Investment in Commercial Property

Report to:	**South Hams Executive Committee**
Date:	**9 March 2017**
Title:	**Investment in Commercial Property**
Portfolio Area:	**Cllr Michael Hicks, Business Development, Strategy & Commissioning**
Wards Affected:	**All**
Relevant Scrutiny Committee:	**Overview & Scrutiny Panel**
Approval and clearance obtained:	**Yes**
Urgent Decision:	**No**
Date next steps can be taken:	**After Full Council**
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Recommendations: That the Executive:

1. **NOTE** the proposed commercial property investment strategy and proposed direction of travel as detailed in Appendix A
2. **APPROVE** the allocation of resources from the Innovation (Invest to Earn) Earmarked Reserve which has an uncommitted balance of £20,500 to gain specialist advice in order to develop a full business case for the commercial property investment proposals set out in this report, which will be brought back to Council for a final decision
3. **AGREE** that officers commence an appropriate procurement process to commission a property agent to work on behalf of the Council in relation to the proposed commercial property investment strategy

1.0 Executive Summary

1.1 On December 8th 2016 and January 5th 2017, Members attended a finance and investment principles workshop which covered the income generation, investment strategy, and efficiency improvement opportunities officers were considering.

1.2 Based on Member feedback from those sessions, and with input from the recently formed 'Invest to Earn' working group, this report recommends the Executive note the proposed property investment strategy.

1.3 Other opportunities to close the budget gap are being pursued concurrently. 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.

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

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.

1.6 If ultimately approved in this form, the strategy could see the Council building a commercial property investment portfolio with a maximum budget of £75m plus an additional 7% of that sum in acquisition costs. Any property acquired would conform to the proposed strategy detailed in Appendix A.

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 forecasted budget gap from 2017/18 onwards as reported to Council on 9th February 2017:

	2017/18 £	**2018/19 £**	**2019/20 £**	**2020/21 £**	**2021/22 £**
Budget gap/surplus	**Nil**	**560,905**	**Nil**	**10,722**	**16,413**
ACTUAL PREDICTED CUMULATIVE BUDGET GAP OVER THE FIVE YEARS TO 21/22					**£588,040**

2.3. The above means that over the period to 2021/22 the above amounts need to be found by way of savings or additional income generation, based on the current financial modelling.

2.4. 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 possible for the Council to invest in UK Government Gilts, bonds, property funds, or commercial and residential property.

2.5. These instruments require the Council to tie up its funds for a significantly longer period than currently determined by its adopted Treasury Management Strategy (reducing liquidity), or would carry a risk of capital loss if markets were to go down.

2.6. Therefore, the Council's policy has hitherto been not to invest in these more risky and less liquid forms of investment. 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 again bail out a failing bank

(b) The outlook for short term bank deposit yields being below inflation

(c) A growing UK economy that could support other forms of investment

(d) A challenging SHDC budget that would benefit from additional investment income

2.7. Officers have therefore considered a variety of different forms of investment. 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 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%.

2.8. To achieve financial sustainability, based on the current MTFS, the Council needs to generate or save c.£600k pa. The table below depicts the options and the applicable investment required if one option was chosen solely to close the forecast budget gap:

To Achieve £600k per annum… (Indicative Returns)	**Gilt 1%**	**Low Risk Equity 3%**	**Property Fund *(e.g. CCLA)* 5%**	**Property Investment 5.75%^**
Capital Required (£)	60,000,000	20,000,000	12,000,000	80,250,000
Funding Available?	**No**	**No**	**No**	**No**
Borrowing Allowed?	**No**	**No**	**No**	**Yes**

^5.75% is gross yield. Finance & management costs and a sinking fund need to be deducted to generate a net yield. This is detailed in Appendix A.

2.9. Market analysis by local property agent Vickery Holman in 2016 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%

2.10 Investment in residential property is not recommended due to the risk of 'Right to Buy' affecting investment returns. The Council is actively looking at other forms of residential development and investment and these are the subject of other reports for consideration by Council.

2.11 The Council does not have significant funding available to enable investment in gilts, equities nor property funds at this time to achieve financial sustainability. Officers have concluded that investment in commercial property could be the way forward initially, as part of a balanced investment portfolio. Therefore, the remainder of this report will focus on property investment as it is understood that Public Works Loan Board (PWLB) borrowing is available to the Council to acquire capital assets.

3.0 Investment in Commercial Property

3.1 Members recently approved the formation of a Member 'Invest to Earn' working group. This group have worked with officers to formulate the Commercial Property Investment Strategy and Business Plan shown at Appendix A. The Terms of Reference for the group are shown in Appendix C.

3.2 Subject to the approval of a full business case and obtaining specialist legal and treasury management advice, 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 12 months.

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

3.4 Purchases will be made using predominantly prudential borrowing or any other unallocated or available Council reserve or capital receipt. Borrowing will be taken on a repayment basis, over a maximum 40 year term.

3.5 The portfolio will target a gross investment yield of 5.75%. The strategy will be reviewed on an annual basis.

3.6 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. 16 elected Members participated in the survey. Of those:

3.6.1 94% said the Council should acquire a commercial property portfolio to sustain the Council's revenue position

3.6.2 69% said investment should be made into a mixed estate (no sector preferred) but with the decision based on availability and acceptable risk

3.6.3 94% said it was acceptable or desirable to acquire properties outside of the district

3.6.4 94% said it was acceptable for the Council to take on borrowing to acquire such an estate

3.7 Initially, it is proposed that the Council appoint a property agent to work on its behalf to source investment opportunities. It is recommended that funding is allocated from the Innovation (Invest to Earn) Earmarked Reserve to acquire specialist advice in relation to the preparation of a full business case which will be brought to Council for decision.

4.0 Options available and consideration of risk

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

4.2. The overall investment quantum and strategy is designed to provide sufficient income to cover the predicted budget gap in its entirety. This approach will be assessed as part of the treasury management advice procured e.g. affordability requirements. If the total investment amount is reduced, the income generated would not be sufficient to create financial sustainability.

4.3. If Members chose to vary the portfolio investment yield target, overall budget, or funding source, these would result in different financial outcomes.

4.4. There are risks that should not be discounted. It is proposed that the Council takes in a significant sum in borrowing to finance the acquisition of a commercial property portfolio.

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 and capital value increases have not been factored into the financial calculations.

4.7. A drop in capital value would only affect the Council's cash flow position if it chose to dispose of the investment whilst the value was less than at acquisition.

4.8. However, using PWLB to fund a purchase means lending is not secured against the property and so the Council could opt to lose money on one property if the overall capital value of the portfolio is greater than the loss capital value.

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

4.10. 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. Refer to Appendix A and B for details of the strategy, criteria, and the business case that would need to be completed before a purchase is recommended to the delegated authorities to consider.

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

4.12. A breakeven position, where the loan repayment, maintenance and management are covered by the rental income earned by the portfolio is achieved with a portfolio gross yield of 4.88%. 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. For the past few years, 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.

4.14. 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. This strategy would need to be updated if this direction of travel is pursued. A revised Treasury Management Strategy would be presented to Council with the business case for the commercial property investment.

5.0 Proposed Way Forward

5.1 It is proposed that if the Executive Committee approve this report's recommendations, further due diligence will be completed by way of securing counsel from the Council's treasury management advisors and external legal advisers, to inform the strategy and the Council's legal powers to build a portfolio as described in Appendix A.

5.2 A property agent will be commissioned to work on behalf of the Council in relation to this proposed strategy.

5.3 The funding required to obtain the specialist advice and services will be financed from the Innovation Fund (Invest to Earn) Earmarked Reserve.

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 will be sought from external specialist advisers. Member approval is sought to authorise the allocation of resources for this purpose. This advice is to be funded from the Innovation (Invest to Earn) Earmarked Reserve which has an uncommitted balance of £20,500.
Financial	Y	Advice is being sought from Capita, the Council's retained Treasury Management advisors, regarding the ability of the Council to meet the financial obligations inherent with borrowing up to £75m (plus acquisition costs) to fund the proposed commercial property investment strategy. This advice is to be funded from the Innovation (Invest to Earn) Earmarked Reserve which has an uncommitted balance of £20,500. Part of the business case for commercial property investment will be an assessment of the Internal Rate of Return (IRR) calculation. If successful, the proposed commercial property investment strategy has the potential to make a significant contribution to the current predicted cumulative budget gap for the Council.
Risk	Y	Any PWLB borrowing to fund the acquisition of commercial property is not secured on the property acquired. The security risk is that the capital value of the property acquired falls. 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 borrowing rate will be fixed for the term of the loan. As lending will be taken on a repayment basis, at the end of the term, the loan will be repaid in full and property will be a 100% owned asset of the Council (in actuality

		as the loan is not secured against the property, the asset will be 100% owned from day one). 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 agents commissioned to manage the asset and 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, limiting the risk to the Council's portfolio. The Council already owns and operates a commercial property estate valued at c.£70m. It therefore has experience of managing such an estate and can act as an intelligent client, with the aid of commissioned property specialists. The cost of these specialists has been included in the net yield. 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. A revised Treasury Management Strategy will be presented to Council with the business case for the commercial property investment. Investment interest income is reported quarterly to SLT and Executive.
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 Investment Strategy & Business Plan
Appendix B – Business Case for Property Investment
Appendix C – Terms of Reference for the 'Invest to Earn' Working Group

Background Papers:

- MTFS, presented to Executive Committee September 15th 2016
- Revenue & Capital Budget Proposals Report – 2017/18, presented to Council, February 9th 2017

Approval and clearance of report

Process checklist	Completed
Portfolio Holder briefed	**Yes**
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**