

## LONDON BOROUGH OF BARKING AND DAGENHAM

### INVESTMENT AND ACQUISITION STRATEGY 2022 - 2027



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## 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 challenges it faced from Government cuts to public sector spending, and it is reviewed annually. 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 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. The IAS will significantly increase the Council's debt and the amount of interest the Council pays
- 1.2 The scale of the investment strategy within the Borough is significant with over 50,000 new homes to be built by 2040. 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 can support economic growth and/or deliver economic regeneration. Schemes with low returns may be considered for strategic reasons.
- 1.3 The IAS has and will continue, to change over time as schemes are accelerated, delayed, amended or removed. In addition, new investment opportunities to support both the IAS and Council objectives and funding requirements are considered. Investments are agreed and monitored by an Investment Panel (IP).
- 1.4 The IAS has an income objective of £11.6m, split into £6.6m in 2022/23 for surplus returns and £1.5m from capitalised interest. Developments are delivered primarily by the Council's development vehicle, Be First. Be First will accelerate the regeneration of the borough but it is important that they manage the schemes and puts forward investment schemes that are within the IAS budget limitations.
- 1.5 The Council capitalises interest costs for most schemes, and this will improve both the IAS and the Council's financial positions but will add to the total cost for each scheme. To ensure the level of borrowing is sustainable, the Council invests in schemes that provide a positive return after all costs and invests in a number of different asset classes and assets with different cash flows requirements.
- 1.6 The impact of increased build costs, as well as inflation on the strategy is outlined in section 5, with several schemes delayed and a number of schemes no longer viable using the original assumptions. Where schemes were no longer viable, it has been necessary to increase the grant used, including Right to Buy receipts, reduce the on-lending interest rate and to mix different tenure types to allow an element of cross subsidy between tenures. Currently the pipeline of schemes, which includes regeneration of a number of key areas within the borough, is unviable without an increase in grant or a reduction in build costs.
- 1.7 As the IAS grows it is important to regularly review the investment criteria and guidelines. 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.

## 2. IAS Governance

- 2.1 The IP was constituted by the Managing Director (MD) 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 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 is responsible 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 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.

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 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. Where a scheme is not viable based on the IAS hurdle rates, but has significant regeneration drivers, a scheme may still be agreed but careful consideration must be taken around how the property will be held, managed, and maintained. Currently the IAS is under strain, with reduced cashflows and greatly reduced surpluses and it will be difficult for the strategy to fund schemes that are unviable.

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). Quarterly

reporting to be provided to IP at the November, February, May and August IP, and, from 2022/23, quarterly reporting to Cabinet.

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 smaller of total variance is greater than £1m, or 5% of total scheme cost;
- 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.

## 2.2 Assumption Changes

Long-term assumptions are reviewed at least annually but can happen at any time. As these are proposed, how these changes impact the strategy need to be considered. Some will require retrospective changes to both operational and development schemes. Shorter-term assumptions (i.e. changes to assumptions for between 1 and 5 years) are updated depending on market conditions. Where assumption changes are agreed, they must be presented to the IP (and then Cabinet) with the impact on all the schemes reported. Any mitigating approaches must be included with any assumption change.

Any changes to the operational assumptions must be agreed by Reside and then IP and after careful consideration of market conditions. Assumption changes should be measured, with short-term assumptions used to smooth out any short-term market fluctuations.

Gateway 5 Reports and handover reports are taken to IP for consideration. These reports will outline any issues at handover and may result in changes to assumptions based on the local market conditions.

### 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. Even after a scheme is agreed, market conditions, due diligence or scheme changes may make the proposal no longer viable or no longer an investment that meets the Council's investment objectives.

## 4. Investment Objectives

### 4.1 Strategic Objectives

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

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

### 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 2022/23 TMSS are £1.6bn for the Operational Boundary Limit and £1.7bn 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 holistic 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.
- 5.6 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. There is currently pressure on interest rates and if this continues then this will lead to an amendment to the assumptions for future schemes.



## **6. Capitalisation of 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 has agreed to capitalise interest costs incurred during the development period 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.
- 6.3 Capitalisation of interest starts 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 either the completion date of the purchase or the date of this accounting policy.
- 6.4 Interest is capitalised on a quarterly basis and is 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.
- 6.5 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.

## **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 Strategy (MTFS).
- 7.2 A four-year net interest forecast has been established by the Council within the 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. Where schemes are agreed that provide negative returns, especially in the initial operational years, the impact on the overall strategy, as well as on Reside needs to be carefully considered to ensure that there are sufficient cashflows to cover any shortfalls

- 7.3 Table 1 summarise the current net income arising from the IAS and the interest requirement to support the strategy. Table 2 provides a forecast of the IAS income to 2026/27. The IAS is forecasting a deficit of £756k for 2022/23 and there are a number of deficits from 2025/26 onwards.

**Table 1: Investment and Acquisitions Forecast 2021/22 to 2024/25**

£'000s	2021/22	2022/23	2023/24	2024/25
	Budget	Budget	Budget	Budget
MRP	8,658	9,058	9,458	9,858
Net Interest Budget	7,090	6,890	6,690	6,490
Investment Income	-6,587	-6,587	-6,587	-6,587
<b>Net GF Cost</b>	<b>9,161</b>	<b>9,361</b>	<b>9,561</b>	<b>9,761</b>

**Table 2: IAS Income Forecast 2022/23 to 2026/27**

Income Streams	2022/23	2023/24	2024/25	2025/26	2026/27	Total
	£'000s	£'000s	£'000s	£'000s	£'000s	£'000s
<b>IAS Target</b>	<b>-6,922</b>	<b>-6,922</b>	<b>-6,922</b>	<b>-6,922</b>	<b>-6,922</b>	<b>-34,610</b>
<b>Post GW4 and Turnkey</b>	2,597	1,910	4,225	1,239	2,179	<b>12,150</b>
<b>Reside (Current)</b>	400	400	400	400	400	<b>2,000</b>
<b>Commercial Income</b>	800	800	800	800	800	<b>4,000</b>
<b>Be First Commercial</b>	1,329	1,329	560	560	560	<b>4,336</b>
<b>Travelodge / CR27</b>	1,115	1,197	1,197	1,197	1,197	<b>5,903</b>
<b>Commercial Loans</b>		870	589	303	0	<b>1,762</b>
<b>Pianoworks</b>	76	76	76	76	76	<b>378</b>
<b>Expenses</b>	<b>-150</b>	0	0	0	0	<b>-150</b>
<b>Total (shortfall) / Surplus</b>	<b>-756</b>	<b>-340</b>	924	<b>-2,349</b>	<b>-1,711</b>	<b>-4,232</b>
<b>Accumulative</b>		<b>-1,097</b>	584	<b>-1,424</b>	<b>-4,059</b>	<b>-5,996</b>

- 7.4 There is much greater certainty over the interest payable requirement for current schemes agreed at Gateway 4, with a borrowing strategy in place to fund schemes and therefore the level of the interest payable is very likely to be achieved. With the exception of Beam Park, the majority of borrowing for current developments has been secured.
- 7.5 There is greater uncertainty over the Interest Receivable and Investment Income targets due to the on-lending rate reduction and the reduced surpluses from investments, which have been caused by the significant increase in build costs for each scheme.
- 7.6 In addition, for pipeline schemes, there is uncertainty over the borrowing costs as borrowing is still to be taken for these schemes and currently there is upward pressure on interest rates. Based on current modelling, there are a number of pipeline schemes that will not meet viability metrics and, unless build costs reduce they will unlikely progress passed Gateway 2.
- 7.7 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, predominantly caused by an increase in build costs;
- iii. significant drop in treasury returns either through lower returns or lower investible cash balances;
- iv. proportion of assets bringing in income being lower or proportion of assets that require development finance being higher than expected; and
- v. agreeing unviable schemes or schemes with initial negative cashflows, that need to be funded through surpluses from other schemes.

## 7.8 Investment Risk Mitigation Approaches

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 or pressure on build costs and operational costs, 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. An update, in blue, has been provided to summarise the approach the Council has taken to mitigate the current pressures on the investment strategy. These are outlined in greater detail in section 9.

### i) Reduce return required

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. **For all schemes, the return has reduced on the revised base assumptions, with return for Private Rental Schemes (PRS) reducing as management of these schemes will likely be by an external manager, which is more expensive than modelled if it were managed internally. The forecast return for the residential schemes has been reduced, which in turn has placed additional pressure on the IAS return target.**

### ii) Reduce the on-lending rate

If conditions deteriorate to a level where schemes are marginally profitable or where there are losses at tenure level and there is insufficient income to cover debt and borrowing positions, then adjustments can be made to on lending rate. This will reduce the interest margin to the Council.

**This situation has already occurred for the majority of schemes, which has increased the IAS risk and has also removed the ability to adjust the strategy if there are further issues.**

### iii) Increase Grant and other funding

Increase grant, including Right to Buy (RtB) receipts and GLA grants and / or utilise other sources of funding for schemes, including S106 / CIL and other types of grant.

**This approach has been implemented for most schemes, with additional grant from the GLA requested, RtB use increased from 30% to 40% and S106 used where possible.**

iv) Reduce / delay schemes

The Council, in more extreme cases, can reduce its investment activity and focus on the more profitable assets and/ or sell or refinance assets.

**This approach has already been implemented, with a number of schemes delayed or put on hold.**

7.9 Table 3 outlines the borrowing requirement for schemes that have been agreed and then for pipeline schemes.. Pipeline schemes do not include the regeneration of Thames Road, which will require significant funding. The amount of borrowing will increase if the Pipeline schemes and commercial schemes are progressed, although it is expected that the majority of the commercial schemes will be sold as they are purchased as part of land assembly.

**Table 3: Be First Business Plan Summary 2022/23 to 2026/27**

<b>Investment and Acquisition Strategy Forecast 10 Year Cashflow</b>												
	<b>Pre 2021</b>	<b>21/22</b>	<b>22/23</b>	<b>23/24</b>	<b>24/25</b>	<b>25/26</b>	<b>26/27</b>	<b>27/28</b>	<b>28/29</b>	<b>29/30</b>	<b>30/31</b>	<b>Total</b>
	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>	<b>£ms</b>
<b>Post-G4</b>	135.8	239.8	195.6	60.2	-18.5	-2.0	-	-	-	-	-	610.9
<b>Pre GW4</b>	5.2	6.7	52.2	97.3	105.4	1.7	-	-	-	-	-	268.5
<b>Turnkey</b>	12.1	72.2	30.0	84.8	34.5	25.1	13.8	14.8	-5.9	0.0	-	281.5
<b>Pipeline</b>	-	-	16.9	19.9	120.4	230.0	206.2	50.2	149.3	231.2	233.9	1,258.1
<b>Commercial</b>	204.8	11.8	30.8	17.3	-4.9	0.5	-	-	-	-	-	260.2
<b>Total</b>	<b>357.9</b>	<b>330.5</b>	<b>325.5</b>	<b>279.5</b>	<b>236.9</b>	<b>255.3</b>	<b>220.0</b>	<b>65.0</b>	<b>143.4</b>	<b>231.3</b>	<b>233.9</b>	<b>2,679.1</b>

7.10 The funding requirements in table 2 are significant and will require the Council to borrow an additional £400m of long-term debt over the next four year just to fund the schemes that have been agreed. This borrowing requirement will reduce if the commercial schemes are sold and as scheme start to repay some of the borrowing when they are operational. The borrowing requirement, even to fund already agreed schemes remains significant.

7.11 If the pipeline, excluding Thames Road, is included then an additional £1.8bn is required, which is a significant risk for the Council, especially given the current pressure being experienced within the agreed schemes.

7.12 In delivering its business 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. In addition, with a large number of PRS schemes scheduled to become operational in the next few years, confirming the operational costs for these schemes is essential to reduce operational costs of managing these schemes.

## 8. Ownership of Investment Funding

8.1 Investment 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 & commercial purposes of investments and will be held in tax efficient structures consistent with Local Authority powers as follows:

1. 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.*

2. Investment assets held by wholly owned vehicles (e.g. Reside vehicles, including the Registered Provider):

*Debt finance provided by the Council to project entities and project finance provided by third party funders.*

3. 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 3<sup>rd</sup> party funders and co-investment between the Council and 3<sup>rd</sup> party investors. [Funds may be provided as senior debt, junior debt or equity dependent on the requirements and commercial arrangements of schemes.]*

4. 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.*

5. 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 3<sup>rd</sup> party debt.*

6. Lease and Lease Back Funding (income strips):

*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. With the exception of schemes already agreed, this option will no longer be part of the investment strategy.***

## **9. Investment Assets**

### **9.1 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.

### **9.2 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.

### **9.3 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.

### **9.4 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

### **9.5 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.

## 10. Asset Classes and Investment Returns

10.1 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.

### 10.2 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 agreed schemes and their target Practical Completion (PC) dates is provided in table 4:

**Table 4: Pipeline of Residential Investment Schemes**

Project	GW2 PC	GW4 PC	Latest PC
Sebastian Court	Jul-20	Jan-21	Feb-22
Becontree Avenue 200	May-21	May-21	Mar-22
Gascoigne West Phase 1	Feb-21	Sep-22	Mar-22
GEP2 - C	Sep-21	Nov-21	Mar-22
Sacred Heart	Aug-21	Sep-21	Mar-22
Chequers Lane	Aug-22	Aug-22	Apr-22
Crown House	Sep-21	Mar-22	May-22
GEP2 E2	Sep-21	Nov-22	Nov-22
Woodward Road	Jul-22	Sep-22	Dec-22
Industria	Sep-22	Feb-23	Feb-23
GEP3A - J	Sep-24	Sep-23	Sep-23
GEP2 F	Sep-21	Dec-23	Nov-23
Padnall Lake P1	Mar-22	Jan-22	Nov-23
Padnall Lake P2	Dec-25	Dec-22	Nov-23
Oxlow Lane	Aug-21	Sep-23	Dec-23
Jervis Court / RBL	Jul-23		Jan-24
Gascoigne West Phase 2	Jun-24	Dec-23	Mar-24
Trocoll House	Mar-24	Mar-24	Mar-24
12 Thames Road	May-23	Dec-23	Apr-24
GEP3A - I	Aug-22	Jun-24	Jun-24
GEP2 E1	Sep-21		Oct-24
Transport House	Jul-24	Dec-24	Dec-24
Roxwell Road	Sep-21		Jan-25
Town Quay Wharf	Jan-24	n/a	Jan-25
Brocklebank	Dec-23		Mar-25
Gascoigne East Phase 3B	Sep-25		Mar-25
Padnall Lake P3	Dec-27		Sep-25
Beam Park - Phase 6 - Scheme	Apr-25	Jul-26	Jul-26
Beam Park - Phase 7 - Scheme	Mar-26	Aug-30	Aug-30

10.3 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 and the minimum criteria should be met at a scheme and tenure level:

- 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%.

10.4 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. It is essential that all future scheme assumptions are agreed by Reside to ensure that the schemes are transferred based on forecast Reside assumptions.

10.5 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.

#### 10.6 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.



### 10.6.1 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 5 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 5: Commercial Activity**

Development Project	Funding Required
	£Ms
<b>Commercial Budget</b>	-322.20
23 Thames Road	5.72
26 Thames Road	5.85
3 Gallions Close	6.33
8 River Road - Welbeck Regear	26.28
Dagenham Heathway	7.33
Industria	37.09
11-12 Riverside Industrial	0.60
1-4 Riverside Industrial (27 Thames Rd)	1.21
44-52 River Road - Restore	12.59
47 Thames Road	3.66
Barking Business Centre	27.75
Muller Site	50.00
Travelodge - Dagenham East	7.25
London Road	44.00
To be identified	86.54
<b>Remaining Commercial Budget</b>	<b>0.00</b>

10.6.2 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)

### 10.6.3 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.

### 10.6.4 Lease and Lease Back

Cabinet have previously agreed to invest in two Lease and Lease back arrangements (CR27 and the Isle of Dogs Travelodge). In 2021/22 Cabinet agreed to invest in an in-borough residential Lease and Lease back, Trocoll, as part of regeneration of Barking Centre. 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, aparthotel operator or Reside as a 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 up to 50 years, with lease increases based on an inflation index and usually have a cap and collar arrangements to keep the rental increases within a set margin.

For each deal the Council has mitigated 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. For Trocoll, the scheme is forecast to have a number of years of negative cashflows and there will not be a reserve set aside. Trocoll was agreed for regeneration purposes, with negative cashflows funded via the IAS.

These schemes increase the Council's Capital Financing Requirement and are now viewed by HM Treasury as a form of borrowing. Agreeing future lease and lease back arrangements will mean that the Council will no longer be able to access PWLB borrowing, although this will not impact current agreements. In addition, these schemes increase the Council's exposure to inflation linked repayments and provide a long-dated obligation (of up to 50 years) with an institutional investor.

As a result of this, lease and lease back arrangements will be removed from the IAS list of investible assets.

## **11. IAS Indicators**

- 11.1 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.
- 11.2 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.
- 11.3 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).
- 11.4 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 10% in 2024/25. 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.
- 11.5 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.

## **12. IAS Assumptions**

- 12.1 Appendix 1 contains a list of the assumptions used for Post GW4 schemes and then Pre GW4 schemes, Pipeline schemes and commercial schemes.
- 11.2 Appendix 2 includes Management and Maintenance Assumptions and revised assumptions for PRS based on PRS being managed externally.
- 11.3 Appendix 3 contains long term Inflation Rates assumptions. It is likely that these will be updated over the next few months as Reside confirm the operational assumptions.

## Appendix 1 - Investment and Financial Modelling Assumptions – 2022/23

Category	Post GW4 Schemes	Pre GW4 and Pipeline Schemes	Comments
Council short-term Interest rate	2.00%	2.00%	
Council long-term interest rate	2.25%	2.75%	for LAR and Target
	2.75%	3.00%	for AR & LLR
	3.00%	3.00%	PRS and SO
	3.25%	3.25%	for all schemes long term
Market interest rate	5.00%	5.00%	
NPV Discount Rate	5.0% (6.09% for external funding)	5.0% (6.09% for external funding)	
MRP Repayment Period	50 years	50 years	
MRP Start Date	Year 3 (can extend to 5 yrs)	Year 3	
Cashflow Period	50 years	50 years	
Build cost inflation (development)	3.50%	3.50%	
Base inflation rate	2.00%	2.00%	
Cost inflation (operational M&M)	2.00%	2.00%	long-term inflation rate (BoE CPI target rate)
House Price Inflation (HPI)	3% p.a. long-term trend	3% p.a. long-term trend	
Initial Equity Tranche	30%	30%	
Rent on unsold equity	2.75%	2.75%	
Staircasing	Staircasing starts from yr 5 to yr 50 (45 yrs of staircasing) 1.5% pa	Staircasing starts from yr 5 to yr 50 (45 yrs of staircasing) 1.5% pa	
Unsold equity at end of appraisal term	40% unsold by year 50.	40% unsold by year 50.	
Year 1 & 6 Surplus/Deficit	Year 1 and 6 positive	Year 1 and 6 positive for all tenures	
Worst Year Surplus/Deficit	Worst year – Should be positive	Worst year – Should be positive.	
IRR – Private Sale	15.00%	15.00%	
IRR – Private Rent	7.00%	7.00%	
IRR – Shared Ownership	7.00%	7.00%	
IRR – Affordable Rent	6.00%	6.00%	
IRR – London Affordable Rent	5.00%	5.00%	
IRR – Extra Care Private	7.00%	7.00%	
IRR – Extra Care Affordable	6.00%	6.00%	
IRR – Student Private	7.00%	7.00%	
IRR – Student Affordable	6.10%	6.10%	
Yield on Cost	4.00%	4.00%	
Profit on Cost Private	15.00%	15.00%	
Profit on Cost Affordable	5.00%	5.00%	
Cost to value	85.00%	85.00%	
Service charge as cost to scheme (ex. PRS)	£25 per unit PW for all affordable	£30 per unit PW for all affordable	
B&D Energy Charges	£260 unit per year	£260 unit per year	

## Appendix 2 - Investment and Financial Modelling Assumptions Operational Costs – 2022/23

Management and Maintenance, Voids and Bad Debt Assumptions									
	Target Rent	LAR	Affordable Rent	London Living Rent	Market Rent	Shared Ownership	Private Sale	Temporary Acc	Community
Current	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year	Per unit per Year
Management costs	£764	£764	£764	£764	See Below	£764	£764	£764	£764
Maintenance costs	£764	£764	£764	£764	See Below	£764	£764	£764	£764
Current									
Management costs	1.5% of rent	1.5% of rent	1.5% of rent	1.5% of rent	See Below	1.5% of rent	1.5% of rent	1.5% of rent	1.5% of rent
Maintenance costs	1.5% of rent	1.5% of rent	1.5% of rent	1.5% of rent	See Below	1.5% of rent	1.5% of rent	1.5% of rent	1.5% of rent

## PRS Costs (Savills) – 2022/23

PRS Operational Costs				
		IAS Allowance (in-house original assumptions)	Savills Assumptions	Variance
Management	Staff & Office		£1,574	
	Amenity		£139	
	Marketing & Leasing		£302	
	Fees		£706	
	<b>Total</b>		£764.00	£2,721
Maintenance			£503.83	£764.00
Service Charge			£1,551.47	£1,300.00
<b>Sub Total</b>			<b>£4,776.66</b>	<b>£2,828.00</b>
Lifecycle			£2,500.00	£2,500.00
<b>Total</b>			<b>£7,276.66</b>	<b>£5,328.00</b>

### Appendix 3 - Long term Inflation Rates

Long term Inflation Rates								
Total rate applied (inc. base)	Market rent	Affordable Rent	Shared Ownership	London Living Rent	LAR	Target Rent	Community	Commercial
Base = 2%								
0-5 years	3%	3%	3%	2%	3%	3%	2%	2%
6-50 years	2%	2%	2.5%	2%	2%	2%	2%	2%
<b>Previous position</b>								
Total rate applied (inc. base)	Market rent	Affordable Rent	Shared Ownership	London Living Rent	LAR	Target Rent	Community	Commercial
0-10 years	3%	CPI + 1%	RPI + 0.5%	CPI + 1%	CPI + 1%	CPI + 1%	2%	2.50%
0-50 years	3%	CPI	RPI + 0.5%	CPI	CPI	CPI	2%	2.50%