Property Investment Strategy
Annual Property Plan 2019-20
Cllr Izett, Cabinet Member for Property and Development

Report to	**Cabinet**
Ward(s):	**All**
Key Decision:	**No**
Appendices:	**None**
Papers relied on:	**Property Investment Strategy – approved by full Council on 23 February 2017**

Foreword - Cllr Izett, Cabinet Member for Property and Development

"These proposals for the further evolution of this council's Property Investment Strategy for the upcoming financial year build on the excellent progress made by officers during 2018. Following the enhanced income now flowing as a result of 4 new property transactions in the borough, we are well on track to achieve the additional £1.7m by 2021 of annual income over the returns obtainable by investing in conventional treasury.

Priorities for the year ahead are clearly stated in this report including opportunities to modernise and improve our existing long held property portfolio and support our ambitions as a council through the Housing Investment Strategy, currently being developed by officers, to intervene in the local housing market, not least at Manydown, and to assist and accelerate delivery of the new homes our residents of all ages and situations require.

I am pleased to note the good progress being made with existing tenants and developers to enable the redevelopment of obsolete buildings. It is important that this council continues to facilitate the renewal of premises so that new job opportunities can be created.

I look forward to receiving the comments and advice of councillors on Audit and Accounts Committee in carrying out their important role in connection with our Property Investment Strategy."

Recommendation:

- **That Cabinet recommends Council to agree that if necessary investment funds available for the Property Investment Strategy can be increased by up to £5 million funded from property receipts.**
- **That Cabinet agrees the Property Investment Strategy Annual Property Plan 2019-20.**

Background, corporate objectives and priorities

This report accords with the Council Plan 2016 to 2020, and specifically the objective set out in the Finance and Resources Directorate Service Plan to develop and implement a commercial property investment strategy.

Glossary of terms

Term	Definition
Lease re-gearing	Variations to a lease agreement agreed by the landlord and tenant, which may typically include changing the lease length, the amount of annual rent, the provisions for review of the rent, and other terms which affect the value of the respective parties' interest in the property.
Yield compression	A reduced investment return in recognition of lower interest rates, lower risk, rental growth or capital growth.

Main considerations 1 Executive summary

1.1 A Property Investment Strategy for the council's property investment portfolio was approved by full Council in February 2017.

1.2 The objective of the approved Strategy is to ensure a stable long term source of income from a balanced property investment portfolio and to contribute to the generation of additional income to meet the council's Medium Term Financial Strategy in support of the council plan and financial requirements. Rental income from the property investment portfolio significantly assists the funding of council facilities and services, without which service provision to residents and businesses in the borough would be adversely affected unless a replacement source of income were available.

1.3 The value of the investment portfolio at the last valuation in March 2018 was £296 million from which an annual rental income of approximately £16.58 million per annum is derived.

1.4 The approved Property Investment Strategy highlighted the need for a comprehensive modernisation of the approach to the management of the portfolio. This included acquisition of new investment properties through a £30 million allocation of Treasury Management funds, enhanced asset management of the portfolio and a pro-active approach to day to day management.

1.5 The agreed Strategy provided for amended governance arrangements including Cabinet approval of an Annual Property Plan at the start of each year with on-going monitoring and scrutiny of the strategy via quarterly reporting to the Audit & Accounts Committee.

1.6 The 2019/20 Annual Property Plan as proposed is intended to continue the work started in 2017/18 to deliver additional net income of £1.7 million per annum by the end of 2020/21 through increased rental income. To the end of December 2018 implementation of the agreed strategy has already achieved a net increase in council income to £1.129 million per annum through new investment acquisitions and the strategy is on course to deliver the £1.7 million target.

2 The proposal

2.1 This report sets out the proposed 2019/20 Annual Property Plan for the council's property investment portfolio in pursuance of its agreed Property Investment Strategy, in support of the council's Medium Term Financial Strategy consultation.

3 Background

3.1 The council owns a commercial investment property portfolio principally comprising office, industrial and retail property investments leased to third party tenants. The portfolio is located within the borough with the majority of the assets situated in or around the town.

3.2 It is primarily held to provide the council with a source of annual income to support financing the delivery of services across the borough, and currently generates a rental income of approximately £16.58 million per annum. This income directly assists provision of facilities and services for residents and businesses in the borough, and without which such services would be adversely affected unless a replacement source of income were available.

3.3 Some investment properties are held in support of wider council initiatives and/or to provide a larger land ownership for longer term redevelopment opportunities or to bring forward other socio-economic benefits.

3.4 Property consultant Cushman & Wakefield was appointed in February 2016 to advise the council on developing a property investment strategy for its current property investment portfolio. Following analysis of and reporting on the portfolio proposals were taken to full Council in February 2017.

3.5 The approved Property Investment Strategy highlighted the need for a fresh approach to the management of the portfolio, including acquisition of new investment properties through a £30 million allocation of Treasury Management funds, enhanced asset management of the portfolio and a proactive approach to day to day management. Through acquisitions and asset management a target of generating an additional net income of £1.7 million per annum by the end of 2020/21 through increased rental income was set, to directly link with and support the council's Medium Term Financial Strategy. Council Members also provided for the approved strategy to include proposals for appropriate investment in the local residential sector.

3.6 Amended governance arrangements were provided for in the strategy, including Cabinet approval of an Annual Property Plan at the start of each year, on-going monitoring and scrutiny of the strategy via quarterly reporting to the Audit & Accounts Committee, and an officer led Property Investment Panel with delegated authority held by the Executive Director of Finance and Resources to progress investment acquisitions, sales and lease restructures, subject to consultation with Portfolio Holders and subject to a financial limit on any one transaction.

3.7 Preparation of the Annual Property Plan is intended to directly support the council's Medium Term Financial Strategy. As part of this annual Plan review, consideration is given to the need for review of the wider Property Investment Strategy with proposed amendments to be brought forward for formal consideration as appropriate.

4 Progress to date

4.1 Good early progress has been made in implementing the Property Investment Strategy to date.

4.2 The officer team has been working closely with the council's property investment adviser, Cushman & Wakefield, in sourcing new investment acquisitions and bringing forward proposals for re-gearing existing ground leases where there are opportunities for improving rental income, security of the council's income, capital receipts for re-investing and facilitating redevelopment of brown-field sites.

4.3 To the end of December 2018 implementation of the strategy has resulted in four new investments being acquired at a cost of £16 million including stamp duty land tax and fees, from the £30 million treasury funds allocation. This will produce an ongoing annual rental income of £1,129,700 per annum for the council, reflecting an initial yield of 7.0%, see appendix for table of new acquisitions. Having regard to the interest that would have been earned through Treasury Management investments, the net increase in council income is in excess of £896,500 per annum through acquisition of these new investments.

4.4 Negotiations are on-going for further acquisitions and for lease re-gearings which are expected to further increase income and/or provide a capital receipt for re-investment in further investments. A number of the proposed re-gearing transactions will also facilitate re-development of existing sites to provide new buildings which will assist expansion and job creation by existing companies and encourage inward investment into the borough. The more complex transactions are expected to take a number of months before completion of legal agreements but are expected to contribute to the income target before the end of the 2020/21 period.

4.5 Completed acquisitions have accounted for approximately £16 million of the original Treasury Management funds allocated for new investments, and transactions currently being negotiated/agreed are expected to commit a further £8.9 million. If fully committed this will leave a balance for further acquisitions of approximately £5.1 million, before taking account of any future receipts from future re-gearings or sales.

4.6 Pro-active management of the existing property portfolio has continued during 2018/19 and we are forecasting additional rental income of £375,000 above budget. Examples of improved income relate to agreed and projected rent reviews at Down Grange House, Winchester Road (Miller & Carter Steakhouse) and Site 24, Daneshill East.

4.7 In 2018 Deloitte produced 2 high level reports on the objectives, benefits and risks to investing in residential property.

4.8 Furthermore the approved Property Investment Strategy includes considering opportunities for the council to invest in the residential sector and work will continue to identify the availability of residential investments in the Borough with a view to direct investment. Such acquisitions would be funded from the Property Investment Strategy remaining allocation. A target yield of 4% was set for such residential investments.

4.9 In the wider context of residential investments, Members will be aware that the proposals for development at Manydown include the council's direct participation/funding in the delivery of new housing for the borough.

4.10 For 2019 officers will be bringing forward a new preliminary Housing Investment Strategy which reviews options, opportunities and risks of the council meeting its housing objectives for residents through further significant intervention in the housing sector including potential assistance to house buyers.

4.11 Fortnightly progress meetings are held with the council's investment adviser and structured monthly meetings of the Property Investment Panel are held to consider and agree appropriate acquisition and lease re-gearing transactions.

4.12 Overall, the results of activities undertaken during 2018 indicate the strategy is on course to deliver the £1.7 million target for additional net income.

5 Annual Property Plan 2019/20

5.1 The proposed Annual Property Plan 2019/20 seeks to build on the achievements in 2018/19 and proposes implementation of the agreed Property Investment Strategy through the following:

5.1.1 Acquisition of investment properties

- £5.1m remains to be invested out of the £30m investment allocation. However in the event that a new investment is identified that meets the criteria for the Property Investment Strategy, but costs up to £10 million including fees (the maximum limit under the strategy), it is recommended that Council agrees that the investment allocation can be increased by up to £5 million funded from property receipts expected to be generated from disposals and lease re-gearings.

- Sourcing and acquisition of further new investment opportunities to increase portfolio income.
- Review of the Acquisition Matrix with the council's investment advisers in the light of the recently completed investment acquisitions to ensure its ongoing effectiveness.
- Continued use of the Acquisition Matrix to assess the 'portfolio fit' and financial, property & leasing characteristics of new investments.
- Use of the remaining balance of the £30 million of treasury management funds for new acquisitions, with re-investment of capital receipts from lease re-gearings and sales arising.
- Consideration of the opportunities and benefits of allocating further funds to support the property investment portfolio.
- It is worth noting the effect of Brexit has created uncertainty with considerably less available opportunities to purchase in the marketplace.
- Many local authorities have increased debt levels significantly over the past 2 years to finance a range of commercial property investment purchases. Many shopping centres have been acquired by local authorities to facilitate regeneration and mitigate the declining fortunes of the high street in their towns.
- The increased activity by other councils has resulted in a shortage of suitable good quality investment opportunities.
- Unlike other councils, the Property Investment Strategy is not funded by borrowing and therefore this council does not have to account for loan repayments or interest costs.

5.1.2 **Enhanced asset management**

- Producing Asset Plans for individual assets to inform investment decisions.
- Focus on opportunities & options to improve individual asset performance.
- Pro-active targeting of lease re-gearing opportunities, including supporting the council's Invest to Grow Fund and Basing View initiatives. Monitoring tenant compliance with lease obligations.
- On-going reviews of tenant covenant strength, particularly for new tenants.
- The volume of ground lease re-gears negotiations is high and expectations are that this workload will increase significantly.
- It is worth noting that these ground lease restructures can take a long time to negotiate.

5.1.3 **Income management**

- Pro-active focus on managing forthcoming lease events to maximise income security.
- Focus on measures to re-let vacant accommodation and minimise void costs.
- Ensuring arrears of rent & other payments are kept to a minimum.

5.1.4 Investment sales

- Assessment of core and non-core investments.
- Disposal of under-performing or non-core investments, unless retention is required to support other council initiatives.

5.1.5 Creation of a balanced investment portfolio

- Focus on achieving a balance between leasing types, sector types, lease lengths, asset income & value, yield, location and quality of assets.
- Review of preferred levels and basis of ground lease income gearing.
- Establishing a more efficient & less management intensive portfolio.

5.1.6 Residential investment

- Assessment of options for appropriate investment in the residential sector.
- Bringing forward recommendations for the council's consideration.

5.1.7 Governance and reporting

The following governance and reporting procedures are in place:

- Cabinet approval of an annual property plan.
- Half-year report to Cabinet on investment strategy progress.
- Monitoring and scrutiny of the strategy implementation by the Audit and Accounts Committee via quarterly reporting.
- Bringing forward recommendations for approval of governance arrangements for the sale of existing investments which no longer meet retention criteria, within investment strategy parameters and the annual plan.
- The government is now recommending that benchmarking is undertaken for commercial investments against other councils and other types of investment. The council does currently carry out benchmarking for these specific investments however, officers in the property management department have plans to carry out this type of benchmarking once all the investments under the Property Investment Strategy are in place.
- The governance arrangements for these investments are that the council has a specific strategy that was approved by Council and it has an asset management plan. The strategy sets out criteria and limits on this type of investment and officers are required to operate within these criteria and limits. Decisions on commercial investments are made by the Asset Manager – Investment Portfolio, after consultation and approval of Executive Director of Finance and the Portfolio Holder for Property, within limits and criteria approved in the strategy. Property and most other commercial investments are also capital expenditure and therefore will also be approved as part of the capital programme. Quarterly monitoring reports on property investment activity under the strategy are presented to the Audit and Accounts Committee and half year to Cabinet.

6. Legal implications

6.1 Section 120 of the Local Government Act 1972 gives councils the power to acquire property by agreement for the purpose of any of its functions or for the benefit, improvement or development of the area.

6.2 Section 1 of the Localism Act 2011, known as the general power of competence, enables a local authority to do anything that an individual generally may do (subject to prohibitions, restrictions, and limitations in existing statute which are not applicable in the circumstances set out in the report). Further, that power enables the authority to do it anywhere in the United Kingdom or elsewhere, for a commercial purpose or otherwise for a charge, or without charge, and to do it for, or otherwise than for, the benefit of the authority, its area or persons resident or present in its area.

6.3 The council also has the power to invest for the purpose of the prudent management of its financial affairs under section 12 of the Local Government Act 2003.

6.4 The agreed investment strategy provides for new investment acquisitions outside the borough if the supply or quality of investments is not available within the borough. The Localism Act 2011 provides the council with the statutory power to acquire property investments outside the borough in accordance with the property investment strategy.

6.5 The Governance Structure established under the investment strategy will continue with reporting to Audit & Accounts Committee and to Cabinet as set out therein.

7 Financial implications

7.1 The Property Investment Strategy is a key strand in achieving additional income targets and the objective of the strategy recommended in this report is to generate additional annual income of £1.7 million by 2021/22. This additional income will be generated from improved asset management of the existing portfolio and the investment of £30 million switched from treasury management.

7.2 In addition to financing new acquisitions from immediately available capital receipts, the agreed strategy provides that other funding could in future be available from sales of under-performing assets or from premium payments received as a result of lease re-gearings. In accordance with this strategy it is recommended that the investment funds available for the Property Investment Strategy should be increased by up to £5 million funded from property receipts, if an appropriate new investment is identified that meets the criteria of the Property Investment Strategy. The current budget of £30 million is not expected to be fully invested until 2020/21 when the new Eli Lilly Office should be completed.

7.3 The implementation the property strategy will require additional internal resources plus external advice and support. The normal level of external fees that would typically be expected will vary according to the value of the acquisition or re-gearing, but as a guide is approximately 0.7% – 1.00% of the purchase price for acquisitions, and up to approximately 5% of the resultant annual rental for lease re-gearings. Stamp duty costs and due diligence costs arising, particularly for new acquisitions, will be included in the overall costs of the transaction. Additional on-going funding of £300,000 for staffing costs and external fees to adequately deliver the appropriate level of service was added into the on-going budget in 2018/19.

7.5 The first four investments acquired under the Property Investment Strategy during 2017/18 cost £16 million including stamp duty land tax and fees and will produce ongoing rental income of £1,129,700 per annum. After allowing for rent increases and costs that will be incurred over the life of the asset e.g. additional management costs, maintenance and refurbishments and an allowance for void costs, the overall internal rate of return is forecast to be 8.3%. After taking account of the lost interest from treasury management of approximately 1.5% or £233,200 the net additional income is £896,500 per annum in a full year. If a similar return can be achieved on the balance of the £30 million, the strategy is on course to deliver the £1.7 million target.

7.6 In addition to the four transactions referred to above, the council has also conditionally agreed one further transaction, a scheme for a new office building on Basing View to be let to Eli Lilly. Subject to final agreement of the terms of this scheme and the necessary due diligence, this would potentially commit a further £8.9 million of the property investment strategy funds in 2020/21 when the building is expected to be completed.

7.7 It is likely that some due diligence costs could be abortive and not chargeable against an investment and these will be funded from the budget for property fees or from additional property income.

8 Risk management

8.1 A risk assessment has been carried out in accordance with the council's risk management policy and was included in the Property Investment Strategy.

8.2 Property is a riskier asset class than some investments due to its physical characteristics which makes the asset less liquid. Rent income is also at potential risk following tenant vacancies. Consistent with all investment types (cash, shares, bonds, etc.) the expected return on investment increases with the level of inherent risk. In the context of property markets rental and capital values can also fluctuate upwards or downwards over time according to the market and wider economic circumstances. Due to these risks property is a long term investment and only suitable for strategic investment funds with an expected duration of 5 to 10 years or more.

8.3 The main risks are reputational concerning the failure to progress transactions, financial relating to fluctuations in property capital & rental values due to market or wider economic circumstances, financial failure of tenants, a lack of suitable investments for acquisition and property vacancies following lease expiry.

8.4 These risks will be managed at portfolio and asset levels through focussed asset management and can be further moderated by ensuring a balanced portfolio.

9 Equalities implications

9.1 An Equalities Assessment was been carried out as part of the proposals for the Property Investment Strategy to consider the impact of the proposed strategy on the protected characteristics groups, and the implications for the public sector equality duty (Equality Act 2010).

9.2 This concluded that the strategy has no differential impacts on any groups. The strategy aims to ensure a stable and growing long term source of rental income from the investment portfolio to support the council's financial needs and provision of services to businesses and residents across the borough. Properties forming part of the investment portfolio and for which the council has direct responsibility will be assessed to ensure that relevant accessibility legislation is met. This conclusion holds good for the 2019/20 Annual Property Plan.

10 Consultation and communication

10.1 The proposed annual property plan 2019/20 was considered by the Audit and Accounts Committee at its meeting on 8 January 2019. The report was noted with no changes proposed.

10.2 Communication of the agreed Property Investment Strategy has previously been undertaken to local and national commercial property agents, and other key stakeholders, in conjunction with the council's current property investment adviser Cushman & Wakefield.

10.3 Targeted communication of the strategy to key stakeholders will continue alongside appropriate press releases to raise awareness of the council's proactive investment strategy, particularly to commercial property agents and the property sector generally.

10.4 The close working alongside officers and the Fund Manager in respect of the council's Invest to Grow Fund will continue.

11 HR implications

11.1 The initial implementation of the Property Investment Strategy has given rise to the need for additional resourcing of the property services team.

11.2 The need for changes to resourcing arrangements, whether internally and/or through external advisers, will need to be kept under review and managed promptly in order that the implementation of the Annual Property Plan is not adversely affected.

12. Conclusion - Summary and reasons for the decision

12.1 Following approval of the Property Investment Strategy in February 2017 the subsequent approval of the 2019/20 annual Property Plan is recommended, as set out in this report.

12.2 Implementation of the Plan will build on the work commenced in 2017/18 to increase the council's rental income and to work towards ensuring a more balanced & efficient property investment portfolio, providing a stable long term source of income which will contribute to the generation of additional income to meet the council's Medium Term Financial Strategy.

13 The options considered and rejected

13.1 The alternative options considered are to either discontinue or to amend the Property Investment Strategy approved in February 2017.

13.2 Implementation of the approved strategy is in its early stages with some good initial progress made. The strategy's objectives and principles remain appropriate and accordingly the alternative options have been rejected.

Date: 5 February 2019 **Decision to be taken by: Cabinet**

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Version	**Final**
Dated	**6 December 2018**
Status	**Open**
Confidentiality	**It is considered that information contained within this report (and appendices) do not contain exempt information under the meaning of Schedule 12A of the Local Government Act 1972, as amended, and therefore can be made public.**

Appendix – New Acquisitions of Investment Property

	Purchase Price	Acquisition costs (Stamp Duty and other fees	Remedial Works	Total Cost	Additional rental income	NIY	IRR	Valuation at 31/3/18	See notes
1-4 Armstrong Road	£4,200,000	£254,175	£100,000	£4,554,175	£435,580	9.6%	9.4%	£11,650,000	*
1&2 Stroudley Road	£4,685,000	£308,000	£0	£4,993,000	£299,813	6.0%	7.9%	£6,650,000	**
Units 1&2 Winchester Road	£5,615,000	£329,000	£75,000	£6,019,000	£315,300	5.2%	7.8%	£5,658,000	
Ringway House, Bell Road, Daneshill	£450,000	£20,070	£0	£470,070	£79,000	16.8%	13.5%	n/a	
Total	£14,950,000	£911,245	£175,000	£16,036,245	£1,129,693	7.0%	8.3%	£23,958,000	

Notes:

* Freehold asset previously estimated in balance sheet in March 2017 at £3.25m. The head lease was purchased for £4.2m plus costs. Subsequent gain of £3.845m, net of costs is attributable mainly to marriage value and part yield compression.

** Freehold asset previously estimated in balance sheet in March 2017 at £800k. The head lease was purchased at £4.685m plus costs. Subsequent gain of £857k, net of costs is attributable mainly to marriage value and part yield compression.

Schedule completed 21 Dec 2018

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