Herefordshire Council

Student Accommodation Project

Funding Analysis

1. Introduction

1.1. Herefordshire Council (the Council) are considering entering into an arrangement to underwrite an Income-Strip transaction that will see the delivery of 178 units of student accommodation at the Hereford College of Arts (HCA) on the Council owned Station Approach car park.

1.2. Arlingclose have been requested to review the long-term sustainability of the investment, benchmarking of the funding rates suggested by the potential institutional investor, review of the financial business case and comparison of different funding models.

1.3. In this review we have assumed that the total costs of the project have been confirmed by the Councils cost consultants and funding of £18.560million over a 50-year lease period is assumed in any modelling that we have undertaken.

2. Initial Funding Analysis

2.1. QMPF, the Councils consultants, undertook a market engagement exercise in November 2018 to test the market appetite for the provision of indexed lease finance for the development of student accommodation property at Station Approach, Hereford.

2.2. A summary of the responses from the funders approached is provided below (based on a 50-year lease term).

Table 1: Funding Responses

2.3. As can be seen from the above M&G offered the most attractive funding option in terms of indicative yield and initial rent.

2.4. This exercise has essentially provided a benchmark of the funding rates available and the appetite of institutional investors to provide finance for this scheme but as requested by the Council we have undertaken additional research to confirm that the funding rates are acceptable.

3. Alternative Funding Providers

3.1. As part of this review we have contacted alternative institutional investors to ascertain their likely investor appetite and yield requirements using the range of figures outlined in 2.2 above.

3.2. We contacted the following institutional investors (it should be noted that without divulging the names and the exact nature of the potential parties involved in this transaction it has not been possible to get firm price quotations):

- Infrastructure Investments Limited
- BAE Systems Pension Funds Investment Management Ltd
- Phoenix Group

3.3. **Infrastructure Investments Ltd -** A property company with expertise in structured project finance. The company owns a portfolio of around property assets in London and throughout the country, including university halls of residence, offices, hotels and housing. When contacted they wished to understand more about the exact structure of the deal but indicated that an IRR of betweer would be considered appropriate for this type of transaction. This is close to the suggested by QMPF.

3.4. **BAE Systems Pension Funds Investment Management Ltd** – The pension fund seeks to match pension fund liabilities and enhance returns via long-term investments. When contacted they compared the potential funding structure with a bond that the pension fund invests in, a sinkable bond secured on student property with an 18year life which is currently trading above the relevant Gilt. Principal repayments start in 2020 and are variable, linked to the cash flows generated by the underlying business plan. The original coupon was the issue amount In 2020, the first principal repayment is around

3.5. **Phoenix Group -** A FTSE 250 Insurer with around 4.5 million policyholders and around lion of assets. It operates mainly in the UK and specialises in taking over and managing closed life and pension funds. Phoenix Group provided indicative pricing a bove short-term interest rates due to their perceived credit view on the UK University sector . This compares favourably to the indicative yields provided as part of the market engagement exercise.

Alternative Student Accommodation Providers

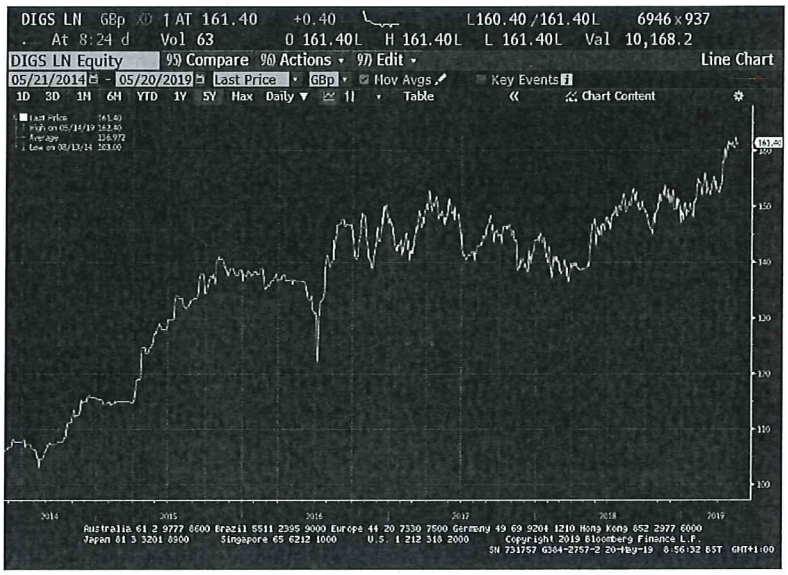
3.6. In addition to contacting the institutional investors mentioned above we have also analysed the yield requirements of several providers of student accommodation. The providers include Unite, UPP and GPC as well as analysing some of the bond yields available on debt issued by individual Universities.

3.7. **Unite** - Unite Students is the largest provider of Purpose-Built Student Accommodation across the United Kingdom. 'Unite Students' is the trade name for The Unite Group Plc, a London Stock Exchange listed Real estate investment trust (REIT) and a constituent of the FTSE 250 Index. On studying various documents available from Unite the yield on the cost of various developments range from between depending on the size and location of the development.

3.8. **UPP** - University Partnerships Programme (UPP) is the leading provider of on-campus student accommodation infrastructure and support services in the UK. On 5 March 2013 UPP Bond 1 Issuer Plc issued secured bond listed on the Irish Stock Exchange. The bond was secured against the income from the properties at the universities of York, Nottingham, Nottingham Trent, Kent, Oxford Brookes and Plymouth. The fact that the bond is secured on the income of several different student accommodation projects supports the lower yield.

3.9. **GCP Student Living** – GCP Student Living was the first REIT in the UK to focus on student accommodation. The Company invests in property primarily in and around London where it is believed that positive returns will be achieved due to the demand supply imbalance and a growth in the number of overseas students wishing to study in the capital. The fact that this is a REIT it is difficult to establish the yield, but we have been able to assess the value of the shares over the past 5 years which has demonstrated steady growth (fall in value in 2016 was a result of the Brexit referendum result):

Graph 1: GPC Student Living Share Price



Source: Bloomberg

3.10. **University Direct Funding Rates** – Many Universities can access funding for capital projects from the capital markets through bond issues. Whilst HCA is not a recognised University and is currently unable to access funding in its own name, we have provided the current yields on several University bonds as a way of benchmarking the funding rates offed by the institutional investors looking to fund this particular transaction:

Table 2: University Bond Yields

University	Maturity Date	Yield
Cardiff	2055	2.637%
De Montford	2042	3.698%
Leeds	2050	2.742%
Liverpool	2055	2.750%
Manchester	2053	2.954%
Southampton	2057	2.447%

Source: Bloomberg – 9th May 2019

The rates on the bonds issued by individual Universities compare favourable with the indicative pricing obtained via the funding exercise undertaken by QMPF.

3.11. **Summary** – There are several different providers of and investors in UK student accommodation. The differing structures of investment make it difficult to compare yields to the IRR suggested by QMPF but the

funding rates suggested by those funders requested to quote for this project do not appear to be uncompetitive when compared to the long-dated debt instruments issued by Universities and the suggested IRR does not seem too far away from the rates of return expected by other long-term investors in this market.

4. Funding Methods Considered by The Council

4.1. Our review of reports prepared by QMPF and the Business Case prepared by the Council have found that the two options considered are the Income-Strip method of funding and the use of PWLB funding via a loan from the Council to the SPV or the use of existing capital receipts.

4.2. At the 13th December 2018 Cabinet meeting it was resolved that the preferred funding model for this project is for a commercial investor to provide funding for the construction and operational phases.

4.3. The freedoms and flexibilities offered by the Prudential Code would allow the Council to borrow to fund this project providing it could demonstrate it was prudent, affordable and sustainable and whilst the project may not be included in the Councils current capital sending plans and CFR forecasts these details can be amended if a business case can be put forward to Members outlining the benefits of the project to the overall financial position of the council.

4.4. Indeed the QMPF report dated 4th December 2018 states

however it appears that the option of the

4.5. For the purposes of this report we have analysed the options available to the Council and present our findings as follows:

Income-Strip Funding

4.6. Our modelling has been based on a total funding amount of £18.560million with an initial rental payment of £464,000 payable to the funding institution. Information provided by QMPF suggests that annual income from student rents will be in the region of £1.040million and with annual operating costs of re will be a profit rent of in year one (based on a 98% occupancy rate).

4.7. Assuming inflation of 2.5% on all costs and income the SPV will make a surplus in each year of operation reachin by year 50 (again based on 98% occupancy) and total surpluses of o on the face of things this method of funding looks a reasonable way to deliver the required student accommodation. The IRR to the funder is lst the IRR to the SPV is

4.8. As has been pointed out by QMPF the risks surrounding inflation and occupancy will rest with the Council as they are underwriting the funding to the SPV. Some element of risk will be dealt with through the cap and collar of inflation at nd if inflation is consistent across all income and expenditure items then the impact on the surplus available to the SPV will be neutral.

4.9. Occupancy rates would be one of the biggest risks that the Council would be exposed to. The modelling has assumed a 98% occupancy rate and the Council's confident that occupancy levels will be maintained at these levels, both through HCA students and students from other institutions.

4.10. The Council should consider some mechanism for sharing in the surpluses generated from the SPV as a reward for granting the guarantee. Appendix A to this report provides our analysis of the finances of this method of funding.

Council Finance, Design, Build and Operate

4.11. The Council could undertake a FDBO of the student accommodation and fund through borrowing from the PWLB, other local authorities or its own resources.

4.12. We have modelled the potential impact on the Councils General Fund of this method of funding assuming borrowing an annuity loan at a rate of 2.43% and making MRP on an annuity basis over a 50-year period. Income and cost levels have been assumed to be the same as those used in the Income-Strip approach.

4.13. In this method the Council would retain all surpluses through the net income received and whilst a small deficit would be exhibited in years 1 and 2 the overall surpluses would total £28.4million over a 50-year period. This produces an IRR of 1.2571%.

4.14. We are confident that funding could be accessed at rates below the PWLB which would increase the net revenue benefit to the Council of this approach. Appendix B to this report provides a breakdown of this structure.

Council Funding – Loan Finance to SPV

4.15. We have modelled the impact of the Council funding the development through a loan and have considered the impact on the SPV and the Councils financial position of such a transaction. In undertaking our modelling, we have considered an annuity loan repayment profile from the SPV to the Council and have assumed that money is borrowed from the PWLB and on lent to the SPV at a rate of 5.10% (considered be minimum State Aid compliant rate).

4.16. Funding the loan at this rate will put pressure on the SPV which would make a deficit of £404,000 in the first year of operation. Deficits would continue until year 21 when surpluses would become available, over the 50-year project a total surplus of £9.5million would be achieved. The Council would have to make annual cashflow loans to the SPV if it were to fund the project through this method.

4.17. The Council would make a revenue gain between the interest paid to the PWLB and the interest received from the SPV. If an annuity loan was used to fund the loan to the SPV, and the SPV repaid to the Council on a similar basis MRP would be covered through the principal repayments so any differential on interest rates would be a gain to the Council.

4.18. The annual revenue benefit to the Council of this approach would be £386,000 generating £19.3million over the life of the project. A detailed breakdown of the cashflows associated with this can be found in Appendix C to this report.

Council Funding – Loan/Equity Finance

4.19. Funding the SPV through 100% loan finance will place pressure on the SPV's ability to function due to the interest costs being high as well as the requirement to repay the principal either through annual repayments.

4.20. Reducing the amount of debt funding through an equity investment would reduce the interest burden on the SPV as well as protecting the SPV from being caught by HMRC "thin capitalisation" rules.

4.21. It may be possible for the Council to fund the SPV through a mix of debt and equity, if a 60% debt/40% equity split was used then the SPV would only pay interest on the debt element of the funding. In the case of a loan at the 5.10% rate the SPV would make surpluses in Year 1, the SPV could pay dividends to the Council as surpluses increase which would be revenue income in addition to the differential in interest rates.

4.22. The only issue with this method of funding would be MRP. MRP on the 60% loan would be met by the principal repayments on the debt whereas MRP on the equity would be made over a period of 20 years with no corresponding payment from the SPV, although this could be covered through any dividend payment made to the Council.

4.23. Appendix D to this report provides a detail breakdown of the cashflows to both the Council ands the SPV and it can be seen that whilst this assists the cash position of the SPV it causes the Council a negative revenue impact over the first 20 years of the project due to the requirement to make MRP over a shorter period for the equity investment.

4.24. **Summary** – Of the four funding methods that we have reviewed the Income-Strip and Council DBFO method offer the most beneficial route. With the Council discounting the DBFO option the Income-Strip method would appear the most appropriate option subject to a mechanism being in place to share the positive cashflows in the SPV.

5. Review of the Financial Model

5.1. As pointed out in 4.7above we have provided an analysis on the potential cashflows for the SPV from an Income-Strip transaction based on the funding and other information provided in QMPF reports.

5.2. The Council provided us with a detailed financial model which we have also analysed. This model is based on a similar approach to the cash forecasts that we have undertaken but with some noticeable difference relating mainly to:

- Total occupancy income – the model appears to be based on 90% occupancy levels and not the 98% referred to in the reports
- Lifecycle costs – the model appears to have an initial lower figure than that quoted in the report but does have higher uplifts in certain periods rather than a constant 2.5% uplift which we have used
- Lease payments – the annual lease payments used in the model are higher than the lease payments suggested in the funding responses
- Tax and interest received – we have not factored this into our modelling

5.3. In summ the model provided suggests that the total cash available in the SPV at the end of year 50 will be around lower than the figure quoted in 4.7 above. Appendix E provides a detailed reconciliation between our modelling and the detailed model provided by the Council and highlights where the differences occur.

5.4. We would suggest that the model is re-run with more up to date information to ensure that he SPV is able to service its costs of funding Etc. The model does suggest that the SPV can function even though there is a period between years 25 to 32 where annual cash deficits exist.

6. Business Case Review

6.1. We have reviewed the Draft Business Case document prepared by Officers of the Council (dated 1st May 2019). The document considers the following options:

- **Do nothing**: Reapply for the site to maintain its status as a temporary (or permanent) car park.
- **Do the minimum**: Develop a student accommodation facility at least cost providing minimum requirements for quality and maximising the use of space for accommodation.
- **Do something**: Develop a student accommodation facility of a standard that meets the requirements of the site, being in a prominent location next to a listed building and forming an important gateway into the city

6.2. In addition to the three options listed above the Business Case outlines that the key objectives of the project are:

- Provide a capital receipt for the site reflecting its value as an asset of the council
- Avoid any reduction in car parking revenue
- Increase economic activity due to support for HCA growth strategy
- Increase economic activity due to support for first three NMiTE cohorts

6.3. Section 4 of the Business Case document states "although the option to fund the project externally is preferred, the possibility that the project is funded by the council was included in the project approval decision. If this approach is taken, then the council will retain ownership of the asset and will commission the SPV to run the facility on its behalf. In this scenario, there will be no capital receipt, but the council will have the benefit of any profit from the SPV".

6.4. The document then goes on to state "This business case assumes that external funding is used to fund the project (the council's preferred approach). The analysis of project finance has considered both options and shows a positive net present value for the project if it uses internal council finance so the business case will remain positive. However, while the capital is available, the project will take a significant proportion of the Development Partnership capital budget. The council will also then own a number of the risks that would otherwise transfer to the finance provider such as the construction programme risk".

6.5. Our findings in section 4 above confirm that the Council could finance the project and make a positive contribution to the Councils annual revenue budget once all costs of capital have been considered. Whilst a number of risks would be transferred to the private sector a number of risks would remain with the Council through the Income-Strip model, so this approach does not take all risk off of the table.

6.6. The Business Case outlines the benefits to the Council of delivering the project. All of the same benefits could be delivered if the Council funded the development including the delivery of the capital receipt if the loan funding option is considered and this has been factored into our analysis in Section 4 of this report.

6.7. The risks to the Council of entering into the Income-Strip transaction are referred to in the Business Case document but only briefly. More detail on the Councils potential financial exposure can be found in the Funding Market Engagement document produced by QMPF dated 6th December 2018. Theses are the Council stepping in to take over the lease payments or buying out the lease from the funder and the potential costs of the buy-out are detailed in this document.

6.8. The QMPF report also provides detail of the potential contingent liability that the Council will be exposed through its underwriting of the lease payments to the funder. The contingent liability ranges from between [redacted] depending on the discount rate used to calculate the liability.

6.9. The accounting around contingent liabilities and financial guarantee contracts will need to be considered by the Council and whilst this review has not been commissioned to look at the accounting for this transaction this issue should be pointed out to the Council.

6.10. If the Council is to treat as a contingent liability then only disclosure in the accounts will be required but if it is considered to be a financial guarantee the fair value of the guarantee will need to be recognised which may have a material impact on the Councils overall financial position.

6.11. We would recommend that the Business case document is expanded to include a detailed risk assessment and would suggest that the following risks (as a minimum) are identified:

- **Loan default risk** – the risk that the SPV defaults on the loan and the Council has to step-in. As the principal guarantor, the Council is theoretically exposed to the full financial risk from the outstanding loan over the term. This risk essentially passes on to the Council, being the ultimate guarantor in an event of default or insolvency of the SPV, the Council will have to make the outstanding financial payment due to the funder.

- **Rental Guarantee risk** – the risk that income from students isn't enough to cover the payments to the funder. The rental income of the property will be dependent on the level of occupation by students over the life of the loan. Any adverse changes to the level of occupation or tenancies to the extent that reduce the minimum net annual rent would result in the Council having to make a financial payment to the funder.

- **Inflation risk** – the risk that the impact of inflation has a different impact on the income and costs associated with the project. The Council has some protection over this through the cap and collar

that would be in place over the inflation applied to the payment to the funder however it will have no control over the inflation impact on the costs of running the SPV etc.

- **Valuation risk** – the risk the asset is worth less at the end of the loan period. The transaction assumes that the student accommodation passes to the Council for £1 at the end of the loan period. If the SPV can service, its financing costs over the 50-year period and the Council can take ownership of the asset with a value at the end of the term then this would be a benefit to the Council. The risks outlined above could result in the Council stepping into the payment of the debt at some point during the loan term and taking ownership of an asset with a lower value in the future.

- **Accounting** – as mentioned in 6.9 above the Council may have to account for this as a financial guarantee contract which may have a material impact on the Councils accounts.

6.12. **Summary**- In our view whilst the Business Case document sets out the rationale for entering into the Income-Strip transaction, we feel that more information should be included around the Council funding option and why this has been discounted over the preferred option. We also feel the risk assessment section could be expanded to include more detail over the risk that the Council could find itself exposed, the probability of those risks occurring and the potential impact on the Councils financial position.

7. Overall Summary

7.1. The Council is considering entering into underwriting and Income-Strip transaction that will see the delivery of 178 units of student accommodation to be used by HCA.

7.2. Indicative funding rates have been obtained by the Councils consultants QMPF and these rates seem reasonable when benchmarked against alternative funding sources and providers. The wide range of options available for the delivery of student accommodation demonstrate that this is an attractive asset class for long-term investors. The Councils effective guarantee of the scheme obviously make this scheme even more attractive to the funders.

7.3. Income-Strip is the preferred method of delivery for the Council as it transfers some of the risks to the private sector, but several other key risks remain with the Council. The Council could look to fund the scheme itself and retain all the revenue benefits of the project and we have provided some analysis of how we think this could work if the Council wished to consider this option in more detail.

7.4. A Business Case has been prepared which we feel could include more detail as to why the direct funding route has not been pursued and expanded to detail more of the risks that the Council will be exposed to and how it plans to mitigate those risks.

7.5. We would recommend that the detailed modelling is re-0run to ensure that all of the information contained within is the most up to date available.

Arlingclose

May 2019

Appendix A – Income-Strip Cashflows

Appendix B – Council Direct Funded

Appendix C – Council 100% Loan Funded

Appendix D – 60% Loan – 40% Equity

Appendix E – Detail Financial Model Reconciliation