Appendix F

Further CIFCO Investment – Stress Test

1. Budget Assumptions

1.1. The projected total net returns to each Council over the next four years, from a further investment of £25m, are £1.9m. Further details of the assumptions used and the interest receivable and payable are set out below:

	2019/20 (Year 1)	**2020/21** (Year 2)	**2021/22** (Year 3)	**2022/23** (Year 4)
Investment Balance at period end	£12.5m	£25m	£25m	£25m
Council loans to fund investments				
Short term loans @ 1.25%	£12.5m	£25m	£2.5m	£2.5m
PWLB 10 Year loan @ 1.96%			£10m	£10m
PWLB 50 Year loan @ 2.88%			£12.5m	£12.5m
Interest Receivable 5% (From CIFCO)	(£0.307m)	(£0.865m)	(£1.116m)	(£1.110m)
Interest Payable	£0.089m	£0.261m	£0.590m	£0.569m
Net Return	**(£0.218m)**	**(£0.604m)**	**(£0.526m)**	**(£0.541m)**
Rate of Return %	**1.74%**	**2.42%**	**2.10%**	**2.17%**

Note: *All long-term loans are Annuity loans (each loan payment is made up of an element of principal repayment and interest) The investments have been profiled in 12ths until fully invested at the end of 2020/21, when the PWLB loans will be taken out.*

2. Interest Payable – Council Borrowing Rate

2.1. Whilst the rates forecast above allow for an increase in the base rate this could increase or decrease before the borrowing is required, depending on the future economic conditions. PWLB rates change daily and once loans are arranged the rates will be fixed for the term of the loan.

1% movement (increase or decrease) in interest rate per Council:

Short term borrowing

Year 1 – £67k increase or decrease to the £89k above
Year 2 – £192k increase or decrease to the £261k above
Year 3 – £25k increase or decrease to the £590k above

PWLB borrowing

From Year 3 – £225k per annum increase or decrease to the £590k above

3. Interest Receivable – Repayment from CIFCO

3.1. The loans between the Councils and CIFCO assume that the interest payable is calculated at 5% on an annuity basis and is underpinned by a signed loan agreement. However, if this were to decrease or increase through a revised loan agreement, it would have the following impact:

Loan rate decrease from 5% to 4%:

When fully invested this would result in a **loss of income per Council of £225k per annum.**

Loan rate increase from 5% to 5.5%:

5.5% is currently seen as the maximum that the loan could be increased to if the yield on the further £50m investment matches that of the current portfolio of properties. When fully invested this would result in **additional income per Council of £112k per annum.**

4. <u>Risks</u>

4.1. The information below relates to the initial investment in CIFCO of £50m, as this is the Councils experience to date. The investment principles that were established for the original £50m are regularly reviewed and updated to reflect the current market conditions e.g. deciding to move away from retail investments. It is anticipated, that should the additional £50m be agreed, that it would be invested in a similar way and hence the risks and numbers outlined below would apply equally.

4.2. The weighted unexpired (lease) term across the current CIFCO portfolio is currently 9 years and 2 months. There are currently 10 assets and 32 tenants. 87% of the portfolio is core long-let liquid assets with 13% of the portfolio being core plus assets.

4.3. The covenant strength of tenants is assessed prior to the acquisition of assets and on a quarterly basis thereafter. A RAG status is applied. 88% of the fund's income is currently attributed to "strong" covenants. In the event that a tenant's covenant weakens this will be monitored to determine whether this is a permanent trend, enabling appropriate action to be taken.

4.4. Should a loss of rental income occur through a void, this should not directly affect the Councils' returns as voids are dealt with by CIFCO using their own cashflows. CIFCO is building resilience within the company to address voids including any associated empty business rates and security costs. There are not currently any voids and in the short term only very small voids are expected for units such as Olympus Close. The impact of a void on CIFCO depends on the unit that becomes vacant. Across the 32 tenants, from investment of the first £50m, the rents vary from £7k to £413k p.a. with 8 being greater than £100k p.a. and 5 being greater than £300k p.a.

4.5. The Councils have security over the assets in the form of a mortgage on the properties, therefore should the company fail to make the agreed loan repayments, the Council would be able to take ownership of these assets and consequently benefit directly from any income derived from the properties or alternatively could sell the asset to cover their loan obligations. Of course, this is a last resort, and the Council would work with the company to explore alternatives.

4.6. If the company were to fail and the Councils took ownership of the assets to benefit from the rental income, each Council would receive approximately. £1.3m in rental income compared to the £1.110m that is currently received in loan interest. Based on the average across the whole portfolio, the voids would need to reduce total rental income by nearly 15% before it would fall below the current level of loan interest and by more than 54% before the borrowing costs could not be covered. To illustrate an extreme scenario, the single largest property in terms of rental income represents just under 16% of the total rental income, so would have the largest impact on total rent received. If this property was vacant for a whole year the income received by the Council would drop slightly below the budgeted level of loan interest. As outlined in 4.4 above, only small voids are anticipated due to the strong covenants that are sought by the CIFCO Board before making investments.

4.7. The assets acquired will be held on CIFCO's balance sheet, therefore any increase or decrease in the valuation of these assets will have no direct financial impact on the Councils and will only affect CIFCO if the company is forced to sell the assets.

4.8. The larger fund of £100m, if the additional £50m is approved, offers more resilience against the identified risks e.g. one or more voids in a £100m fund has a smaller impact than the same voids in a £50m fund.

5. Reserves

5.1. Should any of the above scenarios occur which have a negative impact on the returns to the Councils, reserves could be used in the short-term whilst alternative actions are taken to address any shortfall.

5.2. Babergh has a general fund reserve of £1.2m as well as forecast earmarked reserves of £1.9m as at the end of 2019/20.

5.3. Mid Suffolk has a general fund reserve of £1.052m as well as forecast earmarked reserves of £10.2m as at the end of 2019/20.

5.4. Using the figures from the scenarios in sections 2, 3, and 4 above, the level of general fund reserve for each council could withstand the combined one year impact of a 1% increase in PWLB borrowing (£225k), a 1% decrease in the interest rate charged on the loans to CIFCO (£225k) and the largest property by rental income being void for a whole year (£413k). It is highly unlikely that this extreme set of circumstances would all materialise in the same year.

6. Section 151 Officer Conclusion

6.1. Based on the information set out above and using the experience to date from the initial £50m investment, the advice that CIFCO receives in terms of how it decides upon and monitors investments and the level of general fund reserves, I believe that a further investment of £25m for each Council represents a considered, proportionate and manageable risk for the Councils to take in order to generate additional income to support frontline services.

Katherine Steel
Section 151 Officer
February 2019