Committee: Policy, Resources and Economic Development	**Date:** 3 February 2021
Subject: Brentwood Borough Council and Seven Arches Investment Limited	**Wards Affected:** All
Report of: Jacqueline Van Mellaerts – Corporate Director of Finance & Resources	**Public**
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Summary

At the Ordinary Council on the 7th October 2020 a Motion, as set out below, was received from Cllr Lewis having been previously deferred from the 16th September 2020 Ordinary Council meeting and was resolved unanimously.

Due to the changes to the Committee timetable and resource implications this has been the first opportunity for Officers to provide the report to the Policy, Resources and Economic Development Committee.

In February 2020 the National Audit Office said "Local authorities face potential investment risks from buying commercial property, such as in the event of an economic recession or a downturn in a particular economic sector, particularly where authorities are dependent on their rental income to keep up with debt repayments or fund local services".

In the light of the National Audit Office concerns and the United Kingdom now being in severe economic recession, this Council resolves in order to understand the impact of the Council purchasing commercial property may have on the Council's finances moving forward that members of the Council call upon the officers to undertake a full review into the risks, rewards and relationship between Brentwood Borough Council and its wholly-owned subsidiary company SAIL. A full report must be submitted to the Policy Resources and Economic Development Committee within three months of today's date.

Members are asked to note the report.

Main Report

Introduction and Background

1. At an Extraordinary Council meeting held on 21 March 2018 the creation of Seven Arches Investment Limited (SAIL) was approved. SAIL is a wholly owned company of Brentwood Borough Council and its shareholder's powers are delegated to the Policy, Projects and Resources Committee (PRED). SAIL was registered with Companies House on 12 April 2018.

Relationship

2. SAIL is an investment company which was set up in 2018 to invest in direct property to provide additional income to primarily off set Brentwood Borough Council's budget shortfall. The fund was set an initial investment target of £60m with a return of 6% or above.

3. SAIL now owns a portfolio of five assets, spread throughout the South East, Yorkshire and South West regions of England, which are two single let offices, one single let High Street retail unit, one multi let retail park and one supermarket with a parade of local shops. One of the single let offices is an in borough asset. These assets provide a secure, well-balanced portfolio across the major sectors of the commercial investment market.

4. As stated above the shareholder's powers are delegated to the Councils PRED Committee, in accordance with the Shareholder's Agreement, SAIL Directors are required to provide an Annual Business Plan to that committee. A revised business plan was presented to the PRED Committee on the 21 October 2020.

5. In October 2020 SAIL held its Annual General Meeting for its shareholders who are members of the PRED Committee and invited all other Council members. SAIL hold quarterly Company Board meetings which includes the attendance of the newly appointed Non-Executive Directors (October 2020). In addition, the SAIL Directors also attend the quarterly Brentwood Development Partnership Board meetings.

6. The appointment of the Non-Executive Directors requires them to have the responsibility to monitor the executive directors ensuring they are acting in the interest of the company stakeholders. They are independent and therefore can challenge the direction and performance of the company.

7. The Council's three Statutory Officers (Head of Paid Service, Section 151 Officer and Monitoring Officer) hold monthly meetings with the Directors of SAIL.

8. Under the current Brentwood Borough Council and SAIL governance arrangements any investment proposals or requests for loans must be made to and agreed by the PRED committee.

Rewards

Financial

It should be noted that Seven Arches Investments Limited will provide a substantial income stream to Council which is included within its Medium-Term Financial Strategy commercial income target for 2020/21 as outlined below:

	2020/21 £'000	2021/22 £'000	2022/23 £'000
Commercial Income*	1,130	1,330	1,694

* Targeted income with lending up to £60 million to Seven Arches Investment Ltd as well as potentially lending up to £60 million to the Joint Venture Brentwood Development Partnership

This net Income stream target is net of financing costs the Council must undertake in order to provide the borrowing to SAIL. To the extent that these income streams are not realised, the Section 151 Officer will need to find additional savings elsewhere in the General Fund budget or use Reserve balances to maintain service levels.

SAIL will deliver these returns by following two streams of activity. Securing Investments opportunities commissioned through a specialist property consultancy; as well as launching a Joint Venture partnership for medium to longer term investment with potentially higher yield returns from year 6. Investments do carry a degree of risk and SAIL has reviewed its business plan to demonstrate its sustainability.

The Business Plan identifies that annual investment plans are carried out; quarterly health checks will be presented to their shareholders and individual assets management plans are completed for each asset.

SAIL has in place a loan facility agreement of £60m with the Council, which was approved in October 2019. Currently the full £60m has been utilised. This returns to the shareholder (Brentwood Council) approximately £2.4m per annum by providing loans to SAIL at a commercial rate, as well as a further £406k for provision of services. SAIL also undertakes the lettings of residential properties and returns the income to the Council less SAIL's costs in managing these properties.

The fund has currently invested £60,000,000 (inclusive of fees) acquiring five UK commercial assets and 19 residential apartments, which return a net initial yield of 5.54% (excluding the residential), and 6.0% when including the residential. Whilst

commercial return is below the target of 6% all three assets are single let to A1 covenant strength companies (D&B ratings), with an average Weighted Average Unexpired Lease Term (WAULT) of 11.1 years. These assets will produce a headline of £3,600,000 p.a. from 2021.

Return to Shareholder:

- The Shareholder and the board have agreed to an interest rate applied to loans of 4%.
- Based on the portfolio the Shareholders will receive income of £1,850,000 in loan repayments during 2020/2021.
- Generating gross income to the Councils of approximately £2,394,000. The Board will continue to review opportunities to increase the return to the Shareholders however it is unlikely that it will be able to increase the return dramatically during the next phase of the business plan.
- All occupational leases are full repairing and insuring, it is expected the fund will not be required to add any additional capital during these leases.

There is opportunity for SAIL to return a dividend to the Shareholder. Currently this is not forecast in either SAIL's Business Plan or the Council's MTFS. This is due to company still being in early years of trading and wishing to accumulate balances. Any future dividend payments will be paid after corporation tax and reviewed on an annual basis alongside the revised Business Plan presented by SAIL.

<u>Other rewards</u>

In its 2020/21 Business Plan SAIL identified two areas that would bring rewards to both the council financially and to the community as set out below:

- To investigate future investment opportunities such as Sale and Leaseback of other government buildings.

- Support shareholders residents through financially contributing to local charities and setting up a foundation to offer opportunities to support in borough.

In addition, there are opportunities for any services that the council does operate that could be undertaken by SAIL, for example appointing SAIL to manage the council's current commercial property portfolio thus driving performance, returns and reducing expenditure.

SAIL has the further ability to explore:

- Acquiring assets for regeneration purposes in Borough and undertaking regeneration projects.
- Acquire strategic assets/land in Borough for future regeneration plans of the council.

- Acquire residential development sites opportunities in Borough and build out the residential developments (selling or renting out the homes).
- SAIL has the ability to offer Asset and Property management services to other local authorities to generate a management income from doing so.

Risks

Market conditions/ COVID 19

The October Business Plan highlights the UK economic and property market risks however it is important to add that such risks alter over time and different risks are present in different market conditions.

Although it is relatively straightforward to assess the immediate and direct real estate impact of COVID-19 with event cancellations, office closures, travel restrictions and quarantined areas – the indirect effects are yet to be fully realised. Cities and countries which have seen the highest number of cases will certainly feel the direct impacts the hardest, but all locations will experience the indirect effects, be it a reduction in tourism, breakages in supply chains or even changes to the way we all live and work.

Hospitality, retail and leisure have seen the sharpest decline in sentiment and impact on operating performance. Cross-border activity is also anticipated to be particularly hard hit, especially in those cities targeted by outbound Asian capital. Conversely, with recent shifts in rates, a more accretive currency hedge is expanding the landscape of opportunities for some investors and countering downward pressure.

It is easy to concentrate on the short-term economic impact of COVID-19, the longer-term societal and real estate impacts should not be overlooked.

The impact and aftermath will change our way of living and working, potentially leading to new operational models.

- Office – increased remote working and a greater focus on health, well-being and productivity.

- Retail – the normalisation of online grocery shopping, forcing a change in retailer behaviour.

- Industrial – the de-globalisation of supply chains to mitigate risk.

- Sustainability – changed perception of travel and renewed emphasis on sustainable practices.

- Technology – increased integration of technology, particularly PropTech and MedTech, impacting all aspects of life and business.

The impacts of COVID 19 have resulted in some UK property sectors being hit significantly while others remain resilient and notionally outperform market expectations. This discrepancy will lead to some UK investors having to sell assets to meet guidelines and borrow criteria which presents cash rich organisations opportunities. Investors who are flexible and have the right risk portfolios in place will be in an excellent position to capitalise on market distortions.

We have seen for example that the industrial sector has out preformed expectations to the point that SAIL is unable to compete for good quality stock and therefore no investment within the sector has been possible.

The assets that SAIL has invested in have held up well against the current unprecedented UK economic and property market conditions. This is primarily due to SAIL's investment strategy where they focus on the long-term goals building high-conviction portfolios, investing on the basis of quality first then price. This enables SAIL to effectively manage the risks. The majority of retail tenants having the ability to continue to trade and well positioned office assets, this has transpired to relatively low levels of arrears and limited numbers of tenants seeking assistance or rental holidays.

These risks are continuously being monitored by SAIL and our advisors to ensure threats are minimised such as early engagement with tenants providing ensuring a beneficial partnership should the tenant experience a downturn in their business due to the economic climate.

The property market and property investors are highly pro-cyclical, typically investing into risks that have already delivered returns commensurate with or beyond those risks. Risk can be consistently miss-priced by the market.

By adopting an absolute value approach to investment, the fund will be protected against market fluctuations and rewarded when we hold the right types of risks at the right point in the property cycle.

SAIL is not primarily focused on short-term returns or investing using benchmark-based decisions instead opting of a quality first approach which will prevent inferior longer-term outcomes.

At the core of our processes are the concepts of risk tolerance and risk budgeting and their use to define the extent of the risks which should be taken at different points in the cycle, within the context of our objectives.

<u>Rise in on-line spending</u>

As SAIL has invested in retail assets this is of course a concern however the tenant profile within the fund (food stores, drive thus, discount operators), ensures a resilience to on-line spending given the nature of these operators is predominately bricks and mortar.

Fall in rental levels and capital values.

The make-up of the lease lengths within the portfolio WAULT of approximately 11 years ensures that short term fluctuations in rental levels do not impact the fund. SAIL outgoings of £3.28m p.a. which is approximately 89% of our rental income received therefore SAIL can afford a 10% drop in rental levels. Furthermore, SAIL has approximately £1.85m (approximately 6 months of income) of cash in the bank which could be used as a reserve if required.

Tenant administrations

No property fund or company is totally protected against the risk of tenant failures and the resultant fall in income however through a robust investment strategy and risk matrix SAIL has ensured that 90% of the income is secured against tenants who have 5A1 (D&B rated scores), which suggests low levels of failure.

Further to the unlikelihood of tenant failure within the fund, the quality, location, and durability of the assets acquired when benchmarked against its competitors provide significant advantageous if the property are required to be re-let.

PWLB Borrowing changes

The alterations to the PWLB borrowing criteria have prevented further investment for yield at this time and therefore unless regeneration opportunities are discovered and acquired within the Borough no further investment will take place. This is a risk in respect to further diversification of the income stream. SAIL is actively looking at in borough opportunities and exploring management mandates to continue the diversification of risk.

Finances

If SAIL was to default on its loan repayments, then the Council would need to still service its debt associated with the SAIL loans. Now SAIL has fully utilised its £60 million loan facility, the cost of providing this loan facility to SAIL is approximately £1.2m per annum if all short-term borrowing is refinanced at current PWLB rates.

As already identified, the Council's Medium Term Financial Strategy currently assumes a net return to the Council of £1.130 million increasing to £1.694 million. If these income streams are not realised, the Section 151 Officer will need to find additional savings elsewhere in the General Fund budget or use Reserve balances to maintain service levels, the latter option however is not sustainable for the long term.

Risk Mitigations

SAIL's Risk Mitigations

The business plans highlights the investment ethos, strategy and risk matrix within which SAIL invests.

The investment strategy and risk matrix that has enabled them to actively invest in property, capitalising on opportunities that have presented themselves due to COVID

19 whilst minimising the risks that are present when investing capital in property. Full details are contained within the business plan.

The fund has successfully managed to diversify the asset profile through a move into sub-sector markets such as supermarkets (local), trade, drive-ins and has successfully diversified income risk through acquisition of multi-let properties, favouring investments with good residual values. Capital growth likely to be through asset management and rental growth rather than yield compression.

SAIL have undertaken asset management initiatives such as conversion of vacant space to residential apartments for sale to mitigate the risks of certain assets.

SAIL produces detailed asset management plans for each asset at the start of each financial year, these plans are continuously reviewed throughout the year to ensure each asset is adequately protected against the risks identified.

SAIL produces a quarterly health check document which provides the shareholder with an overview of the portfolio and highlight keys actions or concerns.

The alterations to the PWLB borrowing criteria have prevented further investment for yield at this time and therefore unless regeneration opportunities are discovered and acquired within the Borough no further investment will take place. This is a risk in respect to further diversification of the income stream however is a mitigation of risk by not investing. SAIL is also actively looking at in borough opportunities and exploring management mandates to continue the diversification of risk.

In addition, they have reviewed further risk diversification is required and this can be achieved in several ways.

- Increasing the number of assets
- Increasing the number of tenants
- Acquiring assets in different sectors (trade parks & Industrial)
- Repositioning assets into different sectors (warehouse to industrial)
- Increasing the exposure to residential holdings
- Increase the regeneration opportunities within the portfolio (land purchases)
- Explore other income sources such as asset management mandates for other councils.

SAIL have an Exit Strategy in place which is set out in their Business Plan and this is informed by market consultants.

<u>The Council's Risk Mitigation</u>

The Council's Statutory Officers and Directors SAIL meet monthly to discuss matters arising and address any risks that may arise at the earliest opportunity. In addition, PRED is presented on a quarterly basis health check data from SAIL and an annual AGM is held by SAIL for members and officers to attend.

The Council has placed debentures on all properties acquired by Seven Arches Investment Limited. This mitigates the risk that if SAIL were to default on the repayment of any loan, the Council receives the repayment of this loan from the sale of the asset.

The Council is also reviewing its earmarked reserves to ensure financing risk is mitigated in future years.

As part of the Council's Statement of Accounts, the Council has to produce Group Accounts. The purpose of the group accounts is to provide a consolidated view of Brentwood Borough Council and the company that is controlled by the Council. The group accounts demonstrate the full extent of the Council's wider asset and liabilities, and its exposure to risk through interests in another entity and participation in the activities of that entity. The group accounts provide transparency and enable comparison with other entities that have similar corporate arrangements.

Like the Council's Statement of Accounts, external audit the group accounts and the transactions between the Council and Seven Arches Investment Limited to determine that the Group Accounts represent a true and fair view.

As part of the audit, the Council's current auditors Ernst & Young address the following:

- The valuation of SAIL's assets
- Verifying rental income from SAIL's assets including the town hall
- Reviewing the treatment of the long-term loan from BBC to SAIL
- Ensuring the loan drawdowns were properly authorised and documented.
- Seeking confirmation that no default events have occurred as mentioned in the drawdown agreement.
- Looking at the intra-group transfers between the Council and SAIL
- Reviewing the Council's review that SAIL in their opinion is a going concern.

The audited Statement of Accounts and results report is reported to Audit & Scrutiny Committee and therefore, any risks identified by external audit would be addressed at this committee.

As part of the Council's Capital Strategy, the Treasury Management Strategy addresses Commercial Investment so that the Council complies with the CIPFA Treasury Management Code of Practice and follows this policy throughout its decision making.

The Local Government Act 2003 gives a local authority power to invest "for any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs." There is no provision in the Act for the Secretary of State to regulate the way in which an authority exercises its investment powers. It does however require authorities to "have regard" to such guidance as the

Secretary of State may issue and to such guidance issued by others as he may specify.

For this purpose, the Secretary of State Page has formally endorsed CIPFA's TM Code of Practice and has supplemented the Code with additional guidance. Local authorities are therefore required by statute to have regard to both sets of guidance in their investment activities.

Commercial Investments: These are investments taken for mainly financial reasons. These may include:

- Investments arising as part of business structures, such as shares and loans in subsidiaries

- Investments explicitly taken with the aim of making a financial surplus for the Council. Commercial investments also include fixed assets which are held primarily for financial benefit, such as investment properties.

The Section 151 will ensure that the Council has the appropriate legal powers to undertake such investments and will ensure the proportionality of all investments, so that the Council does not undertake a level of investing which exposes it to an excessive level of risk compared to its financial resources.

In complying with Code of Practice, the Council addresses the lending to SAIL under 'Other Capital Expenditure'. It is essential that, at the very least, 'other' investments need to provide an income to the General Fund which is sufficient to cover these costs, but preferably to also create a surplus that can be used to support the provision of services. However, in complying with the regulations, it is necessary to recognise the risks and in particular that the income generated by these schemes may not be sufficient to cover the costs incurred.

To provide a sense of scale of the extent which the Council is relying on Commercial Activities to fund services, the following percentages compare the total budget requirement of each financial year to the projected income. These tables and indicators are presented to members on an annual basis when setting the budget and are extracted from the Capital Strategy 2020/21 which was approved at Ordinary Council 4th March 2020.

Analysis of Commercial Income to the General Fund

Policy Initiatives	2020/21 £'000	2021/22 £'000	2022/23 £'000
Total Budget Requirement	8,800	9,087	9,480
Commercial Activity – loan to SAIL	1,130	1,330	1,694

Commercial Activity - shops	184	184	184
% of Commercial Income to Net budget	14.93%	16.6%	19.81%

As it can be seen from the table, less than 21% of the Councils budget requirement is being financed by commercial activities in any given year, keeping this reliance on resources at a manageable level. This reviewed on an annual basis as part of the annual budget monitoring and budget setting timetable.

It should be noted that taking on the additional borrowing associated with these activities is not without risk and the management of this is detailed in subsequent sections of the Capital strategy.

All of the borrowing currently undertaken for capital investment purposes is asset backed, i.e. the Council has the ownership of an asset that could be sold if required, with the value sufficient to repay the debt incurred in purchasing it. The Council therefore does not consider that there is a significant risk of the loans being deemed to be impaired in the foreseeable future. In future years, if the loan is deemed to be impaired, the authority will make provision to cover any expected loss by way of minimum revenue provision contribution.

Investment Indicators

The following indicators are provided to enable Members and the public to assess the Council's total risk exposure as a result of its investment decisions.

Total investment exposure the first indicator shows the Council's total exposure to potential investment losses:

Total investment exposure	2020/21 £'000	2021/22 £'000	2022/23 £'000
Treasury Investments	2,000	2,000	2,000
Commercial Activity - SAIL	60,000	60,000	60,000
Commercial Activity – Shops	3,256	3,256	3,356
Total Investment exposure	65,256	65,256	65,256

How investments are funded

This is applicable to the capital investments. Currently all the capital investments are 100% funded from borrowing totalling £65,256 million per annum.

Rate of return received.

This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested.

Rate of return Commercial Activities	2020/21 £'000	2021/22 £'000	2022/23 £'000
Loans to SAIL	60,000	60,000	60,000
Return	1,130	1,330	1,694
Rate of Return	1.9%	2.2%	2.85%

The Treasury Management Strategy as outlined in the Capital Strategy is one way the Council identifies and mitigates risk around its investment strategy addressing the commercial investment specifically and its relationship with SAIL.

A revised Treasury Management Strategy will be prepared and submitted to Full Council where the Section 151 Officer considers that circumstances have changed sufficiently to require a variation to any of the provisions of this initial strategy.

Otherwise, the Section 151 Officer is free to work within the limits determined by the strategy without reference to Full Council. They will, however, as a minimum, draw attention to any such variation in their mid-year report and annual report on TM activity for the year.

The Full Strategy can be found within Appendix C – Capital and Investment Strategy of the Budget Report at Ordinary Council on 4th March 2020. This Strategy is reviewed annually as part of the budget setting process and the revised Strategy will be reported to Full Council on 24th February 2021.

Reasons for Recommendation

For members to note the relationship, risks, and benefits of SAIL.

Consultation

No consultation was undertaken.

References to Corporate Plan

This fits with the Council's 'Delivering an efficient and effective council' priority, to explore new income generating ideas and opportunities.

Implications

Financial Implications
Name/Title: Jacqueline Van Mellaerts, Corporate Director of Finance & Resources
Tel/Email: 01277 312500/jacqueline.vanmellaerts@brentwood.gov.uk

Financial Implications have been addressed in the main body of the report.

Legal Implications
Name & Title: Amanda Julian, Corporate Director of Law & Governance and Monitoring Officer
Tel & Email: 01277 312500/amanda.julian@brentwood.gov.uk

The Council has the power under s1(1) of the Localism Act 2011 to do anything that, individuals may do provided it is not prohibited by legislation and subject to public law principles ('the general power of competence'). Further statutory powers exist to Create and invest in SAIL and s1 of the Local Government Act 2003 permits the Council to borrow and lend.

The Council by having in place robust financial and governance arrangements in place as detailed in the report are ensuring that the any risk to the Council is mitigated.

Economic Implications
Name/Title: Phil Drane, Corporate Director of Planning and Economy
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Commercial income supports the Council's services, including economic development activities. SAIL can also increase investment and opportunities into the borough either directly or indirectly.

Background Papers

None.

Appendices to this report

None