

SURREY COUNTY COUNCIL

CABINET

DATE: 27 MAY 2014

REPORT OF MS DENISE LE GAL, CABINET MEMBER FOR BUSINESS SERVICES

JULIE FISHER, STRATEGIC DIRECTOR FOR BUSINESS SERVICES

LEAD OFFICER: JOHN STEBBINGS, CHIEF PROPERTY OFFICER

SUBJECT: ESTABLISHMENT OF A PROPERTY COMPANY



SUMMARY OF ISSUE:

The Investment Strategy agreed by Cabinet in July 2013 was developed in response to the requirement for the Council to maintain its financial resilience in the longer term. Cabinet approved that the recommended governance arrangements were put in place in order to consider individual investment opportunities and to provide advice to Cabinet on investment decisions.

Cabinet also approved that work commence on the preparation of a business case to establish a property investment company. This work has now been completed, with the aid of specialist advisors, and this paper sets out the proposed company structure and associated governance arrangements.

RECOMMENDATIONS:

It is recommended that:

1. Cabinet approve the business case for the creation of a Property Company and associated subsidiary companies in order to take forward the agreed Investment Strategy.
2. Cabinet approve the governance arrangements for the Property Company (paragraphs 15 to 21), including the Articles of Association of the company.
3. Cabinet approve the provision of initial equity finance, a working capital loan and a loan facility as described in paragraphs 29 to 36.

REASON FOR RECOMMENDATIONS:

The Council's Investment Strategy will support the council in achieving alternative sources of funding, thereby reducing reliance on government grants and council tax increases in the future. The creation of a property company is required to fully implement the recommendations of the agreed Investment Strategy and to achieve the target income included in the 2014-19 Medium Term Financial Plan (MTFP).

Investment Strategy

1. The Investment Strategy was created as one of a series of responses to improve the financial resilience of the Council in the longer term. The Budget report in February 2013 created the Revolving Investment and Infrastructure Fund to meet the initial revenue costs of initiatives to deliver savings and income. Cabinet, in March 2013, approved the arrangements for considering different delivery models, including the creation of trading companies. The Investment Strategy was approved by Cabinet in July 2013.
2. The main principles of the Investment Strategy as agreed by Cabinet are as follows;
 - Use the established Revolving Investment and Infrastructure fund (the Investment Fund) to meet the initial revenue costs of funding initiatives that deliver savings and enhance income in the longer term,
 - Use the Investment Fund to support investments in order to generate additional income to support the delivery of the Council's functions and services,
 - Creation of a diversified and balanced portfolio of investments to manage risk and secure an ongoing annual overall return to the Council,
 - Investing in schemes that have the potential to support economic growth in the county, and
 - Retaining assets where appropriate and undertaking effective property and asset management, and if necessary associated investment, to enhance income generation.
3. The governance for the Investment Strategy is provided by the Investment Advisory Board (AIB), established following the Cabinet report in July 2013 and comprising members of the Cabinet, supported by officers. The Investment Advisory Board is responsible for providing appropriate evaluation of opportunities (including business cases), prior to Cabinet approval and for the strategic management of the overall portfolio of investments consistent with the aims of the Investment Strategy. The IAB will also regularly review actual outcomes of each investment. The terms of reference of the IAB are attached in full as Annex 1.

Property Company

4. Over the last year, the Council has acquired properties to provide for future service requirements or to contribute to the regeneration of a particular area. Each acquisition has been made in line with the Investment Strategy and completed following the consideration of the business case by Cabinet, with the capital spend and associated revenue impact of these decisions reported monthly in the Financial Monitoring report.
5. The Investment Strategy has been put in place in order to generate additional income to support the delivery of the Council's functions and services by investing in a diversified and balanced portfolio. Investment undertaken directly by the Council as described above will not be able to fully realise these objectives. Investments undertaken purely for the income return will be required in order to fully achieve the income target set out in the MTFP (2014-19) and to achieve a diversified and balanced portfolio. Any such investment could only be made through a company in order to comply with the requirements of the Localism Act 2011.
6. The investment portfolio of the Council will therefore be a combination of assets acquired or developed by the Council itself for future service needs or regeneration purposes and those acquired or developed by a wholly owned property company. Activities undertaken by the Council may also include the strategic acquisition of land for future service need, for example in respect of Schools Basic Need, or in relation to the stewardship role of the Council in shaping the long-term future of the county.



7. The proposals set out below in relation to the creation of a property company have been developed with the assistance of independent specialist advisors covering financial, tax and legal disciplines. The most appropriate legal structure under the Companies Act 2006 for the Council to undertake commercial property activities is a company limited by shares. The company will be wholly owned by the Council and will form part of the Surrey County Council owned group of companies created following the incorporation of S.E.Business Services Ltd and Surrey Choices Ltd.
8. The recommended structure for the property company has been developed to provide the most appropriate solution bearing in mind the tax implications that arise from making investments in property or undertaking property development activity.

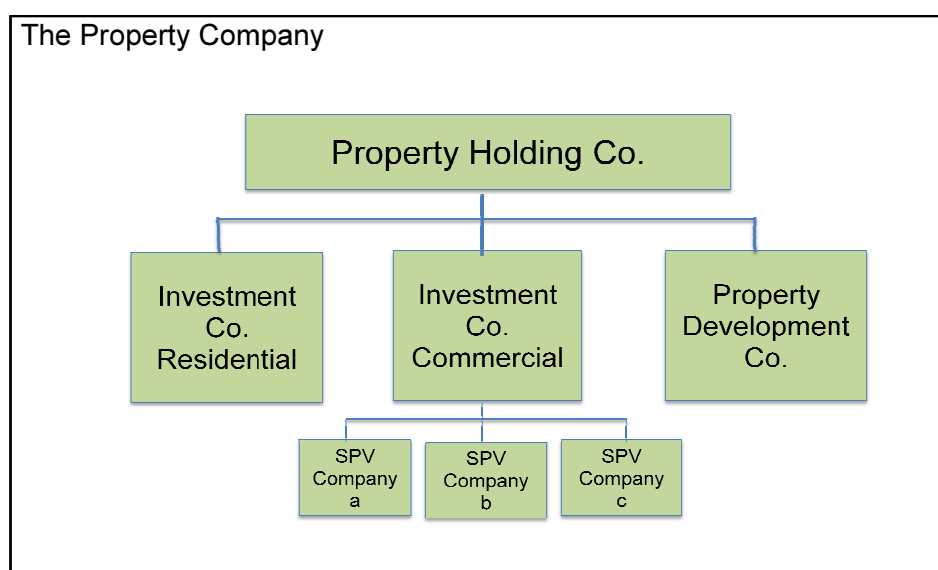
9. The main considerations taken into account are outlined more fully in Annex 2 however in summary; it is advisable to keep investment assets and property development activities in separate companies:

- Investment Asset: A property that is held for the rental return and long-term capital appreciation.
- Property Development: Planning, design, development and build of a property or an estate of properties for sale, or for full or partial retention for the ongoing rental income. Properties that are retained for the long-term rental income become an Investment Asset after completion.

10. In addition, the management structure and support required for each of these activities will differ significantly. This is also applicable to the day-to-day management of different types of investment assets with the primary differences being between residential and non-residential or commercial sectors.

11. The proposal is therefore to create a Property Holding Company (the Property Company) with three subsidiary companies as follows;

- Property Investment Company: Residential
- Property Investment Company: Commercial
- Property Development Company

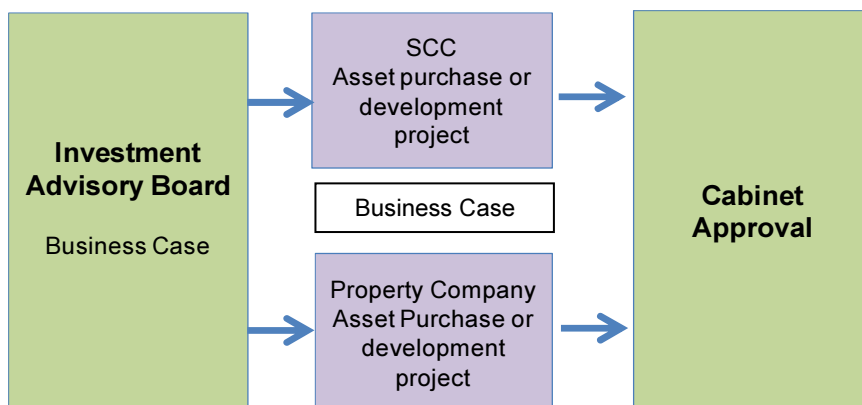


12. Special purpose vehicles (SPV companies, shown as “a” to “c” above) will be created, when required, as subsidiaries to the commercial investment company to hold individual assets of a significant financial value in order to enhance the future sales receipts. The Articles of Association for the Property Company will provide the ability to create these subsidiary companies for this agreed purpose. The proposed Articles of Association for the Property Holding Company and associated subsidiary companies are attached as Annex 3.

13. These arrangements will be put in place in preparation for the commencement of investment and property development activities, which will be undertaken according to the governance and approval process described below.
14. Given the nature of property investment & development, it is possible that opportunities arise in the future that require the creation of a Joint Venture company with other partners, both from the private and public sector. As each opportunity will be quite different in nature, the most appropriate company structure will be determined in separate business cases presented to Cabinet for approval as required.

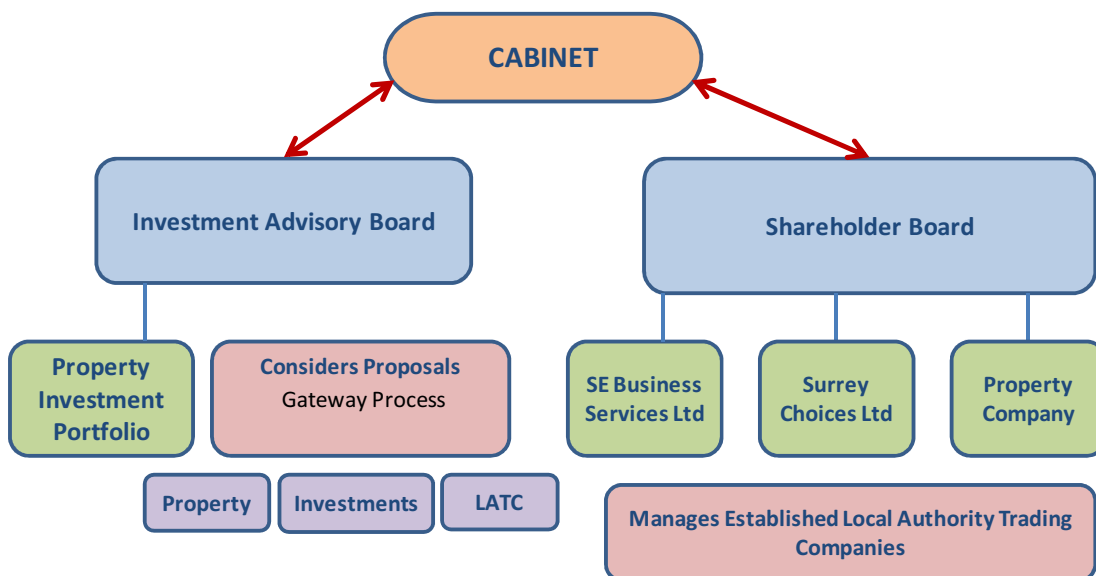
Governance and decision-making

15. The Investment Advisory Board will continue to consider all business case proposals that contribute to the delivery of the Investment Strategy and meet the investment criteria. This includes investments which will be undertaken by the Property Company.
16. Officers, supported by independent specialist professional advisors where appropriate, will provide advice on each proposal coming forward to the IAB for consideration. This advice will include a consideration of how each investment proposal could be taken forward, including a consideration of the risks, how it is structured in terms of appropriate delivery mechanisms, and financed.
17. Decisions on taking forward each investment opportunity will be taken by Cabinet. The IAB will provide advice to Cabinet, ensuring that appropriate and credible options are presented that fully evaluate the financial and risk implications of each proposal.



18. The Investment Advisory Board will be responsible for strategically managing the overall portfolio consistent with the aims of the Investment Strategy and will monitor achievement of the objective that an appropriately balanced and diversified portfolio is created over time across the combination of Council owned assets and those owned by the Property Company.

19. The Articles of Association for the Property Company will be created in accordance with these governance arrangements, with operational decision making residing with the Directors of the company. As part of this operational decision-making the Directors will be authorised to undertake asset and property management to maintain and improve the performance of an investment property. This would include ensuring statutory and regulatory compliance, tenant compliance, landlord responsibilities, securing receipt of rents, dealing with voids and insurance matters. The Directors will be authorised to make capital expenditure decisions on refurbishments and enhancements to improve rental returns, subject to the expenditure being identified in the approved annual business plan of the company and / or within agreed thresholds of spend at the discretion of the Directors. The proposed Articles of Association are attached as Annex 3.
20. The Shareholder Board will be responsible for the oversight of the company in the same way that it is responsible for the oversight of other trading companies created and owned by the Council.



21. A summary of the respective roles of each governance board is outlined in the table below. The Terms of Reference for the Shareholder Board are attached as Annex 4.

Investment Advisory Board	Shareholder Board
<ul style="list-style-type: none"> • Recommend business case for asset purchase or development project to Cabinet • Recommend appropriate delivery structure to Cabinet • Recommend associated finance requirements (equity & debt financing) to Cabinet • Reviews and considers the performance of the total portfolio held by SCC and the Property Company. 	<ul style="list-style-type: none"> • Receive and consider year-end financial accounts and approve proposed dividend • Approve annual business plan • Appoint / remove Directors • Approve changes to the Articles of Association

RISK MANAGEMENT AND IMPLICATIONS:

22. The implementation of the Investment Strategy will mean that the Council will be required to manage a variety of financial risks. Investments will be subject to inherent economic and markets risks and therefore the approved strategy is to create a balanced portfolio of investments. However, a balanced portfolio will take some time to create and will be dependent upon appropriate opportunities coming to the market.
23. The governance process is designed to mitigate these risks, ensuring that all investment opportunities undertaken by the Property Company are subject to the same degree of scrutiny as those that the Council undertakes in its own right. All opportunities will be evaluated based upon a robust business case, developed using technical advisors where appropriate and which take into account due and proper consideration of the balance between risk and reward and the underlying security of the asset. Each business case will clearly set out the risks and associated mitigation measures and will consider market, legal, financial and reputational issues.
24. The performance of the portfolio across the Council and the Property Company will be monitored by the IAB with the assistance of independent specialist advisors where required. As noted in the Investment Strategy specific measures are in place, which include annual valuations of the portfolio and consideration of market intelligence provided by specialist advisors to inform acquisitions and disposals. The Investment Strategy notes a preference towards assets of a good quality, in good or growth locations and the avoidance of over-reliance upon single tenants or types of tenants in terms of their impact as a percentage of the total portfolio.

25. Development opportunities will have higher risks than investing in existing assets but will also provide the opportunity for a greater rate of return. Priority will be given to development opportunities within Surrey where the wider benefits to the county will be taken into consideration, such as provision of affordable housing, new business premises or town centre regeneration.
26. Where appropriate, development risk will be shared with private sector development partners in company structures designed in accordance with the characteristics of arrangement.

Financial and Value for Money Implications

27. The objective of the Investment Strategy is to use the Council's resources to invest in income generating assets to deliver an ongoing return to the Council in order to protect service provision. The MTFP (2014-19) sets a net income target of £5m per annum to be achieved by 2017/18. Investment in commercial property assets will contribute to the achievement of the target.
28. In accordance with the conditions set by the Prudential Code, investment in assets of a commercial nature will be funded by reserves and capital receipts. In order to reflect the opportunity cost of using these internal resources, all investments will be required to demonstrate a return in excess of the opportunity cost of capital, which will be calculated in terms of the interest payable on equivalent borrowing and the statutory minimum revenue provision (MRP) that sets aside funds for the repayment of the borrowing.
29. The Property Company and related subsidiary companies will be incorporated initially with nominal equity of £1,000. All investment proposals will be underpinned by a robust business case which will set out the financing required. The structuring of the financing made available to the Property Company by the Council will have due regard to legal and financial considerations, including competition law and State Aid rules and tax treatment.
30. The Council will provide a mixture of equity and debt financing for each approved opportunity, with the ratio of equity to debt being determined primarily in relation to the prevailing market conditions at the time, in order to ensure that the arrangements are made in accordance with "arm's length" tests of reasonableness. Similarly, asset or development specific loans will be made available by the Council to the Property Company at interest rates that are comparable with the financing available in the market for similar assets or development projects.
31. In the current market this is likely to result in the Council providing equity financing of between 10% and 20% of the value of each investment acquisition and debt financing for the remainder. Financing provided for development projects will be subject to the same market tests and due to the nature of the development risk, will require equity financing of between 40% and 50% in the current market. There is some evidence that the risk appetite in the market is increasing with improving economic conditions and therefore the appropriate debt to equity ratio will be considered as part of the business case evaluation.

32. The availability of capital receipts may limit the ability of the Council to invest in the full range of acquisitions required to create a balanced and diversified portfolio in the desired timeframe. Where this is the case, third party financing may be considered as part of the business case evaluation presented to the Investment Advisory Board and recommended to Cabinet for approval.
33. The Property Company may require further debt financing in order to undertake asset and property management activities as described in paragraph 18, particularly in relation to refurbishment to enhance the value of investment property assets. A loan facility will be provided to the Company for this purpose, which will be made available subject to the expenditure being identified in the annual business plan of the company (approved by the Shareholder Board) and / or within agreed thresholds of spend at the discretion of the directors.
34. The Council will provide the Property Company with a working capital loan of £250,000 to provide for the initial set-up costs of the company, and to provide funds for pre-investment activity including a provision for specialist advisors required.
35. The financial returns to the Council will be dependent upon investment proposals and development opportunities being approved by Cabinet, the profitability of the Property Company and the ability to declare a post-tax dividend. The creation of the Property Company and associated loan facilities as described above are being put in place in preparation for the commencement of approved activities.
36. The Business Plan of the Property Company accompanies this paper in a confidential (Part Two) annex 5. The business plan provides information about indicative investment activity, the management of the company, summary of set-up costs, initial working capital loan required and further details regarding the loan facility.
37. The assets and associated liabilities of the Property Company will be consolidated in the Council's balance sheet and treated in accordance with the Code of Practice of Local Authority Accounting in the United Kingdom, which is supported by International Financial Reporting Standards. The accounting period for the Property Company will be aligned with that of the County Council in order to better facilitate the preparation of consolidated accounts and to simplify auditing requirements.

CONSULTATION:

38. The Investment Advisory Board has been consulted on the proposals and recommends the approach outlined in this paper to Cabinet.

Section 151 Officer Commentary

39. The Investment Strategy and the creation of a Property Company will have a significant impact on the finances and risk profile of the Council. The governance arrangements for the Property Company require that each investment is supported by a robust business case, supported by the Investment Advisory Board and approved by Cabinet. Each business case will consider the Council's legal powers, take into account advice provided by independent technical and professional specialists where appropriate and ensure that the structuring of the investment provides a financial return taking into account all considerations, including taxation.
40. Full due and proper consideration will continue to be required to ensure that an appropriate balance is made between risk and reward, and that the underlying security of the investments proposed are sufficient to protect the financial standing of the Council.
41. The Directors will have authorisation to undertake the day-to-day decision-making of the company including capital expenditure on maintenance and refurbishment required in order to protect the value of the asset and to ensure ongoing rental income.
42. Loan facilities made available to the Property Company will be made on an arm's length transparent basis commensurate with prevailing market conditions. Security is provided by the Investment assets held on the Property Company balance sheet.

Legal Implications – Monitoring Officer

43. The general power of competence, conferred by S1 of the Localism Act 2011 is drawn widely and enables the Council to do anything that a private individual is entitled to do, specifically including things it chooses to do for a commercial purpose. There are however a number of limitations and restrictions on exercise of the power and, of particular relevance to any decision on this report, the general power confers power "to do things for a commercial purpose only if they are things which the authority may, in exercise of the general power, do otherwise than for a commercial purpose": Furthermore, any things done for a commercial purpose must be done "through a company", principally being a company within the meaning of s.1(1) Companies Act 2006.
44. The Council has powers to purchase, sell and lease land and buildings and manage to manage those it owns. It may therefore also pursue these activities for a commercial purpose. There are some limitations on the Council's exercise of these powers and those limitations would continue to apply to any activity of its property companies. However, as explained above, it will require a company or companies to carry out any such commercial activities. The Council may rely upon the power of general competence to enable it to establish those companies it requires.
45. Normal public law principles continue to apply to any exercise of the general power, including the requirement that only relevant considerations are taken into account and that Members take decisions in accordance with their

fiduciary duty. This report sets out the measures that have been taken to ensure that proper advice is available to Cabinet and establishes a framework for future decision making.

Equalities and Diversity

46. There are no direct equalities and diversity implications in creating and managing the Investment Strategy although the Investment Advisory Board will take into account ethical issues when making recommendations to pursue investment opportunities.

WHAT HAPPENS NEXT:

- The Property Company and subsidiary companies will be incorporated to undertake approved activity as and when required.
- The Council will enter into loan facility agreements with the company as described above and as per Annex 5.

Contact Officer:

Susan Smyth – Strategic Finance Manager (020 8541 7588)

Consulted:

Investment Advisory Board

Annexes:

1. Investment Advisory Board Terms of Reference
2. Tax and Property Company Structure: considerations and rationale
3. Articles of Association for the Property Company and subsidiary companies
4. Shareholder Board Terms of Reference
5. Property Company Business Plan (PART TWO REPORT)

Background Papers:

1. Strengthening the Council's Approach to Innovation: Models of Delivery (Cabinet March 2013)
2. Investment Strategy (Cabinet July 2013)

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