

MEMBER WORKING GROUP - INCOME STRIP FUNDING

Council - 26 February 2019

Report of	Cllr. Scholey (Chair - Member Working Group)
Status	For Consideration
Key Decision	No

Executive Summary:

This council has been at the forefront of financial innovation over recent years which has ensured that it remains in a strong financial position while others are struggling. However, it is important to keep looking for new ideas that give a long term benefit to our residents.

A report on Income Strip Funding was reported to Council on 1 May 2018 where it was resolved that a Member Working Group would be set up to carry out further work and report back to a future meeting of Full Council for decision.

This report supports the Key Aim of the effective use of Council resources.

Portfolio Holder	Cllr. John Scholey
Contact Officers	Adrian Rowbotham, Ext. 7153 Andrew Stirling, Ext. 7099

Recommendation to Council:

- (a) Consider the report from the Member Working Group.
 - (b) Not to acquire an aparthotel at 21 Commercial Road, Aldgate using an income strip funding deal.
 - (c) Income strip funding be included as a possible funding method for future property schemes.
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Reason for recommendation: Following in depth research by the Member Working Group it was recognised that the risks of the Aldgate proposal were not appropriate for this council but that income strip funding should be considered as a possible funding option for future schemes.

Council meeting - 1 May 2018

- 1 At the Council meeting on 1 May 2018, a report on Income Strip Funding was discussed and the following resolutions were agreed:
 - a) further work be carried out to explore the opportunities and risks afforded by Income Strip Funding, including the procurement of specialist advice;
 - b) a Member working group to consist of five Members nominated by the Leader be established and tasked to oversee the work; and
 - c) a report on this work and any recommendations be brought to a future meeting of Full Council for decision.

Introduction and Background

- 2 Events over recent years have shown that the prospects for local government are becoming more difficult and their financial ability to deliver increasing services with reducing resources continues to be a key challenge. Our financial strength ensures that we continue to deliver services and to a standard that many other are clearly struggling with, this has required the council to take some carefully assessed risks and has required the exposure to the commercial property market.
- 3 Although this council is in a uniquely strong financial position, it needs to ensure that it is well equipped to deal with the likely extent of new burdens and requirements that will be placed on it in the future. As such we continue to explore new and innovative solutions and were approached with a proposal from Reef Group (“Reef”).
- 4 The proposition was on ‘Income Strip Funding’ with the intention of delivering both parties significant revenue income and a capital asset at the end of the period.
- 5 Reef approached this council because of the relationship already in place following the developments of M&S and Sennocke Hotel and because they are aware that we are an innovative local authority, looking to do things differently for the long term benefits of residents.
- 6 As this proposition was different to anything that has been carried out before, various meetings took place before the Council meeting in May together with research to gain a greater understanding of ‘Income Strip Funding’ and how it could result in financial benefits for this council.
- 7 The Leader and Finance Portfolio Holder were also involved in discussions to gain an initial view as to whether this proposal was one that the council could take forward and would deliver the required benefits and that the risks were acceptable. Following these discussions and from obtaining answers to specific questions raised, it was agreed that it was suitable to take this proposal for consideration by Council in May 2018.

Income Strip Funding

- 8 Income strips are traditional forward funding deals whereby typically an investor, such as a pension fund, in conjunction with a developer, delivers buildings.
- 9 Upfront an entity, such as a Council, University or Housing Provider commits to the development by agreeing to take possession, on practical completion being achieved, tied into a long lease for usually between 35 and 50 years on a non-assignable basis. Rents are fixed and subject to annual increases linked to RPI, often with a cap and collar arrangement.
- 10 Importantly, at the expiry of the lease term, the entity (the Council) has an option to acquire the freehold (and thus the asset) for £1. Liability for repair and the running of the accommodation rests with the entity; hence, the fund landlord just strips the income out of the asset, giving the term 'Income Strip Funding'. The developer / investor sits in the middle to deliver and possibly manage the asset.
- 11 Up to now, local authorities have used this investment model for schemes to develop assets they require to provide their services such as student accommodation and economic development of town centres.
- 12 Income strips are usually funded by pension fund providers who want the pension fund to have a range of risk and reward profiles. Income strips are viewed as having low risks and rewards from the pension fund provider perspective.

Member Working Group

- 13 The Member Working Group consisted of the following Members:
 - Cllr John Scholey (Chair)
 - Cllr Kim Bayley
 - Cllr Ian Bosley
 - Cllr Andrew Eyre
 - Cllr James London
 - Cllr Edward Parson
- 14 The group was supported by
 - Adrian Rowbotham - Chief Finance Officer
 - Andrew Stirling - Head of Economic Development and Property
- 15 The group met on seven occasions and representatives from Reef and Savills attended one meeting each.

- 16 The group looked at income strip funding generally and also the particular scheme proposed by Reef for an aparthotel in Aldgate, London.
- 17 It was recognised that external advice was required for several disciplines as it was important to get the right advice for such a major potential commitment. The following advisors were used:
- Bevan Brittan - legal
 - KPMG - financial and tax
 - Link Asset Services - treasury
 - Savills - property

Initial Proposal from Reef for the Aparthotel

- 18 The initial proposal was for a 50 year income strip fund deal with an initial cost of £110m with payments to the pension fund provider of £2.9m p.a. (£144m over 50 years at current prices). The aparthotel was to be sub-let to a tenant for a rent of £4.1m p.a. (£205m over 50 years at current prices.).
- 19 The operation method proposed was a joint venture between Reef and the Council with benefits shared 50:50. Payment to the funder was linked to RPI and income from the tenant was linked to CPI.

Concerns Raised about the Initial Proposal

- 20 The Member Working Group and the external advisors looked at the initial proposal in detail and found the following concerns:
- The different inflation rates of RPI for the funder and CPI for the tenant was likely to result in the gap between the payment and the income closing over time and raised a significant level of uncertainty of the longer term financial benefits.
 - State aid was raised as a factor that could stop the joint venture proposal being possible. Illegal state aid occurs when a commercial body gains competitive advantage over a competitor through its involvement with a government backed organisation (e.g. a council). In this proposal it was recognised that the covenant of this council gave significant assurance of a long term ability to meet the commitments to the funder that a private developer could not. This would therefore lower the interest rate that the funder was able to offer.
 - The proposed split of profits at 50:50 was not a fair reflection of the respective contributions.
 - The proposed aparthotel tenant was not viewed as one of the best available.

- The commitment would be for 50 years but the proposed sub-lease was 25 years. This may result in a difficulty in obtain a tenant for the second 25 year period.

Revised Proposal from Reef and Further Changes

- 21 The proposal was changed following discussions with Reef and ongoing negotiations. The changes included:
- Due to the state aid issue, the proposal was changed from a joint venture to a traditional income strip funding deal.
 - Payments to the funder and income from the tenant were both linked to CPI with the same cap and collar arrangements.
 - A different aparthotel tenant was arranged who were viewed more favourably due to their track record and stronger financial position.
 - The risks of construction and delays were now borne by Reef rather than the joint venture.
 - A sinking fund equivalent to five years rent would be paid to the council from the initial proceeds.
 - There would also be an extra upfront payment from Reef to the council.

Member Working Group Conclusion

- 22 Taking the combined effect of the following issues in to account, split into risks and value for money, the group concluded that they do not recommend that this deal is progressed:

23 Risks (Commercial)

- 25 year lease with the tenant is different to the 50 year income strip funding deal. The ability to get a second tenant in year 26.
- Current political environment.
- Potential cost of change of use during the 50 years if required.
- Due to the scale of this investment when considered with other council property investments, the group concluded that risks would not be spread wide enough.
- The ability to convince other Members of the benefits of the deal compared to the risks.

24 Risks (Legal and Regulatory)

- The increasing warnings from Government and CIPFA about the rules changing for councils borrowing to invest in property outside of their area and also for large amounts money (both of these issues would apply to Aldgate). If it was for a local scheme that also contained economic development benefits, income strip funding would not be subject to the same legal restrictions as for property purchased outside Sevenoaks District for investment purposes and could enable it to happen.
- Link Asset Services (December 2018 report para 2.2): “We mentioned in our initial report that, from an investor’s perspective, the key is as far as possible to de-risk the arrangements, in particular total security being offered by local authority involvement, whilst from the Authority’s viewpoint we feel that careful attention would need to be given to a number of risk areas. Many of these will not be evident until much greater detail is available, in particular with regard to the more detailed legal arrangements that will need to be put in place.
 - Various Agreements or separate entity establishment arrangements would need to be entered into in respect of the development, resource protection and legal/value for money aspects. But primarily it is evident that the extent of risk that would be taken on by the Authority is not considered acceptable to an external investor, who could alternatively enter into contractual arrangements with Reef without any further third party involvement.”
- The legal requirement to operate the property through a standalone company designed to comply with the Localism Act 2011 and to avoid payment of Corporation Tax adds further complications, costs and risks.
- The property is outside of the district.

25 Value for Money

- KPMG Income Strip Proposal Summary paper (October 2018 para 3.1): “SDC should carefully consider the commercial merit of obtaining debt of £143m to acquire assets valued at £109.3m. Whilst some overpayments to secure the purchase and resultant transaction costs including legal fees and SDLT are a necessary evil in property investment, it is clear SDC is materially overpaying for the asset compared to the commercial valuation.”
- Amount of borrowing compared to the return.

26 However, the group did conclude that income strip funding should be considered as a possible funding method for future property schemes for the following reasons:

- The Member Working Group have gained a vast amount of knowledge during this process and would have a sound understanding when income strip funding was considered for other schemes.
- The income strip funding concept is sound in the right context as the expenditure and income streams are both linked to an inflation index and the property reverts to SDC at the end of the term for a nominal amount.
- If it was for a local scheme that also contained economic developments benefits, income strip funding could enable it to happen.
- It is possible that the cost of funding a scheme through an income strip deal might be less than conventional loans from the Public Works Loans Board (PWLB).

27 The Member Working Group concluded that:

It is recommended to Council that:

- a. SDC does not acquire an aparthotel at 21 Commercial Road, Aldgate using an income strip funding deal.
- b. Income strip funding be included as a possible funding method for future property schemes.

Key Implications

Financial

It was mentioned at Council on 1 May 2018 that in depth due diligence would be required to gain a full understanding of the implications of the proposals which could cost up to £100,000.

The Member Working Group agreed that knowledgeable external advisors would be required for legal, financial, tax, treasury management and property advice. The cost of this work was £55,000.

It should be recognised that if the Aldgate scheme had been agreed, the initial cost of the scheme would have been £110m with a commitment to pay the pension fund provider £144m over 50 years and income from tenants of £205m (all figures are at current prices).

Legal Implications and Risk Assessment Statement.

Bevan Brittan were commissioned to provide legal advice as it was recognised that income strip funding is complex and to ensure that the full implications were considered.

The potential risks of the proposals were discussed at each meeting of the Member Working Groups and are explained within the reasons for the recommendations made by the group.

Equality Assessment

The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Appendices

None

Background Papers

Income Strip Funding report to Council 1 May 2018 (Not for Publication by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

Member Working Group meeting notes (Not for Publication by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

Aparthotel information (Not for Publication by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

External advice (Not for Publication by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

Cllr. John Scholey

Chair - Income Strip Funding Member Working Group