Investment Options

Report to:	**West Devon Hub Committee**
Date:	**24 January 2017**
Title:	**Investment Options**
Portfolio Area:	**Cllr Bob Baldwin, Deputy Leader Business Development**
Wards Affected:	**All**
Relevant Scrutiny Committee:	**Internal**
Approval and clearance obtained:	**Yes**
Urgent Decision:	**N/A**
Date next steps can be taken:	**Recommendation to full Council**
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Recommendations: That the Hub Committee RECOMMEND to Council:

1. That the sum of £500,000 from the earmarked "Invest to Earn" reserve is used to invest in CCLA's (CCLA Investment Management Limited's) Local Authorities Property fund as detailed in section 5 of this report, with the investment being placed at the beginning of the 2017/18 financial year.
2. That a Member working group is set-up to work with officers to evaluate other invest to earn, income and efficiency opportunities for future consideration by the Council

1.0 Executive Summary

1.1 On April 5th 2016, Council approved the principle of utilising £300,000 from the "Invest to Earn" reserve to acquire 2 properties within West Devon, subject, as appropriate, to individual business case sign off by the relevant delegated authority and consideration of full legal and financial implications.

1.2 This report sets out the rationale for not proceeding with that recommendation and instead recommends investment into CCLA's Local Authorities' Property Fund. It is recommended that a sum of £500,000 is invested.

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1.3 Officers have investigated the legalities around direct council acquisition of residential property for income generation purposes and found that this does not represent the best use of council tax receipts based on present legislation and the Council's current organisational structure.

1.4 Officers have consulted with the Council's treasury management advisers, Capita, who advised that the CCLA fund is unique in offering revenue returns and a revenue investment. Other property funds, which do not meet the regulation definition required for revenue classification require capital funds and generate capital returns. The Council requires revenue receipts to meet its forecast budget deficit.

1.5 Officers will continue to investigate other income generation and property investment opportunities and bring forward recommendations to Council in due course. To this end, it is recommended that an "Invest to Earn" Member working group is formed. They will assist officers to produce business cases and rationale ahead of reports to Council.

1.6 Additionally, legal advice is being sought from the Council's retained legal advisors in relation to the opportunities afforded to the Council if a South Hams / West Devon (SHWD) Local Authority Controlled Company (LACC) were to be set-up. It is anticipated that such an organisational structure would enable the Council to purchase and let property for income generation purposes in a less-restrictive manner, affording a greater return on investment.

2. Background

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

2.2. The Council's adopted Medium Term Financial Strategy (MTFS) is based on a financial forecast over a rolling five year timeframe to 2021/22 which helps ensure that resources are aligned to the outcomes in Our Plan. The following table illustrates the predicted cumulative budget gap from 2017/18 onwards as reported to Hub Committee on 19th December 2016:

	2017/18 £	**2018/19 £**	**2019/20 £**	**2020/21 £**	**2021/22 £**
Budget gap/(surplus)	236,017	662,781	Nil	Nil	(189,908)
CUMULATIVE BUDGET GAP OVER THE FIVE YEARS TO 21/22					**£708,890**
In the years 2019/20 and 2020/21, a budget surplus arises and the modelling assumes that these surpluses are used for one-off investment in the years 19/20 and 20/21 and are taken as a saving in the next financial year.					

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2.3. The above assumes any Budget Surpluses are used for one-off investment in the year they occur and that budget surpluses are used in the following year as a saving. This means that over the period to 2021/22 the above amounts need to be found by way of savings and additional income generation, based on the current financial modelling.

2.4. On April 5th 2016, Council approved the principle of utilising £300,000 from the "Invest to Earn" reserve to acquire 2 properties within West Devon, subject, as appropriate, to individual business case sign off by the relevant delegated authority and consideration of full legal and financial implications

2.5. Officers have sought legal counsel regarding the implications of the Council purchasing and letting residential property to generate income. In summary, if the Council were to purchase property and let these to tenants, the tenancy created would be "secure". This means that the tenant would have a statutory "right to buy" the property at some point during their tenancy and this right would be at a discount on the market value. The Council would legally have to fund the discount. The minimum discount that must be offered is 35% after three years for houses or 50% after three years for flats. As an investment option, such a venture would not represent a good return on investment.

2.6. An example would be as shown in the table below. This assumes a purchase price of £150,000 for a 2 bedroom home and a 2% capital value increase per annum, with the tenant opting to buy the home in year five. It is clear from this example, that the Council would lose 28% of its capital value in this example.

Year 0 Purchase	150,000
Market Value Year 1 - 2% Increase	153,000
Market Value Year 2 - 2% Increase	156,060
Market Value Year 3 - 2% Increase	159,181
Market Value Year 4 - 2% Increase	162,365
Market Value Year 5 - 2% Increase	165,612
Sale @ 65% of Market Value	107,648
Discount Due	57,964
Loss to Council (excluding returns)	42,352
% Equivalent Loss On Investment	-28%

2.7. If the Council were to set-up a South Hams / West Devon (SHWD) Local Authority Controlled Company (LACC), it would enable the Council to issue non-secure tenancies and therefore avoid 'right to buy' liabilities. At present there is no definite date as to when a SHWD LACC could be in existence and able to trade. Using the LACC for housing investment is therefore not something that can be pursued at this time.

Officers will in due course continue to investigate the legalities of how to use a LACC effectively to purchase properties or retain some properties built as part of direct investment on SHWD land for ongoing rental purposes.

2.8. Another route open to the Council to enable it to issue non-secure tenancies (assured shorthold tenancies which do not attract 'right to buy' liabilities) would be to use the Council's existing s95 company, Servaco. However, in his statement of 20th March 2015, the Housing Minister said: "it is not acceptable for local authorities to establish new wholly owned or controlled housing companies deliberately to avoid the government's reinvigorated Right to Buy policy" "…Specifically, the government will not support the establishment of such companies where they are developing or acquiring and retaining new social or affordable units for rental purposes." Servaco has been dormant since it was incorporated. If Servaco were only to be used for housing purposes in order to issue non-secure tenancies, the Government would likely deem that the company was set-up specifically to avoid right to buy and would deem that any tenancy issued should be considered as "secure". This would mean that the Council's investment would be at risk, as per the example in 2.6 above. As the proposed SHWD LACC is not being specifically devised to issue non-secure tenancies, investment into residential rental property would not carry the same risk.

2.9. Due to the fact the Council cannot currently issue any form of tenancy other than a secure tenancy, if it is still the desire of the Council to invest some of its Invest to Earn Earmarked reserve, into property, officers recommend investing into a property investment fund.

3.0. **Churches, Charities & Local Authorities (CCLA) Property Fund**

3.1. A variety of investment instruments are available to the Local Authority market. In addition to the notice accounts and fixed term deposits available from UK and overseas banks, it is also possible for the Council to invest, for example, in UK Government Gilts, bond funds and property funds. These alternative instruments would either require the Council to tie up its cash for significantly longer periods, thus reducing liquidity, or would carry a risk of loss of capital if markets go down. The Council's policy therefore has been not to invest in these more risky and less liquid forms of investment.

3.2. However, a variety of factors suggest that now may be an appropriate time to reconsider that approach, including:

(a) The perception of increased risk in bank deposits as a result of a reduction in confidence that the Government would bail out a failing bank.

(b) A growing UK economy that could support a more positive outlook for other forms of investment.

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(c) A challenging WDBC budget outlook that would benefit from the achievement of additional investment income.

3.3. Officers have therefore considered a variety of different forms of investment and have concluded that investment in a commercial property fund could be the way forward. UK Gilts and corporate bond funds could still face a challenging environment, whereas the commercial property market stands to benefit from forecast growth in GDP of in excess of 2% per annum over the next few years. UK Gilts are currently returning a yield of around 1%, whilst reasonably low risk equities generate around 3%.

3.4. The CCLA (Churches, Charities and Local Authorities) Property Fund has been specifically set up for local authorities, and currently has investments of over £673 million, with over 166 local authority investors including 9 county councils, 7 metropolitan councils/London boroughs and over 40 unitary and district councils. Devon County Council, Plymouth City Council and four Devon town councils are invested in the Fund. The fund own and operate 47 commercial properties across the UK, across various sectors with many having blue-chip tenants. By investing in this fund, WDBC would be able to diversify is risk exposure across the UK and multiple property types and sectors, as opposed to be solely investing in the WDBC property market by purchasing two houses within the borough.

3.5. The income yield over the course of the investment is likely be around 5%, significantly above the rates available for term deposits with banks. The income yield will vary from year to year, but tends to be within a fairly narrow range. A £300k investment would have the potential to yield up to £15k additional investment income in its first full year to help offset the budget pressures facing the Council. A higher investment would generate proportionately higher returns, e.g. £500k would generate £25k per annum.

3.6. However, there are risks that should not be discounted. The capital value of 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. There are also charges that would need to be met – a 5.75% charge on entry, a management charge of 0.65% per year, and a charge to redeem the investment of 1.55%. This means that any investment would need to be medium to long term, a minimum of 3 to 5 years, and capital growth would need to be around 3% per year to ensure that the capital redeemed at the end of the investment was at least equal to the initial amount invested. The investment could be redeemed at any time, but it may take 3 to 4 months from the time that the redemption request was made for CCLA to liquidate sufficient of its holdings in order to return the funds. If the Council only invested less than £500k, in normal market conditions it is likely that this could be returned to the Council within one month of the request.

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3.7 It should be noted that the charges above are similar to those that the Council would incur if it were to buy residential property. Stamp duty on an investment property is 5%, whilst agents fees on disposal, legal fees on acquisition and disposal and ongoing management fees for the property would equate (or even exceed) the above costs. The management charge of 0.65% is lower than most typical investment bonds / pension funds, which typically charge 0.75% as an annual fee.

3.8. Appendix A shows a CCLA Property Fund Fact Sheet. Appendix B shows the last 12 month's performance for CCLA prices and yields. Further details about CCLA can be found at www.ccla.co.uk Investments into this fund do not count as capital expenditure; dividends are treated as revenue income and the investment is treated as an "available for sale", financial asset. The council could invest and then sell at a later date and this means not only does the Council obtain regular returns (Paid quarterly), it also has the potential to benefit from an increase in "capital" value.

3.9. The potential return of 5% is approximately 8.5 times higher than the forecast treasury management return. In 2016/17, the average current return achieved is c0.59%.

3.10. Data from local property agent Vickery Holman has found the following investment yields:

	Residential	Industrial	Office
Oct 2007	3.0%	6.25%	5.75%
Oct 2012	7.0%	8.50%	8.00%
Oct 2014	6.0%	7.50%	7.75%
Jan 2016	5.0%	6.50%	7.00%

The above yields show that a return of 5% for the property fund is approximately equal to a residential yield. However, it is important to note some of the risks with residential investment: Tenants may not fulfil their contractual obligations and fail to pay, pay late or fail to quit the property at the end of their tenancy. The Council would also be subject to an insurance risk, the risk that the property market may crash, maintenance issues, borrowing costs in the event that the property is financed via prudential borrowing instead of from reserves, and / or the opportunity cost of cash.

4.0 **Options available and consideration of risk**

4.1. Members could opt to follow the recommendation or invest a higher or lower sum. Alternatively, members could opt to pursue an alternative investment strategy. Investment into this fund should only be considered if the investment can be maintained for a medium – long term, i.e. 3 to 5 years minimum.

If the investment needs to be liquidated before that timeframe, it is highly possible that the sum returned would be less than the sum originally invested.

4.2. The same issue could arise if the Council were to invest directly into property, where once the cost of stamp duty, agents fees, legal disbursements, maintenance and any void periods have been accounted for, the sum returned (after disposal costs) after a short holding period may be less than the sum originally invested.

4.3. The Council has for many years 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 does impact on the income being generated from these investments.

4.4. Officers have consulted with two other local authorities who have already invested into the CCLA property fund. Devon County Council invested £10m in September 2015.

4.5. Officers conducted an online survey of West Devon Members after a Finance & Investment principles workshop held on 5th December 2016. At the workshop, officers explained the merits of the CCLA property fund and how this could form part of a balanced investment portfolio. The survey sought to understand Member views on the options presented. 16 WDBC Members were asked "Is it acceptable for the Council to consider investing in a property investment fund (CCLA) as part of a wider investment strategy?" – 87.5% responded positively.

4.6. **Set-up of an "Invest to Earn" Working Group**
To help officers develop their thinking on bringing forward income generation and efficiency proposals, it is suggested that a working group be set-up. It is envisaged that this group would be formed from no more than 4 elected Members and would (as need dictated), meet with an equivalent SHDC working group. It would be called the "Invest to Earn Working Group" and would work in conjunction with officers on any project or initiative linked to income generation, investment strategy or efficiency improvement.

4.7. Working group Members would provide input and engage/act as advocates with the wider membership on proposals. Members will suggest, consider and evaluate proposals and help officers to shape these, agreeing parameters, criteria and ultimately assist with building credible business cases for presentation and approval at the appropriate Council committee. A suggested terms of reference is shown in appendix C.

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5.0 Proposed Way Forward

5.1. It is proposed that if the Council approve this report's recommendations, officers invest the £500,000 into the CCLA property fund at the earliest opportunity. This investment would be monitored as part of the treasury management function, but it is anticipated that the investment would be left to generate income for a minimum of five years. This type of investment will be less onerous for officers to manage than acquiring two residential properties for let.

5.2. It is recommended that £500,000 is invested as there is £880k available in the 'Invest to Earn' reserve. The remainder of the 'Invest to Earn' reserve will be used to seed fund other asset related invest to earn initiatives. This amount exceeds the £300,000 originally proposed in March 2016, however it is felt that this initiative puts the money to good use now whilst other initiatives are prepared.

5.3. Officers will continue to evaluate property investment opportunities and will also obtain legal advice as to how the emerging plans for a SHWD LACC could open alternative income generation opportunities. When appropriate, proposals will be brought to Council for decision. These opportunities would initially be discussed with the proposed 'Invest to Earn' working group (if approved).

6.0 Implications

Implications	Relevant to proposals Y/N	Details and proposed measures to address
Legal/ Governance	Y	The Treasury Management Strategy Statement (TMSS) for 2016/17, which includes the Annual Investment Strategy, was approved by the Council on 05/04/16 – CM61 (and Audit Committee 15/03/2016 – AC32). It sets out the Council's investment priorities as being: • Security of capital; • Liquidity; and • Yield. The Council aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit rated financial institutions, using our suggested creditworthiness approach, including a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information. The Treasury Management Strategy is risk averse with no investments allowed for a period of more than a year and very high credit rating are required together with a limit of £3m per counterparty. The TMSS will need to be updated accordingly before the CCLA investment can be made. It is anticipated that this will be updated to allow investment in CCLA after 1st April 2017. Setting up a working group and agreeing to invest in the CCLA fund both require Council approval.

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Financial	Y	An investment in the CCLA Property Fund will represent an increased risk of loss of capital in comparison to the use of term deposits with banks and building societies, but during a period when the UK economy is expected to grow this may be an acceptable risk. Such an investment has the potential to provide a significant increase in investment income that could contribute towards the predicted budget gaps highlighted in the Medium Term Financial Strategy.
Risk	Y	The security risk is the risk of failure of a counterparty. The liquidity risk is that there are liquidity constraints that affect interest rate performance. The yield risk is regarding the volatility of interest rates/inflation. 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. The Council engages a Treasury Management advisor and a prudent view is always taken regarding future interest rate movements. Investment interest income is reported quarterly to SLT and the Executive.
Comprehensive Impact Assessment Implications		
Equality and Diversity	N	N/A
Safeguarding	N	N/A
Community Safety, Crime and Disorder	N	N/A
Health, Safety and Wellbeing	N	N/A
Other implications	N	N/A

Supporting Information

Appendices:
Appendix A – CCLA Property Fund Fact Sheet
Appendix B – CCLA Historic Prices & Yields Note, December 2016
Appendix C – Draft Terms of Reference for Invest to Earn member working group

Background Papers:

- Income Generation Proposals Report– presented to Hub Committee, 22nd March 2016
- MTFS, presented to Hub Committee September 20th 2016
- Revenue & Capital Budget Proposals Report – 2017/18, presented to Hub Committee December 19th 2016
- Annual treasury strategy in advance of the year (Audit 15/03/16 – AC32)

Approval and clearance of report

Process checklist	Completed
Portfolio Holder briefed	**Yes**

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SLT Rep briefed	**Yes**
Relevant Exec Director sign off	**Yes**
Data protection issues considered	**Yes**
If exempt information, public (part 1) report also drafted	**n/a**