Part I
Release to Press

Meeting:	**EXECUTIVE**	**Agenda Item:**	**9**
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DRAFT PROPERTY INVESTMENT STRATEGY

BUDGET AND POLICY FRAMEWORK

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1. PURPOSE

1.1 This report outlines proposals for a draft Property Investment Strategy for 2017/18 – 2019/20 and recommends an initial investment of £15m in Property Investment to be resourced from prudential borrowing.

1.2 This will enable the Council to acquire new commercial property investments with a view to generating long term rental income streams to support the delivery of the Future Town Future Council programme and council services. This initiative supports the 'Financial Security' priority and our ambitions for Stevenage. The first phase will focus on acquisition of commercial investments within the Local Plan boundary.

1.3 As a Budget & Policy Framework item the draft proposals from this Executive meeting will be referred to the Overview & Scrutiny Committee for consideration. That Committee's comments will be reported to the next meeting of the Executive where the recommendations to Council will be finalised.

2. RECOMMENDATIONS

2.1 That the draft Property Investment Strategy 2017/18 – 2019/20, attached at Appendix 1, be approved.

2.2 That the new Assets and Capital Board, as part of their terms of reference recommend/reject the purchase of investments including the sanctioning of formal offers and counter offers be approved (paragraph 4.3.2 refers).

2.3 That delegated authority be given to the Strategic Director (Environment) and the Assistant Director (Finance & Estates), following consultation with the Portfolio Holder for Resources and taking advice from the Borough Solicitor to approve completion of investment purchases.

2.4 That a capital budget of £15,000,000 to support the Investment Property Strategy be approved.

2.5 That the Treasury Management Strategy be amended to include prudential borrowing of £15,000,000 be approved.

2.6 Members note that if additional resources to manage the portfolio are required, then a supplementary bid will be made as part of the quarterly monitoring process.

2.7 That a target of £200,000 income contribution to the General Fund per year is approved in approving the capital budget of £15Million (para 7.3 refers).

2.8 That Financial Regulations are amended to exclude property investment purchases from reporting requirements as set out in section 2 of the regulations, (Budget Setting- Capital) if within the tolerances set out in the Investment Strategy and the sums approved.

2.9 That the income generated above the budgeted annual income amount generated from the Investment Strategy be set aside in an allocated reserve to allowing smoothing of peaks and troughs in income levels (paragraph 7.6 refers) and/or to fund any future property investments.

2.10 That that the proceeds from the sale of “property investment” assets sold within the life of the Strategy, including those within the existing commercial portfolio, be ring-fenced to refund any borrowing taken and/or support new investments.

2.11 That an annual report be presented to the Executive on the progress of the Strategy, and progress against the target reported as part of the quarterly monitoring process (paragraph 4.3.3 refers).

2.12 That the decisions taken by the Executive on the above recommendations be referred to the Overview & Scrutiny Committee for comment as a Budget and Policy Framework item.

3. BACKGROUND

3.1 As part of the Medium Term Financial Strategy (MTFS) presented to the Executive on the 13 September 2016, it was recognised that the Council still needed to make budget reductions firstly as a result of the removal of Revenue Support Grant (RSG) by 2019/20 and to achieve the other main aim of the MTFS an on–going balanced budget by 2021/22. The Financial Security priority as part of the Future Town Future Council is the Council’s approach to deliver this.

3.2 The MTFS had a £2.5Million savings target for the period 2016/17-2019/20 of which £1.1Million is still unidentified for the period 2018/19-2019/20. The Financial Security officer and Member group are exploring options under the ‘targeted commercialisation’ work stream which includes the implementation of a commercial property investment to reduce the net costs of the Council and generate long term rental income streams.

4. REASONS FOR RECOMMENDATIONS

4.1 Property Investment Strategy

4.1.1 The Property Investment Strategy 2017/18 – 2019/20 (Appendix 1) focuses on the acquisition of property as an investment and complements the emerging Asset Management Plan (due for renewal in 2017) and the Capital Strategy. The strategy aims to provide a viable and sustainable framework for the acquisition of property investments.

4.1.2 The Strategy focuses on the acquisition of property investments within the Local Plan boundary as part of the first phase in 2017/18. This boundary includes the "functional economic market areas" which are linked to employment areas within the emerging Local Plan. This is to support the Council's ambition for Stevenage and town centre regeneration by investing in the town to help create a vibrant town centre and by so doing, help create renewed confidence and a positive message to other investors, and also to enable the Council to be more financially resilient by delivering on our Financial Security aims.

4.1.3 The purpose of the strategy is to set out:

- The Council's objectives for acquiring property investments
- The criteria for identifying appropriate investment acquisitions
- The geographical location of the assets
- The risks to the Council of such activity and how they might be managed
- The acquisition process (governance arrangements)

4.1.4 The Council's powers to acquire land are governed by the Local Government Act 1972 (Section 120). Section 120 permits the Council to acquire by agreement any land whether situated inside or outside its area for the purpose of any of their functions under that or any other enactment or for the benefit, improvement or development of their area. To be clear if investments are restricted to a geographical area contained within the local plan there is an indisputable direct relationship to the benefit, improvement and development of Stevenage.

4.1.5 The first phase of investments will only be sought from within the local plan area (this includes employment areas outside of the borough boundary). It is proposed to widen the geographical scope at a later stage (possibly 2018/19) when the business case for setting up a Property Development Company has been fully considered and reviewed.

4.1.6 It is recommended that Members acknowledge and endorse the draft Property Investment Strategy, as set out in Appendix 1 to be used as a guide to investments.

4.1.7 The Strategy sets out in section 6 the ideal property types in order to form a balanced portfolio and will be typically based on an indicative mix of commercial uses including offices, retail, industrial, and leisure (this is purely a guide and will depend upon the opportunities available on and off market within the geographical area. The same applies to consideration of lot sizes). The Assets and Capital Board will be able to vary these apportionments as they see fit based on review of performance within each sector.

4.1.8 The Council will acquire investments on the basis of a minimum initial target rate of return of no less than six per cent (6%). However this initial rate of return may be set lower if rental yields are expected to increase soon after purchase. Each investment will be assessed individually with emphasis on covering the cost of the debt repayment/ Minimum Revenue Provision (MRP), interest costs and generate a surplus each year to the General Fund. Paragraph 7.3 under financial implications refers to the reasons behind this specific target in more detail.

4.1.9 Officers will prepare and present an annual report to Executive on the overall effectiveness of the Property Investment Strategy 2017/18 – 2019/20. In the interim, the intention is to report on-going progress as part of the quarterly monitoring process.

4.2 Property Investment Fund

4.2.1 The Council's Financial Regulations require individual capital purchases in excess of £2Million (and included in the capital programme) to be reported to the Executive for approval. In order to respond to investment opportunities as they arise, it is essential that a reactive governance structure is place (see appendix two).

4.2.2 Part of the proposed process to compete responsively in this market is to have the ability to react promptly to a favourable financial appraisal, and therefore it is recommended that delegated authority be given to a Strategic Director and the Assistant Director (Finance & Estates), in consultation with the Assets and Capital Board to approve investment purchases upon the completion of a robust financial appraisal and in accordance with the Property Investment Strategy.

4.2.3 The Council needs to include a sum within the Capital Programme to enable the purchase of property investments. Commercial property by its nature requires significant investment and the General Fund has already made regeneration led property purchases, (since 2012/13) which total £11.1Million. Whilst it is acknowledged this was to support the Future Town Future Council regeneration objective, it illustrates the amount of potential sums required to have a property portfolio. This is the first Property Investment Strategy and, as such, consideration has been given to the amount of funding that should be allocated based on advice from property specialists on the minimum and maximum level of price for any one investment per sector (section 8 of the Strategy refers).

4.2.4 The Council has competing priorities which require funding and potential borrowing and consideration has to be given to the overall level of financial risk the Council is exposed to. Ideally, therefore based on minimum lot sizes of £2Million (section 8 of the Strategy refers) an initial sum of £15Million is recommended for a Property Investment Fund, allowing for between five and seven acquisitions to be made. This number of acquisitions is indicative, given the restriction to seek investments within the local plan area where the supply is limited and investments may not correspond to this lot size. The recommendation is that the capital sums relating to the Property Investment Fund will be funded from prudential funding and all investments must meet the minimum criteria which includes the cost of borrowing. Subject to the success of the Strategy any future sums will be included in the capital programme as part of the Policy and Budget setting process.

4.3 Governance

4.3.1 Each potential acquisition will require a robust financial appraisal signed off by the Assistant Director (Finance & Estates) and approved by the Assets and Capital Board. The appraisal should meet the criteria contained within the Property Investment Strategy 2017/18 – 2019/20. These should include:

- 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.

- The acquisition meets the minimum/maximum purchase thresholds.

- The acquisition meets the property profile as set out in the Strategy.

4.3.2 In order to respond promptly to any investment decision, the Property Development Manager will convene a meeting of the Assets and Capital Board as and when required. Any such meeting will include as a minimum a Strategic Director and the Assistant Director (Finance & Estates) in order for a decision to be made. The Borough Solicitor, Group Accountant/Finance representative, and Corporate Property Manager will be consulted prior to any decision being taken. Other officers will be invited if the proposals to be considered by the Board require other specific technical advice. (See Appendix 4 for the proposed Governance Structure.)

4.3.3 An annual report is to be presented to the Executive to inform Members of the success of the Strategy and include a list of properties and performance information.

4.4 Capacity to deliver

4.4.1 Once an initial positive decision has been made to carry out further work, and prior to making a final decision on an investment purchase, there is a high degree of due diligence required to ensure that the property meets the requirements of the Strategy and therefore to determine a sound investment. This will include building surveys (Condition survey and, Mechanical and Electrical surveys if there are concerns), measured surveys (not all cases) and valuation reports. Some of this early work will be carried out by existing staff within the Property Investment division, such as carrying out visual building surveys and advising on structural matters. However, beyond a visual check, it is anticipated that in the majority of cases, an external building surveyor and separate valuer will need to be commissioned to advise on each investment. All due diligence costs will be included within the cost of the acquisition, and are included in the £15m pot.

4.4.2 In addition to the in-house services mentioned under 4.4.1, there will be a requirement for legal and financial support services to provide legal and financial advice.

4.4.3 If the cost of managing multi-tenants will require additional management costs, these will be factored into the rate of return/financial appraisal.

4.4.4 Under Phase 1 (within the Local Plan boundary) there is no requirement for additional resources to administer the new assets on a day to day basis and it is envisaged that six or seven investments can be managed by existing resources (Estates).

4.4.5 An ambition of the Strategy is to introduce performance measurement of the existing commercial portfolio and this is currently underway within the Finance & Estates section. However within any future phase, it should be recognised that there may be a requirement to employ new staff to help support the delivery of the full strategy going forward due to possible internal capacity issues. Additional costs may need to be built into any future business case for future phases of the Strategy.

4.4.6 A budget of £20,000 per year will be required, of which £15,000 is estimated to cover costs incurred on investment appraisals that do not give rise to a purchase (abortive costs) and a further £5,000 towards the bad debt provision. As time passes, and more investments are held, there may be a shift in this budget between the apportionment for abortive work and holding costs. This has been included in the financial implications. These costs do not include purchaser's costs (approximately 5.8%) which will need to be funded from within the £15m investment fund. These latter costs will be factored into the financial modelling appraisals.

4.4.7 Key performance indicators will be set to help monitor the performance of the strategy. An example set can be found in Appendix 2.

5. Equality impact assessment (EIA)

5.1 This report is of a technical nature reflecting the projected methodology for implementing a Property Investment Strategy. It is not expected that this will impact on any groups covered by statutory equalities duties.

6. Legal implications

6.1 The Council is empowered to buy and sell land 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. This is also covered in 4.1.4 above.

6.2 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.

6.3 Certain acquisitions may require the Council to set up a company. This option is currently being considered by the Legal and Housing Development Teams and will be the subject of a future report. Therefore the implications of this are not discussed here.

7. Financial Implications

7.1 The Council's existing commercial asset portfolio which contains a variety of property types (Offices/Industrial/Retail and land) and tenures (rack rented property and ground rents), currently returns a gross annual revenue income stream of approximately £2.3 million per annum. This portfolio provides a steady year on year rental income, although not all of these assets are held primarily to generate income.

7.2 This report seeks to set an ongoing Property Investment Strategy which allows the Council to adopt a much more proactive and commercial approach to managing its investment property portfolio.

7.3 The rate of return included in the Strategy has been set at a target of six per cent (6%) because of the cost of debt repayment/ MRP and the interest cost on £15Million. A target of £200,000 has been recommended as a contribution to the General Fund Financial Security target. However, while the investment portfolio is being established a £100K target has been set for 2017/18.

7.4 The table below shows the level of returns needed to achieve the £200k annual contribution to the General Fund. Using the straight line method of calculating the annual MRP an initial yield on investment of between 6.19% and 7.04% would be required. In using this method the annual MRP remains constant over the life of the asset.

Gross Yield Required to Achieve £200k annual surplus			
Method of Minimum Revenue Provision (MRP) Used	Optimistic Scenario	Central Scenario	Pessimistic Scenario
Straight Line Method	**6.19%**	**6.62%**	**7.04%**
Annuity Method:			
Years 1-5	**5.33%**	**5.76%**	**6.16%**
Years 6-10	**5.52%**	**5.95%**	**6.35%**
Years 11-20	**5.86%**	**6.29%**	**6.69%**
Years 21-30	**6.40%**	**6.83%**	**7.23%**
Years 31-40	**7.07%**	**7.50%**	**7.90%**

7.5 Alternatively the Strategy allows an annuity method for calculation of the Minimum Revenue Provision (MRP). This means that the annual MRP charge grows as rental income streams increase following rent reviews. Using this method an initial yield on investment of between 5.33% and 6.16% would be required. The most appropriate MRP calculation will be applied based on future rental projection and lease renewals. (See comparison of the two methods at Appendix 3). Current interest rates (at 6 February), are shown in the table below.

`	£15,000,000							
	Equal Instalment of Principal (EIP)				Annuity*1		Maturity *2	
Loan Period (Years)	Interest Rate	Annual Interest	Annual Principal	Total Annual Payment	Interest Rate	Total Annual Payment	Interest Rate	Annual Interest
5	1.05%	£157,500	£3,000,000	£3,157,500	1.05%	£3,095,158	1.43%	£214,500
10	1.47%	£220,500	£1,500,000	£1,720,500	1.48%	£1,624,790	2.18%	£327,000
15	1.88%	£282,000	£1,000,000	£1,282,000	1.91%	£1,159,536	2.60%	£390,000
20	2.21%	£331,500	£750,000	£1,081,500	2.26%	£940,528	2.79%	£418,500
25	2.45%	£367,500	£600,000	£967,500	2.52%	£816,002	2.84%	£426,000
30	2.62%	£393,000	£500,000	£893,000	2.69%	£734,943	2.80%	£420,000

**1 Annuity loans have the same annual payment but the principal element increases as the interest element reduces*
**2 Maturity loans the principal is paid at end of the loan period*

7.6 To ensure that the Property Investment Strategy meets the £200,000 General Fund target, it is recommended that an equalisation reserve is set up whereby net income in excess of the £200,000 target is transferred to allow for years when the target is not reached as a result of unforeseen circumstances.

7.7 If the Council was to make a £15Million investment as part of the Council's Treasury Management Strategy it would currently achieve a return of £180,000 per year based on an investment rate of 1.20% over a five year period. A comparable treasury management investment with a bank, say Close Brothers, would yield a return of £240,000 over the same period. In comparison to direct purchases, historically property funds if held for 5+ years have generated a gross yield of 4.4%, which would be before any costs of borrowing were deducted.

7.7 The yield on property investment would be significantly higher if the Council could use internal borrowing to fund the purchases. External borrowing cost of £337,500 per year based on a 2.25% less loss of interest earnt £87,000 (based on 18/17 forecast investment rates) would increase the yield to £250,500. Property holdings are a long term investment and while internal balances may be available in the short term this may not be true in the medium term and therefore the cost of borrowing needs to be considered in the investment appraisal.

7.9 Investments with a rate of return of 7% to 8% are more financially attractive than 6%, in the market place these rates would be more applicable to investments with a higher risk of bad debt and voids (tenant covenants not so good, and chance of empty units), and this would need reflecting in the costs of ownership, lowering the net yield to the Council.

7.10 It is proposed that if assets are sold within the life of the Strategy including those within the existing commercial portfolio that the proceeds from these sales are ring-fenced to refund any borrowing taken and/or support new investments.

8. Risk Implications

See following tables

Risks	**Initial Likelihood/ Impact**		**Mitigating Actions**	**Residual Likelihood/ Impact**	
Market Forces Fluctuations in demand and supply of individual markets and the wider economy will see the value of the investment and the income rise and fall, the Council risk not recouping the original amount invested.	Medium	High	The Strategy recommends a balanced spread and mix of assets across retail, industrial and offices in order to spread risk. By seeking to acquire property in good condition with a good covenant tenant, the Council is trying to mitigate the risk from the outset. However market forces are unpredictable with difficulties in forecasting ahead.	Low	Medium

Risks	Initial Likelihood/ Impact		Mitigating Actions	Residual Likelihood/ Impact	
Liquidity The process of buying and selling commercial 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 costs and in-ability to realise "sale" capital quickly.	Low	High	By holding property investments, there will always be a physical asset to manage or sell and the Valuer may need to predict the best time to bring that asset to market in order to try and recoup the purchase price/investment. Abortive costs of £15k in buying assets (due to competition from others) have also been included within the budget costings (Sections 4.4.7 & 7.3). The Valuer will try and negotiate purchase terms, subject to due diligence and exclusivity periods to avoid unnecessary abortive costs. In some cases, such as property sold by auction this may not be possible.	Low	Medium

Risks	Initial Likelihood/ Impact		Mitigating Actions	Residual Likelihood/ Impact	
Opportunity The availability of stock is generally limited (this is more so with restricting the geographical area). 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. It is therefore a possibility that a proportion of the fund remains un-invested during these periods.	High	High	Maintaining good working relationships with local and national agents who sell property investments across the retail, industrial and office markets to ensure that the Council is aware of opportunities off market. Restricting the search area to within the borough boundary has increased the risk of not investing the entire funds due to limited investment stock which fulfils the strategy criteria. Evidence of the Council's purchasing power previously will help with providing confidence to agents of the Council's intentions.	Medium	High
Target return With a required target return of 6%, this may preclude the Council from purchasing better stock with a lower gross yield. This may also limit the number of investments available to acquire within the set geographical area	Low	High	Use a wide source of property agents (national and regional).	Low	Medium

Risks	Initial Likelihood/ Impact		Mitigating Actions	Residual Likelihood/ Impact	
Management The portfolio will have the risk of void periods in occupation or tenants may default on payment of rent. The loss of income is a direct result. However voids create further holding (and re-letting) costs which if vacant for a pro-longed period of time can be substantial.	Medium	High	The Strategy seeks to find good covenant single tenant (preferably) and multi-tenant investments with minimal tenant breaks and lease expiries within 5 years. Financial checks will be undertaken of tenants to mitigate future issues. Experience within the Estates Team in managing commercial properties is also a key mitigation tool. However bad debt and other costs (including insurance if not recoverable) have been built into the financial model as a pre-caution (see table within section 7.3 of this report). If the costs exceed the budget it is proposed to use ring fencing income in excess of £200k to meet any of these costs.	Medium	Medium

Risks	**Initial Likelihood/ Impact**		**Mitigating Actions**	**Residual Likelihood/ Impact**	
Contribution to the General Fund There is a risk that the contribution to the General Fund will be marginal and any detrimental change in interest rates may result in a deficit outcome.	Low	High	Each investment will be carefully scored against the criteria set down in the Property Investment Strategy at the outset and the Assets and Capital Board will be able to recommend and reject the purchase of investments. Use of ring fencing income in excess of £200k to meet any of these costs.	Low	High

Background Papers

BD1 - Medium Term Financial Strategy (Executive 13th September 2016)
http://www.stevenage.gov.uk/content/committees/160923/160931/160995/167541

Appendices:

1. Investment Property Strategy 2017/18 – 2019/20
2. Key Performance Indicators
3. Comparison of Annuity and Straight line MRP methods
4. Governance Flowchart