<u>Property Investment Strategy</u>

1. Introduction

1.1 As local authorities continue to face financial constraints including the phased removal of core central government funding, property has become an important part of many Councils financial strategy to increase income for the Councils revenue budget position. Property also plays an important role in shaping places by providing opportunities for businesses and communities.

1.2 This Property Investment Strategy aims to build on the success of the Council's previous strategy to create a Property Investment Fund and in addition develop a strategy for the ongoing management of all the Council's General Fund property investment assets. This strategy does not apply to the Council's Housing Revenue Account assets or the Council's General Fund operational assets.

1.3 The strategy also seeks to respond to latest Statutory Guidance on Local Government Investments (3rd Edition), which was updated to reflect changes in patterns of local authority behaviour including investing in non-financial asset for profit generation and increasing economic growth/regeneration. The guidance clearly sets out the need for transparent investment strategies.

2.0 The Investment Property Portfolio

2.1 The Council holds 174 commercial interests in its investment portfolio which have a current annual rent roll of circa £8.36M. The majority of the rent is derived from a small number of assets with 55.7% generated from the top 10 assets and 69.6% from the top 20 assets. There are a further 292 minor interests generating an annual rent of circa £152,000. Many of these property interests are associated with owning a large estate, such as leases of gas governor sites, electricity substations, easements and wayleaves. There are also a number of other commercial interests producing nominal income.

2.2 The portfolio is largely retail based with 46.6% of the rent coming from this sector, West Quay Shopping Centre equates to a large proportion of this rent at 37.6% (17.5% of whole portfolio). Much of the other property has been held for many years and in the city centre especially it was acquired after the second world war to promote re-development, with long leases granted to developers who re-built damaged parts of the City.

2.3 The portfolio is split between rack rented leases (these are properties let at market rent to occupational tenants) and ground leases (long term, full repairing and insuring leases at either fixed or geared rents). Excluding the miscellaneous property, 53.3% of rent is derived from ground leases and

46.7% from rack rented leases. Ground leases tend to be less management intensive than rack rented property and having a number of ground leases within the portfolio helps to spread property risk.

3. Property Investment Fund – Performance to Date

3.1 A strategy for a Property Investment Fund (PIF) was approved by Cabinet on 19th April 2016. To date £ 29.7M has been invested in 3 commercial properties. This strategy does not apply to the indirect funds which are managed externally by CCLA and incorporated within the Treasury Management strategy.

3.2 The three properties acquired are detailed below.

ADDRESS	DESCRIPTION
241 & 271 Winchester Road, Southampton SO16 6TP	2 detached retail warehouses: 241 (Halfords) - 11,421 sq ft + 30 car parking spaces 271 (Wickes) - 50,210 sq ft + external garden centre & builder's yard + 140 car parking spaces
3 Ely Road, Milton, Cambridgeshire CB23 6DD	Detached 2 storey modern office building, total 17,243 sq ft (includes 322 sq ft media room let to Virgin Media)+ 85 car parking spaces
Unit 50, Warth Parkway, Warth Park, Raunds, Northamptonshire NN9 6NY	modern 42,569 sq ft "highly specified 'cross-dock' parcel distribution facility" on a 3.75 acre site plus 19,886 sq ft nearby (not adjacent) additional car park site

3.3 During the financial year 2018/19 these investments generated £1.8M (gross) and after the costs of borrowing has been taken into account £0.6M net. The PIF has provided the Council with a valuable additional revenue stream to help fund Council services.

4. Property Investment Fund – 2019/20

4.1 The Property Investment Fund's primary purpose at inception, as set out in the recommendation to Cabinet in April 2016 was to generate income thereby contributing to a financial 'future-proofing' effect, underpinning financial security for the Council by providing further income independent of Government funding or Council Tax revenues to fund activities.

4.2 The strategy continues to support the acquisition of commercial property for income generating purposes when suitable opportunities present, however the PIF can also play an important role in helping to stimulate development and provide wider socio-economic benefits to the City thus contributing to Council objectives. This is a strategy which has been adopted by other local authorities such as Torbay Council.

4.3 Given current uncertainties in the economic climate the Council can be instrumental in supporting the local economy by bringing forward development as seen by Ashford Borough Council.

4.4 In refreshing the Strategy it is proposed that the Council's investment activity in commercial property assets be divided into two groups:

- Investment opportunities whose primary purpose is the delivery of a financial return for the Council.
- Regeneration investment opportunities that support the delivery of significant city/district regeneration.

4.5 By having two clear separate objectives it will ensure that the primary driver of the acquisition is understood by members and the public, which will assist in the transparency of decision making. It is possible that an acquisition can meet both objectives but the overriding purpose will determine which group it sits in.

4.6 It is appropriate that different criteria should be adopted for each group and Appendix 1 shows the proposed criteria. All investment activity will be in accordance with this criteria.

4.7 The Statutory Guidance on Local Government Investments (3rd Edition) requires that where a local authority classifies an investment as contributing to regeneration or local economic benefit, it should be able to demonstrate that the investment forms part of a project in its Local Plan.

4.8 Each property investment will be subject to a detailed business case, supported by internal and/or external professional advice. The business case will set out the benefits and risks associated with the investment, detailing how risks will be mitigated.

5. Financing the Property Investment Fund

5.1 Over recent years there has been significant investment by Councils in commercial property, either directly via the purchase or development of property or indirectly via investment in property funds.

5.2 Government has become increasingly concerned about the scale of commercial property acquisition which has been funded by the Public Works Loan Board (PWLB) borrowing. As an example in 2016 Spelthorne Borough Council took out 50 separate Public Works Loan Board loans to fund the purchase of a £360M business park in Sunbury-on-Thames.

5.3 The Council's borrowing will be in accordance with the limits set with the Treasury Management strategy, approved by full Council in February 2019.

5.7 The approach on the Minimum Revenue Provision for commercial property will be agreed by the Service Director Finance and Commercialisation.

6. Management of the Investment Property Portfolio

6.1 The Council's overall property investment assets (including PIF assets) have a total value as at the end of the 2018/19 financial year of circa £135M.

6.2 Investment property assets are currently categorised into Strategic, Managed and Infrastructure. The last review was carried out in June 2015. A review of the system of categorisation has been undertaken and the following has been developed:

- Group 1 (Strategic) – this is property which is being held for strategic land assembly purposes to support re-development and/regeneration initiatives and which are likely to be included in the Council's Local Plan. Properties in this category will only be disposed of (freehold or long lease) where there is a compelling case and the benefits of disposal outweigh those of retention.
- All those properties which fall within development sites identified within the City Centre Action Plan, adopted version 18th March 2015, are included within this group.
- There are 69 properties in this category with a total asset value of circa £47.43M producing a rental income of circa £2.68M per annum
- Some properties within this group will be sold to facilitate re-development/regeneration and whilst this may generate capital receipts there will be a loss of income. Therefore early consideration should be given to mitigating this loss of income by the acquisition of replacement interests ahead of any disposals.
- Group 2 (Managed) – These are all other properties which are not within Group 1.

- Properties which support the following objectives should be retained unless there are exceptional reasons to dispose.

  - strong income producing
  - minimal management costs
  - contribute to a balanced portfolio
  - security of income

- A review of the portfolio has identified 17 interests recommended for retention. The total asset value of these properties is in the order of £62.24M producing a rental income of circa £3.71M per annum.

- The remaining 88 interests account for a rent of £1.97M per annum and have an asset value of circa £18.67M, thus producing a yield of 10.5%

6.3 Given the Council's need to maximise income, where assets are subject to long leasehold interests, consideration will be given to re-gearing leases (extending the lease term). Re-gearing can have a positive impact on an area by encouraging investment in the asset due to the greater security for the leaseholder enabling finance to be raised. This in turn could increase income to the Council where such investment attracts higher rents which the Council then shares in. There is potential for additional value (marriage value) to be achieved through re-gearing, this is more likely to be realised where leases have less than 80 years unexpired. At present there are 18 such leases within Group 2.

6.4 The impact of the potential loss of income on the Council's finances for any sale if a replacement asset(s) is not readily available must be explained. An option could be to invest the proceeds in a property investment fund until a direct investment can be acquired, although any potential costs will need to be taken into account.

6.5 The sale of freehold property subject to occupational leases may be considered if management costs of the asset are excessive in relation to income generated or the sale will generate a capital receipt that can be re-invested in replacement property investment assets that will improve the yield return or sector allocation balance. Replacement assets will be in accordance with the criteria set for 'Group 1 Acquisitions' in Section 3 above.

6.6 Each asset will be dealt with on a case by case basis and decisions will be approved in accordance with the Council's Constitution.

6.7 An investment property will be considered surplus if it is not income producing (notwithstanding temporary uses) and likely to remain so for the foreseeable future and the asset has no potential for future strategic development purposes. The Council will consider all surplus land and property for affordable housing. The identification of alternative uses and development of an appropriate marketing strategy will help maximise the value of surplus land and property assets. The decision to sell surplus assets will be made in accordance with the Council's Constitution.

6.8 The categorisation of assets will be reviewed annually and ratified by an Asset Management Board. The aim of the review is to check and challenge the categorisation of assets and to identify any additional surplus assets to generate capital receipts.

6.9 It is envisaged that this system of categorisation will assist in the management of the Council's investment portfolio by proactively identifying those assets where improved returns could be achieved either through lease re-gearing or disposal to generate a capital receipt.

7. Governance Matters

7.1 All new investments will be subject to initial evaluation by the Council's property and finance officers. Any investments considered suitable will be considered by the Service Lead, Capital Assets in consultation with the Leader and Service Director, Finance and Commercialisation and Cabinet Member for Resources, who will determine whether an offer should be submitted. Offers will be made subject to contract, all necessary surveys, a formal RICS Red Book valuation, legal and financial due diligence and the requisite Council approvals.

7.2 Day to day management of the Council property investment portfolio is undertaken by the Council's in-house Estates and Valuation team and will report into the Asset Management Board.

8. Risk Management

8.1 There is a risk of investments underperforming and impacting on the Council's income particularly where borrowing has been used, the issues of investment risk at the point of purchase will be mitigated by robust due diligence and any remaining risks will be fully explained to the Asset Management Board.

8.2 There are emerging financial risks for owned property, which include falls in rental and capital values and void periods. This risks will be minimised by factoring in potential costs to the financial appraisal process and undertaking relevant credit checks on potential tenants. These risks will be monitored by regular updates to the Asset Management Board. Any negative significant revenue consequences and detail of the mitigating action which is being taken or proposed will be reported as part of the monthly revenue monitoring process.

8.3 The Council will employ use of external experts where specialist knowledge is required.