Appendix 1

Shareholder Financial Review of its Investment in Oportunitas Limited

1. Background

1.1 The council established its housing and regeneration company, Oportunitas Limited in August 2014 with an initial capital investment of £2,287,500 in the form of a 90% long term loan funding facility over 45 years and a 10% equity stake to enable it to acquire residential properties for rent. The council subsequently increased its investment in the company by a further £2,500,000 on the same 90%:10% loan to equity ratio, meaning the approved investment in the company for property acquisitions is now £4,787,500. The council also provided a shorter term loan facility of up to £300,000, met from earmarked capital receipts, to enable the company to meet its liquidity requirements during the period of its initial business plan in recognition it would take time to develop its revenue streams. The council met its whole approved investment in the company from cash reserves without the need for prudential borrowing.

1.2 The council's existing long term loan facility is secured as a first charge on the properties owned by the company. Further, as the sole shareholder, should the company cease trading for any reason the council would benefit from the value of its assets after other creditors had been paid.

1.3 At the time the company was established the agreed commercial interest rate to be charged by the council to the company for the long term loan facility was 4.88% if the acquisition were for residential lettings at a full market rent or 4% if for affordable homes. All acquisitions made to date have been for properties let at the market rent.

1.4 When the company was established it was recognised and reported that it would not be financially sustainable in the long term using the 90%:10% loan to equity ratio because the interest costs due on this level of gearing would leave insufficient income to meet its overheads. It was acknowledged that a review of the council's funding structure for the company would be required towards the end of its initial business plan period.

2 Current Position

2.1 Capital Investment

2.1.1 Table 1 below summarises the latest position for the use of the shareholder's capital investment in the company:

Table 1 Funding and Acquisitions Summary		£	Units
Total Approved Funding		4,787,500	
Acquisitions Made (inc Fees)			
November 2014	5 units at Walter Tull Way, Folkestone	691,342	5
July 2015	2 Grove Terrace, Folkestone	160,700	1
November 2015	15 Grace Hill, Folkestone	515,000	6
December 2016	82-84 Leyburne Road, Dover	864,800	8
May 2017	19 Castle Hill Avenue, Folkestone	1,299,750	10
	Total acquisitions	3,531,592	30
Balance of approved funding for further acquisitions		1,255,908	

2.1.2 At the time of writing, the company is in advanced negotiations to acquire another residential property providing a further 4 units of accommodation for a total cost of approximately £410,000.

2.1.3 To date £80,000 of the £300,000 cash flow loan facility has been utilised.

2.2 Company Trading Position

2.2.1 The original financial modelling and subsequent business plan for the company predicted that losses would be made because of the reasons outlined in section 1, above. Table 2, below, summarises the company's Profit and Loss Account from its inception to 31st December 2017 and shows the accumulated trading loss, before adjustments for unrealised property valuation changes are reflected, is approximately £223,000. This is expected to continue to increase until the action is taken to address the position.

Table 2 Company's Profit and Loss Account

Period Ending	5 months to 31.3.15	Year to 31.3.16	Year to 31.3.17	9 months to 31.12.17	Cumulative
	£	£	£	£	£
Trading income	23,949	90,551	148,184	189,235	
Direct costs	(16,686)	(28,846)	(41,619)	(71,412)	
Interest Payable	(13,440)	(48,213)	(96,167)	(116,022)	
Net Trading	(6,177)	13,492	10,398	1,801	
Overheads etc	(52,347)	(79,386)	(81,212)	(29,963)	
Net Operating Loss	**(58,524)**	**(65,894)**	**(70,814)**	**(28,162)**	**(223,394)**
Unrealised Property Valuation Gains/(Losses)	11,658	50,800	(43,050)	79,898*	
Reported Profit/(Loss)	(46,866)	(15,094)	(113,864)	51,736	

*unrealised property valuation gain at 31/12/17 based on a 3% projection of values at 31/3/17

2.2.2 In broad terms, the company's trading activities of residential property lettings and grounds maintenance cover their direct costs but do not generate sufficient surpluses to meet its overheads.

2.2.3 Table 3, below, shows the income received or accrued by the council as shareholder from the company since its inception:

Table 3 – Shareholder Income

	5 months to 31.3.15	Year to 31.3.16	Year to 31.3.17	9 months to 31.3.17
	£	£	£	£
Loan fees	23,587	0	22,500	0
Loan interest	13,440	48,213	96,167	116,022
Staff recharges	16,522	39,313	25,392	13,999
Directors remuneration	4,273	8,475	11,601	7,928
Advertising income (Shepway Today)	1,054	1,470	1,470	1,130
Grounds Maintenance income	9,394	28,845	41,619	36,611
Total	**68,270**	**126,316**	**198,749**	**175,690**

3. Strategic Financial Review

3.1 A strategic financial review has been undertaken to identify the actions required to ensure the company is financially sustainable in the long term and the impact these will have on the return to the council as shareholder. The review has involved modelling the following key factors to arrive at an optimum position for both the company and the council:

- Level of additional capital investment required by the company for it acquire further properties
- Impact of the accumulated losses continuing to be incurred by the company
- Overall debt to equity ratio for the capital investment
- Consideration of the commercial interest rate to be charged by the council to the company for the housing acquisition loans
- Impact of different rental yields from future property acquisitions (5%, 5.5% and 6.1%)
- Capital financing costs for the council to support further investment

- The overall financial return to the council as shareholder
- The ability to deliver the financial expansion of the company within the existing management and administrative resources available to it

3.2 The three different rental yield scenarios for new property acquisitions were selected for the following reasons:

- 6.1% has been achieved from some of the properties within the existing portfolio
- 5.5% is typical of what is expected from properties being acquired at the moment
- 5.0% is viewed as a prudent level should market conditions tighten further

3.3 Review Outcomes

3.3.1 The financial modelling has identified the following common outcomes to achieve a financially sustainable position for the company while still providing a return to the shareholder based on the three different gross rental yields for future acquisitions:

- A minimum additional capital investment of £6,900,000 is required from the council to enable the company to acquire a sufficient critical mass of residential properties to provide the additional revenue required
- The commercial interest rate for loan element can remain at 4.88% as the economic conditions have not materially changed since this was agreed as part of the original business case for creating the company and is considered to be compliant with State Aid legislation.
- The additional £6,900,000 capital investment by the council to be met from prudential borrowing based on an initial 5 year loan from the Public Works Loan Board at annual interest rate of 1.5%
- The council’s Minimum Revenue Provision (MRP) charge to the General Fund for the borrowing to be mitigated by the loan repayments due from the company
- The model assumes it will take up to 2 years for the company to acquire the additional property and that it will begin to trade profitably on an annual basis from the year after (i.e. year 3)
- It is likely to take up to 4 years from the acquisitions programme being completed for the company to generate sufficient operational profits to absorb the forecast accumulated loss of around £300,000.
- Although the model provides for an increase in the direct costs of operating an expanded property portfolio, it is anticipated that there will not be a material change in the value of management and administrative support (overheads) required by the company to support the expansion.

3.3.2 Table 4, below, summarises the key differences from the three gross rental yield scenarios.

Table 4 – Gross Rental Yields

Scenario	Company - New Rental Yield	Blended Debt/Equity Ratio	SDC Annual Return on Capital Employed	SDC Annual Return on Capital Employed
	%	%	%	£'000
1	5.00%	58:42	2.60%	300
2	5.50%	63:37	2.80%	330
3	6.10%	68:32	3.10%	360

A more detailed analysis of the outcomes of the financial modelling for the company and the council over a 10 year period is shown in annexes 1 and 2, respectively, to this appendix. The key assumptions factored into the modelling are shown in annex 3 to this appendix.

3.3.3 Prudently, it is recommended the 5% gross rental yield option is followed and that the council's overall capital investment of £11,687,500 in the company is based on a ratio of 58% debt to 42% equity. This will provide a return to the General Fund of about 2.6% on the capital employed or £300,000 per annum in a full year once all the acquisitions have been made. The return to the council including the unrealised capital appreciation on the company's property portfolio will be around 6%. Should the gross rental yield be higher than 5% then the company's underlying net cash position may present an opportunity to pay a small dividend to the council as shareholder.

3.3.4 Table 5, below, shows how the proposed additional capital investment of £6,900,000 will need to be split between debt and equity to arrive at the suggested 58%:42% ratio:

Table 5 – Debt to Equity Split

	Ratio	Debt	Equity	Total
	%	£	£	£
Proposed	58:42	6,778,750	4,908,750	11,687,500
Less, existing	90:10	4,308,750	478,750	4,787,500
New		2,470,000	4,430,000	6,900,000

3.3.5 The financial modelling assumes the loan element of the additional investment will be on the same terms as the existing loans, i.e. 45 year annuity loans at 4.88% with periodic review periods provided in the agreement and secured against the properties acquired by the company.

3.3.6 The model anticipates it taking a further two full years for the company to acquire the additional property from the proposed investment (2018-19 and 2019-20). If agreed, the company will have the benefit of the additional equity of £4.43m once the legal agreements are signed. In the short term and until properties are acquired, this will, potentially, provide the company with a significant cash balance. This will alleviate the need for the £300,000 liquidity loan arrangement currently in place to meet the existing losses.

3.3.7 However, if the company is able to fully utilise the total capital investment of £11.69m over the next two years the model indicates it will have a potential cash shortfall of about £300k for up a further 4 years for the accumulated losses already incurred, as outlined in 3.3.1 above.

3.3.8 If a liquidity loan facility was reinstated to cover this at the time it will create an extra pressure on the company's cash flow that may hinder its move towards long term financially stability. As an alternative to this, the council, as shareholder, could choose to provide the additional funding, if required, as further equity.

3.3.9 If the additional capital investment is agreed, it is proposed that the £300k capital resource from the current liquidity loan facility be ring-fenced to support the potential future cash shortfall identified in the financial modelling. In the meantime both the Board of Directors of Oportunitas and Cabinet, representing the shareholder, will continue to closely monitor the cash position of the company as it expands its operations.

3.4 Drawdown of Equity and Loan Funding

3.4.1 Given the company's future acquisition programme is expected to be spread over 2 years, arrangements need to be put in place between to provide the debt and equity funding in tranches. This will help to mitigate the company from being exposed to credit risk from holding large cash balances on its bank account and minimise the loss of interest from not being able to invest these sums to earn interest. It will also mean the council can delay the borrowing required to finance the additional investment until it is needed thereby reducing its interest cost in the short term to the General Fund.

3.4.2 It is proposed that the detailed arrangements for the additional debt and equity funding together with the reviewing the requirement for the existing liquidity loan are delegated to the Corporate Directors for Strategic Development and Organisational Change and the Head of Democratic Services and Law.

4. Conclusions

4.1 The strategic financial review of Oportunitas shows that with the significant additional investment of £6.9m it can become financially sustainable in the long term while still providing the council as shareholder a modest but useful return to the General Fund of around £300k per year, or 2.6% on the capital employed.

4.2 It is likely to take up to 6 years from the investment being agreed for the company to be in a position where it has absorbed its accumulated losses and is trading profitably. In the meantime the company may require further assistance from the council, as shareholder, with its short term liquidity requirement.

4.3 No investment is without its risks. A key risk is protecting the council's capital investment in the company and this has largely been mitigated by;

i) the loans made being secured on the property assets of the company, and

ii) the council being the sole shareholder in the company meaning it will benefit from the value of any remaining assets should the company have to be wound up.