Appendix 1

# LONDON BOROUGH OF BARKING AND DAGENHAM

# INVESTMENT AND ACQUISITION STRATEGY 2020 TO 2025

# Contents

## 1. Introduction

1.1 The 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 is reviewed annually.

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 over 50,000 new homes to be built within 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. The IAS enables the Council to make investments that have the potential to support economic growth and/or deliver economic regeneration within the borough. Schemes with lower returns may be considered for strategic reasons.

1.4 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 limit the Council's investment activities. The IAS will significantly increase the level of debt the Council holds as well as the amount of interest the Council pays.

1.5 A change in accounting policy to capitalise interest on the majority of the schemes during the development stage, as outlined in section 6, will improve both the IAS and the Council's financial positions but will add to the amount that needs to be repaid by each scheme. 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.

1.6 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.

1.7 The IAS has an income objective of £5.12m by 2020/21 and £5.89m in 2021/22. Developments will be delivered primarily by the Council's development vehicle, Be First, and 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.

1.8 The impact of Covid-19 on the strategy is outlined in section 5. It has affected the forecast income for 2020/21, with a number of schemes delayed and with reduced income from operational schemes. This impact has been mitigated to a degree by the reduced borrowing requirement for 2020/21 and the potential for the capitalisation of interest costs. The IAS has a reserve to cover years where net investment income is below the forecast but currently this is not expected to be utilised in 2020/21.

1.9 As the Council's investment portfolio grows it will be important to keep the investment criteria and guidelines 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 IP Chair (IPC) 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 3rd 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 IPC 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 IPC 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 IPC; and

v. ongoing monitoring of investments delivered under the IAS, or as requested by the IPC.

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 IPC for their consideration.

The IPC 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 IPC. The IPC 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 IPC 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 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 S151 Officer under delegated powers of the Council’s constitution and after consultation with the Investment Fund Manager. 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 2020/21 TMSS are £1.25bn for the Operational Boundary Limit and £1.35bn 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 fixed rate 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 hollistic approach to borrowing, taking into account cashflows, borrowing costs and investment returns to reduce the cost of carry.

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 and is in addition to borrowing already taken for current operational schemes. The S151 officer 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 Councils 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. Accounting Policy Change to Interest Costs During the Developments

6.1 The Council uses a mix of short-term and long term borrowing to fund the capital costs for the various IAS schemes. To fund this borrowing the Council has allocated an interest budget for the IAS borrowing. The interest budget includes both interests received, and interest expensed.

6.2 The Council, by opting a change to its accounting policy on interest payable, is able to capitalise interest costs against qualifying assets. A qualifying asset is an asset that takes in excess of two years to get ready for intended use and is where the forecast expenditure is in excess of £10m. Qualifying assets are therefore the majority of the IAS schemes. The Council will look to change the accounting policy to capitalise borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset, with capitalisation of interest against the qualifying asset from 2019/20.

6.3 Capitalisation of interest will start from when the asset has been agreed at Gateway 2, which is the point at which the development is initially agreed and will be on all qualifying expenditure. Where land has been purchased as part of land assembly the capitalisation of interest will be from the later date of the either the completion date of the purchase or the date of this accounting policy.

6.5 Interest will be capitalised on a quarterly basis and will be based on the weighted average of the borrowing costs that are outstanding during the period. Cessation of capitalisation will occur when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete.

6.6 Capitalising borrowing costs moves from charging the interest costs each year to the Income and Expenditure (I&E) to adding the borrowing costs to the cost to build an asset. The costs are then spread over the asset life. Therefore, any capitalised borrowing costs will have a neutral impact on the I&E, the capitalisation of the borrowing costs would increase the asset value on the balance sheet and therefore increase the Council's CFR. It would be expensed to revenue through the Authority's MRP policy.

6.7 A change in accounting policy requires that comparatives are provided unless the Code specifies particular transitional arrangements. A change in accounting policy shall be applied retrospectively by adjusting the opening balance of each affected component of net worth for the earliest period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied, except to the extent that it is impracticable to determine either the period specific effects or the cumulative effect of the change.

6.8 The impact of capitalising interest during the development stage will significantly improve the Council's ability to fund largescale developments.

## 7. Funding the IAS (Proportionality)

7.1 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.

7.2 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.

7.3 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 £0.7m 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 2020/21 to 2023/24**

| MTFS Budget | 2020/21 Forecast | 2021/22 Forecast | 2022/23 Forecast | 2023/24 Forecast |
|---|---|---|---|---|
| | £'000s | £'000s | £'000s | £'000s |
| GF Interest Payable | 15,600 | 21,071 | 24,513 | 24,513 |
| Interest Receivable | (8,374) | (13,395) | (16,387) | (16,387) |
| **Net Interest Required** | **7,226** | **7,676** | **8,126** | **8,126** |
| **Investment Income** | **(5,125)** | **(5,891)** | **(5,891)** | **(5,891)** |
| **Net Cost** | **2,101** | **1,785** | **2,235** | **2,235** |

7.4 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.

7.5 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. significant drop in treasury returns either through lower returns or lower investible cash balances; and
iv. proportion of assets bringing in income being lower or proportion of assets that require development finance being higher than expected.

7.6 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 where 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). This is not the case for all the Council's debt, but it is a portion and provides 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.

7.7 The increase in interest payable in table 1 is to fund the existing and commercial funding requirements included in the Be First Business Plan 2020-25. The amount of borrowing will increase if the Turnkey and Pipeline schemes are agreed. Capitalising interest will reduce the pressure on the Council to fund the additional build costs and this additional cost added to each scheme will be factored into all investment appraisals prior to any agreement.

**Table 2: Be First Business Plan Summary 2019/20 to 2024/5**

| Portfolio Net Development Cost | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 19/20 (£m) | 20/21 (£m) | 21/22 (£m) | 22/23 (£m) | 23/24 (£m) | 24/25 (£m) | BP Total | 2025-30 | Total |
| Agreed Scheme | 95.2 | 162.9 | 231.6 | 181.9 | 80.7 | 79.8 | **832.1** | 107.8 | **940.0** |
| Pipeline IAS | 1.7 | 2.4 | 5.0 | 6.2 | 86.7 | 121.8 | **223.8** | 942.4 | **1,166.0** |
| Turnkey | - | 51.5 | 116.5 | 107.8 | 56.2 | 10.3 | **342.4** | 3.8 | **346.2** |
| Commercial | 173.8 | 26.2 | 16.6 | 8.9 | 3.9 | 1.1 | **230.5** | 5.6 | **236.1** |
| **Total** | **270.7** | **243.0** | **369.7** | **304.8** | **227.6** | **213.0** | **1,629.0** | **1,059.6** | **2,688.0** |
| - IAS pipeline assumes grant funding is available and is based on 75% affordable spilt | | | | | | | | | |
| - Assumes turn-key schemes cost profile as per third party construction programmes | | | | | | | | | |

7.8 The funding requirements are significant and will require the Council to borrow an additional £311m 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 as the Council, as at 31 March 2019, already borrowed £220m of this requirement.

7.9 In delivering its plan, Be First will work closely with the Council, Reside and My Place. 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 <u>Residential Investments</u>

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 agreed 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 Q1 update of the Be First Business Plan (2020/21):

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

| Scheme | Units | Long-term Borrowing Requirement £000s | Target Date |
|---|---|---|---|
| Becontree Heath | 46 | 18,289 | Aug-20 |
| Weighbridge | 92 | 10,820 | Sep-20 |
| Wivenhoe Container | 20 | 3,730 | Feb-21 |
| Grays Court Hospital | 62 | 6,558 | Feb-21 |
| Sebastian Court | 41 | 19,510 | Jul-21 |
| Margaret Bondfield | 15 | 3,741 | Jul-21 |
| A House for Artists | 12 | 3,581 | Aug-21 |
| Becontree Avenue 200 | 19 | 5,782 | Sep-21 |
| Sacred Heart | 29 | 9,304 | Sep-21 |
| Gascoigne East P2 - C Block | 40 | 13,457 | Mar-22 |
| Woodward Rd | 55 | 17,075 | Mar-22 |
| Crown House | 169 | 47,049 | Apr-22 |
| Gascoigne West P1 | 161 | 64,956 | Jul-22 |
| 12 Thames Road | 153 | 51,324 | Aug-22 |
| Gascoigne East P2 - Blocks E1 & E2 | 141 | 73,590 | Nov-22 |
| Gascoigne West P2 | 348 | 121,998 | Sep-23 |
| Gascoigne East P2 - F BLOCKS | 132 | 66,310 | Oct-23 |
| Padnall Lake | 251 | 64,528 | Oct-23 |
| Royal British Legion | 46 | 18,745 | Dec-23 |
| Oxlow Lane | 46 | 12,837 | Dec-23 |
| Roxwell Road | 46 | 19,547 | Dec-23 |
| Gascoigne East Phase 3A | 156 | 71,720 | Jul-24 |
| Gascoigne West Phase 3 | 199 | 66,280 | Dec-26 |
| | 2,279 | 790,731 | |

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 which are included in appendix 1, with key criteria summarised below:

i. Operational Surplus at year 1 and in the worst performing year (worst year is when all costs, including debt, interest, management and maintenance and life cycle costs are incurred and can vary per scheme).
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. As outlined in section 6, for the larger schemes, which normally have fairly lengthy development periods, borrowing costs will be capitalised during the development period. When the scheme becomes operational then income received from rents will be used to cover interest costs, debt repayment and lifecycle and management and maintenance costs.

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
- the Energy Company.

The Commercial Activity and Commercial Lending budgets are combined into one Commercial Investments budget, which totals £322.2m. Combining the budgets will allow Be First greater flexibility to move between different types of commercial investments. The actual budget may increase in-year as new investment opportunities arise. The purpose of the budget is to ensure there is sufficient interest budget available to cover any funding costs.

The majority of the commercial investments are part of regeneration and are likely to be used as part of larger developments. They include income, which is sufficient to cover the hold costs. Any commercial income will go to fund the borrowing costs, with any excess net profit allocated to the Be First return target.

### 9.5.1 *Commercial Activity and Commercial lending*

Be First will identify investment opportunities and bring these to IP then Cabinet for agreement. Investment opportunities are predominantly around in-borough regeneration, with some predating Be First being set up. Table 4 provides a summary of commercial activities included in the Be First Business Plan and the remaining commercial budget agreed by Cabinet. If any proposals require the commercial budget to be increased will be reported as part of the financial implications of that deal and will be agreed by Cabinet.

**Table 4: Commercial Activity**

| Development Project | Funding Required £000s |
|---|---|
| **Commercial Budget** | 322,200 |
| Travelodge | (7,100) |
| Welbeck | (37,000) |
| Unite Building | (1,500) |
| Thames Road | (27,000) |
| Restore | (12,500) |
| Film Studio | (47,500) |
| Heathway | (7,700) |
| Muller | (51,000) |
| To be identified | (70,100) |
| **Total Commercial Activity** | **(247,200)** |
| | |
| London Road (Subject to Cabinet Approval) | (44,000) |
| To be identified | (31,000) |
| **Total Commercial Loans** | **(75,000)** |
| **Remaining Commercial Budget** | **-** |

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) | 1.0% | Industrial (Good Secondary) |
| 1.0% | Hotel and Leisure | 4.0% | Retail (Good Secondary) |

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.

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 to determine commercially appropriate contract interest rate reflecting borrower, project and market risks;
iii. Loan agreement and Security; and
iv. 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 (CR27 and the Isle of Dogs Travelodge). 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 helps grow business rates for business rates pool, help with jobs within the area and support inclusive growth.

## 10. IAS Indicators

10.1 In response 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." 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 2018.

10.2 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.

10.3 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 (includes the MRP and interest payable for the debt in relation to general fund activity.

10.4 The current trajectory of the Council's commercial activities, including company returns, investment income, lease and leaseback and borrowing costs; suggests the biggest impact is the overall level of borrowing, which is expected to peak at 9% in 2023/24. This is a decrease from the previous calculation, predominantly due to a reduction in borrowing costs as a result of the change in accounting for development interest costs.

10.5 To mitigate against commercial risk, the council has created an investment risk reserve, which will be proportionate to the extent of risk and possible loss on returns or head lease arrangements.

## Appendix 1 - Investment and Financial Modelling Assumptions – 2020/21

| Category | Current Metric Agreed | Date and source of current metric | Comments |
|---|---|---|---|
| **Financing** | | | |
| Council short-term Interest rate | 2% (was 1.5%) | Finance Q2 -2020 | Given the size of the programme and the potential to include external funding this has increased to 2% (cost of borrowing) and then capitalised. |
| Financing Rates and Requirements (external funding) | TBC | Market Dependent | Preferences for fixed rate and needs to be below PWLB. If index linked, then market dependent. |
| Council long-term interest rate | 2.75% for RP schemes<br><br>3.0% for current and future residential and mixed-use schemes<br><br>3.25% for acquisitions, fully commercial sche mes and commercial loans | Finance Q2 -2020 | 2.75% relates to RP business plan model |
| Market interest rate | 6.0% | Savills Q1 2020 | Savills advise 5.5% but kept at 6% as long-term trend.<br>Used to calculate residual land value |
| NPV Discount Rate | 5.0% | Finance Q2 -2020 | Agreed measure for all schemes |
| MRP Repayment Period | 50 years | Finance Q2 -2020 | |
| MRP Start Date | Year 3 | Finance Q2 -2020 | 2 years stabilisation at the commencement where MRP not charged |
| Cashflow Period | 50 years | Finance Q2 -2020 | |
| Cashflow Period for TA schemes | 40 years | Finance Q2 -2020 | |

| | | | |
|---|---|---|---|
| **Inflation Measures** | | | |
| Build cost inflation (development) | 3.5% | BCIS and Construction Price Index | Above current forecasts (of 0-1.5% but agreed as long-term trend & conservative position) |
| Cost inflation (operational – management, repairs, lifecycle and maintenance) | 2% long-term trend assumption | CPI Q1 2020<br>BoE Monetary (May-June) | Unit costs for Reside need to include VAT |
| Affordable Rental Income inflation | CPI+1% up to and including 31 March 2030 and then CPI thereafter for 80%, 65% and 50% rents (and any social rent).<br><br>CPI forecasts<br>20/21 – 0.6%<br>21/22 – 0.5%<br>22/23 – 2% | CPI Q1 2020<br>BoE Monetary (May-June)<br><br>Agreed by Reside 1 October 2019 | To be used for AR, LAR, LLR, TR and any other affordable rent tenures.<br><br>Sensitivity test if CPI+1% ends in March 2026.<br><br>LAR Rents CPI+1% (override base assumption for 20/21 & 21/22 in all appraisals) as fixed by Rent Guidance.<br><br>Long-term CPI factor- 2% used for all affordable rent tenures as a base. |
| Shared ownership Rental Income Inflation | 3%+0.5% (RPI+0.5%) | Q1 2020-21 | Assumption to be reviewed by third party.<br><br>Long-term RPI trend of 3% plus 0.5% |
| Private rental Income inflation | 3% per annum long-term trend | | Assumption to be reviewed by third party.<br><br>3% long-term trend |
| House Price Inflation (HPI) | 3% per annum long-term trend | LBBD Finance and external advisor Q1 – 2019 | Assumption to be reviewed by third party.<br><br>Need to more scheme specific (type, location etc.) |
| **Shared ownership** | | | |
| Initial Equity Tranche | 30% (from 1 October 2019) | LBBD Finance and external advisor Q2 -2020 | Assumption to be reviewed by third party. |

| | | | |
|---|---|---|---|
| Rent on unsold equity | 2.75%<br>Shared Ownership | LBBD Finance and external advisor Q2 -2020 | Assumption to be reviewed by third party. |
| Staircasing | Staircasing start year:<br><br>1.5% p.a. | LBBD Finance and external advisor Q2 -2020 | Assumption to be reviewed by third party.<br><br>Update to a more gradual staircasing up to 80% |
| Staircasing ceiling (Unsold equity at end of appraisal term) | 20% ceiling | Finance Q2 -2020 | Assumption to be reviewed by third party. |
| **Investment Hurdle Rates** | | | |
| Year 1 Surplus/Deficit | Year 1 positive | Finance Q2 -2020 | |
| Year 6 Surplus/Deficit | To also include the worst year –should be positive. | Finance Q2 -2020 | Changed to<br>all year's surplus. |
| IRR – Private Sale | 15% Savills | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Private Rent | 7% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Shared Ownership | 7% | Finance Q2 -2020 | Review if 7% is too high |
| IRR – Affordable Rent | 6% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – London Affordable Rent | 5% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Extra Care Private | 7% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Extra Care Affordable | 6% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Student Private | 7% | Finance Q2 -2020 | To be reviewed by independent third party. |
| IRR – Student Affordable | 6.1% | Finance Q2 -2020 | To be reviewed by independent third party. |
| Yield on Cost | 4% | Finance Q2 -2020 | To be reviewed by independent third party. |
| Profit on Cost Private | 15% | Finance Q2 -2020 | To be reviewed by independent third party. |
| Profit on Cost Affordable | 5% | Finance Q2 -2020 | To be reviewed by independent third party. |
| Cost to value | 85% | Finance Q2 -2020 | To be reviewed by independent third party. |
| **Economic** | | | |
| New Homes Bonus Rate | £1,200 per unit per year blended rate | Finance Q2 -2020 | Review underway. |
| Council Tax Rate | £1,200 per unit per year blended rate | Finance Q2 -2020 | No change |

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| **Operational** | | | |
| Management costs | £764 per unit per year | Finance Q2 -2020 | No change.<br><br>Reside costs not included and is charged against net rents. |
| Maintenance costs | £764 per unit per year | Finance Q2 -2020 | No change.<br><br>Benchmark My Place cost & costs to be split into component parts.<br><br>Private and SO full repairing leases and service chargeable. |
| Voids | 1.5% of rent | Finance Q2 -2020 | No change. |
| Bad debt | 1.5% of rent | Finance Q2 -2020 | No change. |
| Lifecycle costs | £2,500 unit per year from YR8<br>(holding assumption) | Finance Q2 -2020<br>2020 Review in October 2020 | To be over-ridden when QS LCC reports are agreed between all entities.<br><br>Assumption to be updated when G&T work concludes. |
| Service charge as cost to scheme | £20-£25 per unit per week for all affordable tenures except SO. | Finance Q2 -2020 | £25k pw for larger estates and £20 pw for smaller schemes (under 50 units)<br><br>Service charge as scheme cost for market rental and affordable rental stock as cannot be recovered from tenant.<br><br>Reside does not charge separate service charges to the tenants except for SO and specific target rent products for rehousing.<br><br>To become more specific over time. |
| B&D Energy Charges | £260 unit per year | B&D Energy | No change, confirmed with Energy Company 29/7/20 |