Annex 1: A Business Case for an Investment Joint Venture for the Council

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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, especially those on brownfield sites. 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

The Proposed Model

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

a) A Joint Venture (JV) will be established. This will be a Limited Liability Partnership (LLP), and will be 50:50 controlled by the Council and its partner, meaning that both parties have equal voting rights in decision making. The JV LLP's purpose will be to develop viable schemes for key sites in the city.

b) The investor that will partner with the Council in the JV LLP is Lucent Peterborough Partnership SARL[1], which will be set up as a wholly owned subsidiary of Lucent Strategic Land Fund. They are specialists in developing viable schemes for sites and obtaining planning permission for these. Lucent Strategic Land Fund was an investor introduced to the Council by Hume Capital Securities PLC as being a potential partner in the arrangements, and is already working with other Local Authorities (Allerdale Borough Council) in similar arrangements.

c) Hume Capital Securities PLC, with whom the Council signed Heads of Terms in April 2014, has since decided to develop an investment fund that would enable it to potentially purchase and take forward schemes developed by the JV LLP. The Heads of Terms have been reviewed and do not prevent the Council entering into an agreement with Lucent to set up the JV LLP.

d) The Council will grant option agreements to the JV LLP for sites it has available for disposal. When the option agreement is called upon by the JV LLP and land transfered, the Council would receive a loan note for the market value of the site and also benefit from profit share from schemes that are developed.

e) In the first few months of the JV's existence, an Investment Plan will be created that programmes the work to develop more detailed scheme-specific project plans, all of which have to be approved by both the Council's and the partner's representatives on the JV's Board before they can be taken forward. It is only after approval of the project plan that the Council will transfer any relevant site to the JV.

f) When the JV LLP exercises a relevant Option Agreement and takes ownership of the land, the Council receives a loan note for the market value of the asset. Market value will be determined by an independent property valuer appointed by the both partners at "day-one" and they will apply an industry standard red-book appraisal against a project brief based on the scheme under consideration for the site. The land value will meet the Council's duty under s.123 Local Government Act 1972 (i.e. the best consideration reasonably obtainable); it will be a market value based on the type of scheme being proposed. The council will receive a 'Loan Note' for that site market value and this is explained further later in this document; their use is normal commercial practice.

g) When the Council and Lucent agree projects to go ahead based on the project plans, Lucent will invest all the money required to develop these projects into the JV LLP on the same loan note basis; the Council will always have the option – but not an obligation – to invest finance, in addition to contributing land.

[1] A SARL is the Luxembourg equivalent of a UK limited company.

h) For approved projects, the JV LLP will create a new wholly-owned subsidiary special purpose vehicle (SPV) to take the scheme through to planning approval, and assigning all the finance required and the relevant land.

i) Once the SPV has developed a viable scheme and obtained planning permission – and always subject to the final approval of both JV LLP partners through the JV LLP's Board – it is sold on so that physical regeneration can take place, to the buyer identified early in the process.

j) Proceeds from the SPV sale pay off the Council's and Lucent's loan notes, and may be required to pay other Third Party land / development costs if necessary.

k) After the retention of a working capital reserve (which will be determined and agreed by the LLP's Board), remaining profits are then split equitably between the JV LLP partners, based on their relative contributions to the JV LLP.

The Joint Venture

Ownership and Form

The Joint Venture (JV) will be a Limited Liability Partnership between Lucent Peterborough Partnership Sarl and the Council. It will be overseen by a Board of four with equal representation from Lucent and the Council, and have a decision-making structure that requires consensus.

Pinsent Masons were asked to advise us on the Council's ability to enter into an LLP for this purpose and have confirmed that this is possible. The Lucent Peterborough Partnership SARL is a Luxembourg-based limited company, for which the Council has received legal advice that it is fully able to enter into the arrangements detailed in this document.

Mode of Operation

The JV's role is to develop project plans for viable schemes that can be considered and approved by the JV's Board and, following that Board approval, also require approval by the LLP members themselves. The JV 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 project plan for a scheme that provides assurance to the Board that a scheme proposal is likely to be viable.

If there is approval for a project plan – which will include details on project costs and funding necessary for the plan to be taken through to planning permission – then the JV will establish a new SPV to complete the work needed to apply for planning permission from the Council. It is also at the point of Board approval that the JV is able to exercise any relevant Option Agreement with the Council that will trigger the transfer of Council land to the JV (or an SPV, if the JV wishes).

The Special Purpose Vehicles

Schemes that have their project plans approved by the JV's Board are taken forward and through the planning process by Special Purpose Vehicles (SPVs) set up specifically for each project by the JV. These are ring-fenced companies wholly-owned by the JV. This approach is taken for commercial reasons, not least because the ultimate sale of a viable, consented scheme is generally simpler if it is within a specific SPV, because it is simply a case of selling the SPV itself.

The First Project: Fletton Quays Phase 1

The first SPV to be established by the JV, following the development of the relevant project plan and completion of necessary Board and member approvals, will be to develop the Fletton Quays, including obtaining planning consent necessary for the new Council offices that will be built on that site to support the Council's office consolidation.

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 JV develops, and for it to do this the Council – through its Board membership of JV – has to approve that the project plan proceeds.

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 takes place that will allow the Council to buy back assets. An Option Agreement on the land assets, granted by the Council to the JV means that the assets will only be sold to the JV if the Council through its membership of the JV Board approves a project plan that needs that asset.

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

1. The JV will develop the scheme project plan, including assuring that the scheme is financially viable from the councils perspective
2. The JV Board, if satisfied that the scheme project plan is viable, and if the Council (through its membership of that Board) is satisfied by the financial position, will approve the plan. This triggers the creation of an SPV to undertake the work to obtain planning consent, which is likely to be for the offices and other components of the initial landmark building, such as flats, small food and beverage space, and mini-retail.
3. The JV will now be able to exercise the Option Agreement related to the land at Fletton Quays, and is likely to do so, directing the Council to transfer the land to the newly-created SPV. The Council will receive a loan note from the JV for this investment. The exercise of this option will also trigger the Council entering into an Agreement for Lease with the LLP for the new offices.
4. Assuming planning consent is obtained by the SPV, the JV will – subject to Board approval – arrange for the SPV to be sold on so that the physical delivery of the scheme can take place.
5. The buyer will raise the necessary funding to complete the construction phase, and procures the supply chain for construction and the build takes place.
6. The Council and other tenants will then occupy the building.

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, and New Homes Bonus from any flats built.

Other Projects

The JV’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
- 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 and possible higher education uses
- 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's primary contribution is through its land assets, for which it will receive market value through the loan note mechanism.

Running Costs

The running costs of the JV will be covered by investment from Lucent, which will receive loan notes on the same basis as the Council does for land assets.

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 has been 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 there being a project plan that the JV Board – which includes the Council – has approved that requires the asset, so that the asset will only leave Council ownership when the Council is confident a viable scheme is ready that needs it.

Approach to asset transfer

The Council will receive a loan note from the JV whenever it transfers an asset to it. This loan note will be equivalent to the market value of the asset as determined by an independent property valuer appointed by the JV, working to the industry standard red-book appraisal mechanism against a project brief based on the scheme under consideration for the site. These loan notes will be repaid to the Council in cash from proceeds from the sale of SPVs with schemes with planning consent.

The loan notes also entitle the Council to a share of any profit from these sales, in a proportion equivalent to the Council's proportion of loan notes. In other words, if the Council has 60% of total value of loan notes in the JV and Lucent 40%, then any profits are split 60%/40% as well.

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 JV's Board and can – with agreement of both parties – be revised to include other assets. The inclusion of any future assets from the Council will follow the usual Council decision making process
2. Each Option Agreement will describe a trigger condition that allows the JV to exercise the option, with the trigger event being the JV's Board approving a project plan that requires the asset
3. At the point the Option Agreement is exercised, the asset's ownership will change from the Council to the JV (or an SPV, if the JV wishes)
4. The consideration that the Council receives for the asset will be a loan note, the market value of which will be determined by an independent valuer appointed jointly by both JV partners and working to a jointly agreed brief
5. The Option Agreements that allow the JV 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 JV, 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 project plan for this scheme.

Sites envisaged as being made available to the JV

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
- The Mill (see note)
- Bayard Place
- Market Multi-Storey Car Park
- Central Library
- Pleasure Fair Car Park
- Wirrina Car Park

Note: Negotiations are taking place around the Mill; it is not currently owned by the Council but if the negotiations complete and the asset is acquired, it would then form part of the sites subject to Option Agreements with the JV.

Financial considerations for the Council

The impact on the Medium Term Financial Strategy

The Council's had originally intended to invest £3m into the JV, funded from the approved capital programme as follows:

- £2m from the 2014/15 PDP capital budget outlined above.
- £1m from affordable housing Section 106 monies.

As this is no longer required, the £2m can be saved. This increases the savings from the proposals by £130k per year. The total savings from the approach are now as follows:

- 2015/16 to 2017/18 £380k per year (up from £250k)
- 2018/19 onwards £530k per year (up from £400k)

The original report outlined the current viability gap for the south bank business case. This remains the case, and it will be the role of the JV LLP to develop the detailed business case, including investigating further the options for ensuring a viable business case. Those proposals would be presented to the JV LLP Board, which includes the Council representatives, for approval before it can proceed. As part of any business case, the Council will also need to consider the impact on business rates and council tax (both in terms of gains from new buildings and homes, but also losses if commercial properties are redeveloped). The viability gap will need to be closed before the scheme can proceed.

The medium term financial strategy (MTFS) agreed in March 2014 by Council included relevant sections in the Capital Strategy, Asset Management Plan and Treasury Management Strategy to allow the JV partnership. This included the revised capital programme, the sites listed in this report on the asset disposal list and the approach to granting option agreements. Whilst not all aspects of these are required, they cover most of what is required under these proposals (see para 9.3.5 below on one further issue).

Under the previous proposals, the Council was to invest £3m into the JV, but received 100% of full market value in return. In this partnership, the Council does not have to invest, but in return gets market value pre planning plus a share of any uplift (sharing that uplift with the partner). External advisers have confirmed this approach is normal commercial practice.

Loan notes

Neither party receives a cash return until planning permission has been granted and the asset sold. In return for assets, cash or services transferred into the JV LLP, both parties receive loan notes in return. These loan notes are paid when the JV LLP receives cash. Interest is payable on the loan notes at a rate of 12%, but is rolled up i.e. it increases the value of loan notes, rather than actually being paid annually.

In summary this process works as follows

- The Council transfers land to the project SPV via the JV LLP once the project plan is agreed. The land is valued at that point before planning permission. The Council's loan note is for that value
- Lucent provides cash to fund the project. Its loan note is for the value of its funding
- Loan notes are aggregated at JV LLP level, even if there are multiple projects and SPV's
- Proceeds are shared out based on the respective share of loan notes at JV LLP level (not at individual project level)
- Once a scheme is complete, the proceeds, less any fees or tax, are shared as follows (from the top down)

Retention of working capital reserve (to be agreed by the Partnership Board) Payment to third parties involved in assisting in obtaining planning consent, such as environmental consultants etc.
Council's Loan Note, including accrued but unpaid interest, is repaid (based on valuation at time of transfer) Lucent's Loan Note, including accrued but unpaid interest, is repaid (based on value of cash put into JV)
Surplus applied to partners in proportion to Loan Note Value at JV level (i.e. combined value of all loan notes across all projects at that stage)

A numerical example of how this could work is outlined below. It must be noted that this is simply an example to help explain the process outlined above. The values are not based on any specific sites or valuations. In relation to a site to be sold, the simple worked example below is based on the following assumptions:

- Council transfers land valued at £1m to the project SPV and is issued loan notes to this value.
- Lucent invest the necessary funding to pay for design and development, which includes planning and legal fees, at £1m and is issued loan notes to this value.
- Sale price of the land = £3 million
- The Purchaser would be under an obligation to pay £3 million to the Project SPV for the land.

The exit methodology would then work as follows:-

- Purchaser pays £3 million to the Project SPV;
- Project SPV uses the £3 million to repay any outstanding SPV Loan Notes held by the JV LLP and then to pay that balance to the LLP
- The JV LLP would receive the £3 million and then allocate this amount to the Members loan accounts, split between the Members in their profit share proportions at that time (in this example, 50:50).

- The amounts allocated to the loan accounts would be used first to repay any outstanding JV LLP loan notes. Any remaining balances could be distributed or reinvested into future projects, as decided by the Member. The net position for the Council and Lucent would therefore be that each would receive £1.5 million, £1m as repayment of the loan notes and £500k profit. The loan note repayment would be treated as a capital receipt, and the profit as revenue income.

This simple example assumes that there is only one project undertaken by the JV. When there are multiple projects (as will be the case for the Peterborough JV), then the profit share is based on the total loan notes held across all projects. If the land transferred to the JV LLP was deemed to have no commercial value (for example, because development values are very low), then the Council would not receive a return (but may wish to see the project proceed for broader regeneration benefits, including potential council tax, new homes bonus and retained business rates).

As before, the Council have engaged Grant Thornton (GT) to advise on the structure and accounting implications of the partnership. They have confirmed that the loan note approach is normal commercial practice. With regard to accounting treatment, effectively the loan note is an asset – gained in exchange for land. The accounting regulations class this transaction as capital spend. The GT advice expands upon the reasons for this, and confirmation has been provided by Pinsent Masons. The proposed treatment has been shared with PriceWaterhouse Coopers as the Council's external auditors. They have confirmed to the Council that they are "not minded to challenge the proposed accounting treatment".

Whilst the loan note is deemed to be capital spend, the Council does not actually make any payments. Nor does it face any capital financing charges, such as minimum revenue provision. There is no budget within the capital programme. Whilst this is in some respects an accounting technicality, it is suggested that any such arrangements are badged against the 'invest to save' budget. The exact values will be known when sites are valued and project plans agreed. Updates can be provided in Cabinet financial reports on the position.

There is some potential risk arising from this partnership, as there is in any type of development arrangement. For example, even though a project plan has been agreed and the asset transferred (with both parties carefully considering and managing as far as possible any risks prior to approval), the JV LLP could encounter difficulties in progressing the scheme. In this case the Council does have the option to buy the asset back (effectively the sale proceeds to JV then repays the Council loan note, so the transaction should be net nil, although the Council would need to pay market value if the value had increased). Such a transaction would need specific approval in the Council.

The assets of the JV LLP (assets transferred by the Council and cash transferred in by Lucent) will be held as security for the loan notes. The only time that the security should be enforceable is if the JV LLP defaults in its payment obligations to the Loan Note Holders (i.e. the Members). This enforcement would require agreement of both Lucent and the Council. In an extreme case, where the cash had been used, Lucent may have access to the remaining security. However the need for the JV LLP Board to act would have been triggered well in advance of such a situation.