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KENT & MEDWAY INVESTMENT FUND

Stage 1 Feasibility Report

Private & Confidential

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Pinsent Masons

CBRE
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Executive Summary

Kent & Medway Investment Fund (KMIF) – Why?

In recent history, assistance and resource (both intellectual and financial) has been provided by central government through means such as the Local Development Agencies and the Homes and Communities Agency to assist local authorities in delivering strategic frameworks. By and large, this is now not available and local authorities are required to source their own intellectual resources and deliver projects using their own initiative.

In recognising that a cohesive approach will be required to deliver Kent's Strategic Framework, *Unlocking Kent's Potential*, Kent County Council has instructed CBRE to develop the concept of a Kent wide fund. The principle is that the fund will be seeded with Local Authority assets and funds, and used as a vehicle both to lever private sector finance, either at a fund or project level, and to make best use of available central government funding streams and initiatives such as Regional Growth Fund, New Homes Bonus and Business Rate Retention.

It is the hope that the fund will joined by most authorities within Kent. The union of the authorities will not only encourage a wider recognition of the regenerative benefits of development across the County, but also creates a critical mass of projects, access to projects and finance, which makes it of a size that becomes of interest to the wider market. This pooling of resources will allow a more efficient resourcing structure and ensure the region can access top quality advice in a cost efficient manner.

The following is an executive summary of how the fund may look (subject to agreement by all potential Partners during the next phase.)

What is it?

The KMIF will be structured as a fund, with an independent professional Fund Manager appointed to deliver an Investment Strategy agreed by the Partners. This Investment Strategy will set out the objectives of the fund, determine the rate of return and risk profile that the fund targets, as well as the type of investment the Fund Manager makes.

The KMIF will be required to invest in line with State Aid regulations and therefore will be investing at a market rate. It will aim to deliver a commercial return to its investors. The KMIF is not about gap funding, but assisting projects that may require a more considered financing solution than the market can offer on its own.

KMIF investments may be in the form of debt, equity or guarantee, and may take first or subordinated security (which will affect the rate of return).

Projects for investment will be selected not only on the basis of a sound business case, but also for the regenerative benefits that they will deliver for the region.

The fund is expected to have an initial life of 10 years, with capital and potentially returns above a certain level being retained by the fund for reinvestment during this period (an 'evergreen' fund).

It is hoped the fund will be seeded with between £20m and £30m by local authorities, any further capital that the Kent Pension Fund may wish to invest and central government funding through one of the many current initiatives.

Structure

It is recommended that the fund is set up as an English Limited Partnership. The Partners would be made up of the Borough Councils, Kent County Council and Medway Council.

There is also interest from the Kent Pension Fund in becoming a Partner, and the structure would allow them and any private sector investor that may wish to join in the future to do so (subject to the agreement of existing partners).

It is envisaged that all partners will be required to invest a minimum sum, and all Partners will have equal voting rights, with returns to Partners equalised on a pro rata basis dependent upon the value of their initial investment.

The partners will agree between them the Investment Strategy, and divest power of investment under the terms of that strategy to the Fund Manager. The Fund Manager will manage the fund on a day-to-day basis, with the assistance of fund lawyers and a fund administrator.

New Partners may join the fund at specified points during its life with the agreement of all Partners.

Benefits of the KMIF

In occupying a position in the funding market that banks and the private sector have retracted from, or reduced their capacity within, the KMIF will leverage a considerable amount of additional development money in Kent.

Because projects will need to be viable, a return will be created from investment by the fund. In addition, projects will need to accord with the Investment Strategy, which will ensure that they deliver beneficial outputs to the region.

These benefits are only made possible by a cohesive approach driven by a group of authorities, resulting in a critical mass that then becomes attractive to institutional investors; whether they will wish to invest at project or fund level, access to the funds that they have available will open up.

Potential Partner Interest to Date

CBRE and Kent County Council have held discussions with all Borough Councils and Medway Council to discuss the principles of the KMIF. The overwhelming majority have shown interest in being involved in developing the concept further. The Kent Pension Fund has also been involved in discussions.

Structural Recommendations

Pinsent Masons has been appointed to provide advice on the legal structuring of the fund, and has worked with CBRE in preparing a series of recommendations for the fund. The executive summary for these is provided as a quick reference table on the following pages.

Fund Summary

KEY RECOMMENDATIONS	KEY RATIONALE
OVERVIEW	
The Fund will initially be formed of Councils within Kent and Medway	To provide a cohesive approach to development and investment across the region. It will be possible (by agreement) for private sector investors to join in the future
The Fund will be managed by an independent professional Fund Manager	To provide a politically independent approach to implementing the aims of the fund and to give confidence to other potential investors
Investments will be made independently by the Fund Manager in line with an Investment Strategy agreed by the investors	To provide the Fund Manager with a pre agreed set of criteria that can be used to make investments without requiring ratification each time, thus reducing red tape
The Fund will lend on market terms and will address the funding gap rather than the viability gap	This is required by State Aid regulations
The Fund will target specific outputs (such as jobs etc) as well as financial returns	To ensure value for risk taken by investors
The Fund will be seeded by cash and assets that can be developed in line with the Investment Strategy	To avoid the fund becoming filled by inappropriate assets where a value cannot be derived
During the life of the Fund, capital would be recycled and reinvested by the Fund	To provide a certain minimum period of investment and maximise the scalability of the Fund
MEMBERSHIP	
Partners will join the Fund in formal stages or "closings" (timings to be agreed)	This will enable the Fund to grow incrementally and capitalise on additional investment offers
Size of partnership on first close will be optimised	This gives the Fund manager certainty over available funds and will help stabilise the Fund earlier
Incoming Partners joining at a later date will pay an equalisation payment	This will create a level playing field amongst the Partners as those joining on second or subsequent close will be joining a Fund with a different risk profile
LEGAL STRUCTURE	
The Fund will be a Limited Partnership	Due to its tax transparency for both the local authority Partners and other non-tax paying Partners such as institutional investors; avoiding tax leakage Flexibility in the way returns are distributed Familiar vehicle: commonly used in the private investment market
REGULATORY	

The local authority partners will likely rely on a mix of powers to participate in and (if applicable) transfer land to the Fund (structured as a limited partnership) or projects/investments	The Well-Being power (potentially combined with investment and incidental powers) will likely be available in so far as well-being is the primary purpose for involvement in the Fund (notwithstanding that a return is generated)
The decision on the powers being relied on will be a local authority one and each authority may decide to use a different combination of powers	After the introduction of the Localism Bill, investment and incidental powers may be available. Alternatively the local authority partners could participate in the Fund through an intermediary company
The Fund can be set up with the local authority partners (and local authority pension fund) without a competitive procurement	Establishment of the Fund will be an investment rather than a procurement of works, goods or services
Any private sector investor should be selected through some form of competitive process	If the investment opportunity is to be limited, some form of competition should be held to avoid any distortion of competition
If an investment involves the procurement of works, goods and/or services sufficient to create a Public Contract it's selection will need to comply with the Procurement Rules	On balance, the Fund is likely to be a contracting authority
FUNDING AND RETURNS	
The Fund will be funded initially by its Partners , as well as applying for central government funding	The Fund will require some cash liquidity
Total commitments will not be drawn down on day one but Partners will enter into a contractual arrangement to make funding available for draw down by the Fund manager on a project by project basis	It would be financially inefficient for contributions to be made in advance of need. However, the manager will need certainty of funding
GOVERNANCE	
The Partners will each have equal voting and control rights (based on a minimum funding contribution)	Voting rights weighted to investment would require a more complex governance structure and would not reflect that the local authority Partners have aligned policy objectives which go beyond simply protecting their investment
Most Limited Partner decisions will be taken by simple majority vote but some will require a 75% majority	Simple majority vote prevents a small proportion of the Partners from prohibiting the passing of resolutions which have majority support. A 75% threshold is usual for fundamental matters which go to the value or nature of a Partner's investment (i.e. minority shareholder protection matters).
The Fund will need to be managed by an FSA regulated organisation	The involvement of an FSA authorised entity will provide comfort regarding the proper management of the Fund's affairs
The General Partner and manager will form part of the same tax group (as opposed to the General Partner being an SPV owned by the Partners)	This will have VAT savings on Fund management costs and would reduce time commitments on the Partners

PROJECTS

The Fund will be a holding fund which will invest in a series of project vehicles (which themselves will invest downstream)	Legal and financial ring fencing of projects Ability to leverage debt against specific assets Allows the Fund to increase its portfolio incrementally Flexibility for diversity of investment Ability to realise investment through disposals. Increases attractiveness to project co-investors
The Fund will invest in accordance with agreed parameters set out in an Investment Strategy. This will be supported by a project pipeline	This provides a framework within which the manager can operate the Fund and allows the Partners to step back from day to day operations
Each project will have its own robust governance arrangements	It is key that project vehicles have jurisdiction to determine how their schemes/projects are delivered; this would not fall within the remit of the General Partner / Manager
The Fund will usually invest on normal commercial terms. If it (or certain Partners) wishes to invest on non market terms or provide grant funding this will need to be through a state aid compliant route	The Fund will invest with a view to making returns for reinvestment and, ultimately, distribution to the Partners
EXIT	
The Fund will be set up for an initial ten year term (with the option for the Partners to agree to extend the Fund for a further 10 years)	Ten years enables the manager to take a medium to long term view to investments which is essential to drive returns and recycle funds. The Partners have the flexibility to extend the Fund if it has a viable pipeline
Limited Partners will not be entitled to withdraw from the Fund but will be able to realise their investment early through a disposal of their interest	The ability of the Limited Partners to withdraw at will would create an unstable Fund. The manager would not have certainty over available funds and private sector investors would be discouraged
The Partners would have the option of agreeing an early winding up	Allows Partners to realise their investment if the Fund is successful in its early years

Section 1 – Introduction

KENT & MEDWAY INVESTMENT FUND (KMIF)

Kent is exploring options to create an investment and delivery vehicle of scale that will help drive economic growth and prosperity across the County.

A strategic framework has already been set in the context of *Unlocking Kent's Potential*. The framework sets out five key challenges that need to be addressed:-

1. Building a new relationship with Kent business;
2. Unlocking talent to support the Kent economy;
3. Embracing a growing and changing population;
4. Building homes and communities; and
5. Delivering growth without transport gridlock.

There is also a cross-cutting theme of meeting climate challenge and sustainability objectives that runs across all of the five areas.

This report therefore develops the proposition for the KMIF outlined in the earlier Scoping Paper (dated February 2011), to assist proactively in delivering projects that meet some of these challenges over the short to medium term. In the same way that the County, Medway and Districts have to come together to agree strategic positions on the regeneration framework and most recently, the housing strategy, a similar alignment behind the proposition for an Investment Fund will also realise the greatest potential benefit.

Background

In recent history, support and resource (including financial) has been provided by central government through means such as the Local Development Agencies and the Homes and Communities Agency to assist local authorities in delivering strategic frameworks. By and large, this is now not available and local authorities are required to source their own intellectual resources and deliver projects using their own initiative.

A number of local authorities have been looking at the potential to set up delivery vehicles often structured as Local Asset Backed Vehicles (LABV). The purpose of these vehicles is to attract and leverage private sector expertise and investment to address specific, often development-focused objectives. However, with the credit crunch and subsequent recession, the historical structure of these delivery vehicles has been questioned. In the current climate transferring land or assets into a vehicle at day one, may mean that a public authority might not achieve the 'best consideration reasonably obtainable' for the disposal of its assets. Combined with this market issue, development finance is now harder and more expensive to secure and whilst equity is available, it is expensive and requires a high return.

CBRE has worked up a model for an investment fund with Kent County Council, presented in this report, which addresses the issues and provides a credible alternative. Whilst the fund may have a LABV arm, it is different from a LABV in that it will be able to make investments in a wide variety of projects in different ways, including debt and equity through cash. It will create a return that can be recycled into other investments, and will invest in line with a strategy that will have a broader remit than the delivery of specific projects.

Section 1 – Introduction

Proposal

Kent and Medway are exploring the potential to create a fund that can invest and also harness the benefits of scale that could be realised through a combination of local authorities working together in partnership to set up and deliver a Kent and Medway wide investment fund.

Whilst this report deals with the scope of potential options and issues to be considered, it is important that the Investment Fund can be set up quickly to capitalise on potential public funding streams, initially the second round of bidding to the Regional Growth Fund, but later to reflect the potential for pooled New Homes Bonus funding and localisation of business rates, all of which will offer opportunity.

The fund will also be in a position to capitalise on the development opportunities presented on council owned assets, in particular those identified through the Total Place initiative.

The intention is that the capital within the fund will be recycled, harnessing assets and capital that can be reused again and again to deliver Kent's strategic framework.

Review of Meetings

Since the Scoping Paper, a number of meetings have been held. Initially these have been introductory meetings to explore the basis of the fund with Chief Executives. The meetings have generally been positive in tone, with all potential partners expressing an interest in working through the concept further. As a follow up to discussions with the Chief Executives, meetings have been held with property and regeneration departments to explore potential projects that may make up the early investments of the fund. A number of these have been discussed in detail later in the report, to investigate how the fund might help the delivery of them. The following local authorities and interested parties have been visited:

Kent CC
Dartford
Gravesham
Medway
Swale
Canterbury
Thanet
Dover
Shepway
Ashford
Maidstone
Tunbridge Wells
East Kent Spatial Development Company

How the Fund has Evolved Since Scoping Paper

Following a competitive procurement process, Pinsent Masons has been appointed by KCC as legal adviser for this stage of developing the concept of the fund. With the benefit of

Section 1 – Introduction

Pinsent Masons's advice, we have now reached a position to advise the most appropriate outline structure of fund. Pinsent Masons has developed a comprehensive paper on governance structure, which is included within this report.

There remain a number of governance questions that are a matter of how the participating Partners will wish the fund to be run, and these will need to be worked through over the next stage of the fund development by Partner representatives.

Following the scoping paper, progress has been made on collecting information on projects that may be presented across the County, and an understanding of the work that will be required on project pipeline has been formed.

Report Structure

This report deals with the overall concept and aims of the fund, and then looks more closely at the particular issues that arise in trying to deliver it. Recommendations for solutions are made, with detailed rationale behind these recommendations. The next stage of the work will be to take these recommendations to a steering group made up of representatives of all partners.

Whilst the concept of the fund is well developed, and generally accepted as an appropriate approach, the recommendations are open to be further developed or adapted by the partners in conjunction with the proposed Fund Manager.

Overview of the Fund

The aim of the KMIF is to optimise the economic and regeneration benefits from the funding made available by the partners – leveraging, but not supplanting lines of private finance for projects that would otherwise be available – whilst providing an appropriate commercial market level return on the funds invested. The fund is not designed to offer any gap funding for unviable schemes.

This policy will ensure that the funds available provide the best value in terms of outputs across the County. On this basis, the fund will only invest in circumstances where its intervention can enable qualifying projects to proceed in circumstances where this would not be the case if purely privately financed.

In this way, the intention is to leverage the benefits of the Kent fund investment as far as possible – applying funding which is complementary to private sector senior debt and equity.

There may be exceptions to this, where the fund has opportunities to invest in good local projects that will provide a strong return, where this will assist and strengthen the track record.

It is open to the fund to invest in equity and debt, both senior and mezzanine, in line with an investment strategy that is to be mutually agreed by Partners. In practice this would mean the fund either owning a share of development projects, or lending to them either in a position where it takes a high risk position (suitably remunerated), or a low risk position with a lesser return.

By necessity, the fund will operate within the framework of the EU State Aid Regulations, the implication of which is that any investments must be made at a market commensurate rate, or in accordance with a State Aid approved scheme.

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The rate of interest, security and other terms and conditions for each project will be assessed on an independent basis according to the circumstances of each scheme. As it is envisaged the Fund will be established with a considerable element of public sector funding, the lending terms will be established having regard to legal advice to ensure State Aid compliance.

Section 2 – Membership

MEMBERSHIP

In order for the fund to be inclusive across the region, but also to retain the ability to allow private sector investors to join if appropriate in the future, the membership structure, investment mechanism and partnership model need careful consideration from the start. It is essential also that these elements of the fund are equitable and fair, but at the same time measures taken to address this don't result in an unwieldy vehicle. The following recommendations (which will be developed over the next stage) have been made by Pinsent Masons to enable this.

Objectives

It is intended that the Fund will be a public/private Fund with the initial participants ("**Partners**") being local authorities across the Kent region and potentially the Kent Pension Fund. The structure needs to retain the ability to admit additional investors at future point(s) or "closings" to enable the Fund to expand and exploit opportunities to increase available funding.

Ideally all local authority participants will join the Fund at day one. If they are not all in a position to do so, there will be an equalisation mechanism to reflect that Partners joining subsequently will be investing in a Fund with a different risk profile and to ensure that the founder Partners are not in an adverse position for joining the Fund at first close.

Recommendations

Staged formal closings: Partners will join the Fund in formal, pre-determined stages or "closings". Founder Partners will join the Fund on "first close" (shortly after set up). Following this, new Partners will be able to join (provided they fulfil certain gateway criteria) and existing Partners will be entitled to increase the amount of their investment at formal closings. Potential Partners will apply for admission by invitation or application following a "call for Partners". New Partners will only be admitted to the Fund with the approval of 75% of the existing Partners (in terms of number rather than investment size) or such other threshold as may be agreed and set out in the Fund's constitutional documents. Partnership size will not be limited.

Size of partnership on first close will be optimised: Notwithstanding the potential for additional Partners to join on subsequent closings, the Fund will seek to maximise the number of Partners on first close.

Gateway criteria: Incoming Partners will be required to commit a certain level of funding (the "**Base Amount**"), subscribe to the Partnership Agreement and make an equalisation payment (see below). New Partners (outside of formal closings) will only be brought in following the exercise or waiver of existing Partner pre-emption rights. Incoming Partners not conforming to the Gateway Criteria would require the approval of existing Partners.

Equalisation payment: In addition to committing to pay the Base Amount, Partners joining on second close (or any Partners increasing the amount of their investment) will commit to paying:-

a. their investment commitment (which will be at least the Base Amount); plus
b. the amount by which the value of the Fund has increased since day one pro rated to the amount of that Partner's investment commitments (expressed through the following formula:-

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Investment commitment of incoming Partner= £10m

Total investments [(excluding incoming Partner)] = £200m

Value of Fund on day 1 = £200m

Value of Fund at relevant close = £300m

Amount payable = (300 – 200) x (10/200) = £5m]; plus

c. A risk payment should be considered, to be agreed between the partners but possibly 1 to 3% of the investment commitment, to account for the de risked profile of the fund;

d. an amount equal to the set up costs of the Fund pro rated to the incoming Partner's commitment (to be equalised amongst the existing Partners);

Amendments to legal documents on subsequent closings: As part of the investment package negotiated with incoming Partners, there may be negotiated amendments to the legal documentation or the structure of the Fund. Any such amendments would need to be approved by the existing Partners in accordance with the normal decision making mechanisms.

Rationale

Staged formal closings

a. Enables the Fund to grow incrementally.

b. Enables the Fund to capitalise on additional investment offers.

Periodic Closings (timings to be agreed)

a. Provides sufficient time for the Fund to establish and market itself to increase appetite for further investment.

b. Allows for the Fund to become more established; meaning it is a more attractive proposition to potential second close investors.

c. Formal set closes (rather than ad hoc admissions to the Fund) give the Fund manager certainty over the funds available for investment and Partners certainty over the size of the Fund and their control over it.

Maximising the number of partners on first close

a. (Subject to timing) may allow local authority Partners to participate relying on current statutory powers (see vires, section 12 below).

b. Gives the Fund manager more certainty over funds available for investment.

c. Will help stabilise the Fund earlier.

Equalisation payment

a. To create a level playing field amongst the Partners to reflect that those joining on second or subsequent close will be joining a Fund with a different risk profile.

b. The investment proposal still needs to be attractive to Partners joining on second or subsequent close. The equalisation payment is a way of levelling the playing field at the outset and may be more attractive to those joining on subsequent closings

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than other mechanisms such as reduced returns (pro rata to investment) or reduced voting rights for the duration of their participation.

Section 2 – Membership

FUNDING PROFILE

Recommendation

The Fund will be funded initially by the Partners (through cash and/or asset contributions). The Partners will have a commitment to contribute a minimum amount (the Base Amount as referred to above) but will be entitled to commit amounts above this. Returns will be pro rata to amounts committed (whether or not actually drawn down). The Partners will therefore not have equal funding commitments but will still have equal control and voting rights.

Where assets are approved by the Fund as appropriate contributions towards "project" delivery (such as a brownfield site or property for re-development) in line with the Investment Strategy, Partners may be able to contribute the Base Amount through the transfer of these assets into the structure. In such circumstances, it is more likely that such assets will be transferred direct to project vehicles rather than the Fund itself (see section 9; Seeding the Fund).

Partners will not be entitled to cancel undrawn commitments.

The Partners will not contribute all (if any) funding on day one. Instead, as investments / projects are identified, appraised and brought forwards (in accordance with the Investment Strategy) the Fund will draw down funding from each of the Partners in proportions pro rata to their total funding commitment. Each Limited Partner will invest in the Fund's entire portfolio (i.e. there will be no "excused investor" provisions).

Other public and private sector co-investment will be sought at Fund and/or project / investment level. The terms of any public grant funding (such as Regional Growth Fund funding) will need to be complied with. This may, for example, require such funds to be ring fenced and allocated for specific purposes.

Rationale

It would be financially inefficient for Partners to contribute funds to the Fund in advance of need. However, the Partners will enter into a legally binding commitment on admission to the Fund to commit a specified amount of funding.

GROUP STRUCTURE

Recommendation

The Fund will be a holding fund which will invest in a series of project vehicles (which themselves will invest downstream) or direct into projects. Investments in projects could be structured as equity, mezzanine or debt finance. For example, it would be possible for the Fund to:

a. establish wholly owned vehicles and/or invest in public private or public public vehicles set up for different investment purposes (such as infrastructure delivery, LABVs, rental funds) and with different risk profiles;

b. Invest in projects as identified above whether existing or new.

The Fund may seek to invest alongside third party / private investment where this is forthcoming or direct in its own right. Where the Fund invests, unless there is an available state aid approved scheme or exemption, the funding should be provided on pari passu

Section 2 – Membership

terms (where in conjunction with third parties) or on market terms (where direct in its own right) to ensure there is no unlawful state aid. (See Section 12 State Aid below).

Limited Partners could co-invest direct into project vehicles to encourage the Fund to adopt schemes in which they have a particular interest. Some projects may involve public assets (e.g. for redevelopment or infrastructure delivery). Where a local authority Partner is transferring an asset to a project vehicle, the transfer documents will need to include appropriate protections and controls for the local authority. However, any such controls will need to be reviewed from a public procurement perspective to establish whether the obligations on the project vehicle are sufficient to create a Public Contract for the purposes of the EU and UK public procurement rules[1] (the "**Procurement Rules**").

The preferred legal vehicle for project vehicles will likely be determined by the most tax efficient structure and the vires analysis (see vires, Section 12 below). The tax profile of any co-investors will be relevant here (see tax, Section 12 below).

Each investment / project will need to have in place its own robust governance arrangements. Requirements will be set out in the Fund's Investment Strategy and evidence of this would (amongst others) be a pre-condition to Fund investment. It is key that project vehicles would have jurisdiction to determine how their schemes/projects are delivered; this would not fall within the remit of the General Partner / Manager (although the Fund will require the Manager / General Partner to monitor compliance with the term's of the Fund's investment).

Rationale

Legal and financial ring fencing of projects; including the ability to leverage debt against specific assets.

Allows the Fund to increase its portfolio incrementally.

Flexibility for diversity of investment.

Ability to realise investment through disposals.

Increases attractiveness to co-investors (allows for investment in one project rather than the Fund's entire portfolio).

PREFERRED PARTNERSHIP MODEL

Recommendations

There are a number of available legal structures that could work here. Section 11 sets out the key features of each of these vehicles and their advantages and disadvantages. However the preferred option is to structure the Fund as a Limited Partnership. In this type of structure, the Partners are de-facto shareholders. There are two types of partners; limited partners (with limited liability) and at least one General Partner (with unlimited liability for the debts of the partnership). Therefore, in the Kent Investment Fund, the Partners would

[1] Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public services contracts, as implemented in England and Wales by The Public Contracts Regulations 2006, S.I. 2006 No. 5

Section 2 – Membership

participate as Limited Partners. The General Partner would have a nominal investment interest in the Fund (typically this is set around 0.1% -1%).

To retain limited liability, the limited partners cannot be involved in day to day fund management- this will be delegated to the General Partner who will have management control. Provided the limited liability of the partners remains in tact, their financial risk in relation to the Fund would be ring fenced to the amount of their investment commitment.

The General Partner will have actual authority as the agent of the Fund to bind the Limited Partners in arrangements that are within the ordinary course of the Fund's business.

The Fund will need to be operated by an FSA authorised entity. If the General Partner is not so authorised, the Fund will also need to engage a separate Fund manager to which the General Partner will delegate the majority of its functions.

The identity of the General Partner (and therefore whether or not there will be a separate Fund manager) will be dictated by the tax analysis. The three principal options here are set out below.

a. **Option 1: General Partner a special purpose vehicle established by the Partners.** The Partners in the Fund would also be shareholders of the General Partner (possibly through an intermediary vehicle). The General Partner could be set up as a company limited by shares (to afford its shareholders limited liability). The benefit of this option would be increased Partner involvement in the Fund governance arrangements. However, this option would add an additional layer of governance and complexity and would increase Partner time commitments. Additional decisions would need to be taken around General Partner membership and decision making. Care would be needed to avoid the arrangements becoming unwieldy and to reassure any private sector investors that the General Partner would not impede the investment process / Fund operations. In practice, the General Partner would delegate the majority of its functions to the professional Fund manager for operational efficiency. This delegation of functions also has the advantage of reducing Partner time commitments to the Fund. This is depicted as **Option 1** below.

b. **Option 2: General Partner to be the Fund manager** (or a member of its tax Group) for tax purposes (see tax analysis at section 12). In this option, although the Limited Partners would not would be directly involved in General Partner decision making, they would have a contractual nexus with the General Partner through the Partnership Agreement which would ensure appropriate governance mechanisms around operating the Fund were in place. A Partner review panel could also be established to give the Partners additional visibility over the performance of the General Partner (see "Review Panel" below). Further, under Option 1, the majority of the General Partner's functions would be delegated to the Fund manager in any event. This is depicted as **Option 2** below.

c. **Option 3: General Partner a local authority special purpose vehicle initially with the option to replace this with the Fund manager in future.** For timing purposes, the General Partner could initially be a special purpose vehicle established by the Partners (as Option 1). At a later date (e.g. after the Fund manager has been identified) the initial General Partner could be replaced by the Fund manager (or member of its tax group) (as Option 2).

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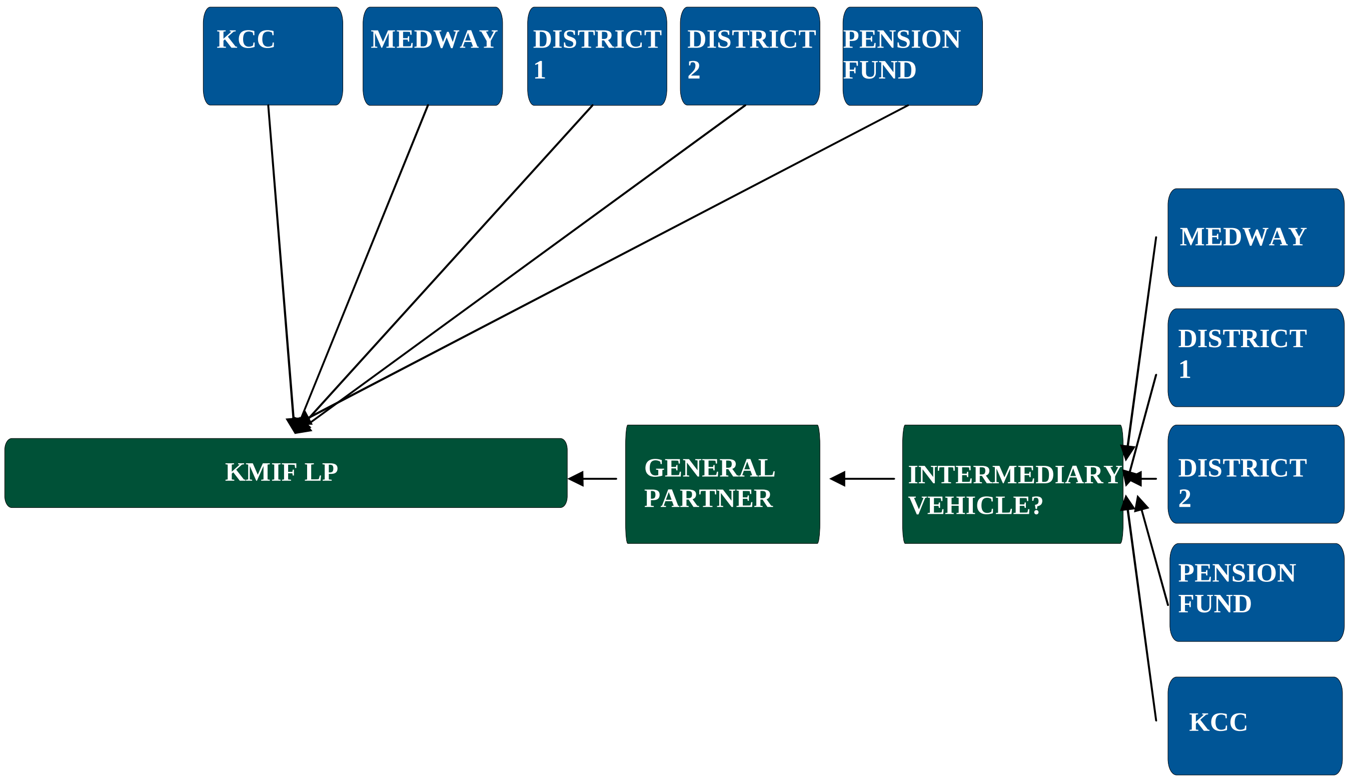
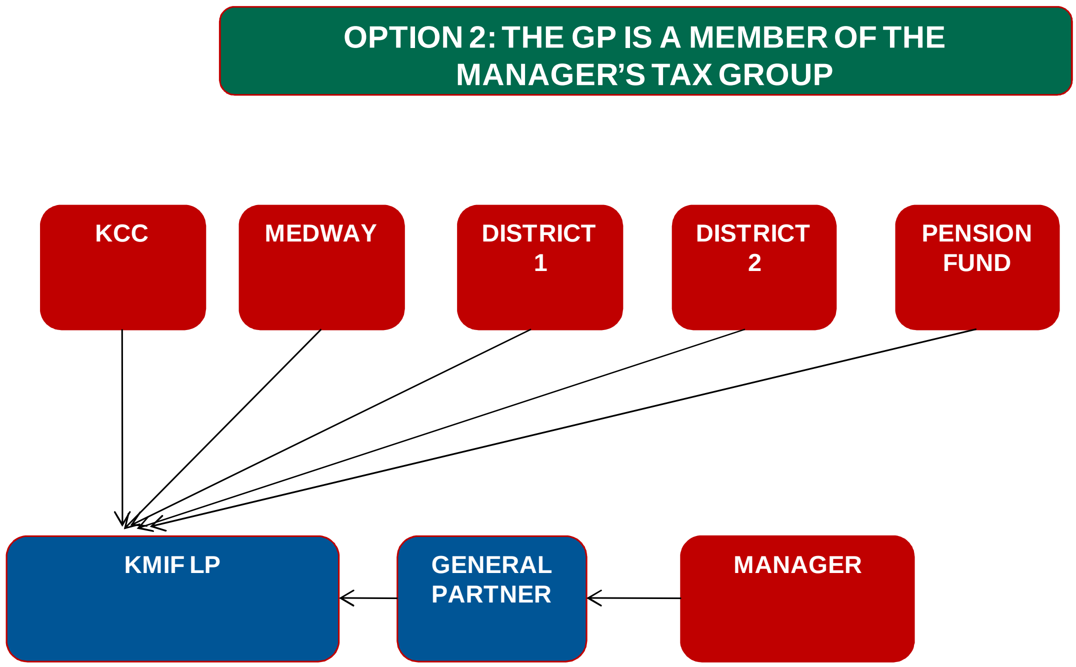
OPTION 1: LIMITED PARTNERS ARE SHAREHOLDERS IN THE GP



OPTION 2:THE GP IS A MEMBER OF THE MANAGER'S TAX GROUP



Rationale

Section 2 – Membership

Limited Partnerships are well recognised investment models in both the private and public sector (used on the Evergreen Urban Development Fund structure, by One NorthEast on its property investment joint venture with Langtree (On Site North East) and on emda's Blueprint) and is the preferred model here because:-

1. the Limited Partnership structure is transparent for tax purposes meaning the local authority Partners (and other non-tax paying Partners) will not suffer tax leakage;
2. the preference is for a single holding Fund structure (rather than other investors at the holding fund level participating or co-investing through a parallel fund structure). Therefore the structure must be attractive to co-investors. The Limited Partnership structure allows certain other tax exempt investors (such as pension funds) to retain their tax exempt status in the context of property investment whereas other structures (e.g. limited liability partnerships) do not;
3. the Partners would have the flexibility to take out returns if agreed (not necessarily in proportion to invested commitments / capital);
4. the Partners could structure their interests separate from the management structure;
5. it would provide a robust governance regime.

	Limited Partnership	Limited Liability Partnership	Company limited by shares	Company limited by guarantee
Tax	Tax transparent (tax exempt investors receive full benefit of exempt status)	Not tax efficient for certain tax exempt investors	Subject to corporation tax (tax leakage for tax exempt investors)	Subject to corporation tax (tax leakage for tax exempt investors)
Returns	Flexibility in the way returns are distributed			Difficult to make returns to the members
Market familiarity	Familiar vehicle: commonly used in the private investment market			Unfamiliar vehicle to the private investment market: more commonly used for by the public sector as a structure to undertake economic and social investment activity

It should be noted that the Limited Partnership structure is more complex than other structures due to:-

a. the requirement for an additional entity (the General Partner);
b. the Limited Partnership itself not being a separate entity and unable to itself enter into contracts, borrow money and hold property (this would be effected through the General Partner by a trust arrangement); and

Section 2 – Membership

c. more complex entry and exit arrangements: interests require assignment.

However, the market has well recognised responses to deal with the additional complexity of the Limited Partnership structure.

The requirement for the Fund to be attractive to the Kent Pension Fund means that the Limited Partnership structure is by far the preferred model; the tax benefits it offers far outweigh the challenges of the additional complexity.

Establishing the General Partner as a special purpose vehicle owned by the Partners (as Option 1 above) would appear to have the benefit to the Partners of retaining additional control over the Fund. However, in practice, the General Partner would delegate its functions to the professional Fund manager in any case. The appointment of a General Partner and manager forming part of the same tax group (as Option 2 above) would be VAT efficient (see tax, Section 12 below). The Limited Partners would have a contractual nexus with the General Partner through the Partnership Agreement which would ensure appropriate governance mechanisms were in place.

Section 3 – Fund Governance Structure

The governance, including decision making forums of the fund, will require buy in from all Partners to ensure maximum engagement and to deliver the cohesive approach to development across the region that is at the core of the KMIF concept. Pinsent Masons has provided the following recommendations, which will be subject to review over the next stage.

DECISION MAKING PANEL

Recommendation: There will be two (if GP is also manager) or three decision making forums within the Fund: the Limited Partners, the General Partner and the Fund manager. Decisions reserved for the Limited Partners will be limited as far as possible with the day to day management of the Fund being delegated to the General Partner and the Manager (where different).

Rationale: The General Partner and Manager (if different) need the freedom to take management and investment decisions without constant referral back to the Partners. There are also liability and FSA regulatory implications for Limited Partners becoming involved in day to day management. The Limited Partners will have the reassurance that the General Partner and Manager (if different) will only be authorised to act within the parameters of the Investment Strategy (approved by the local authority Limited Partners).

FUND PARTICIPANTS

Recommendation: The Partners will each have equal voting and control rights (irrespective of the level of their funding commitment and whether they joined on first or subsequent close). This will include usual "shareholder" protection rights such as reporting and audit rights, appointments to any Review Panel (see "Review Panel" below) and ability to remove the General Partner or manager). Most Limited Partner decisions will be taken by simple majority vote but some will require a 75% majority such as:-

a. the right to remove the General Partner or manager (non-default) and

b. amendments to the Investment Strategy (this will need to be approved by at least three quarters of the Limited Partners);

c. Limited Partner exits (other than through a disposal to an associate (a group company in the case of a private sector Limited Partner or another public body in the case of the public sector);

d. Admissions to the Fund;

It would be possible for the voting structure to be reviewed and adjusted on second close (e.g. to meet the demands of incoming investors), however, a default position would be needed in the case of failure to agree. Alternatively, incoming investors could be granted additional / different rights under Side Letter arrangements.

Rationale: Voting rights weighted to investment would require a more complex governance structure. Although this is common in private sector funds, it does not reflect that the local authority Partners have aligned policy objectives which go beyond simply protecting their investment. If Partners joining on second close had different (lesser) voting rights, again this would be a more complex structure and wouldn't reflect the equalisation mechanism in place to "level the playing field".

REVIEW PANEL

Section 3 – Fund Governance Structure

Recommendations

If the General Partner of the Fund is to be a third party (e.g. the Fund manager), to give the Partners additional visibility over Fund operations, a Review Panel could be established (consisting of individuals appointed by the Limited Partners) to act as a check on the performance of the General Partner (if the manager) / Manager. The Panel would review performance as required (but at least annually), consider any potential conflicts, and would have the ability to recommend removal of the General Partner / Manager to the Limited Partners.

Panel members would have no formal responsibilities or liabilities in relation to the Fund and would not have any formal decision making powers. Instead, the Panel would review investments (retrospectively) against the Investment Strategy to ensure that the Fund had taken the correct advice and that the economic outputs of investments are in line with the Fund's objectives. The ultimate decision to invest would remain with the General Partner / Manager.

Membership of the Review Panel should be limited to avoid it becoming an unwieldy forum. The size will likely depend on the number of Limited Partners. An independent Chair could be appointed to facilitate focussed scrutiny of the Fund's affairs.

Rationale

It is important that any such Panel does not have involvement in the day to day management of the Fund – this must be carried out by the General Partner or Manager (if different) as a regulated entity. In addition, such involvement could cause appointing Limited Partners to lose their limited liability status. It is also important that the General Partner /Manager has the ability to make investments decisions in a timely manner without constant referral to the Review Panel.

FUND MANAGER

Recommendation: The Fund will (through a competitive process) appoint a manager (or the General Partner will be) responsible for the day to day activities of the Fund including establishing appropriate governance arrangements and internal controls to safeguard the Fund's monies and investment portfolio. The General Partner / manager will have an internal Investment Committee responsible for:-

a. Portfolio management
   i. Project selection
   ii. Lending
   iii. Monitoring
b. Fund management
   i. Monitoring performance
   ii. Resourcing and managing reporting requirements and audit requirements
   iii. Reporting to the Limited Partners

There would be a management agreement between the Fund and the manager with appropriate recourse for the Fund in the event of the manager's failure to perform. Through this arrangement, the Partners retain some control over the Fund's activities (although this will fall short of involvement in day to day operations).

Section 3 – Fund Governance Structure

Recommendation: Unless the General Partner will be an entity authorised under the FSA to manage the Fund, the Fund will need to be managed by a regulated organisation (engaged at arms length). FSA authorisation comes with principles-based obligations including acting with due care, skill and diligence, acting with integrity and the observation of proper standards of market conduct. Therefore, the involvement of an FSA authorised entity in the structure will provide the Partners with comfort over the proper management of the Fund's affairs.

Recommendation: The Manager may appoint other consultants to assist with the day to day operating of the Fund (such as a Fund Administrator to carry out more administrative and reporting functions).

Section 4 – Governance at Project Level

It is essential that a clear differentiation between the fund manager and any management of individual projects is drawn. The Fund Manager's role will be to invest funds in suitable projects that meet the investment strategy, and to monitor compliance with the terms, but not to manage the projects themselves. The recommendations below provided by Pinsent Masons set out how project level governance may work.

GOVERNANCE AT PROJECT LEVEL

Each project vehicle would have its own governance structure. The structure would be determined by the ownership structure of the project (i.e. whether the project is a wholly owned subsidiary of the Fund or a joint venture between the Fund and a co-investor).

However, irrespective of the ownership structure, it is envisaged that each project would have its own governance structure in the usual way. It would not fall within the remit of the General Partner / Manager to determine how schemes/projects are delivered (although the Fund will require the Manager / General Partner to monitor compliance with the terms of the Fund's investment).

INVESTMENT STRATEGY AND PROJECT PIPELINE

Recommendations

Adoption: The Fund will invest in accordance with agreed parameters set out in an Investment Strategy (see section 6, Investment Strategy). The Investment Strategy will be the keystone document governing how schemes for potential funding are identified, how terms of investment are agreed and funding implemented. The Investment Strategy will be adopted on establishment. This document is steered by the local authority Partners; the Fund Manager will not have any influence over it and will simply see that it is implemented. On second close, the Investment Strategy could be updated and re-ratified to reflect the interests and objectives of incoming Limited Partners.

The project pipeline development and selection process is described in section 7 of the report, and will form the basis of how projects that meet the Investment Strategy criteria are selected for investment.

Amendments to the Investment Strategy: The Investment Strategy will have firm underpinning principles but will be flexible to adapt to changing policy drivers (intended for exceptional circumstances). There will be a clear mechanism for proposing and adopting amendments to/revised versions of the policy. Any local authority (but no other) Limited Partner may propose amendments to the Investment Strategy at set reviews (to be of a frequency as the Partners agree prior to Fund set up). Partners will also have the flexibility to call for a review of the Investment Strategy outside of these set reviews on the recommendation of the Review Panel, the manager's Investment Committee and/or due to some other extenuating circumstance (to be exercised in exceptional cases) to enable quick response to market changes. Amendments will only be adopted if approved by the local authority Limited Partners as set out above (see Decision Making).

Amendments to the pipeline: The project pipeline will be constantly evolving as investments are identified, appraised and either taken forward or aborted. The pipeline will also need to adapt according to market conditions and policy priorities of the Partners. The pipeline will be developed as set out in section 7.

Rationale

Section 4 – Governance at Project Level

The Limited Partners are asked to take a medium term view to investments. Staged reviews of the Investment Strategy achieves balance between flexibility to adapt to changing circumstances (market conditions and policy drivers) whilst giving the General Partner / manager and private sector investors certainty over the investment portfolio. It also allows for the achievement of output targets and results to be taken into account on the review date.

POTENTIAL PROJECTS

Recommendation: One of the potential projects identified as priorities for the Fund is a LABV (public private local asset backed vehicle). The LABV could be established to, for example, deliver regeneration schemes and/or provide asset management and/or Fund project appraisal services. The Fund's LABV partner would be procured on behalf of the Fund by a nominated lead Partner or the Fund's development function. Alternatively, there may be potential for East Kent Spatial Development Company (or other regeneration vehicles) to provide the appropriate resource and expertise. For the procurement implications of the Fund procuring an LABV partner see section 11.

Rationale: Key benefits of setting up such a delivery vehicle through the Fund structure are the ability to exploit economies of scale to:-

(potentially) increase value for money;

make participation in the LABV structure available to local authority Partners who, of themselves, could not otherwise develop a viable LABV business case.

RETURNS

Recommendations

It is proposed that during the life of the Fund, returns (or part of returns) would be recycled and reinvested by the Fund in accordance with its Investment Strategy (rather than being distributed to the Partners).

At the end of the Fund's life, the General Partner would pay the Limited Partners a return on their investment (similar to a dividend) pro rata to the amount of their total commitment as set out in the Partnership Agreement.

The returns policy may need to be reviewed at the request of incoming investors to allow for (for example) annual distributions. If this was the case, the Fund would need the right to re-draw amounts returned to Partners resulting from e.g. short term investments, aborted investments or bridging finance support.

Section 5 – Outputs

OUTPUTS

Whilst the fund needs to make a commercial return on investments, it also needs to deliver valuable regeneration outputs to Kent and Medway rather than simply facilitating ad hoc development across the region. There needs to be a series of quantifiable outputs that can be targeted in order to deliver this. These will then be used as an important part of the project selection mechanism, and will ensure that best value is delivered against measurable criterion.

The outputs are likely to consist of a targeted total across the region; however there may be room to negotiate separate target areas to ensure that funds are invested on a geographically equitable basis. For example a certain number of jobs may be the main deliverable for East Kent region, whereas Medway might be affordable housing. In practical terms, splitting the targets into more than 2 or 3 separate regions will be difficult.

The actual target categories and numbers will need to be worked up during the fund development, and will require input from all Partners. The targets are likely to be based upon pre existing policies for the region.

Whilst it may be aspirational to aim for the highest possible number of outputs, it must be remembered that the fund must still be able to make a return to keep investors content and to maintain the potential for a private sector investor to join at fund level; therefore an achievable set of outputs per £ invested should be agreed in an attempt to find this balance.

The output targets will then feed in to the project selection process and also the pricing structure.

Example outputs that may be considered are as follows:

Output	Measurable
Jobs created (consider industry specifics or job types; are some more preferable than others etc?)	No. Jobs
Brownfield land regenerated	Ha
Affordable housing units (consider against policies)	No. units
Private sale/private rent housing units (consider against policy)	No. units
Carbon footprint reductions	Not sure if this would be quantifiable/desirable etc
Space created at BREEAM 'excellent' level	Sq ft
Derelict space converted/regenerated/improved	Sq ft

Section 6 – Investment Strategy

INVESTMENT STRATEGY

The Investment Strategy, as explored previously, will be the tool by which the Partners divest investment decisions to the Fund Manager and General Partner. The Investment Strategy will consider a number of factors and is expected to cover the following:

- Foreword – this will outline the objectives of the fund, and give a point of reference for what the more specific elements of the strategy are striving to achieve. This section will reference the strategic frameworks of the region (including the 5 key challenges) and will set the context for the fund. It will provide a central view on the delivery of the fund that will have been developed by all partners and therefore be a useful tool to refer back to when changes to the Investment Strategy are made.
- Basis for Investment – detailing where state Aid compliance will be required, the fund's position on debt/equity, and senior or mezzanine, and how leverage will be achieved.
- Deal Sourcing – the discussions to date around project and investment sourcing have been exploring the involvement of either an internal or external development resource, and the role of project sponsors in bringing projects to the fund. This section will provide clarity on this.
- Investment Sourcing – how funding external to the local authorities will be sourced.
- Investment Process – this section will describe the process of investment, dealing with due diligence, loan underwriting, loan servicing, the role of the investment committee and key personnel.
- Investment Policy – this will contain a strategic policy, such as the fund life period, investment return objectives (eg minimum hurdle rates), outputs, phases of investment and reinvestment, and policy for cash held.
- Terms of Project Funding – Loan Underwriting Criteria. This will usually include the below:
  - Sponsor/Borrower; track record, financial status, equity availability
  - Project; construction process, planning status, rationale, details of timelines, exit strategy
  - Project Team; main contractors and their financial condition, contract details, warranties and duties of care; other financiers
  - Scheme Viability; development appraisal, financial analysis and interdependence of other borrowing, best/worst case scenario analysis.
- Lending Rate Scoring Process – This will usually include a table as shown under the 'pricing approach' section.
- Fund Restrictions and Limits – Detailing any sector or project restrictions, gearing limits, reinvestment periods, geographic limits and prohibited assets.
- Winding Up Provisions – How the fund will be wound up at close, including whether developments are carried for a period after closure before liquidating.

The Level of Commercial Return

The target level of commercial return for the fund will be set by the Investment Strategy. Because all investments will need to be made on a market rate basis or other State Aid exempt or approved scheme, the level of return that the fund will provide for the investors

Section 6 – Investment Strategy

will predominantly be dependent upon the risk level that the Partners decide they are happy with. This is because the market will always price the risk significantly ahead of any other outputs that may be delivered.

This means that the fund should always provide a level of return close to market rate for the agreed risk, but also give the Fund Manager the freedom to value the outputs of each project when pricing the loan and therefore encourage the delivery of these outputs.

Pricing Approach

The pricing approach below shows how the type of investment the fund might make could be priced. This shows the importance that outputs can be given in comparison to the other factors that a Fund Manager may consider when pricing a loan. The weighting could be varied, but it would potentially be undesirable to increase the Employment and Regeneration section to greater than, say 35%. The table is indicative, and would ultimately need to be cross checked against the rate available in the market to ensure State Aid compliance (or proxy rates, as to be strictly in line with strategy it may be the case that market lending is not to be displaced, therefore there would be no market rate.)

This process will allow a suitable balance between financial and regeneration objectives to be met.

AREA	CONSIDERATIONS (BUT NOT LIMITED TO)	SCORE (1 - 5)	WEIGHTING	WEIGHTED SCORE
Employment and Regeneration (pre agreed outputs, see 'outputs' section)	Output numbers in required areas Ability for urban regeneration with a specific focus on support for entrepreneurship, local employment generation and community economic development. Brownfield site regeneration. Geographic and sector balance (end user job creation). Timing and ability to recycle loan into additional regeneration and job creating projects		35%	
Sponsor	Experience generally and specifically relating to the proposed project. Integrity of the borrower. Resource capability, quality and commitment. How many other projects are being undertaken and what is the time line of these. Financial status and analysis of key balance sheet, P&L and cash ratios.		20%	
Construction & Market Characteristics	Location – development being delivered into a liquid market with good tenant demand. Building quality – suitability for end users, BREEAM rating etc. Project Team - Quality of the project team, including the main and sub contractors. Availabilities of warranties and duties of care for the team. Type of building contract being employed.		25%	
Structure	How the capital structure is split between equity, mezzanine and senior. Attachment and detachment points for the mezzanine How will equity be invested – pari passu/up front? The Inter-creditor and the rights of the mezzanine lender - Step-in clause etc		20%	

Section 6 – Investment Strategy

	How are the returns to mezzanine derived? – Upfront fee, current pay, coupon rolled up to maturity, back end fee/profit share/warrants.
Total	

WEIGHTED SCORE	REQUIRED IRR
1 - 2	low
> 2 - 3	medium
>3 - 4	high
>4	very high

Current Returns on Investments

The table below is a broad indication of market terms available for these types of projects. Naturally the actual returns will vary a great deal from project to project. Whilst the fund will not necessarily be lending on the same terms, and may be investing in an area that the market has failed (and therefore there will be no direct comparables), this gives an idea of the type of returns that may currently be achieved across the risk spectrum.

The type of project that may fit in the lower risk end of the spectrum could be a development of new council office accommodation, and therefore with an occupier, with the council in a joint venture with the developer using its covenant to reduce the debt level. The project may be funded with say 45% equity from elsewhere, with the fund taking a senior debt position and therefore first call on any repayment in the event of default.

A high risk type of investment may be a heavily speculative office scheme, owned by a Special Purpose Vehicle (SPV) with no covenant, where the fund lends a subordinated or mezzanine slice of debt. In this instance in the case of default the fund would be the last lender to receives money back, and there are no funds in the SPV to repay the debt.

LOAN LEVEL	INVESTMENT		DEVELOPMENT	
	Max Loan to Value	Total Return*	Max Loan to Value	Total Return*
Senior Debt	65%	4.82%	55%	6.82%
Mezzanine~	80%	15%	75%	18%

Source: CBRE Real Estate Finance, Debt Origination Team

** Total return for senior debt calculated at LIBOR+ Fees+ Applicable margin. Mezzanine returns are an assumed 'all-in' return requirement.*

~ Indicative mezzanine returns based on 65-80% LTV and 55-75% LTC slice above senior level debt.

Issues Surrounding Appropriate Levels of Return for Fund

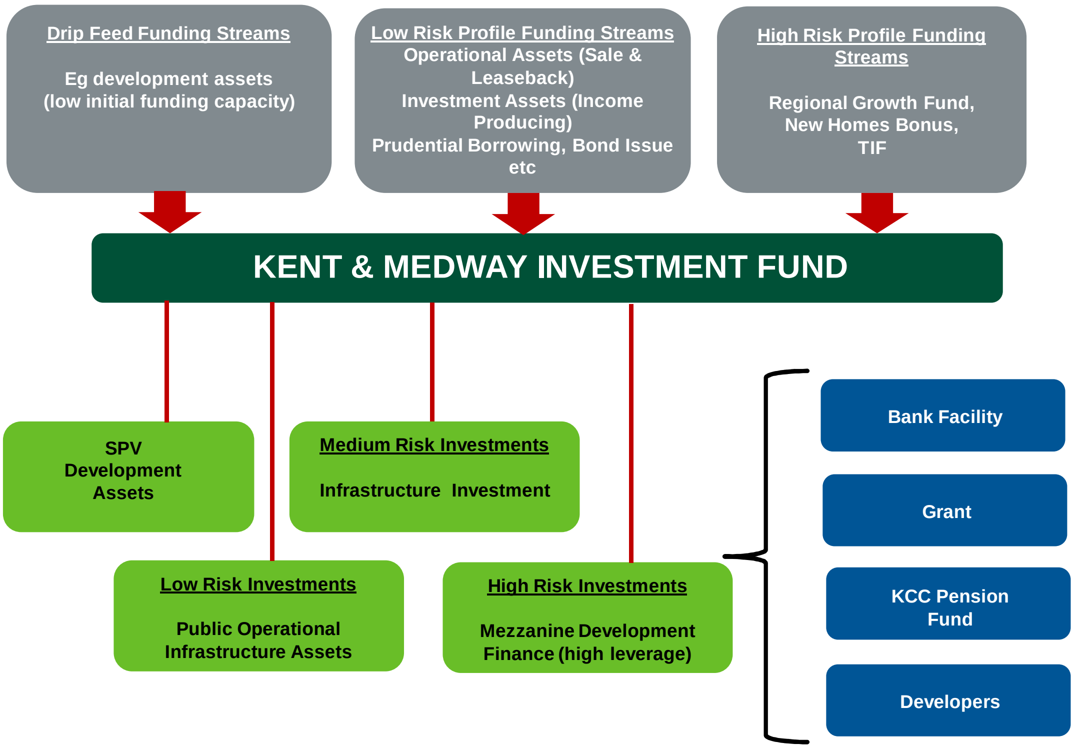
Whilst one of the aims of the fund will be to make a commercial return on investments, the source of funding will need to be clear when considering the level of returns that should be aimed for. For example, if all seed funding is derived from repayable loans, investments in high return projects would mean that the Partner is constantly exposed to a higher risk of not receiving the initial stake back, and therefore not being able to repay the loan. This of

Section 6 – Investment Strategy

course needs to be balanced out with receiving a high enough return to cover interest payments on the original loan.

In a scenario where capital used to seed the fund is likely to cause less risk to the partner if it isn't repaid, it may be appropriate to invest this is higher risk investments as the returns will be better.

Therefore once the basket of assets and capital to be used to seed the fund is confirmed, the Partners will then need to seek advice on the suitable risk profile for the fund. The Fund Manager will then be able to select investments to try and achieve this profile. This is illustrated in the green boxes in the diagram below.



Without an idea of the approach to risk by all potential partners, and indeed a better view of projects, it is not possible to forecast returns at this stage. Neither is it possible to benchmark returns against any other fund, as this is a unique proposal and returns will be driven by the collective requirements of several individual authorities.

Section 7 – Project Pipeline Development and Selection Process

Introduction

This section sets out the mechanism for which potential projects can be selected and evaluated to be put forward for first round investment by the fund. This process will be subject to further development through partner working groups.

The establishment of the criteria is based on a requirement to be:

- Transparent and equitable
- Relatively easy to apply
- Commercial
- Sensitive to regeneration outputs
- Compliant with the fund's investment strategy
- A framework to maximise overall beneficial impact of the fund to the Kent region

The assessment criteria will evolve once the initial investments have been made, for future investments in the fund in line with the Investment Strategy (which is expected to change over time).

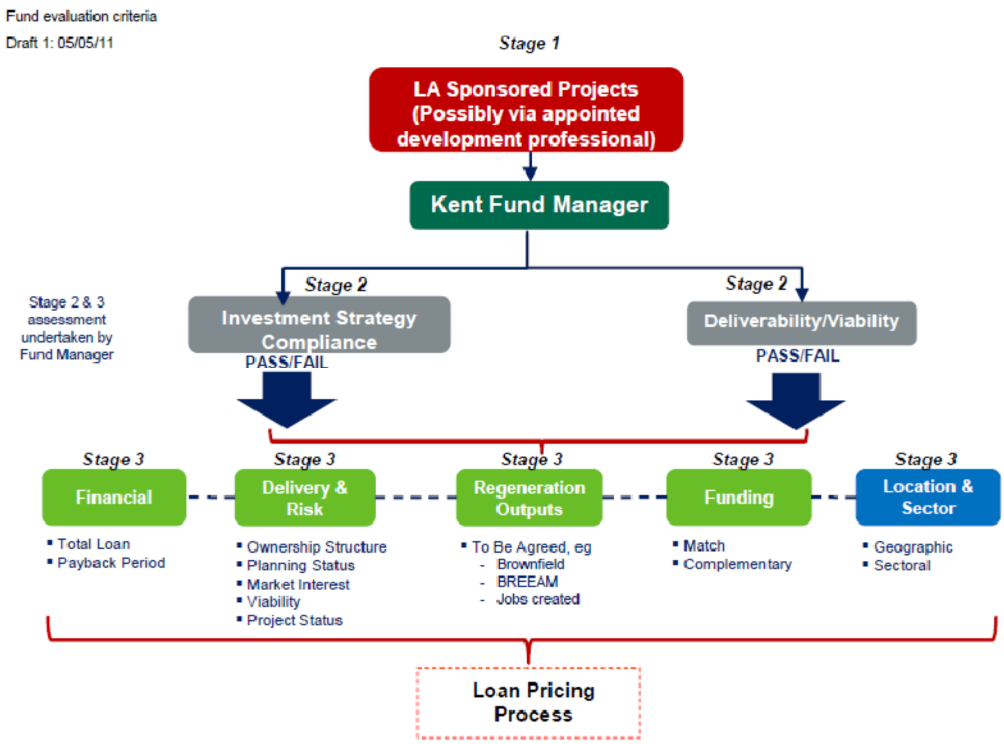
The Process

It is recommended that the project selection and evaluation process will be undertaken over 3 stages:

Stage 1 (Pipeline Development) requires Local Authorities to propose potential suitable projects for investment (which may follow the call for projects).

Stages 2 and 3 are the evaluation process undertaken by the Fund Manager and signed off by the General Partner.

Section 7 – Project Pipeline Development and Selection Process



Stage One – Pipeline Development

Once the initial pipeline has been developed, it will become the responsibility of the partners (either individually or through a combined approach) to continue to develop this. It is likely that local authorities will use tools such as local authority asset management strategies and call for projects (to the public and private sectors) to undertake this.

Local authorities are invited to put forward projects for funding in accordance with KMIF investment criteria. These may be private or public sector projects and the Partner need not necessarily be involved in them, but will be a 'sponsor'. Once the investment strategy is completed, this will form the guidance that Partners will follow to determine whether the projects are likely to be appropriate.

This stage is designed to provide an opportunity for stakeholders to reflect local priorities in deciding which projects to put forward.

In order for projects to be developed to a stage that the fund will be able to make an investment decision, considerable work will be required. Partners will need to discuss whether individual member organisations will carry out this work, or whether a central resource should be employed, at cost to the individual projects, to provide this.

Stage Two

This is a pass/fail sifting process based on the information put forward within the Stage 1 proformas. This will be undertaken by the fund manager.

The Stage 2 sift comprises two tests:-

Section 7 – Project Pipeline Development and Selection Process

1. **Additionality** – will investment in the project create additional investment in the Kent & Medway region? [note that some investments may be made on a purely commercial basis to cross subsidise risk on other projects]

- No displacement of other funding streams
- Additional outputs which would not otherwise be generated
- Acceleration of the delivery of outputs

2. **Financial viability and deliverability** – can the project be implemented within the appropriate timeframe and is it financially viable with the proposed intervention?

Stage Three

Stage three involves ranking projects against each other through a scoring mechanism applying the assessment process set out below.

CB Richard Ellis has created an assessment model which considers risk weighted cost against regeneration outputs.

This provides a transparent, equitable and easy to apply approach to ranking each project which can easily be audited.

The Stage 3 evaluation process works as follows:

1. **Gross Cost**

- Considers amount of loan multiplied by the period it is lent for
- Also considers lead in period for stage 1 projects (ie the period of time money is earmarked for a project during which it cannot be used elsewhere – 'non utilisation')
- The result is a time weighted opportunity cost

2. **Risk Weighting**

- The risk and deliverability will be measured using an agreed matrix
- This acts as a multiplier, where very low risk projects have a multiplier of 1 and high risk have a multiplier of 1.5
- This is applied to the 'Gross Cost'
- The result is a risk and time weighted cost

3. **Regeneration Outputs**

- In order to compare projects, outputs have been turned into 'Regeneration Points' that can be compared like for like
- The total outputs delivered by each project can be turned into points, with each point being 1% of the target. This then gives equal importance to each regeneration target.
- Say the result is one Regeneration point equals 0.98 Ha; 29.2 jobs; 980 sq m BREEAM space
- Each project is then assessed against the above measures.

4. **Cost/Regeneration Point**

- The time and risk weighted cost is then divided by Regeneration Points

Section 7 – Project Pipeline Development and Selection Process

- The result is a cost per Regeneration Point ratio, and this provides a basis for comparison of value of the projects

Below a worked example can be seen. Here project 1 represents better value to the fund at 4.3/Regeneration Point as opposed to 6.6/Regeneration Point.

	PROJECT 1	PROJECT 2
Lead in period	0.5 year	1 year
Loan Period	2 years	3 years
Principle Sum	£8m	£11m
Risk Weighting	1.3	1.5
Risk & Time Weighted Total	*(0.5+2)*8*1.3* 26	*(1+3)*11*1.5* 66
Regeneration Points	6	10
Cost/Regeneration Point	*(26/6)* 4.3/Point	(66/10) 6.6/Point

Stage 3 concludes with an overall numerical priority assessment of the value of each project based on value for money.

[This template and accompanying matrix is subject to final agreement of the proposed weighting mechanism, in particular the risk weighting]

Following Stage 3, full due diligence and underwriting will be commenced. This will include detailed financial and output appraisals. The process to be followed will be developed and described in the Investment Process section of the Investment Strategy (see section 6; Investment Strategy).

Section 8 – Indicative Projects

CBRE has met with many of the Councils in Kent to discuss which projects they are aware of that may be early wins for the fund. At this stage, the list of projects is indicative. These projects have not been selected as confirmed projects, and neither has the opportunity for further projects to be put to the fund been passed.

Given the level of information available, we suggest an official call for projects is made during the next stage. This will also give the opportunity to get a better view of what private sector projects there might be for the fund to invest in.

These projects have simply been chosen as samples, which can be used to demonstrate how the fund might be used in the early stages. Before any projects are actually presented to the fund, selection criteria will need to be developed, and projects prioritised using this.

The previous section of this report (section 7) deals with selection criteria.

Partners Visited

The following potential Partners have been visited to date to discuss projects:

East Kent Spatial Development Company
Gravesham
Dartford
Kent CC
Swale
Medway
Dover
Maidstone
Thanet
Canterbury
Ashford
Tunbridge Wells
Shepway

This list is not exhaustive. Visits will continue to be undertaken and should any further suitable projects that could be used to illustrate different approaches be forthcoming, these may be developed.

These meetings have generally been with heads of property, economic development or regeneration, following referral by Chief Executives after initial Fund briefing meetings.

The list will be constantly changing and updated by the partners during the course of the fund.

Project Criteria

CBRE has been looking for 'quick win' projects, which will be required to both kick start the fund and created an early track record.

The types of projects that CBRE has been looking for, for the quick wins (the fund will inevitably become more diverse over time), are those that would commence within the next

Section 8 – Indicative Projects

say year to two years. These must be viable projects, or if they need gap funding they have this allocated from elsewhere, as the fund must make a viable return for all partners.

Importantly these projects may be private or public sector, and as quick win projects it is unlikely that the fund will own or manage them. The fund will simply make a decision on whether the investment's risk profile and potential outputs are in line with the investment strategy. If so, then either equity or debt finance (to be agreed during fund set up) will be provided. There will be limited interference from the fund in the project, with the exception of monitoring to ensure that funds are being expended as agreed before each tranche of debt is made available.

Quick win projects should be deliverable quickly, and so have planning consent, usually a developer on board, a worked up scheme with a reasonable chance of an exit for the fund at the end of the term of the loan. Any project sponsor should consider when putting projects forwards that it must be attractive for other Partners to invest in, which *inter alia* they will be asked to do through the fund.

Although project criteria will be developed further with Partner involvement, along with the Investment Strategy, it is suggested that at this stage the above criteria is used to explain the type of projects that the fund may be able to assist during the early phases of the fund.

Progress to Date

Progress to date has been varied, with some potential partners having more early deliverable projects than others. It has become clear across the region that the level of insight into private sector projects, and involvement in delivery of private sector projects is varied.

Project Categories

We believe that a number of types of projects should be explored through this process, and these can be broadly grouped as follows:

Low Risk, Low Return Investments

Such as Public Sector accommodation etc.

Medium Risk, Medium Return Investments

Such as infrastructure funded using Tax Increment Finance.

High Risk, High Return Investments

Mezzanine investments.

Development Assets

To be developed through an SPV.

Housing Rental

There is the possibility of the KMIF using assets in some kind of joint venture to encourage housing delivery.

To date a number of projects have been identified that fall within these categories. Below is an illustration of projects identified during meetings to illustrate the type of investments that may be suitable. These are used to illustrate the type of solution the Fund may be able to

Section 8 – Indicative Projects

deliver for them. It should be noted that this list does not infer which specific projects the fund may invest in, nor does it preclude any projects not mentioned.

Low Risk, Low Return Investments

Dartford Borough Council Civic Centre

Currently DBC are fairly far advanced with negotiations with Network Rail and SEEDA to marketing a development proposal at Station Mound on which their offices sit. Whilst they may be able to fund some of the development of new offices with the proceeds of the sale, they may not be able to fund all of it, or the opportunity cost may be prohibitive. Use of the fund could be an alternative to the Council entering into a PPP or similar, and would be a good, reliable long term investment for the fund. Whilst the fund's evergreen nature should mean it is considered as a rotating fund, the presence of a number of long term, low risk investments such as this may add a stability that makes the fund attractive to the institutional market in the future, and allow other higher risk/return investments elsewhere.

Medium Risk, Medium Return Investments

International House, Ashford

International House is one of the SEEDA assets that is currently being disposed of. It is currently unclear how the disposal will work, but on the assumption that it remains within the public sector, and under the control of either Ashford Council or Kent County Council, it is likely to provide an investment opportunity.

The scheme we have seen most recently requires the existing building to be demolished or vacated prior to any works being undertaken on the site; this is a costly solution as income from the existing tenants will be lost, and potentially those tenants will end up occupying elsewhere. It may be possible however for this delivery to be re engineered, and development within the curtilege to start whilst the tenants remain in place. This would then allow a decant into the new offices, thereby retaining rents and vacating International House.

Subject to a development proposal and further progressed scheme, this sort of project could potentially be funded by the KMIF, allowing a more structured development approach through providing early bridging finance. The rate and risk will vary considerably depending upon whose covenant is used in the borrowing and what the scheme actually looks like.

The Bridge District Centre, Dartford

The basic premise is that Taylor Wimpey will come to the maximum number of houses they can build without a district centre (2 doctors, one dentist and some local retail space), but seem to be dragging their heals at delivering it. Meetings with the developer would be required to take this any further, but the district centre seems a viable scheme, which isn't being delivered. The fund could lend to a developer to deliver this, perhaps backed with a rental guarantee from Taylor Wimpey for a period of years, and the exit would be sale to the market in say year 3 – 5 when the units are fully let.

Watermill Wharf, Chatham

This is a redevelopment of 4 railway arches, to be made into business start up units (smart, clean uses). The scheme is in fact not market viable, but it is lettable. Medway feel that it may be possible to include the cost of developing these as a s106 requirement to the site

Section 8 – Indicative Projects

next door (Stroud Riverside), which they own and will be marketing in due course. Therefore the fund could make a loan for the start up units to be developed, releasing business space, regenerating a small area and potentially creating jobs, and the Council could guarantee the loan repayment, until such point that their development land is sold off where a bullet payment is made to the fund by the Council, with the Council being repaid through the s.106.

Eco-refurbishment Fund

The Energy Saving Trust has developed a Public Private Partnership financing and delivery model to enable local authorities to work with the incoming Green Deal legislation.

There is an opportunity to roll this model out across Kent. The model is predicated upon retrofitting private sector housing stock, and recovering the cost through a fixed cost on energy bills (the total is required to be lower than it would have been prior to the retrofit.)

There is a possibility for the fund to enter this as an equity partner, a senior debt funder or a mezzanine funder. At present, the model is being considered across a number of authorities, with Birmingham City Council having completed a business case and due to procure a deliver partner during this summer.

The average return (if an investor takes the entire debt position, as Birmingham CC is considering doing) is forecast to be c.6.5%. The project is scaleable and returns improve through economy of scale.

High Risk, High Return Investments

St James's Street, Dover

St James's Street in Dover is an area in the town centre, currently with an obsolete tower block, a car park and other minor uses occupying it. There is an existing planning consent for a scheme that is now undeliverable, but a new application will be submitted this summer, with a result expected around Christmas.

The revised scheme will be mixed use, with a hotel and restaurant focus. Currently Dover Council own c.70% of the land, and have a development partner, Bond City Developments. At present it is understood that occupiers have been found for the hotel and several restaurants and a number of retail units.

Some bank funding is available for the scheme, which we have been told is viable, however before works can start some further land assembly is required. It is anticipated that the fund could lend money for the purchase of the required land, subject to alignment with the investment strategy, against the covenant of the Council and the scheme could refinance the money once there are further prelets. Using the Council's covenant will move this project from a high risk investment to a lower risk investment, depending who has first call on the security.

Development/Infrastructure Package

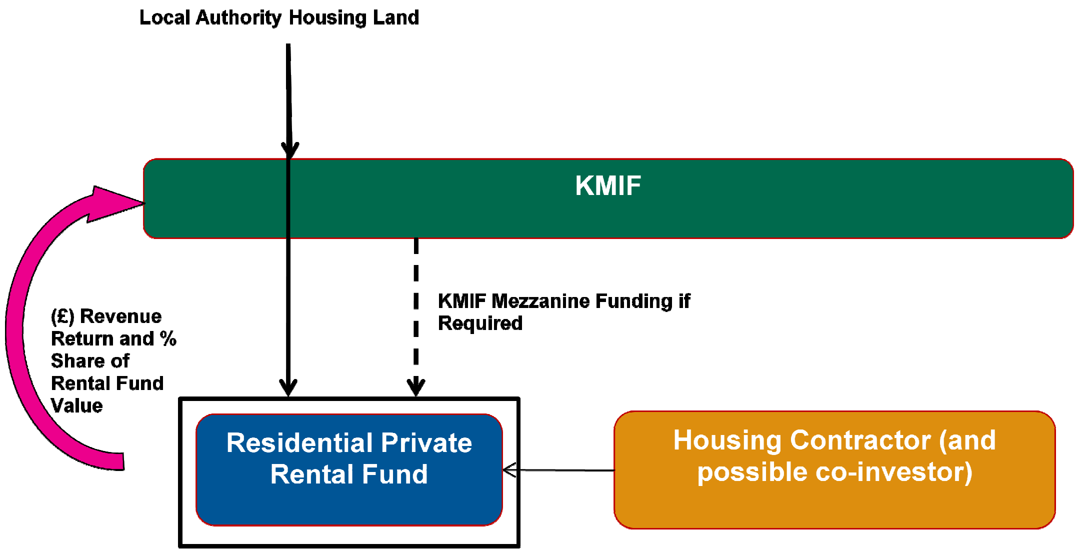
There is also the potential to provide some sort of funding agreement, pre agreed, where a District may be selling land that needs improving. For example, one end of Stroud Riverside is not being delivered by the market (we are told, and the Fund Manager would need to confirm this), as it requires forward funding of say £3m to build a new river wall. Perhaps these types of sites could be sold with the benefit of a pre agreed funding arrangement, with the District's covenant backing it, and in exchange retain a value of the site that can be

Section 8 – Indicative Projects

sold either when the defences are completed or later in the development. This would accelerate housing delivery.

Housing Rental

Through our meetings with local authorities, there is interest amongst some of them in stimulating investment in new private rented stock. It would be possible for the KMIF to invest either directly in new residential units where a developer is promoting a private rental fund or, alternatively through a public sector sponsored proposal that could be structured as follows:



Local authorities in strong locations for a rental product could identify their own sites for development of a potential rental product. Again by taking a portfolio approach, sufficient scale could be achieved across Kent to make it attractive enough for a housing contractor to take a reduced return. In addition to participating local authorities investing their land as equity in the fund, the KMIF may then also want to consider a direct investment into the fund in return for a rental return and the prospect of capital growth. The level of return for such an equity investment would usually be approximately 5% - 6% net of voids, running costs, etc.

The advantage of this structure is that the KMIF would help stimulate a large number of quality private rented units that would be in areas where there is strong rental demand as well as potentially strong capital growth opportunities. Through the fund investing in assets where the local authority itself also has a land interest there is a mutuality of benefit.

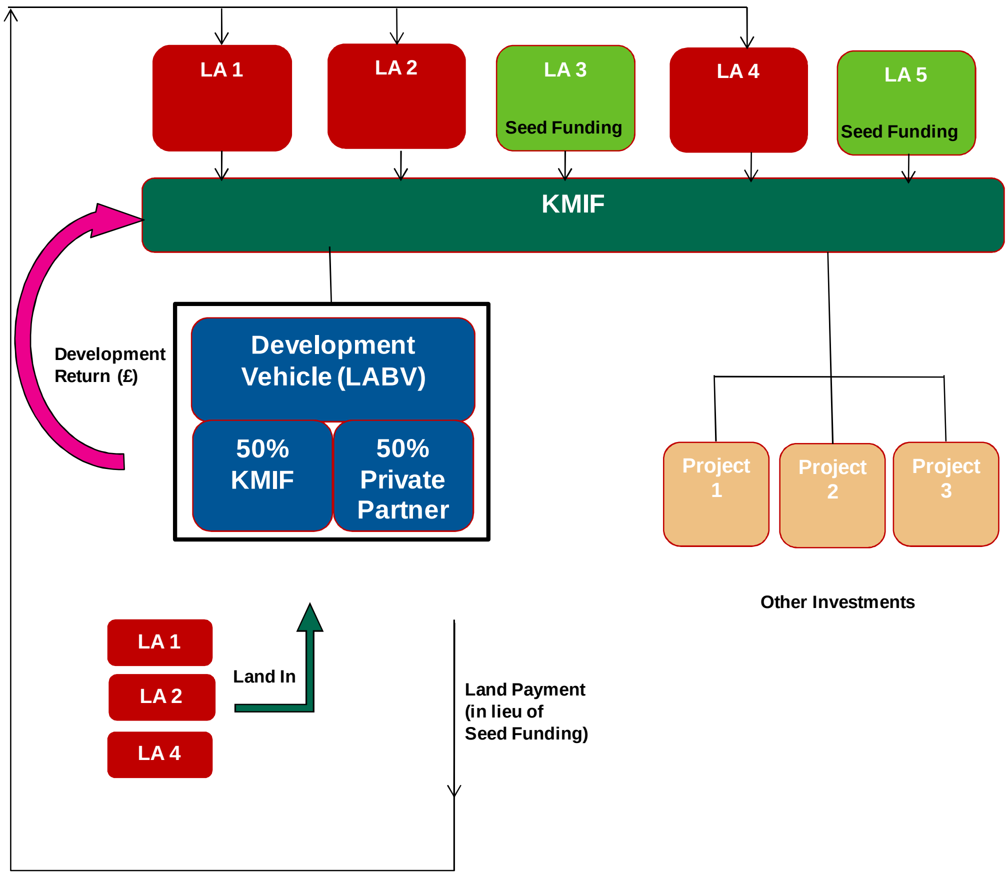
SPV/LABV Development Assets

Further thinking on some type of SPV for development assets – could potentially include SEEDA assets.

Based upon our discussions with local authorities across Kent, a number of publicly owned development assets have been identified. Indeed, some of the local authorities we met with have considered creating a SPV, to realise the development potential of their assets. In some cases the value of the assets has not been sufficient to justify the creation of such a vehicle by an individual local authority. The concept of being able to pool assets to achieve the benefits of a LABV has in principle, been positively received. To achieve the necessary scale we consider a special purpose vehicle/local asset backed vehicle could be created to

Section 8 – Indicative Projects

act as the development vehicle through which the development value in the KMIF Partners' land assets could be realised. A potential structure for this is shown in the diagram below.



A local asset backed vehicle is often structured as a Limited Liability Partnership in which the public and private sector control the development company through a 'deadlock' structure i.e. each party controls 50% of the interest. The LABV is usually seen as an attractive form of vehicle because the private partner obtains access to a pipeline of development projects and benefits from a public partnership where there is a general alignment of interest between the public and private partner.

From the public sector's perspective, such a vehicle provides resourcing and expertise to enable development assets to be worked up and brought forward for development. Because there is some risk sharing and assets are dealt with on a more arm's length basis through the development vehicle, the private sector partner is usually willing to proceed on the basis of an agreed development management fee with the commensurate profit realised from the development then being split on a 50/50 basis with the public sector.

In the proposal outlined above, the return and attraction to the KMIF would be 50% of the development returns through the vehicle as well as potentially a return on any debt that might be provided to the vehicle. In the example provided outline above, if the value of the undeveloped land assets was say £100m with a projected gross development value (post development) of say £300m the return to the KMIF through its 50% ownership in the LABV would be as follows:

Half of the profit at 15% of development costs (say £200m) = £30m

Split 50/50 i.e. £15m + the original value of the land = £100m.

Section 8 – Indicative Projects

Total say £115m

These figures are simplistic and provided for purely illustrative purposes.

Section 9 – How the Fund could be Seeded

The Fund will require working capital and therefore will need to be endowed with either an asset base or other funding stream.

The fund is likely to be seeded from 2 sources; realisation of the value of Partner assets and other availability of funds, potentially made available by central government.

PROPERTY ASSETS

The property assets could broadly be categorised as:-

Partners' Property Assets

- Operational assets;
- Non-operational income producing investment assets; and
- Development assets

Clearly these have different characteristics and the mix and balance between the asset pools will need to be understood before a detailed structure and investment strategy is created.

How Capital can be Realised from Property Assets

It is open for Partners to decide how they will create cash from assets they wish to dedicate to the fund. The first decision however is whether the Partner will transfer the asset to the fund, for the fund to derive value, or whether they will keep control of the asset and derive the value themselves, and simply transfer cash to the fund.

The latter is a cleaner method (and more tax efficient in SDLT terms, as described in section 11) that will ensure Partners can keep control of their assets; however there is the understanding that the Partners may not have the resources to do this.

If the fund is expected to perform these functions this will need to be resourced, either through a sub contractor to the fund (which could be the same firm as the fund manager), or through a sub contractor to the partners; this role could either be resourced externally using an established development practice, or internally using officers or a company such as East Kent Spatial Development Company.

The use of assets will be dependent upon the individual authority's asset management strategy, and can be illustrated as below:

Operational Assets

Any operational asset may be used to provide a capital sum. This is likely to take the form of a sale and leaseback, which could either be by way of the sale of a lease for a fixed period, or outright sale of the freehold, both with the occupier paying a rent. It would seem appropriate for Partners to deal with this themselves, allowing them control over the terms of the agreement. Alternatively the fund could affect this through a back to back agreement with a third party. This would not necessarily require the fund to take ownership at any point, however either the freehold ownership or long lease would no longer be with the Partner and a rental would need to be paid.

Non Operational Income Producing Assets

Non operational, income producing assets dedicated to the fund may be dealt with in a number of ways.

Section 9 – How the Fund could be Seeded

The asset may simply be sold as an investment sale, and the cash transferred. Whether the fund undertakes this, or whether the Partner does so is a matter of administration, however it is likely to be more efficient if the partner deals with this.

Alternatively, the asset may be held, and a capital sum raised against the income by way of a mortgage. Either the ownership may be transferred to the Fund, and the Fund undertakes this work, or the local authority retains control, borrows the money and then puts cash into the fund.

Development Assets

Development assets will be treated in one of two ways; either they may be developed as projects, with the fund receiving value from the finished development through either equity retention, or sale of the completed development, or the assets will simply be sold for best consideration. Again, the Partner could perform these functions if they wish to retain control, or the fund could do so.

The proportion of development assets dedicated to the fund compared to cash and other more liquid assets will determine what amount of the development assets will need to be sold, and what proportion could be held and developed out by the fund.

There appear to be a number of development assets identified by the various local authorities we have met. The opportunity exists therefore to pool these potential development assets into a development vehicle. The advantage of this is that taken collectively as a portfolio of assets, there may be sufficient scale to warrant establishing a developing 'special purchase vehicle' such as 'a local asset backed vehicle'. In isolation, an individual local authority may have insufficient scale or value of assets to justify the establishment of such a vehicle.

Our recommendation is that an option is explored whereby the KMIF holds the 50% stake in the asset backed vehicle, usually structured as a Limited Liability Partnership. By pooling development assets in this way, the fund would be able to benefit from the returns made by the SPV and therefore this structure could be the primary vehicle through which the value of public sector development assets is realised.

How Assets Will be Valued into the Fund

Assets coming into the fund, with the exception of development assets, will be valued on the realisation of the capital value. This is likely to vary from the book value of the assets, and Partners should be aware of this.

Potential development assets, providing they meet the specified project selection criteria, would need to be valued on the basis of their existing use value. This would enable the SPV to capture the uplift in value that is created through enhancing the site through planning, infrastructure investment, or other form of pre-development or risk mitigation work. In the likely event that partners to the KMIF did not all contribute assets of an equal value, a payment or commitment would be required from the remaining partners.

Timing for Release of Seed Funds

The fund manager will have a better idea of the proposed cashflow requirements of the fund nearer the launch. Clearly there is little point in liquidating assets on day one if there is limited call on funds until say year 2. This will lead to a situation where Partners will need to commit assets, perhaps by restriction on title, but will not be required to liquidate them

Section 9 – How the Fund could be Seeded

until the capital is to be invested. An equitable system of call down of these asset liquidations will need to be devised through the working up of the finer details of the fund.

Equitable Return on Assets

Whilst the fund is primarily a regeneration fund, it will also deliver a market rate of return (commensurate to the agreed risk profile) on investment. As explained elsewhere in this report, the basis for investment is that a minimum amount of investment will be required and that funds above this will attract a coupon. This is intended to ensure that all partners will be financially rewarded in line with the success of the fund. This is dealt with in more depth elsewhere in the report.

In terms of return on investment to the Partner's region, this will be governed by the Investment Strategy as it is developed and the project selection process, also dealt with elsewhere in the report.

OTHER FUNDING STREAMS

Other potential funding streams, at present, may include the following, although these are liable to vary through the life of the fund:

- Regional Growth Fund
- New Homes Bonus
- Business Rate Retention through Tax Increment Financing (TIF)
- Prudential Borrowing

Regional Growth Fund (RGF)

There is the potential for RGF monies to be managed through KCC and invested in projects which meet the RGF criteria of delivering private sector employment outputs, supporting sustainable private sector enterprise and alleviating public sector dependency.

Specifically within the Fund's model or approach, it is the intention that the RGF money would address any inherent viability gap within projects that would otherwise prevent them from being investable by the Fund (subject to State Aid rules). This structure facilitates a wider range of projects to meet the Fund's investment criteria, and thus enables a greater level of private sector investment to be leveraged which would otherwise not have been applicable to these projects. Securing RGF for this programme will as such ultimately deliver greater levels of development and consequent employment creation.

Any return on the Fund investment in the respective projects would be recycled back into other projects, with the process allowing for perpetuating development throughout the programme area.

It is Kent's intention to invest RGF monies in a programme of investments allied to sustainable employment growth which would otherwise not be commercially viable in their present form.

New Homes Bonus (NHB)

The Partners may wish to consider drip feeding New Homes Bonus payments that are created by developments delivered through the fund, or a percentage of total NHB payments across their area. On the basis that the fund promotes developments that may not otherwise be delivered, this NHB is exactly a bonus.

Section 9 – How the Fund could be Seeded

Business Rate Retention through Tax Increment Financing (TIF)

Although the legal infrastructure to use TIF within England is not yet in place, it is widely recognised that it is likely to be within the next 2 years. TIF schemes are already in place in Scotland, and provide an opportunity to forward fund an infrastructure project, whilst retaining part of the uplift in business rates.

This provides both an opportunity to capitalise forecast future uplift to release capital, and also an opportunity to invest in the infrastructure itself. It may be that the cost of relevant infrastructure projects are excessive for the fund in its current form, however tackling such a project may present an excellent opportunity for private sector tie in.

TIF projects thus far in Scotland have been predicated upon the LA borrowing money to fund the infrastructure, and not investment from the private sector.

Section 10 – Next Steps

Once the concept of a KMIF has been approved by sufficient potential partners, and these partners are committed, considerable further work will be required. At this stage, it is recommended that the partners are asked to commit to the fund by contributing to the financial cost of the work required to take forward the next stage of development work.

The next step is for the concept to be presented to a special meeting of the Kent Joint Chief Executives. Should the concept be approved, a process of developing the fund to a stage where it can be launched will need to be instigated. This will require the procurement of an adviser with legal support.

An interim governance structure for this stage will need to be developed, which ideally will mirror the Partnership structure once the fund is set up. Two groups should be set up to ensure prompt delivery of the fund; a steering group and a working group.

The steering group should be made up of high level representatives (preferably chief executives) from each potential partner. Depending upon the timescales to get the fund up and running, this group may be required to meet either weekly or fortnightly, along with the consultant assisting in developing the fund. The steering group will oversee the high level development of the fund, fed into by the working group.

The working group will need to work on the following three main workstreams:

- Development of Investment Strategy
- Development of Project Pipeline
- Development of Governance Structure

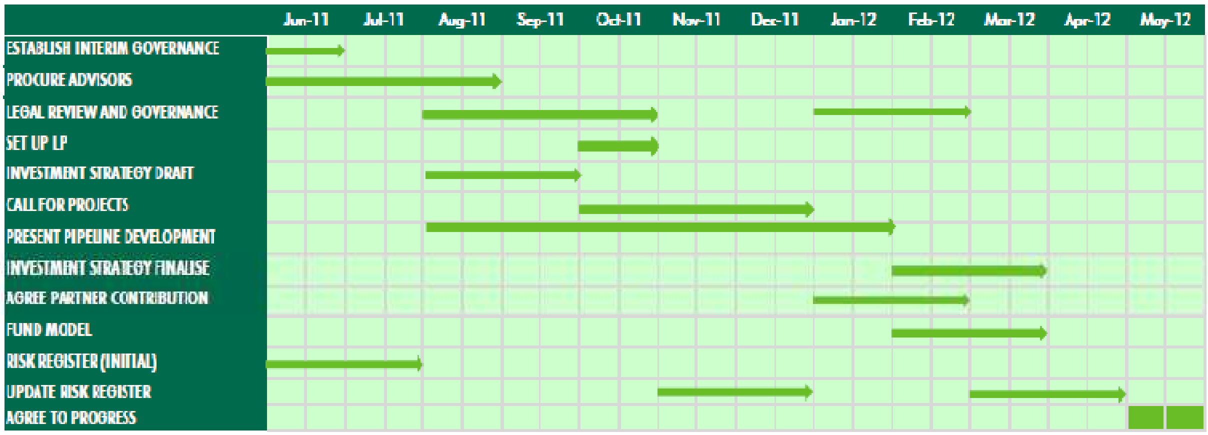
The working group is expected to be made up of relevant officers from each authority. Input from more than one officer in order to cover different disciplines may be required.

At the end of this stage of the fund's development, it is expected that the following will be delivered. This will ensure that all parties are bought into the fund and following the completion of the documents, setting up the fund will be as simple as possible.

- Committed assets. This will require partners to identify how they propose to seed their share of the fund, and letters agreeing to commit those assets.
- A developed pipeline, with projects that are ready for loan underwriting/loan pricing. This will involve a call for projects as well as further working through projects with individual authorities. This will be run in parallel with the resource that is proposed to take on pipeline development for the life of the fund.
- A settled Investment Strategy will be produced once assets are committed and potential projects are identified; this will enable the adviser to guide the potential investors through a process of assessing the level of risk that may be appropriate, alongside agreement on outputs that will be encouraged through this.
- An agreed form of Partnership Agreement. This will require the governance structure to be fully agreed between partners, and for fund lawyers to prepare the documentation.
- An agreed form of Fund Manager/General Partner Agreement. It is suggested that the proposed Fund Manager is involved in this stage.
- Register of risks.

Section 10 – Next Steps

Indicative Timeline for Next Steps



Section 11 – Vires, Procurement, Tax and State Aid

VIRES – EXTRACT FROM 'KENT INESTMENT FUND STRUCTURE NOTE' PREPARED BY PINSENT MASONS

Executive Summary

Local authority Members in the fund will need to identify powers enabling them to establish the Fund and then continue to participate as an investor and (if applicable) transfer assets to it.

The powers available will depend in part on the timing of implementation of the Localism Bill and the orders made under it. However, the local authority Members will likely rely on a mix of powers to participate in and (if applicable) transfer land to the Fund or projects/investments. The decision on the powers being relied on will be a local authority one and each authority may decide to use a different combination of powers

In terms of local authority participation in the Fund (structured as an LLP) prior to the implementation of the Localism Bill, the Well-Being power (potentially combined with investment and incidental powers) will likely be available in so far as well-being is the primary purpose for involvement in the Fund (notwithstanding that a return is generated). After the introduction of the Localism Bill, investment and incidental powers may be available. Alternatively the local authority partners could participate in the Fund through an intermediary company

Power to establish and participate in the fund

Section 2 Local Government Act 2000 ("**Well-Being Power**") - as a power of first resort. Reliance upon it however can only be short term, since the Localism Bill will disapply this provision in England once the general power of competence becomes law.

This will potentially be available to local authority Members in so far as:-

1. Participation in the fund is primarily in pursuance of social, economic or environmental objectives for the benefit and well-being of its area or part of an area or person resident or present in the area. Also for the benefit of an area or person outside its area if it is likely to achieve a well-being objective within the area.
2. The local authority has duly and reasonably formed and recorded its opinion that its participation is likely to directly promote and improve the social, environmental or economic well-being of its area.
3. The local authority has had regard to its Sustainable Community Strategy and set out an indication of how the proposals relate to the strategy and align with it
4. The local authority has had regard to the Guidance published by the Secretary of State on use of Well-Being Powers (the "Guidance") and that the participation in the fund is consistent with it.
5. The local authority has considered the limitations on the use of the well-being power set out in Section 3 Local Government Act 2000 (LGA 2000) and concluded that they do not prevent its use in these circumstances i.e. the Council is not:
    a. doing anything which it is unable to do by virtue of any prohibition, restriction or limitation on its powers which is contained in any enactment whenever passed or made;
    b. raising money - whether by "precepts, borrowing or otherwise"; or

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c. doing something which the Secretary of State has prevented by specific order.

Sections 1 and 12 Local Government Act 2003 – ("Borrowing and Investment Powers")

Section 1 gives local authorities power to borrow and section 12 a separate power to invest, in each case for any purpose relevant to their functions under any enactment or for the purposes of the prudent management of its financial affairs.

Borrowing

A local authority may not borrow if to do so would breach the affordable borrowing limit it has set or is imposed by the Secretary of State. At the present time there is no national limit set by the Secretary of State and so the local authority Members only need address the issues in relation to the requirements in relation to the limit they have determined they can afford to borrow.

At the centre of the new prudential borrowing system is the obligation for authorities to determine and keep under review the amount that they can afford to borrow. It is for each authority to set its own 'prudential limit' in accordance with the detailed rules that are prescribed by the Secretary of State.

The Prudential Code to which local authorities must now have regard is published by CIPFA (The Chartered Institute of Public Finance and Accountancy). In addition regulations require that they must have regard to proper accounting practices, including The Statement of Recommended Practice: Code of Practice on Local Authority Accounting in the UK (SORP) and the Best Value Accounting Code of Practice – both also published by CIPFA.

The key objectives of the Prudential Code are to ensure, within a clear framework, that capital investment plans are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that local authorities have fulfilled these objectives the Prudential Code sets out detailed indicators that must be taken into account under the following headings:

- Affordability
- Prudence and sustainability
- Value for money
- Stewardship of assets
- Service objectives
- Practicality

Affordability is ultimately determined by a judgement about the acceptable level of Council Tax. In considering affordability the local authorities must pay due regard to risk and uncertainty. Risk analysis and risk management strategies should therefore be taken into account.

In relation to this matter, these issues will also be relevant to the consideration of the local authorities' fiduciary duty ie the need to conduct their administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of the Council Tax payers. However it is in each local authority's discretion to determine what the interests of the Council Tax payers are and how they are best served following its analysis of the relevant costs and benefits.

Section 11 – Vires, Procurement, Tax and State Aid

In addition, there are proposals to implement a sub cap on HRA borrowings for housing investment (with focus shifting towards self financing models).

Investment

In relation to borrowing to invest, the Government's commentary on the guidance on the use of the investment powers makes it clear that this provision was introduced to remove doubts which persisted under the previous capital finance regime, but reminds authorities that the practice of speculative borrowing purely in order to invest at a profit remains unlawful.[2]

In exercising its powers of investment local authorities must have regard to the statutory guidance issued by the Secretary of State and specified guidance published by CIPFA. A local authority relying on this power as part of the transaction must ensure that this is consistent with its Annual Investment Strategy approved by full Council[3] or that the Strategy is amended to accord with this new proposal.

The guidance provides that local authority investment strategies much first consider **security** (protecting the capital sum from loss) and then **liquidity** (keeping the money readily available when needed). The informal commentary states that the generation of investment income is distinct from these prudential objectives and is therefore not a matter included in the guidance. However it states that this does not mean local authorities are recommended to ignore such potential revenues and once proper levels of security and liquidity are determined, it will then be reasonable to consider what **yield** can be obtained consistent with the priorities of security and liquidity.

There are specific provisions which need to be taken into account with regard to the treatment of various types of investments and it should be noted that Section 12 does not refer to pension fund or trust fund investments which are subject to separate regulatory regimes.

Section III Local Government Act 1972 ("Incidental Power") – in relation to the local authority's functions

Section 111 of the Local Government Act 1972 provides a local authority shall have power to do any thing (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conductive or incidental to, the discharge of any of their functions. However, a local authority does not have the power under this section raise money, whether by means of rates, precepts or borrowing, or lend money except in accordance with the enactments relating to those matters.

The word "functions" embraces all the duties and powers of a local authority; the sum total of the activities Parliament has entrusted to it. Although seemingly wide, the approach to construing this power is often narrow.

A power is not incidental merely because it is convenient or desirable or profitable.

[2] Guidance on Local Government Investments (second edition 11 March 2010) DCLG. This reflects decisions such as the HL in Hazell v Hammersmith & Fulham Council [1992] 2 AC 1

[3] Formulating a plan or strategy for the control of an authority's investments is not an executive matter.

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Section 11 – Vires, Procurement, Tax and State Aid

If an authority could obtain what it needed by means of a simple contract more elaborate arrangements are likely to involve elements which go beyond what was necessary for that limited objective.

The power has been used to form companies and trusts in the past and was the main power relied upon before well-being. Whilst in principle it is possible, in many of the cases this has been held to be ultra vires due to it being found that there was no valid exercise of an underlying power to attach the incidental power or due to the company formation being too remote to be incidental. There was one case however where the creation of a trust was found to be incidental to section 137 LGA 1972 power (the relevant part now repealed) and not an end in itself, nor did it involve any unlawful delegation.[4]

The incidental power cannot be used where the use of the power has become "incidental to the incidental".

Entering into a contract under Section 1 of the 1997 Act is not discharging a function within the meaning of section 111. So whilst a local authority may enter into a contract as an act incidental to performing one of its functions the contract itself is not a function of the authority for the purpose of section 111.

When a power is claimed to be incidental, the provisions of the statute which confer and limit functions must be considered and construed. Where there is an express limited power, then the Courts may look to see additional powers also in express terms rather than allow use of an incidental power.

So for example in a leading case[5] the question was not whether swap transactions were incidental to borrowing but whether swap transactions were incidental to a local authority's borrowing function having regard to the provisions and limitations of the relevant Act regulating that function. Where such provisions provided a comprehensive code, what it did not expressly or impliedly authorise must be taken to be prohibited.

In that case it was concluded that swap transactions were essentially speculative methods of raising money/making a profit in the hope of reducing the burden of interest payable on money already borrowed and increasing the resources of the local authority. They are a separate and distinct activity - a form of diversification. Whilst individual trading corporations and others may speculate as much as they please or consider prudent, a local authority is not a trading or currency or commercial operator with no limit on the method or extent of its borrowing or with powers to speculate. The local authority is a public authority dealing with public moneys, exercising specific powers. In view of the circumscribed power of borrowing conferred by the statute (at that time in particular Schedule 13, Part I of the LGA 1972 Act) interest swap activities could not be treated as incidental to the function of borrowing conferred upon local authorities by the Act. Whilst the legislation has changed, the principle remains the same and is relevant to the considerations for this proposal.

Localism Bill

Clause 1 of the Localism Bill sets out the proposal to introduce a "**general power of competence**" for local authorities. When enacted, this will replace the Well Being Power in England. It is described as a power for a local authority to do "anything that individuals generally may do". In using the power, the local authority may act "in any way whatever",

[4] House of Lords - Manchester City Council v Greater Manchester MCC 78 LGR 560

[5] Hazell v Hammersmith & Fulham Council [1992] 2 AC 1

Section 11 – Vires, Procurement, Tax and State Aid

whether or not for a commercial purpose, with or without charge and whether or not that action would benefit the local authority, its area or persons resident or present in the area.

The proposed power is subject to statutory parameters (including actions prohibited by other legislation). However, the new power is intended to authorise activities carried out by local authorities for commercial purposes provided they do not relate to charging for services they have a statutory obligation to provide. Significantly the Bill additionally provides "***Where, in exercise of the general power, a local authority does things for a commercial purpose, the authority must do them through a company***."[6] This is defined as a Companies Act company or registered society under the Cooperative and Community Benefits Societies and Credit Unions Act 1965 or the Industrial and Providence Society Act (Northern Ireland) 1969, but not a limited partnership or a limited liability partnership**.** It is the interpretation of the scope of this limitation that will be critical to as to whether the general power of competence can be relied upon if an LLP or LP structure is necessary. See further below.

Limitations on Well-Being and the General Power of Competence

There has been debate in relation to the ability for local authorities to use an LLP ever since the concept was first created; prior to that there were similar debates with regard to the formation of companies and Limited Partnerships. The position in relation to companies has become more accepted, although of course the **Brent[7] Case** demonstrates that such arrangements can still be ultra vires for a variety of complex reasons. There is now of course specific provision for use of a "company"[8] for the purposes of section 95 LGA 2003 (power to do for a commercial purpose anything authorised to do for the purpose of carrying on any ordinary functions) and whilst this has similarities to the provisions contained in the General Power of Competency the situation post the Localism Bill will not be identical to the present powers situation and in our view will be more limited and is likely to mean that the local authorities will have to form a company in order to participate in the investment scheme.

There are now a number of LLPs and LPs in operation and we are aware of a number of leading counsel's opinions which support the use of an LLP and an LP in appropriate circumstances, but there is as yet no case law on this specifically.

The Brent Case also considered the scope of the Well Being Power and the incidental power (section 111) of the London Borough of Brent Council. The case is therefore relevant to considerations for the use of the Well Being Power and an LLP/LP. The Brent Case decision (amongst other things) demonstrates:-

a. that a local authority cannot rely on its Well Being Powers to enter into arrangements to promote its own financial well-being; and

b. that when considering whether a transaction forming part of a larger scheme is intra vires, whilst it is necessary to have regard to the entirety of a scheme, it is also necessary to consider the individual transaction itself is authorised.

Requirements for an LLP or LP

[6] Current clause 4(2)

[7] *Brent London Borough Council v Risk Management Partners Limited [2009] EWCA Civ 4900 (the Supreme Court appeal not proceeding in relation to the vires issues)*

[8] Defined as a company limited by shares or guarantee or an unlimited company or an industrial and provident society.

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For any entity to fulfil the statutory definition of a LLP, or an LP, their respective members must be carrying out a business with a view to a profit. There is no legal definition of "carrying on business" with regard to limited or general partnerships. Section 45 of the Partnership Act 1890 Act defines business as including "every trade, occupation, or profession".

The Law Commission[9] has looked in particular at the definition of the term "business" since there was doubt in some quarters that it covered investment activities. It concluded that the term "business", was sufficiently wide to include investment activities as a commercial venture. The Law Commission in coming to its view referred in particular to the decision in *Smith v Anderson (1880) 15 Ch D 247*. Although it was held, on the particular facts of that case, that a trust formed for the purpose of investment was not carrying on a business, this was on the grounds that the purpose was "once for all investing certain money", rather than "obtaining gain from a repetition of investments." It was accepted that the position would have been different if the "real object of the deed was that the partners should speculate in investments".

On 26 May 1987 the Inland Revenue and the DTI approved a statement on the use of limited partnerships as a vehicle for venture capital investment funds. Since then, limited partnerships have become the standard structure used by venture capitalists not only for United Kingdom funds but also for European funds.

View to a Profit vs Well Being

On the face of it the need for a view to a profit for an LLP or LP creates an appearance of some discord between a council entering into an arrangement under its Well-Being Powers - without the primary purpose of raising money.

There is some help in this from the case of Newstead[10] on the coming into existence of partnerships as it indicates that if a partnership is formed with some other predominant motive but there is also a real (albeit ancillary) profit element then it is permissible to infer that the business itself is still being carried on "with a view to profit" and a partnership can exist.

In relation to LLPs the analysis has been that it is not necessary for a local authority itself to have a view to a profit when it enters into the LLP; rather, the business activities of the LLP must be carried out with a view to a profit. Indeed, there is no statutory requirement for each member of an LLP to share in any profits it generates. The general view taken is that the requirements for a partnership to have a view to a profit do not mean that Section 2 Well-Being Powers cannot be used. There is a difference between the local authorities' purpose in wanting to enter into the arrangement being essentially "non-commercial" and not for the purpose of raising money, and the fact that the activity of the partnership will satisfy the test under partnership legislation of a business and a view to a profit.

The position is similar with regard to LPs, though possibly less certain than for an LLP in that an LP is not a separate corporate body and so the division of intention possibly not so clearly demonstrable, but it should be no difference to a general partnership.

The Secretary of State's guidance on the Well-Being Power also recognises that where an authority uses its powers under Section 2 Local Government Act 2000 to set up a company,

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[9] The Law Commission's Consultation Paper No 161 on the Limited Partnership Act 1907

[10] Newstead (Inspector of Taxes) v Frost [1980] 1 WLR 135

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that company (as a separate corporate entity) is not subject to the restrictions provided by Section 3(2) of that Act. In essence, the guidance recognises the separation of the local authority and an entity set up under the Well-Being Power. The guidance also recognises that a local authority may, for example, invest in a local company for the purposes of the economic well-being of its area and that in doing so it may receive a return on its investment (eg a dividend) but that this will not necessarily make the primary intention of the action raising money and so take it outside of well-being. It specifically recognises the concept of the "primary" and "incidental" objectives of an authority as being important in determining what powers are available in such circumstances.

The separate and free-standing power for local authorities to carry out commercial activities in relation to functions under the Sections 95 of the LGA 2000 ("Trading Power") only through a "company" does not, we believe, act as a prohibition to the local authorities' use of the Well-Being Power through participation in LLPs or LPs. The Government's guidance on the trading power makes it clear that it considers that the Well Being Power can be used as the basis of the function for which to use the Trading Power.

The guidance is set out below:[11]

As a result of section 95 of the Act, activities under section 2(1) of the 2000 Act, such as the provision of goods and services can now be traded, that is made available at a commercial rate in connection with a well-being purpose. An activity undertaken in connection with the exercise of the well-being function is to be regarded as something which local authorities are 'authorised to do for the purpose of carrying on any of their ordinary functions' (see section 95(1)(a) of the Act). The authorisation to trade conferred by the Trading Order amounts to an entirely separate free-standing and specific primary power which can be used in conjunction with the well-being power. There is no basis for regarding the restrictions on raising money provided in section 3(2) of the 2000 Act as having any application to the exercise of the trading power for the following reasons:

• the effect of the prohibition on raising money in section 3(2) is to prevent local authorities from using the well-being power primarily to raise money – in short, 'revenue raising' or commercial purposes' are not purposes which in themselves fall within the scope of the section 2(1) well-being power; however

• Section 95 trading is a separate power which authorises 'function-related' commercial activities and so may be exercised in conjunction with an activity or service whose primary purpose is to achieve the promotion of well-being.

Conclusion on power to establish and participate in the fund

Combination of Powers

The principle of combining powers also applies to this proposal in as much as the local authority is acting as an investor in the Fund set up as an LP. The LP would require a business to be carried on with a view to a profit. Whilst the Well-being power may give the local authorities power to enter into an LP for their wider regeneration purposes, there may be concern about the exercise of those powers if it is ever seen as raising money as a primary purpose. However the local authorities have power under Section 12 of the LGA

1. [11] Government Guidance in relation to Section 95 and 96 Local Government Act 2003 April 2007

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2003 to invest for any purpose relevant to its functions under any enactment. Arguably using its investment power combined with the well-being function should allow the local authorities to participate in the LP with the purpose of achieving well-being outcomes (ie not trading) and at the same time satisfy the LP's needs to be a business with a view to a profit.

After the Localism Bill

After the enactment of the Localism Bill, a local authority in England will no longer have the Well-Being power to rely on for its continued participation in an LP.

If an authority looked to rely up on the general power of competence it is may need to do so through a company and not a partnership.

Unlike the Well-Being power the provision, the provisions relating to the general power contain the express limitation with regard to the exercise of the general power for a commercial purpose. In the current clause 4(2) it is not defined by nature nor extent of the activities. Therefore this may suggest that any action which has any element of a commercial purpose could be construed as overriding or taking precedence over other purposes and there is no suggestion for example, that the commercial purpose must be the primary purpose (and therefore a partnership could be used if the primary purpose was other than for a commercial purpose). This would have to be implied by the Courts.

Andrew Stunell[12] in the House of Commons has stated that it is not the intention for the drafting to change the current position of local authorities in relation to commercial and non-commercial operations. However he has made it clear that "*The underlying point here is that local authorities and their trading arms have to be on a level playing field with the private and commercial sector in both a positive and negative way. They should not be at a disadvantage, but they should not have an outstanding advantage. Taxation is a particular issue. It is right to carry forward the requirement that such bodies should be companies and trading as such. A mutual [or co-operative] can trade as a company and, if appropriate, it pays tax and so on*."

It may be possible to undertake the direct involvement in an LP through the use of other powers and not to use the general power at all. In particular it would seem that it might be possible to use the investment power in section 12 LGA 2003 combined with section 111 LGA 1972. If that was to be the case the local authority would either have to identify the functions for which the investment was relevant (which could not be the general power) or be able to demonstrate that it was for the purposes of the prudent management of its financial affairs. In either case, provided a Court took the view that the investment power was a "function" for section 111, it may be possible to argue that the use of an LP was calculated to facilitate, or is conductive or incidental to that investment. There are clearly issues however around the reliance on section 111 and it may be that the local authorities take the view that it will take the least risk approach and use the general power through a company.

If the Localism Bill precludes local authority participation in a limited partnership directly, the structure could be remodelled as set out below. The Fund would remain a limited partnership (and therefore remain attractive to tax exempt investors. The local authority Members would participate through special purpose vehicles (or existing vehicles) set up as companies limited by shares (CLS) ("**Intermediary Vehicles**"). As a CLS is subject to

[12] Parliamentary under Secretary CLG

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corporation tax, the key disadvantage to the local authority Members would be the additional tax layer.

The local authority Members could either participate through one (**Option 3**) or individual Intermediary Vehicles (**Option 4**). We would recommend Option 4. Option 3 is structurally simpler but an additional shareholders' agreement would be needed to regulate the relationship between the local authority shareholders and additional analysis would be required regarding the decision making as between the Intermediary Vehicle and other Members in the Fund (e.g. the Kent Pension Fund).

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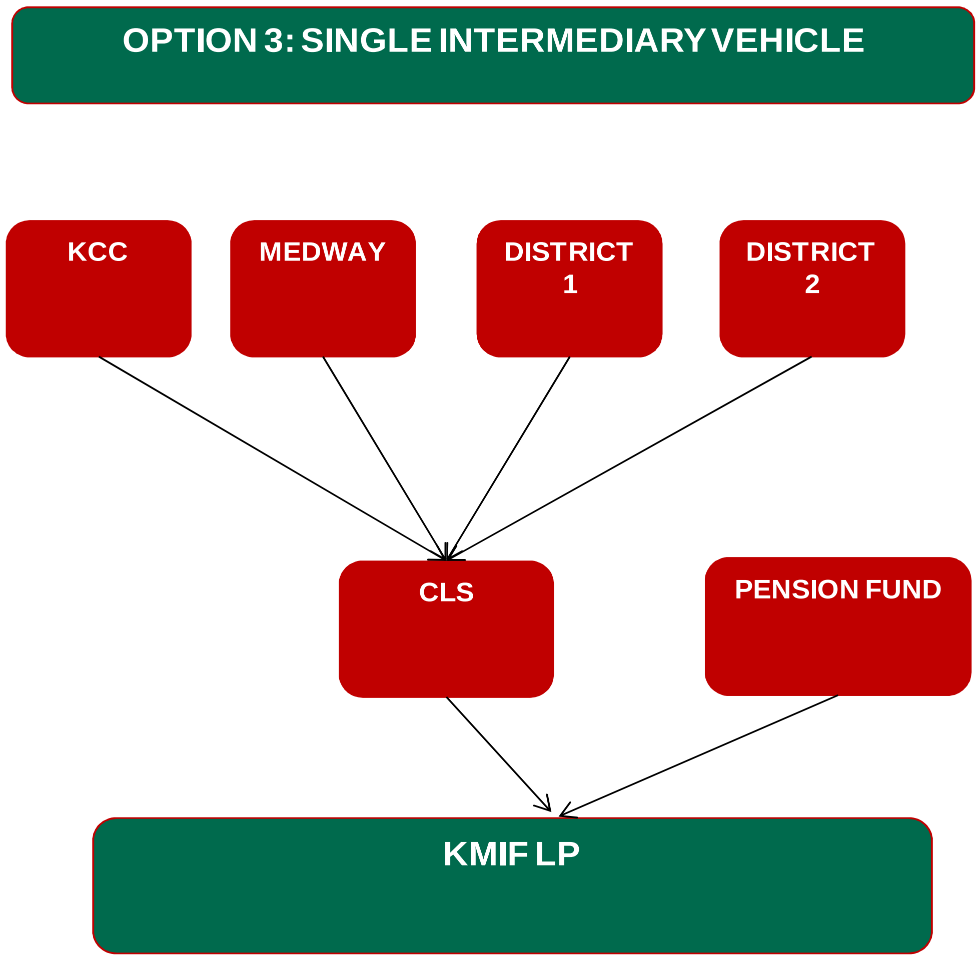
OPTION 3: SINGLE INTERMEDIARY VEHICLE



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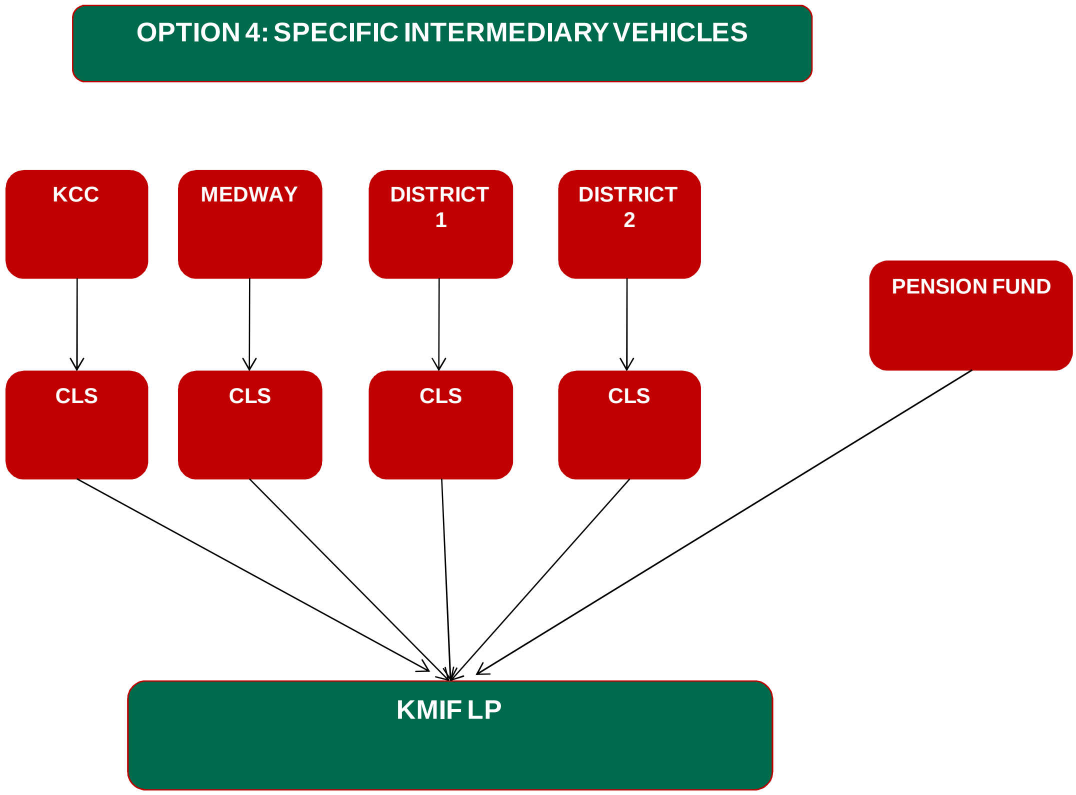
OPTION 4: LA SPECIFIC INTERMEDIARY VEHICLES



Land transfer powers

Power to Dispose of Non-Housing Land - Section 123 Local Government Act 1972. On the transfer of any land to the Fund (or more likely project subsidiaries) a local authority will have an obligation to receive the "best consideration that can reasonably be obtained" for their land and will need to receive independent expert valuation advice to confirm that the consideration proposals represent best consideration. Under the General Disposal Consent 2003 local authorities are able to dispose of land for less than best consideration if they consider that this will achieve the promotion or improvement of economic, social or environmental well-being of their area:-

a. subject to a maximum undervalue of £2m; and
b. provided the disposal is State aid compliant; and
c. if it is satisfied that the land is not held as housing land under the planning acts[13].

Housing Land Powers - Part II of the Housing Act 1985 (esp. Section 32): Under this local authorities are able to dispose of housing land (with the consent of the Secretary of State under Section 32 of the Housing Act 1985 which[14] provides power to dispose of land held

[13] i.e. held under powers which permit it to be disposed of under the terms of the 1972 Act. The consent does not apply to disposals of land held under section 233 of the Town and Country Planning Act 1990 (land held for planning purposes) nor does it apply to land held for housing purposes under the Housing Act 1995.

[14] without prejudice to the provisions of the Right to Buy

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for housing purposes and for the provision of facilities connected with housing. The Secretary of State has issued a General Consent (E3.1) which would apply here provided that the best consideration reasonably obtainable is received (see above).

Section 24 and 25 Local Government Act 1988- The local authorities will need to obtain the Secretary of States consent under Section 25 Local Government Act 1988 ("section 25" consent) to exercise the power under section 24 (Financial Assistance) see below. A local authority will also need section 25 consent if it wishes to use any other powers (including Well Being Powers or general power of competence) for the purposes set out in section 24. If it does not, the transaction will be void.

In addition to this however a local authority will need Section 25 consent if it uses the power in Section 24 or any other power for those purposes of or in connection with the matters listed in Section 24 to provide any person with a "gratuitous benefit" which can include disposal of land at less than best consideration.

General consents were issued in December 2010 in relation to section 25.

Power to Dispose of Land - Section 233 Town and Country Planning Act 1990: This gives local authorities power to dispose of land held for planning purposes in such manner and on such terms as seem expedient in order to secure the best use of the land or the proper planning purposes. SOS consent needed if disposal for a consideration less than the best that can reasonably be obtained. No General Consents.

Power to provide member loans

If the Fund is to invest in schemes involving the delivery of privately let housing, one of the powers LHA's *may* need to rely on is the power conferred by Section 24 Local Government Act 1988 (the "**Act**") (Power to Provide Financial Assistance for Privately Let Housing).

Financial assistance for the purposes of the Sections 24 and 25 of the Act includes the provision of financial assistance to any person "*for the purposes of, or in connection with the.....construction, ...maintenance or management......of any property......intended to be privately let as housing accommodation*" or agreeing to provide such financial assistance.

Financial assistance includes the provision of a grant or loan. (Subject to certain exemptions) to exercise this power, LHA's need the consent of the Secretary of State under Section 25 of the Act ("**S25 Consent**").

CIL collection: Under the Community Infrastructure Levy Regulations certain "charging" authorities are entitled to levy CIL payments on the grant of planning permission for development in their area. The money can be used to fund a wide range of infrastructure that is needed as a result of development (including transport, flood defence and public realm schemes). Charging authorities are able to pool CIL payments to support the delivery of larger 'sub-regional infrastructure' projects provided they are satisfied that this would support the development of their own area.

TIF borrowings: There is no current statutory power although there are proposals to introduce a power to borrow against anticipated business rates.

REGULATORY ISSUES

The Fund will be a collective investment scheme for the purposes of section 235 of the Financial Services and Markets Act 2000 (FSMA). Accordingly, the Fund will need to be operated by an FSA authorised entity.

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STATE AID

Recommendations

The default position is that the Fund will invest on terms on which a reasonable investor would invest in normal market conditions (i.e in accordance with the "Market Economy Investor Principle" or "MEIP"). There may be circumstances in which the Fund (or certain Partners) wishes to invest on softer terms (or provide grant funding (such as RGF) to projects which could amount to State aid. Where this is the case, the Fund will need to provide aid through an approved scheme or exemption (e,g, pursuant to the provision of Services of General Economic Interest or general infrastructure funding). Section 11 sets out the relevant routes for providing lawful aid.

Where the Fund intends to invest in accordance with the MEIP:-

a. If investing alongside a private investor (whether on a debt or equity basis), funding should be provided on pari passu terms;

b. If the Fund is the sole investor (or where third party investment is structured differently (i.e. as debt or equity)), where the Fund is providing debt finance, MEIP terms can be benchmarked by reference to EU Reference Rates and where the Fund is investing equity, there are now a number of market comparators which can be referenced.

Limited Partners who are public bodies will need to invest in the Fund (whether through the contribution of cash and/or assets (at Fund or project level) in a state aid compliant manner. The analysis above applies equally here. Any land assets transferring will need to comply with the State Aid Sale of Land Guidelines.

Any public grant funding of the Fund (for example RGF funds) will also need to be provided in a state aid compliant manner. Again the analysis above applies here. In addition, it may be possible to argue that the Fund would be considered acting as an intermediary fund for the transfer of investment / funding to projects and as such will not be deemed a beneficiary of aid for the purposes of the State aid regime. This is consistent with Community Guidelines on State aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises (the "SME Capital Investment Guidelines").

Where project vehicles are wholly owned by the Fund, dependant on Fund membership, their assets may be deemed public assets (in which case the state aid rules will apply to downstream investments).

PROCUREMENT

Summary

The procurement issues (in the regulatory sense) associated with the Fund structure can be split into two levels:-

(a) The establishment of the Fund (i.e. procurement of the Fund by the Partners)

(b) Procurements made by the Fund (i.e. its investments and Fund manager)

The position can be summarised as follows (see also detailed analysis below):-

(a) The establishment of the Fund: The Fund can be set up with the local authority partners (and local authority pension fund) outside of the procurement rules. Any private sector investor should be selected through some form of competitive process.

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(b) The investments made by the Fund: On balance, the Fund is likely to be a contracting authority. If an investment involves the procurement of works, goods and/or services sufficient to create a Public Contract then it's selection will need to comply with the Procurement Rules.

(c) Appointment of the Fund manager by the Fund: Irrespective of whether the Fund is itself a contracting authority, the General Partner /Fund manager will be competitively procured. This could be carried out by the Partners (or a nominated lead partner) prior to the set up of the Fund.

Establishment of the Fund

The fund can be set up outside of the Public Contracts Regulations 2006 (i.e. its Members would not need to run a procurement under these rules to participate in the fund) as the Members will be investing in the Fund rather than procuring any works, goods or services from it. A watching brief will be needed over the terms of any land transfers or other arrangements to ensure that they don't incur terms sufficient to create a Public Contract.

Since LGPS regional funds[15] are not separate from the local authority which administers them (the administration of the scheme is simply a function of that local authority) the analysis above is not affected by the participation of the Kent Pension Fund as a Member (i.e. it would not need to be procured by the local authority Members). There are certain additional statutory restrictions in relation to pension fund money, but other than these our understanding is that the pension funds should be able to invest without there being any need to run a procurement process.

Where however private sector partners are to be invited to join the LP and the opportunity to do so is to be limited, the public sector bodies should consider an appropriate means of selecting these bodies and to hold some form of competition for this purpose if the opportunity to participate may distort competition.

Investments

It needs to be considered whether the Fund is a contracting authority for the purposes of the Procurement Rules. The Fund, as an LP, is not a separate entity and so it will not come under the category of a "corporation or group of individuals appointed to act together" under the definition of a body governed by public law[16]. It is however likely to fall within the group of contracting authorities who are defined as "an association of or formed by one or more" contracting authorities or bodies governed by public law[17]. If this is the case, to the extent it does procure any works, goods and/or services, it will need to comply with EU and UK public procurement rules15[18] (the "Procurement Rules").

The General Partner, as a separate corporate body, will need to consider whether it is a contracting authority under the definition of a body governed by public law (covering issues such as the membership, control and funding structure). Our view at the present time is that

[15] With a couple of exceptions London Pension Fund Authority and the South Yorkshire Pension Funds Authority which are bodies specifically established to administer certain funds

[16] Regulation 3(1)(w) Public Contract Regulations 2006

[17] Regulation 3(1)(x) Public Contract Regulations 2006

[18] Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public services contracts, as implemented in England and Wales by The Public Contracts Regulations 2006, S1. 2006 No. 5

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it is more likely than not to be found to fall within this definition. If this is the case, to the extent it does procure any works, goods and/or services, it will need to comply with the Procurement Rules (although it is more likely that any procurements will be made by the Fund (acting through the General Partner) not on the General Partner's own behalf.

Even if the Fund and/or the General Partner was not regarded as a body governed by public law it would need to consider if it might be equated to a public body bound by the general treaty obligations (even if not the full Procurement Rules). If it is judged to be an undertaking effectively controlled by the state or another public body and it does not compete in the market, then it may be caught.[19] If it is judged to be an undertaking effectively controlled by the state or another public body and it does not compete in the market, then it may be caught.

When selecting projects for investment, even if the Fund is a contracting authority, it is unlikely that it will be procuring any works, goods and/or services sufficient to create a Public Contract for the purposes of the Procurement Rules. However, the Fund (or the General Partner/manager on its behalf) will need to review this as part of the investment appraisal process.

In any event, there should be a transparent process for the selection of projects such as a "call for projects" similar to the call for grant applicants as would normally operate on grant funding schemes.

Fund management function / other advisory services

Irrespective of whether the Fund is itself a contracting authority, it will need a procurement policy to ensure value for money. This could include obtaining a number of quotes for spend above a specified threshold.

The General Partner /Fund manager will be procured competitively. This could be carried out by the Partners (or a nominated lead partner) prior to the set up of the Fund. The provision of Financial Services is a Part A service under the full requirements of the Public Contracts Regulations 2006, though this does not apply to financial services in connection with the issue, purchase, sale or transfer of securities or other financial instruments in particular transactions by the contracting authorities to raise money or capital or central bank services.[20] Financial Services includes the services provided by fund managers.

TAX

SDLT may be reduced where a limited partner transfers land to the Fund (assuming it is a limited partnership) or, possibly, a subsidiary limited partnership owned by the Fund. In brief, SDLT would not be payable on that part of the value that corresponds to the limited partner's continuing interest. This is however subject to clawback if certain events happen including in relation to the transfer of value out of the limited partnership.

As a Limited Partnership, the Fund will be treated as tax transparent and will not itself be subject to tax on income and gains. Instead, the individual partners would be subject to tax on such income and gains under their usual regime (meaning that local authority and pension fund partners will benefit from their tax exempt status).

[19] This follows the case C-91/08 which concerned a joint venture awarded a services concession contract

[20] Regulation 6((2)(h)

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Any Intermediary Vehicle established by the limited partners (which is not itself transparent for tax purposes) would be subject to the normal corporation tax regime.

The fee charged by the Fund manager will be VATable. The Fund's main activities will be to provide funding to projects. This is a VAT exempt activity. Therefore the fund will not be able to recover VAT paid on these fees; the impact on the financial modelling is not negligible. The VAT chargeable may be reduced by either:-

a. Structuring the Fund so that the General Partner acts as Fund manager (or the General Partner and the manager are in the same VAT group); or

b. Contractual arrangements under which the manager agrees to provide investment services to the Limited Partners and the Fund agrees to provide payment services to the Limited Partners (payment of the Manager's fees on their behalf). Invoices must be addressed to the Limited Partners and it would be helpful (though not necessarily essential) if the Fund charged the Limited Partners a small fee for its payment agency services (VAT exempt) and issue invoices for this. However, such structures have been used in tax avoidance structures to effectively recover input VAT costs in circumstances where (HMRC believe) they should not do so. Although the scenario here is different, HMRC may view the arrangements with suspicion and may argue that the true supply of management services is to the Fund not its limited partners.

The above analysis should be reviewed and possibly refined once the commercial position is agreed.

Investment activities

The outline tax summary in this note assumes that the activities of the Fund will be property investment for tax purposes, and not treated as property dealing or trading where a different analysis may apply, particularly for pension fund investors if the Fund carries on dealing/trading activities.

MEMBERS JOINING AND LEAVING

Capital gains

For any tax paying limited partners, capital gains (or losses) may arise on changes in profit shares in a limited partnership Fund where there has been a previous revaluation of the Fund's assets. As a limited partnership Fund is transparent for tax purposes, no taxable gains or losses would arise to tax exempt limited partners. A change in profit shares would occur when new partners join so taxable partners could be subject to a liability on capital gains where a new Member joins and assets have been revalued.

SDLT

SDLT may arise on (1) a partner joining or leaving the partnership where the limited partnership Fund has directly, or possibly indirectly through an intermediate partnership, an interest in property; or (2) on a partner transferring all or part of its interest in such a partnership; and

Where the rules applying to SDLT on contributions of land by partners to partnerships apply (see paragraph 17.1.2), a reduction on SDLT on contribution may be clawed back where the partner obtains payment or value from the partnership within three years of contribution.

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CLASSIFICATION

Subject to the ultimate membership and control structure, the Fund will likely fall onto the overall public sector balance sheet. However, this is usually only an issue where there would be any lending in the Fund which would count towards public sector aggregate borrowing.

The makeup and control of any decision making body (such as any Advisory Committee) will also impact on consolidation of the Fund to the public sector balance sheet.

This is a financial (rather than legal) issue and may need to be looked at by financial advisers.

ACCOUNTING TREATMENT

Under IFRS and IAS, it is likely that each of the Limited Partners will account for their interest in the Fund as an interest in a joint venture or associate (rather than e.g. a subsidiary). Again this is a financial (rather than legal) issue and may need to be looked at by financial advisers.

APPENDICES

Appendix 1- Legal Vehicle Comparison

LEGAL VEHICLE COMPARISON

LIMITED PARTNERSHIP

Key features

The Partners would be de-facto shareholders.

More complex structure than other vehicles: consisting of limited partners (with limited liability) and a general partner (with unlimited liability).

Limited liability for limited partners: The Partners would be limited partners. To retain limited liability, they cannot be involved in day to day fund management.

Transfers of interests may be subject to stamp duty up to 4%. If the Partners are to take a medium to long term view over the investment this is less of an issue.

Flexible basis for profit distributions (e.g. not necessarily in proportion to invested capital).

Tax transparent, so non-taxpayers (such as the local authority Partners and any pension fund investors) do not suffer tax leakage.

The ability to structure Partners' interests separate from the management structure.

Vehicle familiar to the private investment market

The LP is not a separate entity so cannot itself can enter into contracts, borrow money and hold property (effected usually through the General Partner by a trust arrangement on behalf of the limited partners).

More complex entry and exit arrangements: interests require assignment. Again, this is less of an issue of the Partners are to take a medium to long term view to investment.

Conclusion: Recommended due to tax efficiency, market acceptance and flexibility of profit distribution arrangements.

LIMITED LIABILITY PARTNERSHIP (LLP)

Key features

The Partners would be de-facto shareholders.

There must be at least two designated members responsible for the corporate compliance of the LLP. If two Partners did not volunteer for this role, each Partner could be a designated member.

The liability of the Partners is limited.

Flexibility – some features of a partnership and some features of a company. The governance structure can be flexible to reflect the requirements of the Partners and will be created through the constitutional and corporate documentation. Common vehicle for property development companies.

Low complexity- no complex company law requirements.

Transfers of interests may be subject to stamp duty up to 4%. This is less of an issue of the Partners are to take a medium to long term view to investment.

Appendix 1- Legal Vehicle Comparison

Tax transparent, so non-taxpayers such as the local authority Partners do not suffer tax leakage. Some tax exempt investors (pension funds) lose tax exemption.

The ability to structure Partners' interests separate from the management structure.

Initially concerns over vires issues of local authority participation but becoming increasingly recognised by and used by the public sector.

The LLP itself can enter into contracts, borrow money and hold property.

Easy entry and exit capability to the Partners.

Conclusion: Not recommended due to tax inefficiency for certain tax exempt investors.

COMPANY LIMITED BY GUARANTEE (CLG)

Key features

The Partners would be de-facto shareholders.

The liability of the Partners is limited. Each Partner will contribute a nominal amount of capital (for example £1).

Low complexity.

The ability to structure Partners' interests separate from the management structure.

Recognised by the public sector as a structure to undertake economic and social investment activity (e.g. adopted by the East Midlands Development Agency for the Jessica East Midlands Urban Development Fund). However the key drivers for using the CLG structure was independence of management and no requirement for the members to take out returns.

The CLG itself can enter into contracts, borrow money and hold property.

The CLG structure provides easy entry and exit capability to the Partners. This is less of an advantage if the Members envisage remaining in the Fund long term.

As CLGs are not for profit organisations, they lend themselves to this kind of scheme where the purpose of the fund is not to generate profit and distribute to the Partners. A CLG is therefore not an appropriate structure for the Fund.

CLGs pay corporation tax and therefore this vehicle would not be tax efficient for the Local Authority Partners or any potential pension fund investor.

An asset lock mechanism can be drafted for in the constitutional documentation (i.e. to prohibit the Partners from agreeing to dispose of Fund assets) although the constitutional documents could equally be amended by the Partners to remove the lock.

Conclusion: Not recommended due to tax inefficiency and difficulty around making distributions.

COMPANY LIMITED BY SHARES (CLS)

Key features

Familiar vehicle to both the public and private sector.

Low complexity.

Appendix 1- Legal Vehicle Comparison

The participants would each be shareholders.

The liability of the shareholders is limited. Each shareholder could contribute a nominal amount of capital (for example £1).

Stamp duty is payable on transfers of interests at 0.5%. This low tax liability is less of a benefit if the Partners envisage participating in the Fund over the long term.

Returns are directly linked to risk taken (i.e. capital contributed) - which is not the current intention for the Fund. Although it should be noted that funding could be structured through long term loans rather than capital.

Can be converted to a CLG (although there would be no apparent benefit of this based on current proposals for the Fund).

CLSs pay corporation tax and therefore this vehicle would not be tax efficient for the Local Authority Partners or any potential pension fund investor.

The ability to structure Partners' interests separate from the management structure to a degree but Local Authority directors may have a conflict of interest.

The CLS itself can enter into contracts, borrow money and hold property.

The CLS structure provides easy entry and exit capability to the shareholders. This is less of an advantage if the Partners envisage remaining in the Fund long term.

An asset lock mechanism can be drafted for in the constitutional documentation (i.e. to prohibit the shareholders from agreeing to dispose of Fund assets) although the constitutional documents could equally be amended by the shareholders to remove the lock.

Conclusion: Not recommended due to tax inefficiency.

Appendix 2 – State Aid Compliant Funding Routes

STATE AID COMPLIANT FUNDING ROUTES

RELEVANT STATE AID COMPLIANT SCHEMES

The table below sets out a summary of the most relevant State aid compliant mechanisms or schemes potentially available for any public support provided by the Fund.

STATE AID SCHEME/MECHANISM	WHAT RELEVANT COSTS CAN BE COVERED?	WHAT PERCENTAGE OR AMOUNT OF THOSE COSTS CAN BE COVERED?
Services of General Economic Interest *Altmark* ruling *or* SGEI Decision	Compensation for the costs of providing social housing eg: ■ construction of social housing units ■ clearance of sites on which social housing to be constructed ■ site acquisition	Unlimited.
Support for Land Remediation Dereliction Aid Grant (Valid until 31 December 2013)	Cost of all remediation work undertaken towards bringing contaminated, brownfield or derelict land back into new use. A reasonable level of profit may be included for certain types of land.	Up to 100% of the eligible costs of the work required less the increase in the value of the land after remediation. Must be the minimum amount necessary to bring the land up to a condition where it is suitable for any new use.
General Infrastructure Works	Investment in general infrastructure works provided for general public use rather than for a dedicated purpose or beneficiary. Examples: ■ streets and pathways ■ public spaces ■ water-ways ■ schools ■ improvement of public transport infrastructure or road networks ■ public amenities ■ waste treatment facilities and sewage collection	Unlimited.
Housing Gap Funding (Valid until 31 December 2013)	Grants for providing dwellings for sale or market rent (ie owner occupation or private rent) in order to meet the difference between cost and value. Grants can be provided for new build, conversion, adaptation and/or sub-division projects which contribute to: ■ strategies for regenerating neighbourhoods, particularly where they are characterised by a limited supply, tenure or range of good quality homes; and ■ the provision of owner/occupation and/or market rented housing at affordable prices in pressured market areas where access for lower income households and key workers is constrained.	Grant must not be more than: ■ the gap between eligible costs and the sales value of the houses on completion as determined by an independent Chartered Surveyor *and* ■ 60% of project costs *and* ■ the minimum necessary to allow the project to proceed.
English Property Scheme Regional Investment and Employment Aid (Valid until 2013)	Grant for the bespoke and speculative development of premises and buildings for business, industrial and commercial purposes by the private sector. Covers both the construction of new buildings and the renovation and conversion of existing buildings. Mixed use schemes can only be supported where the residential element forms a minor part of the overall project eg less than 10%.	15% of eligible costs until 31.12.13. If the Fund can be deemed to be an SME this is increased to 35% or 25% thereafter until 31.12.13. Aid awarded must not be greater than the gap between the total eligible costs and the estimated market value on completion. The aid awarded to

Appendix 2 – State Aid Compliant Funding Routes

	Eligible costs include: ■ Purchase of land and/or property at market value ■ Professional fees (legal expenses, design fees etc) ■ Site investigation and preparation, remediation and decontamination ■ Provision of infrastructure and landscaping ■ Construction or refurbishment of buildings ■ Extra cost for meeting environmental standards above UK building Regulations ■ Planning obligations ■ Initial investment costs ■ Irrecoverable VAT ■ Finance charges taking account of any savings due to grant provision Support can also be given for services to support a property development project without charge or at lower than cost. The aid is the difference between the cost of the services and the amount charged.	be the lower of the gap or the aid intensity. The aid recipient must contribute at least 25% of eligible project costs (either through its own resources or by external financing), in a form which is free of any public support. If the investment is to be in capital assets with eligible costs above EUR 50 million then the grant would need to be notified individually to the Commission for clearance *if* the total amount of aid from all sources exceeds a certain figure. What that figure is depends on when the investment was being made and whether Fund is an SME.
English Property Scheme Environmental Aid (Valid until 2013)	Grant for the bespoke and speculative development of premises and buildings for business, industrial and commercial purposes by the private sector. Covers both the construction of new buildings and the renovation and conversion of existing buildings. Costs of investment in environmental protection measures: ■ to deliver environmentally friendly buildings above (or in the absence of) applicable UK/EC standards ■ to provide for energy saving measures ■ for investment in high-efficiency cogeneration plant ■ for the promotion of energy from renewable energy sources	Between 20% to 80% of the extra costs necessary to achieve the energy efficient measure as compared to a standard or reference investment, depending on the measure being implemented. Investment must be notified if it exceeds EUR7.5 million per undertaking per investment project.
English Property Scheme SME Investment and Employment Aid (Valid until 2013)	Grant for the bespoke and speculative development of premises and buildings for business, industrial and commercial purposes by the private sector. Covers both the construction of new buildings and the renovation and conversion of existing buildings. Costs of investment in: ■ tangible assets or intangible assets *or* ■ estimated wage costs of employment directly created by the investment project, calculated over a period of two years.	20% of eligible costs if Fund is a small enterprise 10% of eligible costs if Fund is a medium enterprise