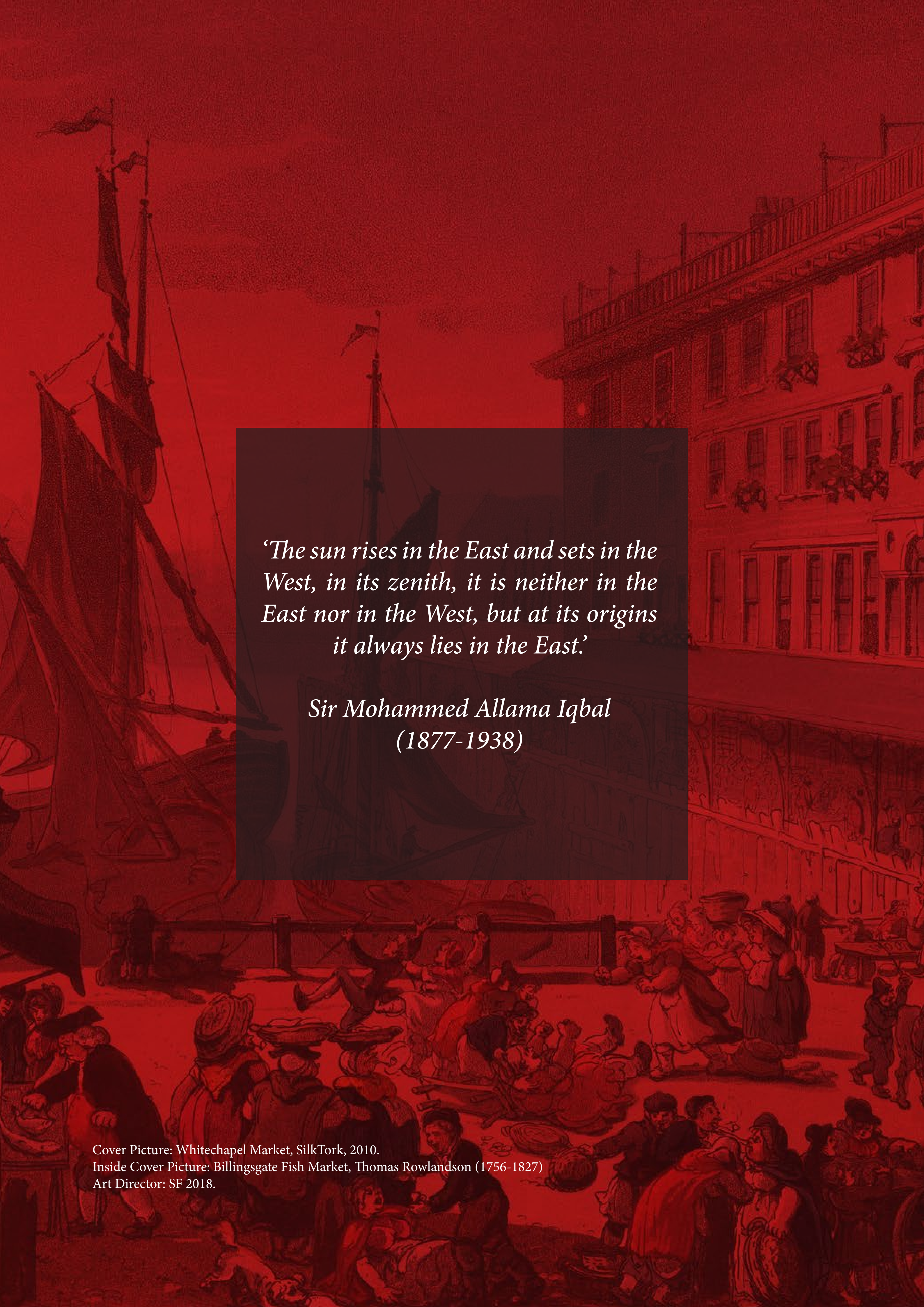
Proposal for a People's Wealth Fund

Councillor Puru Miah



‘The sun rises in the East and sets in the West, in its zenith, it is neither in the East nor in the West, but at its origins it always lies in the East.’

Sir Mohammed Allama Iqbal
(1877-1938)

Cover Picture: Whitechapel Market, SilkTork, 2010.
Inside Cover Picture: Billingsgate Fish Market, Thomas Rowlandson (1756-1827)
Art Director: SF 2018.

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Acknowledgment

To a former head of one of the largest local authority in England, who took time out to read the paper and make suggestions, and who has since first meeting him has been a source of strength and inspiration in thinking out of the box and whilst doing that having a good time. Also, to former Councillor friends who gave much time and insight in helping me understand local government finance and structures.

To the unknown socialists in the City, who gave me access to their wealth of experience in drafting the technical paper. Who due to the current environment in the fields they work in, cannot utter what they deeply desire in the hearts, a fair and just society for everyone.

Picture: Spitalfield's Market, 2017 – pxl.store / Shutterstock.com.

Foreword

The inspiration for writing this paper first occurred, during the time I first got selected as a Councillor candidate for Mile End in November 2017. One of the first house visit I did, was on the Burdett Estate, Fitzroy House, with my colleague Cllr David Edgar. Living in the house, was a couple with a young family. The husband worked as a driver for the school transport, the work was seasonal, therefore the family were struggling with payments of their Council Tax Bill, especially with the Minimum Income Floor calculation in the new Council Tax Reduction Scheme for the Self Employed made by the authorities, which imposed an anticipated fix income and hence no relief. We explained to her that the Council operates a means tested relief system. With tears welling up in her eyes, she explained that she applied for the relief, but found the means testing (where expenditure as well as income are assessed) as humiliating, that she would rather pay the council tax and struggle than face the humiliation of having to justify buying new trainers for her son or buying quality food for the home. Both of us left the home in silence. Soon afterwards, I went and visited her alone, and promised her that once elected I will do something about the problems her and her family faced.

All throughout the election campaign I came across families facing struggling and suffering in the face of austerity, at the same time the new Universal Credit programme was being rolled out. During a hectic and much contested campaign, in between the little time I had to myself, I engaged myself in conversations with former industry colleagues and local government colleagues and through reading literature on the subject I slowly tried to deconstruct the workings of Local Government in terms of finance, deconstruct the rhetoric of fiscal responsibility, the politics of public services, the metaphysics of austerity and the phrase 'we are all init together'. Looking for ideas to disarm the bombs of 'There is No Alternative', (TINA) that current public institutions defend themselves against the Other, the dispossessed and the poor.

Many colleagues reading this paper will find it difficult to understand why certain issues are raised in the Council chamber, and why we can't move on and see the bigger picture. However it is difficult for those of us who live or are from the estates and come from deprived background to move on. To illustrate the predicament some of us are in, the former Algerian President and freedom fighter Houari Boumediene throughout his life refused to visit France, because he could not bear to see the living conditions of French Algerians who were forced to live in squalid conditions by the French authorities, 'Bidonvilles', due to the fact that their name was Aicha or Ahmed. Many of us who live in the estates in the Borough, do not have that luxury, after work, in the shops we shop in, the community centres we frequent and on the estates we live in, we see residents from poorer demographics struggling to make ends meet. On a daily basis we see the humiliation, the hidden anguish of the broken lives, families and homes, made worse by current council policies.

This paper is an honest attempt to square the circle of relieving the anguish of being helpless some of us feel of the inability to change council policies which adds an additional burden on the poorest and vulnerable, with the 'bigger picture' of passing a legal budget. I ask colleagues, to be dispassionate when reading this paper, and to focus on the political and technical arguments. And, also focus on the short-term goals of mitigating the effects of austerity and in the long-term, to providing a sustainable revenue generation strategy, to subsidise and enhance public services. The Labour Party is a broad church, and although we might disagree on the methods, our goal is the same, a fair and just society.

Puru Miah
Mile End Councillor and Community Organiser.

Deconstructing the Budget Crisis in Tower Hamlets

Grammatology of current Local Government Finance: A Perfect Storm?

Local Authorities in England, like the London Borough of Tower Hamlets (LBTH) or Tower Hamlets Council, will have seen between 2015 and 2020, their Revenue Support Grant shrunk by 77p in the pound,[1] according to the Local Government Association. This coupled with a rising demand on council services due to an ageing population and the effects of austerity, mean that a rise in Council Tax will not be able to meet the shortfall in funding.[2] Therefore during the summer, heads of council departments are having to find 'savings' and submit proposed cuts to public services.

Although I started my career in the Civil Service, and did a stint in the charitable/voluntary sector most of my time has been spent woking home and abroad in the private sector. Bringing the perspective of the 'outsider' and using standard practices/tools adopted by the private sector and public bodies abroad, there are alternative approaches available. The paper outlines a technical arguments for such an alternative approach, arguing against the current binary/logo centric approach of cuts to public services to meet cuts in the Revenue Support Grant.

Protecting Services: The Art of offsetting

Offsetting, is a risk management technique used to reduce any substantial losses or gains suffered by an individual or an organisation. In standard finance term, it's offsetting costs with an investment revenue scheme, for example offset loans.[3] Public bodies abroad have adopted such practices, creating Sovereign Wealth Funds (SWF)[4] , using surplus in revenue to Hedge against future costs in terms of an increasing and ageing population. The most famous is the one set up by the Norwegian authorities[5], which has a passive investment[6] approach, equally large are the ones set up by the Emirates[7] (owners of the Gherkin) and the Qataris[8] (Canary Wharf and Shard), which have an active investment[9] approach.

Différance: Arbitrage – taking advantage of market failure

Arbitrage is the term and practice used in economics and finance of taking advantage of price difference between two or more markets: striking a combination of matching deals that capitalize upon the imbalance, the profit being the difference between market prices. LBTH can use its position of borrowing at historic low interest rates from the Public Works Loan Board (PWLB) and take advantage of market failure in the 'real assets' market in the UK and generate profitable returns and capital uplifts to fund the shortfall in the Revenue Support Grant from Central Government. In particular take advantage of Government Backed infrastructure investments, which were designed for Pension Fund investments, which due to current governance structures[10] can't be taken up by Pension Funds. Not only does this situation allow LBTH to take advantage of the difference in market prices (cost of borrowing against rates of return), but allows it to negotiate generous fees and arrangements with Investment Managers in the sector, due to the market conditions of a Neo-Jurisdictional Arbitrage.[11]

"The important thing for Government is not to do the things which individuals are doing already, and to do them a little better or worse; but to do those things which at present are not done at all."

John Maynard Keynes, The End of Laissez Faire (1926).[12]

Imagining and Signifying a new Tower Hamlets – Barrow Boy Socialism

The political and technical argument for a People's' Wealth Fund, give the potential tools and headroom for elected members to come up with creative, imaginative solutions to the age old problems afflicting the residents of Tower Hamlets, that of structural poverty. Currently, as policy makers we are left to interpreting what is happening in the Borough, a People's Wealth Fund allows us to change it.

The investment portfolio, surplus and income from a People's' Wealth Fund gives policy makers in LBTH, potential influence and control over the means of production within the Borough. It gives policy makers the tool to tackle the paradox the is Tower Hamlets, being the 3rd largest Economy in England, but in the top ten percentile in terms of poverty and deprivation.

A People's' Wealth Fund allows policy makers the tools to take a proactive approach a reduce poverty, creating a virtuous cycle, allowing people to make better lifestyle choices, easing the pressure off existing public services. Proactive approaches[13] outlined by the Shadow Chancellor John Mcdonnell in a recent Community Wealth workshop held in London on the 21st July 2018.

Its a novel approach using the signs and symbols of the age old tradition of the East End 'Barrow Boys' of Whitechapel market, taking advantage of market failure and disparity in certain asset classes. But then again, there is a right way of doing things, and a wrong way, and then there is the East London Way!

Picture: Petticoat Lane Market 1920s, George Grantham Bain Collection.

1. Introduction to the Technical Paper

The London Borough of Tower Hamlets (LBTH) is facing a budget shortfall in the coming years, due to steady reduction in the Revenue Support Grant from Central Government. Much of the focus has been around cutting public services to pass the legal requirement of a balanced budget, thus in effect implementing the Tory Government's austerity agenda.

In this paper I want to outline an alternative strategy to meet the shortfall in funding, where income is generated where LBTH appoint a Mayoral Advisor for Community Wealth. The advisor working with both the Council Executive and officers, puts together a strategy and mechanism allowing LBTH make "real asset" [14] focused treasury investments to help fund its ongoing strategic objectives, working towards the objective of LBTH setting up it's own Municipal Wealth Fund.

The purpose of this paper is to:

a) Provide a background on income generating activities by Local Authorities;

b) Research potential sectors for LBTH to target for investment and illustrate the financial impact of implementing an investment programme;

c) Consider the regulatory requirements that Local Authorities must adhere to when making investments and provide some suggested actions that LBTH may wish to consider ahead of implementing a real asset community wealth building strategy; and

d) Establish a working group between the proposed Mayoral advisor for community wealth and officers to report back to the Labour group with further detailed proposals.

This paper should be read in light of the following limitations; that it has been produced a short-period of time with limited resources, however, with input from industry experts and financial analysts. This proposal allows us to mitigate some of the negative factors of austerity measures imposed by central government, although it is not a substitute for a wider political campaign to persuade government to increase funding to local government. Lessons must be learned from Northamptonshire County Council, Hammersmith and Fulham Councils to ensure sound financial management when considering any proposals.

2. Executive Summary

• **Local Authorities are now striving to generate income in a way which achieves multiple strategic outcomes for the same spend**; examining options to balance budgets while simultaneously boosting growth, supporting vulnerable communities and protecting the environment. As a result, UK Local Authorities are increasingly choosing to hold part of their assets in alternative investments to meet such objectives.

• **Many Local Authorities have invested in commercial real estate in order to fund their strategic priorities.** In 2016, local authority property deals were on track to break the £1 billion barrier;

• **The Local Government Act 2003 requires councils to follow the CIPFA Prudential Code for Capital Finance.** The objective is that statutory Section 151 officers – council CFOs – prudently invest the funds held on behalf of their communities. The guidance recommends that authorities should prioritise the highest rate of return for borrowing and investments according to security, liquidity and yield – in that order. While the Code is not prescriptive on whether real asset investments are permissible, it is important that Local Authorities demonstrate that they are able to identify risks associated with their investments and plans they have to mitigate such risks should they arise;

• Based on desktop analysis, commercial property related investments are unlikely to offer LBTH with adequate returns to fund its strategic objectives;

• Renewable energy, bio-energy and student accommodation assets could be attractive sectors for LBTH to consider for investment to fund its strategic objectives. Deal sizes in each sub-sector vary in size and it is likely that most investment opportunities will remain in wind and solar sectors. Nevertheless, it is worth considering other sectors such as bio-energy or student accommodation as appropriate diversifiers from a wind and solar centric strategy;

• A £100m investment programme in these sectors could deliver an annual surplus of £3.3m, or £10m over 3 years and £17m over 5 years on a cumulative basis respectively. Similarly, a £350m investment programme is projected to deliver an annual surplus of £12m or c.£60m cumulatively over a 5-year period;

• There are a number of ways to access the infrastructure asset class. Most institutional investors focus on unlisted infrastructure through closed-end funds while some also consider co-investment and direct investment. Given the potential for a very bespoke set of investment parameters (e.g. tenor of investments, limited leverage, types of sub-sector), a pooled fund solution is unlikely to meet LBTH's requirements, while direct investment requires a lot internal resource to successfully execute and manage transactions;

• Where there is opportunity for a Local Authority to participate in such transactions, while also adhering to its regulatory guidelines, co-investments could be a potential avenue for consideration. Another potential route to accessing real asset investments would be to identify a suitable investment manager to source specific transactions. This is particularly relevant where an investor has a bespoke set of investment criteria (e.g. tenor, sector, returns etc.). By having a framework agreement in place with a preferred investment manager, LBTH may be able to deploy capital more speedily and be assured that all transactions would be structured in a way that meet its requirements.

Next Steps

• Subject to consensus, the appointment of a Mayoral Advisor for Community Wealth, LBTH to update its community wealth building strategy to allow for real asset investment whilst remaining compliant with the Prudential Code;

• Evaluation of capacity to access external borrowing to fund a real asset investment programme;

• LBTH to agree on key parameters for a real asset programme (e.g. size, target sectors and returns, etc.); and

• LBTH to agree the best route to access real asset investments.

Picture: Crisp Street Market, © ceridwen.

3. Income Generating Activities by Local Authorities

According to a recent study by Grant Thornton, English local authority service-based income increased by 4.1% between 2013/14 and 2015/16. By region, the East Midlands had the most notable increase in income at 11.5 per cent, followed by the West Midlands (8.7%) and South West (8.4%).

Local Authorities are seeking to become more commercial and generate income in a variety of ways. Approaches to income generation include:

a) Fees and charges: car parking, household garden waste, private sector use of public spaces;
b) Asset Management: utilities, personnel, advertising and Wi-Fi concession license;
c) Company spin-offs: housing, energy, local challenger banks; and
d) Treasury investments: real estate development, green energy, equity.

2016 was a landmark year for income generation by Local Authorities. Alongside income generation by Local Authorities having increased since 2013/14 by 4.11%, by the second quarter of 2016, less than half (48%) of all treasury capital was kept in banks; a significant contrast to a level of 72% in 2008/09. UK Local Authorities are increasingly choosing to hold part of their assets in property and equity. For instance, in terms of real estate development, local authority property deals were on track to break the £1 billion barrier. This is also reflected in DCLG financial data on English local government investments, which shows a year-on-year increase over the past five years to a high of over £36 billion in 2016/17.

Councils are now striving to generate income in a way which achieves multiple strategic outcomes for the same spend; examining options to balance budgets while simultaneously boosting growth, supporting vulnerable communities and protecting the environment.

Case Study 1: Swindon Solar Farm

The London Borough of Newham is one of four councils jointly investing £60 million in a solar energy farm in Wroughton which will deliver a 6% return by generating enough green electricity to power 12,000 homes. HSBC will pay to take power from the site as part of a 15-year agreement. Instigated and coordinated by Warrington Borough Council, the scheme Rockfire Capital is attractive to Newham, Thurrock, Warrington and a fourth silent council partner as it not only aligns to statement of investment principles for ethically-responsible investment in commercially-viable projects, but also because the four investing councils are able to lower the transaction cost by sharing fees paid for due diligence, thus increasing the profit margin.

Case Study 2: Cheltenham Property Purchase and Lease

Cheltenham Borough Council bought 60,000 sq. ft of commercial property for £14m which included a head lease which expires in 2023, generating annual rent of £1.3m and an annual investment return of 9%. The acquisition was financed through a combination of both internal borrowing and PWLB loans. The building will ultimately allow the council to relocate their headquarters in 2023 and facilitate the redevelopment of their current offices, which are in a prime town centre location, for mixed use development. The redevelopment aims to enhance Cheltenham's offering for residents and visitors; deliver additional jobs; business rates and rental income to support the council's budget and make a significant contribution to the local economy. The council is now exploring options to deliver the relocation and redevelopment earlier than 2023. Office development is one of a wider portfolio of treasury investments by the council, which also includes for instance, joint share ownership of Gloucestershire Airport Ltd.

The remainder of this paper will focus on asset-backed ("real assets") treasury investments and how LBTH can capitalise on current opportunities in the market to meet its strategic objectives by undertaking such investments.

4. The Regulatory Environment for Treasury Investments

4.1 The Prudential Code

The Prudential Code plays a key role in capital finance in Local Authorities. Local authorities determine their own programmes for capital investment that are central to the delivery of quality public services. The Prudential Code was developed by CIPFA, the Chartered Institute of Public Finance and Accountancy, as a professional code of practice to support Local Authorities in taking their decisions. Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties.

The Local Government Act 2003 requires councils to follow the CIPFA Prudential Code for Capital Finance. The objective is that statutory Section 151 officers – council CFOs – prudently invest the funds held on behalf of their communities. The guidance recommends that authorities should prioritise the highest rate of return for borrowing and investments according to security, liquidity and yield – in that order. However, what one council interprets as best value to communities may differ to another council.

4.2 Statutory Guidance on Local Government Investments

Financial investments can fall into one of three categories:
1. Specified investments;
2. Loans; and
3. Other Non-specified investments. Based on the definitions of the three categories, asset backed investments would be classified as "Other Non-specified investments."

For non-specified investments, the local authority's community wealth building strategy ("Strategy") should:

• Set out procedures for determining which categories of investments may be prudently used;
• Identify which categories of investments have been defined as suitable for use; and
• State the upper limits for the maximum amounts both individually and cumulatively that may be held in each identified category and for the overall amount held in non-specified investments and confirm that investments made have remained within those limits.

4.3 Risk Assessment

The Strategy should state the local authority's approach to assessing risk of loss before entering into and whilst holding an investment.

4.4 Liquidity

For financial investments that are not treasury management investments or loans the Strategy should set out the procedures for determining the maximum periods for which funds may prudently be committed and state what those maximum periods are and how the local authority will stay within its stated investment limits.

4.5 Proportionality

Where a local authority is or plans to become dependent on profit generating investment activity to achieve a balanced revenue budget, the Strategy should detail the extent to which funding expenditure to meet the service delivery objectives and/or place making role of that local authority is dependent on achieving the expected net profit. In addition, the Strategy should detail the local authority's contingency plans should it fail to achieve the expected net profit.

The assessment of dependence on profit generating investments and borrowing capacity allocated to funding these should be disclosed as a minimum over the life-cycle of the Medium-Term Financial Plan. However, an assessment of longer term risks and opportunities is recommended.

4.6 Borrowing in advance of need

Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.

Where a local authority chooses to disregard the Prudential Code and this Guidance and borrows or has borrowed purely to profit from the investment of the extra sums borrowed the Strategy should explain:

• Why the local authority has decided not to have regard to this Guidance or to the Prudential Code in this instance; and
• The local authority's policies in investing the money borrowed, including management of the risks, for example, of not achieving the desired profit or borrowing costs increasing.

4.7 Examples of how other Local Authorities address "borrow in advance of need"

Based on analysis from those familiar with public sector budgeting processes, borrowing in advance of need is permissible if there is a pre-agreed program for capital expenditure so if there is known expenditure due in the medium term then Local Authorities are able to borrow now to benefit from the low interest rate environment to fund future requirements.

Analysis of investment strategies published by other Local Authorities points to a number of ways this issue is addressed to mitigate any breach of the Prudential Code:

Case Study 1: Spelthorne County Council

"Investment of Money Borrowed in Advance of Need: The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long-term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks."

Case Study 2: Warrington Borough Council:

"In determining whether borrowing will be undertaken in advance of need the Council will:

• ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio, which supports the need to take funding in advance of need;

• ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;

• evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;

• consider the merits and demerits of alternative forms of funding;

• consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use;

• consider the impact of borrowing in advance (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk and the level of such risks given the controls in place to minimise them.

• Any risks will be reported through the midyear or annual reporting mechanism."

4.8 Latest LBTH Treasury Management Statement

According to the latest LBTH Treasury Management Strategy Statement, the Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. On this basis, it would appear that LBTH has over £1bn of capital that it can deploy to make investments over coming years, as summarised in the table below. By articulating this expected investment profile, LBTH should be able to mitigate any risk of breaching the prudential requirement of not borrowing in advance of need.

Table 1: LBTH Treasury Management Statement 2018/19

Year End Resources	2016/17 Actual	2017/18 Projected Outturn	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Expected Investments	£381.4m	£450m	£350m	£350m	£300m

Source: https://democracy.towerhamlets.gov.uk/mgIssueHistoryHome.aspx?IId=76647

The Council currently has a £100m limit for investments invested for longer than one year and it has been recommended that this figure should be increased to £150m.

The credit criteria for non-specified investments made by LBTH is set out below:

Table 2: LBTH Short-Term Investments

Non-Specified Investments	Fitch Long term Rating (or Equivalent)	Time Limit	Monetary Limit
Term deposits – Banks and Building Societies	Short-term F1, Long-term A-	5 years	As Term Deposits in table 7.15 above
Structured Deposits: Fixed term deposits with variable rate and variable maturities	Short-term F1, Long-term A-	5 years	As Term Deposits in table 7.15 above
Registered Social Landlord	Short-term F1, Long-term A-	5 years	As Term Deposits in table 7.15 above
Part Nationalised or Wholly Owned UK Banks	N/A	5 years	£25m
Local authorities, parish councils, Police and Fire Authorities	N/A	5 years	£25m
Certificates of Deposits, Commercial Paper and Asset Backed securities	Short-term F1, Long-term A-	5 years	As Term Deposits in table 7.15 above
Corporate Bonds & Loans, FRNs and Covered Bonds	Short-term F1, Long-term A-	5 years	As Term Deposits in table 7.15 above
Pooled Funds	AAA	5 years	£10m
UK Government Gilts	N/A	5 years	100% of Investment Portfolio

Source: https://democracy.towerhamlets.gov.uk/mgIssueHistoryHome.aspx?IId=76647

At present, the criteria for non-specified investments does not have sufficient flexibility to allow for making asset backed investments. In order to maximise access to suitable asset backed treasury investments, LBTH may wish to consider expanding its criteria for non-specified investments. For example, Warrington Borough Council ("WBC"), which is a seasoned investor in property and green energy and has the following criteria in place for non-specified investments.

Table 3: Warrington Borough Council Treasury Management Statement 2018/19

	Minimum 'High' Credit Criteria	Maximum Individual Limit	Maximum Group Limit	Maxim Maturi Period
Term deposits – local authorities and other public institutions		£5m	£50m	5 years
Term deposits – banks and building societies		£1m	£5m	5 years
Certificates of deposits issued by banks and building societies	UK sovereign rating	£5m	£20m	5 years
UK Government Gilts	UK sovereign rating	£5m	£50m	5 years
Bonds issued by multilateral development banks	AA	£5m	£20m	5 years
Corporate bonds	Short term F2 Long Term A-	£10m	£20m	10 yea
Green Energy Bonds	Internal Due Diligence	£100m	£200m	10 yea
Collateralised Term Deposit	Local Authority	£5m	£20m	5 years
Sovereign bond issues (i.e. other than the UK government)	AA	£5m	£20m	5 years
Property Bonds		£20m	£50m	5 years
LiveWire Community Energy		£1m	£1m	20 yea
~~Funding Circle~~		£10m	£10m	5 years
Asset Backed Securities	Internal Due Diligence	£20m	£100m	10 yea
Asset Backed Pooled Funds	Internal Due Diligence	£10m	£50m	10 yea

Source: https://www.warrington.gov.uk/downloads/file/15356/treasury-management-strategy-2018-19

4.9 Key regulatory considerations when implementing a treasury funded investment programme

Based on the analysis set out above, it may be worth considering the following ahead of implementing a treasury funded investment programme:

• Existing community wealth building strategy: in view of the example of WBC and existing drafting of non-specified investments, LBTH may wish to consider the parameters of its non-specified investments to allow for greater investment in real assets. In addition, it may wish to consider expanding on how it intends to comply with the principle of "borrowing in advance of need" and how it plans to mitigate any non-compliance should that arise;

• Borrowing capacity: where LBTH is considering external sources (e.g. PWLB) to fund an investment programme in real assets, it may wish to work with its Treasury adviser to assess the headroom to do so as well key parameters such as optimal sources and tenor of such borrowing

• Structure of investment: security, liquidity and yield (in that order) are the key priorities of any investment under the CIPFA Prudential Code. Liquidity would be captured in any exit options analysis performed at the time of investment while yield is a key driver of the investment programme. In order to demonstrate strong compliance with the CIPFA Prudential Code, LBTH may wish to consider structuring all of its investments via debt instruments in projects that have no other external borrowing (i.e. unlevered projects). Debt instruments that pay a fixed coupon would minimise any volatility associated with making an investment and can be sized so that the rate of interest payable would imply a very conservative set of outcomes being achieved (i.e. wind resource, solar irradiation levels, etc.) while also allow for equity-like upside for any out-performance.

5. Potential Sectors for LBTH to Target for Investment

5.1 The attraction of "real asset" investments

A defining characteristic of real assets is that they are "hard" or "tangible" assets and provide ownership of a store of value. They tend to preserve value in inflationary environments and they can also serve as a diversifier within a growth portfolio, as a result of an expected lower correlation to equity-like asset classes. Given current valuation levels, traditional fixed income investments are less attractive to investors as income-generating assets, and uncertainty remains in equity markets — strengthening the case for real assets in portfolios. More importantly, for Local Authorities looking to fund their strategic objectives while remaining in compliance with their regulatory requirements, real asset investments have proven to be an attractive source of predictable income that can be funded via borrowing.

5.2 Property investments

Many Local Authorities have invested in commercial real estate in order to fund their strategic priorities. A notable recent example is the case of Spelthorne County Council ("Spelthorne CC"), who have invested over £650m in commercial real estate, including notably the acquisition of the BP campus located in Sunbury-upon-Thames for £382m. The table below summarises the investments made to date net revenue surplus available to support services. This net surplus equates to c.1% of total capital invested.

Table 4: Spelthorne County Council, Property Investments

	Purchase Cost incl SDLT & fees	Gross Initial Annual Rental	Net initial Yield	Initial Lease length (WAULT)	Initial Full Year financing Cost	First full year set aside for mgt & refurb provision	Initial net Revenue Surplus availabe to support Services
	£	£	%	Yrs	£	£	£
Commercial Investment Assets							
Completed							
BP Main Campus	381,532,600	15,666,000	4.12%	20	-11,785,753	-550,000	3,330,247
BP South West Corner	28,288,142	1,905,000	6.78%	12	-1,022,202	-150,000	732,798
Elmbrook House	7,579,100	477,000	6.35%	10	-99,087	-50,000	327,913
3 Roundwood Avenue*	22,766,190	1,426,000	6.26%	10	-817,988	-130,000	478,012
12 Hammersmith Grove	179,067,914	9,530,865	5.32%	13	-6,255,221	-1,125,000	2,150,644
WBC4	49,148,758	2,446,958	4.98%	15	-1,702,575	-200,000	544,383
Total above	**668,382,704**	**31,451,823**	**4.71%**		**-21,682,827**	**-2,205,000**	**7,563,996**

Source: Spelthorne County Council, 2018

According to Spelthorne CC investment guidelines, "preference is given to investing within borough, or in an adjoining area that is economically important to Spelthorne (for example Heathrow/areas immediately south of Staines Bridge). Properties outside this preferred area should represent a lower risk and higher return." While property investments could be a potential option for LBTH investment, a couple of factors worth considering are:

• Given its proximity to the prime central London market, LBTH is likely to encounter a lot of competition when acquiring assets that will compress returns; and
• Proposed government guidelines that will make it difficult for Local Authorities to borrow and invest in income generating property investments outside of their local area.

On this basis, commercial property related investments are unlikely to offer adequate returns to fund its strategic objectives. However, micro opportunities might arise in the Borough, meeting financial and strategic objectives of LBTH, for example the proposed retail development at Chrisp Street.

5.3 Infrastructure investments

Infrastructure investments typically provide investors with certainty through exposure to assets that boast long lifespans, low ongoing operational costs and secure contracts that often include inflation-linked pricing. Infrastructure can provide many benefits; from lower volatility to defensive characteristics emanating from the provision of essential services and inflation protection given the nature of the underlying contracts.

Notwithstanding the similarities between infrastructure and real estate as "real assets", there are several key differences between the two asset classes. In developed markets, most infrastructure assets are held by governments and other public entities, and the private market is smaller and less mature than that of real estate. Infrastructure assets such as water treatment facilities, bridges, and power grids, operate locally and play an important role in local communities. Thus, infrastructure assets are highly visible, often regarded as community assets, and as a result, in many cases subject to greater governmental regulation and intervention. In real estate, the same is only true for iconic buildings, such as those with a strong cultural heritage, and certain urbanisation projects. These characteristics increase the complexity and costs associated with investing in and managing infrastructure assets compared to real estate.

5.4 The infrastructure risk reward spectrum

Assets are commonly grouped according to their overall risk profile, as illustrated in the diagram below. Some assets, such as electricity and gas distribution networks, can be regulated, which can lead to an increase in return predictability. Depending on the regulation, assets can be volume neutral, offering returns that are independent of volumes and demand fluctuations. The economic cycle can have more impact on unregulated services, such as airports and seaports, though the essential nature of such services mitigates this risk. As a general rule, when looking at different infrastructure asset types, it could be stated that the stronger and more predictable the regulation and contractual framework, the closer the asset type is to "core infrastructure"

Infrastructure assets are also categorised according to their stage of development. Greenfield investing relates to projects in their early stages in which assets are yet to be constructed. Brownfield assets, on the other hand, are established assets with some degree of operational maturity. Greenfield assets, given uncertainties around construction, financing and demand, are typically higher up the risk reward spectrum, but can provide ample premium to their brownfield counterparts if successful.

Indeed, given the strategic objective associated with this investment for Local Authorities, it would be advisable to consider investments that are operational and "core" in nature – i.e. demonstrate stable performance and are yield generating in nature. The table below summarises areas of the core infrastructure space that could come under consideration for investment and their level of attractiveness.

Based on this analysis, renewable energy, bio-energy and student accommodation assets could be attractive sectors for LBTH to consider for investment to fund its strategic objectives. Deal sizes in each sub-sector vary in size and it is likely that most investment opportunities will remain in wind and solar sectors. Nevertheless, it is worth considering other sectors such as bio-energy or student accommodation as appropriate diversifiers from a wind and solar centric strategy.

Table 5: Relative Attractiveness of UK Infrastructure Sectors

Sector	Description	Project Returns	Attractiveness
Onshore wind and solar	• Such projects are supported by long term power purchase agreements and/or revenue support mechanisms such as Feed-in-Tariffs or Renewable Obligation Certificates • Cash flows have a strong inflation linkage • Strong visibility on revenues and as the industry has matured, better technical insight on the quality of renewable resource (i.e. wind/irradiation) available at each site • Positive from an ESG perspective	5 - 7%	HIGH
Offshore wind	• Similar revenue characteristics to onshore assets, though better predicatability of resource quality for offshore sites and greater opportunities for upside • Most assets being traded still have access to government revenue support with strong visibility over revenue • Positive from an ESG perspective	6 - 8%	HIGH
Energy from waste plants Anaerobic digestion plants Biomass plants	• Revenue for each site is typically derived from: • "gate fees" agreed on fixed price, long-term contracts with commercial companies for processing waste; • fees for supplying electricity or gas directly into the national grid (AD only). Electricity prices will be supported by FITs or ROCs; and • renewable heat incentives and potentially through the proposed renewable transport fuel obligation • Positive from an ESG perspective	8 - 10%	HIGH

Note: Returns relate to UK assets and are prior to paying any fees or interest to fund such investments. Returns relate to operational projects

Sector	Description	Project Returns	Attractiveness
Student Accommodation	• The number of students in higher education in the UK increased from 1.5m in 1997 to 2.27m in 2017. In that timeframe, student's expectations of their accommodation has also increased • Potential opportunity to participate in transactions involving "on-campus" sites at leading Russell Group universities, where demand is very "sticky" in nature • Potential risk around investing in property outside of local area	5 - 6%	MEDIUM
Transport leases	• Opportunity to acquire ancillary infrastructure on the rail network (e.g. rail depots) that serve the commercially run train companies • Scarcity of deal flow could present an issue. Best opportunities likely to be in greenfield	5 - 6%	MEDIUM
Regulated utilities	• Includes electricity and gas networks and water companies. Effective monopolies with returns set by an independent regulator • Increasing regulatory uncertainty may dampen returns in the near future, which have been driven down considerably by the wall of pension and sovereign wealth fund capital that has targeted the sector • Potential political sensitivity of investing in high profile regulated assets such as water companies or electricity transmission companies	4 - 6%	LOW
Social infrastructure - PFI	• Availability based payments from government backed counterparties for operation and maintenance of social infrastructure assets (e.g. schools and hospitals) in the local community • Given political sensitivities around PFI and revenue being derived by local authorities, this would not be a suitable sector to consider • Given that we are a Labour authority, this is a no go area.	5 - 7%	LOW

5.5 Illustrative financial returns of an infrastructure investment

The tables below sets out the key parameters for a £50m investment in an infrastructure project funded by borrowing from the PWLB. Some key features of the investment are set out below:

Tenor: renewable and bio-energy assets are considered finite life in nature (though there may be opportunities to extend them in the long run) and most investors assume a 20-25-year life for these assets. Given that LBTH may fund an infrastructure investment with borrowing from the PWLB, it is recommended that investments are made on a 5-6 year buy and hold period. This would allow LBTH to access lower cost PWLB financing maturing over a shorter term and also exit investments either close to or at a premium to their cost;

Cost of borrowing: based on the 6-year rate for PWLB funding;
Project yield: 6%, based on a conventional renewable energy asset such as onshore wind or solar;

Manager fees: for prudence a deduction of 0.75% has been assumed for fees charged by an investment manager;

Net yield: This represents the residual return available to LBTH after financing an investment and paying an asset management fee; and

Capital appreciation at exit: This represents the potential uplift that could be realised upon exiting the asset. Based on feedback from investment managers, most investments see an uplift in value of 0 – 20% over the first 5-6 years so for prudence a 10% uplift has been assumed.

Table 6: Key Assumptions

Size of Investment	£50 million
Tenor (years)	6
Cost of borrowing	1.9%
Project yield	6%
Manager fees	0.75%
Net yield	3.35%
Capital appreciation at exit	10%

Table 7: Infrastructure Investment – Illustrative Cash Flow Profile

Year	1	2	3	4	5	6
Consideration	(£50m)					
Annual yield (net) 3.375%	£1.675m	£1.675m	£1.675m	£1.675m	£1.675m	£1.675m
Exit Flag						1
Exit Receipt						£55m
Net cash flow	(£48.325m)	£1.675m	£1.675m	£1.675m	£1.675m	£56.675m
Cumulative Yield	£1.675m	£3.350m	£5.025m	£6.700m	£8.375m	£10.050m
Upside from capital appreciation	£5m					
Total cash flow generated over investment	£15.050m					
Internal Rate of Return (IRR)	5.9%					

The table above sets out an illustrative cash flow profile for a £50m investment in an infrastructure project that is divested at the end of year 6. Based on the assumptions set out above, an annual yield of £1.7m is generated after funding costs and management fees. Together with a 10% uplift in value upon exit, c.£15m could be generated to fund LBTH's strategic objectives as a local authority. The table below presents an analysis of total cash generated for LBTH by sensitising for capital appreciation and project yield assumptions.

Table 8: Cash Flow Generation on £50m Investment

Capital Appreciation	Projected Yield					
	5.0%	6.0%	6.5%	7.0%	7.5%	8.0%
0%	7,050	10,050	11,550	13,050	14,550	16,050
5%	9,550	12,550	14,050	15,550	17,050	18,550
10%	12,050	15,050	16,550	18,050	19,550	21,050
15%	14,550	17,550	19,050	20,550	22,050	23,550
20%	17,050	20,050	21,550	23,050	24,550	26,050

5.6 Sizing an investment programme to meet LBTH's strategic objectives

The table below sets out the annual revenue surplus that could be generated depending on the size of an investment programme.

Table 9: Impact of Programme Size on Annual Revenue

Programme size	Annual revenue	Cumulative revenue - 3 years	Cumulative revenue - 5 years
£50m	£1.675	5.025	8.375
£100m	£3.350	10.050	16.750
£200m	£6.700	20.100	33.500
£350m	£11.725	35.175	58.625
£500m	£16.750	50.250	83.750

6. Implementing a Real Asset Investment Programme

6.1 Potential access routes

There are a number of ways to access the infrastructure asset class. Most institutional investors focus on unlisted infrastructure through closed-end funds while some also consider co-investment and direct investment.

6.2 Direct investment

Investing directly into infrastructure assets is an attractive option to large institutional investors with significant in-house resource as fund manager fees are bypassed and assets can be better selected, managed and tailored to the needs of the user. Direct investments require the investor to be involved in all aspects of the investment process, including, deal sourcing, due diligence, valuation, execution and ongoing asset management. Whilst this may be the optimal route to access the asset class, it can take several years for an institutional investor to build out their internal capability (and the associated complex governance structure), requiring a significant initial investment. Only very large investors have the financial strength or staffing resources to pursue separate accounts or direct transactions — though the largest, most sophisticated investors are deploying significant amounts of capital directly, usually into core brownfield projects. Indeed, even the largest direct investors in the asset class today have reached this position after many years of investments via funds and tend to invest directly only in their local market or in a market where they have their own dedicated resource.

6.3 Closed-ended fund investment

Closed-ended funds have been the vehicle of choice for most investors investing in infrastructure fund via a co-mingled strategy and are the largest and deepest sector of institutional investor interest. Like private equity funds, these funds are highly illiquid, which can provide downside protection during risk-off market events. The lack of liquidity can allow portfolio managers to focus on assets with superior long-term risk adjusted returns, aligning themselves with the lengthier time horizons of their institutional client base. Whilst liquidity may be limited between the fund and the investor, an investor may look to sell the fund in the (ever-deepening) secondary market to another institutional investor.

Given the potential for a very bespoke set of investment parameters (e.g. tenor of investments, limited leverage, types of sub-sector), a pooled fund solution is unlikely to meet LBTH's requirements.

6.4 Co-investment

The infrastructure co-investment opportunity is also developing quickly. For direct managers, co-investment capital can be an attractive form of additional financing, particularly for capital intensive infrastructure projects. Offering co-investment opportunities also enables them to build more strategic relationships with their investors.

For the co-investors themselves, these opportunities can offer the potential to be more targeted in portfolio construction, capitalise on specific market opportunities as they arise, and build direct exposure to a selection of quality assets while still maintaining manager diversification. Additionally, the lead investor typically charges a much lower management fee for external co-investment capital. Industry experience has shown a number of instances where fund managers may wish to sell down part of their ownership in renewable energy investments from their pooled funds to external investors to minimise concentration limits of funds (e.g. too many wind assets or too much UK). These are known as syndications and are not subject to same level of bid-risk as live transactions that are subject to competitive forces and bid deadlines.

Most investment managers have a long-term investment horizon and target assets that have bank debt in their capital structure. As a result, the investments that they make carry more traditional "equity-like" risk. Where there is opportunity for a Local Authority to participate in such transactions, while also adhering to its regulatory guidelines, this could be a potential avenue for consideration. Bespoke Investment Consulting Service would be able to support LBTH in identifying suitable opportunities to invest alongside investment managers in pursuing suitable transactions.

6.5 Customised solution

Another potential route to accessing real asset investments would be to identify a suitable investment manager to source specific transactions. This is particularly relevant where an investor has a bespoke set of investment criteria (e.g. tenor, sector, returns etc.). By having a framework agreement in place with a preferred investment manager, LBTH may be able to deploy capital more speedily and be assured that all transactions would be structured in a way that meet its requirements, rather than receiving a smaller proportion of deal flow that meets its requirements as set out under the co-investment scenario. Moreover, by having some (though by no means full) certainty on investor participation, the investment manager would be incentivised to provide deal flow for the investor.

Governance is an important part of any customised solution and articulating an investment agreement on key investment parameters is important at initiation of any such relationship. Some investors even retain veto rights on transactions to ensure that the investment manager doesn't have full discretion on transactions. Should LBTH wish to have such an arrangement in place with an investment manager, it should consider delegating the authority to a sub-group that is able to act nimbly with only reserved matters (e.g. removal of investment manager, addition of a new asset class) being considered at the wider level. Bespoke Investment Consulting Service would be able to support in the sourcing and selection of investment managers as well as evaluating transaction opportunities as and when these arise.

6.6 Customised solution – ticket size

Economies of scale that are present with the pooling of investor capital do not occur in a separate account. Separate accounts, therefore, tend to be pursued by institutional investors with the capital available to engage in sizeable investments. Based on industry proprietary information, the median size for a separate account in infrastructure stood at over $500m, which is significantly higher than a typical single fund commitment made by an investor. Most UK based investment managers would have minimum requirement for at least £100m to consider a separately managed account solution. Note, that all of these funds would be drawn down by the manager piecemeal as and when suitable investment opportunities are secured as opposed to on a "lump-sum" basis.

7. End Notes

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