| Key Decision Required: | Yes | In the Forward Plan: | Yes |
|---|---|---|---|

**CABINET**

**9 SEPTEMBER 2016**

**JOINT REPORT OF THE PORTFOLIO HOLDER FOR FINANCE, REVENUE AND BENEFITS AND THE PORTFOLIO HOLDER FOR ENFORCEMENT AND COMMUNITY SAFETY**

## A.6 ACQUISITION OF INVESTMENT PROPERTY

(Report prepared by Richard Barrett and Andy White)

## PART 1 – KEY INFORMATION

| PURPOSE OF THE REPORT |
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| To seek Cabinet's approval of a Commercial Property Investment Policy to enable the acquisition of Commercial Property within the budgets set out in the Capital Programme and in accordance with the Council's Treasury Management Strategy. |

| EXECUTIVE SUMMARY |
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| • The Council has a continuing need to balance its revenue budget by a combination of generating income and reducing costs. As part of its treasury management activities, the Council places on average **£40m to £50m** of investments each year, primarily within the money markets, including with other Local Authorities. Given the relatively low interest rates currently obtained from such investments, there is an opportunity to explore how to maximise returns from the Council's positive 'core' cash flow position through investing in commercial property in the long term.<br>• As part of the 2016/17 budget process, **£0.750m** has been included within the capital programme to enable a modest level of investment in commercial property to be undertaken in the first instance, which would then provide time to reflect on the success / performance of such an approach to inform future investment decisions.<br>• Full Council agreed the Treasury Strategy for 2016/17 in April 2016 which set out the high level background for commercial property investment decisions and so along with the funding position set out above, two key steps have already been put in place to enable investment in commercial property to be considered.<br>• The third and arguably the most important step that this report aims to put in place are the governance arrangements to inform and guide decisions such as how to identify which properties to invest in. There will be several factors that will need to be considered in order to choose the most suitable investment whilst balancing maximising returns with minimising risk.<br>• A Commercial Property Investment Policy is therefore included as **Appendix A** which sets out robust governance arrangements.<br>• It is worth highlighting that obtaining maximum returns requires the flexibility to consider property outside the district boundaries as well as within them. It is acknowledged that investing within the district would be more easily presented to |

the community but the purpose of this proposal is to maximise investment returns. Returns that are made on property purchased outside of the district would be available to support expenditure within the district.

- The window of opportunity to purchase commercial property tend to be short and therefore it is proposed to delegate decision making to Director level but within the framework of the Commercial Property Investment Policy proposed.
- Investing in commercial property was identified as a key savings strand in the Financial Strategy - Financial Baseline 2017/18 report presented to Cabinet on 5 August 2016. This report therefore seeks to put in place the arrangements to secure the necessary savings in 2016/17 onwards.
- Monitoring the performance / success from investing in commercial property will be a key item within the Council’s usual performance framework / budget monitoring processes.

**RECOMMENDATION**

**That Cabinet:**

**(a) authorises the acquisition of investment properties within the budget, criteria and delegations in (b), (c) and (d) below;**

**(b) approves the Commercial property Investment Policy set out in Appendix A subject to a) above;**

**(c) authorises the Corporate Director (Corporate Services) to acquire and invest in property within the investment portfolio subject to the budget and criteria above, in consultation with the Leader and Portfolio Holder for Enforcement and Community Safety and to enter into and conclude all legal agreements and in every respect manage the proposed investment portfolio within the criteria set out and;**

**(d) recommends to Council that the Property Dealing Procedure contains exclusion at 1.2.5 that identified investment properties which become vacant through the duration of an existing lease to be re-let swiftly through a Corporate Director (Corporate Services) decision, with the concurrence of the Portfolio Holder, ensuring maximum return.**

## PART 2 – IMPLICATIONS OF THE DECISION

**DELIVERING PRIORITIES**

The Council needs to balance future revenue budgets in order to maintain its overall ability to deliver services and invest in its corporate priorities.

**FINANCE, OTHER RESOURCES AND RISK**

**Finance and other resources**

The Treasury Strategy agreed by Full Council in April 2016 included the following:

*“The capital programme for 2016/17 includes £750,000 to establish a commercial property investment fund, which is a Non-Specified investment. This fund will be used to purchase*

*property with the aim of yielding both rental income and capital gains. This investment will not have a defined maturity date and it will be an illiquid investment as the Council would need to sell the underlying asset(s) to redeem the investment. The amount invested in any one year will be limited to the amount included within the Council's Capital Programme, with information submitted to members separately to address / acknowledge the priorities and risks set out elsewhere in this strategy as part of the budget setting framework, including future funding decisions. At present it is proposed to fund the scheme from existing capital receipts, so there is no current need to borrow for this investment.*

*A separate policy will be presented to members before any investment in property is undertaken, which will set out the necessary financial and governance arrangements around such investment. This policy will be maintained as a separate document within the wider Treasury Strategy framework".*

In following on from the above decision, this report therefore seeks to set out the separate policy with a proposed Commercial Property Investment Policy included at **Appendix A**.

In terms of interest rates on investments currently placed by the Council, these have recently reduced to between **0.1%** and **0.3%** following the reduction in the base rate to 0.25% on 4 August 2016**.** Although there is no sign of an increase in rates in the short term, it is accepted that at some point in the future, over the life of any property that the Council purchased, rates will increase although historically are not likely to far exceed 4% for any prolonged period of time. Returns from property investment have the potential to deliver returns of between **4%** and **14%** depending on the levels of risk taken. Investment with manageable risk levels could yield between **5%** and **7%** and has potential to deliver revenue income each year over and above the returns from investing in the money markets as is the case at present.

The Council already manages a number of leasehold properties and officers consider that management of a small investment portfolio can be achieved within existing resources.

The property investment proposed is based on a direct approach with the Council purchasing property and then acting as a commercial landlord. As with all types of investments, there are alternatives to acquire property within the Council's overall investment portfolio. Syndicate / collective investment options are available such as property unit trusts. However following further investigation, the Council would have no control over when or where property is purchased or when it is sold which would present a number of risks and would not allow the Council control over the location and nature of the properties invested in. Management costs would also be incurred and it is doubtful that such investment would yield the same returns as directly purchased / managed property in the long term. Although risk would be spread over a much bigger portfolio, and managed externally, on balance it is not proposed to invest in a 'collective' option at this stage.

**Risk**

In line with the risk tolerances that are operated as part of existing treasury management decisions, the security of the actual capital outlay is of prime importance. Investing in property should be seen as a longer term investment, and by doing so the Council has control over the level of exposure to potentially losing money if the resale / market value at any given time is lower than the original purchase price. As long as liquidity is maintained elsewhere within the Council's investment decisions, then property assets can be held until such time as the Council determines, rather than being forced into an unfavourable sale if the Council needed cash to meet its costs. The current budget for investing in commercial property is **£0.750m**, which represents only 1.5% of the average investments placed at any one time and is significantly below the **£3.500m** limit for investments longer than a year as set out in the Treasury Strategy, which although excludes property, it does provide a good ‘marker’ at this stage of developing the Council’s commercial property portfolio.

Apart from the underlying risk mentioned above, investments carry a number of further risks. It is proposed to seek to manage these risks to an acceptable level by applying good diligence before purchasing and good management thereafter. It is proposed to adopt the criteria set out **Appendix A** and in line with good practice in managing investments, a key aim will be to spread risk by setting property investment among a wider investment portfolio as is currently the case i.e. maintaining a number of counterparties such as banks, local authorities and the UK Government.

Various risks are set out in the Commercial Property Investment Policy along with how they are to be mitigated.

**LEGAL AND CONSTITUTIONAL**

Section 120(1) of Local Government Act 1972 provides for the Council to acquire land either within or outside the District for any purpose within that or any other Act or for the benefit, improvement or development of the area.

Section 12 of the Local Government Act 2003 provides a general power to invest (a) for any purpose relevant to its functions under any Act or (b) for the purposes of the prudent management of its financial affairs.

Acquisition can take place notwithstanding that the land is not immediately required for that purpose, however, in this case investment in property is proposed in order to diversify its investment portfolio which in turn generates potential capital growth and revenue rental income, which can be reinvested and supports the Council’s financial position and management of investment risk and by doing so benefits the district in line with the statutory power.

This approach is supported by The Chartered Institute of Public Finance and Accountancy (CIPFA), who consider Section 12 of the 2003 Act as a tool for local authorities to ensure compliance with the key principles of treasury management: that firstly, that their investments are safe; secondly, that they have sufficient liquidity and accessibility; and thirdly, that they provide acceptable returns. Therefore, the case for acquiring investment property needs to be balanced against other investment opportunities through treasury management.

Investment is for financial return either rental or capital growth and assets acquired for these purposes must be distinguished from assets intended to deliver other strategic goals or outcomes, as these fall outside of the definition of investment property. It is possible that some property investment could also bring about economic regeneration or impact but the intended purpose under this strategy is to secure the best possible return and this may involve a best return achieved outside of the District, although it is likely to be a mix of both property inside and outside the district.

It is important to note that financial returns achieved through property investment are also treated differently to income generated through service provision for accounting purposes.

Section 123(1) Local Government Act 1972 indicates that, a local authority may dispose of land held by it in any way it wishes so long as (section 123 (2)) the land is disposed for a consideration not less than the best that can reasonably be obtained.

In coming to decisions in relation to management of assets, the Council must act in accordance with its statutory duties and responsibilities. The Councils disposal powers relate to the potential disposal of investment property either by way of leases or, if the investment becomes unsatisfactory, the freehold. Therefore, on the basis that the Council is intending to acquire property for investment purposes it is important that the properties are continually let for the best return. The Council's Constitution contains the Property Dealing Procedure and it is considered appropriate to seek an amendment allowing identified investment properties which become vacant through the duration of an existing lease to be re-let swiftly through an officer decision in consultation with the Portfolio Holder ensuring maximum return. All decisions will be fully documented and recorded.

**OTHER IMPLICATIONS**

Consideration has been given to the implications of the proposed decision in respect of Crime and Disorder, Equality and Diversity, Health Inequalities, Consultation/Public Engagement and Wards; and any significant issues are set out below.

**Ward**

May impact on all wards

## PART 3 – SUPPORTING INFORMATION

**BACKGROUND AND CURRENT POSITION**

The acquisition of investment property represents one way in which the Council can diversify its investment portfolio along with generating greater returns than can be obtained from its existing portfolio which includes placing money with banks, local authorities and the Government.

It is possible to adopt a management strategy including a number of criteria as well as careful acquisition and management in order to manage risks and maximise investment returns.

A number of steps have already taken place to enable the Council to invest in commercial property e.g. the identification of **£0.750m** in the 2016/17 Capital Programme, and its inclusion within the Treasury Strategy 2016/17. The final stage is to set out the criteria against which commercial property investment decisions are to be taken that balances return, risk and the speed and flexibility required to take advantages of opportunities that may arise either within or outside the district.

The proposed criteria are set out in **Appendix A** which cover the following key principles / risks:

- Objectives
- Management of Risks
- Criteria for the selection of properties including diversification / yield
- Acquisition
- Management
- Reletting / void periods
- Monitoring and Review – including reporting, disposal and annual review activities.

In respect of being able to react promptly to opportunities, it is recognised that commercial property transactions tend to happen quite quickly, particularly when a good investment property comes to market. Some opportunities may also be available at auction. The potential speed of these transactions is incompatible with the Council's multi-stage property dealing policy. It is therefore proposed that Cabinet approves in principle the acquisition, management of investment properties meeting the criteria set out in the Commercial Property Investment Policy but delegates the decisions on individual properties (including terms) to the Corporate Director (Corporate Services) in consultation with the Portfolio Holder for Enforcement and Community Safety. It is also proposed that the re-letting of tenanted properties is identified as an additional exception to the Property Dealing Procedure.

The criteria specifically allow for acquisition of property inside or outside of the District. Acquisition of property outside of the district potentially offers access to a wider range of quality investments which could provide a greater return on investment.

Although it is a longer term project that remains subject to further member decisions, it may be possible to include its property portfolio, buildings within the Garden Community Project on the west of Tendring, at some point in the future. The establishment of a commercial property portfolio now enables the Council to develop its management, performance and property holding arrangements which could in turn support investment in commercial property within the garden communities area at a later date.

| **BACKGROUND PAPERS FOR THE DECISION** |
|---|
| None |

| **APPENDICES** |
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| **Appendix A** – Commercial Property Investment Policy |

# Commercial Property Investment Policy

***Criteria, Targets and Procedure for Investment Properties***

**Introduction and Objectives**

The Council has decided to invest capital funding into commercial property as part of its treasury management activities. These investments are to be made on a purely commercial basis to provide a good income stream and maximise the return on investment.

They could be either inside or outside of the District. The approach to acquiring commercial property for investment is set out in this document. The principal objectives are in-line with those set out in the Treasury Strategy and in translating these to the investment in commercial property, the key items are as follows:

a) The security of the capital invested
b) Optimise return on investment – capital growth and revenue yield;
c) Provide value for money and facilitate sound financial investment for the Council.

Being based on the Council‘s broad treasury management practices, the above are considered primary considerations. It is recognised that investing in commercial property will likely present qualitative opportunities such as supporting the delivery of the Council’s key priorities, but these should be treated as secondary considerations.

Investing in property is not risk-free, so it is important that appropriate measures are in place to maintain the capital value of the asset and security of rental income.

The main risks are vacancy or void periods and the repair and maintenance of properties.
Void periods lead to loss of income and costs falling on the landlord including non-domestic rates, insurance, utilities, security, inspections and management. In addition, there would be the cost of marketing the property, the agent's disposal fees and legal fees for new lease documentation.

Other risks relate to tenants defaulting on rental payments, carrying out unauthorised works or sub-lettings. Risks will be minimised through the criteria targets and procedures set out in this document.

**Risk Management**

The table below sets out the primary risks and how they will be mitigated. Responsibility for the managing risks will be the Head of Property Services

| **Risk** | **Control** |
|---|---|
| Failure of tenants in general or failure to comply with lease terms. | Maintain active management of the portfolio.<br>Purchase only properties let to ‘sound’ tenants following criteria above. |

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|---|---|
| Unforeseen property or repair costs. | Carry out surveys and diligent inspection of documents before purchase.<br>Let on full repairing terms or with full recovery of costs. |
| Void periods. | Purchase properties with ongoing leases with a minimum of five year's unexpired.<br>Maintain active management of the portfolio. |
| Contamination | Carry out surveys and diligent inspection of documents before purchase.<br>Purchase only properties let for non-contaminating uses. |

**Criteria and targets for properties to be acquired**
Any property to be acquired should meet all of the minimum criteria set out below and achieve an overall risk/reward score of 12 based on the assessment below:

| Criteria | Key Risk(s) Addressed | Minimum | Target/ scoring |
|---|---|---|---|
| Target yield* should represent a rational balance between revenue returns and security. | Security of Capital Invested and providing value for money | whichever is the greater of: 6% net or, an investment return greater than that achieved in the financial markets at a comparable risk level. This limit is to be to be applied to overall property portfolio. | Properties with higher yields may be considered if other risk factors can be balanced.<br>7%= 1 point<br>8%= 2 points<br>9%= 3 points<br>10%= 4 points<br>11% or over = 5 points |
| Spread the commercial investment over a number of properties to limit the overall impact that any single failure would have. | Failure of tenants in general and void periods | No single tenancy (after the first three acquisitions) to amount to more than 50% of the portfolio by rental; unless specifically agreed.<br><br>No more than 50% of tenants should be operating in the same market sector unless specifically agreed. | N/A |
| Invest only in property with existing tenants of a sound and solvent nature | Failure of tenants in general or failure to comply with lease terms.<br><br>Unforeseen | Main tenants to be subject to appropriate financial checks as determined by the Chief Finance Officer which will be proportionate to the scale of investment | additional points:<br>1 for a business established for 20 years or more.<br>2 for a PLC tenant<br>3 for a blue chip tenant |

| | | | |
|---|---|---|---|
| | property or repair costs.<br><br>Void Periods | and tenant and where appropriate satisfactory references or parent company guarantees. | |
| Invest only in property with a sufficiently long tenancy term unexpired; | Failure of tenants in general or failure to comply with lease terms.<br><br>Unforeseen property or repair costs.<br><br>Void Periods | a) Main tenancies in any acquisition to have more than 3 years unexpired.<br>b) Main tenancies not to have a break clause exercisable in less than 3 years unless specifically agreed. | Additional points:<br>1 points for more than 5 years unexpired<br>2 points for more than 10 years unexpired<br>3 points for more than 20 years unexpired |
| The property itself should be free from risks as far as possible. | Unforeseen property or repair costs.<br><br>Contamination | To include 'due diligence' such as:<br>a) Buildings to be of robust construction and in sound condition.<br>a) Property use to be commercial,<br>b) not potentially polluting.<br>c) Free from onerous planning conditions, and land contamination | Additional points:<br>1 point for retail use<br>2 points for central business district retail<br>3 points for offices |
| The property should not incur costs that detract from overall performance of the investment. | Security of Capital Invested and providing value for money | a) Main leases to be with full cost recovery by service charge.<br>b) Property to be within a distance to allow inspection by officers within a working day, including travel time. | Additional points:<br>3 points for full repairing and insuring terms.<br>1 point for being located in East Anglia or Kent.<br>2 points for being located in Essex or Suffolk, excluding Tendring. |
| The property nor tenant should bring the Council into disrepute. | Failure of tenants in general or failure to comply with lease terms. | Property use not to be unethical or unlawful. | 2 additional points for property in a community or regenerative use within Tendring district |

*In this context yield at acquisition will be the planned net income divided by the proposed capital and one off costs. And yield at review will be the net revenue passing (or predicted if rent review is less than two years away) divided by the current open market value.

Where investigation or judgements in these areas are required, they will be carried out and recorded by the Asset Management officers with assistance from other service units where necessary.

**Procedure**

1) General
   a) The steps taken under this procedure to support investment decisions will be clearly documented.
   b) Decisions on the acquisition of investment property, management and re-letting are delegated to officers in consultation with the Portfolio Holder.
   c) Any decision to dispose of the freehold of a property or to alter or extend it will be subject to the Council's standard procedures at the time being.

2) Acquisition.
   a) The Head of Property Services will identify potential acquisitions and evaluate them against the criteria and targets.
   b) Where required the Head of Property Services will commission surveys or investigation as he/she sees fit.
   c) The Head of Governance and Legal Services will consider relevant deeds and prepare a report on title.
   d) The Head of Finance, Revenues and Benefits will advise on the financial stability of the tenant(s) including procuring credit ratings and the like where necessary.
   e) The Head of Property Services will consider what future options may exist to enhance the returns from the property or to dispose of it if it fails to meet expectations.
   f) The Head of Property Services will conclude negotiations where necessary and report all of the foregoing to the Corporate Director (Corporate Services).
   g) When the Corporate Director (Corporate Services) is satisfied that acquisition of a property is in the interests of the Council having regard to the objectives of the portfolio he will seek the concurrence of the Portfolio Holder for Enforcement and Community Safety to acquire the property on the terms proposed and such other terms as considered appropriate by the Head of Governance and Legal Services.
   h) Where a potential property is to be sold at auction the foregoing steps will be taken save that the decision in consultation with the Portfolio Holder will include a price limit for the acquisition of the property and the Head of Property Services will then bid for the property up to the limit determined.
   i) Before any additional properties are to be purchased, the Head of Property Services must take into account any repair / maintenance obligations the Council may have in respect of any existing properties within the portfolio or potentially advantageous enhancements or additions to those properties.

3) Management
   a) The responsibility for managing the properties and the portfolio will reside with the Head of Property Services.
   b) The Head of Property Services will put in place appropriate periodic checks and inspections to monitor property condition and compliance.

c) The Head of Property Services will commission further surveys, serve notices and take any other steps necessary to maintain returns from the properties and manage risks to the Council.

4) Re-letting
   a) Where an investment property becomes vacant the Head of Property Services will carry out an assessment of options to re-let or dispose of the property or carry out other measures and evaluate them against the criteria and targets.
   b) Where required the Head of Property Services will appoint agents or market the property for re-letting. Note: any decision to invest in, alter or dispose of the freehold of the property would be subject to the Council's general rules and procedures.
   c) The Head of Finance, Revenues and Benefits will advise on the financial stability of prospective tenant(s) including procuring credit ratings and the like where necessary.
   d) The Head of Property Services will conclude negotiations where necessary and report all of the foregoing to the Corporate Director (Corporate Services).
   e) When the Corporate Director (Corporate Services) is satisfied that re-letting of a property is in the interests of the Council having regard to the objectives of the portfolio he will seek the concurrence of the Portfolio Holder for Enforcement and Community Safety to let the property on the terms proposed and such other terms as considered appropriate by the Head of Governance and Legal Services.

5) Monitoring and Review
   a) Annually the Head of Property Services will report to Cabinet and the Corporate Management Committee which will include the following aspects:
      i. The number and nature of properties in the investment portfolio
      ii. How the property portfolio is performing against the targets
      iii. Whether the risk profile of the portfolio has changed
      iv. Whether the portfolio remains sufficiently well balanced and diverse to limit the risk to the Council
      v. Whether the portfolio is performing satisfactorily against the overall financial target

      In addition to the above, a half year summary review will be included in the Corporate Budget Monitoring reports in-line with the current requirements relating to general treasury management activities.

   b) The Head of Property Services will keep the performance of the property portfolio under on-going review during the year. If conditions / circumstances indicate that the Council would be at a disadvantage if it retained ownership of a property then the relevant decisions to dispose of the property would be undertaken in accordance with the Council's standard procedures at the time being, including any urgency requirements. All decisions must be made against the underlying principle of the security of the money invested and therefore must take into account the potential resale value compared with the original purchase price, set against the reason for disposal and associated financial consequences.

   c) This policy will be kept under on-going review but as a minimum it will either be reconfirmed or amended as part of the annual report to Cabinet and the Corporate Management Committee as set out in 5a) above.