

**SOUTH RIBBLE BOROUGH COUNCIL**  
**INVESTMENT PROPERTY STRATEGY**

**November 2017**



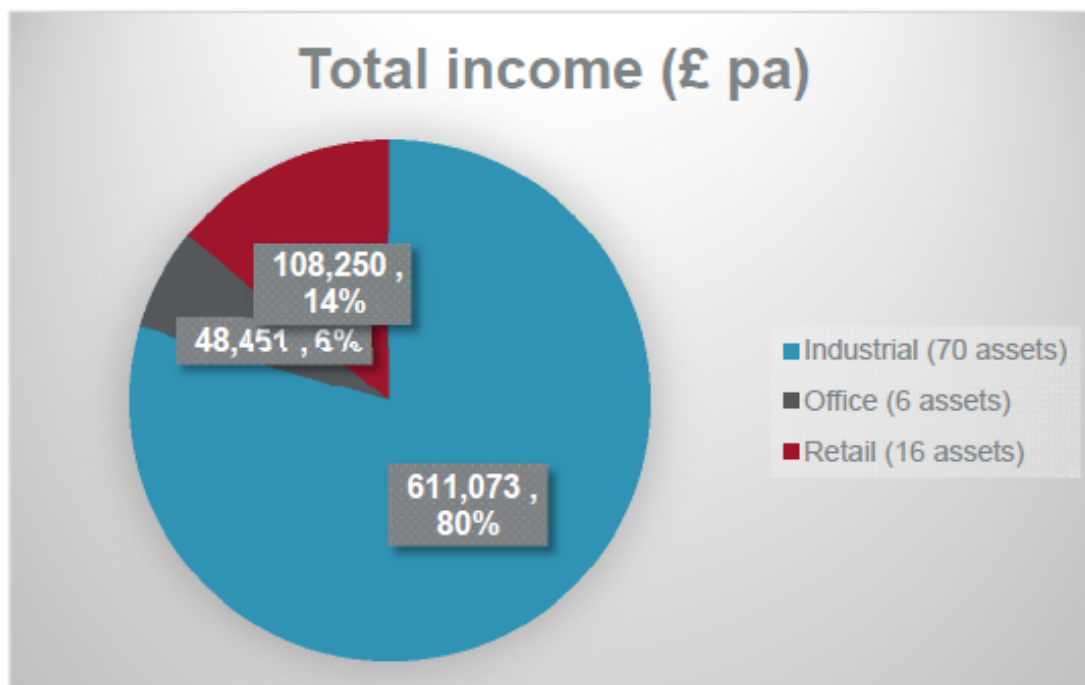
# Investment Property Strategy

## 1. Background

The Council has a commercial non-operational tenanted portfolio comprising of 92 assets generating a rent roll of £770,000 and valued at c £5.7m. This stock base is historic and comprises:

- 76 Industrial Units on 10 sites
- 16 retail units at 3 sites
- 3 offices on 2 sites

These units have been held historically and are located within 6 main residential and employment locations across the Borough. All these properties are fairly small in lot size but collectively provide significant rental income. Whilst the portfolio is managed in an efficient manner, it has not been constructed primarily with the aim of generating property investment income. Many of the leases are short term with an average lease of less than 3 years. This approach is not unusual within local authority historic asset base but brings with it a relatively high management cost with the turnover of leases. The graph below shows how the portfolio is heavily weighted towards the industrial sector in terms of assets and income. This is not surprising given the economic history of the Borough but any new investment should look to diversify the portfolio.



In considering the Medium Term Financial Strategy of the Council, Members looked at the returns made on investments within the Treasury Management Strategy at c0.6% per annum and looked at other potential investment returns. In the light of

returns made by the current portfolio, Members considered investing in wider property investments to realise better investment income. £3.8m was allocated for potential investments looking to realise up to £300,000 per annum which is an ambitious target.

## **2. Objectives**

There are 3 main objectives of this strategy.

### **a) Investments within the Central Lancashire Area**

The first phase will focus on the acquisition of property investments within the Borough and Central Lancashire Local plan area. This is to support the Council's ambition for growth in the area and help create renewed confidence and a positive message to other investors

### **b) Financial Return**

This strategy seeks to increase the proportion of the total income from investing in good quality commercial assets as a way of generating new revenue streams to the Council. These assets will be held primarily for investment value, and as a secondary measure, capital appreciation. The main consideration for doing this is to enable the Council to be more financially resilient and generate income which will support services and contribute to the General Fund.

This can be delivered by specifically targeting investment in purchasing good commercial properties which provide sustainable rental income, through a balanced strategy of acquisition, retention and management of good quality property investments, and also to benefit from long term growth in capital values

### **c) Strategic Asset Review**

All assets within the Commercial Portfolio will undergo a strategic review as part of an overarching Strategic Asset Review. All assets will be examined against how well they meet the objectives for holding those assets and the potential for development, capital receipt or potential income. Specifically with the Commercial Portfolio, the assets will be reviewed to look at how they could be developed to generate a stronger income stream, rationalised or sold. This work will identify both opportunities for investment and potential resources for further investment.

### **d) Performance Management**

It is proposed to introduce a suite of key performance management measures across the whole of the portfolio, including the existing historic stock so that we can understand the existing performance and return. This data will be set in context by our advisers.

### **3. Scope**

#### **a. Investment Value**

Initially £3.8m has been identified as available for investment. Any expansion of the investment will be assessed against the business cases for each investment. If a positive case is put forward and an opportunity generates the Council's objectives, further funding could be allocated. The Council also has a target to generate an additional £300,000 per annum from additional property income.

#### **b. Geographical location**

The first phase of the Strategy will be delivered by acquisition of commercial investments within the Borough and Central Lancashire Local Plan area. It has been suggested that the area needs to be expanded to the wider northwest or even nationally to ensure that South Ribble is exposed to "the best" assets and returns. However, there are already many local authorities in the northwest undertaking large portfolio investments and the Council may be exposed to weaker investments in the wider area. Initially this economic area should produce the right mix. If not, then the Council can review its position.

### **4. Strategy for existing commercial portfolio**

Whilst the main objective of the Strategy is focussed towards acquiring new commercial income producing properties, it is recognised that the historic commercial property portfolio also needs some restructuring and rebalancing to achieve a satisfactory spread of properties across a mix of retail (predominantly), offices, industrial/warehouse uses providing a reasonable return to the Council. There has been no consistent formal measurement of the return historically, as this has provided a steady year on year rental income without too much risk.

Although the risk within the portfolio is spread, the portfolio lacks good quality tenant covenants and the lot sizes are quite small. The strategy would involve enhancing the current portfolio income levels by disposing of lower yielding assets (unless there were other benefits from retention i.e. future redevelopment opportunities) and reinvesting in assets which would generate a higher return.

It is proposed that as a precursor to this step, and on-going, the Council should undertake more formal but simple performance monitoring measures of the current stock and income levels, to understand the existing performance and return. This would place a greater emphasis on the justification for holding these assets and give the Council an ability to measure their outputs. This may lead to a policy of being able to dispose of poor performing assets. It is proposed that capital receipts from any sale within the existing portfolio should ideally be ring-fenced to support the Property Investment Strategy on-going so there are funds to replace assets.

## **5. New Portfolio Structure**

In terms of the new commercial income producing assets, it is important to achieve a spread of risk by acquiring properties across a range of different property asset classes, namely retail, industrial, office and leisure. This is a fundamental objective of this new strategy.

It is proposed to try and obtain diversification and balance on investments by sector, so that there is no reliance on only one sector or type of tenant. This will minimise risk from downturns in specific sectors. Market sectors and locations with rental growth and good letting prospects will be targeted. In order to ensure a balanced portfolio investment should be targeted away from industrial units. The strategy needs to build in flexibility in the mix to reflect the opportunities available and being able to move sectors if this is considered prudent.

In an ideal balanced portfolio no asset class should comprise more than 50% of the portfolio income and each class should contribute at least 15% of the income. As the current portfolio is already 80% exposed to the industrial sector, investment should be stronger elsewhere. It is suggested that the focus is more on Leisure, Office and Retail rather than industrial. This would balance the portfolio and spread the risk.

HOWEVER, flexibility needs to be maintained and if a long term opportunity with a strong covenant came forward in the industrial sector, it needs to be analysed in that context.

### **a) Single use/Multi let investments**

Ideally the Council will be looking for a single use tenant per investment to reduce management resource.

However, mixed use investments would also be potentially suitable additions to the portfolio, and in these cases the Council will be seeking a higher yield as compensation for additional management resource. The Council will need to consider the management arrangement and cost. These may include a mix of commercial uses and residential, or a mixture of retail and office use. In terms of residential accommodation this is likely to be more management intensive than other types of commercial property investment and requires specialist residential management expertise, so it is proposed that residential acquisitions will only be part of this strategy if they are part of a mixed use investment, where the residential element is quite small. Residential investment per se is excluded from this strategy.

### **b) Lot Sizes**

The Council 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. The strategic review suggests that a sensible target would be lot sizes in excess of £1m. The benefits to the portfolio would be improved covenant mix, reduced risk exposure and lower management costs. This also represents the simplest way of growing the Council's income stream quickly. Flexibility is required in case the right deal comes along in one particular sector which may suit the Council's requirements. The principle of not having all your eggs in one basket to mitigate risk still applies.

**c) Locations**

As part of the first phase of this Strategy, the Council intend to purchase property investments within the Central Lancashire area. The objectives of this strategy are clearly identified under section 2 above. The area is an economic growth area and offers opportunities across all the sectors. There should be sufficient opportunities to find suitable investment opportunities.

**6. Investment Property Criteria**

**a) Type of investment**

Investments will include freehold and long leasehold interest acquisitions of properties, subject to a lease.

**b) Yield**

The target net annual yield range is anticipated between 5%-8%. The lower yield will manifest in improved quality assets and longer tenure. Investments should also be required to provide income equal to at least two percent above the Council's required rate of return, defined by the cost of borrowing (as at the 2<sup>nd</sup> October, Public Works Loan Board rate is 2.5% over 25 years). 5% will provide a margin above this level at this moment in time.

The yield will also reflect the risk on the investment. At the lower level, 5%, the investment is likely to be a reasonably safe with a single use tenant occupying under a secure tenancy. At the higher yield, 8%, there is likely to be a greater number of tenants with more risk of tenant/s default, and greater risk of void periods.

**c) Location**

Good prime locations will be sought. Consideration will be given to whether a tenant could be found in the event of default. This will be dictated by opportunity to acquire investments.

**d) Building Specification 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.

**e) Length of lease unexpired**

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 and, typically, the longer the WAULT the more stable the income and therefore the more attractive the investment. There is a correlation between length of lease and yield. Also, properties with shorter WAULT will face higher costs in terms of leasing agent fees, advertising fees and legal fees.

The WAULT on the current portfolio is 2.1 years which is unsurprising with the focus on small industrial units. Therefore to diversify, ideally only leases with a minimum unexpired term of five years will be considered. Our preference is for leases closer to ten years, but we have lowered the expectation here to widen the market for investment opportunities given the target yield (5%).

**f) Financial strength of tenants**

The covenant strength of the tenant should be as a minimum good. This will be determined through financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring. This should be provided on the initial check.

**g) Rental levels**

The current market rent shall be equal to or above the passing rent. The income should be secure reflecting tenant strength and on-going.

**h) Management Issues**

Management issues in relation to the investment should be minimal.

**i) Use – Existing and Alternative**

Consideration will also be given in each case to the alternative use for the property, i.e. development potential and its exit value. This will be considered

as a bonus if residential development is an alternative possibility. However this will not be a primary factor in the decision.

**N.B.** These criteria will be reviewed regularly and changed with Member approval as the market conditions change.

## **7. Financial Appraisal**

A financial appraisal will be prepared for each potential investment by the Council's external **Investment Adviser**. This report will look at and consider the criteria listed above and how that potential investment meets those criteria. Attached at appendix A is a summary proforma that will support any proposal.

## **8. Approval Process**

The appraisal of any potential investment will be reviewed in the first instance by the Council's Corporate Property Officer, Section 151 Officer and Monitoring Officer. The report will then be presented **to Cabinet for approval to proceed**.

## **9. Due diligence checks**

As part of the physical appraisal, due diligence checks will be undertaken prior to purchase to include financial checks, and physical condition checks including building surveys and measured survey (if necessary). The property will be assessed in terms of the condition visually. A Building Condition survey will be undertaken. Legal title checks will be undertaken prior to purchase, and good clean title will be sought.

There will be no requirement for full structural mechanical and electrical surveys unless there is cause for concern as to the condition

## **10. Continual appraisal**

The portfolio will be open to continual appraisal (including consideration of the tenant status and management issues), and on-going financial performance measurement. This will help in future decision making in terms of whether to sell or hold the investment in order to minimise risk.

## **11. Management of new assets**

The Council already has in place an Estates team which manages the current non-operational property portfolio and would, unless geographical location would limit its ability, be able to manage a larger property portfolio to include the investment portfolio.



## Appendix A

<b>Property Investment Strategy Acquisition</b>		
<b>Approvals</b>	<b>Cabinet</b>  <b>Date of Meeting:</b>	Corporate Property Officer Yes/No Date of consultation:
		Monitoring Officer Yes/No Date of consultation :
		Section 151 Officer Yes/No Date of consultation :
<b>Details of the Proposal</b>		
Property Description including floor area		
Age		
Portfolio Area	Retail / Industrial / Offices / Leisure	
Single use tenant	Yes / No	
Multi let building	Yes / No If yes, how many tenants?	
<b>Asking price</b>		
<b>Location</b>		
Type of investment	Long leasehold / Freehold  If Long leasehold, how long is the lease? _____	
Yield	% Gross (Target financial yield %)	
Location	Prime location / Secondary / Tertiary	
Tenant Details		

Length of lease unexpired		
Financial strength of tenant	<p>Covenant strength:      Good/Poor</p> <p>Credit score :</p> <p>If more than one tenant: Covenant strength and credit score for all</p>	
Lease terms	Tenant break option	
	Rent review pattern	
	Upward only review or RPI/CPI uplift?	
Rent per annum	£	
Use – existing		
Use – alternative		
Management arrangements		
Does this purchase comply with the Strategy?		
Due diligence checks proposed	<p>Red book valuation:              Date:      Who:</p> <p>Physical condition checks:</p> <p>Internal visual check:      Yes / No      Date:              Who:</p> <p>External Building survey: Yes / No      Date:              Who:</p> <p>Full structural mechanical &amp; electrical survey required: Yes / No</p> <p>Date :                              Who:</p> <p>Legal title checks – good clean title required:</p>	
Proposed holding period		
Attachments	Property Particulars	
	Copy of the initial Desk top valuation	
	Financial Appraisal	

**Signed:**

**Investment Manager External Adviser**