



# SEFUND FEASIBILITY STUDY

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South East LEP

February 2015

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South East  
Local Enterprise Partnership



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# The scope, viability and market appetite for SEFUND

## THE SCOPE, VIABILITY AND MARKET APPETITE FOR SEFUND

The South East Local Enterprise Partnership (“SE LEP”) has defined their ambition for the South East Fund (“SEFUND”) in the scope for this project, which can be found at Appendix 1. This study aims to investigate further the feasibility of the Fund, and will lead to a second stage where recommendations for design of the Fund are made.

### To identify potential investors who would be interested in investing in SEFUND

There has been much discussion during the scoping period about private sector investors capitalising the SEFUND along with public sector seed funding. Politically this would make a bold statement for the SEFUND and the SE. Over the course of the feasibility period however, CBRE has explained that in practical terms private sector investment at Fund level is unlikely to be attractive to either investors or the Fund at this stage of the Fund lifecycle.

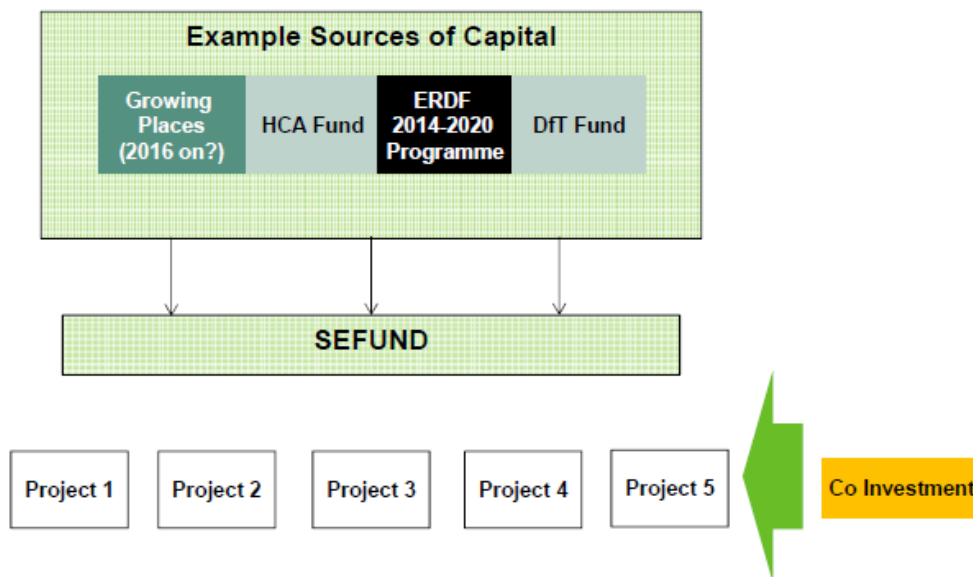
The reasons for this are as follows:

- There is no track record of the Fund’s investment strategy, and the private sector is highly unlikely to invest in a new fund without control to enable them to select specific deals.
- The purpose of the Fund is to invest where others will not; therefore pari passu investment with SEFUND is unlikely to be an appropriate risk and reward position for the private sector, and this means that interests are not aligned.
- If a pari passu investment is not sought, it is preferable to seek co-funders from a wider, open market pool on a project by project basis.
- Control of investment strategy and hurdles for fund level third party investment will in reality limit the investments that are made to those where there would be open market competition anyway.
- Difference in risk and reward appetite would become accentuated in a default situation; a private sector investor may wish to take enforcement action at a different point in an investment, which may not be the most appropriate point in time to achieve the objectives of SEFUND.

CBRE’s experience of other funds is that fund level investment, whilst aspirational, is not necessary to maximise leverage of the available capital.

CBRE’s recommendation therefore is that at this stage investment should be sought at individual scheme level. As projects come forwards, the finance is structured by the SEFUND Fund Managers to create the ‘best value’ finance for the project made up of private, public and SEFUND sources. This enables SEFUND to benefit from third party leverage without adversely changing its founding principles or investment strategy.

# The scope, viability and market appetite for SEFUND



If there are no specific funders tied to the Fund, this enables the Fund Manager freedom to structure finance in the most efficient manner, seeking complementary finance from the entire market.

Developing the Fund using this approach, and accessing the wider funding market means the co funding could be obtained from a wide number of sources. It also allows for greater flexibility as the SEFUND can fill the finance gap, helping to complete the “capital stack”.

We have recently found the following examples co financiers with appetite for this type of investment in the North West and Sheffield City Region:

Funder	Type of Funder	Type of Co-Funding alongside Fund
Carlyle	Investment Fund	Equity
Lloyds Bank	High Street Bank	Senior debt (club with Evergreen)
Barclays Bank	High Street Bank	Senior debt
Pramerica	Investment Fund	Equity
RBS	High Street Bank	Senior debt
Carillion Developments	Self Funding Contractor	Junior debt
Muse Developments / Morgan Sindall	Self Funding Contractor	Junior debt
Tristan Capital	Private Equity	Equity

The above and similar institutions would be potential investors on a project by project basis.

The table below highlights the types of investors who CBRE know from market intelligence are currently active in the market. We have reviewed the levels of investment and type of returns that they are expected to require and the risk levels that they are prepared to accept.

# The scope, viability and market appetite for SEFUND

This knowledge gives a good understanding of how projects can be worked up to minimise public sector investment and maximise private sector investment whilst ensuring that they are deliverable by the market.

Typical Criteria	Senior Development Loan	Higher leverage Senior Development Loan	Mezzanine Development Loan	Equity
Type	Lower return, low risk funding.	Medium returns for increased risk by offering “whole loans” that are senior but provide developers with greater leverage	Intermediate finance, subordinated to senior debt, but ranks ahead of equity. Potential for high returns	First loss equity. Highest returns
Examples	Lloyds, Santander, HSBC, Barclays, RBS, Wells Fargo, PBB	Pramerica, Guggenheim, Daiwa	Pramerica LaSalle IM Investec	The developer community active in the South East
Typical return % on investment	4% – 6%	5% - 10%	7% – 12%	Development upside, typically profit share
Security and Protections	Typically, optimal security: first charge over the asset and contracts	Typically, optimal security: first charge over the asset and contracts	Weaker. Second charge / lower ranking security	First loss
Time frame	1 – 4 years	1 – 4 years	2 – 8 years	Until exit
Financial Leverage	<ul style="list-style-type: none"> <li>Up to 40% LTV on completion</li> <li>50 - 70% LTC during development</li> </ul>	<ul style="list-style-type: none"> <li>Up to 60% LTV on completion</li> <li>60 - 80% LTC during development</li> </ul>	50% – 85% LTV	n/a
Exit (repayment of loan)	<ul style="list-style-type: none"> <li>Refinanced post-completion</li> <li>Conversion to investment facility</li> </ul>	<ul style="list-style-type: none"> <li>Refinanced post-completion</li> <li>Conversion to investment facility</li> </ul>	Disposal proceeds, usually only after repayment of all other loans	Typically on disposal or refinancing to release equity
Risks	Development risk mitigated by security on asset and low LTC	First charge security, with risks dependent upon the amount of equity.	First loss (after equity). Ranks after senior debt	Absolute first loss, with security in favour of any lenders

## Public Sector

There are various public sector sources that will also be of interest over the life of the Fund. These are more likely to be appropriate investors at Fund level, as the objectives will be more aligned with the SEFUND’s. These may include Growing Places fund, Local Growth Fund, and ERDF and are reviewed in more detail in later sections of the report.

To date, CBRE has had discussions with the HCA about devolving some of their recoverable investment funds to SEFUND to invest in the region. We are aware of a number of schemes where the local authority or the HCA may wish to contribute land to a development in lieu

## The scope, viability and market appetite for SEFUND

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of funding, although this is much more likely to be at project level in order that the landowner can recover the value directly, rather than commit it to the Fund.

Once the Fund builds a reputation of delivering projects and economic outputs, the interest from other public funding sources in using the platform is likely to increase.

The Fund Manager, in partnership with the Borrower, will identify the appropriate funding partner as the structured finance and capital stack for each project is developed.

# The scope, viability and market appetite for SEFUND

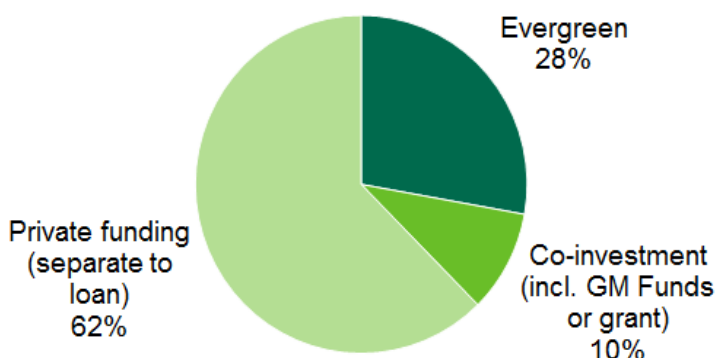
## To quantify private sector interest to invest in or alongside SEFUND

In order to quantify private sector potential investment to the Fund, CBRE has looked to the example in the North West, and particularly the cluster around Greater Manchester, where we are able to analyse the Evergreen Fund and the investment it has attracted. CBRE’s experience establishing and managing the Evergreen Fund has made it possible to quantify potential private sector leverage for the initial £50m phase of the SEFUND.

CBRE also has very good insight into the SCR JESSICA Fund, however Evergreen is a more appropriate fit with a mature portfolio of loans (having been established longer) as well as a more comparable market and projects. The chart below demonstrates the current leverage position and we have extrapolated this for the SEFUND.

The expectation of the SEFUND is to grow significantly beyond the seed capital, so these projections should be considered as a base case target to leverage capital from the original £50 million.

**Co-investment and private funding: total, including forecast loans**



	EVERGREEN	SCR JESSICA	SEFUND Forecast
Fund Size	£55m	£23.2m	£50m
£ Committed	£49m	£18.3m	-
Total First Phase Leverage (Private Sector Capital)	£107m	£13.5m	£110m
Current Leverage Ratio (Private Sector Capital)	1:2.2	1:0.74	1:2.2
10 Year Forecast Leverage	£500m	£86.4m	£450m

# The scope, viability and market appetite for SEFUND

Source: CBRE Annual Reports for Funds.

Note: SEFUND is expected to grow beyond £50m capitalisation, and the leverage of the additional funding will depend upon the strategy for that additional capital.

It is also interesting to analyse the potential spend unlocked as a result of the investments made elsewhere. A site infrastructure heavy fund may attract 100% leverage into the direct cost of funding the projects, but appropriate infrastructure spending may unlock much more expenditure on the individual plots. An example of this is the Logistics North site that Evergreen funded; the cost of infrastructure leverage was match funded, however the total of the plot build values on the site (of which are half sold and in build now) would be in the region of 20 times leverage, although this is not included in the analysis above.

Infrastructure development has the potential to unlock and attract significant private sector capital. Initially, alongside Fund capital in developing the infrastructure; then, once enabled, private sector investment will develop out the serviced plots.

If this is applied to the SEFUND, and assuming some weighting towards this type of infrastructure, the initial £50m could leverage well over £1bn during its first ten years. This will ultimately depend upon the investment strategy and the type of schemes that the Fund invests in.

## To make recommendations for a marketing strategy that will attract major investment funds and developers to SEFUND

The marketing strategy for the Fund should be a two phase process. This will be firstly to developers and local authorities, to enable a pipeline of investments to be developed; secondly to bring the opportunities to the attention of potential funders.

The Fund must be progressed sufficiently, with surety of capital to invest and a real pipeline, before any targeted marketing to borrowers or funders is undertaken.

During the first phase of the Fund, developer focus is critical. This must be at a point at which capital can be made available, to protect the reputation and credibility of the Fund.

Funders may show an initial interest in a Fund concept and pipeline, but until genuine projects are available to review, interest may wain and the risk of this is that momentum is lost.

A good Fund Manager will have necessary contacts and access to speak directly with a large number of potential funders once the time is right for the Fund. A track record is also vital for credibility. A backdrop of press coverage should be ongoing, building on the current very effective campaign. This should be alongside developer roadshows organised in tandem with the local authorities or the LEP to enable the pipeline to progress. These two measures will ensure that the SEFUND enters the thought process of anyone investing in the development or intending to deliver development in the region. Such an approach will need to be continued through the various stages of the Fund's lifecycle.



# Options for and recommend for the operational model for the Fund

## OPTIONS AND RECOMMENDATIONS FOR THE OPERATIONAL

### MODEL FOR THE FUND

#### Draft high level investment strategy for SEFUND

The following Investment Strategy has been issued to stakeholders as draft, and comments are being collated. The final version will be developed over the fund design stage, incorporating comments received. The version below incorporates no changes, and remains a dynamic document at this stage.

#### Background

The SEFUND is being set up as an instrument to support the South East LEP's economic strategy, by providing finance for certain projects where bank funding is not available (referred to as "funding gap", distinct from "grant funding" where a scheme is not viable). The mandate does not currently provide for grant funding, although SEFUND can be used alongside grant funding.

SEFUND will be one of a variety of tools available in the region to assist in delivering the LEP's Strategic Economic Plan. It may be used alongside various local, national and European interventions that are regionally available.

The overarching ambition of the LEP's economic strategy is to deliver:

- 200,000 private sector jobs
- 100,000 new homes
- £10bn of investment

The purpose of the Investment Strategy is to determine how the Fund can contribute to this, and to what extent.

The Fund is to be structured with the purpose of delivering this economic strategy, NOT to make a profit for individual participants. Because of this, the Fund is to be structured for 10 years, with the ability to renew for ten years an indefinite number of times. All profit is to be retained by the Fund.

The exit strategy for the Fund will be that the money is returned in accordance with the regulation for the individual sources. For example this may be retaining it within the LEP as per Growing Places loans that are repaid, or back to DCLG if it is ERDF capital.

This does not stop any local authorities participating in a scheme alongside the SEFUND and making profit, but that remains a matter for that authority and SEFUND will be independent from that scheme other than as a lender.

This is important for the legal structuring the Fund itself, the reasons for which will be reviewed in more detail elsewhere in this report.

#### Purpose of the Investment Strategy

The Investment Strategy exists in basic terms to measure projects against and to ensure that they are appropriate for the Fund to invest in. The Investment Strategy will be reviewed annually.

# Options for and recommend for the operational model for the Fund

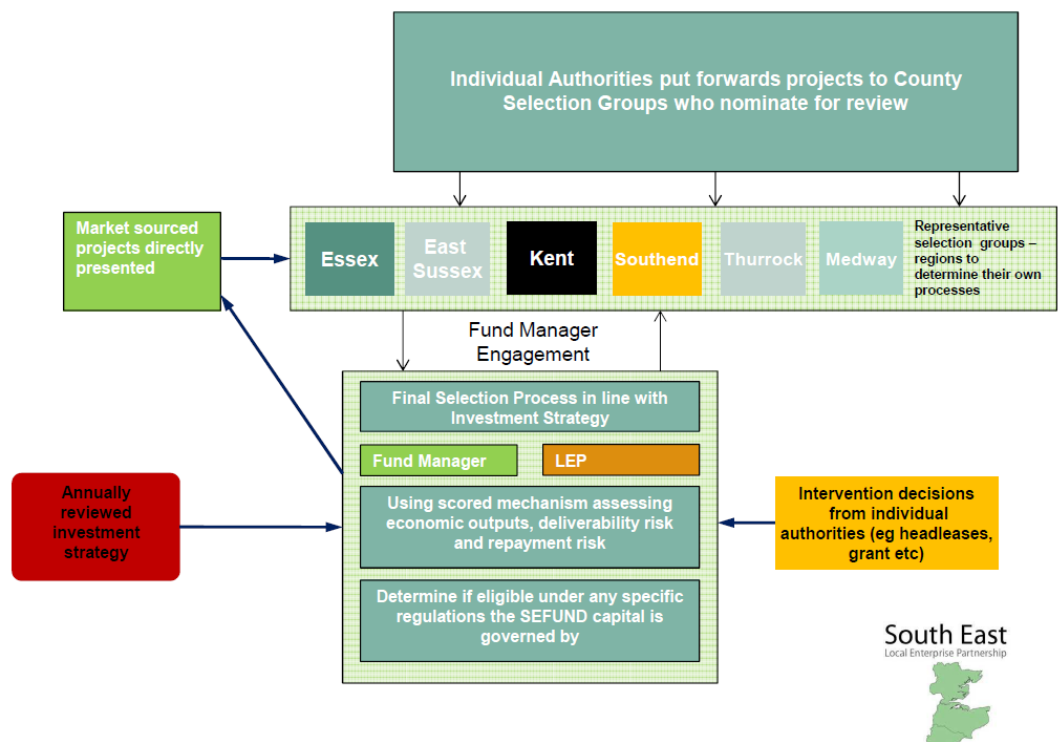
The underlying principle of selection of investments by the Fund will be as follows:

- Determine how the development will assist in delivering one or more of the five key pan-LEP priorities, and the contribution to the overarching ambition of jobs, homes and investment.
- Ensure that the scheme is viable and carries appropriate risk - and where it isn't, engage with the local authority or project sponsor to consider how it could be assisted in conjunction with the Fund to make it deliverable.
- Provide comparison of the proposed investment against other potential investments; including the proposed scheme's contribution to the economic strategy per £ of SEFUND investment (considering time value as well); and the comparative risks of delivery and repayment.

The Investment Strategy will evolve through the Fund lifecycle, as a better understanding of the type of projects in the region is garnered, the regions priorities vary and as the private sector funding landscape changes over time.

## Sourcing of Projects

The Fund Manager will source projects through the course of their business, however for the Fund to be a success it is important that the local authorities take ownership of and are challenged to bring forwards projects that are important to their region. It is also important that the LEP area authorities retain control over the type of projects that are being put forwards, and the approach suggested enables this.



# Options for and recommend for the operational model for the Fund

## SE LEP Five Priorities

The Strategic Economic Plan for the LEP identifies five key pan-LEP priorities:

### 1. Accelerating Growth: Enterprise and Innovation

The LEP has a high proportion of people employed working in public services, education and health and one of the priorities for the LEP will be to support growth in high value sectors. Particular sectors to note are; a) Life sciences and medical technology, b) Advanced manufacturing, c) Logistics and d) The low carbon economy.

### 2. Creating Competitive Locations: Infrastructure and Property

In the Economic Strategy the LEP identifies that “there is a real problem, particularly in town centres, of obsolete commercial buildings and a shortage of Grade A office space. This is a real barrier to the expansion of the knowledge economy and also undermines the economic health of many town centres.”

The SE LEP area has less office space per resident than the national average and the LEP area has seen a decline in industrial floor space (not as fast as the national average) while conversely the office floor space has increased but not as fast as the national average.

Coastal areas in particular suffer from poor transport links. The Strategic Economic Plan sets out the requirements for strengthening transport infrastructure to unlock development and economic growth of the LEP area as well the London economy.

The LEP sea ports contribute significantly to the import and export of goods to the UK (nationally 95% of the UK’s imports and exports pass through the country’s ports, representing 75% of trade by value) and the LEP places priority on the ongoing investment into the infrastructure networks that support the sea ports in the LEP. CBRE considers that airports should be considered in parallel.

Enterprise zones in Harlow and Discovery park are identified as opportunities to support the SE LEP growth plans and the provision of high quality, modern business space to attract inward investment and the ‘21st century workforce’.

### 3. Building a 21st Century Workforce

A skills gap exists in the SE LEP area and reducing this gap will be “vital to enable companies in the LEP area to grow”. The economic strategy outlines the importance of increasing apprenticeships through incentivising employers and focussing on higher apprenticeships and internships.

### 4. Enabling Housing Growth

Ensuring sufficient land is provided for in local plans and how best to bring forward public land for development.

### 5. Investing in Transport Growth Corridor

Focusing growth on 12 growth areas – this is excluded in the submission for ERDF and therefore will be viewed as a cross cutting ambition.

## Type of Investment Projects

# Options for and recommend for the operational model for the Fund

Within the scope of the Fund as it is currently proposed, and following tried and tested investment approaches that have proven successful elsewhere, there are clear areas where the SEFUND can be sensibly focused.

Individual ideas for strategic investments are for the LEP to bring forwards through the Project Sourcing process, building on work that has been done for the Strategic Economic Plan.

- Accelerating Growth and Supporting High Value Sectors
  - Early stage investment in real estate infrastructure to support these sectors. Schemes including life science and medical facilities, advanced manufacturing premises, logistics and low carbon have all been invested in other regions by similar funds; these types of investment have been shown to be deliverable and accretive to the economies surrounding their locations.
- Competitive Locations
  - Placemaking is an essential part of making locations competitive. This is often an early part of an investment strategy for a location, and creates the environment to deliver the appropriate employment space.
  - We have evidenced elsewhere that the part speculative provision of Grade A office space in appropriate locations (and associated placemaking) has led to major employers being attracted to those locations and retained in the region; equally the provision of industrial floor space, or infrastructure to service plots, within manufacturing parks has enabled new suppliers to mobilise on the parks quickly as market conditions have changed, thus encouraging the pick up in local economies.
  - Real estate infrastructure surrounding sea and air ports, enabling business to access the associated benefits more easily and to maintain the region’s market share of import and export.
  - Enterprise Zones – should be targeted for potential projects. The high level of business rate retention available here could provide interesting opportunities for structured finance using the SEFUND.
- Building a 21st Century Workforce
  - The economic strategy outlines the importance of increasing apprenticeships through incentivising employers and focusing on higher apprenticeships and internships, and the Fund must support this by every borrower requiring that a suitable apprenticeship and upskilling training scheme is put in place by its contractors.
- Housing Growth
  - A parallel and complementary strategy required to deliver the objectives of SEFUND, potentially ringfenced and focusing on Housing Companies, interaction with public owned land and any HCA funding that could be devolved to deliver housing requirements.
  - Public sector investment minimized and all schemes to support regional housing policy requirements (i.e. more focused and controlled by the region).

## Options for and recommend for the operational model for the Fund

- Town centre and placemaking to be influenced as part of this strategy. Interdependence with London to be considered.
- This limb of the Fund is to be developed as discussions with the HCA progress.
- Investing in Transport Growth Corridor
  - As for skills growth, this is an overarching position that becomes a Cross Cutting Theme and is to be viewed as desirable across all projects.

Investment types are therefore likely to be as follows (for discussion):

Investment Type	Economic Strategy Key Area	Cross Cutting Theme
Grade A Office	Competitive Locations	Placemaking
Site Servicing for Logistics, Advanced Manufacturing, etc.	Accelerating Growth; Competitive Locations	Town Centres
Logistics and Manufacturing Units	Accelerating Growth; Competitive Locations	21 <sup>st</sup> Century Workforce - Across all investments, contractors should be required to have appropriate apprenticeship schemes
Logistics, Manufacturing Units and Grade A Office supporting/supported by sea and air ports	Accelerating Growth; Competitive Locations	
Low Carbon schemes	Accelerating Growth; Competitive Locations	Leverage of private sector investment to reach £6bn target
Real estate to support High Value Sectors	Accelerating Growth; Competitive Locations	Investing in the Transport Growth Corridor
Housing delivery	Housing Delivery; Competitive Locations	

# Options for and recommend for the operational model for the Fund

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## Rules for Investment

There are various base rules for investment by the Fund that assist with clarity of purpose. These are suggested below, but could be exceptionally varied on an investment by investment basis at board level should the particular scheme merit this. These rules should be revised annually to ensure that they remain relevant.

- Never to supplant private finance
- To support and leverage private sector and local authority investment
- State Aid compliant (i.e. market rate with potential to use a State Aid scheme in the future if required)
- No more than 20% of the Fund in each project
- No more than 30% of the Fund lent to one borrower or group of borrowers
- Schemes must be backed by their Local Authority
- Investment minimum size to be c.£2m (lower by exception)
- SEFUND will not directly participate in projects in order to limit risk to the Fund to the level of individual investments
- Investments to be made by way of loan initially, with potential for equity participation later in the lifecycle of the Fund

## Match Funding

We will need to consider whether there is a maximum % Fund investment in any scheme to ensure leverage. This is to be reviewed against sample projects to determine if appropriate, and will in any case be a metric by which projects can be prioritised.

A project selection processes to be proposed and reviewed during the next stages.

## Where Schemes have a Viability Gap

The Fund is structured to provide lending where schemes cannot source finance, rather than where there is a viability gap. It is anticipated that where schemes have a viability gap, the project sponsor will need to consider complementary methods of improving the viability; there are various interventions that could be considered alongside the SEFUND (which will still be required to provide finance where a traditional lender would not.) The Fund Manager should be involved as early as possible with these discussions to ensure that the minimum intervention necessary is employed. These have included elsewhere:

- ERDF grant.
- Central Government grant (pinch point etc.).
- Council providing a Put Option to the developer at the loan level, thus providing security of exit.
- Council pre purchasing or pre letting.
- Council guaranteeing a rental level for a short period.
- [Growing Places] intervention.

# Options for and recommend for the operational model for the Fund

## Investment appraisal methodology

The contribution of projects defined in the priorities in the previous section could be measured by creating Fund level "Output" targets for the Fund, with varying targets depending upon the importance of the specific Output to the SE LEP area. These will be as follows:

Output	Target
Jobs created and supported by provision of real estate	TBC
Homes delivered	TBC
Amount of potential Grade A or appropriate for location work space provided (including enabling)	TBC
% Leverage of third party investment	TBC
Brownfield land reuse	TBC

These can then be used to drive a selection process. This will be dealt with in more detail, however the matrix below shows how the selection process can be used to select projects that offer the most in terms of outputs, but are still appropriate for the Fund. This matrix is an example, and will need to be worked up properly in response to a number of working groups to ensure that all stakeholders' views are represented equitably.

This shows the importance that outputs can be given in comparison to the other factors that a Fund Manager may consider when pricing a loan. The weighting could be varied, but it would potentially be undesirable in risk terms to increase the Employment and Regen section to greater than 35%. The table is indicative, and would ultimately need to be cross checked against the rate available in the market to ensure State Aid compliance (or proxy rates, as to be strictly in line with strategy it is likely to be the case that market lending is not to be displaced, therefore there would be no market comparison available.)

Area	Considerations (but not limited to)	Score (1 - 5)	Weighting	Weighted Score
Employment and Regeneration (outputs)	<ul style="list-style-type: none"> <li>Placemaking</li> <li>Output numbers in required areas (Grade A space, jobs etc)</li> <li>Ability for urban regeneration with a specific focus on support for entrepreneurship, local employment generation and community economic development.</li> <li>Brownfield site regeneration.</li> <li>Geographic and sector balance (end user job creation).</li> <li>Timing and ability to recycle loan into additional regeneration and job creating projects</li> <li>Demonstration of contribution to skills training</li> </ul>		TBD	
Scheme Feasibility	<ul style="list-style-type: none"> <li>Experience generally and specifically relating to the proposed project.</li> <li>Integrity of the borrower.</li> </ul>		TBD	

# Options for and recommend for the operational model for the Fund

	<ul style="list-style-type: none"> <li>• Resource capability, quality and commitment.</li> <li>• How many other projects are being undertaken and what is the time line of these.</li> <li>• Financial status and analysis of key balance sheet, P&amp;L and cash ratios.</li> </ul>	
Construction & Market Characteristics	<ul style="list-style-type: none"> <li>• Location – development being delivered into a liquid market with good tenant demand.</li> <li>• Building quality – suitability for end users, BREEAM rating etc.</li> <li>• Project Team - Quality of the project team, including the main and sub contractors. Availabilities of warranties and duties of care for the team.</li> <li>• Type of building contract being employed.</li> </ul>	TBD
Capital and Leverage	<ul style="list-style-type: none"> <li>• Quantum</li> <li>• Financial leverage</li> <li>• Additionality</li> <li>• Feasibility</li> </ul>	TBD
<b>Total</b>		

Evaluating projects for investment by the SEFUND in accordance with the business aims and objectives and the Investment Strategy will include:

- Transaction screening and undertaking preliminary evaluation of potential projects including:
  - (i) Early eligibility check (assessment of scheme, review of potential economic outputs, considering a scheme in the context of existing SEFUND investments and pipeline etc.)
  - (ii) market analysis;
  - (iii) alignment with the Investment Strategy;
  - (iv) compliance with any regulation affecting the source of capital (i.e. those imposed by government);
  - (v) discussing investment proposals with Project Developers and obtaining additional information as required, including the re-examination of potential projects
  
- Drafting and negotiation of Heads of Terms with borrowers, including indicative:
  - (b) Facility amounts, leverage, interest margins, financial covenants (loan to cost, loan to value etc.), maturity / length of loan, drawdown profile etc.
  - (c) Other elements including conditions precedents, inter-creditor interaction, security, non-financial covenants and undertakings, minimum obligations etc.
  
- Borrower application form: send the Application Form to borrowers; ensure it is completed and providing guidance where possible. Engage with the sponsoring authority to obtain assistance with completion where required.
- Assisting borrowers with structuring the overall funding package.
- Know Your Client (KYC) and Anti-Money Laundering (AML) procedures.



## Options for and recommend for the operational model for the Fund

- Obtaining and reviewing third-party credit reports on the credit worthiness and solvency of potential borrower entities, e.g. Experian reports and ratings agency documentation (where applicable).
- Appointing third party advisor to provide an independent assessment of economic outputs and any eligibility matters (for example where investing ERDF etc.). Providing them with information and reviewing their reports.
- Attending meetings with borrowers and their advisors for further understanding of potential schemes and the funding structure.
- Attend site visits.

### Due Diligence in accordance with the Investment Strategy

Due diligence is carried out to underwrite potential loan investments at the scheme / underlying asset level, but also in assessing the financial structure, corporate structure, borrower background and credit-worthiness, knowledge of which is required to assess projects fully.

This includes, but is not limited to:

- (i) carrying out technical due diligence as necessary on investment proposals;
- (ii) eligibility and qualifying expenditure analysis;
- (iii) output assessment against the Fund’s targets;
- (iv) undertaking detailed financial analysis of potential projects including alignment with SEFUND cash flow requirements and other performance indicators.

Such due diligence to be documented by at least two reports to the SEFUND Board:

1. A short-form report (“Stage 1 Report”) which includes a high level financial, delivery and risk analysis and details of the potential projects’ level match funding
2. A long-form (“Stage 2 Report”) including detailed financial due diligence of the potential project.

Where underwriting other related loans, we provide reliance on these reports to the relevant third party Funders.

- Recommendation: We provide a recommendation having taken account of all the underwriting and due diligence performed, noting any risks or issues.
- Where underwriting other related loans, we provide reliance on this (for example where a local authority may wish to invest alongside.)
- Full due diligence and underwriting approach.

The following due diligence and underwriting is undertaken and documented in the reports,

# Options for and recommend for the operational model for the Fund

and informs the considerations in the matrix in the section above:

**Borrower / sponsor due diligence:**

Assessment of:

- Experience generally and specifically relating to potential scheme.
- Integrity, resources, capability, quality and commitment.
- How many other projects are being undertaken and what is the time line of these.

**Financial status and analysis of the borrower:**

- Analysis of the balance sheet, profit and loss and key ratios
- Applied to the borrower, its parent, group and guarantor as applicable).
- Commentary on any exceptional matters noted.

**Project due diligence:**

- Understanding and describing the scheme.
- Assessment of the construction process
- Commentary on planning status.
- Full description of timelines and milestones.
- Who is valuing on behalf of the senior lender.
- Whether all potential environmental matters have been addressed.
- Why this scheme works over others.

**Economic outputs due diligence:**

- Working with borrowers to understand the potential for economic outputs from a potential scheme.
- Commentary and assessment of all economic outputs, as targeted by the Investment Strategy.
- Review of potential economic contribution by the transaction in the context of economic outputs achieved in SEFUND to date, against the Fund’s target:

Output	Target
Jobs created and supported by provision of real estate	TBC
Homes delivered	TBC
Amount of potential Grade A or appropriate for location work space provided (including enabling)	TBC
% Leverage of third party investment	TBC
Brownfield land reuse	TBC

**Property market commentary:**

(including statistics and graphs) taking input from CBRE’s research team, covering:

- Review of the relevant property market and sector.
- Supply and demand, including take-up.

# Options for and recommend for the operational model for the Fund

- Competition, i.e. competing developments.
- Recent transactions.

**Project team:**

- Who the main contractors are and what their financial condition is.
- What type of building contract is being employed/what penalties there are for delays etc.
- Who the professional teams are, what their fees are and what the nature of their appointment is.
- Full understanding of the roles within the team and where the lines of responsibility lie.
- Warranties and duties of care for the team.

**Scheme viability assessment:**

- Development appraisal of the scheme.
- Financial modelling of the debt investment (using the resources of CBRE Capital Advisor’s Financial Consulting team).
- Financial analysis to include the senior/mezzanine debt structure and returns to equity.
- Stress testing and sensitivity analysis including impact of changes to key assumptions such as delays in construction and leasing/sale and consequent impact on returns.
- Base case/worst case/best case analysis.

**Financial structure due diligence:**

- Details of the split between equity, mezzanine debt and senior debt.
- Description of senior/mezzanine debt terms.
- How equity is invested, e.g. pari passu / up-front.
- What happens in the event of delay or cost overrun.
- What rights the mezzanine lender has (e.g. step-in clauses).
- Commentary on any other third party sponsors (senior, junior or equity investors).
- Inter-creditor, including commentary on the security implications
- Risks associated with interaction with other lenders.
- How the returns to the mezzanine lender are derived – upfront fee, current pay, coupon rolled up to maturity, back end fee/profit share/warrants.
- What rights the equity has to redeem mezzanine?

**Loan security:**

- Structuring and negotiating of appropriate security.
- Commentary on the security package.
- Structuring and validating guarantees.
- Commentary on guarantees offered.

**Risk analysis:**

- A review of any identified risks, including exit, security, development risks etc. Commentary thereon with discussion of potential mitigants.

# Project appraisal process

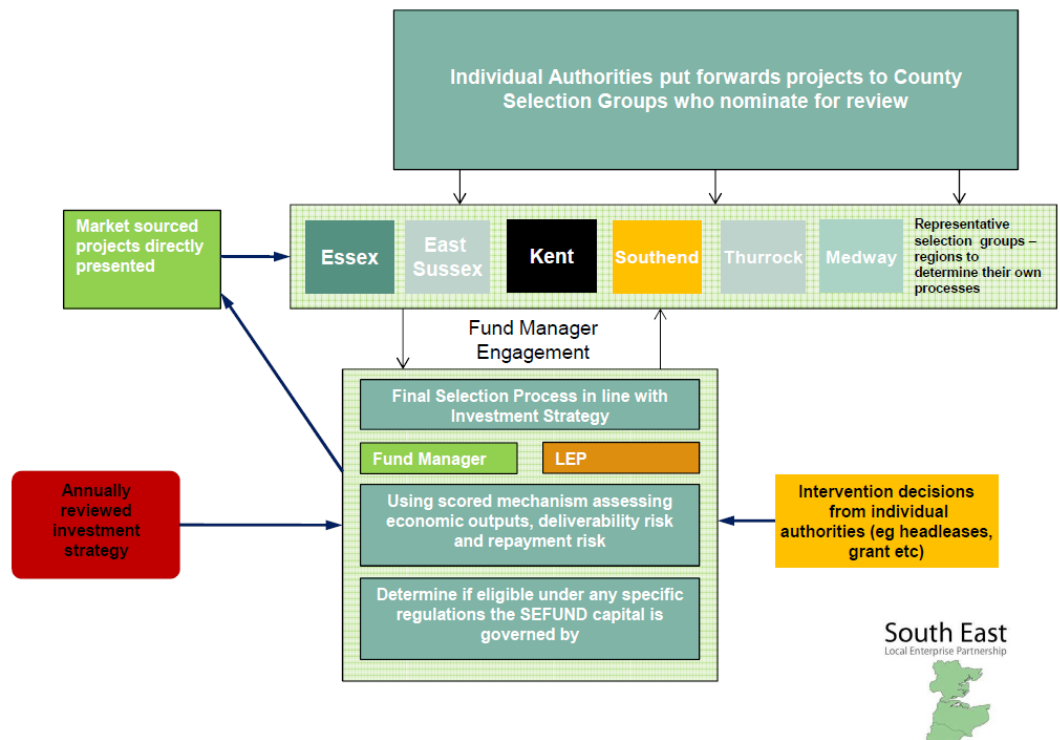
## PROJECT APPRAISAL PROCESS

### To define a project appraisal gateway process.

A clear project appraisal process is fundamental to establishing a fund that is efficient and successful, whilst making investments that are properly underwritten and risk assessed.

This process commences from origination and early sighting of opportunities through to final legal documentation and release of capital. This process requires the involvement of a party to undertake the project appraisal (here defined as the “Investment Advisor” or “Fund Manager”), a reporting format and a governance structure to approve and allow decision making to be implemented.

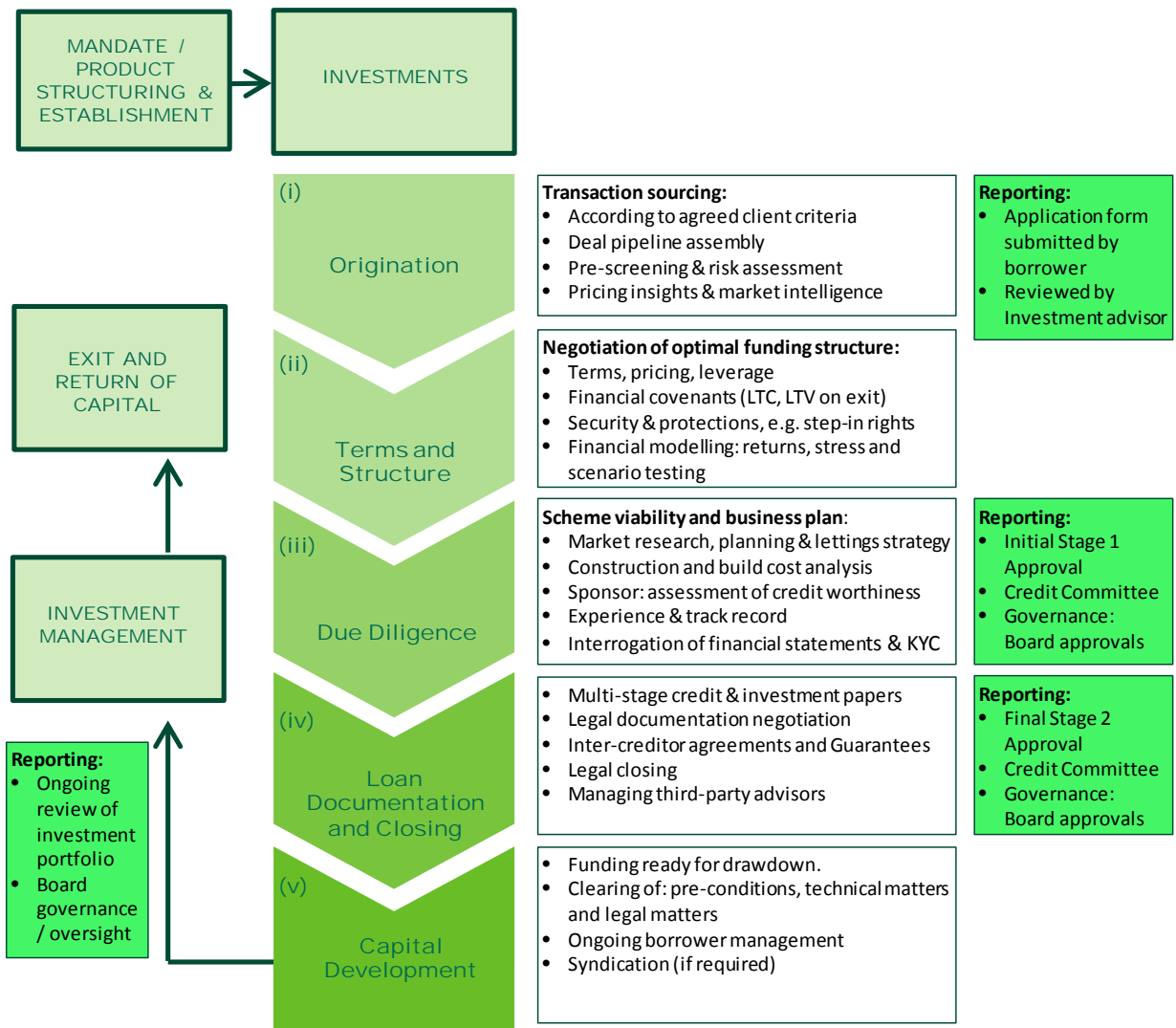
The overarching gateway process is shown in the diagram below, which ensures that all authority areas are involved in the sourcing of projects, and the initial review of them against strategic aims. This process gives local authorities the ability to veto projects in their own areas that are not in line with their strategies.



### Gateway process

Once projects have passed the gateway for the Fund, a subsequent more detailed project gateway process that will take projects to investment decision will be required. This is demonstrated below.

# Project appraisal process



It is important to note that for the SEFUND, once loans are legally committed, there follows a significant process where more work is undertaken to clear any conditions to allow drawdown. Once investments are made and capital is deployed, the loans need to be monitored to ensure the funding terms are complied with and that the underlying properties are delivered (thereby protecting the SEFUND’s security).

## To identify exemplar projects with the potential for "quick wins" within the existing project pipeline

Due to time constraints, it has not been possible to appropriate projects for this stage of the feasibility study. Projects will be identified during the Design stage of this study.

## To detail the relationship with local partners, with investment assembled for projects through local SPVs

Where local authorities have investment ready projects in Special Purpose Vehicles, it is likely there will already be a delivery structure in place. The structure to some extent is not a particular issue for SEFUND, as SEFUND will participate on a debt only basis at this stage in the process.

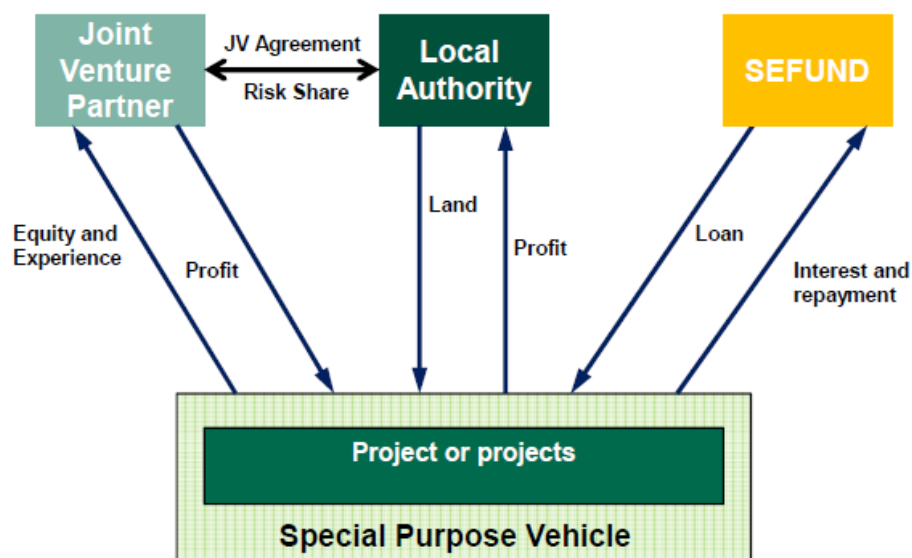
## Project appraisal process

As with other investments the Fund Manager should be able to review and assess project and determine the most appropriate financial structure for the scheme. This will be alongside the Local Authority, the Joint Venture partner and any third party funders.

The basic structure for these type of relationships is shown below, although there will be scheme specific variations.

Should the SEFUND change investment strategy and make equity investments as well as debt, the structure below will remain similar, although there will be a level of direct relationship between the JV partners and the SEFUND (which in itself could become a JV partner).

Investing as below isolates the Fund from risks beyond the value of its loan, and enables the local authority to make and retain profit.



### To quantify the potential for investment brokerage and to advise the SEFUND Board on the viability of this to sustain a revolving investment fund with a 3 – 5 year recovery.

In the short to medium-term, availability of development finance is anticipated to stabilise and then increase moderately. From a national perspective, capital available to fund London schemes will continue to be strong, but gradually increased appetite is expected to radiate out from the key regional markets, such as Manchester. This is likely to be driven by renewed interest from traditional lenders and newer entrants to the market seeking appropriate returns that can no longer be obtained from investment-backed lending.

Whilst the appetite for development funding may improve, the predominant theme will be flexibility and evolution of funding structures. Developers who are outside the group of the largest public and private property companies will need to be increasingly creative by compiling truly structured financings, where senior debt, mezzanine, preferred equity and pure equity, alongside grants, could all play a part in overall funding strategies. SEFUND has a large part to play in this new world of structured finance.

## Project appraisal process

Traditional lenders have constrained risk appetites, meaning their leverage ceilings are lower. Where senior debt is available (i.e. certain locations and schemes) it is now constrained to lower leverage points. Until 2007, up to c.90% loan-to-cost was regularly achievable (up to 100% in special cases), but now this has stabilised at 50% – 65% depending on the element of pre-letting. At the same time, margins have increased. Despite these challenges, some regional schemes have managed to secure speculative funding, such as the English Cities Fund's support of a 125,000 sq ft office in Salford. More expensive but less available debt has created a double burden for developers, who need to find alternatives to replace the gap in the funding package whilst seeing returns diminished by more expensive debt overall. Schemes need to be viable for all funding parties including the developer who needs to make a profit.

Equity and debt have been scarce for development, but rare pockets of funding are available for those who know where to look and are prepared to be creative. Banks have significantly reduced their loan book exposure to development to pre-2007 levels, but are expected to eventually stabilise at lower levels, establishing new market norms. This can be considered as a new rebased equilibrium where development debt constitutes an integral, but more limited part of lending. Debt funds and new entrants are expected to partially supplement these allocations, but total availability is still expected to remain compressed.

Development is still a feature of traditional lenders' origination, but commercial development accounts for just 5% of new business (see Chart 2). Geographically, London and the South-East dominate funding, but the situation is slowly improving in the regions where lending appetite is selectively returning for certain schemes. Speculative developments typically struggle to secure bank finance, unless strong banking relationships exist or if the schemes are in the most attractive locations. Alternative funders can be considered, where pricing and leverage may be higher. Where debt cannot be sourced, developers may resort to funding on an equity-only basis, possibly with a third-party providing the capital where the developer supplies the land and skill. Whilst this can be expensive, it may be the only option available. The developer may hope to refinance with traditional debt once pre-lettings are achieved during the development phase.

Outside of London, traditional lenders such as Lloyds, Santander, RBS, NatWest and Barclays are demonstrating some renewed appetite for development from their local offices, which is a definite change from as little as a year ago. However, this is often restricted by leverage (usually limited to around 50% loan-to-cost), contingent on significant pre-lets and with a bias towards relationship lending.

- Institutions have had a significant impact on investment lending in recent years. However, their appetite for development is broadly limited to forward fundings. This remains a successful financing mechanism, finding favour where it allows institutions to gain access to high quality schemes. For example, Canada Life's £40m forward funding of Development Securities Plc's Abbey Wood scheme pre-let to Sainsbury's.
- By contrast, some debt funds are considering development finance selectively, but their overall contributions are limited in the context of demand. Due to their costs of capital they prefer stretch senior, mezzanine and preferred equity positions which offer developers additional leverage above (in some cases instead of) traditional bank debt. However, such flexibility comes at a risk-adjusted cost.
- Residential funders have carved out an interesting niche, finding success through innovation and flexibility. This has been focused on short-term senior debt in the South-

## Project appraisal process

East in the past. Several have now evolved their strategies to consider developments elsewhere, but crucially will also now structure their investments with greater flexibility, offering senior debt, mezzanine, preferred equity and even straight equity. For example, Montello Bridge Finance is one of the more innovative and flexible lenders.

**Availability is not the only concern. Leverage and pricing are crucial for viability of funding.**

### South East Focus

Since 2010, 13 speculative buildings have completed, adding more than 850,000 sq ft of floorspace to the market, nearly half of which has already been let. The buildings have been delivered at a sustainable rate, with some speculative developers being rewarded for diving in early with strong occupier interest and resultant take-up.

As the supply of Grade A stock tightens and interest in these high quality buildings continues, it is expected that new builds and comprehensive refurbishments due to be delivered over the next 12-18 months will remain popular choices amongst occupiers.

Across the Thames Valley office market, available Grade A space has fallen to its lowest level since 2001. However, over the next two years nearly 1.5m sq ft of new stock is due to be delivered to the market. Around half of this is in the highly sought after west London market, specifically Chiswick, Hammersmith and Uxbridge.

Reading is also seeing a significant amount of town centre development, led by M&G Real Estate and Bell Hammer's No 1 Forbury Place. All of these schemes are located close to the recently upgraded Reading Station and if they all complete will add more than of 600,000 sq ft to the local market.

Beyond the current development cycle there is a pipeline (including major redevelopments or refurbishments) of 320,000 sq ft across four schemes, which have the potential to start within the next 12-24 months.

In the M25 South office market, three speculative buildings (Velocity, Weybridge; Orion Gate, Woking; Renaissance, Croydon) totalling 252,000 sq ft were completed in the last two years. A third of this space has already been let.

A further two buildings are now under construction, which will add just under 100,000 sq ft to the market by the end of 2014. Looking further ahead, three developments, including Croydon Gateway (240,000 sq ft), Crawley Business Quarter (110,000 sq ft) and Prospero, Redhill (48,000 sq ft), could start before the end of the year.

### Conclusion of Potential for Brokerage

- There are significant drivers for increased occupier demand in the South East.
- Bank funding for development has retracted in terms of leverage and consequently risk appetite.
- Schemes without pre let or limited pre-let will struggle to raise finance from traditional sources.
- Occupier demand needs to be satisfied by new stock, and without traditional funding being available the supply will be slowed, and therefore potentially the economy could suffer.

The conclusion is that the potential demand for brokerage is well beyond that which the SEFUND could satisfy with its current capacity.



## Project appraisal process

### To estimate the value-added to the SE LEP area in terms of outputs for housing, jobs, infrastructure and private sector investment.

In order to make a realistic assessment, we have split this into three categories; first, housing; second, jobs, infrastructure and regenerated brownfield land; and third, private sector investments.

Here we again extrapolate from comparable schemes. For housing, we draw reference to the HCA’s recoverable investment fund. Information is not available to us split down into regions, but the information we have been able to access provides an acceptable estimate of the additional homes that SEFUND will be able to deliver. We have made a working assumption that SEFUND will attract c.£50m of HCA recoverable investment fund capital. At present, there is no housing specific allocation.

For jobs and infrastructure, we draw upon Evergreen and what it has achieved. For a similar size fund, this gives some idea of the potential. We are also able to give a view on hectares of brownfield land regenerated.

We have reviewed private sector investment elsewhere in the document.

#### Housing

HCA targets a maximum of £70,000 intervention per home. Working on the basis of a Fund level intervention of £50m, this should mean that the SEFUND is able to deliver 714 homes.

#### Jobs and Infrastructure

Below are the outputs achieved by Evergreen. These are only those which can be attributed to the ERDF eligible spend, and exclude considerable outputs that are achieved as a knock on effect of funding strategic site infrastructure.

The table shows a range that should be deliverable by SEFUND, although will depend upon the pipeline of projects that is developed.

Outputs	Brownfield Reclaimed	Employment Space	Jobs
Evergreen Forecast	15.6 hectares	130,725 sq m	5,747
SEFUND Forecast	14-17 hectares	117,500 – 144,000 sq m	5,170 – 6,320

#### Private Sector Investment

In accordance with the previous section, we have drawn a conclusion on private sector investment from the other funds that we manage. This is shown in the table below.

## Project appraisal process

	EVERGREEN	SCR JESSICA	SEFUND Forecast
Fund Size	£55m	£23.2m	£50m
£ Committed	£49m	£18.3m	-
Total First Phase Leverage (Private Sector Capital)	£107m	£13.5m	£110m
Current Leverage Ratio (Private Sector Capital)	1:2.2	1:.74	1:2.2
10 Year Forecast Leverage	£500m	£86.4m	£450m

Source: CBRE Annual Reports for Funds.

Note: SEFUND is expected to grow beyond £50m capitalisation, and the leverage of the additional funding will depend upon the strategy for that additional capital.

### Outputs Conclusion

From the above, we can conclude that the following outputs could be delivered by the SEFUND.

Output	Potential
Jobs created and supported by provision of real estate	5,170 – 6,320
Employment space appropriate for location provided (including enabling works)	117,500 – 144,000 sq m
Leverage of third party investment	1:2.2
Brownfield land reuse	14-17 hectares
Homes delivered (assuming an <b>additional</b> £50m housing capital pot)	714

# Options and recommendations for delivery models for the Fund

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## OPTIONS AND RECOMMENDATIONS FOR DELIVERY MODELS FOR THE FUND

Pinsent Masons has provided a supplementary paper to address de-risking the fund including local or SE LEP-wide Special Purpose Vehicles (SPVs) and giving consideration to:

- State aid implications
- Taxation implications
- Accounting implications
- EU Regulations

This report is appended at Appendix 2, and supports the principles outlined by CBRE in the main body of the report.

# How to optimise alternative funding streams to match fund SEFUND

## OPTIMISING ALTERNATIVE FUNDING STREAMS TO MATCH FUND SEFUND

As defined elsewhere in this document, the most appropriate level of match funding is at project level. There is however scope to attract public sector funding at Fund level.

In order to maximise alternative funding at project level, there are a number of attributes that will set up a platform that can do this. The Fund will then need to ensure that these are put into practice and a reputation for being reasonable to deal with is earned.

### Debt and Equity including Public sector borrowing (project level)

The general success of pipeline and project sourcing will determine the amount of project level funding that becomes invested alongside the Fund. There are some behaviours that will help influence this:

- Structuring of investments to provide market appropriate protection for third party funders, whilst putting SEFUND at as little risk as possible. This will include ensuring that the Borrower takes an appropriate level of risk.
- Market standard intercreditor principles.
- Clarity of funding objectives through a clear and dynamic investment strategy.
- Clear governance position.
- Local authority as well as LEP support.
- Proof of concept and developer track record.

### Equity (Fund level)

Equity available from public sector sources will grow with the Fund; once a point is reached where the Fund is a known funding source developers will start to work up projects where SEFUND investment is intrinsic to the opportunity, rather than in the reactive manner that will be necessary at the start of the Fund. This in turn will build confidence that the SE region can manage capital in a devolved manner, and encourage more money to be placed under regional control.

In order to build this confidence, there are a number of key areas that the Fund must enforce:

- The Fund must fulfil investments they are contracted to.
- Clarity of the investment criteria and application process.
- Confidence in the governance and project selection process; particularly that once an early view on likelihood of funding is given, that it is followed through subject to due diligence.

For the reasons that we have dealt with elsewhere, private sector equity at fund level is unlikely to be beneficial or available to the Fund.

# How to optimise alternative funding streams to match fund SEFUND

## Debt (Fund level)

The Fund would be able to raise debt through the individual authorities within the LEP. This carries risk for those authorities, but there is a potential position that protects the individual authorities debt; if the existing Growing Places is used as seed capital, intermingled with the debt provided by the local authorities but takes a first loss position ahead of that debt, this could provide a sufficient level of protection to the local authorities dependent upon the level of leverage. Care would need to be taken that the protected position of the local authority debt isn't compromised by overleveraging elsewhere. This is unlikely to be appropriate at the inception of the Fund but could be considered once governance is settled and investments are being made.

This may be problematic for a number of reasons:

- An equitable mechanism would need to be developed whereby individual authorities believe that they have a fair opportunity to access the capital.
- There is a repayment date for this borrowed money, and unlike Growing Places or ERDF must be repaid at a point in time. This will determine the risk level that the Fund will be able to operate at, and will reduce the opportunities for the Fund to invest in appropriate projects (for example a project that provides good leverage and job creation may carry too high a risk for the Fund, defeating the object of the Fund.)

These reasons are some of the same reasons that the Kent and Medway Investment Fund did not proceed.

## EU Funding programme

The most relevant EU funding programme is likely to be the regional ERDF allocation. EU funding can be attracted to projects in one of two ways; either by creating a JESSICA fund within SEFUND, or by individual projects applying for ERDF funding.

Discussions have been had with the region's European funding personnel, and the ability and desire to structure such a fund is being explored at present.

Creating a JESSICA Fund has historically been complicated; however there have been improvements in the process as all those involved have learned from early structures, and the more recent funds have been created relatively quickly.

There are some particular aspects of JESSICA funding that should be considered.

## ERDF Match funding

In basic terms, match funding could potentially be done at either project or fund level. At one point DCLG was much more comfortable with matching at Fund level as it is easier to evidence. It is actually easier to invest pre-matched capital as a higher loan to cost can be achieved and usually means that the Fund can be allowed a senior security rather than a junior security over a scheme, as there is less requirement for a large other loan in the project. CBRE's understanding is that for the current round of ERDF funding, project level match funding seems to be more acceptable. To be tested with DCLG.

SCR JESSICA is fund level matched by public sector capital; Evergreen is project level matched.

## Holding Fund

# How to optimise alternative funding streams to match fund SEFUND

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Evergreen was the first JESSICA fund, and the structuring was very complicated, with a holding fund across Evergreen and Chrysalis and the EIB managing the administration and regulation side.

Subsequently SCR JESSICA has been set up with a relatively straight forward funding agreement directly from DCLG and with specific reporting requirements, and CBRE appointed to manage it. This was structured extremely quickly.

## Investment Types

Both SCR JESSICA and Evergreen support different priority areas and axes, but both are clear to invest in office and manufacturing real estate, and associated infrastructure. For example, SCR JESSICA may not invest in logistics, but Evergreen may. It will be crucial for any SE fund to ensure that it is able to invest in the appropriate schemes; otherwise any capital will remain unallocated.

## Other matters

The EIB is currently working with various potential JESSICA funds in assisting in the set up (rather than managing a holding fund.)

The set up need not be complicated. In setting up the SEFUND, the vehicle will exist in any case and only the reporting and compliance matters and an Investment Strategy targeted to priority areas will need to be back-solved to add a JESSICA element to SEFUND. Work need not be duplicated.

Other JESSICA regions also use ERDF for grant purposes, rather than giving the full allocation to the JESSICA fund. On occasions JESSICA and ERDF grant are used together in the same projects.

The major benefit for borrowers is that most of the red tape is dealt with at Fund set up and reporting level. Whilst responsibilities are passed down to the borrower, a lot of the arduous reporting is done collectively by the Fund.

## Other grant funding

There are various other types of grant funding used in projects funded by the other funds; these include English Heritage grant; Pinch Point funding; Local Authority interventions, including recoverable grant;

It should be possible to encapsulate any round of grant funding that becomes available from central government and can be used either to bolster the Fund or in individual projects on a case by case basis to de risk or make projects viable.

# Risks associated with SEFUND

## Risks

Such an ambitious fund structured across the largest UK LEP outside London will have a number of issues that need to be addressed in the structuring. Getting these right will ensure that it is successful in its aims.

We have sign-posted the risks below, and over the process of the Fund design stages we will determine mitigants for these risks.

There is an additional risk section addressing the State aid, taxation, accounting and vires implications within the Pinsent Masons report.

RISK	MITIGATION (TO BE DEVELOPED THROUGH PROJECT)
<b>SEFUND establishment risks</b>	
Wide variety of interests across region	Clear investment strategy set at start; Fund manager to be allowed to follow investment strategy and project selection process. Continuous engagement with representative group to ensure support from all authorities.
Attracting sufficient private sector level investment in Fund that invests where there is market failure	May be investment at project level at a different risk reward point, or creating different investment vehicles to work together at fund level. Appoint a well-respected FCA regulated Fund Manager with daily experience of raising capital.
Competition for SEFUND capita;	The current propose funding allocation inherently means that on first use of this capital only a limited number of schemes can be funded. This creates a risk that the SFUJN is oversubscribed and cannot fund otherwise eligible schemes.
Structuring investments that use various sources of capital	Typically, the greater the number and diversity of underlying funding, the greater the risk that such sources will carry restrictions and/or conditions that prevent its expected usage.
Investment strategy execution	There is a risk that the initial pipeline of transaction do not completely conform to the final Investment strategy.
<b>Property risks</b>	
Projects in pipeline that are not viable	Fund to work alongside other potential funding sources to make projects viable within the State Aid context.
Development risk: Delays	Delays to the development programme, may impact the underlying scheme (e.g. in terms of its feasibility in the property market) but may also cause issues for the SEFUND timing of delivery according to the final Investment Strategy.
Development risk: Cost-overruns	Cost-overruns can be an issue, where the development costs increases. In such instances, equity and/or debt may be used. The risk to SEFUND is that it may not be able to commit further funding, or if it can, this may alter the exposure risk profile of the investment. The Borrower may lack sufficient equity to fund the over-runs.
Development risk: completion	The risk that the borrower runs out of funding to complete the scheme may mean that the SEFUND has a charge over an incomplete asset, that may not have sufficient value to repay the loan and/or may require further funding to complete it.
Planning risk	Planning consent would typically be a condition of a loan. However, should planning not be achieved then any committed loans may not be drawn, meaning the allocated capital may need to be deployed elsewhere.
Valuation risk	If the value achieved by the built asset is below expectations this can erode the underlying security to the loan. Similarly, any loans will be made subject to a formal bank-style valuation as a condition to the loan. However, if such valuations re undertaken using inappropriate methodologies or assumptions the due diligence and basis for the investment decisions may be at risk.
Variations to the scheme	Often developments require variations to both the scheme and or funding package, due to alterations in the underlying design or other factors. This can impacted the overall scheme, with consequences for the underlying asset security, as well as potentially impacting eligibility.
Intervention risk	Should an issue arise on a development, SEFUND’s ability or inability to “step-in” could impact its

# Risks associated with SEFUND

	ability to protect the underlying security of its loans.
Letting risk	For many property asset classes, ensuring an acceptable lettings profile is often crucial in creating significant value. This creates various risk points. Certain asset classes are highly specialised by their inherent nature (e.g. scientific properties) and can be harder to find appropriate tenants for. This risk is greater where the loan underwriting is more dependent on full or partially let value to derive enough value to facilitate a loan exit. VP value will be lower and offer less value by way of security/
Developer / contractor risk	If the developer or any of its key contractors should be inappropriate or undergo financial difficulties (e.g. bankruptcy) then the development may be at risk in terms of quality timing and actually completing.
<b>Financial Risks</b>	
Borrower / guarantor default risk	Should the borrower and/or guarantor legal entities fail or breach their undertakings / legal commitments, then the loan they are party to could be at risk of default as well as their ability to operate being impaired with implications for their ability to undertake their duties in relation to the development.
Loan structure risk	The financial structure of the loans themselves may carry inherent risk, for example the amount of leverage and loan to value or the interest charged may put the scheme under stress (e.g. financial covenants being breached with action required thereon).
Legal documentation risk	If the loan documentation (including the facility agreement and others such as inter-creditor agreements) is not adequate then the loan may not operate as expected, with possible consequences for the security.
Repayment and exit risk	SEFUND ability to be able to exit from the loan commitment at an appropriate point (e.g. final loan, maturity or earlier as appropriate) is vital. Such reasons may include project delays or lack of refinancing possibilities. Any factors that inhibit SEFUND's exit means that its capital may not be returned as expected.
<b>Funding risks</b>	
Public funding risks	Co-funding for scheme (e.g. grant or other public funding) may be contingent or subject to provisions that may prevent it from being drawn, thereby risking leavening schemes co-funded with the SE FUND without sufficient capital
Private funding risk ( e.g. senior or junior debt)	SEFUND could encounter schemes that have some third party capital sourced from the private sector, e.g. bank debt (senior to SEFUND) or junior debt (subordinated to the SEFUND). This carries risks to the security structure and can impact any enforcement action. For example, other forms of funding come with their own conditions and covenants, which can have impacts on the availability on such third-party funding.
Borrower equity	The ability for the borrower to invest its equity into the scheme, both the amounts agreed as its committed minimum at the outset of the transaction as well as its ability to fund cost overruns etc. can be a direct risk in the context of developer solvency and ability to complete the development.
<b>Public Sector Funding risks</b>	
Economic Output risks	There is a risk that the expected regenerative / economic outputs are not delivered in the quantities expected by individual schemes. This could adversely impact the Fund-Level totals achieved by the SEFUND.
Defrayment risk	If the SEFUND must adhere to a set time period to deploy its funding, then any matters such as delays on-site on developments or construction delays, could adversely impact the SEFUND's targets.



# Appendix 1 – SEFUND Feasibility & Design Scope of Works

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## **SEFUND: a £5billion Property and Infrastructure Fund for the South East**

*“...Government recognises the LEP’s intention to establish a South East Fund (SEFUND) and will work with the LEP to help deliver the Fund and bring forward an implementation plan with South East LEP within the next three months.”*

***SE LEP Growth Deal, July 2014***

### **Proposal**

The South East Local Enterprise Partnership - the biggest LEP outside of London - aims to establish a revolving £5billion property and infrastructure investment fund known as SEFUND (South East Fund), drawing together public, private and EU money to boost business and jobs across East Sussex, Essex, Kent, Medway, Southend and Thurrock.

Our ambition is to facilitate property and infrastructure development that will have a transformational impact on growth through the direct and indirect delivery of housing, jobs and essential infrastructure. We wish to speed up development and remove barriers to the development of complex sites by using public sector investment and commitment as leverage to attract private investors and professional property expertise.

It is our intention that the investment fund should be fully recoverable with an optimum pay-back period of between 3 – 5 years if possible and that it will be based on a rigorous outputs-focused process of prioritisation.

To establish SEFUND - building on the significant work already undertaken for our Growth Deal - SE LEP now wishes to procure property, financial and legal advice to carry out a feasibility assessment on the original concept set out in Annex A (Feasibility Stage) and, design how that can be implemented to support a robust business case and secure SE LEP Board approval in March 2015 to establish and implement the fund (Design Stage).

We wish to have advisers in place in the week commencing 1<sup>st</sup> December, 2014.

### **1. Background**

The SEFUND concept was developed as part of SE LEP’s Growth Deal proposals submitted to the Government in March, 2014. As a result, Government has committed to “work with the LEP to help deliver the Fund and bring forward an implementation plan with the South East LEP”.

At its meeting on 26<sup>th</sup> September, the SE LEP Board agreed to establish a SEFUND Shadow Board to develop an implementation plan and to commission further specialist property, financial and legal advice to support this. This Shadow Board includes

property, finance and legal professionals, local authority leaders and a representative from the Cabinet office.

The SEFUND Shadow Board met at the Cabinet Office on 13<sup>th</sup> November and agreed a swift procurement of advisers to ensure SEFUND is established and operational by the end of March, 2015.

Central to this work will be the production of a draft investment strategy to guide future investment decisions and fund management.

Further details of the SEFUND concept as it currently stands can be found in Annex A of this specification.

## **2. Specification**

In developing an implementation plan and establishing SEFUND, the SE LEP Board agreed that specialist property, financial and legal advice should be commissioned through Essex County Council as SE LEP's Accountable Body, working closely with the SE LEP Secretariat.

The SE LEP Accountable Body, Essex County Council, will commission the work whilst day to day management of the project will be undertaken by the SE LEP Secretariat working to the SEFUND Shadow Board. To support this, a small officer working group coordinated by the SE LEP Secretariat with one representative from each county/unitary authority within SE LEP area will be established to provide a senior point of contact in each council for the appointed specialist consultants. The county/unitary authorities that form SE LEP are: East Sussex County Council, Essex County Council, Kent County Council, Medway Council, Southend-on-Sea Borough Council and Thurrock Council.

The outline specification for property, financial and legal advice is as follows, broken down into two identified stages of work:

### **2.1 Stage 1: Feasibility Assessment**

**The purpose of the feasibility stage is to test and further develop the existing vision and concept for SEFUND.** The consultants are required to provide the SEFUND Board with **property, financial and legal advice** and where appropriate, to identify options and make recommendations to aid decision making in relation to the following:

- The scope, viability and market appetite for SEFUND
  - To identify potential investors who would be interested in investing in SEFUND
  - To quantify private sector interest to invest in or alongside SEFUND
  - To make recommendations for a marketing strategy that will attract major investment funds and developers to SEFUND
- To identify options for, and recommend the most suitable, operational model for the Fund

- To develop a draft high level investment strategy for SEFUND
  - To develop an investment appraisal methodology
- The project appraisal process
  - To define a project appraisal gateway process.
  - To identify exemplar projects with the potential for "quick wins" within the existing project pipeline
  - To detail the relationship with local partners, with investment assembled for projects through local SPVs
  - To quantify the potential for investment brokerage and to advise the SEFUND Board on the viability of this to sustain a revolving investment fund with a 3 – 5 year recovery.
  - To estimate the value-added to the SE LEP area in terms of outputs for housing, jobs, infrastructure and private sector investment.
- To identify options for, and recommend the most suitable, delivery models for the Fund which aim to de-risk the fund including local or SE LEP-wide Special Purpose Vehicles (SPVs) and give consideration to:
  - State aid implications
  - Taxation implications
  - Accounting implications
  - EU Regulations
- To set out how to optimise alternative funding streams to match fund SEFUND including consideration of:
  - Debt, including Public sector borrowing
  - Equity
  - EU Funding programme
  - Other grant funding
  - Other funds
- To set out the risks associated with SEFUND

### **Deliverables**

At the end of Stage 1 the consultants will be required to present their findings in report format and in a presentation to the SEFUND Shadow Board. On satisfactory conclusion of this stage, and in light of any decisions made by the SEFUND Shadow Board, the consultants will then be required to design the operation of the SEFUND and develop an implementation plan.

## **2.2 Stage 2: Design**

The purpose of this stage is to develop the agreed concept into a formal operational design comprising operational model, governance and decision-making, funding and investment strategy, partnership protocols, marketing strategy and delivery vehicles.

The consultants are required to provide the SEFUND Board with **property, financial and legal advice** and where appropriate, to identify options and make recommendations to aid decision making in relation to the following:

- To fully develop and specify the optimum legal and financial structure for SEFUND taking into account:
  - State aid implications
  - Accounting implications

- Taxation implications
  - EU Regulations
- To develop a project selection process with which to identify a two – five year project pipeline
- To produce the SEFUND investment strategy
- To agree, specify and identify appropriate partnership working arrangements with county/unitary councils investing alongside SEFUND through a range of appropriate special purpose vehicles (SPVs), memorandum of understandings and contractual requirements
- To finalise an engagement and marketing strategy aimed at raising awareness of SEFUND s amongst the property and investment market and to attract expressions of interest.
- To set out a performance monitoring process
- To advise on vires issues for both LEP and local authorities and necessary approval processes for the setting up of the fund
- To advise on the potential and legality of using different sources to seed the fund (eg Growing Places, New Homes Bonus, s106, CIL, HCA programme monies, private sector funding, etc)
- To advise on options for incorporation taking into account:
  - Optimum financial and shareholding structure
  - Taxation implications
  - Gainshare mechanisms
- To advise on potential ERDF and EU funding issues relating to SEFUND

## **Deliverables**

- Detailed proposal and business case for SEFUND
- Investment strategy
- Investment appraisal process map
- Governance and decision making process map
- Project pipeline
- Performance monitoring process
- Market assessment
- A marketing and engagement strategy
- Presentation to SE LEP Board

## **2.3 Future Work**

A detailed proposal and business case will be produced for approval by the South East Local Enterprise Partnership. This will provide the framework document for the set-up, implementation and operation of the SEFUND proposal which is known as Stage 3 and which will be subject to a separate procurement. As such it is a requirement of this specification that the design work is agnostic to provider and also that where the appointed provider under this specification also wishes to bid for the implementation and operation stage, clear walls of separation and confidentiality are maintained so as not to prejudice against other bidders.

## **4. Budget**

The total contract value for stage 1 and 2 of this work as identified above will not exceed £95k.

The stages of work identified will be treated separately and stage 2 will follow only on the satisfactory completion of stage 1. It is expected that the same consultants will carry out both stages of the work, but this will be dependent on successful completion of stage 1. Consultants should provide prices for stage 1 and stage 2 separately.

## **5. Applications**

Interested consultants should apply in writing in no more than 5 pages indicating:

- Their understanding of the issues faced in establishing SEFUND
- Their proposals to deliver this work, either directly or through a consortium
- Their approach and methodology and how they will address each requirement
- What they propose to add to the specification
- Their ambition for the success of SEFUND, including their assessment of the market and opportunity
- Case studies demonstrating their experience of establishing and managing similar funds and the added value they bring
- Who would be working on this project, both in overseeing the delivery and day-to-day management, and case studies demonstrating their related experience.
- Case studies demonstrating their previous involvement with LEPs
- Case studies demonstrating their experience in the SE LEP area
- Approach to communication, project management and quality assurance
- Where a consortium approach is preferred, approach to partnership working and collaboration is required.

## **6. Award Criteria**

**Applications will be judged according to the following criteria:**

**Question – do these criteria relate to ECC’s assessment criteria?**

- Price
- Direct experience of establishing similar property and infrastructure funds
- Experience of the work of LEPs
- Proposals for managing and resourcing the project including expertise and experience of relevant staff
- Added value that consultants will bring
- Wider experience of property market investment and the issues involved
- Experience of associated public sector issues
- Track record of innovation and development on similar and associated issues

Additional detail may accompany the tenders indicating past experience and references.

Only consultants on existing Government procurement frameworks will be considered.

## 6. Timetable

Recognising Government interest in the SEFUND model, the timetable for completion of this work is challenging.

Date	Completion
w/c 1 <sup>st</sup> December	Contract awarded
12 <sup>th</sup> December	SE LEP Board Meeting - update
9 <sup>th</sup> January	Feasibility Report – interim findings
23 <sup>rd</sup> January	Feasibility Report
20 <sup>th</sup> February	Design Report – interim findings
6 <sup>th</sup> March	Design Report
20 <sup>th</sup> March	SE LEP Board approval

The SEFUND Shadow Board will make a decision on consultants for the concept in the week commencing 1<sup>st</sup> December.

Fund managers/consultants to support SEFUND implementation will be sought on the conclusion of the Concept Report.

SEFUND aims to be operational by 1<sup>st</sup> April, 2015.

## 7. Further information

For further information, please contact David Godfrey on 07920 428556.

## Annex A

### What is SEFUND?

SEFUND builds on the commitment of Government in the LEP's £442m Growth Deal announced in July and is a vehicle to accelerate the speed of development or to make development happen which would not otherwise have taken place.

SEFUND will have 3 major elements:

- **A recyclable real estate and infrastructure fund**: Beginning with an immediate transfer of £50m, the fund will be piloted in 2015/16 and will build confidence and scale towards its £5b ambition
- **A funding "brokerage"**: Reflecting the significant private sector interest already shown, SEFUND will connect private investors to a strong pipeline of schemes in the SE LEP area
- **A source of professional property expertise**: SEFUND will provide local authorities with specialist advice to ensure robust scheme development and delivery

### What type of intervention will SEFUND make?

SEFUND will primarily offer Debt financing and will generally expect that a project is capable of repaying investment within an appropriate period of time and is capable of servicing that debt finance at a level which reflects both the project and the risk. In some circumstances, it will also consider Equity, Rental Guarantee and "last resort" Grant funding.

Scenarios may include: absence of pre-let; insufficient pre-let; bridging finance for site remediation and servicing; bridging finance for infrastructure, local authority assets required; build to rent housing or guaranteeing housing take-out.

### How are we preparing SEFUND?

We are commissioning work to bring SEFUND forward, to enable us immediately to **place the existing £50m SE LEP Growing Places Fund programme within it.**

We will continue to pursue further public funding and know there is also already **serious private sector investment interest** in such a fund. We will enter discussions with potential investors, either to invest into SEFUND directly or into priority projects.

**Local authority support continues to be critical and member councils have already in principle jointly committed £250m of investment at project level to SEFUND schemes**



## **How will SEFUND operate?**

**Clear Investment Strategy:** SEFUND will have a clear Investment Strategy. This will take account of the types of projects that are vital to promoting growth across SE LEP and why the market is failing to bring these projects forward.

Projects promoted by both private and public sector organisations (including registered social landlords) will be considered on equal terms and there will be periodic calls for projects.

The Investment Strategy will set out the targeted returns and outputs for SEFUND as a whole and will demonstrate how frequently funds will be recycled.

**Professional Fund Management:** SEFUND will be driven by professional fund management which is likely to be either a firm of chartered surveyors with development, real estate finance and fund management expertise or a professional property fund manager.

The Fund Manager will be responsible for identifying investment projects, managing the investment project pipeline, advising on the preparation and shaping of the project for investment, monitoring the development, and securing the repayment of SEFUND monies.

**Transparent Governance:** SE LEP will appoint a Board to be responsible for SEFUND. We envisage that this will include representatives from each county and unitary council in our area, business members from the SE LEP Board, and a senior official from Government. A Shadow Board is already in place.

## **What impact will SEFUND have?**

An initial SEFUND Investment Strategy will detail the outputs that SEFUND will secure and the areas and types of investment it seeks.

On the assumption that investment is split equally between housing and commercial development projects, based on £2.5bn of investment we envisage that as a minimum, SEFUND would lead to:

- **Securing the development of 1 million sqm of new business space;**
- **Enabling the development of 20,000 additional homes;**
- **Leveraging of £2.5 billion of additional investment;**
- **Creating or safeguarding 75,000 jobs; and**
- **Creating £65 million of additional business rate income annually.**

For further information, please call SE LEP Director David Godfrey on 07920 428556 or Chairman Peter Jones on 07801 275037.

## Appendix 2 – Pinsent Masons Legal Structure Proposals

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## SEFUND: PM STRUCTURE NOTE

### 1. MEMBERSHIP

#### 1.1 Objectives

- 1.1.1 It is intended that SEFUND will be a public/private fund with the initial participants being county/unitary authorities within the area covered by the South East Local Enterprise Partnership ("**SELEP**") including East Sussex County Council, Essex County Council, Kent County Council, Medway Council, Southend-on-Sea Borough Council and Thurrock Council.
- 1.1.2 The structure needs to retain the ability to admit additional investors at future point(s) dependent upon the future shape of SEFUND this may require an equalisation mechanism or "closings" to enable the SEFUND to expand and exploit opportunities to increase available funding.

### 2. FUNDING PROFILE

- 2.1 SEFUND will be funded initially through receipts from the investment of £50M from the SELEP Growing Places fund programme.
- 2.2 The aim of SEFUND is to grow from recoverable investments, additional public sector funding and, potentially in the future, private sector investors. Other public and private sector co-investment will be sought at fund and/or project / investment level.
- 2.3 Other potential sources of public sector funding include (not exclusively):-
  - 2.3.1 funding from the Homes & Communities Agency
  - 2.3.2 the European Regional Development Fund (2014-2020 programme); and
  - 2.3.3 funding from the Department for Transport.
- 2.4 The terms of any public grant funding will need to be complied with. This may, for example, require such funds to be ring fenced and allocated for specific purposes.

### 3. GROUP STRUCTURE

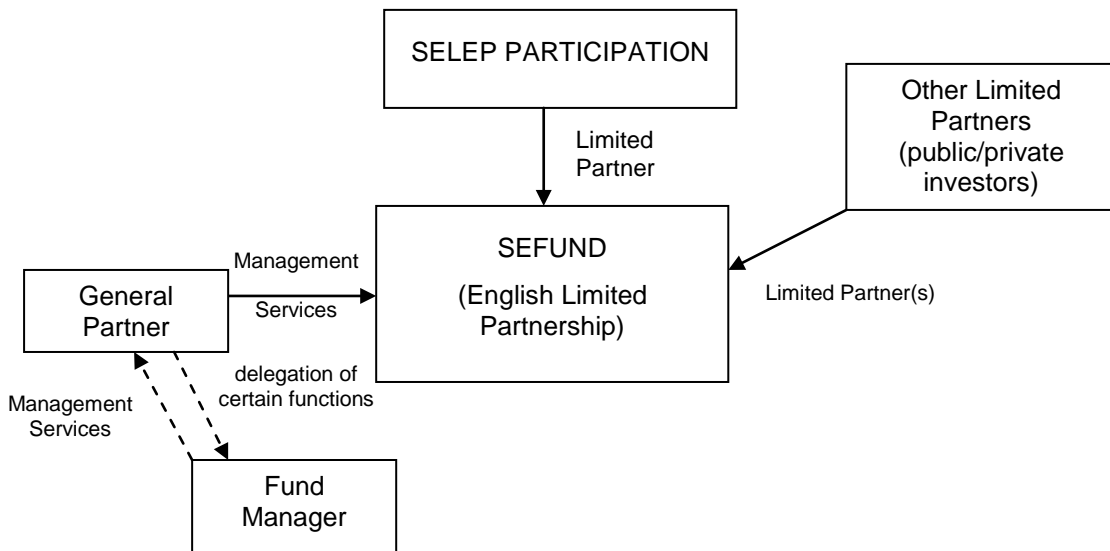
- 3.1 SEFUND will provide funding (initially debt funding) in a series of project vehicles or direct into projects. Investments in projects could be structured as equity, mezzanine or debt finance. For example, it would be possible for SEFUND to:
  - 3.1.1 establish wholly owned vehicles and/or invest in public / private or public / public vehicles set up for different investment purposes (such as infrastructure delivery, LABVs, rental funds) and with different risk profiles;
  - 3.1.2 invest in projects as identified above whether existing or new.
- 3.2 SEFUND may seek to invest alongside third party / private investment where this is forthcoming or direct in its own right. Where SEFUND invests, unless there is an available State aid approved scheme or exemption, the funding should be provided on pari passu terms (where in conjunction with third parties) or on market terms (where direct in its own right) to ensure there is no unlawful State aid. (See Section 9 below).
  - 3.2.1 Limited Partners and third-party investors could co-invest direct into projects to encourage SEFUND to adopt schemes in which they have a particular interest.

3.2.2 Each investment / project will need to have in place its own robust governance arrangements. Requirements will be set out in SEFUND's Investment Strategy and evidence of this would (amongst others) be a pre-condition to SEFUND investment. Projects would have appropriate governance arrangements in place to determine how their schemes/projects are delivered; this would not fall within the remit of the General Partner / fund manager (although SEFUND will require the fund manager / General Partner to monitor compliance with the term's of SEFUND's investment).

**4. PREFERRED MODEL**

- 4.1 There are a number of available legal structures that could work here (appendix 1 sets out the key features of each of these vehicles and their advantages and disadvantages). However the preferred option is to structure SEFUND as a Limited Partnership. In this type of structure, there are two types of partners; limited partners (with limited liability) and at least one General Partner (with unlimited liability for the debts of the partnership). The General Partner would have a nominal investment interest in the SEFUND (typically this is set around 0.1% -1%).
- 4.2 To retain limited liability, the limited partners cannot be involved in day to day fund management - this will be delegated to the General Partner who will have management control. The General Partner will have actual authority as the agent of SEFUND to bind the Limited Partners in arrangements that are within the ordinary course of SEFUND's business.
- 4.3 The SEFUND will need to be operated by an FCA authorised entity (see Fund Manager below). If the General Partner is not so authorised, SEFUND will also need to engage a separate fund manager to which the General Partner will delegate the majority of its functions. The appointment of the General Partner/fund manager will need to be competitively procured in accordance with the Public Contracts Regulations 2006 (see Procurement in Appendix 3 below).

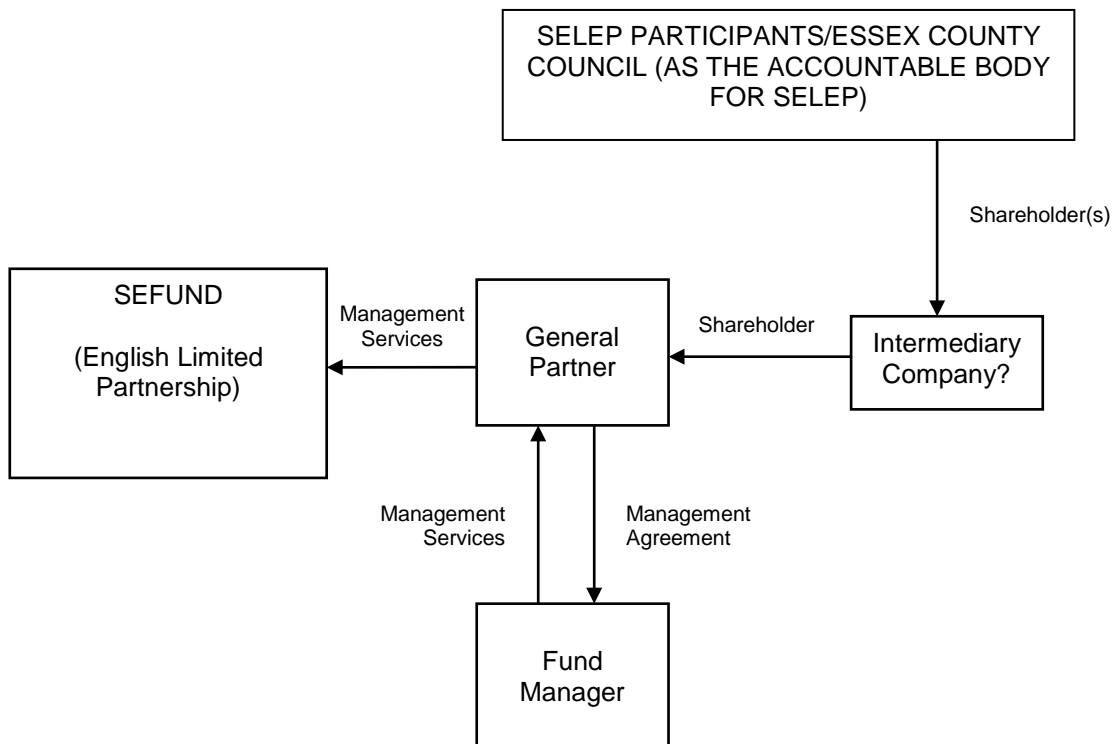
**Limited Partnership Model**



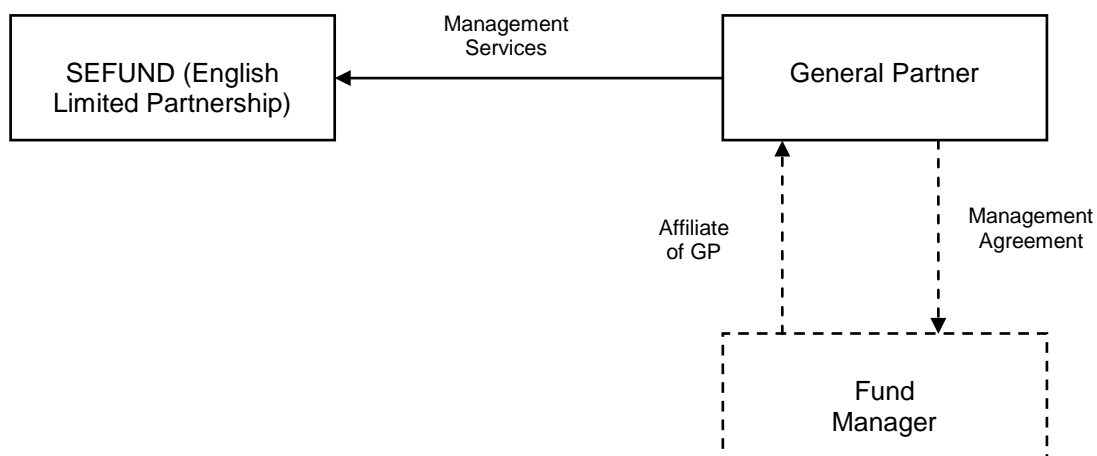
4.3.1 The identity of the General Partner (and therefore whether or not there will be a separate fund manager) will be influenced by the tax analysis. The General Partner could either be:-

- (a) a special purpose vehicle established solely to act as General Partner. The Partner(s) in SEFUND would also be shareholders of the General Partner (possibly through an intermediary vehicle). The General Partner could be set up as a company limited by shares (to afford its shareholders limited liability). In practice, to prevent General Partner governance arrangements becoming unwieldy (due to the number of shareholders), the General Partner would delegate the majority of its functions to the professional fund manager for operational efficiency. This also has the advantage of reducing Partner time commitments to SEFUND. This is depicted as **Option 1** below and is the preferred option; or
- (b) the fund manager (or a member of its tax Group) for tax purposes (see Tax below). The Limited Partners would have a contractual nexus with the General Partner through the Partnership Agreement which would ensure appropriate governance mechanisms around operating SEFUND were in place. This is depicted as **Option 2** below.

**OPTION 1: SELEP PARTICIPANTS ARE SHAREHOLDERS IN THE GP**



## OPTION 2 : THE GENERAL PARTNER IS A MEMBER OF THE FUND MANAGER'S TAX GROUP



4.3.2 Limited Partnerships are well recognised investment models in both the private and public sector (used in the JESSICA and JEREMIE Funds) and is the preferred model here because:-

- (a) the Limited Partnership structure is transparent for tax purposes meaning that non-tax paying Partners will not suffer tax leakage;
- (b) in the future, additional investors may invest at the holding fund level or co-invest through a parallel fund structure. Therefore the structure needs to retain flexibility for future investors. The Limited Partnership structure allows certain other tax exempt investors (such as pension funds) to retain their tax exempt status in the context of property investment whereas other structures (e.g. companies) do not;
- (c) the Partners could structure their interests separate from the management structure;
- (d) it would provide a robust governance regime.

4.3.3 Key features of the most likely alternative legal vehicles are set out at Appendix One.

4.3.4 Establishing the General Partner as a special purpose vehicle owned by the Partners (as Option 1 above) would appear to have the benefit to the Partners of retaining additional control over the SEFUND. However, in practice, the General Partner would delegate its functions to the professional fund manager in any case. Fees charged by the fund manager to the General Partner under Option 1 will be subject to VAT which will be irrecoverable. The appointment of a General Partner and fund manager forming part of the same tax group (as Option 2 above) would be VAT efficient as VAT will not be charged within a VAT group (see Tax below). In both options, the Limited Partners would have a contractual nexus with the General Partner through the Partnership Agreement which would ensure appropriate governance mechanisms were in place and, where necessary, agreed parameters with respect to the extent of delegated functions to a separate fund manager.

## 5. SEFUND GOVERNANCE STRUCTURE

### 5.1 Decision Making Forums

5.1.1 There will be a number of decision making forums within SEFUND: the Limited Partners, the General Partner and the Investment Board. Decisions reserved for the Limited Partners must be limited as far as possible with the day to day management of the fund being delegated to the General Partner.

5.1.2 The General Partner and fund manager (if different) need the freedom to take management and investment decisions without constant referral back to the Partners. There are also liability and FCA regulatory implications for Limited Partners becoming involved in day to day management. The Limited Partners will have the reassurance that the General Partner and fund manager (if different) will only be authorised to act within the parameters of the Investment Strategy (approved by the Investment Board).

### 5.2 SEFUND participants

5.2.1 SEFUND's constitutional documents will dictate how voting and control rights will be allocated to Partners. This will include usual "shareholder" protection rights such as reporting and audit rights, appointments to any Investment Board (see Investment Board below) and ability to remove the General Partner or fund manager). Some Partners may have specific rights (for example, due to their own obligations or concerns) which are not required or appropriate for all Partners. These will be granted under side letter arrangements. Most Limited Partner decisions will be taken by simple majority vote but some will require a 75% majority such as:-

- (a) the right to remove the General Partner or fund manager (non-default) and
- (b) amendments to the Investment Strategy (this will need to be approved by at least three quarters of the Limited Partners);
- (c) Limited Partner exits (other than through a disposal to an associate (a group company in the case of a private sector Limited Partner or another public body in the case of the public sector));
- (d) admissions to the SEFUND;

It would be possible for the voting structure to be reviewed and adjusted on second close (e.g. to meet the demands of incoming investors), however, a default position would be needed in the case of failure to agree. Alternatively, incoming investors could be granted additional / different rights under Side Letter arrangements.

5.2.2 Should other public or private investors be admitted to SEFUND, the governance structure may need to account for their differing levels of investment (possibly with voting rights weighted to funding commitments)

### 5.3 Investment Board

5.3.1 An Investment Board should be established (consisting of individuals appointed by SELEP) to act as a key governance control. The Investment Board would also review performance as required (but at least annually) and consider any potential conflicts.

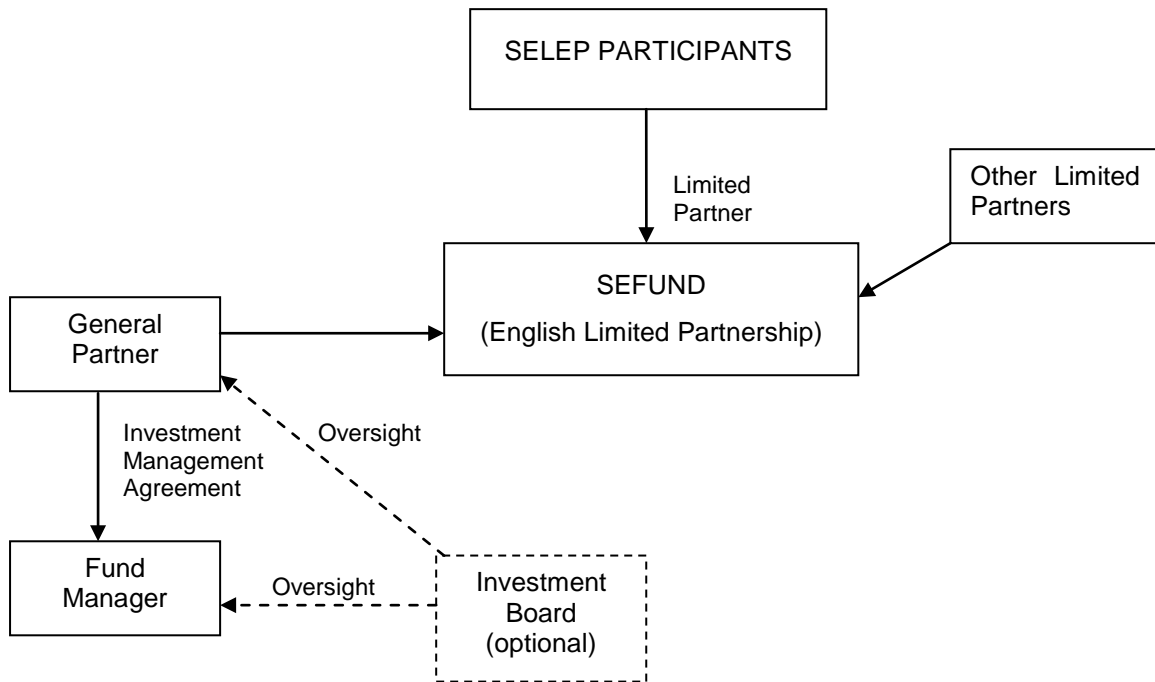
5.3.2 External independent experts could be recruited to ensure transparency of appointments and provide access to additional skills and expertise. There



could be costs associated with this including fees of recruitment consultants and fees or expenses of Investment Board members for their time. There should a mechanism for the rotation of appointments to the Investment Board which takes into account the requirement to maintain the appropriate balance of skills.

5.3.3 The Investment Board would review investments as recommended by the Fund Manager against the Investment Strategy to ensure that the correct advice and that the economic outputs of investments are in line with SEFUND's objectives and Investment Strategy.

**Decision-Making Forums**



**5.4 Fund Manager**

SEFUND will (through a competitive process) appoint a fund manager (or the General Partner will be) responsible for the day to day activities of SEFUND including establishing appropriate governance arrangements and internal controls to safeguard SEFUND's monies and investment portfolio. The General Partner / fund manager will have an internal investment committee responsible for:-

- 5.4.1 Portfolio management
  - (a) Project selection
  - (b) Lending
  - (c) Monitoring
- 5.4.2 Fund management
  - (a) Monitoring performance

- (b) Resourcing and managing reporting requirements and audit requirements
- (c) Reporting to the Limited Partners/Investment Board

There would be a management agreement with the fund manager with appropriate recourse for the SEFUND in the event of the fund manager's failure to perform. Through this arrangement, the Partners retain some control over SEFUND's activities (although this will fall short of involvement in day to day operations).

- 5.5 Unless the General Partner is authorised by the FCA to manage SEFUND, SEFUND will need to be managed by an FCA authorised firm (engaged at arms length). An FCA authorised firm is subject to the prudential and conduct of business rules in the FCA Handbook. The involvement of an FCA authorised firm in the structure will give the Partners comfort over the management of SEFUND's affairs but will carry a compliance cost.
- 5.6 The fund manager may appoint other consultants to assist with the day to day operating of SEFUND (such as a fund administrator to carry out more administrative and reporting functions).

## 6. **GOVERNANCE AT PROJECT LEVEL**

Each project would have its own governance structure determined by the structure of the project. It would not fall within the remit of the General Partner / fund manager to determine how schemes/projects are delivered (although SEFUND will require the fund manager / General Partner to monitor compliance with the term's of SEFUND's investment).

## 7. **INVESTMENT STRATEGY AND PROJECT PIPELINE**

- 7.1 The SEFUND will invest in accordance with agreed parameters set out in an Investment Strategy. The Investment Strategy will be the keystone document governing how schemes for potential funding are identified, how terms of investment are agreed and funding implemented. The Investment Strategy will be adopted on establishment. This document is steered by the Investment Board; the fund manager will not have any influence over it and will simply see that it is implemented. The main body of the CBRE Report looks at the Investment Strategy.
- 7.2 Structure and content: The Investment Strategy will be developed as described in Part 2 of the CBRE Report and is likely to contain:-
  - 7.2.1 Fund objectives and strategy
  - 7.2.2 Resourcing and management
  - 7.2.3 Financial targets
  - 7.2.4 Funding profile
  - 7.2.5 Outputs and targets
  - 7.2.6 Eligibility criteria: a merits-based method for assessing projects for potential support
  - 7.2.7 Investment heads of terms: the terms on which investment will be provided
  - 7.2.8 how frequently funds will be recycled

7.3 Project pipeline: As well as an overarching Investment Strategy, individual investment appraisals will be worked up in relation to the provision of investment for specific projects consistent with the Investment Strategy. Part 3 of the CBRE Report looks at the approach to project pipeline. Projects or investments will go through different layers before being formally adopted in the project pipeline:

7.3.1 SELEP participants will work up projects falling within their region and present these to SEFUND. Projects presented to SEFUND will need to accord with the Investment Strategy and fulfil certain gateway criteria

7.3.2 We anticipate a two-stage due diligence process to be suggested and agreed during the design stage of this work.

7.3.3 Sign-off by the Investment Board as an approved project.

Projects/investments will be selected based on:-

7.3.4 Policy alignment with strategic priorities of SEFUND (set out in the Investment Strategy)

7.3.5 Experience and delivery track record of the organisation (where relevant e.g. for investment in arm's length projects)

7.3.6 Ability to procure additional private / public sector leverage and co-finance

7.3.7 Forecast financial returns to SEFUND

7.3.8 The overall risk profile of the portfolio (which will be a combination of low, medium and high risk investments).

## 8. SELEP PARTICIPATION IN SEFUND

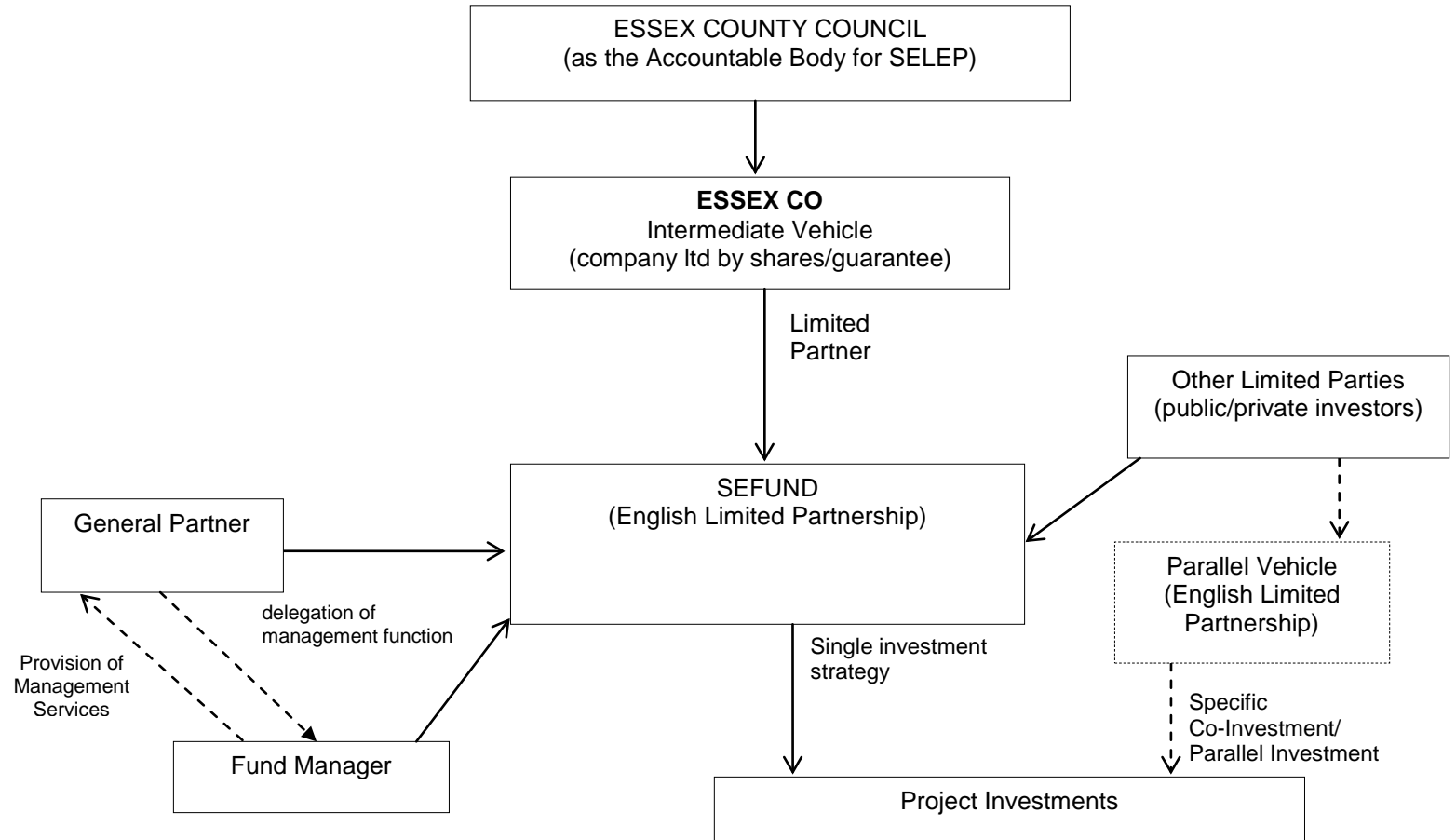
8.1 SELEP participants in SEFUND will need to identify powers enabling them to establish and then continue to participate as an investor and (if applicable) transfer assets to SEFUND. There are four powers which can be considered for this and each is considered separately in Appendix 3. Following the analysis within Appendix 3, it is recommended that SEFUND be formed as an LP but local authority participation will need to be through a company.

8.2 The SELEP participants could either invest in SEFUND through Essex County Council (as the accountable body for SELEP) using a specially set up intermediate vehicle ("**Essex Co**") (**Option 1**) or collectively into a specially set up intermediary vehicle ("**LEP Co**") (**Option 2**). We would recommend Option 4. Option 3 would require an additional shareholders' agreement to regulate the relationship between the SELEP shareholders and additional analysis would be required regarding the decision making as between the LEP Co and other Partners in SEFUND.

8.3 It is important that the SELEP participants in SEFUND are able to participate as an investor in SEFUND within the extent of their powers. In order to benefit from a LP structure, it will be necessary to set up an intermediate company through which the SELEP participation can invest. By participating through Essex Co, this avoids the need for an additional tier of complex governance arrangements in the intermediate vehicle.

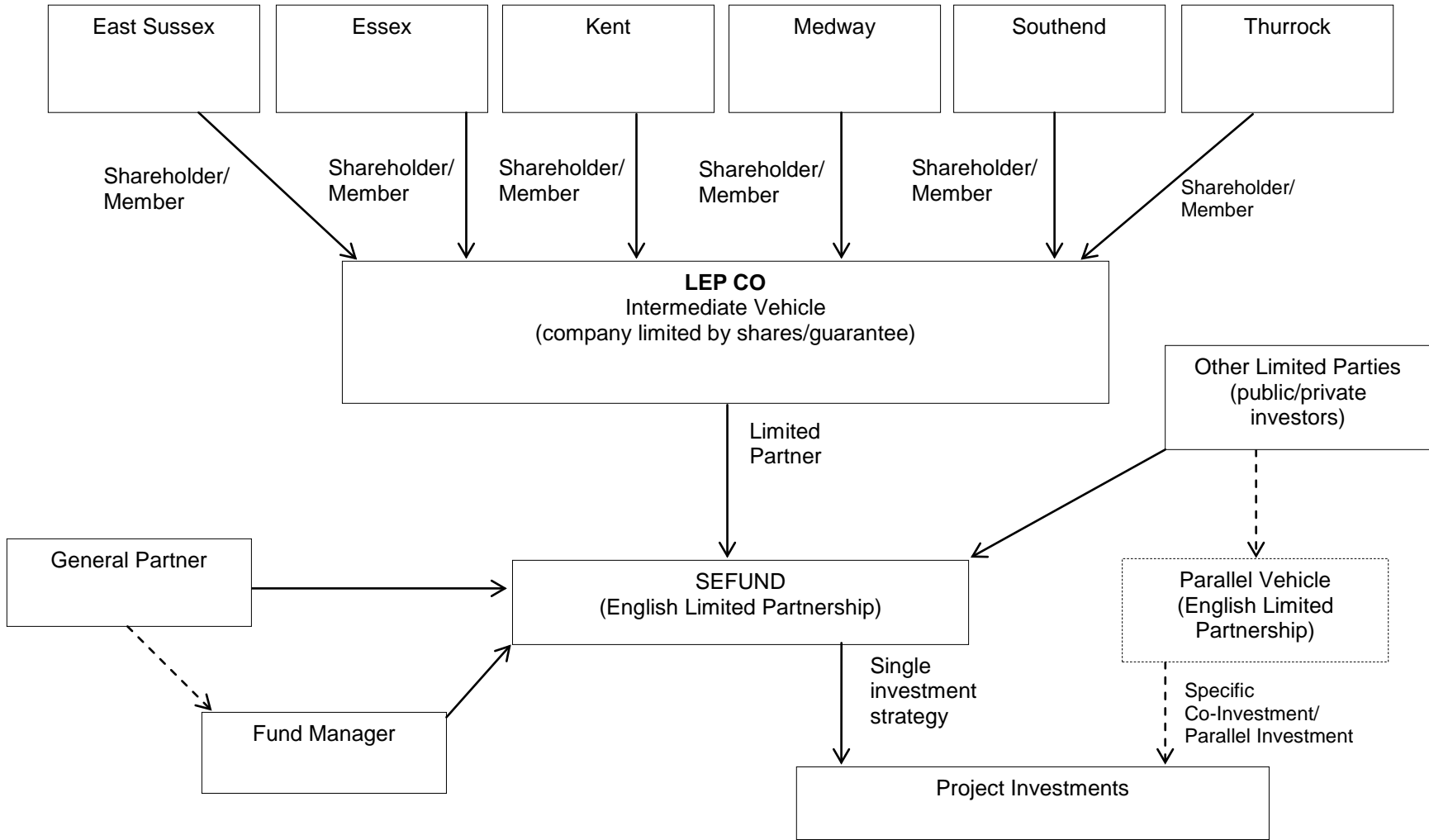
# SELEP PARTICIPATION STRUCTURES

OPTION 1



**SELEP PARTICIPATION STRUCTURES**

OPTION 2



## REGULATORY ISSUES

8.4 SEFUND is likely to be a collective investment scheme (CIS) for the purposes of section 235 of the Financial Services and Markets Act 2000 (FSMA). SEFUND may also be treated as an alternative investment fund (AIF) under the AIFMD (2001/61/EU). If SEFUND is a CIS and/or an AIF, it will need to be managed by a FCA authorised firm which will have a compliance cost.

## 9. STATE AID

### 9.1 Identifying if State aid is present

9.1.1 It is necessary to consider the financial architecture of the SEFUND and the financial population of it to establish whether it is likely to constitute State aid. It is therefore necessary to consider whether Article 107(1) of the Treaty on the Functioning of the European Union ("TFEU") is satisfied. Article 107(1) provides as follows:

*Save as otherwise provided in the Treaties, any aid granted by a Member State or through **State resources** in any form whatsoever **which distorts or threatens** to distort competition by **favouring** certain **undertakings** or the production of certain goods shall, in so far as it **affects trade** between Member States, be incompatible with the internal market.*

9.1.2 This Article gives rise to the "Four Part Test" for State aid. The Four Part Test is cumulative and State aid will only exist if all four parts of this test are met. For State aid to exist, the following must be satisfied;

1. Aid is granted by a Member State or through state resources;
2. To a certain undertaking;
3. Thereby creating a selective advantage; and
4. The transfer of resources distorts or has the potential to distort competition and trade between Member States.

9.1.3 In our view, there are four separate levels where State aid may exist:

- (a) at the SEFUND level, between the public sources of capital (Growing Places, HCA) and the SEFUND vehicle itself (the "First Level");
- (b) at the development project level, between the SEFUND and the individual regeneration projects (the "Second Level"); and
- (c) at the co-financing level, between the SEFUND and the private sector co-investors (the "Third Level").
- (d) at the fund manager level, between the SEFUND and the fund manager (the "Fourth Level")

We have considered each of these levels within Appendix 2 to establish whether any or all are likely to satisfy the Four Part Test.

### 9.2 Conclusion on the Four Part Test

9.2.1 Having considered each part of the Four Part Test, it is clear that there is potential for robust 'No Aid' arguments to be made at each level. This is on the basis that at least one part of the Four Part Test is failed at each level. As the Four Part Test is cumulative, if even one part of the Test is failed, then aid will not be present. To summarise:

- (a) At the First Level, Parts 1 and 4 of the Test are satisfied, as State resources are involved, the resources are not being vested on market terms and there would be a potential effect on intra-Community competition. Part 2 and 3 of the Test will not be satisfied as SEFUND would be considered by the European Commission to be a mere investment vehicle which cannot be a State aid recipient<sup>1</sup>.
- (b) At the Second Level, Parts 1, 2 and 4 of the Test are satisfied, as State resources are being conferred upon project developers which are undertakings carrying out economic activities. Furthermore, there would be a potential effect on intra-Community competition. Part 3 of the Test will not be satisfied however, provided the funds are conferred on the project developers on commercial terms (see Section 9.7) below for further analysis on market term investments.
- (c) At the Third Level, Parts 1, 2 and 4 of the Test are satisfied for the same reasons as the Third level. Part 3 of the Test will not be satisfied however, provided the terms of investment which SEFUND offers the private sector co-investors are market terms and there is no 'over-compensation' to the private sector investors above what they would normally obtain on the open market.
- (d) At the Fourth Level, Parts 1, 2 and 4 of the Test are satisfied. Part 3 of the Test will not be satisfied however, provided the remuneration paid to the fund managers represents market rate.

### 9.3 State Aid Risk Profile

- 9.3.1 In light of the above, it is not unreasonable to conclude that each level of current proposal can be carried out in an aid compliant manner, one which results in their being 'no aid', as opposed to 'compatible aid'. Much will depend on the exact terms agreed at each level as the project takes shape. It is therefore important that a detailed assessment is carried out of the proposed project terms (at each level) during the project planning stage.
- 9.3.2 This assessment should take into account the market economy investor principle ("MEIP"). MEIP involves a hypothetical assessment of the support provided by the public body in question. *Would a private investor in comparable circumstances have provided such sums or support to the recipient if it were operating under normal market economy conditions?* An MEIP assessment is a joint legal and commercial analysis.
- 9.3.3 In the event that it is not possible to structure one or more levels of the project in such a way that it is compliant with MEIP, there is a risk that that level/s will involve State aid. In such an event, it will be necessary to consider whether alternative State aid solutions can be applied to ensure that the aid is 'compatible aid'. For example, if it is not possible to structure Level 2 in such a way that the SEFUND funding to the individual project developers is on market terms, or alternatively if external 'viability gap' funding is obtained from other sources, then it will be necessary to consider the General Block Exemption<sup>2</sup>, amongst other instruments, to see if the funding can be legitimised in some way

<sup>1</sup> We would, however, recommend that both vehicles are incorporated with the necessary constitutional controls such that the vehicles do not have the appropriate power to undertake the commercial investment. This would make both vehicles directly analogous with the NW Jessica fund which the European Commission approved as a 'non-undertaking' and would thus be the optimal risk mitigation strategy.

<sup>2</sup> Commission Regulation (EU) No. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty.

## 10. **TUPE**

10.1 It is not anticipated that there will be a transfer of any functions to SEFUND from the limited partners which would result in a TUPE transfer.

## 11. **EXIT**

### 11.1 **Recommendations**

11.1.1 SEFUND will be set up for an initial ten year term (with the option for the Partners to agree to extend SEFUND for a further 10 years in additional yearly tranches). The Partners would have the option of agreeing an early winding up

11.1.2 On a winding up of SEFUND, its assets would be distributed in accordance with the manner in which such assets were contributed to SEFUND. Where such funding was ERDF or similar it would be dealt with in accordance with the parameters of that programme and referred to Governance where appropriate.

## 12. **TAX**

### 12.1 **SDLT**

If property assets are held directly by the Limited Partnership (or through subsidiary limited partnerships or LLPs) and the Limited Partnership carried on mainly property investment activities, SDLT may arise on transfers of partnership interests, changes in profit shares and, in some cases, on new partners joining the Limited Partnership.

### 12.2 **Tax on returns**

12.2.1 As a Limited Partnership, SEFUND will be treated as tax transparent and will not pay any tax on returns. Instead, the individual partners would be subject to tax under their usual regime (meaning that local authority and pension fund partners will benefit from their tax exempt status).

12.2.2 Any Intermediary Vehicle which is a company established by the limited partners would be subject to the normal corporation tax regime so would be subject to tax on its income and gains. Shares of profits arising in the Limited Partnership and which are attributable to the Intermediary Vehicle as a partner would therefore be taxable. Profits made on debt funding by the Intermediary Vehicle would also be taxable, and the terms of loans between the local authority shareholders and the Intermediary Vehicle would need to be on arm's length terms.

### 12.3 **VAT**

12.3.1 The fee charged by the fund manager will be VATable. SEFUND's main activities will be to provide funding to projects. This is a VAT exempt activity. Therefore SEFUND will not be able to recover VAT paid on these fees; the impact on the financial modelling is not negligible. This cost can be mitigated by structuring SEFUND so that the General Partner acts as fund manager (or the General Partner and the manager are in the same tax group) HMRCs general approach is to treat the General Partner's profit share as not giving rise to a VAT supply (though this should be reviewed further once the final structure is known).



#### 12.4 **Re-valuations on new Partners joining**

As mentioned, SDLT may arise on a new Partner joining where real estate is held directly by the Limited Partnership (or through subsidiary limited partnerships/LLPs). A taxable gain or profit may also arise to Limited Partners – and be taxable where the limited partner is a corporate Intermediate Entity- where there is a revaluation of assets on a partner joining. This will depend on the type of assets (eg whether assets are held for investment purposes or for trading purposes, or are debt), the accounting treatment and possibly whether the revaluation is credited to the existing partners' accounts.

#### 13. **CLASSIFICATION**

14. Subject to the ultimate membership and control structure, SEFUND will likely fall onto the overall public sector balance sheet. However, this is usually only an issue where there would be any lending in the SEFUND which would count towards public sector aggregate borrowing.

14.1 The make up and control of any decision making body (such as the Investment Board) will also impact on consolidation of SEFUND to the public sector balance sheet.

14.2 This is a financial (rather than legal) issue and may need to be looked at by financial advisers.

#### 15. **ACCOUNTING TREATMENT**

15.1 Under IFRS and IAS, it is likely that each of the Limited Partners will account for their interest in SEFUND as an interest in a joint venture or associate (rather than e.g. a subsidiary). Again this is a financial (rather than legal) issue and may need to be looked at by financial advisers.

## APPENDIX 1

### LEGAL VEHICLE COMPARISON

#### 1. LIMITED PARTNERSHIP

##### 1.1 Key features

- 1.1.1 The Partners would be de-facto shareholders.
- 1.1.2 More complex structure than other vehicles: consisting of limited partners (with limited liability) and a general partner (with unlimited liability).
- 1.1.3 Limited liability for limited partners: The Partners would be limited partners. To retain limited liability, they cannot be involved in day to day fund management.
- 1.1.4 Transfers of interests may be subject to stamp duty up to 4%. If the Partners are to take a medium to long term view over the investment this is less of an issue.
- 1.1.5 Flexible basis for profit distributions (e.g. not necessarily in proportion to invested capital).
- 1.1.6 Tax transparent, so non-taxpayers do not suffer tax leakage.
- 1.1.7 The ability to structure Partners' interests separate from the management structure.
- 1.1.8 Vehicle familiar to the private investment market.
- 1.1.9 The LP is not a separate entity so cannot itself can enter into contracts, borrow money and hold property (effected usually through the General Partner by a trust arrangement on behalf of the limited partners).
- 1.1.10 More complex entry and exit arrangements: interests require assignment. Again, this is less of an issue for the Partners are to take a medium to long term view to investment.

1.2 **Conclusion:** Recommended due to tax efficiency, market acceptance and flexibility of profit distribution arrangements.

#### 2. LIMITED LIABILITY PARTNERSHIP (LLP)

##### 2.1 Key features

- 2.1.1 The Partners would be de-facto shareholders.
- 2.1.2 There must be at least two designated members responsible for the corporate compliance of the LLP. If two Partners did not volunteer for this role, each Partner could be a designated member.
- 2.1.3 The liability of the Partners is limited.
- 2.1.4 Flexibility – some features of a partnership and some features of a company. The governance structure can be flexible to reflect the requirements of the

Partners and will be created through the constitutional and corporate documentation. Common vehicle for property development companies.

- 2.1.5 Low complexity- no complex company law requirements.
  - 2.1.6 Transfers of interests may be subject to stamp duty up to 4%. This is less of an issue of the Partners are to take a medium to long term view to investment.
  - 2.1.7 Tax transparent, so non-taxpayers do not suffer tax leakage. Some tax exempt investors (pension funds) lose tax exemption where the LLP carries on property investment activities.
  - 2.1.8 The ability to structure Partners' interests separate from the management structure.
  - 2.1.9 Initially concerns over vires issues of local authority participation but becoming increasingly recognised by and used by the public sector.
  - 2.1.10 The LLP itself can enter into contracts, borrow money and hold property.
  - 2.1.11 Easy entry and exit capability to the Partners.
- 2.2 **Conclusion:** Not recommended due to potential tax inefficiency for certain tax exempt investors.

### 3. **COMPANY LIMITED BY GUARANTEE (CLG)**

#### 3.1 **Key features**

- 3.1.1 The Partners would be de-facto shareholders.
- 3.1.2 The liability of the Partners is limited. Each Partner will contribute a nominal amount of capital (for example £1).
- 3.1.3 Low complexity.
- 3.1.4 The ability to structure Partners' interests separate from the management structure.
- 3.1.5 Recognised by the public sector as a structure to undertake economic and social investment activity (e.g. adopted by the East Midlands Development Agency for the Jessica East Midlands Urban Development Fund). However the key drivers for using the CLG structure were independence of management and no requirement for the members to take out returns.
- 3.1.6 The CLG itself can enter into contracts, borrow money and hold property.
- 3.1.7 The CLG structure provides easy entry and exit capability to the Members. This is less of an advantage if the Partners envisage remaining in SEFUND long term.
- 3.1.8 As CLGs are not for profit organisations, they lend themselves to this kind of scheme where the purpose of the fund is not to generate profit and distribute to the Partners. A CLG is therefore not an appropriate structure for SEFUND.
- 3.1.9 CLGs pay corporation tax and therefore this vehicle would not be tax efficient for Partners who are non-tax payers.

3.1.10 An asset lock mechanism can be drafted for in the constitutional documentation (i.e. to prohibit the Partners from agreeing to dispose of fund assets) although the constitutional documents could equally be amended by the Partners to remove the lock.

3.2 **Conclusion:** Not recommended due to tax inefficiency and difficulty around making distributions.

#### 4. **COMPANY LIMITED BY SHARES (CLS)**

##### 4.1 **Key features**

4.1.1 Familiar vehicle to both the public and private sector.

4.1.2 Low complexity.

4.1.3 The participants would each be shareholders.

4.1.4 The liability of the shareholders is limited. Each shareholder could contribute a nominal amount of capital (for example £1).

4.1.5 Stamp duty is payable on transfers of interests at 0.5%. This low tax liability is less of a benefit if the Partners envisage participating in the SEFUND over the long term.

4.1.6 Returns are directly linked to risk taken (i.e. capital contributed). Although it should be noted that funding could be structured through long term loans rather than capital.

4.1.7 Can be converted to a CLG (although there would be no apparent benefit of this based on current proposals for SEFUND).

4.1.8 CLSs pay corporation tax and therefore this vehicle would not be tax efficient for non-tax paying Partners or any potential pension fund investor.

4.1.9 The ability to structure Partners' interests separate from the management structure to a degree but SELEP directors may have a conflict of interest.

4.1.10 The CLS itself can enter into contracts, borrow money and hold property.

4.1.11 The CLS structure provides easy entry and exit capability to the shareholders. This is less of an advantage if the Partners envisage remaining in SEFUND long term.

4.1.12 An asset lock mechanism can be drafted for in the constitutional documentation (i.e. to prohibit the shareholders from agreeing to dispose of fund assets) although the constitutional documents could equally be amended by the shareholders to remove the lock.

4.2 **Conclusion:** Not recommended due to tax inefficiency.

## APPENDIX 2

### STATE AID – FOUR PART TEST ANALYSIS

#### 1. PART 1 - STATE RESOURCES

- 1.1 Article 107(1) refers to aid granted "by a Member State or through State resources"; this includes central and all local governments together with public or private bodies which use State resources or are controlled by the State. A "transfer of resources" can be positive (e.g. a grant) or negative (e.g. a tax rebate or loan at less than market rates of interest). If the transfer improves the beneficiaries' net financial position, or prevents it from deteriorating, then it is likely to constitute a transfer of State resources.
- 1.2 In this case, we must consider whether each of the four levels involves a transfer of State resources. In light of the involvement of the Growing Places fund, it is clear that the State exercises control over the funds and the decisions to provide the funds are therefore imputable to the State. Even once these funds are transferred to a different vehicle (i.e. SEFUND), the origin of the State resources is not lost and these funds will simply be considered to be indirect State resources. State resources are therefore present at each of the four levels and ***this element of the Four Part Test will be satisfied at each level.***

#### 2. PART 2 - TO AN UNDERTAKING

- 2.1 This element of the Four Part Test requires an assessment of whether the recipient of State aid is an 'undertaking' within the meaning of European law. An undertaking is an entity in any legal form whatsoever which is engaged in an economic activity i.e. an activity consisting of offering goods or services on a given market. Even if the recipient of aid is a publicly owned company, a non-profit making company or even a local authority; it is irrelevant so long as it carries on an economic activity in competition with other operators.
- 2.2 At the First Level, we must consider whether the SEFUND vehicle is carrying on economic activities. We understand that there are no plans for this vehicle to undertake urban regeneration activities. Rather, SEFUND will be used for holding and transferring funds.<sup>3</sup> On that basis, ***the SEFUND will not be considered to be an undertaking for the purposes of Part 2 of the Four Part Test.***
- 2.3 At the Second Level of potential aid, we must consider whether the individual regeneration project developers in receipt of SEFUND financing, are carrying on economic activities. The new projects will be carrying out regeneration activities, including the development of enabling infrastructures which will be carried out for commercial use. The urban project developers will charge operators/users for the use of developed property or sell it in the market, as opposed to making it available free of charge in the common interest. ***The project developers will accordingly be undertakings which are carrying out economic activities and Part 2 of the Four Part Test would therefore be satisfied.***
- 2.4 At the Third Level of potential aid, we must consider whether the private sector co-investors could be deemed to be undertakings carrying on economic activities. It is widely recognised that risk capital financing is a commercial activity and one which is regularly undertaken in the pursuit of profit.<sup>4</sup> As such, we are of the view that the

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<sup>3</sup> The European Commission confirmed the status of such holding funds as 'non-undertakings' in the NW Jessica decision SA.32835, at paragraph 187. In this decision, the European Commission states that the urban development funds were not aid beneficiaries as they were prohibited from undertaking development and regeneration activities themselves and instead were simply acting as vehicles for transferring the funds to the urban projects

<sup>4</sup> This is exemplified by Article 21(14) of Commission Regulation (EU) No. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty ("GBER").

private sector co-investors **are undertakings carrying out economic activities and Part 2 of the Four Part Test would therefore be satisfied.**

- 2.5 At the Fourth Level, we must consider whether the SEFUND fund manager could be deemed to be an undertaking carrying on economic activities. It is widely recognised that fund management is a commercial activity which is regularly carried out in pursuit of profit. As such, we are of the view that the SEFUND fund manager **are undertakings carrying out economic activities and Part 2 of the Four Part Test would therefore be satisfied**

### 3. PART 3 - SELECTIVE ADVANTAGE

- 3.1 In order to establish whether either party will derive a "selective advantage", it is necessary to consider whether the undertaking is in receipt of an economic advantage which could not have been obtained under normal market conditions.

- 3.2 In order to determine whether this part of the Four Part Test is satisfied at any of the four levels of potential aid, it is necessary to analyse whether the provision of funds would have been provided by a private undertaking operating under the same market conditions. If the (monetary) compensation that the State receives in exchange for the funds is lower than what a private investor would have required in the circumstances, then an advantage will be deemed to have been conferred.

- 3.3 At the First Level, we understand that the state resources will be vested in the SEFUND without any form of return or repayment obligation. Notwithstanding this, as set out at Section 9.3.2 above, investment vehicles are not generally considered by the European Commission to be recipients of State aid. As such, SEFUND will be in receipt of a selective advantage as any advantage will be cascaded down the funding chain to another aid recipient. **Part 3 of the Four Part Test would not therefore be satisfied.**

- 3.4 At the Second Level of potential aid, we must consider whether the individual regeneration project developers in receipt of SEFUND financing are in receipt of a financial advantage which could not be obtained under normal market conditions. As SEFUND is intended to be a revolving fund, any funds paid out to project developers will be repayable. Provided therefore that the loan/equity financing transferred to the developer carries with it a rate of interest or return which is commensurate with market rates, the developer would not be in receipt of a selective advantage and **Part 3 of the Four Part Test would not therefore be satisfied.** It is important to note, however, that if the terms of the financing are considered to be sub-commercial in any way (whether that be that the funding is a grant and non-repayable or that the return is lower than market norm), then this part of the Four Part Test would be satisfied as the developer would be in receipt of a selective advantage.

- 3.5 At the Third Level, it is necessary to consider whether the private sector co-investors are in receipt of an advantage which would not otherwise be available on the open market. To determine this, we must establish whether the investment terms being offered to the private sector co-investors are terms which represent market terms. Provided the terms are commercial market terms and, most importantly, the SEFUND is obtaining a market rate return in relation to the private sector investment, there will not be any selective advantage conferred upon the private sector co-investor. On this basis, **Part 3 of the Four Part Test would not be satisfied at the Third Level.**

- 3.6 At the Fourth Level, it is necessary to consider whether the remuneration paid to the SEFUND manager represents remuneration which is normally paid under normal market conditions. Provided the remuneration represents normal market level, and does not involve any level of overcompensation, there will be no selective advantage. We note that the fund manager will be procured using an open and competitive tender process. On that basis, SEFUND can be confident that the remuneration represents market rate and thus **Part 3 of the Four Part Test would not be satisfied.**

#### 4. PART 4 - POTENTIAL TO DISTORT COMPETITION

- 4.1 The key aspect of this last part of the Four Part Test is whether the selective advantage conferred on the undertaking has the potential to distort competition. There is no requirement for an actual distortion to be evidenced. As a general rule therefore, this part of the Four Part Test is easy to satisfy and, more often than not, the selective advantage will be found have the potential to distort competition.
- 4.2 If aid is found to have an appreciable effect on trade, it is inevitably found to distort or threaten to distort competition<sup>5</sup>. The ECJ stated in the *Philip Morris v Commission* judgement that, when State financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by that aid<sup>6</sup>. The fact that competition to attract investment in regeneration exists generally across the EU is likely to be sufficient to satisfy this part of the Test at all levels. Additionally, competition takes place between property developers and investors in the property development market. As such, we are of the view that **Part 4 of the Four Part Test would be satisfied at every level.**

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<sup>5</sup> T-288/97, *Regione Autonoma Friuli Venezia Giulia v Commission*, 2001 ECR II-1169

<sup>6</sup> 730/79, 1980 ECR 2671 at Para 11

## APPENDIX 3

### Vires and Procurement Advice

#### 1. VIRES

1.1 Local authority participants in SEFUND will need to identify powers enabling them to establish and then continue to participate as an investor and (if applicable) transfer assets to it. There are four powers which can be considered for this and each is considered separately below.

#### 1.2 Power to establish and participate in the fund

##### 1.2.1 Section 1 Localism Act 2011

Section 1 of the Localism Act 2011 introduced a "**general power of competence**" for local authorities (the "GPC"). The GPC replaced the Well Being Power in England. The GPC is a power for a local authority to do "anything that individuals generally may do". In using the power, the local authority may act "in any way whatever", whether or not for a commercial purpose, with or without charge and whether or not that action would benefit the local authority, its area or persons resident or present in the area.

The GPC is subject to statutory parameters (including actions prohibited by other legislation). However, the GPC is intended to authorise activities carried out by local authorities for commercial purposes provided they do not relate to charging for services they have a statutory obligation to provide. Significantly the Localism Act additionally provides "**Where, in exercise of the general power, a local authority does things for a commercial purpose, the authority must do them through a company.**" This is defined as a Companies Act company or registered society under the Cooperative and Community Benefits Societies and Credit Unions Act 1965 or the Industrial and Provident Society Act (Northern Ireland) 1969, but not a limited partnership ("LP") or a limited liability partnership ("LLP"). It is the interpretation of the scope of this limitation (particularly "commercial purpose") that will be critical to as to whether the general power of competence can be relied upon if an LLP or LP structure is necessary. See further below.

##### 1.2.2 Section 95 of the Local Government Act 2003

There is a parallel power to the GPC contained in Section 95 of the Local Government Act 2003. Section 95 enables local authorities to do for a commercial purpose anything which they are authorised to do for the purpose of carrying on any of their ordinary functions. The requirements with regard to the exercise of this power are set down in the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009.

Taken together Section 95 and the 2009 Order require the following (a) the activities traded must be activities that the authority is authorised to undertake for the purpose of discharging its ordinary functions, (b) the activity must not be one which the authority has a duty to provide to someone nor is authorised to provide commercially under any other enactment, (c) the authority must have regard to statutory guidance on the exercise of the power, (d) the authority must consider and approve a business case for the particular trading activity. The 2009 Order defines "business case" as a comprehensive statement of (i) the objectives of the



business (ii) the investment and other resources required to achieve those objectives (iii) any risks the business might face and how significant those risks are and (iv) the expected financial result of the business, together with any other relevant outcomes that the business is expected to achieve, (e) the trading must be undertaken through a company and (f) the authority must recover the costs of any accommodation, goods, services, staff or other things that it supplies to the company (necessary in any event to comply with EU State aid requirements).

As with the GPC therefore where a local authority uses Section 95 for undertaking a commercial purpose it must do so through a company and again it is the interpretation of the scope of this limitation (particularly "commercial purpose") that will be critical as to whether this funding power can be relied upon if an LLP or LP structure is necessary. See further below.

### 1.2.3 **Section 12 of the Local Government Act 2003**

- (a) Section 12 of the Local Government Act 2003 gives local authorities a separate power to invest for any purpose relevant to their functions under any enactment or for the purposes of the prudent management of its financial affairs.
- (b) There is no definition of the word "invest" in the 2003 Act and therefore ought to be given its normal meaning. Therefore to bring the participation by the local authorities in SEFUND within Section 12 each payment out by SEFUND would have to be categorised as an investment (allowing for some de-minimus payments for other purposes).
- (c) In exercising their powers of investment local authorities must have regard to the statutory guidance issued by the Secretary of State and specified guidance published by CIPFA. A local authority relying on this power as part of the transaction must ensure that this is consistent with its Annual Investment Strategy approved by full Council or that the Strategy is amended to accord with this new proposal.
- (d) There are specific provisions which need to be taken into account with regard to the treatment of various types of investments and it should be noted that Section 12 does not refer to pension fund or trust fund investments which are subject to separate regulatory regimes.
- (e) In relation to borrowing to invest, the Government's commentary on the guidance on the use of the investment powers makes it clear that this provision was introduced to remove doubts which persisted under the previous capital finance regime, but reminds authorities that the practice of speculative borrowing purely in order to invest at a profit remains unlawful.<sup>7</sup>

### 1.2.4 **Section III Local Government Act 1972 ("Incidental Power")** – in relation to the local authority's functions

- (a) Section 111 of the Local Government Act 1972 provides a local authority shall have power to do any thing (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of

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<sup>7</sup> Guidance on Local Government Investments (second edition 11 March 2010) DCLG.

their functions. However, a local authority does not have the power under this section raise money, whether by means of rates, precepts or borrowing, or lend money except in accordance with the enactments relating to those matters.

- (b) The word "functions" embraces all the duties and powers of a local authority; the sum total of the activities Parliament has entrusted to it. Although seemingly wide, the approach to construing this power is often narrow.
- (c) A power is not incidental merely because it is convenient or desirable or profitable.
- (d) The power has been used to form companies and trusts in the past and was the main power relied upon before well-being and more latterly the GPC. Whilst in principle it is possible, in many of the cases this has been held to be ultra vires due to it being found that there was no valid exercise of an underlying power to attach the incidental power or due to the company formation being too remote to be incidental.
- (e) The incidental power cannot be used where the use of the power has become "incidental to the incidental".
- (f) When a power is claimed to be incidental, the provisions of the statute which confer and limit functions must be considered and construed. Where there is an express limited power, then the Courts may look to see additional powers also in express terms rather than allow use of an incidental power.
- (g) Following on from this In the leading case to come before the courts, the actual purpose of the local authority activities was examined which really amounted to a speculative trading in interest rates swaps as opposed to entering into those swaps as being incidental to its borrowing function. In addition there was an existing "Statutory Code" for borrowing and entering into interest rate swaps was neither within that "code" nor incidental to it.

Where does the above leave us in using Section 111 of the Local Government Act 1972? For Section 111 to be used as the enabling power for participation in SEFUND, a function would need to be identified for which the activity of participating in SEFUND is calculated to facilitate, or is conducive or incidental to, the discharge of any of that function. Economic development and regeneration is clearly a function of a local authority. Although there is no express power covering economic development it has been recognised as a function by the Secretary of State in making orders to establish Combined Authorities where the function covered has been described as "such functions of the constituent authorities as are exercisable for the purpose of economic development and regeneration in relevance on the general power of competence under Section 1 of the Localism Act 2011".

However the principal issue against using Section 111 would be the argument that there are statutory provisions which limit the use of entities for a commercial purpose or trading to companies. Such a restriction or limitation must necessarily bear on the use of Section 111 with the underlying economic development power.

### 1.2.5 Requirements for an LLP or LP

- (a) For any entity to fulfil the statutory definition of a LLP, or an LP, their respective members must be carrying out a business with a view to a profit. There is no legal definition of "carrying on business" with regard to limited or general partnerships. Section 45 of the Partnership Act 1890 Act defines business as including "every trade, occupation, or profession".

### 1.2.6 View to a Profit v Commercial Purpose

- (a) On the face of it the need for a view to a profit for an LLP or LP creates an appearance of some discord between a local authority entering into an arrangement under the GPC - without the primary purpose of raising money.
- (b) It is generally accepted that if a partnership is formed with some other predominant motive but there is also a real (albeit ancillary) profit element then it is permissible to infer that the business itself is still being carried on "with a view to profit" and a partnership can exist.
- (c) In relation to LLPs and LPs the analysis has been that it is not necessary for a local authority itself to have a view to a profit when it enters into the LLP; rather, the business activities of the LLP must be carried out with a view to a profit. Indeed, there is no statutory requirement for each member of an LLP to share in any profits it generates. The general view taken is that the requirements for a partnership to have a view to a profit do not mean by itself that a LLP or LP cannot ever be used. There is a difference between the local authorities' purpose in wanting to enter into the arrangement being essentially "non-commercial" and not for the purpose of raising money, and the fact that the activity of the partnership will satisfy the test under partnership legislation of a business and a view to a profit. However on this occasion one of the primary purpose appear to be recycling revenue for a commercial purpose.
- (d) When a local authority uses the GPC there are often several distinct purposes for which the power is used. It is generally accepted, following court decisions under similar worded powers, that the purpose which is actually enabled by the GPC should be the primary purpose. The primary purpose can be gleaned from local authority papers e.g Cabinet reports or other documentation produced for the local authority. Local authorities who have entered into bona fide joint ventures LLPs or LPs have followed this argument where it is abundantly clear from supporting documentation that the primary purpose for participation in the LLP or LP is a joint venture development or regeneration project or other similar purpose. This approach is usually also supported by evidence of the absence of a primary desire on the part of the local authority to immediately retain the revenues but to use these for recycling into the development.

It is suggested that there is a difference between a bona fide joint venture and SEFUND. Initially, the primary purpose of SEFUND is intended to be regeneration, job creation and economic growth. However, consideration should also be given to the possibility that the generation of revenue may become a primary purpose at some point in the future (particularly if private sector investors intend to

invest directly into SEFUND) albeit there will be economic outputs for the local authorities area from SEFUND. As such therefore an argument of a primary purpose other than a commercial one would be much more difficult to sustain in those circumstances. Furthermore it is presumed that any LLP or LP is likely to have as a partner a wholly owned local authority company. This is also likely to lead any court to a view that the LLP or LP is potentially a sham to circumvent the commercial purpose requirements in the GPC.

#### 1.2.7 What is the Solution?

- (a) For a LLP or an LP to be used for SEFUND instead of a company one or more of the following must be present (throughout the existence of the fund):-
  - (i) To use Section 1 of the Localism Act 2011 (GPC) and/or Section 95 of the Local Government Act 2003 (trading power) SEFUND must not be established for a commercial purpose by the local authority(ies). It is the local authority's intention rather than the LLP or LP which is important. The LLP and LP can make a profit but it still may not be the intention of the local authority to the LP or LLP for a commercial purpose.
  - (ii) To use Section 12 of the Local Government Act 2003 (power to invest) the local authority(ies) must be "investing" and such investment must be for any purpose relevant to their functions under any enactment or for the purposes of the prudent management of its financial affairs. Whilst economic development is a function, primarily under the GPC the important point is whether all payments by the LLP or LP (apart from de-minimus) can be categorised as investment or whether some (as is likely over time) would be categorised as a commercial revenue driven purpose.
- (b) In view of previous case law it is unlikely that Section 111 of the Local Government Act 1972 can be used.
- (c) If the tests in (a)(i) and (ii) cannot be satisfied then SEFUND will need to be incorporated as a company using the GPC (and taking into account also the requirements of Section 95 the trading power (being overlapping powers and one, the trading power, having limitations an authority should take cognisance of those limitations) It still remains possible for SEFUND to be formed as an LP or LLP but the local authority participation will be through a company. This still retains the attraction of the proposition for tax exempt investors but is of much less benefit to a local authority (because of the additional tax layer). As a wholly owned company there are also some routine procedural and propriety requirements contained in Part V of the Local Government and Housing Act 1989.

### 1.3 Borrowing

- 1.3.1 Section 1 of the Local Government Act 2003 gives local authorities a power to borrow for any purpose relevant to their functions under any enactment or for the purpose of the prudent management of its financial affairs. So long as the authority is borrowing for a function (and that can be a general function such as economic development) it can on lend in addition to making loans from other funding sources.

- 1.3.2 A local authority may not borrow if to do so would breach the affordable borrowing limit it has set for itself or is imposed by the Secretary of State. At the present time there is no national limit set by the Secretary of State and so the local authority participants only need address the issues in relation to the requirements in relation to the limit they have determined they can afford to borrow.
- 1.3.3 At the centre of the new prudential borrowing system is the obligation for authorities to determine and keep under review the amount that they can afford to borrow. It is for each authority to set its own 'prudential limit' in accordance with the detailed rules that are prescribed by the Secretary of State.
- 1.3.4 The Prudential Code to which local authorities must now have regard is published by CIPFA (The Chartered Institute of Public Finance and Accountancy). In addition regulations require that they must have regard to proper accounting practices, including The Statement of Recommended Practice: Code of Practice on Local Authority Accounting in the UK (SORP) and the Best Value Accounting Code of Practice – both also published by CIPFA.
- 1.3.5 The key objectives of the Prudential Code are to ensure, within a clear framework, that capital investment plans are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that local authorities have fulfilled these objectives the Prudential Code sets out detailed indicators that must be taken into account under the following headings:
- Affordability
  - Prudence and sustainability
  - Value for money
  - Stewardship of assets
  - Service objectives
  - Practicality
- 1.3.6 Affordability is ultimately determined by a judgement about the acceptable level of Council Tax. In considering affordability the local authorities must pay due regard to risk and uncertainty. Risk analysis and risk management strategies should therefore be taken into account.
- 1.3.7 In relation to this matter, these issues will also be relevant to the consideration of the local authorities' fiduciary duty ie the need to conduct their administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of the Council Tax payers. However it is in each local authority's discretion to determine what the interests of the Council Tax payers are and how they are best served following its analysis of the relevant costs and benefits.

- 1.4 In addition, there are proposals to implement a sub cap on HRA borrowings for housing investment (with focus shifting towards self financing models).

## 1.5 Land transfer powers

### 1.5.1 Power to Dispose of Non-Housing Land - Section 123 Local Government Act 1972.

On the transfer of any land to SEFUND (or more likely project subsidiaries) a local authority will have an obligation to receive the "best consideration that can reasonably be obtained" for their land and will need to receive independent expert valuation advice to confirm that the consideration proposals represent best consideration. Under the General Disposal Consent 2003 local authorities are able to dispose of land for less than best consideration if they consider that this will achieve the promotion or improvement of economic, social or environmental well-being of their area:-

- (a) subject to a maximum undervalue of £2m; and
- (b) provided the disposal is State aid compliant; and
- (c) if it is satisfied that the land is not held as housing land under the planning acts. (i.e held under powers which permit it to be disposed of under the terms of the 1972 Act. The consent does not apply to disposals of land held under section 233 of the Town and Country Planning Act 1990 (land held for planning purposes) nor does it apply to land held for housing purposes under the Housing Act 1995.)

### 1.5.2 Housing Land Powers - Part II of the Housing Act 1985 (esp. Section 32):

In addition to keeping a separate account for Council housing (i.e separate from their General Rate Fund "GRF") the powers to deal with or dispose of housing land are also contained in Part II of the 1985 Act and these are slightly different to the disposal powers for the GRF.

Section 32 of the Housing Act 1985 allows Local Housing Authorities to dispose of housing land but only with the consent of the Secretary of State. The Secretary of State (CLG) has published a series of general consents since 1985, the latest being The General Housing Consent 2013 published in March 2013. The 2013 General Consent contains in fact four separate consents with the most relevant being "A: The General Consent for the Disposal of Land held for the purposes of Part II of the Housing Act 1985-2013."

Consent "A" draws a distinction between vacant land and dwellings. A Local Housing Authority may dispose of a dwelling provided it is at market value. However there are two important exceptions to this:-

- (a) where the disposal is to a body or entity owned or partly owned by the local authority. However this does not apply when first, the local authority has closed its Housing Revenue Account (which may vary depending upon whether Essex district councils have undertaken a stock transfer) or secondly, where the disposal is one of the first five dwelling disposals in a financial year; and
- (b) where the dwelling is occupied by a tenant(s).

Where (a) or (b) above apply a specific consent is required. In relation to (a), the consent requirement applies to the transfer of a vacant dwelling to an entity in which the local authority has an interest (whether majority or minority) if it is the sixth such transfer of a dwelling (taken individually) in the relevant financial year. The aim of this consent requirement is to prevent

local authorities transferring housing stock in parts to entities (so called "trickle transfer") and thereby undermining the HRA settlement which the Government put in place with local authorities when the new HRA regime came into operation in April 2012.

However again there is a further "exception" for dwellings to take them outside of the requirement for a specific consent if the dwelling can be brought within the definition of vacant land. The General Consent simply allows a local authority to dispose of vacant land. This can be at any price (market value or less (subject to compliance with State aid rules)). Vacant land is defined as land on which no dwelling houses have been built or where dwelling houses have been built such dwelling houses have been demolished or are no longer capable of human habitation and are due to be demolished. The land transferred to the EHC will need to be brought within the latter definition to avoid the requirement of a specific consent. There is no qualification or limitation on the disposal of vacant land to entities in which the local authority has an interest.

A disposal can be by way of conveyance of the freehold or grant of a lease of any duration. Vacant land would also include land held for housing purposes within the HRA which has other structures on it e.g garages.

#### 1.5.3 Section 24 and 25 Local Government Act 1988

The local authorities will need to obtain the Secretary of States consent under Section 25 Local Government Act 1988 ("section 25" consent) to exercise the power under section 24 (Financial Assistance). This power enables the provision of financial assistance in relation to private let accommodation. A local authority will also need section 25 consent if it wishes to use any other powers (including the general power of competence) for the purposes set out in section 24. If it does not, the transaction will be void.

General consents were issued in December 2010 in relation to section 25.

#### 1.5.4 Power to Dispose of Land - Section 233 Town and Country Planning Act 1990

This gives local authorities power to dispose of land held for planning purposes in such manner and on such terms as seem expedient in order to secure the best use of the land or the proper planning purposes. SOS consent needed if disposal for a consideration less than the best that can reasonably be obtained. These are General Consents.

## 2. **PROCUREMENT**

### 2.1 **Partners**

- 2.1.1 SEFUND can be set up outside of the Public Contracts Regulations 2006 (the "**Regulations**") (soon to be replaced by the Public Contracts Regulations 2015) (i.e. its Partners would not need to run a procurement under these rules to participate in SEFUND) as the Partners will be investing in SEFUND rather than procuring any works, goods or services from it. A watching brief will be needed over the terms of any land transfers or other arrangements to ensure that they do not incur terms sufficient to create a 'Public Contract' as defined within the Regulations. Where however private sector Partners are to be invited to join the LP and the opportunity to do so is to be limited, the public sector Partners should consider an appropriate means of selecting such private sector Partners and to hold some form of

competition for this purpose if the opportunity to participate may distort competition.

## 2.2 **Projects**

- 2.2.1 Subject to whether it is a body governed by public law (covering issues such as the membership, control and funding structure) SEFUND itself may be a 'contracting authority' as defined in the Regulations. If this is the case, to the extent it does procure any works, goods and/or services, it will need to comply with EU and UK public procurement rules (the "Procurement Rules").
- 2.2.2 SEFUND will also need to consider if it might be equated to a public body bound by the general treaty obligations (even if not the full procurement rules). If it is judged to be an undertaking effectively controlled by the State or another public body and it does not compete in the market, then it may be caught.
- 2.2.3 When selecting projects for investment, even if SEFUND is a contracting authority, it is unlikely that it will be procuring any works, goods and/or services sufficient to create a Public Contract for the purposes of the Procurement Rules. However, where SEFUND will be acquiring works, goods and/or services directly (or placing obligations on other parties to carry out certain works), those contracts may be caught by the Procurement Rules. SEFUND (or the General Partner/manager on its behalf) will need to review this as part of the investment appraisal process.
- 2.2.4 In any event, there should be a transparent process for the selection of projects such as a "call for projects" similar to the call for grant applicants as would normally operate on grant funding schemes.

## 2.3 **SEFUND management function**

- 2.3.1 Irrespective of whether SEFUND is itself a contracting authority, it will need a procurement policy to ensure value for money. This could include obtaining a number of quotes for spend above a specified threshold.
- 2.3.2 The General Partner/fund manager will need to be procured competitively. The provision of 'Financial Services' is a Part A service under the full requirements of the Regulations (however this does not apply to financial services in connection with the issue, purchase, sale or transfer of securities or other financial instruments in particular transactions by the contracting authorities to raise money or capital or central bank services). 'Financial Services' does however include the services provided by fund managers.