowing levels will be adjusted to manage corporate borrowing constraints and where alternative sources of finance provides better investment outcomes.

3.2 Ownership of Investment Funding

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:

- <u>Directly held investment assets</u> (e.g. commercial property):

  Direct General Fund borrowing through the PWLB, institutional funders or bonds as may be most advantageous from time to time.

- <u>Investment assets held by wholly owned</u> 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.

3.3 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
- equity and loan debt 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

3.4 Asset classes

Investments will made into the following asset classes. Investments will be expected to make the level of returns set out below, noting that these benchmark returns will be periodically reviewed.

Asset class	Sector	Target Portfolio structure	Target Allocation £m's	Gross yield (income)	Net yield before debt (3.00%)	Net yield after debt
Residential	Social & Affordable Rent	56%	560	5 to 6%	3.75% to 4.5%	0.75% to 1.5%
	Shared Ownership			2.75%	2.75%	2.75%
	Market Rent (secondary)			6%	4.50%	1.50%
	Market Sale	10%	100	20% profit of GDV or 25% profit on TSC (assuming 100% debt funding)		
Commercial	Offices (good secondary)	10%	100	6.50%	4.88%	1.88%
	Retail (good secondary)			9.50%	7.13%	4.13%
	Industrial (Good secondary)			5.50%	4.13%	1.13%
	Student & Creative Arts			TBC	TBC	TBC
	Hotel & Leisure			4.85%	3.64%	0.64%
Infrastructure	Energy	3%	33	c6.5% IRR		
	Infrastructure					
Commercial Lending	Debt	20%	200	case by case basis		
Total		**100%**	**993**			

Yields from CBRE July market analysis except Shared Ownership and Infrastructure

3.5 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.

3.6 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.

Indicator	Purpose	Definition	Assessment
Acquisition and Development efficiency			
Gross initial yield	Performance against published market benchmarks	Annualised rent / property value	Comparison to data published by property consultants
Net initial yield	Efficiency of management costs as a function of design and construction	Annualised rent less non-recoverable property expenses/ property value plus purchaser's costs	Comparison with published data (assumes 25% management and maintenance costs)
Yield on Cost	Development efficiency spread to market expectations	Annualised rent/ Total Scheme Cost	Comparison to published data
Cumulative year breakeven	As above	first year that project turns cumulative cash positive and contributes positively to portfolio returns	As above
Investment Returns (long-terms financial returns)			
Net Present Value	Balance sheet value created Comparison of project efficiency	Financing period NPV and reversion NPV	Internal
IRR (project) (pre and post debt)	Economic profit and return to equity	IRR calculated	Internal
Debt underwriting for commercial loans			
Loan to Value (LTV)	Maximum level of lending commensurate with project risk profile	Loan amount/ property value	Internal
Debt Service Cover Ratio (DSCR)	Income cover over debt service liability	Net Operating Income/ Debt Service Payment	Internal
Risk analysis (project and portfolio)			
Sensitivity analysis (project & portfolio)	Key variable and impact on key investment indicators	NPV variance	Internal
Scenario analysis (project & portfolio)	Project stress testing showing impact of unexpected changes to key assumptions	Pessimistic Base (expected Optimistic	Internal

Operational Efficiency (fully stabilised and operational schemes)			
Operating Expense Ratio	Shows that operating expenses do not differ from market norms – i.e. 25% maximum or we should be managing the units	Operating expenses/ Gross Effective Income*	Internal
Break Even ratio	Ability of income to pay all expenses and debt service	(Operating expenses + debt service)/ Gross Effective Income	Internal
Net Operating Income definition	Key data to drive financial appraisal and project analysis	**Gross Rental Value** (plus other project income - ground rents etc) **= Gross Potential Income** Less voids & bad debts **= Gross Effective Income** Less operating costs (m&m costs) **= Net Operating Income**	

3.7 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

3.8 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.

3.9 Liquidity

In line with Government policy real estate assets will be structured to allow future disposals and refinancing recognising that these assets fall into the relative illiquid private real estate market requiring specialist advice to facilitate liquidation.

3.10 Leverage

Notwithstanding that most investment schemes will be financed with 100% debt; the long-term aim is to reduce <u>portfolio</u> leverage to 55% for fully stabilised assets. Higher levels of leverage will be considered for opportunistic and value-added investments on a case by case basis.

4 Reporting and Review

4.1 It is 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.

4.2 In line with Government investment guidance the investment strategy should be reported and approved by Cabinet and Council Assembly on an annual basis.

4.3 Review timetable

The Investment and Regeneration Strategy will be formally reviewed and monitored as follows as follows:

Annual review:	the investment strategy will be formally reviewed and reported to Cabinet and Council Assembly annually.
Half-yearly review:	progress in implementing the investment strategy will be reported to Cabinet every six months.

In addition, regular review of project acquisitions and investment management will be undertaken monthly by the Investment Panel and Capital & Assets Board.

4.4 Scope of Review

Each review will include assessment of the following:

a) Impact of changes in the wider economy and specific investment markets on the Council's proposed acquisition and development programme, level of expected returns and potential for realising capital growth

b) Performance of operational assets against forecast levels of return at both individual asset and portfolio levels.