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South Hams Overview and Scrutiny Panel

Title:	**Agenda**
Date:	**Thursday, 20th July, 2017**
Time:	**9.00 am**
Venue:	**Cary Room - Follaton House**
Full Members:	***Chairman*** Cllr Saltern ***Vice Chairman*** Cllr Smerdon *Members:* Cllr Baldry, Cllr Birch, Cllr Blackler, Cllr Cane, Cllr Green, Cllr Hawkins, Cllr Hicks, Cllr Huntley, Cllr May, Cllr Pennington, Cllr Pringle
Interests – Declaration and Restriction on Participation:	Members are reminded of their responsibility to declare any disclosable pecuniary interest not entered in the Authority's register or local non pecuniary interest which they have in any item of business on the agenda (subject to the exception for sensitive information) and to leave the meeting prior to discussion and voting on an item in which they have a disclosable pecuniary interest.
Committee administrator:	Member.Services@swdevon.gov.uk

Page No

1. Apologies for Absence

2. Urgent Business

brought forward at the discretion of the Chairman;

3. Division of Agenda

to consider whether the discussion of any item of business is likely to lead to the disclosure of exempt information;

4. Declarations of Interest

Members are invited to declare any personal or disclosable pecuniary interests, including the nature and extent of such interests they may have in any items to be considered at this meeting;

5. Commercial Property Acquisition Strategy **1 - 22**

Report to:	**Extraordinary Overview and Scrutiny Panel**
Date:	**20 July 2017**
Title:	**Commercial Property Acquisition Strategy**
Portfolio Area:	**Cllr Keith Wingate, Business Development, Strategy & Commissioning**
Wards Affected:	**All**
Relevant Scrutiny Committee:	**N/A**
Approval and clearance obtained:	**Yes**
Urgent Decision:	**No**
Date next steps can be taken:	**After Full Council on 27 July 2017**
Authors:	**'Invest to Earn' Working Group: Cllrs Foss, Birch, Hopwood, Pennington & Wright.** **Darren Arulvasagam,** **Group Manager, Business Development** **Darren.Arulvasagam@swdevon.gov.uk**

Recommendations:

That the Panel RECOMMEND that the Executive RECOMMEND to Council to:

1. **APPROVE & IMPLEMENT the proposed commercial property acquisition strategy as detailed in Appendix A;**
2. **AGREE that officers conclude an appropriate procurement process to commission property experts to work on behalf of the Council in relation to the proposed commercial property acquisition strategy;**
3. **DELEGATE individual commercial property portfolio acquisition and disposal decisions to the Head of Paid Service, in consultation with the Council's S151 officer, the Leader and the appointed Chair of the 'Invest to Earn' working group; and**
4. **BORROW funds on fixed rate terms from the appropriate source in order to pursue this strategy. To fulfil the first tranche of the proposed strategy, this would require borrowing of up to £26.75m (£25m plus acquisition costs of 7%).**

(NOTE: a version of this report is also on the agenda for the Executive meeting on 20 July 2017 and, in accordance with Procedure Rule 5.2 (below), the Chairman of the Panel has called an extraordinary meeting to enable the Panel to consider this agenda item before its presentation to the Executive:

'An extraordinary meeting of the Overview & Scrutiny Panel may be called by the Chairman of the Panel, by any four members of the Panel or by the Monitoring Officer if he/she considers it necessary or appropriate.')

1.0 **Executive Summary**

1.1 On 9th March 2017, the Executive noted the proposed commercial property investment strategy and direction of travel. It also approved the allocation of resources to commission specialist advice in order to develop a full business case. This report sets out that business case based on the advice received.

1.2 The Council is facing a budget gap for 2018/19 of £0.585m as detailed in the Medium Term Financial Strategy. Action is required to close this gap.

1.3 The objective of this proposed strategy is to generate revenue streams to contribute to the financial sustainability of the Council, enabling it to continue to deliver, and where possible improve, frontline services in line with the Council's adopted strategy & objectives.

1.4 Additionally, regeneration efforts within the District can be funded from revenue generated by the implementation of the strategy. It will be necessary for officers to continuously review on a case by case basis which areas within the District can benefit from the revenue generated from the acquisition of properties.

1.5 Revenue generation would be achieved by the focussed acquisition of existing commercial property assets using predominantly prudential borrowing or any other unallocated or available Council reserve or capital receipt. Income is designed to contribute closing the Council's predicted budget shortfall from 2018/19.

1.6 If ultimately approved in this form, the strategy could see the Council expanding its commercial property portfolio utilising a maximum budget of up to £75m plus an additional 7% of that sum in acquisition costs. Any property acquired would conform to the proposed strategy detailed in Appendix A. This report seeks approval to the first tranche of £25m plus the additional 7% acquisition costs.

1.7 It is important to note that the elected 'Invest to Earn' working group would consider each and every acquisition on its own merits. Building a balanced property portfolio conforming to the proposed strategy could take up to two years from now. If approved, the Council will implement this strategy with the aid of commissioned property experts, whose costs are included within the financial projections.

1.8 Portfolio performance will be closely monitored by the 'Invest to Earn' working group and the Council's Senior Leadership Team. It is also proposed that portfolio performance will be reported to the Council's Audit Committee on a quarterly basis.

1.9 The proposed strategy and/or implementation could be amended or ceased at any point prior to the full acquisition budget being expended, if Members determine that market conditions deteriorate sufficiently to make the strategy financially unattractive. The 'Invest to Earn' working group retain the right to review the acquisition strategy at any time.

1.10 The Council will not be able to fund its forecast budget deficit through normal efficiency savings or transformation alone, nor is continuous service reduction a realistic option, therefore other methods of income generation must be considered as an alternative strategy.

1.11 This Property Acquisition Strategy identifies an alternative key source of income that could potentially deliver a major element of the required savings. The strategy is being recommended as a key deliverer of income: it must be understood that its principal purpose is not to drive regeneration in South Hams, rather as an income producing fund identifying properties from anywhere in the country that will deliver the required returns (which can be used to help take forward regeneration and other Council priorities).

1.12 It must be noted that alternative efficiencies and sources of income still need to be identified to close the Council's budget gap are two of these are on the Executive agenda at this meeting. If pursued, this recommendation presents the Council with significant achievable revenue streams in-year, whereas other opportunities will take longer to realise and are not solely capable of achieving the required quantum.

1.13 Property acquisition is a dynamic area which generally does not sit well with traditional officer, committee, Council meeting schedules and structures. Decisions often need to be made quickly otherwise opportunities can be missed. Research shows that where Councils undertake this activity, there is an increasing level of delegation, enabling them to move quickly when properties come to the market. This report recommends that decisions are delegated to the head of paid service, in line with the strategy detailed in Appendix A.

1.14 A report entitled "Governance & Risk Aspects of the Proposed Commercial Property Acquisition Strategy" is due to be presented to Audit Committee, July 20th 2017. The report details the governance and risk aspects of this proposal and also highlights other local authorities which are also pursuing similar strategies.

2. **Background**

1.1. During 2015/16 the Council reviewed its priorities and Members agreed that their top priority was to achieve financial sustainability. The Members also stated that they did not want to see a reduction in the level and quality of the services delivered to their communities.

1.2. The Council's adopted Medium Term Financial Position (MTFP) is based on a financial forecast over a rolling five year timeframe to 2022/23. The following table illustrates the forecasted budget gap from 2018/19 onwards as reported to Executive on this agenda (20th July 2017):

	2018/19	2019/20	2020/21	2021/22	2022/23	TOTAL
	£	£	£	£	£	£
*Cumulative Budget Deficit	584,647	753,278	816,626	835,040	898,953	898,953

*Cumulative position is for illustrative purposes only. In reality, Councils must submit a balanced budget each year.

2.4. The above table shows that the budget gap facing the Council for 2018/19 is £0.585m. This means that over the period to 2022/23 the above amounts need to be found by way of savings or additional income generation.

2.5. A variety of investment instruments are available to the Local Authority market. These were discussed in the March 9th report entitled "Investment in Commercial Property" and are not repeated here. Please refer to that report for more information or to understand why pursuing a commercial property acquisition strategy is being proposed above other options and how the strategy being proposed has been justified. This strategy and direction of travel was noted by Members at that time.

2.6. To achieve financial sustainability, based on the current MTFP, the Council needs to generate or save c.£0.585m pa. Assuming a target gross initial yield of 5.75% and taking borrowing over 40 years at current Public Works Loan Board (PWLB) rates, the Council would need to budget £80.25m to generate the £0.585m required. Further detail about this can be found in Appendix A and B.

3.0 Commercial Property Acquisition

3.1 Members recently approved the formation of a Member 'Invest to Earn' working group who have an approved terms of reference. This group have worked with officers to formulate the Commercial Property Acquisition Strategy and Business Plan shown at Appendix A and B.

3.2 The portfolio objective is to generate recurrent revenue streams to contribute to the financial sustainability of the Council, enabling it to continue to deliver frontline services in line with the Council's adopted strategy & objectives.

3.3 Additionally, regeneration efforts within the District can be funded from revenue generated by the implementation of the strategy. It will be necessary for officers to continuously review on a case by case basis which areas within the District can benefit from the revenue generated from the acquisition of properties.

3.4 If the proposed strategy as shown in Appendix A is adopted, it is proposed that the Council commits a maximum budget of £80.25m to invest £75m in commercial property acquisitions, plus a further 7% of that sum (£5.25m) to cover related acquisition costs towards this strategy, in order to build a commercial property portfolio within 24 months. It is proposed that this spend is split into tranches, with the first tranche of spend totalling £25m plus acquisition costs. The remaining £50m would be requested in future tranches, once Members are satisfied with the success of the strategy.

3.5 The elected 'Invest to Earn' working group would consider each and every acquisition on its own merits and to build a balanced property portfolio conforming to the proposed strategy could take up to two years from now.

3.6 This report recommends that decisions are delegated to the head of paid service, in line with the strategy detailed in Appendix A.

3.7 Portfolio performance will be closely monitored by the 'Invest to Earn' working group and the Council's Senior Leadership Team. It is also proposed that portfolio performance will be reported to the Council's Audit Committee on a quarterly basis.

3.8 The proposed strategy and/or implementation could be amended or ceased at any point prior to the full acquisition budget being expended, if Members determine that market conditions have deteriorated sufficiently to make the strategy financially unattractive. The 'Invest to Earn' working group retain the right to review the acquisition strategy at any time.

3.9 Acquisitions will be made using predominantly prudential borrowing or any other unallocated or available Council reserve or capital receipt. It is envisaged that borrowing will be undertaken, over a maximum 40 year term, but ultimately this is at the discretion of the s151 officer in line with the Council's adopted Treasury Management Strategy and Affordable Borrowing Limits.

3.10 The portfolio will target a gross initial yield of 5.75%. It is proposed that the strategy will be reviewed on an annual basis.

3.11 Following the Finance & Investment principles workshop, held on December 7th 2016 and January 5th 2017, a Member survey was undertaken to understand Member appetite for acquiring a commercial property portfolio. 13 elected Members participated in the survey. Of those:

3.11.1 92% said the Council should acquire a commercial property portfolio to sustain the Council's revenue position

3.11.2 77% said investment should be made into a mixed estate (no sector preferred) but with the decision based on availability and acceptable risk

3.11.3 92% said it was acceptable or desirable to acquire properties outside of the district

3.11.4 92% said it was acceptable for the Council to take on borrowing to acquire such an estate

3.12 Initially, it is proposed that the Council appoint property experts to work on its behalf to source acquisition opportunities.

3.13 Legal counsel opinion along with specialist legal and treasury management advice has been obtained. This confirmed that the Council has the legal powers to pursue its intended strategy, purchasing properties in and outside of the district, utilising prudential borrowing and holding such acquisitions on its balance sheet.

3.14 A report entitled "Governance & Risk Aspects of the Proposed Commercial Property Acquisition Strategy" is due to be presented to Audit Committee, July 20th 2017. The report details the governance and risk aspects of this proposal and also highlights other local authorities which are also pursuing similar strategies.

4.0 **Options available and consideration of risk**

4.1. Members could opt to follow, amend or reject the report recommendations.

4.2. The overall acquisition quantum and strategy is designed to provide sufficient income to cover the current predicted budget gap in its entirety. This approach has been assessed as part of the treasury management advice procured (affordability requirements) and found to be sound. If the total budget were to be reduced, the income generated would not be sufficient to create financial sustainability.

4.3. If Members chose to vary the target portfolio yield, overall budget, or funding source, different financial outcomes would be achieved.

4.4. There are risks that should not be discounted:

4.4.1. **Market Forces** - fluctuations in demand and supply of the individual market and the wider economy will see the value of the investment and the income rise and fall, the council may not recoup the original amount invested in full. To mitigate this risk, criteria to diversify for purchase can be adopted and due diligence will be followed for all transactions

4.4.2. **Liquidity -** The process of buying and selling property, in relation to some other forms of investment, is complex and can result in transactional delay and uncertainty which carries risk from market shift, abortive transactional costs and inability to realise "sale" capital quickly. This risk can be managed and improved through good portfolio management. The Council will partner with external experts to manage the acquired portfolio, as in-house skills are limited and at capacity. It is proposed that the Council takes a significant sum in borrowing to finance the acquisition of a commercial property portfolio

4.4.3. **Opportunity -** The availability of asset stock is generally limited; there will be times where lack of or lost opportunities through negotiation and competition will frustrate the process. This is often exacerbated by a general lack of transparency and openness in the market creating barriers to entry. To counter this and to offset the lack of internal skills, suitably qualified property experts will be commissioned to seek out as many appropriate opportunities as possible, build relationships and communicate to the market the Council's requirement and ability to perform

4.5. The capital value of any property can go down as well as up, and therefore the capital redeemed at the end of the investment could be less than the sum initially invested.

4.6. This investment strategy is based on revenue income. Capital value fluctuations, up or down, have not been factored into the financial calculations. A drop in capital value would not immediately affect the Council's cash flow position. It would however affect the yield, but the impact of this would be only be felt if a rent review was due. The purpose of developing a balanced, diversified portfolio is to mitigate against market fluctuations affecting a single sector, geographic area or tenant. A reduced capital value may also hinder or delay the disposal of an asset, however it is not envisaged that properties will be traded within the first 5 – 7 years. Furthermore, PWLB lending is not secured against property, so the Council could opt to lose money on one property if the overall capital value of the portfolio is greater than the lost capital value.

4.7. The commercial property market has survived the EU referendum result relatively well with only modest falls in capital values coming through and a small upturn in capital values in October suggesting an overall dissipation of the Brexit effect. Despite the effect on capital values, total returns (capital growth and rental income) rose by 2.9% in the twelve months to September 2016 suggesting sector stability and resilience in difficult times. The table below shows the current yields for specific commercial property sectors:

Sector	**Yield**
Prime shops	4.25%
Good Secondary shops	6.75%
Prime Shopping Centres	4.65%
Secondary Shopping Centres	7.75%
Retail parks: Prime - open user	5.50%
Prime offices: Major Provincial	5.25%
Offices: secondary	9.00%
Prime Industrial Estates	5.25%
Secondary Industrial Estates	8.25%

(source: CBRE Nov 2016)

4.8. Analysts estimate that commercial property will grow, on average, by 2% per annum over the short to medium term. Over the long term, 10 years plus, the property market is expected to offer good capital growth, in addition to yields in excess of other investment opportunities open to the Council.

4.9. The strategy looks to mitigate risks by setting specific criteria for purchases and necessary due diligence must be completed before officers and the 'Invest to Earn' group recommend any purchase.

4.10. The strategy and business plan allow for the costs needed to acquire and manage the portfolio, e.g. acquisition, disposal, maintenance and management.

4.11. The target yield, less costs, will comfortably outperform the current investment returns achieved by the Council – 0.5% is forecast in the MTFP as an average for 2017/18 rising to 1.0% by 2021/22.

4.12. A breakeven position, where the loan interest, maintenance and management are covered by the rental income earned by the portfolio is achieved with a portfolio gross yield of 4.46% in year one. This breakeven point will vary depending on the financial treatment chosen to provide for the borrowing obtained. Individual purchase decisions and portfolio management would be taken with this in mind. It is felt there is significant distance between the target yield and the breakeven point.

4.13. In the recent past, the Council has adopted a very cautious and prudent approach to treasury management. Lending has only been made to banks and building societies which have strong credit limits and meet the criteria set by the Council, using information published by the three major credit rating agencies. This policy has been maintained in the knowledge that putting security before liquidity or yield impacts on the income that can be generated. A revised Treasury Management Strategy will be brought to Members at the July Council meeting for approval if this report's recommendations are approved to amend the current investment policy approach.

5.0 Proposed Way Forward

5.1 It is proposed that if the Executive approve this report's recommendations, a property expert will be commissioned to work on behalf of the Council in relation to this proposed strategy. As and when suitable properties have been sourced, the 'Invest to Earn' group will convene to appraise the available options and recommend action to the delegated parties (as described in Appendix A) as appropriate.

6.0 Implications

Implications	Relevant to proposals Y/N	Details and proposed measures to address
Legal/ Governance	Y	Advice on the relevant powers and appropriate vehicles for delivering these proposals has been sought from external specialist advisers and legal counsel. Legal counsel opinion has been obtained (31st May 2017) setting out the various powers available to the Council, which supports the Council's proposed strategy as described in this report. This proposal is consistent with the Council's powers to borrow and invest under the Local Government Act 2003 and section 1 Localism Act 2011 (the general power of competence) and / or section 120 Local Government Act 1972 (power to acquire land). The Council is empowered to buy pursuant to section 120 of the Local Government Act 1972. Section 1 of the Local Government Act 2003

		provides a power to the Council to borrow for the purposes of any enactment. Disposal of any of the acquired properties will have to be undertaken in accordance with the provisions of section 123 Local Government Act 1972. In order to lawfully implement the acquisition strategy, each proposal (including the funding strategy for purchases) should be reviewed as part of a decision to purchase or sell, and tested for value for money, and regulatory compliance. There is an overriding duty toward prudent management of risk, and officers, including the Council's section 151 officer owe a fiduciary duty in relation to given transactions. Given the limited nature of the proposals, the current levels do not suggest that the Council is engaged in commercial work, though this matter would need to be reviewed as this strategy develops. Concluding that it is commercial work would necessitate conducting business through a separate company.
Financial	Y	The Council will purchase assets directly on balance sheet and therefore the direct costs of purchase and acquisition can be capitalised. This will include costs such as stamp duty, legal fees, due diligence and agency fees. When individual purchase decisions are made, a bespoke business case will be produced alongside a package of due diligence information to support the decision making process. The delegated authorities approving a purchase will need to be satisfied that any proposed acquisition not only delivers best value but also meets the criteria contained within the Commercial Property Acquisition Strategy and has proper regard to the following: • The relevant capital and revenue costs and income resulting from the acquisition over the whole life of the asset. • The extent to which the acquisition is expected to deliver a secure ongoing income stream. • The level of expected return on the acquisition. • The payback period of the capital acquisition. Part of the business case for each commercial property acquisition will be an assessment of the Internal Rate of Return (IRR) calculation. Any PWLB borrowing to fund the acquisition of commercial property is not secured on the property acquired. PWLB borrowing rates are fixed for the term of the loan. Individual borrowing decisions will be taken prudently in line with the Council's treasury management strategy and by officers within that function. The Council will not exceed its affordable borrowing limit to implement this strategy. The Council has adopted the CIPFA Code Of Practice for Treasury Management and produces an Annual Treasury Management Strategy and Investment Strategy in accordance with CIPFA guidelines. If this report's recommendations are approved, a revised Treasury Management Strategy will be presented to Council before this strategy is implemented. If successful, the proposed commercial property acquisition strategy has the potential to make a significant contribution to the current predicted cumulative budget gap for the Council. If a portfolio yield of 5.75% is achieved, the financial model suggests that a budget of £80.25m could generate a surplus of between £0.461m to

		£0.891m per annum depending on the treasury management strategy employed in order to provide for Minimum Revenue Provision (MRP). An explanation of MRP can be found in Appendix C of this report. This is net of forecast administration and maintenance (sinking fund) costs. Using the same basis, a £25m investment could generate a surplus of between £0.15m to £0.3m per annum. Further financial considerations are discussed in Appendix B. Investment interest income is currently reported quarterly to SLT and Executive.
Risk	Y	The security risk is that the capital value of an acquired property may fall. Whilst this would have an effect on the Council's balance sheet, the value of the property only becomes an issue if the Council chooses to sell the property and realises a capital loss. The liquidity risk is the risk of failure of a tenant within one of the acquired properties. The yield risk is that the income derived from the acquired assets will alter during the life of the asset. This will be actively managed; with property management experts commissioned to manage the assets and their tenants. Properties will only be acquired if they have a minimum of 5 years unexpired lease term and are located in areas deemed to be attractive for future lettings / sales / redevelopment, limiting the risk to the Council's portfolio. The Council already owns and operates a property estate valued at c.£75m. It therefore has experience of managing such an estate and can act as an intelligent client to fulfil the proposed strategy implementation, with the aid of commissioned property experts. The cost of these experts has been included in the financial consideration information shown in Appendix B.
Comprehensive Impact Assessment Implications		
Equality and Diversity	N	Not Applicable
Safeguarding	N	Not Applicable
Community Safety, Crime and Disorder	N	Not Applicable
Health, Safety and Wellbeing	N	Not Applicable
Other implications	N	Not Applicable

Supporting Information

Appendices:

Appendix A - Commercial Property Acquisition Strategy & Criteria
Appendix B - Further Financial Considerations
Appendix C - Explanation of Minimum Revenue Provision (MRP)

Background Papers:

- Investment in Commercial Property, presented to Executive, March 9th 2017
- MTFP, presented to Executive July 20th 2017

- Revenue & Capital Budget Proposals Report – 2017/18, presented to Council, February 9th 2017
- Annual treasury strategy in advance of the year (Audit 15/03/16 – AC32)
- Governance & Risk Aspects of the Proposed Commercial Property Acquisition Strategy, due to be presented to Audit Committee, July 20th 2017

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Appendix A – SHDC Commercial Property Acquisition Strategy & Criteria

Overall Objective:
The objective of this strategy is to increase revenue streams to contribute to the financial sustainability of Council, enabling the Council to continue to deliver and/or improve frontline services.

Additionally, regeneration efforts within the District can be funded from revenue generated by the implementation of the strategy. It will be necessary for officers to continuously review on a case by case basis which areas within the District can benefit from the revenue generated from the acquisition of properties.

The revenue will be earned by the focussed acquisition of existing commercial property assets using predominantly prudential borrowing or any other unallocated or available Council reserve or capital receipt.

Strategy
- Acquire commercial properties to provide rental income with a minimum gross yield of 5.75% across the portfolio (once complete)
- Achieve a spread of risk across a greater number of assets and by acquiring properties across the range of different property asset classes, namely retail, leisure, office, industrial or alternative (e.g. health, energy/renewables)
- Properties will be acquired to hold rather than to trade
- The Council will operate independently - The Council is not reliant on another Council to progress with this strategy
- The Council will acquire so that the portfolio’s net revenue receipt delivers sufficient income to fund the initiative and make a significant contribution to the Council’s forecast budget gap (with the potential to meet the budget gap)
- Acquisition costs are forecast not to exceed 7% (Stamp Duty Land Tax (SDLT) / Legal / Agents / Due Diligence). These services are to be commissioned via a procurement exercise.
- Management of the acquired assets will be outsourced to property professionals. The cost of this management will be included within the target return
- The legal work required to complete transactions is to be outsourced
- Specialists will be commissioned to act on behalf of the Council to source suitable properties and manage the acquisition due diligence process

Risk
- The risks of acquiring property may be mitigated through the acquisition of assets with secure, long income streams
- This needs to be balanced against the requirement for a given level of return on capital used to acquire properties in a careful and controlled manner, with specific analysis of risk carried out in the ‘due diligence’ stage prior to the completion of each purchase
- Once the budget is fully exhausted, should the portfolio yield drop below 5.75%, a review of the strategy will be triggered
- The portfolio of properties being acquired should be diversified in order to spread risks via a balanced portfolio, such diversification principally being across geographical locations and the use type of properties
- The portfolio will be relatively risk-averse, when appropriate, limiting fresh acquisitions to properties with minimum unexpired lease terms of five years at the date of acquisition, and tenants of strong financial standing

Initially, acquisition decisions will be taken as long as they fit within the below criteria:
Location:
- Neutral – wherever opportunities arise in order to acquire good properties which deliver the minimum prescribed yield, that are deemed an acceptable risk
- In order to not over expose the Council to one particular geographical area, properties outside of the Council's area will be favoured
- As the portfolio gets larger, a mix of locations will be sought to create a balanced portfolio
- A maximum exposure of 25% per location is sought once the budget is exhausted (excluding the existing estate at the time of this strategy being adopted)
- Good, commercially strong locations to protect capital value and ensure ongoing occupier demand. E.g. for retail good out-of-town retail clusters/parks; for offices close to transport infrastructure and catchment for employees; for industrial close to major road / rail hubs. Consideration will also be given to possible exit-strategies for each asset acquired, e.g. potential re-development

Sector:
- Neutral – Wherever opportunities arise in order to acquire good properties which deliver the minimum prescribed yield and are deemed an acceptable risk
- As the portfolio gets larger, a mix of sectors will be sought to create a balanced portfolio
- A maximum exposure of 25% to one sector will be sought once the full budget is exhausted

Tenant mix:
- As the portfolio gets larger, a mix of tenants will be sought to create a balanced portfolio
- A maximum exposure of 15% to one tenant will be sought once the full budget is exhausted
- The final decision over the appropriateness of any tenant would be reviewed prior to acquisition

Lease length:
- Minimum 5 years unexpired (mean unexpired term for multi-let properties)
- Unless in exceptional circumstances (e.g. the property is being purchased with a view to re-development or the property is located in a prime location), single-let properties are not favoured
- For multi-let properties, a mix of lease expiry dates are preferred, thereby limiting void risk (unless the property is purchased with a view to re-development)
- Properties are to be well-let to sound tenants on leases with a preference for 'Full Repairing and Insuring' leases for single occupiers and through internal repair obligations and a service charge for multi-let properties
- The final decision over the definition of "well-let" and "sound" will be agreed between the property acquisition advisers (including legal due diligence) and the individuals delegated with the responsibility to conclude the acquisition of the properties
- This decision will be based on both the risk to capital and revenue

Yield:
- Per lot, a minimum initial yield of 4.0% will be sought, before management, maintenance and funding costs
- An initial yield in excess of 11% will not normally be sought
- As the portfolio gets larger, a mix of yields will be sought to create a balanced portfolio
- The overall portfolio will have a target initial yield of 5.75%

Cost:
- Individual lot sizes of up to £15m

- Larger lot sizes are favoured - smaller size properties have disproportionately higher management costs and expose the Council to greater property void risks
- All acquisitions will normally be subject to a minimum lot size of £3m

<u>For all of the above, flexibility of +/- 15% (relative to the measure) is allowable in order to conclude a deal without recourse to the delegated authorities or reviewing the terms of this strategy. The overall budget for acquisitions is not subject to this flexibility.</u>

Funding:

- This is to be secured on a case by case basis on the most favourable terms available predominantly through prudential borrowing or any other unallocated or available Council reserve or capital receipt
- The term will not exceed the expected remaining life of the property, but as a rule, the Council wishes to secure borrowing over a maximum 40 year term
- The Council will opt to borrow monies on the most commercially advantageous terms, seeking advice from its retained Treasury Management Advisors
- Ultimately, all borrowing is at the discretion of the S151 officer in line with the Council's adopted Treasury Management Strategy and Authorised Borrowing Limits

Exit Strategy:

- The Council intends to hold for the short to medium term (e.g a minimum 7 year period). It is not looking to actively trade commercial property within this timeframe
- If capital values determine that the most prudent action is to sell an individual asset, this will be considered on a case by case basis and will be acted upon in consultation with the 'Invest to Earn' group Chair, Leader, S151 officer and Head of Paid Service
- It is proposed that all properties will be held as Council Assets. This may change if the Council were to set-up an arms-length management organisation (ALMO) or trading company and it was found to be commercially advantageous for such a vehicle to hold the asset(s)
- It is important to note that there would be early repayment charges if the loan(s) used to acquire commercial property were to be repaid before the end of the loan term. However, Public Works Loan Board (PWLB) lending is not secured against property, so this would not inhibit the asset being traded during the loan period. An alternative asset would need to be purchased (& held) with any capital sale proceeds

Tax Implications:

- Due to the Council holding the asset, it is not anticipated that there will be any corporation tax or income tax implications from this strategy
- Some properties may be VAT elected, meaning VAT must be charged to tenants. This will be dealt with on a case by case basis and will be covered by the due diligence connected with that acquisition. The Council is able to charge and recover VAT
- Capital Gains Tax would not apply to assets sold from Council ownership. This position may change if a company were to be used to hold the acquired asset

Governance Arrangements:

Purchase

Purchases must conform to the adopted commercial property acquisition strategy. Any deviation from the agreed strategy (beyond the flexibility parameters) will require Council approval.

Delegated authority to be given to the Head of Paid Service, in consultation with the S151 officer and Leader and Chair of the 'Invest to Earn' group. Each receive one vote to proceed with purchase. In the event of a split decision, the S151 officer has the casting vote. Only purchases which accord with the agreed strategy will be considered.

The 'Invest to Earn' group will determine its chair and will receive details of potential purchases from the Assets CoP and/or Group Manager, Business Development. The group will vote on whether to bring a potential purchase decision to the Head of Paid Service.

Running / Review
Assets are to be managed by a contracted third party initially, with overview by the Assets CoP, Group Manager, Business Development and the S151 officer. 'Invest to Earn' group to receive regular reporting to confirm portfolio composition and performance. Regular reporting to Audit Committee and the Council's Senior Leadership Team.

Disposal
Once acquired, decisions relating to the ownership of any acquired properties will be dealt with in line with the Council's constituted scheme of delegation

Disposal will be considered if the portfolio breaches the approved strategy. Decisions to be made in consultation with the 'Invest to Earn' group Chair, Leader, S151 officer and Head of Paid Service.

Appendix B – Further Financial Considerations

Based on information available at the time of writing (11th July 2017), SHDC require c£0.585m of revenue income and/or savings per annum in order to be financially sustainable, in line with its published Medium Term Financial Position (MTFP). Below is a breakdown of how properties valued at £75m plus acquisition costs can derive c£0.89m of revenue after costs to support the financial sustainability of the Council. The proceeds from spends of £25m and £50m are also shown.

	£25m	£50m	£75m
Capital Investment (£)	**25,000,000**	**50,000,000**	**75,000,000**
Acquisition fees @ 7%	1,750,000	3,500,000	5,250,000
Total Borrowing / Expenditure (£)	**26,750,000**	**53,500,000**	**80,250,000**
Borrowing			
Term (Years)	40	40	40
Maturity PWLB Loan Interest Rate %	*2.37*	*2.37*	*2.37*
Interest Payments pa (£)	**633,975**	**1,267,950**	**1,901,925**
Profit & Loss Example *(Income less Costs)*			
Target Portfolio Yield %	*5.75*	*5.75*	*5.75*
Rent Receivable *(Yield x Investment)* pa	**1,437,500**	**2,875,000**	**4,312,500**
Interest Payments pa	(633,975)	(1,267,950)	(1,901,925)
Management costs @ 3% of Rent Receivable	(43,125)	(86,250)	(129,375)
Sinking fund @ 5% of Rent Receivable	(71,875)	(143,750)	(215,625)
Surplus Generated (before MRP*) pa	**688,525**	**1,377,050**	**2,065,575**

Option 1 - Straight Line MRP* Treatment			
Surplus Generated (before MRP*) pa	688,525	1,377,050	2,065,575
Minimum Revenue Provision (MRP*)	(535,000)	(1,070,000)	(1,605,000)
Surplus (after Straight Line MRP*) pa	**153,525**	**307,050**	**460,575**
Option 2 - Annuity MRP* Treatment			
Surplus Generated (before MRP*) pa	688,525	1,377,050	2,065,575
Annuity MRP* Treatment	(391,615)	(783,230)	(1,174,845)
Surplus (After Annuity MRP*) pa	**296,910**	**593,820**	**890,730**

**Minimum Revenue Provision (MRP), the provision for the repayment of borrowing, is explained in more detail in Appendix C of this report.*

Sensitivity analysis in change in gross rental income

The business plan identifies a target gross rental yield of 5.75%, which if achieved would generate £2.065m per annum in income after costs. The table below shows the impact a change in the gross income yield could have on the annual income estimates:

Sensitivity Analysis	£25m	£50m	£75m
Change in income yield 0.5%	£ 125,000	£ 250,000	£ 375,000
Change in income yield 1.0%	£ 250,000	£ 500,000	£ 750,000
Change in income yield 1.5%	£ 375,000	£ 750,000	£ 1,125,000
Change in income yield 2.0%	£ 500,000	£ 1,000,000	£ 1,500,000
Change in income yield 2.5%	£ 625,000	£ 1,250,000	£ 1,875,000

For example, if the income yield were to increase from 5.75% to 6.75% (an increase of 1%), this would generate additional income of £250,000 per annum on a £25m portfolio, £750,000 per annum on a £75m portfolio. A reduction in yield would have the opposite effect.

Sensitivity Analysis on the Surplus Generated
A sensitivity scenario analysis is shown in the table below to illustrate the effect that the yield has on the return achievable from the portfolio – assuming properties are acquired to value of £75m or a spend of £50m or £25m. This highlights that the portfolio needs active management and care in choosing the right acquisitions to ensure the minimum yield is achieved.

All of the figures below are based on the 40 year annuity MRP treatment (option 2) shown above, providing either £1.175m (for £75m spend), £0.783m (for £50m spend) or £0.392m (for £25m spend) of MRP in year one. The provision for the repayment of borrowing (level of MRP) would increase year on year, as described in Appendix C of this report.

Based on Annuity Method MRP			
Portolio Size	**25,000,000**	**50,000,000**	**75,000,000**
Projected Annual Surplus @ 5.75%	296,910	**593,820**	**890,730**
Projected Annual Deficit @ 4.00%	**(105,590)**	**(211,180)**	**(316,770)**
Projected Annual Surplus @ 4.50%	9,410	18,820	28,230
Projected Annual Surplus @ 5.00%	124,410	248,820	373,230
Projected Annual Surplus @ 5.50%	239,410	478,820	**718,230**
Projected Annual Surplus @ 6.00%	354,410	**708,820**	**1,063,230**
Projected Annual Surplus @ 5.28%	188,810	377,620	**566,430**
Breakeven: Projected Annual Surplus @ 4.46%	**210**	**420**	**630**

Breakeven
A minimum yield of 4.46% is required in order for a £75m spend to breakeven in year one, i.e. cover the cost of loan repayments, the annuity method Minimum Revenue Provision, the sinking fund for maintenance and the expected management / administration costs.

Indicative Borrowing Financial Implications
The Council will consider a number of factors when assessing how much the Council will borrow to finance the commercial property strategy. It is likely that the majority of the commercial property acquisition strategy will be funded via Public Works Loan Board (PWLB) borrowing.

When assessing affordability, the Council will consider the annual cost of financing the acquisitions, the income generated, the costs of running and maintaining the property and the factors that could potentially affect the net income to the Council (which is needed to repay the financing costs of the property acquired).

Council officers who have responsibility for treasury management will, in consultation with the S151 officer, determine the most appropriate product(s) for the Council's borrowing requirements. There are a number of options available to them and they will be advised by the Council's treasury management advisors and guided by the Council's adopted treasury management strategy, the Council's affordable borrowing limit and CIPFA regulations.

Percentage Increase in Council Tax
It is clear that a significant reduction in rental income (a yield below 4.46%) would result in a revenue budget deficit being created. If the Council did not have the available budget surplus to cover this additional cost, it may be forced to cut expenditure or increase Council tax to cover the deficit. The table below shows the impact on Council Tax and the additional income that a % increase in Council Tax generates (using the existing Council Tax base).

Impact on Council Tax	£
Increase of 1.0%	£ 58,000
Increase of 2.0%	£ 116,000
Increase of 3.0%	£ 174,000
Increase of 4.0%	£ 232,000
Increase of 5.0%	£ 290,000
Increase of 6.0%	£ 348,000
Increase of 7.0%	£ 406,000
Increase of 8.0%	£ 464,000
Increase of 9.0%	£ 522,000

The business case for property acquisition allows for reserves to be built up in a sinking fund to cover any shortfall in rent or maintenance cost for which the Council would be liable. The strategy that is to be adopted by the Council addresses the risk that changes in rental income could affect overall portfolio profitability by virtue of being spread across asset types, classes and geographies. Different tenant classes and lot sizes and indeed borrowing terms will mean that a loss on one asset could well be compensated by a profit on another asset. It also important to note that the strategy has excluded any profit or loss generated by a change in capital value.

Summary
If a portfolio yield of 5.75% is achieved, the above figures show that property acquisition budget of £75m could generate a surplus of between £0.46m to £0.89m per annum depending on the treasury management strategy employed and the accounting Minimum Revenue Provision (MRP). This is net

of forecast administration and maintenance (sinking fund) costs. Using the same basis, a £25m budget could generate a surplus of between £0.15m to £0.3m per annum, whilst a budget of £50m could generate a surplus of £0.31m - £0.59m.

As part of the Annual Treasury Management Strategy setting process, Members have the opportunity to set the Council's policy for dealing with MRP (Minimum Revenue Provision). There are various methods and periods which can be employed and members will be able to determine the most prudent method of provision. The accounting method chosen will have a fundamental impact on the surplus that can be generated from this strategy. *MRP is further explained in Appendix C.*

Appendix C - Explanation of Minimum Revenue Provision (MRP)

What is MRP?
Minimum Revenue Provision (MRP) is the minimum amount which a Council must charge to its revenue budget each year, to set aside a provision for repaying external borrowing (loans). This is an annual revenue expense in a Council's budget.

Who approves the Council's MRP policy?
The Guidance from the Department of Communities and Local Government (DCLG) recommends the preparation of an annual statement of policy on making MRP, which has to be submitted to Council for approval. This is part of a Council's Treasury Management Strategy.

What different methods are there for MRP?
i) Equal Instalment Asset Life Method (i.e. over 50 years expected asset life of asset acquired)
One method of calculating MRP is on the Equal Instalments of Principal (the Asset Life method). In this instance, MRP is an equal annual charge every year which is calculated by dividing the original amount of borrowing by the useful life of the asset.

An example is therefore, if an amount of £26.75 million is borrowed for the first tranche, the calculation of MRP is £26,750,000 divided by 50 years (asset life) = annual MRP charge of £535,000. (This is shown in Option 1 in Appendix B).

So every year the Council makes a provision in its revenue budget to repay the borrowing of £535,000 annually (the same amount for each of the 50 years)

ii) Annuity Method (over the 40 years of the borrowing term)
Another method the Council could use is the Annuity Method for calculating MRP. Under this calculation, the revenue budget bears an equal annual charge (for principal and interest) over the life of the asset by taking into account the time value of money. Since MRP only relates to the 'principal' element, the amount of provision made annually gradually increases during the life of the asset. The interest rate used in annuity calculations will be referenced to prevailing average PWLB rates.

Under this example, the MRP charge in Year 1 on a £26.75 million borrowing would be £0.39m, this rises to £0.4m in Year 2, £0.41 in Year 3, £0.42m in Year 4 and £0.43m by Year 5. (This is shown in Option 2, Appendix B).

What's the difference between the two methods for MRP?
The first method (equal instalment) means £535,000 is the revenue charge every year for 50 years.

In the second method (annuity), the payments start off lower e.g. £0.39m and then gradually increase every year for each of the 40 years. So for the first 13 years there is a lower revenue charge using the annuity method, this then becomes higher in the latter years.

The Annuity method could benefit the strategy as it develops as it allows time for revenue income streams to materialise and surpluses to be generated. It more closely reflects the income streams generated from property, which tend to increase over time due to rent reviews. This accounting treatment would not only help close the projected budget gap, but it could also allow the Council to build additional reserves for asset redevelopment, voids, major maintenance or other contingencies in the early years.

Are there other methods for calculating MRP?
Yes. Under the current guidance, Councils have some discretion over how they provide for MRP over the asset life. For example the Council could decide that it would be appropriate to make MRP based upon the rental income received each year, or a percentage thereof, until the debt liability is repaid.

Is a recommendation being made (as part of this report) on the method of MRP for the Council to adopt?
No recommendations have been made on this yet and further advice will be sought on this subject. This will be the subject of a future Council report.