Appendix G(i) – Financial and Governance Overview

1 What is the City Fund?

1.1 The City Fund concept has been developed by City Partners as a pilot to provide a channel of funding, filling the gap left by austerity measures, risk-averse investors and shrinkage in public sector funding. The 'Fund' is a discrete and independent entity (no legal status), born out of the City Funds initiative. The Fund is proposing to use two separate drawdown options, a City Fund Grant managed by Quartet Community Foundation and City Fund Investment managed by Bristol & Bath Regional Capital (BBRC). City Funds will adopt the strategic aims and objectives which are consistent with those of the One City Plan. Following its establishment the Fund will become a collective investment scheme and will mean investor capital can be earning returns from the initial investment.

1.2 Investment is being sought from Bristol City Council (BCC), to provide the initial 'first brick' investment and leverage further public / private investment to achieve its long term target of c. £61m revolving credit facility. Big Society Capital Limited (BSC) has agreed in principle to match BCC's investment, to a maximum value of £5m and therefore in optimising the additional funding that will be available to Bristol, BCC are proposing to investment £5m in the fund which with the leverage will result in an initial investment fund of £10m.

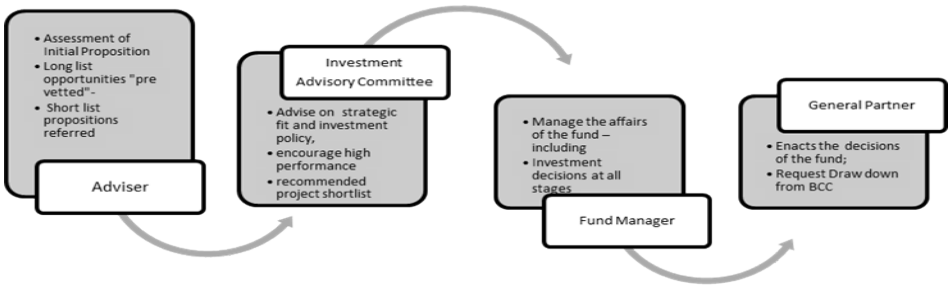
1.3 BBRC have had discussion on the potential fund structure with both Burges Salmon, Solicitors, and with input from NCM Fund Services Limited, a regulated specialist fund manager, has decided that an English Limited Partnership ("LP") structure is most appropriate. The LP is a commonly used investment vehicle which has no legal personality and enables different types of investors to co-invest. LPs are governed by a relatively light statutory and regulatory regime when compared to companies and limited liability partnerships. This flexibility means LPs can vary greatly in terms of size and complexity.

1.4 The LPs (BCC and BSC) will make a minimal equity contribution each and will be parties to a limited partnership agreement. The main element of the investment will be debt financing which will be allocated within the portfolio via a matrix of secured lending, unsecured lending and risk investment, each of which will have varying risks profiles. These legal agreements are yet to be finalised and the finance provisions will include the base investor information, financial reporting requirements, the permitted uses of capital, circumstances after which capital may no longer be called and the rights and remedies of the fund in the event of a default by an investor or advisor.

1.5 By not engaging in decision making, the LPs liability is limited to the value of their capital stake. There is no additional cost or risk to BCC in this direct investment model. Limited Partners may not direct the investment decisions of a LP based fund without sacrificing their limited liability status. However, they can and should influence the way that the fund is invested at a strategic level by setting the Investment Policy which will be adhered to by the Adviser and Fund Manager.

2 Accountable Body

2.1 BBRC will be the Accountable Body and the fund will employ an experienced Fund Manager regulated by the Financial Conduct Authority (FCA) responsible for investment decisions at all stages through to disposal or exit/realisation. A General Partner, has been created, which will be operated by BBRC and will accept all liabilities that may stem from this activity. Adviser to assist in the sourcing, initial evaluation and filtering of applications for funding which will be referred to the Investment Advisory Committee. A high level illustration of the investment decision flow is outlined below.



2.2 To cover the operational costs BBRC will not charge any additional fee in respect of the monies invested by that investor but will charge an overarching management / administration remuneration of c.3% p.a. (c.£5m = £150,000) of the fund it raises and deduct (top slice) this from the relevant funds raised. The current financial model indicates a figure in the region of £131,000, although the Collaboration Agreement allows for BBRC to be remunerated up to 5% for its services.

2.3 In respect of particular funding initiatives, similar remuneration of 1% - 3%, will be applied for the arrangement and monitoring of the project. As the Accountable body all loans from the fund will be between BBRC and the applicants – although it would be expected that the Bristol One City brand would be widely used.

3 The Financial Implications

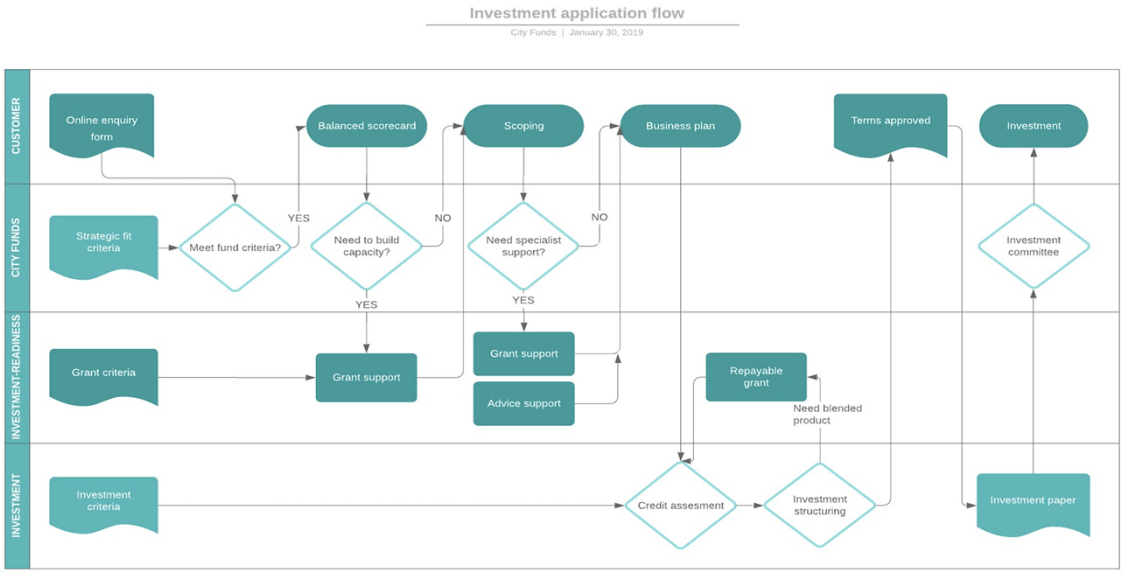
3.1 The initial fund is presently expected to have a ten year life and yield returns of 4%per annum for investors. The funds will be invested in longer term less liquid opportunities ranging between £50,000 - £1m with interest rates of 4% - 10%.

3.2 The Adviser will act in effect as "gatekeeper" for enquiries to the Fund and from a financial perspective will include the following assessments:.

- Conducting anti money-laundering checks as agreed with the fund Manager.
- Analysis of any potential state aid implications.
- Evaluate, by reference to the investment policy criteria, applications for funding
- Lead on financial "due diligence" and credit risk analysis.
- Be the Fund's representative in negotiations with prospective recipients of funding.
- Take advice from VAT Advisory Services Limited as to the VAT implications for the Fund and the way in which the contracts and the cash flows associated with them are structured.

3.3 The Adviser role is purely advisory and will not have the power to bind the Fund or to make any decisions as to any investments on its behalf. Once this initial "pre-vetting" has been undertaken by the Adviser and the Investment Advisory Committee, the proposal will be formally referred to the Fund Manager for a decision. The Fund Manager will need to assess and evaluate each investment proposal and to have a completely unfettered discretion on approvals. The Fund Manager can only approve investment propositions that have adhered to the robust process of full review by the local fund advisor and the Investment Advisory Committee. If the Fund Manager approves a particular investment, it will make arrangements for the General Partner to implement it.

3.4 The Funds will support funding applicants which have a sound and commercial business idea on their journey to make their project investment ready. Early stage ideas could be supported with City Grant Fund whilst they work together with the City Funds team to build their capacity and business case in preparation for an investment application. The process from the potential project's perspective is shown in the investment application flow, below. The goal is to help these organisations reach sustainability and therefore build resilience into the social sector as a whole.



3.5 This customer journey is designed around a gated decision-making process, addressing key assessment areas and providing wrap-around support to maximise successful outcomes. Through this process, applicants will build resilience into their organisation at the same time as minimising credit risk to the Fund.

3.6 The loans provided, where appropriate can include flexible repayment plans including interest and capital repayment holidays. The indicative draw down of BCC investment is outlined in Appendix G (ii) with the first BCC drawdown expected within 2019. Due to the need to scale up and grow the fund for the first 5 years it is not proposed that investor returns will be drawn down for the first 5 years of the Funds operation.

3.7 Following the first 5 years of operation, should a decision be made to release the funds, due to their likely non liquid status, notice of 5 years will be required to release the fund, enabling assets to be converted to liquid form or alternatively seek new investors. Given the wider social impact expected to be derived from these investments, From year 5 BCC will also have the opportunity to consider annually the extension of the period of investment for a period of (+1), (+1) up to 2 years (12 years in total).

3.8 The investment of £5m will be funded from one-off funding attributed to additional Section 31 business rates received in 2018/19, from which an earmarked reserve was created during the 2019/20 budget process, specifically for this purpose. BCC would not be required to put any monies into the fund until individual projects are approved. As such the amount of money invested in City Funds will rise over time until it hits the £5m maximum.

3.9 BCC's invest will become part of the borrowing base and as such will be subject to capital calls issued periodically by the General Partner of the fund. When issuing capital calls, the Fund Manager faces potential uncertainties relating to whether or not the funds will be received as required, as well as built-in time delays imposed by fund governing documents which typically require 7 to 15 business days advance notice. This, at the very least, hampers a fund's flexibility in deciding when to call capital and also creates risk of a potential default by a fund in meeting its contractual obligations, such as paying the purchase price at a closing, because it does not have the money in hand. To deal with these concerns, BCC's approval and payment process will need to be sufficiently agile to meet the Fund's needs.

4 Sensitivity analysis

4.1 A sensitivity analysis and stress test has been undertaken on the City Funds financial model, which provides an indicative Internal Rate of Return (IRR) of 6% for BCC (4% BCC minimum). The key risks to achieving this IRR are:

- the number of projects being approved.
- the interest rates achievable on each project.
- the level of default rates.
- the amount of first loss funding available.

4.2 The focus point in managing the success of the fund should be on ensuring that the split between the themes stays on target as too many projects in Economic Inclusion and/or No Child Goes Hungry will reduce the IRR. The default, interest and first loss rate risks can be managed on a project by project case to ensure that it is adhering to the fund's parameters; however the split between the themes will need a more holistic overview to keep it in line with the model.

4.3 The stress testing shows the following:

- If the number of projects drop by 30% specifically in the Community Initiatives and Environmental Transformation themes the IRR will drop to 3.9%
- If interest rates reduce by 3% across all projects the IRR will drop to 3.2%
- If default rates increase by 15% on all projects the IRR will drop to 2.9%
- If the amounts funded by first loss funders reduce by 15% on all projects the IRR will drop to 2.4%

5 Alternative Usage

5.1 The alternatives usage for this fund needs to be given some consideration as part of decision making. A Council with approximately £5m of liquid reserves would typically place these on short term deposits with lower rates. The average rates achieved for deposits of this nature for BCC is 0.9% amounting to £45,000 per year (£450,000 for 10 years). Whilst like all investments there is a risk that future cash-flows do not materialise. This potential increase in investment income from alternative usage should be compared against wider social value and or c.4% - return amounting to £1,055,000. See Appendix G (ii) for breakdown.

6 How is risk being managed?

6.1 There are financial risks associated with this investment that will need to be managed throughout the life of this investment. The longer term aim of the City Funds is to create a legacy pot for the city, via the returns it generates. This is part of a wider resilience strategy, however there is not a 'tried and trusted' route for the proposed investment and therefore the partners will need to be responsive and work collaboratively to ensure issues are addressed and risks are managed in an effective and efficient manner.

6.2 The high level risks identified by the proposer are outlined within the business case, with proposed mitigations and further risks considered by BCC are outlined in Appendix D as well as the actions to mitigate and reduce those risks to the BCC. A risk framework is required to ensure proper oversight and assurance can be provided that the portfolio themes remain within their guidelines and constraints, market volatility is appropriately tracked and risks assessed and consistently reported.

6.3 The progress of the fund will be managed as part of the BCCs Investment Fund and it will be monitored on a regular basis by the Capital Board chaired by the Executive Director Resources and movements on the funds reported to Cabinet with annual performance and impact assessment available for Scrutiny.