HAMBLETON DISTRICT COUNCIL

Report To: Cabinet
15 January 2019

Subject: **COMMERCIAL INVESTMENT PROPERTY PORTFOLIO**

All Wards

Portfolio Holder for Economic Development and Finance: Councillor P R Wilkinson

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1.0 PURPOSE AND BACKGROUND:

1.1 The purpose of this report is to seek approval for the principal of acquiring commercial investment properties to generate income for the Council. The Council's Commercial Vision as set out in the Commercial Strategy is to be self-sufficient by 2020/21 and not rely on Government grant to support the budget. This requires the Council to generate additional income of £400,000 in 2020/21, rising to £600,000 in 2021/22 and then £800,000 in 2022/23 as set out in the 10 year Financial Strategy. Acquiring commercial investment properties will help achieve those income targets.

1.2 The Council is currently in the process of acquiring its first commercial investment property, Treadmills Phase 1. While the capital expenditure is significant, the investment requires very little management and with tenants of strong covenants, poses a low risk to the Council.

2.0 PROPOSAL

2.1 The proposal is to increase the total budget for commercial property investment to £40,000,000 (including the purchase of Treadmills Phase 1). However, this figure could be increased or decreased if necessary. £40m could generate approximately £600,000 in annual revenue which would make a significant contribution to the Financial Strategy and exceeds the target set for 2020/21. The annual financing payment is estimated to be £1.4m, if £40m was borrowed for 50 years at an interest rate of 2.5% from the Public Works Loan Board. Interest rates are volatile and the Council would take the best opportunity to ensure favourable rates at the time of investment.

2.2 The proposal to acquire a commercial investment property portfolio has the potential to make a significant contribution to the Financial Strategy and therefore to the delivery of public services and projects to improve community, economic and environmental well-being of the District. However, the proposal is not without risks. The following measures will be put in place to reduce the management risks.

Proportionality

2.3 Advice from CIPFA is that borrowing for investment should be proportionate to the Council's overall budget. The finance costs would represent approximately 17.3% of the Council's current estimated budget for 2019/20 at £8.078m. 20% limit is deemed as an appropriate level for the commercial investment finance costs to be set as a proportion of the budget. The financing cost is deemed to be manageable if income from the investment properties was reduced, due to the Council's balance on reserves being £13.5m at quarter 2 2018/19. The finance costs as a proportion of the reserves is 12.96%. It is important to note that the main risk is a shortfall in net income, but it is highly unlikely for the entire net income to be eroded so a smaller proportion of funding would need to be found. The Council's reserves are allocated over 10 years in the financial strategy; this strategy would be reviewed and reported to Members at the earliest opportunity if there was to be a short fall in income.

Geographical and Sector Diversity

2.4 The commercial investment would be made across several assets in different sectors and geographies to reduce the risks associated with this investment. To ensure a low risk profile it is crucial to invest across the UK and in different sectors. The Council is already in the process of acquiring Treadmills Phase 1 within its administrative boundaries and, as part of a balanced portfolio, the Council would seek opportunities in other areas in the UK, outside the retail sector. Opportunities are likely to be sought in the industrial, warehousing and office sector.

2.5 Several Local Authorities have already invested in commercial property. The risk profiles of assets vary greatly and this is reflected in the yield of an asset. The higher the yield of a property the more income it generates as a proportion of its purchase price. However, a higher return on investment correlates with a higher risk of voids, maintenance costs, income shortfall and/or failing tenants. It is therefore crucial to acquire assets where a balance is struck between an acceptable return on investments and a low risk of income shortfall. The proposed budget of £40m would include all purchaser's costs associated with any acquisition. All commercial properties will be sought to be occupied under full repairing and insuring terms. The Council as Landlord is likely to insure the properties, but will be able to claim the costs back from tenants.

Investment Advisor

2.6 Approaches by agents would be motivated by the desire to sell a property and would not take into consideration whether these properties are a good investment for the Council. It is for this reason that a property investment advisor should be appointed to help develop and implement the Acquisition Strategy and act on behalf of the Council. Property investment advisors have established relationships that give them access to off-market opportunities, preferential treatment and the experience to avoid bidding wars. The investment advisor would be expected to produce quarterly reports to the Investment Board to report on the Council's Investment Portfolio, the commercial property market, any management issues emerging as well as any risks. The property investment advisor could also act as the property manager carrying out any management function (Licence for Alterations, landlord inspections, rent reviews etc). The management cost would be taken into account when establishing the net yield of the portfolio.

2.7 The Council will seek advice on the terms required in the tendering of the property investment advisor to ensure strict monitoring for the Council and to be able to hold the advisor to account.

Decision Making and Acquisition Strategy

2.8 A robust decision making process for making commercial investments would be devised to ensure that appropriate oversight, quality assurance and risk management is in place. This would include the Investment Board (as set out in the Cabinet Report "Commercial Opportunities" on the 9th October 2018). The Investment Board currently consists of the Chief Executive, the Deputy Chief Executive, the Finance Director (S.151 Officer) and the Director of Legal and Governance (Monitoring Officer). The role of the Investment Board and its membership will be reviewed and brought back to Cabinet.

2.9 The Council's policies for investment decisions would be set out in an Acquisition Strategy, which would be developed and approved by Council before any further purchases are made to avoid a reactive approach to market opportunities. This would ensure that any investments that are considered are in a strategic context. Within the Strategy an overall net yield between 4.5% and 5.5% should be targeted to balance risks and returns. Advice from property investment advisors shows that most Local Authorities are looking for a yield between 4.5% and 5.5%. The strategy would also consider thresholds and criteria for acquisitions which will provide safeguards to avoid overexposure to one particular location or sector.

3.0 CIPFA PRUDENTIAL CODE AMENDED DECEMBER 2017 AND STATUTORY GUIDANCE ON LOCAL GOVERNMENT INVESTMENTS (3RD EDITION) APRIL2018

3.1 CIPFA's Prudential Code and the Statutory guidance on Local Government investments state that Council should not "borrow in advance of need" in reference to borrowing to invest in commercial property for profit. The interpretation of the Code and the Statutory Guidance has varied across organisations. However, a large number of Local Authorities have recently invested in Commercial Property in a bid to generate additional revenue. Investments within a Local Authority's administrative boundaries have been criticised less than those outside its boundaries. It is argued that this type of investment is not only carried out for profits but also to assist regeneration and to support economic development.

3.2 The increased borrowing by Local Authorities from the PWLB to fund property investments and the continued ambiguity around what constitutes "borrowing in advance of need" to invest in commercial property for profit has prompted CIPFA to release a statement on the 18th Oct 2018 stating that

"local authorities *must not* borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed."

It further states that

"CIPFA considers that where the scale of commercial investments including property are not proportionate to the resources of the authority, that this is unlikely to be consistent with the requirements of the Prudential Code and the Treasury Management Code."

3.3 The Council is mindful of the CIPFA prudential Code and does not propose to borrow more than or in advance of need. The capital expenditure for the commercial investment portfolio will be incorporated into the Council's capital programme where the borrowing of the Council will be looked at in it totality within its capital financing requirement and the appropriate Authorised Borrowing Limit will be set in the Treasury Management Strategy Statement and approved by Council in February 2019 prior to any commercial investment occurring. In addition, in relation to commercial investment and proportionality this is described in paragraph 2.2 above in this report.

3.4 The Statutory Guidance on Local Government Investments (3rd edition) sets out the expectations in terms of disclosures where a Local Authority chooses to disregard part of the Prudential Code which includes risk management of any potential income shortfall (Paragraph 47).

"*Where a local authority chooses to disregard the Prudential Code and this Guidance and borrows or has borrowed purely to profit from the investment of the extra sums borrowed the Strategy should explain:*

• *Why the local authority has decided not to have regard to this Guidance or to the Prudential Code in this instance; and*

• The local authority's policies in investing the money borrowed, including management of the risks, for example, of not achieving the desired profit or borrowing costs increasing."

3.5 The Council will address the issues set out in the Statutory Guidance on Local Government Investment in the Capital Strategy and the proposed Acquisition Strategy; this is a new requirement prior to the beginning of each financial year and will be presented to Cabinet and Council in February 2019. In addition these matters will also be address in a future report to members on this Commercial Investment portfolio.

3.6 In addition CIPFA is of the view, as well as is stated in the guidance, that if a local authority invests outside its boundary, using borrowing to support this, in other areas of the UK to generate profit then it may be hard to justify this as it is not for core services to the resident. CIPFA is aware of the requirement for local authorities to support themselves due to reduction in Government funding however if commercial property investments are looked at in isolation then the local authority will be open to scrutiny to justify the borrowing for this this. If reserves where used to fund the commercial property investment then this would be in accordance with the guidance. The reserves of the Council is currently only £13.5m and this is already allocated in the 10 year financial strategy and is part of the capital programme.

3.7 The Council believes that in accordance with the Prudential Code and investment guidance that if the capital programme is reviewed as whole and borrowing is for the entirety of the capital programme and property investment is looked at within this then this commercial property capital expenditure investment could be considered as justifiable. For example if property investment occurred in Scotland and the income generated form this support the Business & Economy Section (not a statutory service) then this enables resident to receive a valuable service to help them with their business through 'lunch & learn', conferences, funding opportunities etc. As long as the local authority can clarify and confirm its position on prudence then this is in line with the code. (It should be noted that this is not the view of the Council's treasury management advisor Link Asset Services who believe that investment should be maintained within the boundary)

3.8 Consideration of the Minimum Revenue Provision statement is also key - Guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003 – where it suggests that the life of an asset should not be greater than 50 years. If a local authority deems an asset to have a life greater than 50 years then a professional advisor is required by the local authority to support this. Currently, the financial costs have been calculated using an asset life of 50 years and therefore this is likely to be the steer to the Property Investment advisor. However the Council currently in its investment of the Treadmills site phase 1 has had professional advice to support the asset life at 60 years. Therefore in due course when the Commercial Property advisor is reviewing the Council's future portfolio, they will consider asset life at that time.

3.9 The guidance also suggests a range of indicators should be established and reviewed on a regular basis as part of the Capital Strategy; this will be available for approval at Cabinet and Council in February 2019 before the beginning of the 2019/20 financial year. The Capital Strategy will address non-treasury investments, such as the commercial investment portfolio discussed in this report. The strategy is likely to include Key Performance Indicators such as Debt to Net Service Expenditure (NSE) ratio, Loan to Value Ratio and Investment Cover Ratio. Additionally, the trend of operating costs should be monitored. The strategy may also consider a minimum yield that may be acceptable to the Council, which is described in this report for the commercial investment at between 4.5% and 5% as described above in paragraph 2.9.

4.0 LINK TO COUNCIL PRIORITIES:

4.1 This project is instrumental in meeting the Council's commercial vision of becoming self-sufficient in 2020/21. Securing this commercial income will underpin the delivery of the Council's priorities across all departments.

5.0 RISK ASSESSMENT:

5.1 **Risk in approving the recommendations**

Risk	Implication	Prob*	Imp*	Total	Preventative action
Management costs increasing or higher than expected	Depending on the scale of cost increase, additional income streams may need to be identified to maintain funding of Council Services at the same level	3	4	12	Careful choice of property, tenants as well as monitoring through the Investment Board and property investment advisor input
Rental income reducing due to business failures or delay in reletting units	Depending on the scale of income reduction, additional income streams may need to be identified to maintain funding of Council Services at the same level	3	4	12	Careful monitoring through the Investment Board and property investment advisor, also advice from property investment advisor regarding market intelligence
Legislation is introduced that prohibits Local Authorities to borrow for commercial profit	The Council may need to reduce its total budget for property acquisitions	3	4	12	If borrowing has occurred prior to any legislation being introduced this is unlikely to impact on the Council's acquisition strategy
There is insufficient knowledge within the Council to support this commercial investment	Opportunities are missed and risk unidentified	3	4	12	Regular monitoring reports from Property Investment advisor should minimise this risk

5.2 **The key risk in not approving the recommendations are as shown below:-**

Risk	Implication	Prob*	Imp*	Total	Preventative action
The Council struggles to find alternative income streams	Reduction of services and projects	4	4	16	Explore further savings and efficiencies
The Council embarks on higher risk projects to secure additional income	The income is potentially volatile and at risk	4	4	16	Fully appraise each project and consider all risks

5.3 The main risk in investment in commercial property is the shortfall of net income either through vacancies, increased operating costs or reduced rent. This risk can be mitigated through securing investment grade tenants with a strong credit rating. The diversification of the property portfolio in terms of sectors and geographies reduces the risk exposure significantly. The risk that the entire net income would be eroded is highly unlikely due to the anticipated diversity of the portfolio.

5.4 While there is a risk that asset values could decrease, the nature of the anticipated tenancies means that rent should increase and without a significant shift of yields the asset values should increase. A particular focus of the acquisition strategy will be to ensure that asset values and maintained, which is likely to mean that new built or refurbished properties will be considered for purchase. The initial purchase costs (legal, agent's fees etc.) mean that the initial capital expenditure will be higher than the asset value that could be realised. However, as part of the on-going monitoring, the asset value and portfolio value will be formally assessed on an annual basis and also on an on-going basis to determine any potential risks.

6.0 FINANCIAL IMPLICATIONS:

6.1 The following table shows the impact on the Council's income by investing £40m, taking into account financing (borrowing at 2.5% over 50 years) and assuming a net yield of 5% of the portfolio. The net yield takes into account all purchaser's and management costs. The return to the Council following financing is set out in the table below. In reality not the entire £40m would be invested at the same time, but over a longer period when appropriate opportunities become available and the Council successfully bids for these.

	Year 1-5	**Year 6-10**
Annual Net income	2,000,000	2,318,548
Net Initial Yield	**5.00%**	**5.80%**
Annual Financing Cost	-1,402,284	-1,402,284
Net annual return to Council	597,716	916,264
Yield to council	1.49%	3. 05%

6.2 The type of acquisitions that the Council would consider, are likely to have 5 yearly rent reviews linked to the Retail Price Index (RPI). The table above is assuming a compound annual increase of 3% which results in the increase of income from year 6. The table is only an indication as the timing of rent reviews, the staggered purchase of properties and varying yields will result in a different income profile, which can only be determined as and when properties become available for purchase. Advice from property investment advisors suggests that it would take between 6-12 months to acquire properties of £40m (less purchaser's costs) taking into account that the purchase of Treadmills Phase 1 is with solicitors.

6.3 A large number of Councils are investing in commercial property within and outside their administrative boundaries. Several authorities have used Public Works Loan Board (PWLB) funding to finance the acquisitions. The scale at which Local Authorities have borrowed to finance property investments has raised concern and CIPFA has issued a statement on this matter (see Section 3).

6.4 The development of an acquisition strategy by a property investment advisor is estimated to cost £10,000 and this will be funded from the Income Generating Fund. It is proposed that the acquisition strategy is then approved by Cabinet.

6.5 The ongoing financial implications of the whole commercial portfolio will be included in the Capital Strategy to be approved prior to the beginning of the financial year in February 2019. This will include indicators which will allow Members to monitor the commercial portfolio on a quarterly basis in the regular revenue, capital and treasury management financial monitoring reports.

7.0 LEGAL IMPLICATIONS:

7.1 The Council has sought legal advice to confirm under which legal powers it is acquiring commercial properties, Counsel's advice on the legal status of the CIPFA guidance and how the proposals in this report fit with the guidance. The advice had not been received at the time of writing the report, so this will be reported verbally at the meeting.

7.2 The value of the contract with the property investment advisor is likely to be above OJEU thresholds and would therefore need to follow the appropriate procurement routes unless an appropriate framework can be identified.

8.0 EQUALITY/DIVERSITY ISSUES

8.1 Equality and Diversity Issues have been considered however there are no issues associated with this report.

9.0 RECOMMENDATIONS:

9.1 That Cabinet approves and recommends to Council that:-

(1) a total Commercial Investment Property Portfolio budget of £40m is approved in principal and included in the Capital Programme 2019/20;

(2) £10,000 is allocated to develop an Acquisition Strategy funded from the Income Generating Reserves as detailed in paragraph 2.9;

(3) the Acquisition Strategy is reported back to Cabinet and Council for approval and that a decision on whether to proceed with the Commercial Property Investment Portfolio be made at this time.

(4) the proposed decision making process for commercial investments be approved by Cabinet.

MICK JEWITT
DEPUTY CHIEF EXECUTIVE

Background papers: None

Author ref: HH

Contact: Hannah Heinemann
Head of Service – Commercial and Programme Management
Tel: 01607 767144