

Cabinet	Agenda Item: 8
Meeting Date	9 November 2016
Report Title	Capital financing and investment
Cabinet Member	ClIr Dewar-Whalley, Cabinet Member for Finance & Performance
SMT Lead	Nick Vickers, Head of Finance
Head of Service	Nick Vickers, Head of Finance
Lead Officer	Nick Vickers, Head of Finance
Classification	Open
Recommendations	<ol style="list-style-type: none"> 1. To approve funding and acquiring of the leisure and big box retail development in Sittingbourne. 2. Approve borrowing of up to £28m, in line with the Council decision of 16 March 2016. 3. Approve the investment of up to £2.2m in highways-related infrastructure for Sittingbourne Town Centre. 4. Approve funding of up to £500,000 to underwrite unconditional pre-works demolition costs, which will be funded from South East Local Enterprise Partnership funding. If the development agreement does not go unconditional the Council will be required to repay this funding to the SELEP. 5. Delegate to the Head of Finance, in consultation with the Leader and Cabinet Member for Finance & Performance, the final decisions on the amount of borrowing within the limit set, other financing and release of the funds for highways works and demolition costs. 6. Delegate to the Head of Finance, in consultation with the Leader and Cabinet Member for Finance & Performance, the final Terms of the Agreement.

1. Purpose of Report and Executive Summary

- 1.1 On 16 March 2016 Council authorised a variation to the Budget Framework permitting the Council to borrow up to £30m for capital investment, subject to a business case to Cabinet. This report sets out a business case for borrowing up to £28m of the £30m approved, and seeks agreement to funding of some specific works associated with the Sittingbourne Town Centre redevelopment which are required.

2 Background

- 2.1 As was highlighted in the 16 March Council report, the reduction and eventual elimination of Revenue Support Grant means that all councils have to look at ways in which they can become financially self-funding. Indeed, this Council instigated an Income Generation project led by the Corporate Services Director earlier this year, which will be fundamental to balancing the Council's budget over the medium term time horizon. This proposal aligns with the purpose of this project.
- 2.2 There has been extensive press coverage of income generation initiatives, including recently our neighbour Canterbury City Council borrowing £79m to purchase half of the White Friars Shopping Centre; and Spelthorne Borough Council in Surrey borrowing £360m for a sale and lease back property transaction with BP. The use of property investment to generate long term income returns to substitute for lost Government grant is becoming a mainstream activity for local authorities.
- 2.3 In-terms of the Council's treasury management activities, there have been three key developments this year:
 - (i) Investing £3m in the CCLA Property fund- this pooled investment fund significantly added to returns in 2015/16;
 - (ii) investment income - the latest reduction in base rate has led to further reductions in deposit rates. National Westminster Bank, for example, are current offering 0.1% on overnight deposits. With the strong possibility of a further cut in base rate to come, there is a real possibility of negative interest rates for corporate if not retail depositors. This makes it even more important that alternative sources of revenue are sought; and
 - (iii) Public Works Loan Board borrowing costs - with gilt yields reducing further so have borrowing costs, with long term maturity loans now available for around 2.5%.
- 2.4 The Council's core reserves are £18m, and daily cash investments are typically £35m.
- 2.5 Members will be well aware of extensive work which has been underway with the Spirit of Sittingbourne consortium, consisting of U&I, Essential Land and Quinn Estates, to move the Sittingbourne Town Centre development forwards. With the significant progress made in the summer with the letting of restaurants and the big box retail on the former waste depot site, discussions started on Spirit's mechanism of funding the scheme through its approach to the funding market, which was the next stage in the process.

- 2.6 This raised the question of whether the Council could step in as the funder and the acquirer of the leisure and big box projects as a commercial investment opportunity. The extent of the two projects is:
- (i) the leisure elements - an eight screen cinema of 20,925 square feet already pre-let to The Light, six restaurant units with a total of 25,765 square feet, with 65% pre-let by rental value to Pizza Express and Wildwood, and a 60 bed Travelodge, and
 - (ii) the big box retail - 27,800 square feet pre-let or terms of agreement being finalised.
- 2.7 The third element of the overall project is the private rented housing, where there is already an agreement in place with a purchaser for all 213 units.
- 2.8 In September Officers met with representatives of Spirit to see whether there was any way of bringing together the Council's desire to see the project delivered and generate a financial return for the Council with the next steps Spirit would take on seeking funding for the project. From the Council's perspective this has to be looked at as a commercial property transaction which has to work on its own terms financially and legally.
- 2.9 The currently very low returns on treasury deposits, the low costs of long term borrowing, and the need for new income streams all strongly supported that dialogue with Spirit over a change in the Council's role, from a passive provider of land into that of a funder and acquirer of the leisure and retail elements of the project.
- 2.10 This would be a very significant step for the Council to take, and one of the first actions was for the Interim Director of Regeneration to commission Pinsent Masons to provide independent expert legal advice, supplementing the Mid Kent Legal Service; and Turnberry Real Estate to advise on the commercial deal. The action recommended reflects this professional advice.
- 2.11 In looking to the Council as the funder and acquirer U&I will provide rent guarantees on the leisure and retail. The Council would have no financial exposure on build costs. We take this as a strong sign of the commitment of our partners to this project.
- 2.12 As well as the bigger strategic issue there are a number of operational issues which need to be dealt with at the same time as looking at the overall funding of the project.
- 2.13 Firstly, the project also requires highways works, which are estimated at this time at around £4.7m. The South East Local Enterprise Partnership (SELEP) has allocated £2.5m to the project, but that leaves £2.2m of works for which there is no financial return. The Council has therefore examined the option of funding these costs up front from reserves, and thus reducing the overall funding requirement for the project by £2.2m.

- 2.14 Secondly, there is an opportunity to undertake demolition works at the old depot site on Princess Street and on Fountain Street in advance of the Development Agreement becoming unconditional. There is a small risk in incurring this expenditure in advance of unconditionality, but the Council would need to clear these sites in any event. The Council has therefore been asked to consider underwriting funding up to £500,000 of demolition costs before unconditionality. If the Development Agreement does not go unconditional, the Council will be required to repay this money to the SELEP.
- 2.15 A report on progress against the Development Agreement, and any amendments required, is anticipated to be made to the December Cabinet meeting. This also gives more time for due diligence work to be undertaken.

3. Proposals

- 3.1 The draft Turnberry Real Estate financial evaluation is attached in Appendix I in a confidential note. The note is confidential for reasons of commercial sensitivity. The financial appraisal is summarised in the table below.

Table 1: Summary Financials

Total costs		£27.9m
	50 year financials	Annual average
Gross income	£145m	£2.8m
Debt charges	£34.3m	£0.7m
Average annual yield		7.8%

Notes:

- a. The Council will also be required to make an annual Minimum Revenue Provision at 2%. This is a charge to revenue, but is held on the balance sheet. This reduces the average annual yield to 6.8%, but all the monies are retained within the Council.
 - b. Borrowing is assumed to be on a maturity basis ie there is no repayment of principal.
 - c. The period of borrowing and how much is financed internally are to be determined.
- 3.2 The appraisal shows that the Council would make a gross revenue surplus over the 50 years of £110m. This represents a yield of 7.8%, with an average annual net income of £2.1m. As such this is clearly well in excess of any return the Council could achieve through its treasury management activities.

- 3.3 Pinsent Masons have been asked to review the state aid and procurement implications of the approach proposed. The Pinsent Masons opinion is attached in Appendix II in a confidential note. The note is confidential for reasons of legal privilege.
- 3.4 The Council will fund £2.2m of highways works from reserves to reduce the up-front cost of the project.
- 3.5 The Council will also underwrite up to £500,000 of demolition costs from reserves, which will then be repaid using SELEP funding.
- 3.6 The two main risks to the Council are that build costs exceed those projected, and that full letting of the restaurants is not achieved. To mitigate these Spirit is prepared to work to a fixed cost on the build costs, and will guarantee the restaurant rents for 24 months from completion. In addition, throughout the project the Council will have security as the owner of the physical assets.
- 3.7 After completion the Council has the choice of either retaining ownership of the asset for the long term income stream generated, or selling it to an institutional investor for a capital sum which can be used to repay the borrowing and to fund other capital investments in the Borough.
- 3.8 These proposals are key to delivering the Spirit of Sittingbourne project, and in so doing meeting not only the Council's aspirations in terms of the regeneration of Sittingbourne Town Centre, but also the Council's need to move towards financial self-sufficiency.
- 3.9 The proposals are subject to ratification by the U&I Board, and to final due diligence by the Council with its advisers.
- 3.10 Delegations are sought on the final decisions on the amount of borrowing within the limit set, and release of the funds for highways works and demolition costs and the final Terms of Agreement. These delegations will all be within the parameters set, and are necessary to deal with the detailed arrangements for the phasing of payments to Spirit in particular, and to allow the Head of Finance the scope to minimise the total financing costs.

4 Alternative Options

- 4.1 Members and officers have examined a wide range of options with Spirit. It has been concluded that none of them achieve the same outcomes either financially or in terms of speed of progress.

5 Consultation Undertaken or Proposed

- 5.1 Professional advice has been obtained from Pinsent Masons and Turnberry Real Estate – their advice is attached as confidential appendices to this report.

6 Implications

Issue	Implications
Corporate Plan	The project has financial, economic, cultural and social benefits supporting the Council's corporate objectives, in particular A Borough to be Proud of.
Financial, Resource and Property	<p>The proposals fully support the Council's objective to become self-financing.</p> <p>The treasury implications are in line with the DCLG Investment Guidelines and the CIPFA Code of Practice on Treasury Management.</p> <p>The Head of Finance will work with our treasury advisers, Arlingclose, to ensure that we maximize the scope for internal borrowing and minimise external borrowing and the interest costs which then become payable.</p> <p>Account will also be taken of beneficial opportunities for borrowing taking into account fluctuations in PWLB rates which are linked to gilt yields.</p>
Legal and Statutory	<p>External legal advice has been obtained due to the nature and complexity of the matter under consideration.</p> <p>In particular, it is important to understand both state aid and procurement law in relation to the proposal to vary the Development Agreement so that the Council will acquire the retail and leisure elements of the development, and for the Council to fund public infrastructure.</p> <p>The detailed advice is attached as legally privileged and confidential appendix. It sets out the high level advice and strategy to address these points.</p> <p>In principle there is nothing to prevent the Council proceeding in the manner set out in the report. However, additional detailed analysis will be undertaken to provide due diligence and assurance.</p>
Crime and Disorder	Not applicable.
Sustainability	Not applicable.
Health and	Not applicable.

Wellbeing	
Risk Management and Health and Safety	<p>The key risks have been fully evaluated and mitigations put in place. The two main risks are set out at paragraph 3.6.</p> <p>STC is already identified as the highest risk to the Council in the Corporate Risk Register, and a comprehensive risk register for the project is also maintained. Regular reports will be made to Cabinet and Audit Committee</p>
Equality and Diversity	Not applicable.

7 Appendices

7.1 The following documents are included in the confidential appendices:

- Appendix I: Draft Turnberry Real Estate financial appraisal
- Appendix II: Draft Pinsent Mason legal opinion

8 Background documents

16 March Council report

<http://services.swale.gov.uk/meetings/documents/s4874/Report.pdf>