APPENDIX 1

Investment Property Strategy

2017/18 – 2019/20

1. Background

The Council has a commercial non-operational tenanted portfolio comprising of 390 assets generating a rent roll of £2.3m and valued at c £20m. This excludes assets held for redevelopment purposes and assets held for economic regeneration. This stock base is historic and the majority comprise neighbourhood centre shops and workshops within the Borough, with some ground leases in respect of surgeries and pubs. These were originally transferred from the Stevenage Development Corporation. All these properties are fairly small in lot size but collectively provide significant rental income and also as a secondary consideration, held because of latent development opportunities. Whilst the portfolio is managed in an efficient manner, it has not been constructed primarily with the aim of generating property investment income (nor capital appreciation), as social value is also a factor (i.e. community service uses).

The Council has more recently acquired properties in strategic locations within the town centre, in order to help promote and enable regeneration. These comprise two key portfolios within Town Square and The Plaza which also provide an investment stream to the Council currently, although they are held and were purchased primarily for regeneration purposes. These acquisitions amount to £11.1m.

2. Objectives

There are two main objectives of this Strategy, as follows:-

1) Investments within Stevenage

The first phase will focus on the acquisition of property investments within the Local plan area/Borough boundary. 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. This complements our Town Regeneration aims.

2) **Financial Security**

This strategy seeks to increase the proportion of the total income from new good quality commercial assets as a way of generating new revenue streams to the Council. These assets will be held primarily for investment value, and as a secondary measure, capital appreciation.

The main consideration for doing this is to enable the Council to be more financially resilient by delivering on our Financial security aims through generation of additional net surpluses which will support services and contribute to the General Fund.

This can be delivered by specifically targeting investment in purchasing good commercial properties which provide sustainable rental income, through a balanced strategy of acquisition, retention and management of good quality property investments, and also to benefit from long term growth in capital values.

3) **Performance Measurement**

It is proposed to introduce a suite of key performance management measures across the whole of the portfolio, including the existing historic stock so that we can understand the existing performance and return.

3. Scope

Investment Value

Initially £15m has been identified as available for investment. Any expansion of the investment will be assessed following the conclusion of the current programme of investment.

Geographical location

The first phase of the Strategy will be delivered by acquisition of commercial investments within the Local Plan area (including the Functional Economic Market area which includes parts of Baldock and Central Bedfordshire).

4. Strategy for existing commercial portfolio

Whilst the main objective of the Strategy is focussed towards acquiring new commercial income producing properties, it is recognised that the historic commercial property portfolio also needs some restructuring and rebalancing to achieve a satisfactory spread of properties across a mix of retail (predominantly), offices, industrial/warehouse uses providing a reasonable return to the

Council. There has been no consistent formal measurement of the return historically, as this has provided a steady year on year rental income without too much risk.

Although the risk within the portfolio is spread, the portfolio lacks good quality tenant covenants and the lot sizes are quite small. The strategy would involve enhancing the current portfolio income levels by disposing of lower yielding assets (unless there were other benefits from retention i.e. future redevelopment opportunities) and reinvesting in assets which would generate a higher return.

It is proposed that as a precursor to this step, and on-going, the Council should undertake more formal but simple performance monitoring measures of the current stock and income levels, to understand the existing performance and return. This would place a greater emphasis on the justification for holding these assets and give the Council an ability to measure their outputs. This may lead to a policy of being able to dispose of poor performing assets. It is proposed that capital receipts from any sale within the existing portfolio should ideally be ring-fenced to support the Property Investment Strategy on-going so there are funds to replace assets.

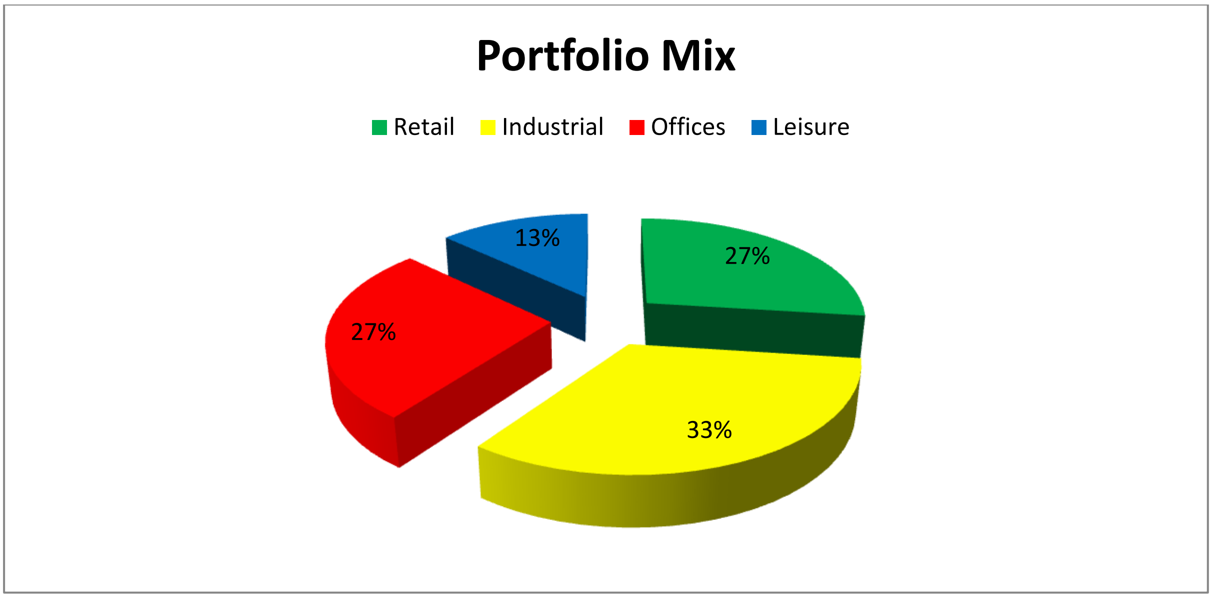
5. <u>New Portfolio Structure</u>

In terms of the new commercial income producing assets, it is important to achieve a spread of risk by acquiring properties across a range of different property asset classes, namely retail, industrial, office and leisure and this is a fundamental objective of this new strategy.

6. <u>Portfolio Mix</u>

It is proposed to try and obtain diversification and balance on investments by sector, so that there is no reliance on only one sector or type of tenant to minimise risk. Market sectors and locations with rental growth and good letting prospects will be targeted. In order to ensure a balanced portfolio, indicative percentages have been given below per sector as a guide. The strategy needs to build in flexibility in the mix to reflect the opportunities available and being able to move sectors if this is considered prudent. *(The impact of Brexit on assets is still uncertain and unquantifiable).*

The pie chart below shows an indicative apportionment of the investment fund: This will obviously depend upon the investment opportunities available.



Retail – 27% (£4m)

This is a lower percentage than Industrial and Offices given that we have a high percentage of retail within the existing commercial portfolio, and within investments within the Town Centre.

Industrial – 33% (£5m)

This is the highest percentage given that there are only a small number of industrial units within the existing portfolio, and currently this sector is producing one of the highest returns for any investor, with income yield ranges from around 6-7%.

Offices – 27% (£4m)

This is the second highest percentage sector. The types of offices are modern offices (built no earlier than the 1990s) in good locations in cities/towns with a strong economy, or in good out of town business parks.

Leisure – 13% (£2m)

This is the lowest percentage as the opportunities may be fewer with a great risk of tenant default and potential voids.

This balance would provide a good balanced portfolio. However, there needs to be some flexibility in the percentages based on opportunities available on the market.

7. Single use/Multi let investments

Ideally the Council will be looking for a single use tenant per investment to reduce management resource.

However, mixed use investments would also be potentially suitable additions to the portfolio, and in these cases the Council will be seeking a higher yield as compensation for additional management resource. The Council will need to consider the management arrangement and cost. These may include a mix of commercial uses and residential, or a mixture of retail and office use. In terms of residential accommodation this is likely to be more management intensive than other types of commercial property investment and requires specialist residential management expertise, so it is proposed that residential acquisitions will only be part of this strategy if they are part of a mixed use investment, where the residential element is quite small. Residential investment per se is excluded from this strategy.

8. Lot Sizes

In order to ensure a balanced portfolio, the lot sizes will be governed to a certain extent by the apportionment across the four sectors stated within the pie chart above. A National Commercial agent has advised that lot sizes should ideally be no smaller than £2m for one individual property, and no greater than £5m per investment in order to secure good investments. However a Regional Agent has advised that lot sizes within the local area (within the Borough boundary as part of Phase 1) may be a lot smaller. Flexibility is required in case the right deal comes along in one particular sector which may suit the Council's requirements. The principle of not having all your eggs in one basket to mitigate risk still applies. This may change as we expand the current programme.

Referring to section 5 above, assuming a lot size of £2m, this may indicate a possibility of seven investments purchased for the £15m fund. Possibly maximum of two within the retail sector, two within the office sector, two/three within the Industrial sector and one within the leisure sector. Alternatively there may be larger opportunities within each sector where one investment requires the whole fund per sector (no greater than £5m per lot).

9. Locations

Phase 1

As part of the first phase of this Strategy, the Council intend to purchase property investments within the Local Plan area/Borough boundary. The objectives of this strategy are clearly identified under section 2 above. The Borough extends approximately to a 10 mile radius from Stevenage Town Centre, and offers opportunities across all the sectors (retail/industrial and offices, although leisure opportunities may be limited). Given the size of the borough, and the limited number of local transactions, there is a risk that not all the funds will be utilised under the first phase.

Later Phases

The Council's current strategic land ownership with the town centre is a high proportion of the available secondary stock. In addition the Council holds 390 assets across the Borough in mostly tertiary locations. Property Investment Funds usually spread their risk with investments in diverse locations. Therefore, it is proposed that a wider area should be considered for new investments nationally. In view of due diligence requirements and management responsibilities, it is proposed that the investment be no more than a single day's travel from Stevenage in the United Kingdom.

10. Investment property criteria

(i) Type of investment

Investments will include freehold and long leasehold interest acquisitions of properties, subject to a lease.

(ii) Yield

The target net annual yield range is anticipated between 6-10% (generally other Councils have applied 8% internal rate of return). Investments will be required to provide income equal to at least two percent above the Council's required rate of return, defined by the cost of borrowing (as at the 20th September, Public Works Loan Board rate is 2.42% over 25 years), 4.42%. 6% will provide a margin above this level.

The yield will also reflect the risk on the investment. At the lower level, 6%, the investment is likely to be a reasonably safe with a single use tenant occupying under a secure tenancy, and at the higher yield, 10%, there is likely to be a greater number of tenants with more risk of tenant/s default, and greater risk of void periods.

(iii) Location

Good prime locations will be sought. Consideration will be given to whether a tenant could be found in the event of default. This will be dictated by opportunity to acquire investments. Proximity to Stevenage will be considered in terms of logistics as discussed above.

(iv) Building Specification quality

Only investments with full repairing and insuring (FRI) terms or FRI by way of service charge will be considered. This is ensuring that all costs relating to occupation and repairs are borne by the occupier/s during the lease term. The property itself is to be in good repair and condition.

(v) Length of lease unexpired

Only leases with a minimum unexpired term of five years will be considered. Our preference is for leases closer to ten years, but we have lowered the expectation here to widen the market for investment opportunities given the target yield (6%).

(vi) Financial strength of tenants

The covenant strength of the tenant should be as a minimum good. This will be determined through financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring. This should be provided on the initial check.

(vii) Rental levels

The current market rent shall be equal to or above the passing rent. The income should be secure (including whether the tenant can pay the rent) and ongoing.

(viii) Management Issues

Management issues in relation to the investment should be minimal.

(ix) Use – Existing and Alternative

Properties tenanted by companies which provided services or products which may not be acceptable to the Council will be excluded. This may include gambling institutions and other non-ethical uses.

Consideration will also be given in each case to the alternative use for the property, i.e. development potential and its exit value. This will be considered as a bonus if residential development is an alternative possibility. However this will not be a primary factor in the decision.

11. Financial Appraisal

A financial appraisal will be prepared for each investment showing a positive return within the first ten years.

The target Internal Rate of Return will be 8% and net initial yield 6%. This is a common percentage for the IRR among Local Authorities as confirmed in an article published by Nottingham Trent University (source: ACES The Terrier Summer 2016).

12. Exclusions from this Strategy

In the first phase, vacant property will not form part of this Strategy because of the risk of long void periods and no new income. Vacant land will also not be considered under this Strategy. Development of land of this nature will need to be considered under other forms of ownership and management.

The purchase of residential properties will not be part of this Strategy (save where these are part of a mixed use investment which meets all the other criteria above).

13. Due diligence checks

As part of the physical appraisal, due diligence checks will be undertaken prior to purchase to include financial checks, and physical condition checks including building surveys and measured survey (if necessary). There will be no requirement for full structural mechanical and electrical surveys (unless there is cause for concern as to the condition. In which case further more detailed surveys will be undertaken to inform the purchase), but the property will be assessed in terms of the condition visually, by using internal Council Building Surveyors. A Building Condition survey will be undertaken. Legal title checks will be undertaken prior to purchase, and good clean title will be sought.

14. Continual appraisal

The portfolio will be open to continual appraisal (including consideration of the tenant status and management issues), and on-going financial performance measurement. This will help in future decision making in terms of whether to sell or hold the investment in order to minimise risk.

15. Holding Period

It is usual for an investment "holding period" to be defined at the point of purchase. This is the period the Council will hold the asset before sale. This is to counter any significant depreciation eroding value or before the need for re-development arises. The holding period will be determined or each individual property at the appraisal stage.

16. Management of new assets

Phase One

The Council already has in place an Estates team which manages the current non-operational property portfolio and would, unless geographical location would limit is ability, be able to manage a larger property portfolio to include the investment portfolio. This is true for single use tenants, and in this strategy possible 6 or 7 new assets.

In the first phase, it is proposed that the Property Development Manager undertakes the task of acquisition supported by the Estates and Regeneration teams, external agents and consultants, and the Group Accountant in respect of performance monitoring. The capacity and success of this approach will be carefully monitored.

In the case of mixed commercial and residential investments where a service charge is payable, this is likely to require the services of a management company and this will be considered as part of the business case for acquiring the asset, and considered by the Assets and Capital Board.

Later Phases

Subject to the success of Phase One, and investment opportunities available in a wider geographical area, it may be necessary to review the staff resources to support the Strategy.