Report to:	**Council**
Date:	**27th July 2017**
Title:	**Commercial Property Acquisition Strategy**
Portfolio Area:	**Cllr Keith Wingate, 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:	**Immediately following this meeting**
Author:	**Darren Arulvasagam,** **Group Manager, Business Development** **Darren.Arulvasagam@swdevon.gov.uk**

Recommendations:

That Council:

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, the lead Executive Member for Business Development; and the appointed Chair of the 'Invest to Earn' working group**
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%)**

1.0 Executive Summary

1.1 On 20th July, the Executive received a report entitled "Commercial Property Acquisition Strategy" and agreed its recommendation to present the above recommendations for Council approval.

1.2 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.

1.3 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.

1.4 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.

1.5 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.

1.6 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.

1.7 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.

1.8 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.

1.9 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.

1.10 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.

1.11 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.

1.12 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).

1.13 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 Council 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.

1.14 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.

1.15 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 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. 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.

4.6. If approved, a sinking fund will be created, funded by 5% of any rent received. This is shown in the financial considerations, appendix B. This sinking fund will be used to fund any capital required improvements or offset any rental voids.

4.7. The models presented in Appendix B show that the interest repayments are c44% of the rent payments received. The strategy is predicated on a diversified, balanced portfolio. This means acquiring properties across different asset types, geographies, lot sizes and tenants. Because of this approach, it is extremely unlikely that all tenants would default or that all properties will become void at the same time. This mitigates the risk to the Council's finances.

4.8. Commentators and property experts have estimated that in the UK, LA's account for less than 5% of the market. They do not suggest that this is of significant size to alter the market.

4.9. 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)

4.10. 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.

4.11. 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.

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

4.13. 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.

4.14. Appendix B explains the financial model. The headlines are clear – 5.85% portfolio target, 2.37% interest rate. Breakeven has been calculated at 4.46% - covering the annuity method MRP (see appendix C), loan interest, a sinking fund of 5% of rent received and management costs at 3% of rent received. The target yield, less costs (equating to 1.2%), 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.

4.15. 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 is on this agenda for approval to amend the current investment policy approach and borrowing limits.

4.16. The Council will commission property experts to actively manage acquired properties. These experts will ensure that if a 5 year lease is acquired at the outset of the strategy, consideration of letting potential or exit options will be implicit in the acquisition decision. The Council cannot remove all risk from this strategy, but the strategy is built in such a way to mitigate the risk as much as possible.

4.17. The exit strategy will differ for each and every property acquired and will form part of the due diligence process for each acquisition. The 'Invest to Earn' group Members and the delegated authorities will need to satisfy themselves that this strategy is acceptable before acquiring a property.

5.0 Proposed Way Forward

5.1 It is proposed that if Council 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

<u>Supporting Information</u>

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, presented to Audit Committee, July 20th 2017
- ‘Invest to Earn’ group Terms of Reference, July 2017