Gloucester City Council

Meeting:	**Cabinet**	**Date:**	**21 June 2017**
Subject:	**Property Investment Strategy**		
Report Of:	**Cabinet Member for Regeneration and Economy and Cabinet Member for Performance and Resources.**		
Wards Affected:	**All**		
Key Decision:	**No**	**Budget/Policy Framework:**	**Yes**
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Appendices:	**A. Property Investment Strategy & Business Plan**		
	B. Property Investment Board Terms of Reference		

FOR GENERAL RELEASE

1.0 Purpose of Report

1.1 The Council's latest Medium Term Financial Strategy shows that for the financial years between 2017 and 2022 the Council is facing a deficit of £2.6m.

1.2 This report outlines a strategy to help address the shortfall in funding, with the implementation of a strategy to enable further investment in property assets.

1.3 **Recommendations**

2.1 Cabinet is asked to **RESOLVE** that:

(1) The Property Investment Strategy, as set out in this report, be approved.

(2) The setting up of a Property Investment Board in line with the Terms of Reference as set out in Appendix B be approved.

(3) Authority be delegated to the Council Solicitor to negotiate and conclude such documents deemed necessary or desirable to reflect the heads of terms negotiated by the S151 Officer and Head of Place to enable the completion of each acquisition.

2.2 Cabinet is asked to **RECOMMEND TO COUNCIL** that**:**

(1) Authority be delegated to the S151 Officer in consultation with the Cabinet Member for Performance and Resources to:

a) amend the capital programme to create a Property Investment fund of £80m in order to acquire new investment property;

b) borrow as required to fund investment property purchases; and

c) Amend the Treasury Management Strategy and Prudential Indicators as necessary to reflect the Council's borrowing requirement.

(2) Subject to the approval of recommendation 1, the following delegations be approved to proceed with the acquisition of assets, subject to the acquisitions meeting the parameters of the Property Investment Strategy:

a) Asset purchases of up to £15m to be approved by the S151 Officer in consultation with the Property Investment Board.

b) Asset purchases in excess of £15m be referred to the Cabinet.

3.0 Background and Key Issues

Why should we do this?

3.1 Like all local authorities, the council is facing further cuts to the money it gets from the government. The council has to make £1.65m of savings in the current financial year and in the next four financial years we need to save £2.6m from around £14.2m of net controllable spend - this is in addition to savings in excess of £10m already made in the last six years.

3.2 The Council's Money Plan has highlighted the need to deliver these savings as levels of expected funding from Central Government continue to reduce. The Council has delivered savings and efficiencies to meet the challenges to date. The Council is currently undergoing a major transformation programme to meet the savings targets in 2017-18, however this cannot be repeated in the medium term to meet the savings requirements whilst still delivering the Council's business priorities. The Council's adopted Money Plan is based on a financial forecast over a rolling five year timeframe to 2021/22 which helps ensure that resources are aligned to the outcomes in our Council Plan.

3.3 The draft Council Plan 2017-2020 has four key priorities, of which one is "Working to provide great services that offer value for money". As stated above the Council will not be able to deliver the required savings through efficiencies and transformation alone, nor is continuous service reduction a realistic option, therefore we need to look at methods of income generation as an alternative strategy. This Property Investment Strategy identifies an alternative key source of income that will potentially deliver a major element of the required savings. The strategy is being put in place as a key deliverer of income: therefore it must be understood that its principal purpose is not to drive regeneration in Gloucester, 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). It must be noted that alternative efficiencies and sources of income will still need to be identified as part of the Money Plan.

3.4 There are a number of risks and opportunities with a property investment as a Council strategy, namely:

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;

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 likely need to partner with external experts to manage a portfolio, as in-house skills are limited and constrained.

Opportunity - The availability of 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 agents can be employed to seek out as many appropriate opportunities as possible, build relationships and communicate to the market the council's requirement and ability to perform.
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3.5 A variety of investment instruments are available to the Local Authority market. In addition to the notice accounts and fixed term deposits available from UK and overseas banks, it is possible for the Council to invest in UK Government Gilts, bonds, property funds, or commercial and residential property.

3.6. These instruments require the Council to tie up its funds for a significantly longer period than currently determined by the adopted Treasury Management Strategy (reducing liquidity), or would carry a risk of capital loss if markets were to go down. Therefore, our policy to date has been not to invest in these more risky and less liquid forms of investment. However, a variety of factors suggest that now may be an appropriate time to reconsider that approach, including:

a) The perception of increased risk in bank deposits as a result of a reduction in confidence that the Government would again bail out a failing bank

(b) The outlook for short term bank deposit yields being below inflation

(c) A growing UK economy that could support other forms of investment

(d) A challenging budget that would benefit from additional investment income

3.7 Officers have therefore considered a variety of different forms of investment. UK Gilts and corporate bond funds could still face a challenging growth environment, whereas the commercial property market returns in particular stands to benefit from forecast growth in excess of 2% per annum over the next few years

4.0 <u>Property Market Outlook</u>

4.1 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.

4.2 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)

4.3 Over the long term, the property market is expected to offer good capital growth in addition to yields in excess of other investment opportunities.

4.4 Where opportunities arise to invest in non-commercial properties these will also be explored. As with other properties the decision to invest in residential property will be based upon the expected yield exceeding investment criteria. The purpose of the investment would be income generation.

4.5 The use of property to provide an income stream is becoming more popular with an increasing number of Councils purchasing pure investment assets. Locally, a number of Councils have been actively increasing the size of their investment property portfolio, which makes a substantial contribution to their annual budget. A desk-top review of their activity has provided a helpful steer in considering investment property acquisitions.

4.6 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.

4.7 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.

4.8 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.

4.9 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.

How should we do this?

5.0 PROPERTY INVESTMENT STRATEGY

5.1 The overall investment quantum and strategy is designed to provide sufficient income to cover a meaningful proportion of the entire predicted budget gap. That is, an investment fund of some £80m should provide an expected return in excess of £500k per annum. This approach will be assessed as part of the treasury management advice procured e.g. affordability requirements. If the total investment amount is reduced, the income generated would not be sufficient to create financial sustainability or a meaningful contribution to tackling the savings requirement in the money plan. If Members chose to vary the portfolio investment yield target, overall budget, or funding source, these would result in different financial outcomes.

5.2 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.

5.3 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.

5.4 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 loss capital value.

5.5. 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.

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

6.0 <u>Professional Support</u>

6.1 In order to source appropriate investment assets, conduct due diligence and successfully negotiate the acquisition of property, it will be necessary to contract buying agents to act on behalf of the Council. An agent's knowledge of the market and properties that are about to come to market is invaluable in sourcing the best investment options. Properties that end up in the wider public domain are usually those that don't represent the best investment 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.

6.2 Having brought a potential investment to the attention of the Council, the agent will be in a position to conduct the necessary due diligence including a full market appraisal within the timescales required. 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 entered and at a level that is matching or slightly better than competitors. The use of an agent also lends substance to the Council's bid and can help to form a well-rounded bid.

6.3 Given these benefits, it is suggested that the council tender for buying agents services at the earliest opportunity. It is estimated that the costs of contracting an agent will be between 0.5% and 0.8% of the properties' purchase price.

7.0 Criteria for Selecting Investment Assets

7.1 Investment property acquisitions need to be subject to the agreed parameters of our investment strategy. Officers recommend that the Council's initial selection of an asset be assessed on two main criteria on a pass or fail basis.

a) Due to the Council's requirement to generate income through a satisfactory level of return, the net initial yield (NIY) range that we could expect to achieve on the investment is likely to be between 5.0% and 9.0%. In order to achieve the requirement, the net initial yield, which allows for the cost of purchase such as agents fees, surveys and stamp duty, should exceed a minimum level of 5.0%.

b) All investments considered must initially provide income (yield) equal to or above the Councils required rate of return (RRR) defined by the cost of capital borrowing for purchase.

7.2 Any asset meeting these criteria will pass to the next stage for consideration. We will not consider any properties that do not meet the two main criteria.

7.3 For assets that pass the first two criteria, officers recommend evaluating any prospective property against a comprehensive set of defined property specific criteria. . These criteria are referenced in appendix A and based on issues such as: tenancy strength and tenure mix; lease length and length of unexpired tenure; sector mix; location mix; investment yield; repairing terms; and investment lot size. The way in which these criteria will be applied will be finalised following consultation and advice from the appointed professional advisors.

7.4 Terms of Purchase

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)

7.5 **Purchaser's Costs**

Any direct property acquisition would be subject to purchasers cost, typically these would include the following:

1) Stamp Duty and Land Tax (SDLT) – no SDLT is paid against the first £150,000 of the transaction and only 2% paid on the next £100,000. After that SDLT is paid at a rate of 5%

2) Agent's fee – as previously highlighted this fee could be around 0.8% of purchase price

3) Surveys and searches – to complete the necessary building surveys and property and environmental searches it is estimated that around £10,000 per transaction would be needed

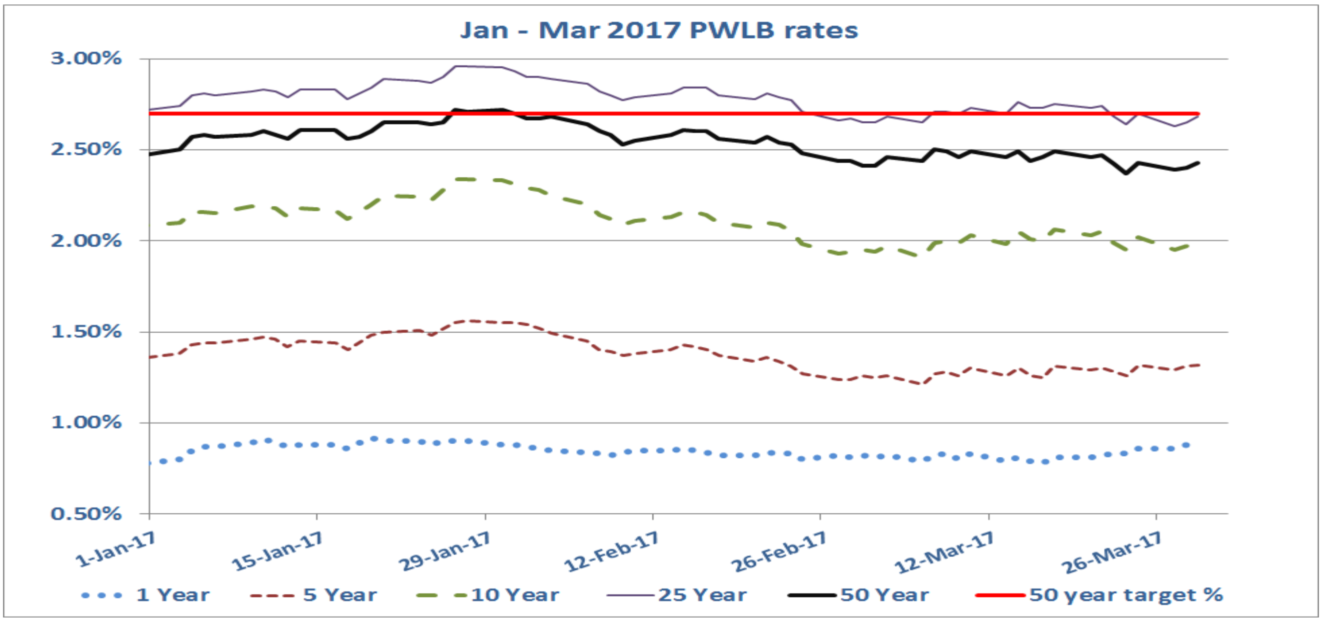
4) Legal fees – to complete the purchase in a timely fashion, legal fees estimated to be around £15,000 would be required per transaction although the council would look to minimise this through its own in-house service

7.6 For each option an assumed level of the acquisition fees highlighted above of 7% has been made.

Financing Costs

7.7 Whilst the council will use, where possible, any capital receipts it may generate from land sales to help finance acquisition costs, 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. 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%.

7.8 The table below illustrates the cost of borrowing.



7.9 Whilst the decisions on who to borrow from and for what period are subject to the Treasury Management Strategy, it is worth highlighting within this report the potential added benefit that can be accrued by borrowing for short periods of time in the current market. If the borrowing was kept short term e.g. between 3 and 6 months, rates of between 0.3% and 0.8% can be obtained in the current market with forecasts expecting this to continue for at least the next two years. Should forecasts of market movement start to show an upward curve of borrowing costs the Council would lock in longer term borrowing at the current rate for loans of between 20 and 40 years.

7.10 In addition to the interest cost, the Council will need to make a Minimum Revenue Provision (MRP) in order to repay the borrowing requirement. The Council's current strategy for MRP, which is approved annually as part of the budget process, allows for charging the borrowing principal over the expected useful life of the relevant assets in equal instalments or as the principal repayment on an annuity with an annual interest rate, starting in the year after the asset becomes operational. So for example, if an asset was anticipated to have a remaining useful life of 50 years the Council could decide to charge MRP at 2% per annum.

8.0 Governance

8.1 To oversee the investment of the £80m fund suggested, it is recommended to establish a Property Investment Board. It is suggested that this Board meet during the acquisition phase to oversee and recommend the purchase of appropriate investment properties. Consideration was given to using Cabinet for decision making but with only eight meetings planned in the cycle and the fixed nature of these meetings this may not be flexible enough to meet the demands of asset investment. Similarly calling full Council for ad hoc investment decisions was not considered to be an efficient process.

8.2 The suggested Terms of Reference for the Board are attached at Appendix B. It is further suggested that delegation is given to the S151 Officer (Head of Finance) and Head of Regeneration & Economic Development) to approve investments of up to £15m in any one lot following consultation with the Board and any potential investment over £15m is referred to Cabinet for final decision.

8.3 It is important to note that the Board and S151 Officer will be bound by the overall parameters of the Property Investment Strategy when making investment decisions. This will 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.

8.4 The Board will be time limited for the investment of the £75m as recommended within the strategy. Once investment has been completed up to this level, the ongoing management and monitoring of the portfolio will fall under normal arrangements. The Board will be disbanded unless the Council agrees to increase the investment sum available to the Board.

9.0 OTHER OPTIONS CONSIDERED

9.1 The Council will also consider the opportunity of non-direct property investment through managed funds such as CCLA. These funds aim to provide investors with a high level of income and long-term capital appreciation. They are not however classed as capital expenditure and therefore cannot be financed from external borrowing.

9.2 The Council could decide against further property investment and rely on other sources of income and savings to meet the budget deficit of the Council. It is not clear whether such a plan will be sufficient to meet the financial requirements of the council.

10.0 Reasons for Recommendations

10.1 A Property Investment Strategy is recommended to give a framework in which investment decisions can be made. The approval of this strategy will allow the Council to benefit from historically low borrowing rates in order to provide a net return on each investment the Council decides to make. This income will help to deliver a range of priorities and objectives set out in the adopted Council Plan.

11.0 ABCD Implications

11.1 There are no ABCD implications as a result of this report.

12.0 Financial Implications

12.1 Selecting appropriate property investment opportunities offers the Council the potential to make significant revenue income contributions towards the projected £2.6m deficit the Council faces over the next five years.

12.2 Appendix A details a range of scenarios and returns from any potential investments.

13.0 Legal Implications

13.1 The following legislation currently enables a local authority to buy property and borrow to finance that activity:

- Localism Act 2011 Section 1.
- Local Government Act, 1972, Section 101, 111, 120.
- Local Government Act 2003 Section 1.

13.2 The Council has a general power to acquire property, including investment properties, and also has a general power to borrow but is under a general duty to act prudently (Local Government Act 1972 powers).

13.3 Investment in Property is permitted under the General Power of Competence introduced in the Localism Act 2011 which gives Councils the power to do anything an individual can do provided it is not prohibited by other legislation.

13.4 Local Government Act 2003 Section 12 allows a local authority to borrow money for the purposes of the prudent management of its financial affairs. In these situations the S151 will be key in deciding whether the Council should invest monies 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 investment and whether the investments would fit within the agreed investment strategy of the Council. The decision to purchase a particular property must, of course, have regard to all relevant considerations including the purposes for which the investment would be made, taking into account all relevant considerations, ignoring irrelevant considerations, not acting irrationally and balancing the risks against the potential rewards. In addition, the Secretary of State's Guidance relating to the adoption of an investment 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.

13.5 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.

13.6 The legal considerations in respect of each acquisition will be considered as part of the initial assessment process and be reported to the Property Investment Board.

(One Legal have been consulted in the preparation this report.)

14.0 Risk & Opportunity Management Implications

14.1 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.

15.0 People Impact Assessment (PIA):

15.1 None.

16.0 Other Corporate Implications

16.1 Community Safety

None.

16.2 Sustainability

None.

16.3 Staffing & Trade Union

None

Background Documents: None