APPENDIX 3

DRAFT
Business Plan Risks
Development Proposition
Eagle Wharf, Peckham

Southwark Council & Mountview Academy of Theatre Arts

DRAFT FOR DISCUSSION
September 2015

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Introduction and Background

Southwark Council are exploring the option for Mountview Theatre Academy (MV) to relocate from their current site in Haringey to a Southwark Council owned site in Peckham. This relocation would involve a development of the site (Eagle Wharf) costing approximately £20m.

The Academy relocation is seen by the Council as a significant boost to the local area as part of the wider regeneration of Peckham. As such, the Council has the appetite for, and has explored advantageous terms to help MV to fund their relocation within an annual budget of c£1m p.a. for premises costs.

As part of the relocation agreement Southwark would propose to negotiate a 99 year lease for the ground rent of Eagle Wharf and a loan from the Council to MV equal to the capital spend required at a preferential interest rate of between 4 and 4.50%p.a.

In considering the proposed relocation project Southwark have engaged legal support from Pinsent Mason who have provided advice on whether the loan would constitute State Aid and we understand that their advice is that a General Exemption based upon the non-profit status of Mountview would be available. We make no comment on the strength of this advice, but for the purposes of this report presume that this exemption is available and therefore there are no State Aid restrictions on the agreement of the interest rate and terms of the loan to Mountview that need to be considered.

In our role as financial advisors to Southwark and under the terms of out engagement letter dated 16/07/2015 we are pleased to provide this commentary on the key risks associated with the proposed loan based on our discussions with Southwark Council and Mountview and our review of the Mountview business projections provided to us.

In considering the key risks we have reviewed the Mountview business plan dated 20th July 2015 and labelled as the "Anticipated Case – As sent to PWC". This review does not constitute a model audit nor does it represent a review of any tax or accounting assumptions contained within the model. We have examined the outputs of the model and discussed the inputs and sources of assumptions made with representatives of Mountview in the presence of Southwark Council staff with a view to identifying material areas of risk to the repayment of a loan were it made by Southwark.

Whilst we comment on what factors could impact Mountview's ability to repay the loan we have not modelled sensitivities on the business plan in order to quantify the impact of these factors.

Key Business Plan Outputs

In reviewing the business plan we have identified some of the key inputs, outputs and cost drivers and set them out below. MV have modelled three possible scenarios, Downside, Anticipated and Upside. As part of this process we have only reviewed the Anticipated Case but we have included the MV summary of key assumptions for all three cases as an appendix to this report.

The business plan includes cashflow projections from FY 2015/16 to FY 2043/44. Those projections show Mountview successfully repaying the loan on the terms described below and building a surplus of cash totalling £11m in 2043/44 from an opening cash balance of £4.6m.

Loan Structure & Debt Service

The total loan is modelled as £21.2m. It is modelled as drawn-down at the start of 2018/19 and incurs interest at 4.0%p.a.

£3m of the loan is repaid at the end of FY 2018/19 with the proceeds of a fundraising campaign. An additional CiL (Community Infrastructure Levy) injection of £1.5m to reduce the loan is made in 2020/21.

The remainder of the loan is repaid through cash reserves or surplus cash generated in year from operating activities until the final repayment in 2038/39 (i.e. 20 years from drawdown).

Total debt service (interest + principal) grows from £750k p.a. to £2m p.a. by 2036/37.

The minimum cash balance after debt-service in any year is £2.6m and average cash balance over the period is £5.5m. However, it should be noted that in line with the charitable status of MV some of the cash held is in restricted reserves based on legacy donations and may not be available as security against the Southwark loan.

Debt service represents between 9 and 19% of the projected revenue each year.

Income

Of the income projected 90% is made up of fee income from students. This has been projected for each course offered by MV and shows an annual uplift in fees of 2.0% p.a. and an irregular growth in student numbers for each course based on the MV understanding of their likely applications. The total projected fee income grows from £4.8m in 2015/16 to £11m by 2043/44.

Other school related income includes audition fees that are payable by prospective students and box office income from the student performances as well as fundraising income of £25k p.a. Other school income ranges from £300k p.a. to just over £400k p.a. by the end of the business plan.

Additional commercial income from the commercial spaces planned within the new facility (including catering, bars and hire of rehearsal spaces) is modelled at between £400k & £600k p.a.

Operating Costs

The largest two expenditure items for MV are teachers' salaries and production costs of the shows which form a core activity of the Academy. The business plan models these costs as 100% variable with income received (43% and 16% respectively of the fee income), however, if there was a rapid fall in fee income it seems likely the fall in staff and production costs will be slower affecting the cash reserves of the Academy.

The plan also includes a projected tax credit of over £100k p.a. related to tax allowances of theatre productions. This income will be subject to future tax policy.

Once operating costs are netted against the revenue projections the school projects a trading surplus before loan interest and depreciation of approximately £1.5m p.a.

Key issues to note

It is clear from our review of the business plan that the projections of MV are contingent primarily on achieving student number projections, but changes in tax policy, lack of commercial revenue or additional employment costs of staff could quickly affect the achievement of the surplus.

Given the dependencies on unsecured revenue projections we believe the loan on offer would not represent a commercial deal achievable by MV elsewhere in the market. We will go on to discuss some of the key commercial issues and risks that the Council should consider in negotiating final terms with MV, however, it is important to note that structures other than a loan may be available.

We have considered the possibility for the Council to build the facility themselves and lease the building to MV when it is complete. This would reduce the credit risk the Council would be taking, although the Council's return on their own capital investment would still be dependent on the creditworthiness of MV as occupant to the extent that there are limited alternative uses for the buildings and limited alternative occupiers. It would also allow to Council to retain greater control over the capital project itself to prevent the risk of failure or cost overruns.

We understand there are exemptions/relaxations of s123 requirements which may or may not be applicable to the MV project should the Council seek to pursue them. This could still meet the primary objective of providing facilities in the Southwark area at less than £1m p.a. by structuring a lease payment at below market value subject to s123 exemptions.

We understand from discussions with the Council that this approach is not favoured and that some of the rationale behind this decision links to perceived procurement issues of direct construction contracting among other issues. However, it does remain an option available to them which could better mitigate the investment risk to the Council. To the extent that the Council chose not to pursue it we would advise that they have a firm understanding of the factors that have led them to reject it.

Commercial Issues and Risks

In general it should be recognised by the Council that the terms of the proposed loan arrangement are not on commercial terms and would not be acceptable to third party lenders in the market. As noted above although an approach where the Council were to develop the new facility and rent it back to MV may be a more commercial and lower risk option, that MV would not be able to afford the corresponding lease payments at full market value and therefore the more affordable proposed ground lease and development loan proposition has been identified by the Council. Given the local regenerative importance of attracting an educational use of the site from a leading Academy, we understand the Council therefore supports this loan based arrangement.

Below we have commented on the proposed ground lease and loan arrangements, considering risks to MV servicing the loan as modelled by MV in their business plan. We have identified the following issues that Southwark should consider:

Interest Rate Negotiations

Whilst MV have modelled an interest rate of 4.0%p.a. on the loan, Southwark are currently willing to offer 4.5%. This would mean additional interest costs of £1.3m over the projected life of the loan. This would lead to either a need for MV to increase their debt service payments each year, further eroding cash reserves (the additional annual payment could be as much as £110k), or extending the life of the loan which when the compounding effect of interest is taken into account could be an additional 2 years. Given the current repayment schedule is over 20 years, and the Council requires full repayment within 30 years, there is potentially flexibility to therefore extend the loan term.

One of the issues for Southwark's consideration regarding the interest rate is whether or not they would cover their own cost of capital. The most recent financial statements of the Council suggest average interest rates on their borrowings of more than 5%p.a., which would imply the proposed MV loan would be loss-making for the Council. However, were specific PWLB borrowings drawn for the purpose of the MV loan, the rates quoted on the 27th August 2015 remain below 4% and would therefore imply better value from the rate offered to MV.

In understanding whether or not the loan interest charged is sufficient, as well as comparing to the interest paid by the Council on their own borrowings, the Council should consider whether the accounting impact of any Minimum Revenue Provision against the loan to MV affects the overall cost to the Council's I&E account.

If the Council were to agree to the lower interest rate it increases the likelihood of the loan costing the Council money even when it is repaid in-time and in-full but the final conclusion will require confirmation from the Council's treasury department.

Loan Drawdown Date

MV have modelled the loan as drawn down in 2018/19, but in fact the funds will be needed as early as 2016. During this period MV would be unable to fund either the interest or any capital repayments on a loan. If Southwark were to structure the loan such that interest was rolled up during this period and was added to the capital amount it could lead to additional borrowings of c.£2m. This would represent a 10% increase in the loan and the debt service in each year or require a longer repayment profile of between 2 and 3 years.

Any further discussions with MV will need to raise this issue and the final loan document will need to reflect the actual drawdowns and an agreed approach to interest during the construction period during which time it is understood that MV will not have available cash to service the debt.

Sufficiency of Capital Amount

The business plan sets out the capital requirement, however, we are aware that a final construction price has not been agreed. Whilst there would appear to be headroom for MV to service additional capital if the Council are willing to agree to a 30 year repayment profile, unless MV demonstrate they have a fixed price construction contract passing the risk of construction delays and price increases to a building contractor with a suitably strong guarantee arrangement, the Council could find themselves in the position of having allowed the full loan to be drawn-down and the asset not be completed. Indirectly the Council would therefore be bearing some of the development risk.

From discussions with MV we expect that they do intend to enter into a fixed price contract, however, in order to protect the Council from funding an expensive unfinished asset and needing to provide further investment at a diminishing return to complete the asset, the satisfactory agreement of the Construction contract could be made a condition of any draw-down of funds. In addition the Council should consider its position in terms of providing debt to fund fit-out expenditure which would have less security than built assets.

In line with standard practice for project financing, which the proposed arrangement has a number of clear parallels with, the Council should also consider the risk of mismanagement on the part of MV and whether step-in rights to the construction arrangements are required such that the Council can act to influence the successful completion of the construction project. Such step-in rights are well understood in the market and the Council could discuss arrangements with legal advisors as required.

We would also highlight that other project finance controls over drawdowns may be applicable, such as certification of completed construction milestones by an independent certifier. If the Council wish to explore any of these protections in more detail we would be happy to discuss them.

Repayment conditions

The business plan shows regular principal repayments throughout the loan life, however, the Heads of Terms shared with MV and discussions held with MV representatives make repayment terms less clear. MV have discussed the ability to repay based on affordability and whilst this may mean they would hope to repay early to minimise interest charges, it may also suggest they expect to be able to deviate from the principal repayments projected in the business plan if they feel they cannot afford the full amount. Our understanding from discussions with the Council suggests that full repayment of principal over the loan life is a priority, and failure to meet the modelled repayments would certainly act as a flag that the MV business is struggling. With this in mind the negotiation of the loan documents, the repayment principles and the security the Council take over the buildings (including their rights to exercise that security) will need to be carefully negotiated and clearly documented.

Revenue downturn

Whilst MV have invested time and effort in projecting forward revenues, 90% of their income is contingent on students applying to study at the college. We understand that there can be no absolute certainty over the revenue assumptions and that no party can underwrite or guarantee the income assumptions. Whilst comfort can be taken from the information provided by MV on current application numbers and the solid operational history of the academy, the reality of the business plan is that if there was a material fall in student numbers following the move to new premises MV would find themselves struggling to repay the loan principal.

If Southwark were to offer the loan they would be accepting the risk on MV student numbers.

The largest two expenditure items for MV are teachers' salaries and production costs of the shows which form a core activity of the Academy. The business plan models these costs as 100% variable with income received (43% and 16% respectively of the fee income), however, if there was a rapid fall in fee income it seems likely the fall in staff and production costs will be slower and would therefore lead to erosion of the cash reserves of the Academy.

We would also note that we have not benchmarked these costs as part of our engagement and therefore can make no comment on whether the percentages chosen are appropriate.

We note in the business model that contingency sums are included of c.£150k p.a. to help manage the risk of the projections being inaccurate and discussions with MV have also revealed that the business plan does not presume that the school will operate at maximum capacity for either teaching income or commercial income. This helps build confidence that management have considered the risks but cannot remove the risk that revenues will fall to a level that threatens debt repayment.

In the case that revenues fall such that MV cannot repay the loan as it falls due, or even worse are unable to meet the interest in any period, the Council will need to understand what security is available to them and ensure the rights to exercise that security are clearly set out in the loan documents.

Security

As described above, whilst MV have provided a detailed forward looking business plan, the success of that plan, and the repayment of the Council's loan are dependent on achieving student numbers and fees in accordance with the projections. There can be no guarantee that the student fee income will be received and hence the Council should protect themselves by obtaining a level of security over the assets of MV, in this case the new building.

The loan documentation should set out clearly that the Council have a first charge over the Eagle Wharf buildings in the event that MV default on their loan repayments or interest. This would allow them to attempt to recover their loan through sale or operation of the asset without MV. The ground lease documentation should also bear this in mind and provide suitable clauses which provide the Council with the ability to take back the ground lease for non-payment of rent, or default of the loan agreement, so as to provide flexibility for the Council to collapse the lease and consider alternative use in the event of a failure. It should however be noted that the realisable value for the Council in exercising their charge over the asset is not guaranteed and it may remain the case that the best value is realised by the continuing operation of the MV Academy.

The other benefit of holding a charge over the MV assets as security is that it will maintain the Council's position as senior creditor and limit MVs ability to enter into any other borrowing arrangements that would further risk the repayment of the Council's loan.

We recommend that the Council take appropriate legal advice over the exact form of the security they obtain and how it can be structured into the lease and loan documents

Commercial Income

It is noted that the proposed development includes a number of commercial units that may generate additional revenue for MV. Commercial income has been modelled at between £400k and £600k p.a. over the life of the business plan, and therefore could represent a material amount of the debt service. It was also clear from discussions with MV that there was a real expectation that the actual levels could grow beyond those anticipated currently in the business plan.

As additional commercial income could provide additional cashflow to aid the servicing of the debt it is in the interest of the Council to encourage additional revenue. However, given that any generation is directly linked to the provision of the loan by Southwark there is a possibility that the Council may wish to see a proportion of this possible up-side shared with themselves. This would help avoid any perception that a lower than market interest rate had been provided to MV who were then generating large profits from their commercial operations, and reinforces the proposed uses agreed as part of the negotiations.

One route to protecting the Council's interests would be to re-structure the ground rent as a geared lease. A base amount which increased only when excess commercial income was received. When raised with MV this was not considered unacceptable in principle, but it must be considered alongside other Council priorities such as a higher interest rate.

Fundraising

The business plan includes significant cash receipts from fundraising activities linked to the proposed move (£3,000,000). These funds are not guaranteed, but it is expected that the move to the new premises may help stimulate a fund-raising campaign. The business plan projects that these funds will be used to pay down the debt in the first year of the new site being opened. Any delay in receiving these funds or lower than expected contributions will have a knock on effect on the cost of finance as a greater amount of repayments will need to be funded by operating surpluses which will likely increase the length of the payback period.

Whilst it seems unlikely that Southwark could receive any guarantees over the level of fundraising, and will therefore need to re-model the payback profile presuming no funds are received to ensure they understand the repayment profile in the event of minimal fundraising success, they should require that fundraising activities within this period have an agreed target and are contractually reserved to pay down the loan and cannot be used for other purposes.

Use Restrictions

In order to protect the Council from MV using the site for alternative more profitable uses, the Council may wish to protect the use of the site through: a) planning restrictions; b) use clauses within the ground lease arrangement; and c) repayment clauses in the loan agreement should the major use of the facility not be for operational MV purposes.

Conclusion & Next Steps

Based on our understanding of the state aid advice from Pinsent Masons, the Council are in a position to negotiate the final details of the loan agreement. We have identified to the Council that the proposed loan arrangement is not considered to be on commercial terms and understand there are wider Council benefits that impact the Council's final choice of structure. To the extent that the proposed structure is taken forward with MV, based on the considered risks and issues above there are a number of principles set out in the next steps below that we believe will help mitigate the Council's financial risk and that should be addressed as any loan documentation is finalised

- As highlighted above there is further detail required on the timing of the drawdowns and treatment of interest prior to construction completion;
- The final agreement of interest rate is required with the Council ensuring they understand the impact on their own I&E account of the rate which is offered;
- The loan agreement will need to be drafted to specify the security the Council can take over the built assets and the link to the proposed ground lease;
- The Council should ensure that the terms of the construction contract are well understood and appropriately allocate the risk of construction delays and cost overruns prior to releasing funds;
- The loan agreement will need to specify the terms of repayment and the triggers for default that lead to the Council being able to exercise their rights over the assets;
- The loan profile will need to be re-modelled to show the repayment profile assuming no fundraising is available, but the loan document should be negotiated such that fundraising receipts must be used to pay-down the debt; and
- The protections associated with protecting alternative uses of the site, and/or sharing in commercial income are considered.

Appendix 1: MV assumptions

Mountview Academy of Theatre Arts

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Business Modelling - Critical Assumptions - July 2015

		Downside	Anticipated	Upside
1	**Income**			
	Additional BA Students			
	Acting	8	8	8
	MT	8	8	8
	Actor Musician		2	4
	Production Arts		1	2
	Additional PG Courses			
	Existing courses to a cohort of 10	17	17	17
	New Course - 1	10	10	10
	New Course - 2	10	10	10
	New Course - 3			10
	Commercial Income -			
	Percentage of Calculated Total - Year 1	20%	30%	35%
	Percentage of Calculated Total - Year 2	40%	60%	70%
	Percentage of Calculated Total - Year 3	60%	80%	80%
	Percentage of Calculated Total - Year 4	80%	80%	80%
	Additional Summer Courses		£50K	£100k
2	**Inflation**			
	Income	1.75%	2.0%	2.5%
	Costs	2.5%	2.5%	2.5%
3	**Teaching Costs**			
	Percentage of Fees Years 1 - 5	41.0%	42.0%	42.0%
	Percentage of Fees Years 6 - 10	41.0%	42.0%	42.0%
	Percentage of Fees Years 11 - 15	42.0%	43.0%	43.0%
	Percentage of Fees Years 16+	42.0%	43.0%	44.0%
4	**Production Costs**			
	Percentage of Fees Years 1 - 5	14.0%	15.0%	15.0%
	Percentage of Fees Years 6 - 10	14.0%	15.0%	15.0%

	Percentage of Fees Years 11 - 15	15.0%	16.0%	16.0%
	Percentage of Fees Years 16+	15.0%	16.0%	16.0%
5	**Other Direct Costs**			
	Teaching Costs - Cost Inflation Assumption	2.5%	2.5%	2.5%
	Theatre Production Tax Credit	15%	15%	15%
6	**Overhead Costs**			
	Site Costs are as in 2018/19 - plus inflation for subsequent years			
	Site Cost - Maintenance - Years 1 - 7	£10 psm	£10 psm	£8 psm
	Site Cost - Maintenance - Years 8 +	£12 psm	£12 psm	£10 psm
	Site Cost - Utilities	£12psm	£11 psm	£10 psm
	Site Cost - Cleaning	£8.5 psm	£8.5 psm	£8.5 psm
	Site Cost - Security	£3.5 psm	£3.5 psm	£3.5 psm
	Site Cost - Other Site Costs	Base + 20%	Base + 17.5%	Base + 15%
	Overhead Contingency - Percent of Total Sales	1.5%	1.5%	1.5%
7	**LBS Factors**			
	Base CIL	£2M	£2M	£2M
	Additional CIL		£1.5M	£2M
	Loan Rate	4.5%	4.0%	4.0%
	Ground Rent - 5 Yearly increases	15%	13%	10%
8	**Depreciation**			
	Building Costs	50 Yrs	50 Yrs	50 Yrs
	Other Capital	10 Yrs	10 Yrs	10 Yrs