WMCA Board

Date	22 March 2019
Report title	WMCA Commercial Fund Extension
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Report has been considered by	18 February 2019 - WMCA Investment Board 8 March 2019 - WMCA Programme Board

Recommendation(s) for action or decision:

The WMCA Board is recommended to:

(1) Approve the implementation of a new £70 Million investment fund targeted towards the residential sector as detailed within this report.

(2) Approve a £70 Million extension of the existing £70 Million Commercial Investment Fund (total £140 Million) targeted towards the commercial sector as detailed within this report.

(3) Approve the characteristics of each fund as summarised in Section 3.

(4) To agree that the funds are operated by West Midlands Development Capital as outlined within this report, subject to the Combined Authority and West Midlands Development Capital coming to an agreement on fee levels as detailed in Section 4.

(5) Delegate authority to the West Midlands Combined Authority, Head of Governance and the Director of Housing & Regeneration to agree the fee payable to West Midlands Development Capital for fund management services, following the extension to the commercial funds, as detailed in Section 4.

1. Purpose

1.1 For the West Midlands Combined Authority Board to review and agree proposals to increase the existing investment funds which operate on a commercial basis.

1.2 For the West Midlands Combined Authority Board to agree to commission West Midlands Development Capital to operate the funds on the Combined Authorities behalf, as documented within this report.

2. Background

2.1 On 10 June 2016, the Combined Authority Board approved the establishment of a £70 Million Collective Investment Fund (CIF). The essence of the fund is essentially to seek out economic regeneration opportunities to bring forward schemes which require financing that is typically not considered a priority investment by mainstream lenders.

2.2 Lending is provided to developers from the CIF at commercial rates reflecting the level of risk within each transaction and the loans are typically be repayable after between 12 to 24 months. The returned funds are then re-invested in new proposals resulting in an evergreen investment fund. The fund was a key component of the 2016 devolution deal with the Government and was expected to fund £1 billion of investments through this revolving facility.

2.3 The existing fund remains capped at £70 Million as a committed value, meaning the value of loan commitments will never exceed £70 Million against the fund and the drawn value (i.e. the amount out with developers) will typically be much lower. Each transaction will carry a unique set of risks and opportunities for the Combined Authority. The credit risk is generally covered in full or part by the Combined Authority having a charge over the assets. Although residual risks will always remain, Investment Board review each individual proposal and must be satisfied that adequate risk mitigation and / or security is in place prior to the investment being approved.

2.4 The existing fund was committed to the value of £56.2 million as at 15 December 2018 with loans drawn of £26.1 million. Four investments have already been repaid and as such, the fund is starting to revolve as originally intended. The interest rate against the existing loans ranges 4.5% to 10% with 6% being a typical average. The Combined Authority are able to fund these loans using debt financing from PWLB, typically at rates of under 2% for 24 months. As such, the fund delivers a net contribution to the Combined Authority (currently over £1 million) through this differential in interest rates which covers the cost of West Midlands Development Capital operating the fund. The net contribution is used to supplement the Combined Authority revenue budget and hold down constituent and non-constituent contributions.

2.5 For information the investments made are on track to deliver the following outputs;

- 2,528 new jobs being created
- 62.54 acres of brownfield land regenerated
- £58.5m of initial private sector leverage
- 1,245,683 sq ft of new commercial space
- £3,798,972 of new business rates
- 4 investments fully repaid totalling £17.28m

- No provisions or adverse trends shown in portfolio

2.6 Due to the success of the fund, the KPIs, Deliverables and Strategic Objectives agreed by the Combined Authority with Government in its March 2018 Housing Deal and by the Housing and Land Board in December 2018, it is proposed to increase the size of the existing fund from £70 Million to £140 Million and roll out an additional investment fund totalling £70 Million which operates on a similar basis but with a focus on the residential sector. This recommendation is supported by evidence from existing fund managers that there is strong demand for an extension to the fund on both a residential and commercial basis, which is reflected in a strong pipeline of potential schemes already being developed.

3. Fund Details

3.1 The key characteristics of the proposed funds are:

	Residential Fund	Commercial Fund
Fund value	Maximum £70m committed	Maximum £140m committed (including £70m existing fund)
Fund focus	To accelerate delivery of “residential-led projects, principally on brownfield sites. Aimed at scheme sizes of 50 units and above (but with appropriate discretion to fund smaller schemes consistent) – no upper unit limit.	To target void or derelict brownfield sites to stimulate urban renewal through the provision of employment floorspace
Qualifying geography	All constituent and non-constituent Authorities.	
Project selection and assurance	In line with the emerging WMCA Single Commissioning Framework (to be launched 1st April 2019).	
Sectors	Residential/Residential with ancillary mixed-use	Commercial, Industrial and Offices.
Deal size	Typical minimum £1 million. In order to mitigate risk, individual loans will be capped at £10m.	
Security and return	Deals secured where possible with appropriate financial return being aligned to risk, return being secured on conventional terms or deferred in line with developer exit.	
Funding structure	Funding on senior debt, mezzanine or equity and joint venture terms, funding alongside developer equity and suitable senior debt lenders if required. Additionally the fund will have the ability to provide Guarantees to accelerate development.	The majority of projects will be funded on a senior debt basis, however fund will be have the flexibility to provide mezzanine or equity funding should individual projects warrant that level of support.
Fund Management	West Midlands Development Capital	

3.2 It should be noted that the individual deal limit on the existing fund is £7 million (i.e. 10% of the overall total) but it is proposed to increase this maximum level to be coterminous with the value Investment Board are able to approve, thus allowing more flexibility over the developments WMCA are able to help bring forward. As detailed above, all investments would be supported by security to a level which Investment Board are minded to approve before investments can be finalised.

4. Fund Management

4.1 West Midlands Development Capital is incorporated as a public authority controlled subsidiary of the Combined Authority and set up as a Teckal company which acts similarly to a 'framework' where any member of the Combined Authority has the right to use West Midlands Development Capital for fund management services without the need for a procurement process. The Combined Authority Finance Director is a permanent member of the West Midlands Development Capital Board.

4.2 West Midlands Development Capital currently undertake all deal sourcing, deal appraisal, due diligence, contract development, execution, monitoring and close out of investments against the original fund. This is done in full oversight of the Combined Authority who scrutinise all investments in the Investment Advisory Group before onward approval by Investment Board.

4.3 The fee for West Midlands Development Capital to manage the existing £70 million fund is £350,000 and is based a percentage of the overall fund (0.5%) which was broadly considered to be equivalent to the costs of operating the fund. In addition to the management fee, West Midlands Development Capital benefit from an income stream from each investment deal which proceeds to a full contract part of which is refunded to the Combined Authority via a rebate mechanism.

4.4 It is proposed that power is delegated to the Director of Housing & Regeneration, Finance Director and Head of Governance to agree the fee that West Midlands Development Capital will charge to the Combined Authority to act as fund managers for the extended funds. This will be subject to the Combined Authority being able to adequately verify that the fee represents value for money

4.5 It is further proposed that power is delegated to the Director of Housing & Regeneration, Finance Director and Head of Governance to establish an appropriate level of fee payable by applicants to WMCA to access WMCA funds, to cover the costs associated with administering the funds. It is proposed that this would not apply to submissions made by WMCA constituent and non-constituent members

5. Managing Risk

5.1 No financial investment will be entirely risk free and the interest payable on the investment should always be proportionate to the degree of risk inherent within the transaction. The Combined Authority manage the risk of a default in its commercial investments through the following mitigations:

- Sector specific, local fund managers are used to select initial proposals
- Only developers with a proven track record of delivery will qualify for the fund
- Thorough due diligence is undertaken on the development by the fund manager
- Independent valuations are used to inform the shape of each investment

- Investment Advisory Group and Investment Board scrutinise each potential investment, with the latter taking the decision on whether the degree of risk is acceptable to the Combined Authority.
- The loan arrangements are properly documented and are legally binding
- A charge is taken over the developer assets, released upon repayment. Typically this is a first charge over land and or property
- Proportionate values of investment are included from the developer to ensure there is a mutual interest in the build being completed
- Loan terms are generally short (up to 2 years)
- Regular monitoring of the financial position of the investment and progress on site

5.2 Notwithstanding the mitigations above, it is possible that some of the deals will encounter difficulties as the funds revolve over a number of years. Should this be the case, the Combined Authority would be in a forced sale position (of a part complete site) or, subject to having the appropriate mechanisms in place to do so, could step in and complete the project.

5.3 The Combined Authority are obliged under Accounting Standards to make a suitable financial provision for credit losses which, in the event of a default would be used to negate the in year impact of the event.

5.4 In a worst case scenario, should there be a systemic downturn in the construction sector and a number of investments default, it is possible that losses in excess of the amounts provided for could be realised. In this event, the Combined Authority would seek to support the revenue account through use of alternative incomes / resources following any provisions to meet the liability being exhausted.

1. Financial Implications

6.1 The financial implications associated with the proposals are detailed throughout this report. It should be noted that the costs of operating the fund will be met entirely from the returns the fund generates. As such, neither the current fund nor the extended funds have any impact against WMCA Investment Programme funding.

6.2 The Combined Authority operates within an external debt limit agreed by HM Treasury and the current agreement expires in March 2021, after which, a new limit will need to be agreed. Forecasts show that the current debt limit is able to accommodate the extensions to the fund. The limits agreed with HM Treasury for 2021/22 onwards will need to take into account the borrowing projections of the fund.

2. Legal Implications

WMCA Powers

7.1 Section 113A(1)(a) of the Local Democracy, Economic Development and Construction Act 2009 gives the CA power of competence to act for purposes 'incidental' to carrying-out any of its functions. Part 4 of The West Midlands Combined Authority Order 2016 (2016 No 653) confers on WMCA a general power of competence, exercisable concurrently with constituent authorities, to do anything (not otherwise prohibited) relating to economic development and regeneration in the combined authority area. Part 3 of The West Midlands Combined Authority (Functions and Amendment) Order 2017 confers functions corresponding to the functions of the Housing Community Agency has in relation to the combined area.

7.2 WMCA has power to borrow in connection with its functions by virtue of the Combined Authorities (Borrowing) Regulations 2018 granted in order to achieve alignment with its additional functions. The powers to lend derives from its general power of competence referred to above.

WMDC

7.3 WMDC was incorporated on the 8th May 2017 as a public authority controlled and wholly owned subsidiary of the WMCA. WMDC (a Teckal Company detailed in paragraph 4 of this report) has been set up as an Investment Management Company. Any fees payable by WMCA to WMDC will need to be agreed taking into account the general duty of Best Value placed upon it by virtue of the Local Government Act 1999

8. Equalities Implications

8.1 There are no specific equalities implications as a result of this report. The equalities implications of each investment would need to be considered on a case by case basis.

9. Inclusive Growth Implications

9.1 The funds subject to this report will aid delivery of the Combined Authority's strategic ambitions. These funds will be allocated in line with the West Midlands Combined Authority Single Commissioning Framework which takes into account matters arising from the requirement to ensure Inclusive Growth.

10. Geographical Area of Report's Implications

10.1 The funds will be available to all Constituent and Non-constituent Local Authorities.