A Business Case for an Investment Joint Venture for the Council

Table of Contents

Background and Document Purpose

When, in 2009, the Council developed a new approach to tackling the challenges that the economic downturn was having on Peterborough's growth ambitions, a key part of its strategy was engagement directly with the capital markets. The severely restricted levels of funding had constrained private sector development across the UK, but the Council believed that if it could effectively engage directly with the capital markets it could develop a new way of funding major growth projects within the city. This paper outlines a proposed joint venture to do precisely that, delivering potential new investment arrangements for the city that will help Peterborough bring forward some of its key city centre development opportunity sites.

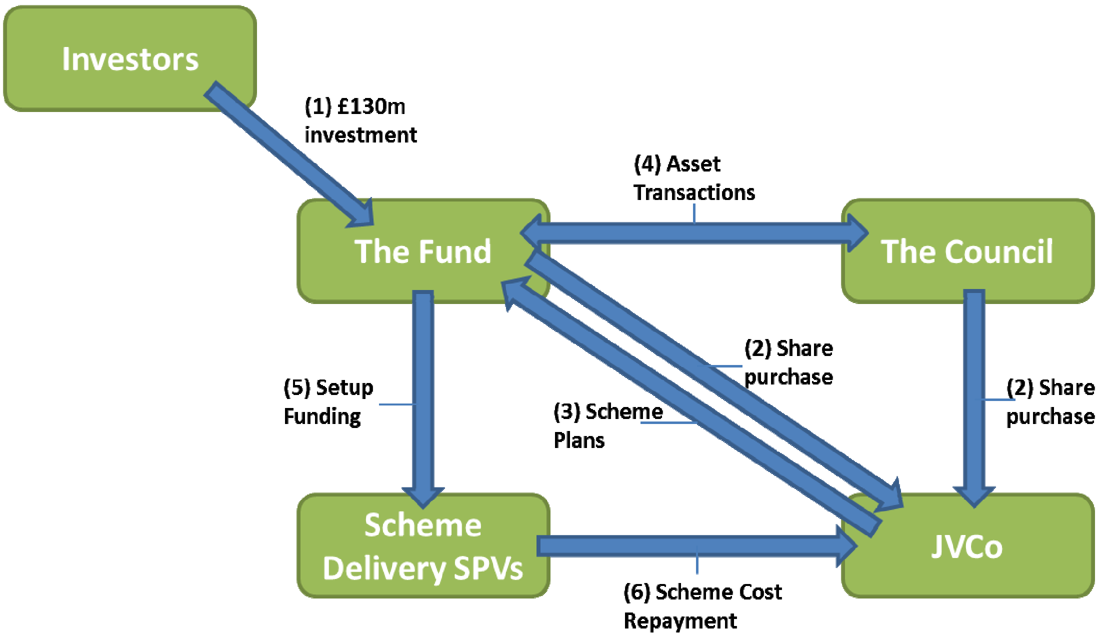
Recapping the Council’s Drivers for These Proposals

- Peterborough has an ambitious growth agenda, but private sector investment is typically opportunistic and relatively short-term, and what government funding is available is now lower and more difficult to obtain than before the recession
- The Council wants a long-term partner willing to work with us to develop projects across the city rather than cherry-pick the easiest sites that represent low risk options
- The Council wants a scheme that can kick-start regeneration of the Fletton Quays area, and sees the use of its covenant as an opportunity to do this
- The Council wants to establish a capability that can deliver a pipeline of projects and that does not have to be freshly established each time
- The Council wants to establish a collaboration with the capital markets that will demonstrate to investors and developers that the council can make a valuable contribution to the viability, optimisation and delivery of infrastructure projects in the city
- The Council needs to absolutely minimise its exposure to any financial risk
- The Council would like to benefit from upside as a result of these arrangements, in excess of the current market value of the land assets it may invest into them

Overall Structure and Operating Process

In outline terms, the process for how these arrangements are established and operate is:

1. Investors would make available in the region of £130m of investment in these arrangements and approved schemes that come forward
2. Both the Council and the Fund would buy shares in the Joint Venture Company (JVCo) for £3m in cash, payable to the JVCo quarterly over three years
3. The JVCo develops viable schemes and passes these plans to the Fund to invest in and take forward to delivery
4. The Council sells assets involved in viable, approved schemes to the Fund. The Council may choose at the point of sale to receive payment either in cash or in units in the Fund
5. The Fund creates scheme delivery companies (Special Purpose Vehicles (SPVs)) to take forward each scheme, pulling together working capital that allows these to operate. The precise ownership structures of these SPV's would be determined on a case by case basis.
6. The scheme delivery companies would refund to the JVCo the costs that the JVCo has incurred in developing the scheme that the company was created to deliver



The Joint Venture Company

The diagram and outline above only provides a broad overview as to how these arrangements will be put in place and subsequently operate. This section provides more detail about the set-up and running of the Joint Venture Company

Ownership and Form

The Joint Venture Company (JVCo) will be owned 50:50 between the Fund and the Council. It will be overseen by a Board of four with equal representation from the Fund and the Council, and have a decision-making structure that requires consensus. Both parties will pay £3m for shares in the JVCo[1], the payment of which to the JVCo will be phased over three years, with equal amounts from both parties drawn down quarterly. This phasing of payments can be adjusted in the future with the agreement of the JVCo's Board.

Pinsent Masons were asked to advise on the form that the JVCo should take, and have advised that it should be a company. The proposed company form for the JVCo is therefore a company limited by shares. The founding parties may by agreement at any time dilute their shareholding in the JVCo by selling shares to a third party (for example, by issuing non-voting shares).

Mode of Operation

The JVCo's role is to develop viable schemes for consideration by the company's Board. It will undertake a variety of work related to this, the exact nature of which will vary according to scheme, but will ultimately result in a detailed scheme business case for a scheme that provides assurance to the Board that a scheme proposal is viable. If the Board approve, the JVCo would then apply for planning permission for the scheme from the Council.

For schemes that secure planning consent, the JVCo Board then recommend them to the Fund's Investment Committee, and, subject to the Investment Committee agreeing to the project's business case, the Fund will establish a ring-fenced SPV to take delivery of that scheme forward. The SPV will reimburse to the JVCo all of the project development costs that the JVCo has incurred.

The Special Purpose Vehicles

Schemes that are approved by the JVCo's Board and the Fund's Investment Committee are taken forward to delivery through Special Purpose Vehicles (SPVs) set up specifically for each scheme by the Fund. These are ring-fenced companies whose shareholdings and financing are determined on a case-by-case basis by all shareholders in the SPV.

The First Project: Fletton Quays Phase 1

As part of the process of establishing these arrangements, the Council will enter into an Agreement for Lease with the Fund for new offices as part of its office consolidation programme, which will be built on Fletton Quays. The first SPV to be established by the Fund will deliver these offices.

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[1] Pinsent Masons have confirmed to the Council that it has the legal power to make such an investment, and that the establishment of the joint venture company does not raise a procurement requirement

Through the process of developing these proposals, it has been borne in mind that the Council's budgets are under significant pressure, and that consequently the office consolidation cannot result in the additional cost to the Council. The Council's protection against this is – by design – integral to how these arrangements will operate, because the offices scheme would be a project that the JVCo develops, and for it to do this the Council – through its Board membership of JVCo – has to approve that the project.

In terms of the land assets involved, these are detailed in the Assets section later in this paper, and there will be contractual protection for these in the event that there is an abortive project or a Fund default takes place. An Option Agreement on the land assets, granted by the Council to the Fund, means that the assets will only be sold to the Fund on the achievement of a specific trigger condition specified within the Option Agreement, which will be the achievement of planning consent for a scheme on that site.

The process by which the first scheme will be developed is outlined below:

1. The JVCo will develop the scheme, including assuring that the finances stack for the Council.
2. The JVCo Board, if satisfied that the scheme is viable, and if the Council (through its membership of that Board) is satisfied its finances stack, will approve the submission of the scheme to obtain planning consent. This will be for the offices and other components of the initial landmark building, such as flats, small food and beverage space, and mini-retail.
3. Assuming planning consent is obtained, the JVCo's Board and the Fund's Investment Committee approve the project, an SPV is established by the Fund; the SPV's shareholdings would be agreed at that point.
4. The achievement of planning consent allows the Option Agreement on the land related to the scheme to be exercised, at which point the land will now be owned by the Fund. The land will be transferred or otherwise made available to the SPV.
5. The Fund will raise the necessary funding to complete the construction phase.
6. The SPV procures the supply chain for construction and the build takes place.
7. The Council and other tenants will then occupy the building.
8. The asset will then be re-financed and any debt the SPV raised paid off.

In terms of the Council's cash flows involved in this, its outgoing cash flow is for the rent and operating costs of the building, with income cash flows from rent received from sub-lets, business rates, a share of the profits from the SPV / Fund[2], and New Homes Bonus from the flats.

Other Projects

The JVCo's primary purpose is the development of a series of financially viable and deliverable schemes. There is an initial pipeline of schemes that will be examined and taken through this development process, outlined below.

- Fletton Quays Phase One - new offices for the Council's back office functions
- the completion of Fletton Quays - a mixed use scheme with high quality homes, offices, ancillary retail and leisure uses, and potentially student accommodation
- the Wirrina car park – new homes close to the city centre

[2] The Council would receive an appreciation in the value of units it holds in the Fund, if the Council chose to receive units instead of cash when the relevant land is transferred; a description of this mechanism if provided later in this paper.

- the Pleasure Fair Meadow car park - a new multi-storey car park topped with residential accommodation
- Northminster multi storey car-park / Bayard Place – new homes in the city centre
- re-use of the Town Hall (retained in the Council's ownership) – retention of the existing civic suite and democratic functions, and relocation of the Council's customer interface from Bayard Place. The feasibility of relocating Central Library here would also be considered, alongside plans for re-using remaining parts for higher education use

Other schemes will be developed following these.

Council Contributions

The Council makes two primary contributions initially:

- The Council agrees to pay £3m for shares in the JVCo. This money will be drawn from existing capital budgets approved for growth and regeneration purposes. The funding, matched by the Fund pound for pound, provides three years' working capital for the JVCO on its initial business plan.
- Existing staff from its Growth and Regeneration team are seconded into the Joint Venture Company. Their salaries are recharged to the JVCo.

In terms of the £3m share purchase, Grant Thornton has advised that this is a capital acquisition.

Running Costs

A budget forecast has been made for the first three years of operation, totalling £6m and equating to about £2m per annum. A draft business plan for the JVCo that provides detail about this forecast expenditure will be taken to the JVCo's Board for approval early in the company's life.

The JVCo's budget is primarily concerned with funding the activities necessary to develop schemes to the point where they are viable and can obtain planning consent. The JVCo is not designed to make a profit, but it is designed to recover costs. As schemes are taken forward into SPVs by the Fund, the JVCo will invoice the relevant SPV for the costs that the JVCo has incurred in the scheme development. The better the JVCo does its scheme development role – characterised by schemes being taken forward to delivery by SPVs – the closer the JVCo will get to cost neutrality, with the initial £6m effectively forming a revolving fund for scheme development.

Where the JVCo expends money on schemes that are not taking forward, these abortive costs would not be recoverable and would therefore run down the total available working capital of the company. It is obviously in everyone's interest for this risk to be minimised, and the JVCo's Board is expected to be active and challenging to ensure project development results in viable schemes.

After the first three years, if it is necessary or desirable to re-finance the JVCo (perhaps to expand its operations), then this can be achieved by issuing new shares and/or by debt issued by the Fund and/or the Council; this will be for the JVCo's Board to determine at the appropriate point, and is only included here to highlight the possibility exists.

The Peterborough Fund

The Fund is intended to be the primary instrument for financing the Special Purpose Vehicles established to deliver the projects that have been approved by the JVCo's Board. It will do so either by financing them directly itself, leading the formation of funding syndicates, or leading the process of raising appropriate debt. The Fund will share many characteristics with Private Equity Funds, having long-term investments requiring considerable investor commitment, and a mixture of returns being achieved requiring a focus on the overall Fund returns.

The current proposals for the Fund are that it will be:

- A Collective Investment Scheme
- A closed-end Fund
- Have a minimum duration of ten years
- Be domiciled in Guernsey and be regulated by the Guernsey Financial Services Commission
- Be VAT registered in the UK
- Be established as a Limited Liability Partnership (LLP)

Pinsent Masons have confirmed that the Council is free to enter into legal agreements with a Fund domiciled outside of the UK, though it has suggested that "all contracts have the exclusive jurisdiction of the Courts of England and Wales and that all contracts with the Fund are subject to English Law"). The Council would take this into account in legal drafting around these proposals.

The initial raise for the Fund is to be £130m which will come from sovereign wealth funds and international investors. It will be managed by an experienced Fund Manager, regulated by the UK Financial Conduct Authority and the Guernsey Financial Services Commission. The Fund's objectives are to deliver infrastructure in Peterborough. The Council's primary interaction with the Fund will be when it disposes of an asset to it. Pinsent Masons have confirmed that this is an exempt activity for the purposes of the Public Contract Regulations 2006, and that the Fund will therefore not be subject to procurement for obtaining the land assets.

Pinsent Masons have advised the Council that it is able to sell assets directly to the Fund, but if the Council wishes to invest in the Fund, the advice is that "the Council considers establishing a trading company in order for it to participate" because "the 2011 Act and the LGA 2003 require commercial activities conducted by a local authority to be performed through a trading company". This is important because the Council has a choice – defined in the next Assets section of this paper – as to whether the consideration it receives from the Fund for Council assets is cash or units in the Fund. Both are possible, as indeed is a mix of both, but in the event the Council wished to acquire units then it would need to do this through an intermediary trading company.

Assets and Asset Transfer Process

The Council has a number of assets that it would look to be made available to support growth and regeneration through this investment approach. The proposed list of assets is later in this document and is subject to agreement through the Council's normal decision-making arrangements. These assets will be made available through a contractual mechanism that incorporates a trigger condition of achieving planning consent on a scheme that requires the asset, so that the asset will only leave Council ownership when there is a viable scheme ready for delivery that uses it.

Approach to asset transfer

The Council has a choice about the nature of the consideration it receives for its assets. The simplest option is that it will receive a cash payment for the asset. The Council will receive upside in this scenario from the increase in the land value that has occurred through the JVCo developing a scheme and obtaining planning consent.

Early on in developing these proposals, however, the Council asked for the possibility to be explored whereby it may be able to receive a share of the upside from the whole scheme, not just the land value. The Fund has offered it the option of taking units in the Fund instead of a simple cash consideration. The units it would receive would match an agreed fair market value for the asset. As schemes are delivered, through the SPVs discussed above, successful schemes will increase the value of the Fund overall, and the value of the Council's units in it. In this way, the Council can have exposure to not only an increase in basic land value, but also the subsequent value created by schemes that are delivered. The Council needs to be clear that, if it chooses to take units in the Fund, there is a possibility of the units going down in value as well as up or staying the same; whilst the Fund will clearly have a commercial interest in ensuring schemes are successful and increase the Fund's value, market risks cannot be eliminated.

Both approaches will use independent third party valuations using standard market assessment methods to ensure fairness. The Council is not required to decide in advance whether it wants cash, units or a mixture of both from the assets it Options to the Fund; this can be decided by the Council at the point each Option Agreement is exercised.

The process that controls the release of assets is:

1. List of assets agreed as part of the set-up of these arrangements. This list of assets is reviewed annually by the JVCo's Board and can – with agreement of both parties – be revised to include other assets.
2. Each Option Agreement will describe a trigger condition that allows the Fund to exercise the option, with the trigger event being the acquisition of a relevant planning consent.
3. At the point the Option Agreement is exercised, the asset's ownership will change from the Council to the Fund.
4. The consideration that the Council receives for the asset will vary by agreement (either being cash or participation in scheme upside through Fund units or both)

5. The Option Agreements that allow the Fund to acquire assets will include a 'long stop' date, after which the Option Agreement expires and the Council is under no further obligation to sell the asset to the Fund, unless the Council chooses to extend the arrangements for a further period of time.

Wirrina and Pleasure Fair Meadow Car Parks

The Council currently receives income from both sites. The Council will continue to operate and maintain the car parks as currently, and retain all income from such operation, until the sites are required for redevelopment. It is also likely to be different for each site, with the Wirrina expected to be released first.

The Council also currently receives an income stream for the staff permits it issues. In the event that staff park entirely at a redeveloped and then privately owned Pleasure Fair Meadow Car Park, it is recognised this income might be lost. Therefore, in the financial model for this new car park, a mechanism to accommodate this loss will be included. The appropriate value and mechanism will be agreed as part of the process of completing the appropriate disposal agreements for this.

Sites envisaged as being made available to the Fund

The sites listed below represent the list of assets that are envisaged being made contractually available to the Fund to acquire, subject to the aforementioned trigger condition being met.

- Bridge House (Site)
- Former Matalan (Site)
- Former B&Q (Site)
- Engine Sheds
- Aqua House (see note)
- The Mill (see note)
- Bayard Place
- Market Multi-Storey Car Park
- Central Library
- Pleasure Fair Car Park
- Wirrina Car Park

Note: Aqua House is in the process of being acquired by the Council, and negotiations are taking place around the Mill. These assets are included here on the presumption these purchases will conclude.

Financial impacts for the Council

There a range of financial benefits to the Council from these proposals.

- the Council's investment in developing growth projects is doubled by the Fund's contribution
- the capital investment from the Council into the JVCo allows greater resource to be targeted towards getting schemes moving more quickly than would be the case if the Council simply continued investing its revenue budget at around £0.5m per year
- the use of capital investment into a company in this manner frees up some of the revenue budgets outlined above (the JVCo will undertake development work, and pick up the costs of the team). The Council will still have some internal costs, and may need to create a sinking fund to support some of the one-off office consolidation costs, including the stamp duty costs from the move, but otherwise the savings are as follows:
    - 2015/16 to 2017/18 - £250k per year
    - 2018/19 onwards - £400k per year
- The Council has also have several possible areas of benefit that can arise from schemes that get taken forward by the Fund:
    1. the Council would receive payment for its assets, either:
        a. in cash, at market value, or
        b. units in the Fund equivalent to the valuation of the assets, an appreciation of whose land values through scheme delivery would increase the value of the Fund, and thus the Council's shares within it
        c. a mix of the two
    2. Shares of developers' profits in relevant SPVs (if the Council is a participant in the SPV, although it should be made clear it is not under any obligation to do so)

There is some potential risk arising from the £3 investment into the JVCo, as there is in any type of development arrangement. For example, the JVCo could get to the end of three years and have not developed a viable scheme. There are a number of controls and mitigations against this:

- money can only be spent by the JVCo on developing projects that the JVCo Board – and thus the Council, through its joint control of the Board – approve, giving consideration to the probability of a successful scheme being developed that the JVCo could recoup its costs from
- the Board will receive regular reports on the progress of developing a viable scheme to be presented to it. This would allow it to review progress and be assured that a scheme is likely to remain commercially viable. Projects where this viability was in question would be halted by the Board
- the £3m contributions from both the Council and the Fund will be paid quarterly over 3 years, offering an extra level of control

The initial finance within the JVCo from the Fund and the Council's share purchase would fund its operation for three years. The collaboration is designed so that the JVCo should create financially viable schemes that can be taken forward within that time. When the Fund takes a scheme forward, the company it creates to do this would reimburse the JVCo for all of the costs the JVCo incurred developing that scheme. This would help finance the JVCo's activities beyond the first three years of operation, creating a revolving fund.

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