Report

Newport City Council

Part 1

Date: 30 April 2019

Subject **Update of 2019-20 Capital Strategy**

Purpose For Council to consider an update to the 2019-20 Capital Strategy following development of a commercialisation strategy which is recommended from Cabinet.

Author Head of Finance/Assistant Head of Finance

Ward N/A

Summary The financial position facing local government continues to be a significant challenge. Over the period to 2022, the projected savings required to balance our annual budgets will cumulatively be around £30m. The Council has managed its financial challenges to date through managing demand and efficiencies but as these become harder to deliver, the Cabinet, in their meeting on 17th April 2019 considered a commercialisation approach, based on reviewing options around the setting up of a 'trading company' and the principle of investing in commercial property to create a net income for the Council. At the meeting, they recommended the establishment of a £50m investment fund for this purpose. These represent an additional option for the Council, to work alongside other options, to meet its on-going financial challenges.

On 26th February 2019, Council approved the 2019-20 Capital Strategy. This is required under the 'Prudential Code', which Councils must have regard to in their capital programme plans and investments. Commercial activities is one of the key areas of the capital strategy that Council need to have regard to when considering stewardship, value for money, prudence, sustainability and affordability. The commercialisation strategy must therefore be embedded within the Capital Strategy, requiring Council approval after understanding the key issues around pursuing this approach as well as authorising an increase to the existing 'borrowing limits' of the Council to make available the recommended £50m for commercial property investments.

The capital strategy approved in February highlighted that a commercialisation strategy was being developed, this report updates the capital strategy following the development of the commercialisation approach set out to Cabinet. It sets out the long-term context in which capital expenditure and investment decisions are made and details both risk and reward of the approach.

Proposal Council is asked to:

1. Note the development of the commercialisation approach, in particular the two options outlined as the first step towards implementing this approach, as a strategy to contribute towards the Council's on-going financial challenges.
2. Note that Cabinet recommended that these approaches be pursued, including the establishment of a £50m commercial property fund to create a net income for the

Council, subject to the Councils consideration through their inclusion in the Council's Capital Strategy.

3. Consider the benefits & risks of the proposed commercialisation strategy recommendation from Cabinet, in particular the establishment of a £50m property investment fund.
4. Note the Council will be committing to a long-term indebtedness and the risks associated with this, highlighted in this report, alongside existing risks.
5. Having regard to the above, if satisfied:
    - Approve the update to the capital strategy extract in Appendix 1 which sets out these options to the Council's commercialisation approach.
    - Approve a borrowing limit of £50m and associated approved limits in the Appendix 2

Action by Cabinet
Senior Leadership Team
Head of Finance

Timetable Immediate

This report was prepared after consultation with:

- Chief Executive
- Strategic Director (Place)
- Head of Law & Regulation
- Cabinet

Signed

Background

Over the last few years, as government funding to support local government services has failed to keep pace with cost pressures, authorities have looked at alternative ways of delivering financial sustainability. As a result, an increasing number of councils have focused on generating new sources of income, often outside core activities, to support ongoing service delivery.

Newport City Council faces a particularly challenging set of circumstances:

- Welsh Government 'Revenue Support Grant', which funds around 75% of the council's net revenue budget, has failed to meet our rising costs and there is no certainty of future levels of support.
- We have seen significant increases in demand in social care and education/schools, which has been the main pressure on our budget in recent years.
- Savings of circa £45m have been delivered over the last 5 years and on current projections, we will need to find a further £30m of savings by 2022.
- Newport City Council spends around £8m less than its standard spending assessment, due to its relatively low council tax. So we are a relatively low funded council.

Faced with these circumstances it is appropriate to look at how putting in place a commercialisation strategy can help meet the challenges we are facing.

Adopting this approach requires careful thought as it introduces new activities and different types and levels of risk. This report sets out a proposed framework and a number of proposed actions. Further work will be necessary as part of this approach.

Proposal

At its meeting on 17th April 2019, Cabinet agreed to a commercialisation approach, which includes:

- Establishment of a trading company to deliver services aimed at creating a profit in line with the strategic objectives.
- Setting up a £50m property investment fund to create a net income stream for the Council

A feasibility study, for which Cabinet have authorised £100k from the Invest to Save reserve, will be carried out on the establishment of a trading company, and once this is complete a further report will be taken to Cabinet.

A more immediate action is proposed for the setting up of a property investment fund, for which an investment board will be established, and for which detailed terms of reference and investment parameters for the board to operate under will need to be approved by Cabinet before any activity commences.

Cabinet's decision on 17th April was the first step in implementing a more commercial approach to the way the Council operates. The commercial property investment element is more immediate than other parts. Given this, there is a requirement to update the capital strategy previously approved by Council and highlight to Council the high-level risks, cost/benefits and long-term implications of establishing such a fund and approach to commercialisation.

Prudential Code and Capital Strategy

Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003. In order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a 'capital strategy' that sets out the long-term context in which capital

expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes.

A required section in the Capital Strategy is the Council's 'Commercialisation Approach/Activites' as these come with new activities and risks.

The Capital Strategy approved by Council in February 2019 noted that a commercialisation strategy was being developed which would set out the approach and policy for the Council's future commercial agenda. Following the recent report to Cabinet, this approach has taken a step forward and therefore it is appropriate to update the capital strategy and highlight to Council the high-level risks, rewards and long-term implications of the proposed approach.

A proposed updated 'commercialisation' section for the Capital Strategy is shown in Appendix One. This incorporates the establishment of a £50m property development fund and subsequent investment in commercial property both within and outside the boundaries of this Council to generate income. Council are asked, if satisfied with this approach, to approve this updated commercialisation section to its Capital Strategy and an increase in its borrowing limits to allow the fund to be established.

Financial Summary

The Cabinet report summarised a number of risks and opportunities of the commercialisation approach that is proposed, highlighting that further details would need to be given at this Council meeting when the approach was reviewed. In regards to the establishment of a trading company, a feasibility study is to be carried out, and a further report will be taken to Cabinet to agree the future steps/opportunities. In regards to the investment property fund and investing in commercial properties for income generation purposes, if approved, this will have significant financial impacts and potential inherent risks associated with it. Council need to be aware of these when considering this commercialisation approach and are shown below.

<u>Costs and Benefits</u>

In any new approach, an investor needs to be satisfied that the benefits (i.e. the returns) of any investments are commensurate with the risks being taken to generate those.

It is proposed that an investment fund of £50m is set up to support the investment in commercial properties. There are a number of costs that need to be taken into account when investing in commercial properties, which in effect reduce the 'real' return to the Council, these include:

- **Cost of borrowing and repayment of debt (capital financing costs)** – if expected life of the asset of 40 years is used, for example, and based on current interest rates, there would be costs of approximately 4.5% of any return that would need to be deducted.

- **Professional advice** – in order to ensure that the Council is investing in properties that have sufficient level of security and due diligence, the Council may need to use advisors for the investment and these costs would need to be deducted.

- **Void costs and income risks** - over the long term, the income generated or required to be generated cannot be guaranteed. This risk depends on the asset types bought into but will include tenants, in basic terms, tenants going into administration or seeking rent reductions in future years.

- **Asset management** – depending on the type of asset invested, there may be a need for professional asset management advice and services and these costs would need to be deducted

- **Lifecycle costs** – in order to maintain the asset to achieve the income, there will need to be investment in the asset throughout its life.

As highlighted earlier in the report the terms of reference and investment parameters are yet to be agreed for the Investment Board, the following table gives an illustration of the realistic range of the real 'net' financial returns/benefits that could be achieved from investing £50m in existing/operating commercial properties:

Table 1 – Illustration of net financial returns from £50m investment

	Return Net of Costs from investment of £50m				
Net return	**1%**	**1.5%**	**2%**	**2.5%**	**3%**
£	**500,000**	**750,000**	**1,000,000**	**1,250,000**	**1,500,000**

Depending on asset types invested into – future rent review could provide an opportunity to grow rents and interest costs reduce over the long term as loans are repaid.

In terms of 'risk', the key areas include:

Interest rates

- As highlighted in the table above, the margins that could be achieved through investing in commercial properties could be relatively low. Due to current low interest rates, it is likely that long-term debt would be the preferred option as the risk of re-financing at a higher rate in the future may take out most, if not, all of any margin. This does however, lock the Council into the commitment of long-term borrowing. This issue would need top be reviewed on a case by case basis.

Income generation

- Potential uncertainty in the income generated. The fund is clearly being established to generate a net income and should therefore cover any associated capital financing costs and be 'self-contained' in that respect but inherently, any investment over the longer term cannot guarantee that income levels can be sustained. These are long-term investments and therefore, the property market will change over that period which could introduce risk to the income being generated and/or value of the investment held. For example, whilst investment could have existing long term leases associated with them, over the long term, tenants could cease trading or enter into company voluntary arrangements to re-negotiate terms. On the other hand, there is the opportunity that the value of properties and rentals could rise over time also as noted above.

Liquidity (How quickly we could sell the property)

- With this type of asset, there is poor liquidity compared to other types of investments, i.e. a relatively long timeframe to sell or change the investment. Therefore if income generation were to fall or the Council wanted to change its direction on investing in commercial properties, it may take a relatively long period to sell the asset, during which the cost of financing the borrowing would continue.

Long-term and fixed cost commitment

- Undertaking investment in commercial properties would significantly increase the Council's long-term debt, therefore any income generated would need to be sustained to cover the 'capital financing costs' that have been incurred over the long-term. If income were to drop, then these costs would still need to be covered.

In addition to the direct benefits and risks in commercial property investing outlined above, the decision to pursue these approaches needs to be viewed in the context of some key issues, which the Council need to consider. The investment in commercial properties has to be taken into account alongside the various other capital and financial commitments the authority currently has. These include:

Other financial commitments

- To support the economic regeneration of Newport City Council the authority has agreed to a number of loans to companies for the development of various assets, this includes loans for Newport Market, Mill Street sorting office, Chartist Tower, and various WG repayable funding schemes. These are in

themselves 'commercial transactions' though with a primary focus on regeneration – not pure income generation which is the main focus of this report.

It has to be noted that the loans that have been provided have been subject to substantial due diligence and are subject to various levels of security and charges that have been assessed before agreement for loan has been approved. In saying this, there is still an inherent risk in this activity and asset valuations supporting the security would likely have fallen if there is default in these loans. The table below provides the maximum potential loans/financial commitments, this shows the Council has maximum loans/commitments of £13.7m which are not funded or backed by reserves or provisions:

Table 2: Other financial commitments

Commitment type	**£m**
Max loans committed in 18/19	3.7
Max loans estimated in 19/20	9.6
Other potential financial commitments to support economic regeneration	7.5
Total committed	**20.8**
Amount funded or covered by reserves/provisions	(7.1)
Total net 'at risk'	**13.7**

- Capital and borrowing commitments
  The Council is committed to borrowing of c£290m, while it only has currently c.£150m of external borrowing, the Council will have to borrow the additional £140m over the medium/long term and is committed to this. Its capacity for internal borrowing is now at its peak and therefore:

  - It will need to borrow that £140m above as its capacity to be 'internally borrowed' will reduce over the medium/long term.
  - All new borrowing requirements now, coming from the core capital programme or investment activities will incur an immediate need to borrow

  The approval of the investment fund will add a further £50m to this committed borrowing when invested, and while the cost of financing should be covered by the income generated, if this income is not achieved in the future, it will add to the already increasing cost of financing that was highlighted in the capital strategy in February and explained above.

  Given the increase in borrowing, if satisfied, Council will need to approve £50m additional borrowing for investing in commercial properties. This will amend the borrowing limits as follows as shown in the extract of the Capital Strategy in Appendix 2.

Risks

Risk	Impact of Risk if it occurs* (H/M/L)	Probability of risk occurring (H/M/L)	What is the Council doing or what has it done to avoid the risk or reduce its effect	Who is responsible for dealing with the risk?
Risk that interest rates will rise in the future increasing the cost of borrowing	M	H	When investing in a commercial property the Council is likely to undertake long-term borrowing to mitigate the risk of increased	Head of Finance

			cost of rate rises impacting on the net return.	
Income achieved is lower than anticipated or decreases over time.	H	M	Robust and reliable due diligence and appraisal of the investment before purchase. Investing in assets with high security and long and reliable lets. Clear and prudent investment parameters for the investment board to work within. Sound asset management.	Investment Board / Advisors
If the Council wanted to dispose of the asset the income will no longer be achievable therefore a significant impact on the revenue budget and due to the high time it may take to sell the asset the Council will be left with the ongoing borrowing costs also.	H	L	If Council wanted to sell asset, plans would need to be put in place to cover the income lost and cover the long-term commitment of the borrowing costs.	

* Taking account of proposed mitigation measures

Links to Council Policies and Priorities

The overall mission statement of Newport City Council is “Improving People’s Lives”. The report sets out a clear framework for developing a commercialisation strategy which will need to be aligned to the priorities set out in the corporate plan.

Options Available and considered

To consider and approve the update to the capital strategy, and approve the increase in the borrowing limit by £50m to fund an investment fund for investment in commercial properties to generate a net income for the Council.

To consider the update to the capital strategy and not approve the update or increase in the borrowing limit.

Preferred Option and Why

It is for Council to consider the changes and risks outlined and if satisfied approve the update to the capital strategy and increase in the borrowing limits.

Comments of Chief Financial Officer

This report has been written for Council in order to comply with the requirements of the Prudential Code which requires commercialisation approaches and plans to be considered by full Council, via the Capital Strategy. This is to ensure Councils understand the inherent risk and also opportunities that come with these activities and is a response to the growing number of, mainly English Councils who are embarking on commercialisation activities, in particular commercial property investments. Having approved the two

main approaches outlined in this report in their meeting on 17th April 2019, this report is required to enable implementation, in particular the commercial property fund.

This Councils approach was considered by Cabinet on 17th April 2019 and focussed on (i) setting up a trading company and more work is now being undertaken to understand the opportunities here in more detail and (ii) more imminent is the establishment of a £50m fund (funded from borrowing) for investing in commercial property to make a financial return.

In common with other Councils who have already embarked on commercialisation approaches, this provides an opportunity to bring forward another option to meet the on-going challenges to the Council's financial challenge. It will not deal itself with the scale of the challenge the Council may face but contributes towards that.

The report outlines the opportunities and key areas of inherent risks involved in pursuing the commercial property activity and are explained in more detail in the body of the report. This approach is one which is pursued by many English Councils as one of a number of strategies to deal with on-going financial sustainability challenges.

A key issue which can help reduce risk is the governannce arrangements and investment guidelines which the Board will operate under and these, as noted, will be developed as soon as possible and approved by Cabinet.

Comments of Monitoring Officer

The Council has a general power to invest for the purposes of discharging its functions or for prudent financial management under section 12 of the Local Government Act 2003 and can prudentially borrow for this purpose, subject to compliance with Prudential and Treasury Management Codes and the capital strategy. Cabinet have agreed to the proposed commercialisation approach and any individual investment decisions would be an executive function for Cabinet and the Investment Board. However, the establishment of the proposed £50m investment fund and the commercialisation approach will require a change to the Council's capital strategy and this forms part of the policy framework under the constitution. Therefore, this will need to be approved by full Council, who will also need to agree the risk appetite and the long-term sustainability of the commercial investment strategy as an integral part of agreeing to the establishment of the fund. Any investment policy needs to have regard to the security and liquidity of any investments and the appropriate balance of risk and reward.

Comments of Head of People and Business Change

There are no direct HR implications associated with the report.

Earlier this year the Council approved the 2019-20 Capital Strategy and this report provides an update to the strategy following the development of the commercialism approach set out by the Council. The Capital Strategy must consider the requirements of the Well-being of Future generations Act and sets out the long term context in which capital expenditure and investment decisions are made. Commercial activities are one of the key areas that must be considered to ensure value for money, sustainability and affordability. The strategy fits in with the well-being goal of a Prosperous Wales.

Comments of Cabinet Member

The Chair of Cabinet has confirmed her approval for this report to be considered by Council. The Cabinet considered and approved the commercialisation approaches shown in this report in their meeting of 17th April 2019.

Local issues

N/A

Scrutiny Committees

N/A

Equalities Impact Assessment and the Equalities Act 2010
N/A

Children and Families (Wales) Measure
N/A

Wellbeing of Future Generations (Wales) Act 2015
The report seeks to address the requirements of the Well-being of Future Generations Act through implementation of a new commercialisation approach. The Capital Strategy has been updated to reflect this and the aim of the this approach is to take well managed risks in order to off-set and prevent the long term impacts of continuing budget reductions. The development of a commercialisation strategy and approach seeks to enable the Council to mitigate the on-going impacts of budget reductions on the long-term prospects of individuals, families and communities. Whilst the other sustainability principles are not explicitly addressed within the report, the updated capital strategy and new approach will seek to address them through a focus on social value, economic growth and new ways of delivering services.

Crime and Disorder Act 1998
N/A

Consultation
Cabinet considered the approaches outlined in this report in their meeting on 17th April 2019. This report is required to ensure that the appropriate and required review and approvals to enable the commercialisation approach approved by Cabinet can be implemented i.e. the updating of the Capital Srategy and borrowing levels increased by £50m.

Background Papers

Cabinet meeting 17th April 2019

Dated: 30 April 2019

Appendix 1 – Extract from updated Section 6: Commercial Activities of the Capital Strategy report

6. COMMERCIAL ACTIVITIES

6.1. COMMERCIALISATION

In order to help meet the financial challenges faced by the authority Cabinet have approved an initial commercialisation strategy. A link to the report can be found here https://msmodgovdb01.corporate.newport/documents/s15159/8%20Commercialisation%20Strategy.pdf

The proposed strategic objectives of the strategy are set out below:

1. We will target activity to promote social value
2. We will prioritise activities to generate a net profit, which can be used to support core services.
3. Our income generating activities should stimulate economic growth by creating employment.
4. Where appropriate, we will modify methods of service delivery to reduce costs to ensure we take a more commercial approach.
5. We will develop new skills in the organisation to create a modern council

Within these objectives three strands of activity have been identified:

1) Current services we could provide on a more commercial basis e.g Trade Waste
2) New services we could look to provide e.g energy services
3) Property investment – commercial and residential

Establishment of a trading company

A feasibility study will be undertaken on the setting up a trading company through which the commercial activities are managed. This will ultimately seek to support the delivery the first two activities.

Property Investment

In regards to the property investment, an investment board will be created to oversee the delivery of this activity. The investment board will be responsible for the following:

- Ensuring that investment opportunities are thoroughly evaluated, that there is an appropriate balance between risk and reward and that the acquisition contributes to the overall aims of the strategy.

- Approving property investment acquisitions, property management expenditure, property investment disposals and the provision of finance to enable the council to purchase assets.

- Monitoring the progress made in respect of achieving an appropriately balanced and diversified portfolio of assets and its performance.

The Investment Board should prioritise property acquisitions within the Newport City Council municipal boundary but will have authority to invest outside Newport as well. Detailed terms of reference and investment parameters will need to be established for the Board to operate under. These will need developing and approval by Cabinet.

The Investment Board will be a sub set of cabinet and function as a public committee with all the associated governance. The recommended membership is as follows:

Members:	Leader Deputy Leader Cabinet Members x3
Advisors:	Chief Executive Strategic Director (Place) Head of Regeneration, Investment & Housing Head of Law & Regulation (Monitoring Officer) Head of Finance (Section 151 Officer) Supported by NORSE as specialist professional advisors

While the parameters are yet to be established. The decision making on this would be based on a number of factors which would take into account potential for returns and risk into account other costs such as interest and Minimum Revenue Provision if financed through borrowing. The priorities for the Council when acquiring property interests for investment purposes are (in order of importance):

- **Covenant Strength**
- **Lease Length**
- **Rate of Return**
- **Risk**
- **Lease Terms**
- **Growth**
- **Location**
- **Sector**
- **Building Age and Specification**

An investment fund of £50m is to be established for the delivery of this activity. This requires the borrowing limits approved by Council to be increased by this value for the purpose of the investment fund. While it is unlikely the full £50m will be required in 19/20, the borrowing limits have included the full £50m in each financial year to allow for the flexibility if required. This is shown in the prudential indicator in table 7 of this report.

Council Assets

The Council also need to continuously assess all of the Council assets to understand what of the Council's assets can and should be making a financial return and maximising those and stop or dispose of them where they are not and is best way forward. To maximise on the Council's financial strength and covenant, and skill is within its workforce and partners where appropriate.

- We will look to use our existing infrastructure for commercial gain and use our land and buildings where we can to deliver housing and growth in such a way as to maximise benefits to the Council

- We will look to share and collaborate with our partners in use of buildings and other assets and generate capital receipts and reduce costs

- We will, through the Councils Treasury Strategy, consider changing our risk appetite for investing in higher return / less liquid assets and recalibrate the cost/benefit of the Councils current practices.

- Implementing this strategy will require, in some areas, financial resources and this will need to be made available via the Councils Invest to Save reserve and where appropriate, prudential borrowing. This will need to be approved via the governance framework upon business cases meeting assessment criteria, in particular payback period and levels of return.

The Council has an existing investment portfolio, which is 100% based within the city including retail, industrial and office. The Council are currently undertaking a project alongside our property advisors, Norse Newport Ltd, assessing the performance of our Commercial & Industrial portfolio and potential for maximising returns on those assets (which may require up-front investment).

Risk and long-term commitment

Interest rates

- The margins that could be achieved through investing in commercial properties could be relatively low. Due to current low interest rates, it is likely that long-term debt would be the preferred option as the risk of re-financing at a higher rate in the future may take out most, if not, all of any margin. This does however; lock the Council into the commitment of long-term borrowing. This issue would need to be reviewed on a case-by-case basis.

Income generation

- Potential uncertainty in the income generated. These are long-term investments and therefore, the property market will change over that period which could introduce risk to the income being generated and/or value of the investment held. For example, whilst investment could have long term leases associated with them, over the long term, tenants could cease trading or enter into company voluntary arrangements to re-negotiate terms. On the other hand, there is the opportunity that the value of properties and rentals could rise over time also.

Liquidity (How quickly we could sell the property)

- With this type of asset, there is poor liquidity compared to other types of investments, i.e. a relatively long timeframe to sell or change the investment. Therefore if income generation were to fall or the Council wanted to change its direction on investing in commercial properties, it may take a relatively long period to sell the asset, during which the cost of financing the borrowing would continue.

Long-term and fixed cost commitment

- Undertaking investment in commercial properties would significantly increase the Council's long-term debt, therefore any income generated would need to be sufficient to cover the 'capital financing costs' that have been incurred over the long-term i.e. the income has to be sustained over the long-term. If income were to drop, then these costs would still need to be covered.

Appendix 2 – Borrowing Limits extract from updated Capital Strategy

Table 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2018/19 limit	**2019/20 limit**	**2020/21 limit**	**2021/22 limit**
Authorised limit – borrowing	217	230	204	207
Authorised limit – investment fund	N/A	50	50	50
Authorised limit – PFI and leases	46	44	43	42
Authorised limit – total external debt	**263**	**324**	**297**	**299**
Operational boundary – borrowing	197	220	194	197
Authorised limit – investment fund	N/a	50	50	50
Operational boundary – PFI and leases	46	44	43	42
Operational boundary – total external debt	**243**	**314**	**287**	**289**

- Further details on borrowing are in the treasury management strategy

The above limits look at the following factors and are set providing flexibility for these:

- Current external borrowing values and maturing debts that will require refinancing.
- Ability to undertake borrowing for loans to third parties for regeneration purposes (subject to strict due diligence)
- Flexibility to borrow for commercialisation agenda (subject to governance arrangements)