Coventry City Council

Public report
Cabinet Report

A separate report is submitted in the private part of the agenda in respect of this item, as it contains details of financial information required to be kept private in accordance with Schedule 12A of the Local Government Act 1972. The grounds for privacy are that it contains information relating to the financial and business affairs of any particular person (including the authority holding that information). The public interest in maintaining the exemption under Schedule 12A outweighs the public interest in disclosing the information.

Cabinet	25th February 2020
Council	25th February 2020

Name of Cabinet Member:
Cabinet Member for City Services – Councillor P Hetherton
Cabinet Member for Strategic Finance and Resources – Councillor J Mutton

Director Approving Submission of the report:
Deputy Chief Executive (Place)

Ward(s) affected:
None

Title:
Acquisition of a commercial asset

Is this a key decision?

Yes -the proposals involve financial implications in excess of £1m per annum.

Executive Summary:

Officers have been exploring the commercial and financial viability of acquiring a commercial asset. The Council has entered into an exclusivity and confidentiality agreement to undertake due diligence to assess the commercial opportunities and business risks associated with acquiring this business. The acquisition presents several opportunities to add value to an internal service, that could only be delivered from acquiring these shares. The current owners have expressed a preference to complete the transaction by the end of the financial year (10th March 2020). The estimated acquisition price will be adjusted for net debt within the business and working capital. The final value will not be known until the legal documents have been agreed and due diligence has been completed on the management accounts for the current financial year.

This paper explores the options available to the Council in relation to the acquisition and the impact under each scenario. The recommended option in the report is for the Council to acquire shares in the commercial asset which also includes the business of related companies.

Recommendations:

The Cabinet is requested to recommend that the Council:

1) Approve the use of its powers under Section 12 of Local Government Act 2003 and Section 1 of the Localism Act 2011 to acquire the shares in the company as a commercial investment for the maximum value as disclosed in the Private report (including transaction costs), subject to any adjustments detailed in the report.

2) Approve the addition of the commercial investment as detailed in the Private report to the capital programme.

3) Delegate authority to the Director of Streetscene and Regulatory Services, Director of Finance and Corporate Services and City Solicitor and Monitoring Officer to agree detailed terms of the transaction with the Commercial Asset.

4) Delegate authority to the Director of Streetscene and Regulatory Services, Director of Finance and Corporate Services and City Solicitor and Monitoring Officer to enter into the relevant legal agreements and associated documents necessary to complete the transaction.

5) Approve the implementation of the governance structure and associated terms of reference for the Shareholder Panel and Board of Directors, as detailed in section 2.14 of the report

6) Delegate authority to Leader of the Council to approve the appointment of three Members onto the Shareholders Panel to represent the Council as sole shareholder of the Company.

Council is requested to:

1) Approve the use of its powers under Section 12 of Local Government Act 2003 and Section 1 of the Localism Act 2011 to acquire the shares in the company as a commercial investment for the maximum value as disclosed in the Private report (including transaction costs), subject to any adjustments detailed in the report.

2) Approve the addition of the commercial investment as detailed in the Private report to the capital programme.

3) Delegate authority to the Director of Streetscene and Regulatory Services, Director of Finance and Corporate Services and City Solicitor and Monitoring Officer to agree detailed terms of the transaction with the Commercial Asset.

4) Delegate authority to the Director of Streetscene and Regulatory Services, Director of Finance and Corporate Services and City Solicitor and Monitoring Officer to enter into the relevant legal agreements and associated documents necessary to complete the transaction.

5) Approve the implementation of the governance structure and associated terms of reference for the Shareholder Panel and Board of Directors, as detailed in section 2.14 of the report

6) Delegate authority to the Leader of the Council to approve the appointment of three Members onto the Shareholders Panel to represent the Council as sole shareholder of the Company.

List of Appendices included:
None

Background papers:
None

Other useful documents
None

Has it been or will it be considered by Scrutiny?
No

Has it been or will it be considered by any other Council Committee, Advisory Panel or other body?
No

Will this report go to Council?
Yes – 25th February 2020

Report title: Acquisition of a Commercial Asset

1. Context (or background)

1.1 Councils are increasingly looking for opportunities to generate an ongoing revenue stream through capital investment to help bridge the gap in relation to the cost of providing services and the funding available to deliver them. CCC has been no different in seeking commercial returns through growth in its traded services to looking externally at other avenues for income generation.

1.2 The Commercial asset is a going concern company that has achieved year on year growth in their turnover position, which has increased by 35% over 4 years and is forecast to continue with this trend this year. The current owners have decided to sell the business and the Council has entered into an exclusivity and confidentiality agreement to consider the transaction.

1.3 This report recommends the Council takes proactive action to acquire shares in the commercial asset, with a view to developing an action plan for the future operation of the company and any links to internal services.

2. Options considered and recommended proposal

2.1 **<u>Option 1 – Do nothing</u>** – the commercial asset will be sold to another entity. They will have greater flexibility in terms of pricing, cost management and commercial operation than any internal services, so may have a detrimental effect on similar services provided in house and potentially therefore on the Council's future medium term financial strategy.

2.2 **<u>Option 2 – Council acquires the commercial asset</u>**– The Council acquires 100% of the shares in the commercial asset.

2.3 The due diligence process has highlighted that there are other companies that are linked to the operation of the commercial asset which are also being considered as part of this transaction. It is envisaged that prior to completion of the transaction, the business from linked companies will transfer into the commercial asset.

2.4 The total turnover generated by the group of companies being considered as part of this transaction is detailed in the Private report. The transaction includes the revenue and assets from linked businesses moving to the commercial asset.

2.5 The earnings before interest, tax, depreciation and amortisation (EBITDA) position reflects the net earnings for the company, excluding the costs of financing, accounting for capital expenditure and tax.

2.6 The financial performance for the first six months of the current year (2019/20) indicates that the core business has continued to grow with an increase in when compared to the same period the year before.

2.7 Further due diligence is being undertaken on the financial performance of the group for 2019/20 as the management accounts are provided to the Council for review.

2.8 The balance sheet for the commercial asset shows a highly geared position (high proportion of debt), but there are sufficient assets to cover the debt in the business. The business has secured favourable commercial terms for the debt in place and as such there is no benefit for the Council to refinance the debt within the business, without extending the length of the loan. This could be considered in the future.

2.9 Acquisitions are usually undertaken on a debt free/ cash free basis, which means the value attached to the shares (equity value) is based on having adjusted for the debt and cash to remain within the business.

2.10 The value attributed to the business is disclosed in the private report, adjusted for the net debt and a normalised level of working capital.

2.11 A share acquisition can only be financed over a maximum period of 20 years, which means the capital financing costs for the business are higher than if it was possible to spread this over a longer term. The current profit (2018/19 for group) is sufficient to service this level of investment costs and deliver dividends that could be attributed to the medium term financial strategy. Based on this performance, it would be possible to extract dividends over and above the capital financing costs without jeopardising the day to day operation of the business. There has been growth for the current financial year, which has shown an increase in profit for the first 6 months of the year (April to September 2019), strengthening this financial position.

2.12 As part of the due diligence, costs have been incurred with our external financial advisors for financial due diligence, our external legal advisors for legal due diligence and our external environmental advisors for an environmental survey and due diligence. There will be costs incurred to complete the transaction as part of the Sale and Purchase Agreement. Approval is being requested to incur these fees retrospectively for the due diligence work and going forward to enable the shares to be acquired within the company. Flexibility is requested to utilise the approved financial envelope to meet the acquisition costs and any transaction costs to complete the deal.

2.13 Our environmental advisors were instructed to undertake an environmental survey for the sites operated by the commercial asset. The survey has concluded there are a number of operational and environmental risks that can be mitigated through the Share Purchase Agreement and actions by the Company pre completion.

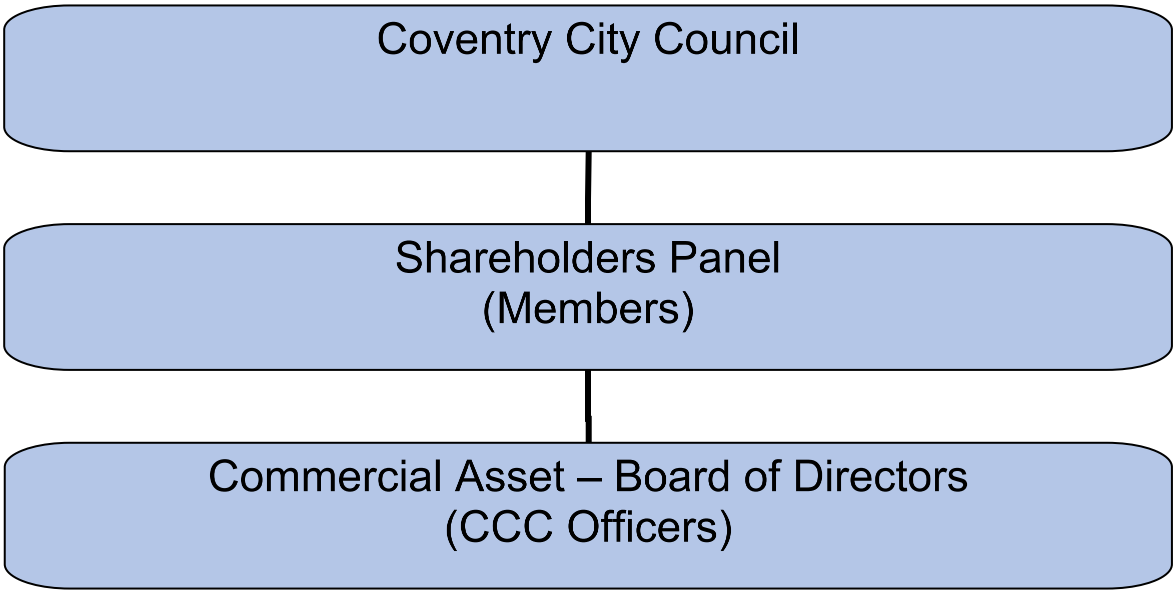
2.14 It is proposed that the following governance arrangements (Figure 1) are implemented to manage this commercial investment:

2.14.1 Creation of a Member Shareholder Panel with overall responsibly for the investment, approval of the business plan and the financial parameters within which the Board of Directors and Management team can take forward decisions. It is proposed this group would meet on a minimum bi-annual basis to set the budget and receive information about the performance of the business. The Shareholders Panel will be made up of three Members.

2.14.2 Board of Directors made up of officers who would meet on as a minimum on quarterly basis to oversee the management of the business and monitor the performance against the approved business plan.

2.14.3 The Board of Directors would be supported by suitably qualified Non-Executive Directors to provide advice and challenge to the Board and the Management Team. It is proposed that the current owner will provide consultancy advice and support to the Company to ensure there is a suitable continuity, handover and oversight for the operation of the business for a period of 24 months, this could be in the form of a Non-Executive Directors. The membership of the Board of Directors will be agreed in consultation with Cabinet Member for City Services.

Figure 1: Governance structure for the proposed transaction



2.15 The finances of the group demonstrate a net return to the Council, acquiring the business and operating it as a standalone investment at this time, is the recommended option.

2.16 Alignment of the company with internal services could deliver additional value, which includes targeting a level of efficiency such as removing duplicate costs and increasing revenues and growth in businesses. To inform this integration, senior key council officers would observe and work alongside the commercial asset to understand the current business, from marketing, pricing, securing customers through to operational delivery for minimum period of 6 months. These experiences would then be used to develop a plan to consider alignment with internal services. A further report will be bought forward to Members once details have been developed and there are clear recommendations for approval.

2.17 **Option 3 – Integrate the commercial asset with internal services** - It is not possible at this time to provide greater clarity on the impact of integrating the company with existing internal services as the details will only be developed once the transaction is complete and there is a greater understanding of the operation of the business. There are a number of areas that need to be explored including but not limited to, considering the ideal company structure for ongoing operations, HR implications including TUPE, tax structuring and operational planning work which will all be considered at the appropriate time. Currently this is not the recommended option. A report will be bought forward in the future with details of integration and the value that can delivered through this option post acquisition of the company.

3. Results of consultation undertaken

3.1 None

4. Timetable for implementing this decision

4.1 The timescales for the transaction are detailed below:

- March 2020 – Agree a final price for the shares based on negotiations and any adjustments as a result of the Environmental survey. Finalise any legal documents required to implement the decision, to be formally signed to transfer ownership on receipt of Member approval to procced with the transaction.

5. Comments from Director of Finance and Corporate Services

5.1 Financial implications

It is important to consider the proposed Council's investment in the company in the context of the Council's Commercial Investment Strategy approved by Council as part of the Budget Setting Report in February 2020. The proposed investment has been subject to a detailed business case assessment as set out in the private report, identifying the risks and how these can be managed.

Although the investment is being funded through prudential borrowing the Council is not borrowing purely in order to profit, and the purchase will realise significant service benefits as well as provide a forecast financial return to the Council over time. The Council has the skills required in respect of operating a business within this sector and this acquisition will only strengthen that position.

Acquiring the assets of the company as part of the transaction provides greater security for the Council in terms of realising additional value and presents an opportunity to consider alternative use for the site currently being utilised by Council services . This acquisition supports the diversification of investments made by the Council, reducing the reliance on other operations to generate a return to support the Councils medium term financial strategy.

The investment is proportionate to the size of the Council. In addition, the investment will be within the limit set within the Strategy for total investments in shares. The view of the Director of Finance and Corporate Services is that the investment is consistent with the Commercial Investment Strategy.

The maximum additional financial exposure for the Council could be reduced based on ongoing negotiations and lower professional fees to complete the transaction. The acquisition of shares is capital expenditure and would, subject to Member approval, be incorporated into the capital programme. The expenditure is unfinanced capital spend, as capital receipts, revenue contribution or grant have not been set aside to meet this cost. All future dividends would be due to the Council as sole shareholder. Based on past performance, the commercial rent for the site and dividends would be sufficient to meet the ongoing capital financing costs of acquiring the shares. The most appropriate financing option will be determined by the Director of Finance and Corporate Services depending on the availability of capital receipts, cash balances, interest rates etc. Options are being explored to reduce the capital financing costs for investments in the future where it is commercially advantageous to do so.

The business case for acquisition is based on the operation of the company currently. There is no guarantee that the financial projections will be delivered, however based on previous performance the company should be successful in generating year on year growth. There are external factors that are outside of the Council's control which could impact on the financial performance of both waste operations. The governance arrangements in place should be sufficient to monitor performance and to provide ongoing challenge to the commercial asset's management team on performance and the operation of the business.

5.2 **Legal implications**

5.2.1 Under Section 12 of the Local Government Act 2003 the Council has a specific power to invest. The power states "a local authority may invest for any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs". This provides the Council with a power to invest in the commercial asset, for any purpose relevant to its functions (this function would have to be identified) or if the Council can show it is for the prudent management of its financial affairs. Under section 1 of the Localism Act 2011, the Council also has a power “to do anything that individuals generally may do” (the “General Power of Competence”). “Individual” means an individual with full capacity. The General Power of Competence gives the Council:

i. power to do a thing anywhere in the United Kingdom or elsewhere,
ii. power to do it for a commercial purpose or otherwise for a charge, or without charge, and
iii. power to do it for, or otherwise than for, the benefit of the authority, its area or persons resident or present in its area.

5.2.2 Where the Council uses the General Power of Competence to do something for a commercial purpose, section 4 of the Localism Act 2011 requires that the Council must do so through a company (which has a wider definition than for the purposes of section 95 Local Government Act 2003).

5.2.3 The requirement under section 4 of the Localism Act 2011 is very similar to the requirements of section 95 of the Local Government Act 2003 (the “trading power”). The Council will be compliant with the requirements of both the General Power of Competence and the trading power as any commercial purpose activity or trading will be done through the commercial asset. This report serves as a business case for the proposed investment in the company and the proposed trading through that company following the share purchase.

5.2.4 The General Power of Competence is limited by any restrictions on any pre-existing powers of the Council. The General Power of Competence can be used in conjunction with existing powers, for example the section 95 trading power.

5.2.5 If the Council is considering providing any services directly to the commercial asset, for example a contract to provide back office support such as payroll, it can use the “incidental power” under section 111 of the Local Government Act 1972, which enables it to “to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions” (its function in this case being the General Power of Competence).

5.3 **Governance and Articles**

5.3.1 The company’s Articles will be redrafted to reflect that the Council will be the sole shareholder. As soon as the Transaction is completed the necessary resolutions will take place to approve the Governance in section 2.25.3

5.4 **Procurement and State Aid**

5.4.1 The Council is not purchasing any services, goods or works as part of the transaction, and so the Public Contracts Regulations 2015 and the Council’s contract procedure rules will not apply.

5.4.2 The Council is complying with EU State aid law as the transaction is being undertaken upon arms' length terms, meaning that no benefit is conferred on the vendor and there is no distortion to competition. It is important that the commercial asset is to be treated as commercially at arm's length.

5.5 **Legal Due Diligence -** The Council has appointed external legal advisors to undertake independent Legal Due Diligence on the commercial asset. The Share Purchase Agreement which documents the transaction will have the necessary warranties and indemnities to protect the Council in making this investment resulting from the due diligence which has been undertaken

6. Other implications

A small number of the commercial assets Management Team and Council officers have been involved in the discussion and negotiations. Formal briefings are required to inform all staff of the change in ownership. The Council and the Company will work together to ensure this briefing is undertaken in an empathetic and sensitive manner. It is likely there will be an impact on management and possibly operational staff as part of the integration. Details are not yet developed but will be shared once available and approval sought through the relevant governance process.

6.1 How will this contribute to the Council Plan (www.coventry.gov.uk/councilplan/)?

This commercial investment should deliver a return that will support the Council to continue to provide services in line with the Council's core aims.

6.2 How is risk being managed?

As this is an arm's length commercial investment, it is key that the governance structure in place allows the business to operate as a commercial entity. The management team in place will need to be have appropriate skills and experience to be able to manage the day to day operations as well as any strategic decision approved by the Board of Directors and Shareholders Panel. The existing management team will continue in post until the initial review of the Company is undertaken. It is proposed that the current owner will also continue to play an active role within the company for a period of 24 months to ensure there is effective handover and oversight of the Management team and operations.

This investment decision has been based on investing capital to receive an ongoing revenue benefit. There is no guarantee that the financial projections will be delivered, however based on previous performance the Company has been successful in generating year on year growth and there are areas where the two services could make cost savings. There will be commercial skills within the Company which can help to drive in the future. There are some factors that are outside the control of the business and the Council, such as an economic downturn that could impact of the financial and operational performance. These will be managed through the proposed Governance structure should this arise in the future.

6.3 What is the impact on the organisation?

There is likely to be an impact on the staffing within the Commercial asset and any related Council service at a management level. The management structure for the service is yet to be developed and will be influenced by the observations during the initial 6 months of operation.

6.4 **Equality and Consultation Analysis (ECA)**

No equality impact assessment has been carried out as the recommendations do not constitute a change in any Council policy or service. An ECA will be undertaken when there is greater clarity on the impact of changes for the internal service.

6.5 **Implications for (or impact on) climate change and the environment**

This significantly greater Council controlled entity in the city will place us in a stronger position to be able to deliver the objectives of the strategies detailed in the private report.

6.6 **Implications for partner organisations?**

There will be an impact as with any change in ownership for the partner organisations that are also customers of the Company being acquired. The impact will be managed to ensure there is a smooth transition and little change in customer experience and service received by all customers.

Report author(s):

Name and job title:
Andrew Walster – Director of Streetscene and Regulatory Services
Parmi Mudhar – Programme Manager - Finance

Directorate:
Place

Tel and email contact:
02476 83 2621 Andrew.walster@coventry.gov.uk
Parminder.mudhar@coventry.gov.uk

Enquiries should be directed to the above person.

Contributor/approver name	Title	Directorate or organisation	Date doc sent out	Date response received or approved
Contributors:				
Lara Knight	Governance Services Officer	Place	17th Feb 20	17th Feb 20
Phil Helm	Finance Manager	Place	4th Feb 20	10th Feb 20
Grant McKelvie	Commercial Business Director	Place	4th Feb 20	5th Feb 20
Gurbinder Singh Sangha	Major Projects Commercial Lawyer	Place	4th Feb 20	10th Feb 20
Michael Rennie	Lead Accountant - Business Partnering	Place	4th Feb 20	6th Feb 20

Names of approvers for submission: (officers and members)				
Finance: Barry Hastie	Director of Finance and Corporate Resources	Place	10th Feb 20	14th Feb 20
Legal: Julie Newman	Head of Legal Services	Place	10th Feb 20	12th Feb 20
Director: Martin Yardley	Deputy Chief Executive (Place)	Place	17th Feb 20	17th Feb 20
Members: Councillor Patricia Hetherton	Cabinet Member for City Services	Elected Member	17th Feb 20	17th Feb. 20
Members: Councillor John Mutton	Cabinet Member for Strategic Finance and Resources	Elected Member	17th Feb 20	17th Feb 20

This report is published on the council's website:
www.coventry.gov.uk/councilmeetings