Report to:	**Hub Committee**
Date:	**20 June 2017**
Title:	**Investment in Commercial Property**
Portfolio Area:	**Cllr Philip Sanders, Leader of the Council, Strategy & Commissioning**
Wards Affected:	**All**
Relevant Scrutiny Committee:	**Overview & Scrutiny Committee**
Approval and clearance obtained:	**Yes**
Urgent Decision:	**No**
Date next steps can be taken:	**After Full Council**
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RECOMMENDATIONS

That the Hub Committee RECOMMEND to Council to:

1. **APPROVE & IMPLEMENT the proposed commercial property investment strategy as detailed in Appendix A;**
2. **AGREE that officers conclude an appropriate procurement process to commission specialists to work on behalf of the Council in relation to the proposed commercial property investment strategy;**
3. **DELEGATE individual commercial property portfolio purchase 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 complete tranche 1 this would require borrowing of up to £26.75m (£25m plus acquisition costs of 7%).**

1.0 Executive Summary

1.1 On 28th March 2017, the Hub 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 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.

1.3 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.

1.4 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. This report seeks approval to the first tranche of £25m plus the additional 7% acquisition costs.

1.5 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.

2. **Background**

2.1. 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.

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.

2.3. The following table illustrates the forecasted budget gap from 2018/19 onwards as reported to Council on 7th February 2017:

	2018/19	2019/20	2020/21	2021/22	TOTAL
	£	£	£	£	£
In Year Budget Gap/(Surplus)	974,460	Nil	Nil	(128,874)	845,586
*Cumulative Budget Deficit	974,460	1,948,920	2,923,380	3,768,966	3,768,966

*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 £0.974m. This means that over the period to 2021/22 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 28th 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 investment 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 MTFS, the Council needs to generate or save c.£1m pa. Assuming a target gross investment yield of 5.85% and taking borrowing over 50 years at current Public Works Loan Board (PWLB) rates, the Council would need to invest £80.25m to generate the £1m required. Further detail about this can be found in Appendix A and B.

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 and B.

3.2 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.

3.3 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.

3.4 Purchases will be made using predominantly prudential borrowing or any other unallocated or available Council reserve or capital receipt. Borrowing will be undertaken, over a maximum 50 year term.

3.5 The portfolio will target a gross investment yield of 5.85%. The strategy will be reviewed on an annual basis.

3.6 Following the Finance & Investment principles workshop, held on December 5th 2016, 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 property specialists to work on its behalf to source investment opportunities.

3.8 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 Borough, utilising prudential borrowing and holding the properties on its balance sheet.

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 current predicted budget gap in its entirety. This approach has been assessed as part of the treasury management advice procured (affordability requirements). If the total investment amount were to be 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, different financial outcomes would be achieved.

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. Capital value fluctuations have not been factored into the financial calculations. A drop in capital value would only affect the Council's cash flow position if it chose to dispose of the investment whilst its value was less than at acquisition.

4.7. 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.

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

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 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.

4.11. 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 3.88% 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.

4.12. 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.

4.13. This policy has been maintained in the knowledge that putting security before liquidity or yield impacts on the income being generated from these investments. This strategy needs to be updated if this direction of travel is pursued. A revised Treasury Management Strategy will be brought to Members at the July Council meeting for approval if this report's recommendations are approved.

5.0 Proposed Way Forward

5.1 It is proposed that if the Hub Committee approve this report's recommendations, a property specialist 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) which sets 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 investment 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 investment work, the current levels do not suggest that the Council is engaged in commercial investment 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 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 Investment Strategy and has proper regard to the following: • The relevant capital and revenue costs and income resulting from the investment over the whole life of the asset. • The extent to which the investment is expected to deliver a secure ongoing income stream. • The level of expected return on the investment. • The payback period of the capital investment. Part of the business case for each commercial property investment 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 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 investment strategy has the potential to make a significant contribution to the current predicted cumulative budget gap for the Council. If a portfolio yield of 5.85% is achieved, the financial model suggests that an investment of £80.25m could generate a surplus of between £0.57m to

		£1.365m 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 £0.19m to £0.45m per annum. Further financial considerations are discussed in Appendix B. Investment interest income is reported quarterly to SLT and Hub.
Risk	Y	The security risk is that the capital value of an acquired property 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 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 specialist agents commissioned to manage the asset and its 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 property estate valued at c.£25m. It therefore has experience of managing such an estate and can act as an intelligent client to fulfil the proposed strategy, with the aid of commissioned property specialists. The cost of these specialists has been included in the net yield.
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 & Criteria
Appendix B - Further Financial Considerations
Appendix C - Explanation of Minimum Revenue Provision (MRP)

Background Papers:

- Investment in Commercial Property, presented to Hub Committee March 28th 2017
- MTFS, presented to Hub Committee September 20th 2016
- Revenue & Capital Budget Proposals Report – 2017/18, presented to Council, February 7th 2017
- Annual treasury strategy in advance of the year (Audit 15/03/16 – AC32)