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NORTH YORKSHIRE COUNTY COUNCIL

EXECUTIVE

15 JANUARY 2019

ALTERNATIVE INVESTMENT – YEAR 1 REVIEW

Report of the Corporate Director, Strategic Resources

1.0 INTRODUCTION AND BACKGROUND

1.1 In August 2017 the Executive approved an alternative investment framework with £50m earmarked for longer term, more commercial investment. This was in response to the financial environment and low Bank Base Rate (BRR) which meant that the Council was (and still is) getting incredibly low returns on traditional investment of the Council's cash balances.

1.2 The approved strategic approach to managing cash resources was in accordance with the Council's Treasury Management Strategy and aimed to improve treasury returns, achieve revenue savings and potentially support the Council's wider objectives – for example driving additional income to support the Council's savings plans which in turn helps to ease pressure on front-line services.

1.3 The aim through this approach is to identify, assess and implement longer term (5 years plus) investment decisions including an element that targets commercial returns whilst ensuring the Council has access to sufficient cash to manage its day to day operations.

1.4 This report reviews the progress made over the last year, identifies lessons learned and the intended direction for the year ahead. Scrutiny Committee received this report at their meeting in December (draft minutes attached at **Appendix D**).

2.0 OPTIONS CONSIDERED

2.1 The opportunities for investment fall into 3 broad categories:

- Internal Financing Adjustments – these opportunities are concerned with the use of resources within the Council, allowing resources to be earmarked or set aside to achieve revenue savings. They may not include the actual transfer of cash and as such can provide flexible opportunities.
- Treasury Management – these opportunities involve extension of the institutions and/or cash investment vehicles available to the Council through its traditional treasury management function.
- Alternative investments – these opportunities are associated with the potential to invest in physical assets and projects delivered either directly by the Council or by/with partners in order to achieve a payback of the investment and an added return.

3.0 THE FRAMEWORK

3.1 The options available to the Council are varied and individual investments are subject to business case. However limits on the sums invested and targets for investment returns ensure an appropriate balance between risk and reward, a diverse portfolio to

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help manage risk, and churn of cash to take advantage of future opportunities down the line.

3.2 In order to establish a high level decision framework the following limits and target returns were approved:

Type of investment	Risk	Maximum Exposure £000	Maximum Term Years	Target Rate (above BBR) %
Alternative treasury instruments - *note already covered in Treasury Strategy*	**Low**	**20,000**	**1 - 5**	**> 0.1**
Alternative Investments (overall Max):		**50,000**		
Spend to Save	Low	5,000	7	4.0
Loans to Council Companies	Low - Medium	15,000	10	4.0
Loans to Housing Associations	Medium	10,000	20	3.0
Projects which deliver local economic growth	Medium	15,000	5	5.0
Solar Farm (or similar)	Medium	5,000	20	7.0
Commercial investments	High	10,000	10	8.0

3.3 It should be noted that the overall maximum exposure for these alternative investments is £50m but the maximums for each individual investment category total £60m which provides a degree of flex within the framework whilst working within the overall £50m.

3.4 Consideration of individual investment opportunities are subject to detailed business cases with their risks and rewards assessed.

3.5 Given the technical nature of such investments and strong linkages to the Council's Treasury Management function, appropriate governance and decision making arrangements are needed to ensure robust due diligence and the necessary agility to act. A Commercial Investment Board has been established to considered the identified opportunities and oversee the arrangements.

3.6 The Executive delegated authority to enter into individual investments up to £1m within an overall total of £5m p.a. The Board's approved terms of reference are attached at **Appendix A**.

3.7 The Board meet routinely every 2 months but more frequently when opportunities are actively being considered. This flexible approach enables a degree of agility for lower value opportunities, with investments in excess of £1m requiring Executive approval and therefore a longer lead in time.

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4.0 ONE YEAR ON – A REVIEW OF ACHIEVEMENTS

4.1 The investment framework approved by the Executive in August 2017 identified a range of potential investment options. In the last year, each of the investments identified under the framework has been explored, with significant progress made in the following areas.

Internal Financing Adjustments

Additional Minimum Revenue Provision (MRP)

4.2 When the Council increases its capital financing requirement (i.e. by the amount of capital expenditure not financed from revenue and/or grants) it must set aside an amount to repay borrowing (internal or external), even if actual external borrowing is not taken. The amount of MRP is determined by the Council's Minimum Revenue Provision Policy but typically this is the equivalent of the 'unfinanced' capital expenditure divided by the life of the asset concerned.

Example

The Council purchases a new office building for £1m with an expected life of 25 years

The cost is funded through internal borrowing (i.e. the Council borrows the money from itself)

An MRP charge of £40k is charged against the Council's revenue budget (£1m/25 years) to pay back the money borrowed.

4.3 This MRP is a charge against the Council's revenue budget and hence Council Tax each year and is set aside in a ring-fenced unusable reserve. The physical cash remains within the Council's accounts and forms part of the investment balances placed with the various banks and institutions on the Council's lending list, until such time as it is needed to repay borrowing.

4.4 The option to repay an additional MRP Payment presents low risk in that the cash stays with the Council and it produces a guaranteed annual revenue saving (setting aside lump sums up front rather than annual revenue contributions). However, whilst it reduces the amount of usable reserves, it is still available for other investment allowing the actual cash held to be invested and deliver an added return until it is needed to repay borrowing.

4.5 To date £15m voluntary MRP contributions have been made - £5m financed from in-year underspends and the £10m sum earmarked for alternative investment. Together, these contributions have saved £600k p.a. from the revenue budget.

Alternative Treasury Management Instruments

4.6 A number of alternative instruments are potentially available to the Council – some already covered by the approved Treasury Management Strategy but not yet used. Typically higher credited rated instruments offer lower rates of return and therefore some of these types of investment have limited impact on overall returns. However they do provide alternatives to the investment we currently use and as such allow us to diversify our portfolio. Options currently used are:

i) Money Market Funds

ii) Certificates of Deposit (CDs)

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iii) Property Funds

4.7 A review of the Council's Treasury Management Strategy was undertaken in 2017/18 and a £20m limit was included for these opportunities. The infrastructure for the alternative Treasury Management instrument investment options identified is now in place.

Money Market Funds

4.8 Following a selection process supported by the Councils Treasury Management advisers the following Money Market Funds were selected for investment:

- BlackRock Money Market Fund
- State Street Global GBP Liquidity Fund

Accounts have been opened with both funds, however, while investment opportunities have been continually monitored since access was obtained, the rates available have only now reached a competitive level. An initial investment was placed with the State Street Global Fund in October 2018.

Certificates of Deposit (CDs)

4.9 The Council has now established a custodian account to enable investment in a wider range of treasury instruments, including Certificates of Deposit (CDs). The Council has invested in the following CDs:

- Nat West Bank (£5m)
- Credit et Industriel Bank (£5m)

Both of these investments were actioned in July for a 6 month duration. Further potential investments continue to be monitored.

Property Funds

4.10 A detailed selection process was undertaken, supported by the County Councils Treasury Management advisers and, two Property Funds have been selected for immediate investment:

- BlackRock UK Property Fund
- Threadneedle Property Unit Trust

Accounts have now been opened with both funds and a £3m investment in each fund has been agreed with transactions completed at the end of October 2018.

Loans and Projects

Loans to LA Companies

4.11 The Council currently owns (in whole or part) a number of companies which have been established to deliver a variety of objectives.

4.12 The Council provides cash flow support to these companies and has £7.6m loans (at 31 March 2018) on its balance sheet at a variety of terms (duration and interest rates).

4.13 Given the nature of the companies and the Council's direct involvement in their operation, relative to other types of investment these are considered lower risk and are currently offered at a rate of bank base rate plus 4%.

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4.14 Loans are classed as capital expenditure and financed through internal borrowing in accordance with the Council's Treasury Management Strategy. Current Loans to Limited Companies:

Company Loan	Total Loan Approved £k	Interest Rate %	First Drawdown Date	Total Loan 31/03/2018 £k	Interest 2017/18 £k
NYNet*	10,000	Base + 3.0	01/04/2006	0	18
Yorwaste I	3,700	Base + 4.0	23/05/2012	3,700	161
Yorwaste II**	3,850	Base + 4.0	19/06/2017	3,498	120
Brierley Homes***	25,000	Base + 4.0	12/05/2017	327	5
Align Property Partners	500	Base + 4.0	N/A	0	0
First North Law	250	Base + 4.0	09/05/2017	60	1
	43,300			**7,585**	**305**

* The NYNet Loan is an overdraft facility and the average balance in 2017/18 was £548k - this is expected to rise to £6,113k in 2018/19

** The Yorwaste II balance was £3,148k as at 30/09/18

*** The Brierley Homes loan was £2,014k as at 30/09/18 and is expected to rise to £6,885k in 2018/19

4.15 As shown in the table above, there is an increasing demand for loans from the Councils limited companies, particularly from Brierley Homes. Consequently, consideration will need to be given as to whether to flex the limits on this investment category within the overall £50m investment or whether an increase on the overall £50m limit is required given projected demand.

Local Economic Growth/'Commercial' Property

4.16 Direct investment in commercial property can be aligned to the Council's Economic Development Strategy and/or can be undertaken on a purely commercial basis. Returns can vary significantly and each opportunity has to be considered on its merits having due regard to risk and reward. To date the Council has shortlisted 44 potential property investments; taken 14 to business case stage; five bids have been formally submitted; and two of these properties have been successfully acquired. Details of property investments to date are as follows:

Bank Unit in Stafford Town Centre

4.17 The acquisition of a freehold bank unit and lease in Stafford Town Centre, Staffordshire. The property is currently let to Bank of Scotland plc trading as Halifax and is held on a lease that runs to November 2031. The property was purchased for £850k with purchase of costs of £33k. The current rent is £53k p.a. providing a Net Initial Yield of 6.0%.

Harrogate Royal Baths

4.18 The acquisition of a leasehold restaurant / leisure investment in Harrogate Town Centre. The property comprises of four commercial units, all of which are currently let with expiry periods ranging from 2027 – 2038. The lease has been secured subject to contract and is expected to provide a Net Initial Yield of approximately 5%.

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5.0 ESTIMATED RETURNS

5.1 **Appendix B** sets out a summary of the estimated returns from the investments made to date. In total MRP savings of £600k have been achieved, returns on treasury investments are estimated to be £383k and returns on the alternative investments in place are estimated at £859k p.a. The total projected annual gross income/savings generated from the alternative investments to date is £1,842k – this is a margin of £1,510k over traditional treasury management returns.

5.2 The report which set out the proposed framework indicated that annual revenue savings/returns of in excess of £1.7m could be reasonably achieved (subject to projects being identified and approval of business cases).

5.4 Internal administration of the investment 'pool' is required and the current Finance savings plan includes an assumption of £20k from this work. Given the proposals to extend the scale of this work an indicative 2% top-slice was approved, which based on returns of £1,842k estimated to date would result in a top-slice of £37k. This will be kept under review as further investments are made.

6.0 LESSONS LEARNED

6.1 Whilst significant returns are expected from these investments the resource input required from within and external to the Council is also significant. Each proposition requires careful assessment of the market, the legal issues, and the risks and the returns expected in order to inform a robust business case.

6.2 The competitive nature of the market for these investments means that a degree of failure to secure investments is to be expected and indeed some business case work will be abortive as some investments will not be considered appropriate for investment. Where possible early sifting of proposals aims to focus efforts on opportunities worth pursuing but inevitably not all business cases will result in a successful acquisition.

6.3 Appropriate due diligence is crucial in order to take decisions for investment and it is important that timely expert advice is sought when necessary, in order to adequately assess the potential risks and rewards from such opportunities.

6.4 The target returns from these alternative investments ranged from 4% to 8% above the Bank Base Rate however experience of the market over the last year has shown that returns are substantially below the upper end target and consequently it would be prudent to scale back our expectations and for the purposes of future guidance a return of 3-4% above Bank Base Rate would be more realistic.

6.5 In addition, consideration will need to be given to investment limits within the current overall £50m limit. Investments to date within Commercial Property and future projections for loans to Limited Companies, for example, suggest upper limits could be met in the next 12 months. In light of the progress with some of the investments, the overall £50m limit could also be reviewed. The initial report on alternative investments suggested that the Council's cash balances are forecast to drop to £83m over the 4 years to 2020/21 and then rise to £100m over a 20 year period and therefore it is proposed that the total amount available for alternative investment (excluding the treasury instruments) be increased to £60m. This will ensure that sufficient short term cash balances remain available to manage day to day requirements.

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6.6 Acknowledging the requirements for the Council's limited companies it is proposed to increase the loan limit to £25m over the next 12 months although this will need to be kept under review.

6.7 Experience also shows that the timescales for turning around the necessary due diligence requires a degree of agility regarding decision making and consequently the Commercial Investment Board propose to request that the Executive extend the current delegations to approve individual investments to a limit of £2.5m (from £1m) per investment and up to a total of £10m (from £5m) in any one financial year.

7.0 NEXT STEPS

7.1 Over the coming 12 months opportunities will continue to be sought but our efforts will be focused on the following:

<u>Commercial Investment</u>

7.2 Further opportunities for commercial investment will be sought over the coming year building on the experience gained to date. The aim will be to maximise the investments within the approved framework. It is proposed that a single commercial investment limit of £20m be applied to direct commercial property acquisition (rather than the current separate limits for local growth and commercial investments). Subject to Executive approval this would leave £9,521k available for commercial investment.

<u>Solar Farm (or similar)</u>

7.3 A feasibility study into the potential for a council owned solar farm has been carried out. Investment of circa £5m could deliver a 5mw land based solar farm. The Council has a number of land holdings which could be suitable for a land based solar scheme (including former land fill sites and county farms sites) although government cuts to the subsidy regime means that costs need to reduce in order to deliver a viable scheme. 'Grid parity' is the point at which it is no more expensive to deliver a solar scheme v other non-renewable methods negating the need for subsidy. A scheme could enable the Council to generate electricity for its own consumption thereby reducing the volume procured and providing corresponding protection from future price rises or it could generate power for sale either back to the grid or direct to commercial or domestic clients (the latter required through a separate electricity supply company).

7.4 Typically it is expected that for an investment of between £4m - £5m a target rate of return of 5% should be set (subject to grid parity) which would give a margin of say 4% and generate an additional return of at least £160k - £200k. The decision to invest in such a scheme would be subject to a separate detailed business case.

7.5 Due to the Government cuts to the subsidy arrangements, a number of authorities have had to revisit their business plans around solar energy projects and put their plans on hold. A small number of solar projects have recently been built with subsidy, however, these are largely projects where there is a local demand for the energy they will produce. Although the price of solar equipment has reduced, the costs are not yet at 'grid parity' but there are examples of some larger projects which are being taken forward (for example Warrington's recent acquisition of 'off-plan' solar farm developments near York and Hull). Given the potential land the Council has available for such development, the business case will be revisited over the next 12 months.

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Loans to Housing Associations

7.6 Soft market testing suggests that there is opportunity to provide loans to housing associations for delivery of affordable housing which could also work alongside our market housing investment through Brierley Homes. A number of associations and charities operate with the County and may be interested in borrowing from the Council. Consideration would need to be given to an appropriate rate, term, loan type (interest only or annuity) and security, which would be part of the due diligence for such loans and would be included within the legal agreement that would be required. Assuming a term of up to 20 years and loans of £5m at a margin of 3%, interest of £150k could be achieved.

Debt Repayment

7.7 This follows on from the MRP option above. The Council currently has external borrowing of £288m as at 31 March 2018 with varying terms and interest rates. Repayment of borrowing would reduce the Council's Capital Financing Requirement and hence it's MRP charge and would save external interest payments however there may be penalties for loans repaid early.

7.8 Link, the Council's treasury management advisors regularly review the Council's debt portfolio and current interest rates and future forecasts suggest that it is not beneficial to repay debt at this time as there would be little opportunity for early repayment without the Council incurring substantial premium charges. This will continue to be monitored as part of the Council's on-going treasury management activity.

Payment to North Yorkshire Pension Fund

7.9 The Council has the option to pay one-off sums to reduce the historic deficit on its pension fund. The opportunity arises every 3 years when the results of the latest triennial valuation are factored into the coming 3 years' contribution rates. The next triennial valuation is due in 2019 and this will be kept under review.

8.0 CONCLUSIONS

8.1 Good progress has been made on alternative investments and together this new approach has secured estimated annual revenue savings/income of £1,842k a margin of £1,510k over traditional treasury management returns.

8.2 Experience has shown that the commercial investment market is highly competitive and accordingly our guideline returns should be scaled back – accordingly a target return of 5% is proposed.

8.3 Of the £50m earmarked for investment £31m remains available but some changes to the approved thresholds and delegations are proposed:

- The total amount for alternative investment be increased to £60m;
- The local growth and commercial investment limits be combined into a single limit of £20m;
- The target return for commercial investment be set at 5%;
- The limit for loans to NYCC companies be increased to a total of £25m;
- The delegations to the Commercial Investment Board (formally through the Corporate Director Strategic Resources) be extended to a limit of £2.5m (from £1m) per investment and up to a total of £10m (from £5m) in any one financial year.

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8.4 Further work to pursue the options within the approved framework will be undertaken over the next 12 months with a focus on: commercial property acquisition, affordable housing loans, and exploration of investment in solar energy.

9.0 RECOMMENDATIONS

9.1 It is recommended that the Executive:

i) Note the progress to date and the future actions proposed

ii) Approve an increase in the total amount available for alternative investment from £50m to £60m;

iii) Approve the revised thresholds set out at Appendix C;

iv) Approve the extension of the delegations to the Commercial Investment Board (formally through the Corporate Director Strategic Resources) to a limit of £2.5m (from £1m) per investment and up to a total of £10m (from £5m) in any one financial year.

Gary Fielding
Corporate Director – Strategic Resources

COUNTY HALL
NORTHALLERTON

15 January 2019

Author of report – Karen Iveson

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Appendix A

Commercial Investment Board

Purpose

The Board will not be a constituted body and will therefore not have formal decision making powers. However, it will be the chief means of identifying, reviewing and recommending schemes for investment decisions. Such formal decisions will be taken within the existing delegations namely through delegated authority to the Corporate Director, Strategic Resources and further decisions as made by the Executive.

To consider and recommend detailed business cases for alternative investments within the framework approved by Executive.

To approve individual investments to a limit of £1m per investment and up to a total of £5m in any one financial year.

To consider appropriate due diligence proportionate to the investment/risk/reward proposed.

Notwithstanding the Corporate Director, Strategic Resources authority to terminate investments should concerns be raised - to consider and recommend cases for early termination of alternative investments.

To monitor returns against approved performance targets.

To report performance of alternative investments to the Executive on a quarterly basis

To make recommendations to Executive on any proposed changes to the framework.

Membership

Lead Member for Finance (Chair)

Lead Member for Growth

Corporate Director Strategic Resources

Corporate Director Business and Environmental Services

Assistant Director Strategic Resources – LBP to CFO

Assistant Director BES - Growth, Planning and Trading Standards

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Frequency of meetings
Board meetings likely to be held quarterly however the nature of investment opportunities will require agility and meetings will be arranged as required outside of the quarterly schedule.

Approved 15 August 2017

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APPENDIX B

Investment/Returns at 30 September 2018

Alternative Investment Options	Priority	Actual Investment	Actual rate of return %	Term	Actual Yield/ Saving p.a. £	Comments/Notes
Additional MRP (non-cash movement)[1]	**1**	**15,000**	**4%**	**N/A**	**600**	
Treasury instruments	**2**					
Property Funds		6,000	4.86%	5 -10 years	291	Investment to commence Oct 18 – Indicative Return based on historic average of funds
Certificates of Deposit		10,000	0.79%	6 Months	79	Weighted Rate of Return
Money Market Funds		2,000	0.66%	Instant Access	13	Investment to commence Oct 18
		18,000	**2.13%**		**383**	
Alternative Investments						
Loans to LA owned companies	2	7,585	Base + 4%	Various	305	Balance and Return as at 31/03/18
Local economic growth	3	0	N/A	N/A	0	
Commercial property – investment only	2	10,479	5.29%	10 years	554	Harrogate Royal Baths purchase expected to complete October 2018
Loans to housing associations	3	0	N/A	N/A	0	
Total Alternative Investments (subject to risk appetite)		**18,064**	**4.76%**		**859**	
Total annual saving/income [2]		**51,064**	**3.61%**		**1,842**	
Treasury Management Return			0.65%		332	
Total annual margin over standard returns			**2.96%**		**1,510**	

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APPENDIX C

Proposed Revised Thresholds

Type of investment	Risk	Maximum Exposure £000	Maximum Term Years	Target Rate (above BBR) %
Alternative treasury instruments - *note already covered in Treasury Strategy*	**Low**	**20,000 Per category**	**1 - 5**	**> 0.1**
Alternative Investments (overall Max):		**60,000**		
Spend to Save	Low	5,000	7	4.0
Loans to Council Companies	Low - Medium	25,000	10	4.0
Loans to Housing Associations	Medium	10,000	20	3.0
Solar Farm (or similar)	Medium	5,000	20	7.0
Commercial investments	High	20,000	10	5.0

Subject to Executive approval

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APPENDIX D

Extract from Draft Minutes of the Corporate and Partnership Overview and Scrutiny Committee, 3 December 2018

72. North Yorkshire County Council Investment Strategy

Considered -

A progress update on the delivery of the County Council's alternative investment framework provided by Karen Iveson which highlighted;

- An alternative approach had been required following a decade of low interest rates and therefore the difficulties in finding places to invest;
- That the alternative approach was a more commercial approach than previously taken;
- The County Council had considered fourteen potential investment opportunities before agreeing to take three forward;
- Bids on two investments had been successful following substantial due diligence – a £900k investment in a freehold bank unit and lease in Stafford Town Centre had been completed and a £9.1m leaseholder investment in Harrogate Baths building was in progress;
- £6m had been invested in two property funds
- Specialist advice had been sought where needed

Karen Iveson went on to detail the estimated returns from the investments made to date and the focus of the work to be undertaken in the next twelve months.

In regard to the potential for the council to own a solar farm, County Councillor Derek Bastiman suggested agricultural holdings may prove a suitable site.

County Councillor Richard Musgrave queried how the County Council planned to mitigate the risks associated with the property funds and in response Karen Iveson acknowledged that:

- Investment in property funds did bring a greater degree of risk than traditional investment routes
- The approach taken in considering any potential investment opportunities did ensure diligent consideration of all the risks involved
- The financial modelling tool used enabled the varying of assumptions.
- Risk mitigation limited exposure to the risks
- An element of funding would be set aside to address any issues that might arise during the lifetime of each investment.

County Councillor Mike Jordan suggested the Government was looking at what local authorities were doing as it was concerned that they were losing sight of what they were here to do, and that a lot of time and resources were involved in maintaining the County Council's approach. In response Karen Iveson confirmed that the approach had required changes to working structures, not additional resources.

County Councillor Bryn Griffiths suggested in was important to manage the public's perception of the county council's investment approach and in response Karen Iveson confirmed that the County Council had not borrowed money in order to invest unlike some other local authorities, and always took the necessary time to apply due diligence to the process. Members thanked the officer for the report and

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Resolved -

i) To note investment progress to date and the planned focus of the work over the coming 12 months.