Report to:	**Audit Committee**
Date:	**20th July 2017**
Title:	**Governance & Risk Aspects of the Proposed Commercial Property Acquisition Strategy**
Portfolio Area:	**Strategy & Commissioning**
	Cllr Keith Wingate
Wards Affected:	**All**

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Recommendations:

That the Committee ACKNOWLEDGE the risks and REVIEW & ENDORSE the proposed governance arrangements relating to the implementation and management of the Council's proposed commercial property acquisition strategy.

1.0 Executive summary

1.1. This report has been prepared in response to the request by Audit Committee at its meeting held 22nd June 2017.

1.2. It sets out the background and rationale behind the need for a commercial property acquisition strategy, details about the National Audit Office's investigation into Local Authority Property Investment and explains some of the national context.

1.3. Additionally, this report sets out the process by which properties would be sourced and acquired and then actively managed, focussing on the risks identified and mitigated, the strategy that will be pursued, along with the governance and monitoring arrangements.

1.4. This report does not require Audit committee to approve the proposed strategy and its implementation. A separate report entitled "Commercial Property Acquisition Strategy" is due to be presented to the Executive on 20th July 2017 and contains those recommendations. It is recommended that report is read in conjunction with this report.

2.0 Rationale for Acquisition Strategy

2.1 The overall acquisition quantum and proposed strategy as detailed in the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017, is designed to provide sufficient income to cover a meaningful proportion of the predicted budget gap. A fund of £75m should provide an expected return in excess of £585k per annum, whereas a fund of £25m should provide a return of between £0.15m and £0.3m.

2.2 Local authorities throughout the UK are concerned that changes to how they are funded will potentially leave a significant shortfall in their revenue budgets on top of the reduction in real terms that are already being experienced. This means that, for a large proportion of local authorities, additional, secure and sustainable sources of ongoing income will be required to maintain services at anything like current levels.

2.3 This has encouraged public bodies of all shapes and sizes not only to reassess how they use, and increase the benefit from, their current property portfolio but also to invest in property in non-traditional ways. To see property as a pure investment opportunity or, as they have in the past, to support regeneration and economic development whilst also producing a significant beneficial rate of return on the capital investment made.

2.4 A few local authorities are also starting to invest in property outside their administrative areas and, occasionally, looking for ways to operate outside the legislative constraints that were traditionally imposed on Local Government but have been relaxed as a consequence of the Power of General Competence granted through the Localism Act 2011.

2.5 The economic climate that has existed since 2008 has seen the rate of return from traditional investment routes such as equities and bonds or simply letting capital reserves 'sit in the bank', drastically reduce. Some Local Authorities are relatively capital rich but revenue poor, however capital cannot simply be used to support a revenue shortfall unless significant service improvements/efficiencies are made as a result, in any event such a policy is clearly unsustainable and authorities are now looking at ways of making capital work to fund their shortfall in revenue.

2.6 Local Authorities currently also have access to relatively low cost and long term borrowing via the Public Works Loans Board and other lenders. Borrowing to invest in property that will not only generate a 4%+ return, but also gaining an asset that will potentially increase in value would therefore appear to make good business sense.

2.7 There have recently been a number of negative articles in the National Press and some Members of Parliament have questioned and criticised this strategy and likened it to the Icelandic banking crash. However much of this criticism has been made on the back of large investments which have made the headlines by one or two councils, rather than on a balanced view of activities as the proposed by Commercial Property Acquisition Strategy for South Hams District Council.

3.0 National Audit Office Investigation

3.1 The National Audit Office highlighted the trend of local authorities acquiring commercial property in its June 2016 report on 'Financial sustainability of local authorities: capital expenditure and resourcing'. This highlighted that:

3.2 'Authorities have been prepared to make capital investments if they feel there is potential to secure future revenue income. This reflects recognition that the sector is moving towards a largely self-financing model'.

It also highlighted that 'While there was significant interest and activity in these types of schemes, most authorities were in the early stages of setting them up'.

Furthermore, some authorities felt that their potential to benefit from these initiatives was limited because of the nature of their local economy and property market.

Whilst local authorities are potentially well placed to take advantage of property investment opportunities, as with all forms of investment there are risks and one of the key issues will be skills and experience.

3.3 This was of concern to the House of Commons Public Accounts Select Committee which highlighted in its investigation on the Financial sustainability of local authorities that:

‘The Department for Communities and Local Government expects authorities to become more ‘entrepreneurial’ as it encourages local government to become largely self-financing. But we are concerned that the Department appears complacent about the risks to local authority finances, council tax payers and local service users arising from the increasing scale and changing character of commercial activities across the sector.’

‘The Department does not have good enough information to understand the scale and nature of authorities’ commercial activities or which authorities are placing themselves at greatest risk and it does not use the information it does have to give it a cumulative picture of risks and pressures across the sector.’

‘Local authorities are increasingly making commercial capital investments aimed at generating revenue income, for example by purchasing properties to lease to businesses, developing houses for market rent, and developing commercial units. Oversight of these new commercial activities will require skills of elected members that may be in short supply in some authorities.’

‘Already some authorities are less confident than others about members’ ability to provide strategic oversight of the sustainability of capital programmes. Members receive support from officers but these new ventures may require specialist skills and experience that have not been needed by officers in the past. The market value of the commercial skills and experience required is not a good fit with local authority pay scales’.

3.4 South Hams benefits from employing several officers who have significant experience of acquiring, managing and disposing of multi-million pound commercial properties, both in the private and public sector. It is therefore very well-placed to act as an intelligent client to implement the proposed strategy.

4.0 Local Authorities as Property Investors

4.1 The use of property to provide an income stream is becoming more popular with an increasing number of Councils purchasing pure investment assets. A desk-top activity review of a few authorities can provide a helpful steer in considering property acquisitions:

4.2 Cheltenham Borough Council holds investment properties within its boundaries that generate circa £2.247m investment income per annum and include a shopping complex, office accommodation and industrial units. A strategy for further commercial investment is currently being considered.

4.3 Cotswold District Council holds investment properties within the District that achieve £218k rental income per annum from offices, commercial units, cafes and workshop, whilst outside its boundaries it generates circa £316k investment income per annum from three retail outlets including a small element of residential.

4.4 West Oxfordshire District Council holds investment properties within the District that generate £682k per annum from industrial units, offices and retail, whilst outside its boundaries it generates circa £1.874m investment income per annum which include £1.650m for offices and industrial units within Oxfordshire and £224k for two restaurant/diners outside the County.

4.5 Portsmouth City Council has invested in excess of £100m through its property investment strategy across the country to generate new income to fund services across the council.

4.6 West Devon Borough Council's Hub Committee have recommended to their Full Council that a first tranche of £25m is set-aside to fund commercial property acquisitions to help close their predicted budget gap. The strategy they are due to follow is essentially the same as is proposed for SHDC.

5.0 Skills and capacity

5.1 The 'Invest to Earn' member group has discussed with officers the need for the appropriate skills to implement the proposed strategy. It is understood that whilst there is a highly skilled, capable workforce with significant relevant national property experience and industry-recognised qualifications, there is not sufficient spare capacity to implement such a vital income generative undertaking. Implicit within the proposals to Executive is the need to commission property specialists to implement this strategy, reporting to Council officers (who have property-related qualifications and significant commercial property experience) and the 'Invest to Earn' member group.

5.2 These specialists will cover a range of areas, not only the identification and acquisition of investment property, but also those involved in the day to day management of assets, through to portfolio management and legal advice. The Council already commissions treasury management advice from Capita Asset Management Solutions. The choice of expert advisors will be made after an OJEU compliant procurement process, though initially, a procurement exemption will be sought to ensure that no time is lost between Council approving the strategy and property sourcing commencing. A soft market test has already be held for the main activities and proposals received.

5.3 External advice has the benefit of being available as and when required; there is unlikely to be sufficient activity in this area to justify new, adequately salaried, full time post/s in the short term.

6.0 Risk Analysis

6.1 There is a level of risk that will be inherent in investing in illiquid assets for the long term. These risks can be mitigated through the initial selection process and by constant review of the individual property, portfolio and the market in order to inform a hold and sell strategy for Council assets. Early engagement with current tenants or the market will allow for continued occupancy of the properties.

6.2 It is proposed that the Council takes in a significant sum in borrowing to finance the acquisition of a property portfolio. In other words, the initial loan to value ratio would be close to 100%, and this creates a risk that Members should be aware of.

6.3 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. This investment strategy is based on revenue income and capital value increases have not been factored into the financial calculations.

6.4 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. 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 lost capital value.

6.5 The strategy and business plan allow for the costs needed to acquire and manage the portfolio, e.g. acquisition, disposal, maintenance and management. The strategy looks to mitigate risks by setting specific criteria for purchases and necessary due diligence must be completed before any purchase.

6.6 It requires 11-18 assets to reduce "diversifiable risk" by a factor of 90%. The optimal number of properties for any portfolio is 15-20 reducing risk by 95%. ("What's in a number?" CBRE global investor research 2015)

6.7 The target yield, less costs, will comfortably outperform the current investment returns achieved by the Council in other treasury management activity.

6.8 External legal advice has been taken. The Council's Monitoring Officer and Commercial Lawyer are content that the proposed strategy is in line with the powers that are available to the Council, having obtained and considered counsel opinion.

6.9 There is a risk of challenge - but in the event of said challenge being upheld, which is in itself a lengthy process, officers have been advised the Council would not be forced to unwind any acquisition. Instead, it would likely need to cease any further implementation of the strategy and may be required to transfer ownership of any acquisitions into a separate wholly owned company. This would increase the operating cost of maintaining those acquisitions but this is not expected to mean that the acquisition is no longer financially viable or attractive.

6.10 Further information about the risks associated with the strategy can be found in the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017.

6.0 Acquisition and management

6.1 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 are active in this investment area there is an increasing level of delegation being authorised to enable them to move quickly when properties come to the market. Work doesn't stop once all the assets have been acquired. Arrangements need to be in place for maintenance, rent reviews and collection, valuations etc.

6.2 The SHDC proposal seeks to commission these services from third party property specialists and the cost for this is included within the business case. This will be a departure from the management of the Council's existing property estate and this is discussed in the Commercial Property Acquisition Strategy report to Executive, due to be presented on 20th July 2017.

6.3 Property assets are not commodities and each one is unique. A council may have a sound approach in place but it will need to be applied prudently, and each asset must be assessed carefully before acquisition preferably utilising an agreed scoring and assessment matrix. Any new acquisition should fit into the agreed strategy, and the associated risks must be acceptable.

6.4 Councils need to be aware of the potential risks and generally be cautious regarding this type of strategy, taking external expert advice and commissioning experienced property specialists to assist with the sourcing, acquiring, managing and ultimately disposing of such assets. This is of particular importance when making acquisitions outside the Council's district to consciously avoid the 'all their eggs in one basket' scenario, thereby acquiring in a variety of property sectors, to multiple low-risk tenants, in dispersed areas of the country.

6.5 Once a council has secured the funds to create an investment property portfolio, it is essential to ensure it remains separate from its operational buildings. In line with recognised best practice, it's always best to have a balanced and diverse portfolio in order to spread the risk.

6.6 This means purchasing a range of asset types, a locational spread and a mix of tenants with sufficient covenant strength relative to the specific asset. Ideally, councils should also invest in a combination of lease types to provide security; some with a higher yield and shorter leases for properties with strong residual values, and some longer leased properties. This will help to cope with market cycles and ensure there is always a minimum income covering the cost of the outstanding debt.

7.0 Sourcing the best property & obtaining Value for Money

7.1 When investing in any property, prime considerations are the suitability of location, occupational demand, needs of the user and risk of building obsolescence. An asset plan for each property will be determined at the outset and this will then be reviewed on a regular basis when acquired. Active Portfolio Management will be employed, i.e. keeping abreast of trends, sectors and markets and how these could impact on the portfolio.

7.2 In order to source appropriate investment assets, conduct due diligence and successfully negotiate the acquisition of property, it will be necessary to commission property acquisition experts to act on behalf of the Council. An expert's knowledge of the market and properties that are about to come to market is invaluable in sourcing the best acquisition options. Properties that end up in the wider public domain are usually those that don't represent the best prospects. Good agents can bring information to the Council of the best assets available before the information is more widely known and therefore put the Council in an advantageous position.

7.3 Having brought a potential acquisition to the attention of the Council, the property expert will be in a position to conduct the necessary due diligence including a full market appraisal within the timescales required. Such an agent will also help ensure the Council obtains value for money through the bidding and negotiation stage. It is the relationships that exist between buying and selling agents that result in a better chance of a successful bid being submitted at a level that is matching or slightly better than competitors.

7.4 Further detail about the acquisition strategy can be found in Appendix A of the Commercial Property Acquisition Strategy report to Executive, due to be presented on 20th July 2017. The covering report also contains further detail about the procurement of a property expert.

8.0 Terms of Purchase

8.1 Officers recommend that acquisitions be conditional on the following points:

i. The agreement of contract terms

ii. Satisfactory report on title and completion of legal, tax, financial and technical due diligence.

iii. Satisfactory building and environmental surveys.

iv. Full verification of the information provided within the marketing particulars.

v. The benefit of any unclaimed capital allowances to be transferred to the purchaser.

vi. Each party to bear its own costs in the transaction (if appropriate, following expert advice)

An assumed level of the acquisition fees of 7% has been used in all projections.

9.0 Financing Costs

9.1 Whilst the Council will use, where possible, any capital receipts it may generate from land sales to help finance acquisition costs or unallocated reserves, the main source of financing of these transactions will come from borrowing. Market rates are, at this time, at an historic low and forecast to continue at these levels for at least another couple of years.

9.2 By way of an example the Public Works Loan Board (PWLB), which is the traditional source of borrowing for local government, has seen an average borrowing rate over the last 22 years of 4.46%. SHDC has been quoted a rate of 2.37% for a 40 year borrowing term.

9.3 The actual rate that will be obtained differs from day to day and the s151 officer will take treasury management advice before completing any borrowing to enable the implementation of the proposed strategy.

9.4 The Commercial Property Acquisition Strategy report to Executive, due to be presented on 20th July 2017 contains further detail about financing property acquisitions.

10.0 Governance Process

10.1 The Council's 'Invest to Earn' group will oversee the investment of the £80m fund proposed. It is envisaged that this group will meet regularly during the acquisition phase of the implementation strategy and then at regular intervals once the portfolio is established.

10.2 It is important to note that the 'Invest to Earn' group and the s151 Officer will be bound by the overall parameters of the Commercial Property Acquisition Strategy when making purchase decisions. This should give Council confidence that the business case for each property acquisition has met a minimum level of security and return as defined within the strategy.

10.3 The strategy is not time limited (see Appendix A of the Commercial Property Acquisition Strategy report to Executive, due to be presented 20th July 2017). It is anticipated it could take up to two years to complete the portfolio build. Once the portfolio has been completed up to this level, the ongoing management and monitoring of the portfolio will fall under normal arrangements, unless otherwise requested. Regular reporting to the 'Invest to Earn' group, the Council's Audit Committee and the Council's Senior Leadership Team will continue as long as it is required. It is envisaged that the membership of the 'Invest to Earn' group will be annually appointed by the leader of the Council.

10.4 Local Government Act 2003 Section 1 allows a local authority to borrow money for the purposes of the prudent management of its financial affairs. The s151 officer will be key in deciding whether the Council should acquire properties and the decision in any particular case should be made with a view to the financial return that may be generated as a result of the acquisition and whether the acquisition will fit within the agreed strategy of the Council.

10.5 In addition, the Secretary of State's Guidance relating to the adoption of a treasury management strategy (annually) will be relevant - specifically the need for the Council to consider security, liquidity and yield (in that order) in relation to any proposed investments. Finally, regard should be had to the Council's fiduciary duties to tax payers. The decision to acquire any particular property should be made subject to the S151 undertaking due diligence and determining that the purchase and associated borrowing will constitute prudent management of the Council's financial affairs.

10.6 There is always a danger that decision makers will get caught up in the moment. Councils must be convinced that an asset is right for them, only committing to buy if they are certain. If not, walk away. The Governance process allows for this. Only properties that fit within the defined criteria will be considered.

10.7 Acquisitions must pass a number of steps before a bid is made:

1. The commissioned property expert must recommend an asset to officers and advise why they think it is a good fit with the Council's strategy
2. Officers (Group Manager Business Development & the Assets Community of Practice Lead) must then review and approve the asset. At this point a bespoke acquisition appraisal will be prepared.
3. If approved, the 'Invest to Earn' member group will be convened to review the asset and its' fit with the existing portfolio and corporate objectives. This group will vote on whether to recommend to the Council's delegated authority. Please refer to the "Commercial Property Acquisition Strategy" report, being presented to Executive on 20th July 2017 for further information on the delegated authority. 'Invest to Earn' group voting will follow the group's Terms of Reference, shown in Appendix 1.
4. If the asset has been recommended to the delegated authority, that group will be convened to approve a bid being made. If approved, officers will engage with the property experts to place a bid and further negotiate the acquisition subject to the completion of necessary due diligence*. Tolerances are built into the acquisition strategy (see Appendix A of the Commercial Property Acquisition Strategy report to Executive, due to be

presented 20th July 2017), enabling officers to conclude an acquisition (after the due diligence has been completed and the bespoke acquisition appraisal has been updated) without recourse to the delegated authorities.

*In addition to valuations, appropriate title checks and searches will take place before the Council is committed to purchase any property, in order to ensure that the title the Council acquires is good and marketable, with (where relevant) enforceable leases in place and the rents payable verified. The legal considerations in respect of each acquisition will be considered as part of the initial assessment process and be reported to the delegated authorities.

11.8 Ultimately, decision making is to be delegated to the Executive Director, Strategy & Commission (Head of Paid Service), in consultation with the Leader of the Council, the chairman of the 'Invest to Earn' member group and the s151 officer.

11.9 Further information about the risks associated with the strategy can be found in the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017.

11.0 Monitor, review and adapt

11.1 Ongoing performance measurement is essential to ensure an effective property portfolio. Monitoring key financial benchmarks will enable a local authority to react if specific assets do not fulfil their anticipated potential, or if local markets change over time.

11.2 It is important that the new portfolio is seen as something that needs to be continually moulded to achieve the best financial return rather than just sitting back and expecting the money to accumulate.

11.3 The strategy recognises this and the OJEU procurement that will be undertaken to assist the implementation of the strategy will specifically cover this.

11.4 Regular reporting will be provided to the Council's Senior Leadership team, the 'Invest to Earn' Member group and to the Council's Audit committee.

2. Proposed Way Forward

2.1. That the Committee ACKNOWLEDGE the risks and REVIEW & ENDORSE the proposed governance arrangements relating to the implementation and management of the proposed commercial property acquisition strategy.

14.0. Implications

Implications	Relevant to proposals	Details and proposed measures to address
Legal / Governance	Y	The full legal aspects and implications of the proposed commercial property acquisition strategy are contained within the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017.
Financial	Y	The full financial implications of the proposed commercial property acquisition strategy are

		contained within the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017.
Risk	Y	The full risk implications of the proposed commercial property acquisition strategy are contained within the "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017.
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

<u>Supporting Information</u>

Appendices:

Appendix 1: SHDC Invest to Earn Working Group – Terms of Reference

Background Papers:

- "Commercial Property Acquisition Strategy" report to Executive, due to be presented on 20th July 2017
- Investment in Commercial Property, presented to Executive, March 9^{th} 2017
- MTFP, presented to Executive July 20^{th} 2017
- Revenue & Capital Budget Proposals Report – 2017/18, presented to Council, February 9^{th} 2017
- Annual treasury strategy in advance of the year (Audit 15/03/16 – AC32)