CORPORATE OVERVIEW AND SCRUTINY PANEL – 15 DECEMBER 2016
CABINET – 4 JANUARY 2017

PORTFOLIO: FINANCE AND EFFICIENCY

STRATEGY PROPOSAL: TO INVEST IN COMMERCIAL PROPERTY

1. INTRODUCTION

1.1. This report looks at a proposal where the Council invests in commercial property. This could either be for the purpose of economic development or regeneration within the district, or for the purpose of income generation for the provision of services or a mixture of both.

1.2. This report considers the issues that should be taken into account when considering such a strategy and the general approach the Council should take in formulating the strategy.

1.3. It is recognised that further work will be required to complete the strategy but Cabinet will be invited to approve the overall “direction of travel” in connection with this proposal.

1.4. The medium term focus and so the direction of travel laid out in this report is on commercial property (office, industrial, retail) as a manageable piece of work. A separate paper can be prepared on a residential property investment strategy at a later date but this is a complex area.

2. BACKGROUND

2.1. The Council is considering a proposal to invest in commercial property. This could either be for the purpose of economic development or regeneration within the district, or for the purpose of income generation for the provision of services or a mixture of both.

2.2. Other authorities, including many in Hampshire, make significant investments in commercial property. Investments could be funded either from the Council’s own resources or by taking advantage of its ability to borrow at relatively low rates of interest from the Public Works Loan Board (PWLB) compared to the return on property assets.

2.3. The management of existing Council property assets (through its Asset Management Strategy) is a separate piece of work. The Council does have some existing property assets which might be thought of as “commercial property investments” as summarised below

	Number of sites	**Capital value**	**Gross rental income**	**Gross yield**
Commercial and Investment Properties	**23**	**£9,642,400**	**£672,508**	**7.0%**

2.4. Other Local Authorities in the region have extensive commercial property investment portfolios. However it should be noted that these have often built up over many years and so such authorities are in a different place to NFDC in this respect.

2.5. Commercial property investment opportunities often arise unexpectedly and it is important to be nimble in order to take advantage of opportunities when they arise. To that end an investment strategy is important so the Council can assess quickly whether an opportunity may be of interest to the Council. Commercial property can come to market either through the traditional route of a selling agent and bidding process, through auctions and even "off market" through direct approaches from prospective sellers who want to circumnavigate the formal marketing process in order to save time and risk of abortive costs. Receivers or administrators of distressed sellers may also seek offers for commercial property assets quickly. The Council therefore needs to be in a position to assess investment opportunities in a systematic manner but should also be able to move quickly when a compelling opportunity arises.

3. THE FINANCIAL STRATEGY AND BUSINESS CASE

3.1. Should the Council decide to implement a commercial property investment strategy either for the purpose of economic development or regeneration in the district or for the purpose of income generation for the provision of services or a mixture of both, a key issue for the Council to decide would be the value of the property portfolio and the expected target net yield.

3.2. The initial view of officers is that a target for investment return would need to generate a net profit in the region of £500,000 per year.

3.3. The experience of other local authorities indicates a yield of between 5% - 7% on the value of the investment is achievable on the types of commercial property likely to be of interest to a local authority.

3.4. The Council holds a significant level of cash, held in a variety of investment types. The management of those funds is dictated within the Council's Treasury Management Strategy. The average yield achieved in 2015/16 from these investments was 0.98%. The investment portfolio includes a modest sum (£3m) in pooled property funds which are higher earning (4.52% achieved), with the majority of other funds being held with less than 1 year to maturity and so low earning.

3.5. Officers believe that the Council could potentially borrow funds with the PWLB at a rate of around 2.5%. The PWLB needs to be satisfied the Council is acting lawfully when borrowing funds.

3.6. One-off and on-going costs would be incurred in order to deliver the strategy, including:

- Finders Fees (0.5% - 1%)
- Legal Fees (0.5% - 0.75%)
- Stamp Duty (5% on freehold purchases over £250K)
- Finance Costs (2. 5% PWLB) on borrowed funding
- Business Rates (tenants should be covering these)
- Repairs and maintenance (depending on lease type – probably covered in a service charge)

- Running costs of building, including building management (depending on lease type – again probably covered in a service charge)
- Additional Staff Costs (2 -4 people) to manage the portfolio

Note that bids would allow for transactional costs (finder's fees, valuations, legal costs, stamp duty, etc.) when calculating the yield.

3.7. NFDC already has substantial loans of c£144M following the HRA resettlement. The current prudential indicators agreed as part of the Council's Treasury Management Strategy limits borrowing to £178.1m in total. This means £34.1M is available for borrowing purposes at the present time.

3.8. By way of example only, considered on a prudent and cautious basis, an investment in the order of £25M funded by borrowing on a repayment basis may be required to achieve a net profit of £500k, based on a 6% gross target yield.

3.9. If the Council were to adopt an asset investment strategy, there will be staff and resource implications both to design a new asset investment strategy, to procure commercial properties and then to manage the properties in the future.

3.10. It is of course necessary that the Council takes a prudent approach to the management of its financial affairs. When assessing investments taking a prudent approach, the Council will need to consider such factors as the security against loss, the liquidity of the investment, the yield, change in interest rates and property values.

3.11. The Council will also need to consider the level of reserves that should be maintained, the effect of borrowing upon its credit score and its overall borrowing limits when preparing an investment strategy.

3.12. In short the Council must get right the balance between risk and reward in a prudent manner to ensure the cost of funding the proposal does not fall on the tax payer.

4. WHAT ARE THE OPPORTUNITIES FOR NFDC?

4.1. In preparing this report, officers have made enquiries about the activities of other local authorities investing in this market and their findings are summarised below. A number of key points emerge:

- Investment portfolio range £16M - £57M.
- Target yield 5 – 7%.
- Finders fees up to 1%.
- Some Local Authorities invest within their District, others more wide ranging (depends on whether investing own resources or PWLB loans and extent of local investment opportunities).
- Some Local Authorities can buy "opportunistically" when attractive opportunities are presented.
- Some Local Authorities have adopted a structured scoring basis to measure the strength of investment propositions (see table in Appendix 1 as an example).
- Mainly commercial property (industrial, retail, office) is acquired, with tenants of between 5 – 10 years.
- "Better" investments (strong tenants, minimum 10 year unexpired leases, fully let, good quality building) likely to be more expensive and generate lower yield (5%).
- Invest in staff to take on more management intensive property and increase yield.

4.2. A recent market report (UK Commercial Property Investment Review Q3 2016 prepared by The Costar Group) indicates Local Authorities have invested over £786M in Q3 2016, more than in the previous 3 years combined. Spelthorne BC has recently invested £350M in the BP Campus Sunbury on Thames at an initial yield of c4.25%.

4.3. Costar's report says there has been a decline in UK commercial property activity over recent quarters, with an acute drop in Q3 2016 after the Brexit vote. In that respect the entry of local authorities into the market stands out. There appears to be cautious optimism in the longer term with yields from commercial property remaining attractive compared to other assets, low levels of vacancy and a large pool of capital (especially from overseas) available for investment. It may be that once valuations have stabilised the market will improve.

4.4. Were the Council to adopt an asset investment strategy, officers believe that to maximise the chances of securing good quality investments it would be beneficial to have the freedom to invest in a variety of locations. In order to prioritise property investment in the smaller towns within the District, that could be recognised within the property scoring matrix (see example in Appendix 1), which would increase the chance of bidding successfully on local properties.

4.5. Were the Council to adopt an asset investment strategy there may be circumstances where the Council may need to move quickly to secure such opportunities which may only rarely come onto the market.

4.6. Were the Council to adopt an asset investment strategy, then it would need a clear and efficient decision making protocol, e.g. delegated authorities, approved criteria for selecting properties etc. Rapid decision making is important in this market, and all the more so when purchasing property at auction or from receivers for example.

5. AN ASSET INVESTMENT STRATEGY

5.1. If the Council is minded to adopt an asset investment strategy it would be important to prepare a clear asset investment strategy document to be applied when making investment decisions and to demonstrate the Council is acting prudently in the management of its financial affairs. There are a number of important matters an asset investment strategy must cover, for example:

5.1.1. The Council should consider commercial property investment either as part of an economic strategy for local economic development and regeneration in the district, or for income generation for the provision of services or a mixture of both. The overall objectives for that programme would need to be set out as well as how particular properties would be selected for acquisition.

5.1.2. The Strategy should identify the quality and type of commercial property to be acquired (the perceived level of financial risk on the property will affect prices and yield). Officers anticipate the Council would only deal with high quality prime or secondary market real estate with a low level of risk unless there were special factors such as development potential.

5.1.3. The return the Council expects and over what time period. Officers anticipate a target yield of between 5 – 7% for the type of property the Council would consider. This would be in line with similar authorities.

5.1.4. Financing the programme. Is the Council prepared to borrow to fund investment or does it want to “start small” with local investment funded from existing reserves? It is anticipated that much of the strategy would be funded by borrowing and that the Council would take a prudent approach to its investment strategy. As outlined in paragraph 3.8, an investment in the region of £25M may be needed to produce a return of £500,000 per annum based on a 6% gross yield.

5.1.5. Nature of the portfolio. Officers anticipate a portfolio would be made up of several properties, with a variety of tenants and uses (for example offices, retail or industrial) and locations.

5.1.6. Will the Council go it alone or look for partners? In order to get the strategy up and running it would appear more appropriate to commence operations without seeking partners, at least to begin with.

5.1.7. Ongoing management of the portfolio. Property management varies between properties. Managerial issues include rent collection, service charge calculation and collection, building maintenance, security, dealing with tenants, re-letting empty units if they become available, negotiating terms of rent reviews, dilapidation claims and the general miscellany of property management. A decision would be needed as to whether such work should be undertaken in house or whether it should be contracted out to external property managers.

5.1.8. Exit strategy. Withdrawal from the programme must be considered. Properties should have good and marketable title. Exit success depends on the market conditions at the time. Can be a slow process.

5.2. The scoring matrix referenced in Appendix 1 may be used to assess the commercial property investment opportunities and appears to be the kind of tool that could be adopted by this Council.

5.3. The Council will need to consider whether to create a wholly owned property investment company through which to purchase commercial property. If the Council needed to borrow funds to buy commercial property solely for the purpose of income generation, this will need to be carried out through a property investment company.

5.4. However if the Council wishes to invest existing resources in commercial property (inside or outside the District), or if the Council were acting for the purpose of economic development or regeneration within its District using borrowed funds to buy commercial property, then no separate company would be required. If the Council had a mixed purpose of economic development and income generation then provided the economic redevelopment was one of the main purposes of the property acquisition this could be undertaken without using a company.

6. ACQUIRING AND MANAGING PROPERTIES

6.1. If the Council were inclined to support the strategy to acquire commercial investment property this would be carried out in a prudent manner. The note attached as Appendix 2 sets out in broad terms how the Council would approach the purchase and ongoing management of commercial property. This would be carried out in a systematic manner, taking external valuation property and legal advice and undertaking thorough due diligence before entering into formal contracts to protect the Council’s position.

6.2. The current Estates and Valuation Manager has the relevant experience to support the acquisition process from an Estates perspective but is currently fully utilised on day to day business. To advance any of the above will create a significant impact on resources.

6.3. Appendix 2 also refers to the ongoing management of commercial investment properties. Managerial issues include rent collection, service charge calculation and collection, building maintenance, security, dealing with tenants, re-letting empty units if they become available, negotiating terms of rent reviews, dilapidation claims and the general miscellany of property management. Management of commercial investment property portfolios is commonly conducted by staff within the authority's Estates and Valuation team. However it should be noted that NFDC's property investment holdings are relatively small at present by comparison to other authorities. Staffing levels would need to be increased to cope with enlarged management commitments if new acquisitions are to be managed in-house.

7. RISK FACTORS

7.1. Property investment brings with it the potential for significant losses if things go wrong.

7.2. A common risk area is that vacancies (voids) in the portfolio will reduce average yield. As well as lost rental income on vacant units, the Council could find itself liable for a share of on-going costs which a tenant would normally pay such as empty property rates.

7.3. Disputes with tenants are another risk area. Common disputes include ongoing maintenance and repair costs of buildings and the ability to recover those costs from tenants.

7.4. External factors. Property investment, whether direct or through pooled funds, is subject to factors the Council cannot control, e.g. failure of tenants, poor building management, changes in perception of what is a good location, economic downturn, increased borrowing rates, etc.

7.5. How long before Government intervenes to restrict such strategies?

8. PORTFOLIO HOLDERS COMMENTS

8.1. I am pleased to see the Council developing an asset investment strategy that will promote economic development and regeneration in the district as well as giving the opportunity to derive financial benefit to the Council.

9. ENVIRONMENTAL IMPLICATIONS

9.1. Any proposed commercial property investment and their environmental impacts would also be considered by the relevant officers at the planning development control stage if appropriate.

10. EQUALITY AND DIVERSITY IMPLICATIONS

10.1. There are no equality and diversity implications arising from this report.

11. CRIME AND DISORDER IMPLICATIONS

11.1. There are no existing crime and disorder implications arising from this report.

12. FINANCIAL IMPLICATIONS

12.1. If the Council were to adopt an asset investment strategy, there will be staff and resource implications both to design a new commercial property investment strategy, to procure commercial properties and then to manage the properties in the future. These figures could be significant and will be clarified as part of the strategy as it develops.

13. CONCLUSION

13.1. Should the Council decide to invest in commercial property either for the purpose of economic development or regeneration within the district, or for the purpose of income generation for the provision of services, or a mixture of both then an asset investment strategy should be developed.

13.2. Other local authorities are purchasing commercial properties in support of these goals and it does appear there are opportunities to secure good quality commercial property at a level that can generate a worthwhile yield albeit also recognising the risks that are involved in such investments.

13.3. Local authorities can borrow funds from the Public Works Loan Board to finance such strategies at competitive levels of interest.

14. RECOMMENDATION

14.1. That the overall approach set out in this report is approved and requests that a commercial property investment strategy is developed for consideration by February 2017 Cabinet.

14.2. That a Task and Finish Group be established involving 3 members of the Corporate Overview and Scrutiny Panel to work with officers and the Portfolio Holder for Finance & Efficiency in developing the strategy.

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Appendix One

Scoring Matrix

	Score	4	3	2	1	0
SCORING CRITERIA	Weighting Factor	Excellent / very good	Good	Acceptable	Marginal	Unacceptable
Location	12	Major prime	Micro prime	Major secondary	Micro secondary	Tertiary
Tenancy strength	10	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant	Tenants with poor financial covenant strength
Tenure	9	Freehold	Lease 125 years plus	Lease between 50 & 125 years	Lease between 20 & 50 years	Lease less than 20 years
Occupiers lease length	5	Greater than 10 years	Between 7 and 10 years	Between 4 & 7 years	Between 2 & 4 years	Less than 2 years; vacant
Repairing terms*	4	Full repairing & insuring	Internal repairing - 100% recoverable	Internal repairing - partially recoverable	Internal repairing - non recoverable	Landlord
Lot size	2	Between £6m and £12m	Between £4m & £6m or £12m & £18m	Between £2m & £4m or £18m & £20m	Between £1m & £2m or £20m & £25m	Less than £1m or more than £25m

APPENDIX 2

PROCESS TO PURCHASE OF A COMMERCIAL PROPERTY INVESTMENT

1. SALES PROCESS IN OUTLINE

1.1. There are many ways in which a commercial investment property can come to market. These could be a full marketing and sales exercise run by the seller's agent, an auction, an "off market" opportunity offered by a seller directly to the Council without public marketing or sales by the receivers or administrators of a distressed seller. The steps and timing of the process are usually set by the seller. However the kind of steps the Council would be expected to undertake in order to progress the transaction would include:

- 1.1.1. Review of Seller's information memorandum or sales particulars on the proposed sale (including if any employees are included in the sale)
- 1.1.2. Walk the site (externally)
- 1.1.3. Meet with seller to get more detail and build relationship
- 1.1.4. Complete formal confidentiality agreement
- 1.1.5. Determine the Council's valuation of the proposed sale through internal and external valuation
- 1.1.6. Negotiate and agree with seller the price and principal terms and timetable subject to contract, due diligence and necessary Council approvals.
- 1.1.7. Obtain confirmation of EMT support (who will hold informal consultations with Members)
- 1.1.8. Obtain confirmation of Cabinet / Full Council / Portfolio Holder support as required
- 1.1.9. Confirm means of finance and instruct external solicitors
- 1.1.10. Property Due Diligence – such as buildings / measured surveys as required using external surveyors.
- 1.1.11. Legal Due Diligence, title check and comment on copies of legal documents / leases
- 1.1.12. Contract negotiations
- 1.1.13. Exchange contracts and complete

1.2. Of course some of these actions are concurrent. Without a sales process fixed by the Seller it is difficult to be specific about how the process will unfold and how long it will take. However a large and complex site involving multiple tenants and complex title can take up to 3 - 4 months to complete; a straightforward site with one or two tenants, say 2 - 3 months. Of course both parties will want to reduce the process period as much as possible.

2. THE NEED FOR EXTERNAL ADVICE

2.1. If the project is large and complex, the Council will require external support in order to conclude it.

2.2. External valuers will be required to confirm the valuation of the asset and to support any internal valuation carried out by the Council. External surveyors will be necessary to carry out building and property surveys of the assets being sold.

2.3. External Solicitors will be necessary to carry out legal due diligence (which can be a significant piece of work) to check title, confirm details of the occupational leases, advise and negotiate contract documents and support the process.

2.4. Commercial property investment acquisitions represent a new area of activity for this Council and will impact significantly on present resources. Even with contracting out to external advisors there is a need to link with advisors, to process information, to seek instructions from senior people and drive the process forward. The seller is usually impatient to progress a deal especially if they think the Council has received a "good deal" by agreeing to a sale without a public sales process

3. ONGOING MANAGEMENT RESOURCES FOLLOWING PURCHASE

3.1. Once a Property has been purchased, there will be an ongoing need to manage the Property. Managerial issues will include rent collection, service charge calculation and collection, building maintenance, security, dealing with tenants, re-letting empty units if they become available, negotiating terms of rent reviews, dilapidation claims and the general miscellany of property management.

3.2. The extent of property management depends on the property but these are the kind of issues that may arise.

3.3. In addition there may be further opportunities to negotiate with adjoining land owners if the Council wishes to use the purchase as an opportunity to undertake further economic redevelopment or regeneration opportunities following acquisition of the property.

3.4. Management of commercial investment property portfolios is commonly conducted by staff within the authority's Estates and Valuation team. However it should be noted that NFDC's property investment holdings are relatively small at present by comparison to other authorities. Staffing levels would need to be increased to cope with enlarged management commitments if new acquisitions are to be managed in-house.

3.5. The Council would need to decide whether to place such property management services with external property management companies at a cost (maybe 10% per annum of the annual rental income) or whether it would be more cost effective to create internal resource to undertake such work.