Rother District Council **Agenda Item: 8.1**

Report to	-	Cabinet
Date	-	14 May 2018
Report of the	-	Executive Director
Subject	-	Property Investment and other investments

Recommendation to COUNCIL: That the revised Property Investment Strategy set out at Appendix B be approved and provision for £100,000 be made in the Revenue Budget to be met from the Medium Term Financial Strategy Reserve, to meet the costs of specialist advice as set out in the report.

Lead Cabinet Member: Councillor Lord Ampthill

Introduction

1. At the full Council meeting on 26 February 2018 a briefing paper was circulated in support of the draft Revenue Budget proposals. This note set out the latest position with regard to property investments and highlighted that a revised Property Investment Strategy (PIS) and revised terms of reference for the associated Panel would be required as a result of regulatory changes. A copy of the briefing is shown at Appendix A.

Revised Property Investment Strategy

2. The current PIS was drafted before the Government and CIPFA published changes to the statutory guidance and Prudential Code and to respond to these changes, it has been necessary to reconsider the PIS. The changes bring a loss of flexibility in where investment can be made which could be seen as unhelpful in achieving the best returns, but it is however considered positive, in the sense that the Council's regeneration ambitions for the Rother area are now at the forefront of the PIS.

3. A revised draft Strategy is shown at Appendix B and is now focused on supporting and safeguarding the economy of the Rother area through the long term protection of existing and the creation of new employment space. For the plan to be sustainable the property investments must make a net positive return for the Council. For new developments this may not occur in the early period but must by the medium term make a positive return. The Council will however need to manage the effects of any negative cash flow in the short term through the use of cash reserves.

4. Reported elsewhere on this agenda is a proposal to establish companies wholly owned by the Council. The PIS indicates that property investment may take place beyond the Rother border if it can be demonstrated that it will economically benefit this area. This could be sole investment by the Council but also it seems sensible to have the option to go into partnership investments with neighbouring councils. It should be noted that no such plans

exist at present. To invest beyond the Council border is likely to require the use of a wholly owned company in order to comply with legislation, in particular the Localism Act 2011.

Resources

5. Management of the portfolio will be delivered from existing resources within the Council's Estates team, supplemented by specialist external advice as needed. However, a specific budget provision will be necessary as part of delivering the PIS to acquire specialist advice. It is suggested that an initial budget provision of £100,000 be made available to meet these external costs funded from the Medium Term Financial Strategy Reserve. This approach will be reviewed regularly by the Property Investment Panel, including on-going resource requirements, as the portfolio grows.

Risk Management and Governance

6. Members will recall that to manage the acquisition process, a Panel of Members and Officers was established. At the time of writing it has not been necessary to call a meeting of the Panel. However training is being organised for the Panel and they will be supported with specialist valuation and financial advice. Members should be aware that ultimately the Council's Chief Financial Officer has right of veto over any investment where they consider the appraisal does not show the long term soundness of the investment.

Dr Anthony Leonard
Executive Director

Risk Assessment Statement
If we do not have an approved PIS then there will be no steer for the Panel and they may take decisions in conflict with full Council's thinking.

Briefing for Full Council – Property Investments

Introduction

1. The Medium Term Financial Strategy and the Efficiency and Sustainability Plan identify that increasing income is one way the Council can protect front line services from the impact of government funding reductions. The ambition is to deliver an extra £1m per annum by 2020. Whilst increasing income from existing services the Council charges for is possible, it would not generate the size of extra income needed. The Council is also working to reduce operating costs and a further target of £800,000 of savings has been set over the next five years. It is considered unlikely that further efficiency savings can be delivered beyond this amount over the next three years. If income generation is not pursued then it would be for Members to decide which discretionary services should be deleted and/or which services should be reduced in scope.

2. In December 2017, Cabinet supported the establishment of a property investment strategy (Appendix A), supported by a Panel of Members and officers to receive proposals for and agree property investments. The initial proposal was to use £7m of earmarked reserves to acquire property recognising that to invest beyond that sum would require the Council to enter into borrowing. The £7m investment was expected to deliver somewhere in the region of £350,000 of income annually. The aim of the Property Investment Strategy (PIS) is to deliver the majority of the additional £1m of income required.

Markets in Financial Instruments Directive

3. However since the December report, the treasury management landscape for Councils has changed. From January 2018 changes have been introduced under the Markets in Financial Instruments Directive (MIFID II). The new investment rules mean the Council needs to maintain a minimum of £10m cash invested in treasury related investments (e.g. bank deposits, government bonds/ commercial bonds, property funds) to remain a professional client. Taking account of the funding demands of the Capital Programme over the next three years, the Council can no longer use £7m of cash funds for direct purchases of property as had been planned if it is to maintain treasury investments at the £10m minimum amount.

4. If the Council were to lose its professional client status it would be treated as a retail customer. As such most of the current types of treasury investment made by the Council would no longer be accessible. Existing investments would also have to be terminated early with the likelihood of financial losses. For 2018/19 treasury investment activities are expected to generate £362,000 of income. As a retail customer treasury investment returns would fall considerably, and the lost income would have to be replaced by additional savings.

Borrowing

5. If the Council can no longer utilise its cash to acquire property then it will be necessary to enter into borrowing to fund direct property investments. Currently the Council already retains investment properties (such as Elva

Way) which meet two policy objectives, the main one being helping economic regeneration. They also make a positive financial return which avoids having to divert funds away from the delivery of other Council services. Experience shows that the return equates to an average of 6% per annum (6.23% in 2016/17) net from the Council's existing £10.447m of investment properties.

6. Using 6% as the benchmark return, the Council can borrow at approximately 2% interest rates and repayment of the debt equates to approximately 2% per annum. So if a return of 6% is achieved, there is scope to make a 2% net return.

7. It is on this basis that borrowing of up to £35 million is proposed which is expected to generate in the order of £700,000 per annum to help offset the reduction in government funding. Members will see that the Capital Programme has spread this investment over three years so that the investments can be better managed and if necessary stopped.

8. It is not permitted to borrow to invest in treasury activities in order to make a surplus on the margin. Borrowing has to be used to fund legitimate capital expenditure.

Where can the Council Invest

9. Members will be aware that the value of recent property investment by local authorities to generate income has been significant with figures in excess of £2bn being quoted. The majority of this investment has been funded by way of loan from the PWLB. The current cheap cost of borrowing has meant that Councils can make a margin on the rent income versus the cost of borrowing. The Government are however concerned that in addition to the sheer scale of investment, Councils are investing outside their geographic boundaries and are not making provision for the repayment of the debt. Consequently the MHCLG and CIPFA have issued new statutory guidance on Local Government Investments and updated the Prudential Code to curtail this activity.

10. To react to these changes it will be necessary to reconsider the PIS. In particular it will be necessary to focus on the Council's role in supporting and safeguarding the economy of the Rother area through the protection of existing and the creation of new commercial property and employment. For the plan to be sustainable the property investments must however make a net positive return for the Council.

11. The current PIS was drafted before the government and CIPFA changes to the statutory guidance and Prudential Code. Whilst the loss of flexibility in where investment can be made could be seen as unhelpful in achieving the best returns, it is positive in the sense that the Council's regeneration ambitions for Rother can now be at the forefront of the PIS. Therefore it will be necessary to redraft the approved strategy to ensure the Council is compliant.

Risk Management and Governance

12. Since going debt free in 2003, the Council has maintained a very cautious treasury strategy and has been able to rely on cash reserves and capital receipts to fund capital expenditure. However, the impact of austerity means

that Members and officers can no longer be as risk adverse if it is to improve the long term financial sustainability of the Council. This does not however mean the Council will be making risky investments. Security of Council funds will remain the highest priority and the investments made will be subject to detailed scrutiny by the Property Investment Panel. Regeneration and property investment is a long term strategy. The property market fluctuates over time and values will rise and fall. However history shows that over the long term taking the annual income flows and the change in capital value, there is a high probability of a positive financial return.

13. The Panel will need to have relevant training and will be supported with specialist valuation and financial advice. Ultimately the Council's Chief Financial Officer has right of veto over any investment where they consider the appraisal does not show the long term soundness of the investment.

Conclusion

14. The Peer review concluded that to deliver the ambition of the financial plans, the Council would need to increase its risk appetite. As stated above this does not mean taking risky decisions, more that the Council needed to actively manage its financial risks it was exposed to rather than avoiding them completely. The financial forecast shows that doing nothing is not an option and without increasing income there will have to service cuts. Members should be assured that there are robust governance arrangements in place to ensure the investment decisions made are prudent and any risks are transparent.

Robin Vennard
Service Manager Finance and Welfare – 21 February 2018

PROPERTY INVESTMENT STRATEGY

April 2018

Objective of the Strategy

1. The Council is committed to supporting and safeguarding the economy of the Rother area through the long term protection of existing and the creation of new employment space. This objective will in part be achieved through the investment in land and property in the Rother economic area. For this strategy to be sustainable the investments must make a net positive return for the Council. For new developments this may not occur in the early period but must by the medium term be making a positive return. The Council will review this strategy as the portfolio develops and as the Council's business needs evolve.

What will the Council invest in –

2. The Council will seek to maintain a diversified and balanced portfolio of property assets, having regard to the considerations set out below. The general principle is that properties will be acquired in order to protect their current or desired use and generate a stable revenue income for the Council.

3. Established property investment practice has evolved based on long standing markets for assets in mainstream sectors such as offices, retail, industrial and residential. Investing in these traditional asset categories in a balanced fashion, allows for a lower risk investment when compared to emerging markets such as Student Accommodation, Nursing Homes and Medical Centres.

4. The Council will focus on acquiring properties which contribute to local economic or social benefit, provided they meet the minimum yield requirement.

5. Where properties include residential accommodation either rented or on long leasehold (likely especially in town centre locations), the Council will seek to make alternative holding and management arrangements outside of the Council.

6. The Council will consider opportunities within the Rother District; or within its immediate environs where a case can be made on the basis of local benefit.

7. Freehold tenure is preferred to leasehold. Freehold provides for greater levels of security than a leasehold asset that would effectively decrease in value over time. However the Council may also buy back ground leases on assets where the Council is already the freeholder, in order to gain control over future development and benefit from increased rental income.

8. Properties should preferably be let to a single tenant on a full repairing lease, in order to minimise management input. Properties with more than one tenant may be considered however if the management requirements are considered to be acceptable. Whilst properties let to only one tenant may present a level

of risk of a void in the event of tenant failure or at the end of the lease, detailed financial due diligence would be undertaken to ascertain their financial stability.

9. The Council will balance investments that are already producing an income, with existing tenants in place, with properties with vacant accommodation or development sites where the return on investment is expected in the medium term particularly where there are strategic reasons for doing so. The interim funding implications will be considered as part of the business case for investment.

Size of Investment Lots and investment criteria

10. Due to the nature of the local property market the Council will be flexible on lot size and consider investment opportunities on their individual merit; however the ideal suggested lot size is between £1m and £10m. This will be flexible if there is an overriding strategic reason to acquire a property.

11. Opportunities may be sought that lend themselves to a potential to increase rental income than is currently being realised.

12. The following specific criteria will be applied:

- Minimum Income Yield of 5% gross of borrowing costs, based on an average over 10 years.
- Individual Properties or Portfolios.
- Flexible lot size but £1m – £10m preferred.
- Freehold preferred.
- Single tenanted preferred, or multi tenanted where management input required is at an acceptable level.
- Asset categories: likely to focus on Industrial, Office, Retail, Leisure, Trade Counter; but others may be considered.
- Geographically located within Rother District, or immediately nearby where a case can be made on the basis of local benefit.

Land and Property Disposals

13. The Council's land and property holdings will be reviewed regularly to assess their contribution to the objectives of this strategy and where there is a shortfall may consider disposal. In addition where there is significant capital appreciation of an asset, disposal may be considered where the capital receipt enables reinvestment in the Rother area.

Funding the Investments

14. Funding for the acquisition of assets will be reviewed on a case-by-case basis from a number of sources:

- Receipts from previous property disposals.
- Receipts from proposed land / property disposals in future years.
- Reallocation of some of the funds currently held in reserves.
- Borrowing from external lenders – Bank Real Estate Finance, Annuity Funds, Pension Funds.

- Borrowing from the Public Works Loan Board.
- Municipal Bonds Agency.

15. An initial budget of £35m to cover the three financial years 2018/19 to 2020/21 funded through borrowing has been approved to fund investment acquisitions, to be drawn down as and when required.

Expert Support and Guidance

16. External specialist property investment advisors will be retained as necessary on each transaction, advising on suitability having undertaken detailed pre purchase due diligence, including valuation, risk analysis and lease / title reviews.

Managing Risk

17. The risks of each potential investment will be considered by carrying out due diligence to include the following:

    - Valuation.
    - Market Conditions.
    - Covenant strength of tenants.
    - Terms of leases.
    - Structural surveys.
    - Funding options.
    - Future costs.

18. The subsequent management of the portfolio will be delivered from existing resources within the Council's Estates team, supplemented by specialist external advice as needed. A specific budget provision will be made available to meet these costs. This approach will be reviewed regularly by the Property Investment Panel, including on-going resource requirements, as the portfolio grows.

Monitoring the Strategy

19. Performance of the investment portfolio will be measured against a number of targets to be agreed annually by the Property Investment Panel. These will include both financial and non-financial measures. It will also be necessary to forecast performance of current assets to identify any which may fall below the income return target.