Appendix 1

Property and Asset Investment Framework

June 2017

1.0 Criteria for Property and Asset Acquisition

1.1 **Return on Investment –** nett of one off and management costs this should be in-between 5% and 9% which supports the assumptions in the MTFS.

1.2 An important measure of income risk is the **weighted average unexpired lease term (WAULT).** This metric is often used by investors to measure the risk of a multi-tenanted property going vacant – typically, the longer the WAULT the more stable the income and therefore the more attractive the investment. Also, properties with shorter WAULT will face higher costs in terms of leasing agent fees, advertising fees and legal fees. A WAULT of between 2 and 3 years should be sought for investments such as small industrial units which represents an acceptable financial performance. The average WAULT across the Council's investment portfolio is 2.1 years which is within this range although at the lower end. However, for larger investments a higher WAULT should be sought.

1.3 **Sectoral diversification** – The strategic review recognised that SRBC will likely always have a bias towards industrial investment property given the nature of the local economy, however a move towards achieving a greater balance between different property types than present should be sought in order to mitigate risk. Notably, office space as a leading asset class is under-represented in the current portfolio.

An ideal balanced portfolio should comprise:

- No individual asset class (industrial/office/retail) to contribute more than 50% of portfolio income
- Each of the asset classes to contribute at least 15% of portfolio income
- Other assets to contribute at least 5% of portfolio income.

However, location does have a significant impact on portfolio balance depending on the opportunities in that area. Data from Property Finder indicates that the most popular requirement for the borough is for general industrial units in sizes ranging up to 3,000 square feet.

Whilst sector diversification should always be considered, the most likely opportunities within the borough in the short term and especially the short timescales for delivering the £300,000 income target in the MTFS is likely to be industrial units which needs to be recognised. However, consideration should also be given to any office or retail properties which represents a good opportunity, especially if consideration is given to property outside the borough where opportunities in these sectors are most likely to be found.

1.4 **Increase geographical diversity -** At present the entire commercial property portfolio is located within the borough. However, realising investment opportunities outside South Ribble could not only deliver a greater and more secure income for the Council but mitigate the Council's current level of risk by introducing a level of exposure to other markets. This is an increasingly common practice within other local authorities who are investing beyond their administrative boundaries where the right opportunities exist.

Also in light of the short timescale to deliver the MTFS target it is unlikely that this can be achieved by investing in the borough alone. Therefore the target area for investment should be a preference for the borough and then the wider City Deal and Central Lancashire area. Should good opportunities become available in the wider Lancashire area, North West Region or countrywide then these will also be considered.

1.5 **Increase lot size** – SRBC owns many low value, management intensive assets. The average income across the commercial portfolio is £8,345 pa per property, and approximately 25% of all properties have an annual income of less than £5,000 pa. The strategic review suggested that a sensible target would be lot sizes in the range £2m to £4m capital value. The benefits to the portfolio would be improved covenant mix, reduced risk exposure and lower management. This also represents the simplest way of growing the Council's income stream quickly.

However, this in itself is not without risk particularly for large industrial units which tend to be let to a sector which requires 5 year break clauses.

Therefore the target lot size should be up to £4m but should opportunities arise which meet many of the other criteria in this framework, consideration should be given to investments of a higher value.

1.6 **Improve quality** – The strategic review recommended that the Council place an emphasis on quality in seeking new investment opportunities. There will always be a demand for lower cost, lower grade space, but investing in higher quality stock going forward will provide greater long term protection against obsolescence (both functional and physical), tenant churn and costs. SRBC also needs to focus strategically on improving the quality of its asset base in order to manage risk and facilitate a transition to a more resilient or "future-proofed" property portfolio in the context of new property development expected to be facilitated in the coming years by City Deal investment. Future acquisitions should therefore be considered with the aim of improving the quality within the portfolio.

1.7 **Tenure** – when considering the tenure of an asset, freehold interest is preferable to leasehold. Freehold provides for greater levels of security against a leasehold asset that would effectively decrease in value over time. However, assets on long leasehold will also be considered.

1.8 Whilst the above criteria should be used to guide future investments, any potentially good investment opportunity which may not strictly fall within the above criteria should always be considered on a case by case basis.

2.0 External Verification

2.1 For each potential asset purchase external specialist property investment advisors will be retained to carry out a due diligence exercise and advising on the suitability of the purchase. Any exceptions to this will be included in the approval report to members stating the reasons.

3.0 Evaluation Matrix

3.1 The commonly used Dun and Bradstreet scoring matrix below can be used to help determine whether a potential investment is a good or acceptable opportunity. Use of the matrix will provide further guidance for the evaluation of prospective properties with a minimum score required of at least 100 out of a maximum score of 168 (60th percentile).

3.2 There may however be sound reasons for acquiring a property that does not meet the score and the matrix should be treated as guidance rather than mandatory.

	Score	4	3	2	1	0
SCORING CRITERIA	**Weighting Factor**	**Excellent**	**Very Good**	**Acceptable**	**Marginal**	**Unacceptable**
Location	12	Major Prime	Micro Prime	Major secondary	Micro secondary	Tertiary
Tenancy strength	10	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant	Tenants with poor financial covenant strength
Tenure	9	Freehold Lease	125 years plus Lease	between 50 & 125 years Lease	between 20 & 50 years Lease	less than 20 years
Occupiers lease length	5	Greater than 10 years	Between 7 and 10 years	Between 4 & 7 years	Between 2 & 4 years	Less than 2 years; including vacant property
Repairing terms	4	Full repairing & insuring	Internal repairing - Remainder 100% recoverable	Internal repairing - Remainder partially recoverable	Internal repairing - Remainder non recoverable	Landlord
Lot Cost	2	Between £1m and £4m	Between £0.5m & £1m	Under £500,000 or over £4 million	N/A	N/A

4.0 Legal Considerations and the Power to Invest

4.1 For each proposed acquisition, the appropriate legal advice will be sought to ensure the legality of the proposed transaction.

5.0 Investment Risks for the Council

5.1 The framework recognises that any form of investment is not without risk since the value of any investment may rise or fall over time, especially where it is to be retained over many years.

5.2 Accordingly, the consideration of any investment shall include a risk assessment that shall aim to measure as objectively as possible the likelihood and severity of the impact should the risks identified be realised. This can provide comparison against the potential benefits (financial and otherwise) for which the investment is being considered in the first place, and form part of the decision making process.

5.3 The Council needs to acquire property and asset investments to support meeting the targets in the MTFS. There is a risk that the best opportunities for investment may not fall within the target period.

5.4 Among the risk factors to be considered are:

Acquisition Risk – the Council may incur transaction costs without guarantee of securing the investment (e.g. the Council may be one of several bidders).

Price & Cost Risk – Once acquired the price or cost of the investment may fluctuate over time, which may in itself reflect variations in demand and supply.

Economic / Political Risk – the ability to retain or dispose of an investment may be inhibited by the economic and political environment at any point in time.

Market Risk – the Council's ability to influence the price, financial return or other benefits pertaining to the investment may be limited by the market in which it operates.

5.5 In order to manage some of the risks associated with the acquisition of assets under this investment framework, a thorough due diligence process must be undertaken to identify any potential risks as part of the evaluation process.

6.0 Other Investment Opportunities

6.1 This investment framework considers property related assets only which is an immediate priority of the MTFS.

6.2 Consideration needs to be given to other forms of asset and property acquisition such as land, housing development, commercial and industrial unit development. These need to be investigated including a full review of the council's land assets and how they may be used for this purpose. This work will be carried out in parallel to the work involved in property acquisitions which is the main focus of this framework. This framework will be extended to take account of any future opportunities identified which will also be incorporated in to the Corporate Planning process and MTFS.