PURPOSE OF REPORT

The GM Housing Fund ("GMHF") investment strategy was updated and approved by the GMCA on 29th July 2016. Included within the investment strategy was a proposal to procure a fund adviser to make loans up to £2m. This report sets out further details in respect of the establishment of the small loans fund.

RECOMMENDATIONS:

The GMCA is recommended to:

a. Approve the establishment of a special purpose entity and the procurement of a fund manager/advisor to manage the Small Loans Fund ("SLF") on the basis set out in this report.

b. Note the use of GM Housing Fund resources to cover any fund overheads for a three year interim period until recycled interest and fees can cover the cost base. Such costs will be determined by a procurement exercise but are estimated at £0.6m - £1.2m over three years and assumed to be revenue neutral over the life of the fund; and

c. Delegate authority to the GMCA Treasurer and Monitoring officer to finalise and agree the arrangements to establish the SLF including any ancillary agreements necessary and finalise the documentation to give effect to the appointment of a fund advisor/manager

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Revenue Consequences
Nil.

Capital Consequences

The £10m contribution to Newco by way of loan and equity investment will constitute capital expenditure on the MCC balance sheet to be funded from within the GM Housing Investment Fund resources.

Should the GMCA secure borrowing powers, then the proposal is that the proposal novates with the wider Housing Fund from MCC to the GMCA and the investment will be shown on the GMCA balance sheet.

BACKGROUND PAPERS:

GM Housing Fund: Updated Investment Strategy 29 July 2016

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<td>Does this report relate to a major strategic decision, as set out in the GMCA Constitution (paragraph 14.2) or in the process (paragraph 13.1 AGMA Constitution) agreed by the AGMA Executive Board:</td>
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<td>Are there any aspects in this report which means it should be considered to be exempt from call in by the AGMA Scrutiny Pool on the grounds of urgency?</td>
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1.0 BACKGROUND & OVERVIEW

The hypothesis behind the GM Housing Investment Fund is that there is a market failure in the provision of finance to the residential development sector that is preventing viable schemes from being delivered. This failure is impacting most notably on SME developers.

Applications made to the GM Housing Fund vary in terms of loan size and nature of the borrower. Requests for smaller loans i.e. less than £2m, under the current fund arrangements require the same level of due diligence as larger loans. This is not particularly efficient from a management perspective and the controls currently in place for the larger loans are too restrictive for the smaller borrowers that do not have sophisticated development teams. However, not proceeding with such deals would go against the objective of the fund which is to unlock or accelerate viable housing schemes located in GM. There is anecdotal market evidence to suggest that it is still difficult for borrowers to access funding below the £2m threshold. This report sets out a proposal to develop a mechanism by which we can efficiently deliver smaller loan sizes to the market.

2.0 Small Loans Fund Adviser

Given the need to support smaller projects and the resource intensive nature of the investments being made, it is proposed that the GMHF appoints an external fund adviser to run, initially, a £10m Small Loans Fund, on a performance based fee structure, to invest in projects on behalf of the GMHF. This approach will also mitigate any risk associated with changes in the market and traditional lenders entering the market in the longer term.

In recognising that the existing resource and processes are geared towards larger loan sizes, therefore it is important that any solution addresses these challenges and ensures there is a streamlined process that is fit for purpose. Any structure should ensure that investment decisions and processes are managed by the fund adviser wherever possible with a regular reporting of progress back to the Housing Investment Board. It is not possible to achieve this through a contractual solution since neither MCC nor GMCA are able to delegate the investment decisions to an external legal body. As such, a separate legal structure is required.

A paper setting out the proposed investment strategy and approach was approved by the CA in July 2016. The variation to the strategy and the establishment of the fund will require CLG approval. CLG have advised they will provide this before the contract is awarded.

3. Proposed SLF approach

3.1 Legal structure
The most common structure to deliver an outsourced decision making model is a Limited Partnership. The General Partner of the Limited Partnership appoints a separate fund manager to provide portfolio and risk management services to the fund.

This model is already used by the GMCA for its investments of the GM Loan Fund and, the GM and Cheshire Life Sciences Fund.

The borrowing powers of the Combined Authority are currently restricted to transport related functions only and therefore at its meeting on 27th February 2015, the GMCA approved an approach whereby Manchester City Council has been asked to act as the lead authority for the loan arrangement and manage the GMHF.

In the event that the borrowing powers of the GMCA are extended, it is proposed that the GMHF will transfer over to the GMCA and the GMCA will establish the small loans fund.

Set out below are the proposed options to establish the SLF:

Option 1) GMCA establishes the fund:

The proposed route to establish the new fund is to set up special purpose entity in the form of a Limited Partnership to receive the funds and for the General Partner to contract for a range of services in respect of how monies are managed on behalf of the Partnership. The proposed structure is depicted in the diagram below:
Under this structure, it is the fund manager who would establish the GP entity and who would take the investment decisions and back office functions associated with the £10m. There will be regular reporting on progress to the Housing Investment Board and GMCA. The funds will be advanced to the Partnership via a loan from GMCA on similar terms to that between DCLG and GMCA.

2) MCC establishes the fund

Under this structure, it is the fund manager who would establish the GP entity and who would take the investment decisions and back office functions associated with the £10m. There will be regular reporting on progress to the Housing Investment Board and GMCA. The funds will be advanced to the Partnership via a loan from GMCA on similar terms to that between DCLG and GMCA.
If the CA is unable to establish the fund, then it would remain with MCC. MCC’s powers under the Localism Act provide that, when acting for a commercial purpose, MCC would be required to establish a Companies Act company to enter into a Limited Partnership arrangement. It is proposed that the company is established as a 100% owned subsidiary of MCC.

It is to be noted that the proposed legal structure gives rise to tax and overhead inefficiencies, however, it is not anticipated that significant profits will accrue at the fund.

The GMCA Treasurer and Monitoring Officer will work to finalise the legal structure taking into account the need to ensure a smooth and efficient investment and back office operation as well as ensuring value for the public purse.

3.2 Scope of activities

GMCA is seeking establish a small loans fund for an initial size of £10m with no single loan facility to exceed £2m. It is proposed that the minimum loan will be no less than £0.5m. The fund will have an initial investment period of 5 years.

The detailed metrics of the fund will become evident following the procurement process but it is expected that deal volumes will be in the region of 1-2 transactions per month with an appropriate commercial interest rate dependent on security and the covenant strength of the borrower.

GMCA or MCC will procure a fund manager/adviser over the small loans fund to invest via senior or mezzanine debt in residential projects on behalf of the wider £300m GM Housing Fund. By necessity, this will operate at a higher LTC covenant than the existing fund with the fund manager being able to invest at up to 80% loan to cost ratio or 65% loan to value. Such metrics are in line with the approved investment strategy. The fund manager will bring significant experience of residential development funding and knowledge of the Greater Manchester residential property market.

Expected outputs for the fund are a minimum of 250 units across the initial five year term but this will be further refined as part of the procurement process.

It is proposed that the fund manager will review the suitability of applications from developers and housebuilders for development funding in respect of residential schemes. Where an application meets the investment criteria, the approval will be evaluated by the fund manager who will progress the funding request through to completion, drawdown and monitoring.

A business plan will be developed in conjunction with the successful tenderer. This will summarise the investment profile and other key metrics for the fund.
Progress will be measured against the milestones set out in the business plan.

Any fund overheads such as management fees, audit and legal costs will be funded from within the £10m loan contribution and recycled interest and fees. It is not known what the level of fund manager fees will be until the procurement exercise is complete, but £0.2m - £0.4m pa is comparable to similar funds. It is likely that Housing Fund resources will be required to cover such overheads for the first 3 years until the capital begins to recycle. As interest and capital is returned, this can be used to repay the initial loan. The intention is that any defaults within the fund should be covered by the interest received and fees.

### 3.3 Implications for indemnity

Manchester City Council is the administering Local Authority on behalf of GMCA with its default risk on the £300m fund proportionally indemnified by the other 9 GM Local Authorities. It is intended the fund will novate to the GMCA assuming GMCA receives the requisite borrowing powers as part of the devolution agenda. Until the novation occurs, it is important to consider the implications of creating the new fund on GM authorities with regard to their indemnity.

Given the higher LTC and nature of the borrowing entities for the proposed fund, the risk profile will increase and in turn, the likelihood of any indemnity being called.

The risk is mitigated by a combination of factors such as ensuring the fund manager is incentivised to recover monies advanced and prices the risk accordingly as well as actively monitoring the performance of the fund to identify any issues to ensure the fund manager takes appropriate action before such issues become material. Given that the proposed fund size is £10m and will be spread across a broad portfolio of investments, should any losses eventuate within the fund, they should easily be accommodated within the 20% element of the Housing Fund not underwritten by GM.