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Report of the Director of Corporate Services to the meeting of Overview & Scrutiny Committee to be held on 26th April 2017.

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Subject: Property Investment Strategy

Summary statement: The purpose of this report is to outline the Council's proposed Investment Strategy and objectives for acquiring property assets for investment purposes.

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Portfolio: Leader of Council and Corporate

Overview &Scrutiny Area: Corporate

1. PURPOSE OF THIS DOCUMENT

1.1 The purpose of this report is to set out the Council's proposed Property Investment Strategy, its objectives and benefits for acquiring and creating strategic property assets for investment and regeneration purposes, to support the Council's financial pressures.

2. INTRODUCTION

2.1 It is proposed in this report that the Council takes a pro-active approach and invests further in commercial property. The Council currently holds a property investment portfolio valued at around £45 million, which generates a net income of £2.8 million per annum. The proposed investment could either be to support 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 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.

2.3 It is recognised that further work may be required to complete the strategy and further approvals will be sought to the overall "direction of travel" in connection with this proposal.

2.4 The focus of this report is for investment in commercial property (offices, car parks, industrial, retail, etc.) as a manageable piece of work.

3. BACKGROUND

3.1 Bradford Council has for a number of years taken an enhanced strategic approach to the management and operation of property assets following the mobilisation of the Property Programme in 2009. To date this has concentrated mainly on the operational estate.

3.2 The Council already owns a substantial investment portfolio, currently valued at around £45 million, generating an income stream of circa £2.8 million. The portfolio includes properties such as the Airedale Shopping Centre in Keighley (managed by a head tenant), the Asda supermarket in Shipley, and also a number of smaller individual management intensive properties.

3.3 The Property Investment Strategy forms part of the overall strategic management of the Council's estate and concentrates specifically on the investment portfolio and property investment decisions.

The strategy relates to the acquisition of existing investments and creation of new developments for not only investment purposes but also to aid regeneration.

Adopting a Property Investment Strategy is a long term approach to help mitigate the gap in funding caused by the continuing reductions in Council budgets, to support Council revenues. Many other local authorities have recently adopted this approach, taking advantage of favourable borrowing interest rates from the government. 'Prudential Borrowing' interest rates or long term annuities from the government currently run between sub 1% and 2.45%, and with property investment yields generally ranging between 4.5% - 8%, there is therefore a margin which the local authority may benefit from.

3.4 The Strategy will provide additional revenue, the need for which is more prevalent than ever as the phasing out of Government grants over coming years is applied. In addition to the additional revenue generated, the assets will also increase in capital value in the medium to long term and be capable of re-sale in the future.

3.3 Investment in Property

3.3.1 It is beneficial for a local authority to hold strategic investments as in the long term it will not only provide the Council with a positive revenue stream, and capital growth but allow the local authority to influence the future growth and development of the city or district. When assessing the potential benefits of a property acquisition, the authority needs to act like a pension fund/life insurance company, who seek long term safe investment propositions providing both rental and capital growth.

3.3.2 Consideration needs to be given to an investment's location, type of property, security and strength of covenant and yield, ie return on capital invested, and also by way of appreciation of its underlying potential for capital growth. Further detail on this is provided later within the report. Investment in property is normally a medium to long term investment. It is therefore important that any capital invested will not be required in the short or medium term.

3.3.3 In a low interest rate economy, there is a substantial benefit for a local authority to invest in property due to the yield differential, as highlighted earlier, it is possible to use the 'Prudential Borrowing' facility from the government with borrowing rates at sub 1% or borrow by way of an annuity which could be over a term of say 40 years at a fixed interest rate of 2.45%. Therefore if the investment acquired is yielding a return in excess of 5%, the local authority benefits over the length of the lease by the differential between borrowing costs and rental income, and at the end of the borrowing period the council retains 100% of the revenue and from then on has an asset to retain/sell/redevelop.

3.3.4 Investment in property and generating surplus revenues is one of the key financial outcomes to contribute to supporting the Council's finances over the next four years and the target approved at full Council in February 2017, is to deliver a net additional revenue stream of £250k over the next two financial years from investing in property, and it is envisaged this will grow further in succeeding years. It is envisaged that acquisitions will be from retail, industrial and commercial sectors.

3.4 Key considerations when acquiring property as an investment

The key components when the authority is considering acquiring an investment, is location, type/sector of property, security of income stream ie quality/strength of tenant covenant, yield (return on capital) and management of the property. These are looked at in detail below:

3.4.1 **Location –** location of the property is critical to ensure it is an attractive position, so that in the long term it optimises its ability to re-let/re-sell if capital is required, or is strategically located for re-development. The location of the property will ideally enable the Council to be able to undertake inspections and to deal with any management issues without the need to employ specialist agents.

3.4.2 **Covenant Strength** - the quality of the tenant and, more importantly, their ability to pay the rent on time and in full is essential. This is particularly important where the Council has borrowed against the investment, and minimum acceptable financial strength for any given tenant will be determined through a financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring.

It is however worth noting that the Council, as a public body, may not wish to invest in properties where the occupiers are generally seen to be undertaking business which is contrary to its corporate values.

3.4.3 **Lease length** - the unexpired length of the term of the lease is of key importance in ensuring that the landlord's revenue stream is secure and uninterrupted. The Council will take into consideration the risks associated with a tenant vacating and the potential to attract good quality replacements tenants at acceptable rental levels.

3.4.4 **Yield/Rate of return –** is the net rate of return from the property (e.g. through the annual rental income) Prudential Borrowing or acquiring annuities are currently at exceptionally low levels, however, if the cost of borrowing can be fixed over the length of the lease or longer, at substantially less than the property yield, it will generate over the length of the lease an annual revenue surplus to the authority. It is prudent to adopt a theoretical borrowing rate of 4.5%, to ensure that there is sufficient margin between cost of borrowing and income should interest rates rise in the future, and this can be reviewed on an ad hoc basis or special circumstances by way of a further report to Executive in the future. Please note the net yield is the return on capital having taken account of the full cost of acquisition, ie Stamp Duty, legal fees, external valuations and structural surveys.

Different types of investment will provide different levels of return, income and capital. Historic data shows that a 6% income return from property is achievable over the longer term and through a full economic cycle. The Council's current investment estate is attaining an average gross return of 7.8%.

Various factors will affect the level of income return a property investment strategy will deliver over time including;

- the general economic environment (driving rent growth or reductions)
- interest rates (low rates drive prices up and property yields down)
- investment demand (high liquidity drives prices up and property yields down)

3.4.5 **Risk** - return is one side of the coin; risk is the other. In general, the higher the sought level of return from an investment, the higher level of risk that it carries. The intention throughout this policy is to minimise the risk to the Council on any acquisition.

3.4.6 **Cost of management** – The Council currently has an in-house Estates team, which manages the investment estate, and it is proposed that they would manage any additional investments within the existing estates budget. Most modern leases are based upon Full Repairing and Insuring terms (FRI) ie where the tenant is responsible for maintaining the structure and fabric of the building and also insuring the building, so that the estates team role is solely to collect the rental, normally quarterly in advance, ensure that the tenant complies with the lease covenants, including keeping the building in a good state of repair and deal with any rent reviews at the appropriate time.

3.4.7 **Growth** – property investments have the potential for both revenue and capital growth. The Council will take into account that potential when assessing the strength of the investment opportunity. Property values can fall as well as rise and mechanisms to minimise revenue reductions should be identified. Monitoring and review of the portfolio and any anticipated trends, will actively manage and change composition over time. In respect of rental growth – most modern leases are for between 15 and 25 years in length and subject to regular upward only rent reviews and the normal rent review pattern is either reviewed on an every 3 or 5 year cycle, and it is envisaged that the Estates team will undertake the rent reviews.

With the Bank of England interest rates at such historically low levels, even with forecast increases to above 2% per annum, current returns from property investments provides a significant ‘buffer’ for any further increase and means that ultimately any return achieved above 2% will make a positive contribution.

3.4.8 **Sector** - information as to the sector of use of the property (e.g. office, retail, retail warehousing, industrial, and leisure) will assist in deciding on the risks associated with specific properties and the mix of sectors within the portfolio. As the portfolio grows it is healthy to have a spread across the sectors.

3.5 In summary, this proposed strategy for the Council acquiring property investment assets is to:

3.5.1 Acquire properties that provide long term safe revenue streams in accordance with corporate objectives
3.5.2 Maximise rental income and minimise management costs to ensure the best net return is generated whilst minimising risk to the Council.
3.5.3 Promote collaborative working with adjoining owners and Developers to maximise value.
3.5.4 To consider creating investments on council owned land.
3.5.4 Prioritise properties that yield optimal rental growth and stable income

4. THE CURRENT SITUATION

4.1 The Council's existing property assets, termed as the investment estate and considered to be "commercial property investments" are summarised below:

Use	Count	Count %	Income £	Income %	Yield %
Office	23	3.8%	158,633	5.6%	8.4
Industrial	60	10.0%	348,253	12.4%	7.8
Retail	88	14.6%	1,443,573	51.3%	8.3
Commercial Land	32	5.3%	148,287	5.3%	7.3
Agriculture	145	24.0%	174,912	6.2%	4.1
Leisure	60	10.0%	167,120	5.9%	8.0
Car Park	54	9.0%	125,590	4.5%	9.2
*Other	141	23.4%	248,084	8.8%	9.3
	603	**100.0%**	**2,814,452**	**100.0%**	

*Nurseries, Quarries etc.

It should be noted that these have been built up over many years. The agricultural estate in particular dates back to early 1900's.

4.2 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.

4.3 The Council needs to be in a position to assess investment opportunities in a systematic manner with the ability to respond quickly when a compelling opportunity arises to take advantage, particularly as commercial property investment opportunities often arise unexpectedly.

5. FINANCIAL & RESOURCE APPRAISAL

5.1 It is proposed that the Council 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.

The initial proposal is that a target for investment return would need to generate a net surplus over the next two years in the region of £250k.

5.2 The experience of other local authorities indicates an average yield on commercial property investments of between 5% - 7%.

5.3 As a result of such expenditure being classified as capital and the authority's cash surplus' being utilised to effectively finance the transaction, there will be an increase in the authority's Capital Financing Requirement (CFR) in the year(s) in which the transactions are incurred – and this will be managed through the annual Treasury Management Strategy updates to the Finance & Audit Committee.

5.4 All expenses directly attributable to any purchase, will be in accordance with accounting regulations, charged to the investment fund as part of the cost of acquisition, and will therefore be taken into account as part of the overall evaluation of the property acquisition.

5.5 Investment properties purchased through this strategy will need to be re-valued on a regular basis in accordance with the Code of Practice on Local Authority Accounting.

6.0 Other considerations

6.1 Decision making process – there maybe a need for the Council to be able to respond quickly in the event of a suitable property coming to market.

6.2 When an investment opportunity is identified, the Assistant Director, Estates and Property will carry out the due diligence for a potential acquisition in consultation with the Strategic Director, Corporate and the City Solicitor, and will submit a report to the Project Appraisal Group (PAG) for consideration.

As such, an allowance will be made in the annual Council budget to allow for property investment acquisitions to be made, and it is proposed that any decision on acquisition is delegated to the Strategic Director of Corporate Services following consultation with the Leader and Portfolio Holder providing the investment meets the criteria within this report, and is supported as an acquisition by PAG.

6.3 Resources – The purchasing of investment properties will require additional officer resources (finance, legal and property) related not only to the purchase but also to their ongoing management. It is not envisaged that the Council would purchase more than a small number of properties and as such it is anticipated that no additional resources will be required although if e.g. a significant number of properties were to be purchased, or properties were purchased further afield, this could change.

7. RISK MANAGEMENT AND GOVERNANCE ISSUES

7.1 Investing in direct property has the second lowest risk (after bonds) as measured by volatility (standard deviation)

7.2 Risks are outlined in Section 3, Item 3.5.3 of this document.

7.3 Risk management will be managed within the Council's Property Programme as part of the programme and will be subject to regular review by the monthly Programme Board.

8. CONCLUSION

8.1 It is proposed that the Council invests in commercial property investments 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 and in doing so following the asset investment strategy as detailed in this report.

8.2 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.

9. RECOMMENDATION

That the Corporate Overview & Scrutiny Committee, considers and note, the contents of this report.

10. BACKGROUND DOCUMENTS

None