## Appendix B – Further Financial Considerations

Based on information available at the time of writing (June 2017), WDBC require c£1m of revenue income and/or savings per annum in order to be financially sustainable, in line with its published Medium Term Financial Strategy (MTFS). Below is a breakdown of how an investment of £75m plus acquisition costs can derive c£1m of revenue after costs to support the financial sustainability of the Council. The investment proceeds from the first tranche of £25m are also shown.

| | First Tranche | Entire Investment |
|---|---|---|
| **Capital Investment** | **25,000,000** | **75,000,000** |
| Acquisition fees @ 7% | 1,750,000 | 5,250,000 |
| **Total Borrowing / Expenditure** | **26,750,000** | **80,250,000** |
| **Borrowing** | | |
| Term (Years) | 50 | 50 |
| Maturity PWLB Loan Interest Rate % | *2.32* | *2.32* |
| **Interest Payments pa** | **620,600** | **1,861,800** |
| **Profit & Loss Example *(Income less Costs)*** | | |
| Target Portfolio Yield % | *5.85* | *5.85* |
| **Rent Receivable *(Yield x Investment)* pa** | **1,462,500** | **4,387,500** |
| Interest Payments pa | (620,600) | (1,861,800) |
| Management costs @ 3% of Rent Receivable | (43,875) | (131,625) |
| Sinking fund @ 5% of Rent Receivable | (73,125) | (219,375) |
| **Surplus Generated (before MRP*) pa** | **724,900** | **2,174,700** |
| **Option 1 - Straight Line MRP* Treatment** | | |
| Surplus Generated (before MRP*) pa | 724,900 | 2,174,700 |
| Minimum Revenue Provision (MRP*) | (535,000) | (1,605,000) |
| **Surplus (after Straight Line MRP*) pa** | **189,900** | **569,700** |
| **Option 2 - Annuity MRP* Treatment** | | |
| Surplus Generated (before MRP*) pa | 724,900 | 2,174,700 |
| Annuity MRP* Treatment | (270,000) | (810,000) |
| **Surplus (After Annuity MRP*) pa** | **454,900** | **1,364,700** |

**Minimum Revenue Provision (MRP), the provision for the repayment of borrowing, is explained in more detail in Appendix C of this report.*

**Sensitivity analysis in change in gross rental income**

The business plan identifies a target gross rental yield of 5.85%, which if achieved would generate £2.175m per annum in income after costs. The table below shows the impact a change in the gross income yield could have on the annual investment income estimates:

| Sensitivity Analysis | £25m | £75m |
|---|---|---|
| Change in income yield 0.5% | £ 125,000 | £ 375,000 |
| Change in income yield 1.0% | £ 250,000 | £ 750,000 |
| Change in income yield 1.5% | £ 375,000 | £ 1,125,000 |
| Change in income yield 2.0% | £ 500,000 | £ 1,500,000 |
| Change in income yield 2.5% | £ 625,000 | £ 1,875,000 |

For example, if the income yield were to increase from 5.85% to 6.85% (an increase of 1%), this would generate additional income of £250,000 per annum on a £25m portfolio. A reduction in yield would have the opposite effect.

**Sensitivity Analysis on the Surplus Generated**

A sensitivity scenario analysis is shown in the table below to illustrate the effect that the yield has on the return achievable from the portfolio – assuming an investment of the full £75m or the tranche 1 investment of £25m. This highlights that the portfolio needs active management and care in choosing the right acquisitions to ensure the minimum yield is achieved.

All of the figures below are based on the annuity MRP treatment shown above, providing either £810,000 (for the £75m investment) or £270,000 (for the £25m investment) of MRP in year one. The provision for the repayment of borrowing (level of MRP) would increase year on year, as described in Appendix C of this report.

| Portolio Size | 25,000,000 | 75,000,000 |
|---|---|---|
| *Projected Annual Surplus @ 5.85%* | 454,900 | **1,364,700** |
| Projected Annual Surplus @ 4.00% | 29,400 | 88,200 |
| Projected Annual Surplus @ 4.50% | 144,400 | 433,200 |
| Projected Annual Surplus @ 5.00% | 259,400 | 778,200 |
| Projected Annual Surplus @ 5.50% | 374,400 | **1,123,200** |
| Projected Annual Surplus @ 6.00% | 489,400 | **1,468,200** |
| Projected Annual Surplus @ 5.32% | 333,000 | **999,000** |
| *Breakeven: Projected Annual Surplus @ 3.88%* | 1,800 | 5,400 |

**Breakeven**
A minimum yield of 3.88% is required in order for the £75m investment to breakeven in year one, i.e. cover the cost of loan repayments, the alternate Minimum Revenue Provision, the sinking fund for maintenance and the expected management / administration costs.

**Indicative Borrowing Financial Implications**
The Council will consider a number of factors when assessing how much the Council will borrow to finance the commercial property strategy. It is likely that the majority of the commercial property acquisition strategy will be funded via Public Works Loan Board (PWLB) borrowing.

When assessing affordability, the Council will consider the annual cost of financing the investment, the income generated, the costs of running and maintaining the property and the factors that could potentially affect the net income to the Council (which is needed to repay the financing costs of the proposed property investment of £25m or £75m).

Council officers who have responsibility for treasury management will, in consultation with the S151 officer, determine the most appropriate product(s) for the Council's borrowing requirements. There are a number of options available to them and they will be advised by the Council's treasury management advisors and guided by the Council's adopted treasury management strategy and CIPFA regulations.

**Percentage Increase in Council Tax**
It is clear that a significant reduction in rental income (a yield below 3.88%) would result in a revenue budget deficit being created. If the Council did not have the available budget surplus to cover this additional cost, it may be forced to cut expenditure or increase Council tax to cover the deficit. The table below shows the impact on Council Tax and the additional income that a % increase in Council Tax generates (using the existing Council Tax base).

| **Impact on Council Tax** | **£** |
|---|---|
| Increase of 1.0% | £ 45,000 |
| Increase of 2.0% | £ 90,000 |
| Increase of 3.0% | £ 135,000 |
| Increase of 4.0% | £ 180,000 |
| Increase of 5.0% | £ 225,000 |
| Increase of 6.0% | £ 270,000 |
| Increase of 7.0% | £ 315,000 |
| Increase of 8.0% | £ 360,000 |
| Increase of 9.0% | £ 405,000 |

The business case for property investment allows for reserves to be built up in a sinking fund to cover any shortfall in rent or maintenance cost for which the council would be liable. The strategy that is to be adopted by the Council addresses the risk that changes in rental income could affect overall portfolio profitability by virtue of being spread across asset types, classes and geographies. Different tenant classes and lot sizes and indeed borrowing terms will mean that a loss on one asset could well be compensated by a profit on another asset. It also important to note that the strategy has excluded any profit or loss for a change in capital values.

**Summary**

If a portfolio yield of 5.85% is achieved, the above figures show that an investment of £80.25m could generate a surplus of between £0.57m to £1.365m per annum depending on the treasury management strategy employed in order to provide for Minimum Revenue Provision (MRP). This is net of forecast administration and maintenance (sinking fund) costs. Using the same basis, a £25m investment could generate a surplus of between £0.19m to £0.45m per annum.

As part of the Annual Treasury Management Strategy setting process, Members have the opportunity to set the Council's policy for providing for MRP (Minimum Revenue Provision). There are various methods which can be employed and members will be able to determine the most prudent method of provision. The accounting method chosen will have a fundamental impact on the surplus that can be generated from this strategy. *MRP is further explained in Appendix C.*