

REPORT TO	ON
CABINET	21 June 2018



TITLE	PORTFOLIO	REPORT OF
Investment Property Strategy	Cabinet Member (Assets and Transformation)	Director Planning and Property

Is this report a KEY DECISION (i.e. more than £100,000 or impacting on more than 2 Borough wards?)	No
Is this report on the Statutory Cabinet Forward Plan ?	No
Is the request outside the policy and budgetary framework and therefore subject to confirmation at full Council?	No
Is this report confidential?	No

1. PURPOSE OF THE REPORT

1.1 The purpose of this report is to;

- (i) Seek approval for the revised Investment Property Strategy following meetings with the Council's appointed advisers Lambert Smith Hampton Investment Management (LSHIM). This report finalises the investment matrix and sets the ground rules for LSHIM to find appropriate investments to meet the Council's aims;
- (ii) Note development of two further complementary Investment Strategies, to support Economic Development/Regeneration and Housing.

2. PORTFOLIO RECOMMENDATIONS

2.1 Cabinet is asked to;

- (i) Approve the Investment Property Strategy as attached at Appendix A;
- (ii) Note development of two further complementary Investment Strategies, to support Economic development/Regeneration and Housing and consider at a future meeting.

3. REASONS FOR THE DECISION

3.1 The Council identified investment in commercial property as an opportunity to increase its income whilst protecting its capital in its Budget for 2017/18. An Investment Strategy and appropriate governance was developed over the following months and agreed at Cabinet on 6th December 2017. At that meeting it was agreed to procure specialist advice. LSHIM were subsequently properly procured and appointed in March 2018.

3.2 LSHIM met with officers to establish a common understanding of the opportunities that could be available and the practical challenges that would need to be addressed to meet the potentially tight timescales for decisions. On 25th April 2018 Chris Hornung, Managing Director of LSHIM, held workshops at Civic Centre with Members of the Cabinet and the Asset Working Group outlining the staged approach to identifying and selecting investment opportunities. The Investment Strategy has been revised following those workshops and is attached at Appendix A. Approving this Strategy at Cabinet enables LSHIM to embark on identifying potential opportunities and progression to investment.

4. CORPORATE PRIORITIES

4.1 The report relates to the following corporate priorities:

Excellence and Financial Sustainability	X
Health and Wellbeing	
Place	

Projects relating to People in the Corporate Plan:

People	
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5. BACKGROUND TO THE REPORT

5.1 Investment in commercial property was identified as a potential sustainable income stream for the Council and £3.8m of balances was earmarked for such investment in 2017/18 budget. An Investment Strategy was developed in 2017 and agreed, after due consideration by Governance Committee, by Cabinet on 6th December 2017. LSHIM were then appointed as specialist advisers to support this policy.

5.2 The workshops held between the Council and LSHIM looked to finalise the criteria for investments and the decision making governance and timescales. At the outset it was agreed that this is just one element of the Council's property strategy that is solely for investment purposes. The key themes identified were that this funding is aimed at low risk, long term investments with a sustainable income stream that preserves capital. Two further strategies and funding will look at economic development/regeneration and housing.

5.3 Following a further discussion with LSHIM on the quality of investments available, it was identified that an increase in the funding available would generate better and more sustainable investment opportunities. General reserves increased at the end of 2017/18 due to an underspend on the 2017/18 budget. This provides Cabinet with the opportunity to consider increasing the funding available for property investment without impacting on the current medium term financial strategy. This additional funding would enable LSHIM to identify assets with better investment potential and a more sustainable income stream into the future. Cabinet are therefore asked to consider transferring £0.8m from the general reserve to the Property Investment reserve.

5.4 In considering this strategy, Members need to be conscious of investment in economic development/ regeneration and housing in the Borough. A further report will be brought forward on separate funding and investment plans to deliver on these objectives in due course. Effectively this will be a plan to utilise the City Deal Reserve of £1.6m and any additional funding which may be identified.

5.5 Members were re-assured by the rigour that LSHIM apply in identifying investment opportunities. The criteria for investing were discussed and are summarised in the

Investment Strategy in Appendix A. Only opportunities that meet these criteria will be progressed to Stage 2 of the process.

- 5.6 Section 5 of the Investment Strategy describes the 4 stages of the process. LSHIM undertake stage 1 which identifies potential opportunities that meet our criteria. Stage 2 is a short “thumbnail” description that is sent to officers at South Ribble to identify if there are any reasons that the investment should not be pursued. Stage 3 is the due diligence that LSHIM undertake looking at the full business case, standard of asset and location. If it passes their internal rigour and meets the business returns required, LSHIM will make a recommendation to bid for the property and a MAXIMUM price that could be paid. At this point South Ribble Borough Council need to approve LSHIM proceeding. The time to decide could be as little as 24 hours from this point.
- 5.7 The original strategy stated that Cabinet approval would be required to authorise the final investment. However, having met with LSHIM and received a greater understanding of the due processes undertaken, it is recommended that the authority to approve LSHIM making a bid is delegated to Section 151 Officer and Corporate Property Officer in conjunction with the Portfolio Holder.
- 5.8 If the offer is accepted and Heads of Terms issued, stage 4 commences. Exchange and completion could be set for within 10 to 15 working days. LSHIM will instruct and coordinate the relevant surveys required for the acquisition and will liaise with the appointed legal advisors. This will include a Building Survey, Environmental Survey and independent Valuation. Prior to exchange, a detailed Investment Report will be issued by LSHIM to South Ribble Borough Council which will provide a detailed analysis and cash flow of the investment but will also provide summaries of all 3rd party advisors reports.
- 5.9 Following completion LSHIM will continue to monitor performance and report to Members on a quarterly basis.

6. CONSULTATION CARRIED OUT AND OUTCOME OF CONSULTATION

- 6.1 This investment strategy has been part of the Council’s 5 year financial strategy which was consulted widely upon. There were no issues raised.

7. ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

- 7.1 This was one investment strategy identified for sustainable income. Other investment opportunities have been identified and funded through the Council’s 5 year Capital Strategy.

8. FINANCIAL IMPLICATIONS

- 8.1 The funding required to purchase investments is identified within the 5 year Capital Strategy approved by the Council on 28th February 2018. The report seeks Cabinet approval to the revised strategy to progress identification of investment opportunities.

9. LEGAL IMPLICATIONS

- 9.1 The original report identified some of the potential challenges of using borrowing to fund investment in property. However, the funds identified are from Council balances that are cash backed and not borrowings. Therefore there is no potential challenge at pursuing these investments.
- 9.2 The original strategy identified Cabinet to approve the investments identified via this approach. Following the workshops with LSHIM and a broader understanding of the process and due diligence involved, the report recommends delegation at that decision to section 151 officer and corporate property officer in conjunction with the Portfolio holder. There is a degree of speed required to give authority to bid to LSHIM. Whilst it would be possible to call

a Cabinet at short notice, delegating the authority to key officers will enable a smoother process. Reporting the decision to the next Cabinet ensures Members retain ownership of the policy.

- 9.3 Implementing this strategy creates the need to complete any successful transaction within 15 days. This could prove challenging and may require external legal support to achieve. Such support has been identified.

10. HUMAN RESOURCES AND ORGANISATIONAL DEVELOPMENT IMPLICATIONS

- 10.1 There are no direct human resource or organisational development implication with this report.

11. ICT/TECHNOLOGY IMPLICATIONS

- 11.1 There are no direct ICT implications at this stage.

12. PROPERTY AND ASSET MANAGEMENT IMPLICATIONS

- 12.1 Acquisition of investment property gives the Council an asset. A full business case is produced by LSHIM ahead of the final completion with all due diligence. Any asset will have long term tenants and minimal landlord maintenance requirement. Therefore there will be little initial impact on asset management. Eventually there will be requirements to conduct rent reviews and lease renewal that will need to be programmed into future plans.

13. RISK MANAGEMENT

- 13.1 As with any commercial investment there is a risk of potential loss of value. However, the strategy identified in Appendix A and the due diligence that will be undertaken by LSHIM looks to minimise that risk. Key factors include evaluating the tenant(s) covenant strength, investing only in assets with unexpired leases in excess of 5 years and good building condition. The latter is important to ensure the asset could be re-let or sold should the tenant fail.

14. EQUALITY AND DIVERSITY IMPACT

- 14.1 Implementing this strategy should have no impact on equality and diversity issues.

15. RELEVANT DIRECTORS RECOMMENDATIONS

- 15.1 The Investment Strategy, agreed with LSHIM, is recommended for approval by Cabinet.

- 15.2 Cabinet is asked to delegate the final approval to invest on LSHIMs recommendation to Section 151 Officer and Corporate Property Officer in conjunction with the Portfolio Holder.

- 15.3 Cabinet is asked to note development of two further complementary Investment Strategies, to support Economic development/Regeneration and Housing and consider at a future meeting.

16. COMMENTS OF THE STATUTORY FINANCE OFFICER

- 16.1 Investment in commercial property was identified as a potential sustainable income stream for the Council and £3.8m of balances was earmarked for such investment in the 2017/18 budget. An income target of £100,000 is included in the 2018/19 approved budget, rising to a challenging target of £300,000 for future years. Failure to meet this target will impact negatively on the longer term budget for the council.
- 16.2 Transferring £0.8m to the Property Investment Reserve from the General Reserve can be achieved without impacting on the council's medium term financial strategy due to the reported 2017/18 underspend that has not been factored into any financial plans. This increase in funding could also reduce the risk of under recovery of rental income. This would increase the total amount available to invest to £4.6m.
- 16.3 It is proposed that prior to the consideration of any investment opportunity by officers under delegation, the specialist investment advisors (LSHIM) will undertake due diligence on behalf of the Council. They will only make a recommendation with regard to bidding for the property if it passes their internal rigour and meets the business returns required.

17. COMMENTS OF THE MONITORING OFFICER

- 17.1 Legal services have previously advised on the Investment Strategy. In a nutshell we were comfortable with what was proposed.
- 17.2 It is clear that speed will be of the essence (at Stage 3 of the identified process) when it comes to making investment decisions in particular cases. Seeking a decision of Cabinet for all such decisions could be rather difficult in practice given the timescales involved. Hence on a practical level it seems sensible to proceed on the basis of the decision making powers being delegated as is proposed in the report.

18. BACKGROUND DOCUMENTS

Cabinet on 6th December 2017 Investment Property Strategy

19. APPENDICES

Appendix A Investment Strategy

**Jonathan Noad
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South Ribble Borough Council

Commercial Property Investment Portfolio Investment Strategy

May 2018

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Forward

Lambert Smith Hampton (LSH) has been appointed by South Ribble Borough Council (SRBC) to act as Investment Manager in establishing a commercial investment portfolio. The objective is to create a balanced property investment portfolio, from which to derive a long term secure revenue stream. This report outlines what LSH perceive to be a prudent approach for SRBC to invest in commercial property and sets out the recommended investment strategy.

LSH is a leading specialist property consultancy with 31 offices and 1400 staff across the UK. LSH Investment Management (LSHIM) is the investment management arm of the business and will be directly responsible for this mandate.

LSHIM acts for Public Sector, Institutional and Private Investor clients wishing to invest in commercial property. Existing public sector clients of LSHIM include Watford Borough Council, Essex County Council and Mansfield District Council.

LSHIM operates independently of LSH. Whilst able to take advantage of the expertise and experience within LSH it is not obliged to do so and can therefore adhere to a policy of using only 'best in class' advisors and service providers in the acquisition and asset management of its client's investments.

1/ Introduction

The public sector as a whole has been suffering an unprecedented squeeze on capital and revenue budgets following central government “austerity” cuts in Local Authority funding over the last 9 years. SRBC, along with many other local authorities, has not been immune from these budget pressures and with the financial outlook unlikely to change in the short to medium term, the Council needs to find new and innovative ways of creating additional revenue.

In recent years local authorities have spent in excess of £1bn per annum on commercial property across the UK having implemented strategies to acquire income generating assets with the sole purpose of generating additional revenue to support public services. This is quite distinct and not to be confused with buying assets for regeneration purposes and/or promoting local employment. These assets have been purchased both ‘in and out of borough’ meaning that assets are purchased in many cases outside the administrative boundaries of the buying entity.

2/ Importance of Setting a Strategy with Clear Objectives and Governance

In building an investment portfolio, it is important that SRBC acts in a prudent manner, and is seen to be doing so, to ensure that the makeup of the portfolio will generate sustainable income streams, preserve value and provide an opportunity for capital growth. To do this, the following is needed:

- ☒ A clear portfolio strategy to achieve pre-agreed objectives.
- ☒ Rigorous evaluation of potential investments that will stand up to scrutiny, against a set of pre-agreed criteria.
- ☒ Investment decisions to be taken following professional advice and recommendations from LSHIM.

Cabinet will approve the Portfolio Strategy on an annual basis which is set out below under Sections 3 and 4 of this document. LSHIM will source suitable opportunities based upon the criteria meeting the portfolio requirements (Stage 1 of Acquisition Process set out under Section 5). These are the only opportunities to be pursued with the capital made available. LSHIM will issue SRBC a short summary of any suitable opportunities (Stage 2 of Acquisition Process set out under Section 5). The Council’s Corporate Property Officer in conjunction with the Section 151 Officer will respond to LSHIM within 48 hours.

If the response is to proceed, LSHIM will then undertake full due diligence on the investment and if appropriate make a recommendation to bid with a maximum price stated (Stage 3 of Acquisition Process set out under Section 5). Cabinet will delegate the authority to the Section 151 Officer and Corporate Property Officer in conjunction with Portfolio Holder for Assets to authorise LSHIM to bid for the asset up to the maximum recommended price. A response will be provided back to LSHIM within 48 hours.

The responsibility for ensuring that the acquisition and the on-going financial returns meet the performance targets is held by LSHIM which is a specialist role requiring a combination of property and financial skills and access to the property investment markets. LSHIM will maintain a portfolio overview and implement specific actions required and acquisition recommendations to meet the portfolio objectives. LSHIM will be responsible for the identification, selection, acquisition of stock and its asset management.

3/ Objectives

Below are the key objectives for the investment strategy:

- ☑ To invest in commercial property to generate a sustainable income stream, preserve value and provide opportunity for capital growth
- ☑ Low risk profile investing in core/core plus assets – typically long leases and better quality buildings
- ☑ Generate a gross income yield in excess of 4.5% across portfolio
- ☑ Manage risk across portfolio by diversification in asset type and geography
- ☑ Initial capital to invest £3.8M but if minded to develop the strategy, further capital may be provided to increase portfolio size

4/ Investment strategy

Value of Acquisitions

We recommend that the £3.8M initial capital available is used to purchase one single asset. Once purchase costs including stamp duty have been included, the sum available will be in the region of £3.5M. Acquiring smaller lots sizes of between £1M to £3M will generally mean the quality of the investments will not be of institutional grade quality i.e. let to strong covenants with long unexpired lease terms, meaning the key objectives set for the portfolio will not be met.

Capital available for investing is currently £3.8M. Although no decision has been taken to add to this level, it is important to consider when developing a strategy that more capital could be made available and this needs to be considered at the outset. As such, to accommodate further capital being provided and more acquisitions made, we recommend no single asset should comprise more than 20% to 25% of the overall portfolio target value and for a fund of between £3.5M to £20M, individual lot sizes should be in the region of £3M to £5M.

Portfolio Balance

It is important to invest in a range of assets and locations to achieve a balanced portfolio. We are aware that SRBC has a desire to source properties in the North West which we are happy to adhere to. However, should properties not be found matching the requirements after an initial 4 week period, then we will need to consider properties across the UK and in particular outside the North West. By investing in a range of assets and locations, this will provide a good degree of protection against geographical, sector and tenant specific risks, as well as enabling rental and capital growth in different locations and sectors of the market to be enjoyed.

The following sector allocations are recommended (figures in brackets represent the maximum quantum per sector):

- Offices (35%)
- Industrial (35%)

- Retail (30%)
- Alternatives (10%)

Target Rates of Return

We recommend a gross target return of between 4.5% to 6.5% on all acquisitions. As part of the due diligence process carried out by LSHIM, a detailed cash flow model will be developed for all acquisitions. This will ensure full visibility on projected returns.

Maintaining value of Properties in the Portfolio

LSHIM will develop an individual asset strategy plan for each property so that it meets the objectives of the portfolio, thereby ensuring income flow remains constant as far as possible and capital value is maintained.

Typically, LSHIM will recommend purchasing properties with sound fundamentals in the core/core plus spectrum which demonstrate the following fundamentals:

- ☑ Strong tenant covenant to meet rental liabilities;
- ☑ An average unexpired lease term of at least 5 years;
- ☑ Prime/good secondary locations meaning at end of lease term the property should re-let with minimum voids;
- ☑ The building will not become obsolescent;
- ☑ Opportunities during hold period for rental growth and capital value increases through active asset management i.e. lease re-gear, RPI/CPI and open market rent reviews, refurbishment.
- ☑ No investment in speculative development

Performance Measurement

The performance of the portfolio and each investment should be monitored regularly against targets and Key Performance Indicators (KPIs) of benchmarks. These should not be based on just return performance but include rent collection efficiency, arrears and building inspection frequency.

5/ Acquisition Process and Property Selection Criteria

The key tasks that LSHIM will perform in the acquisition of each property are summarised below:

- Asset selection
- Opportunity Overview (Light Bulb Summary)
- Property Inspection
- Market research
- Cash flow modelling
- Due diligence
- Recommendation to Bid Report
- Investment Recommendation Report

Stage 1:

LSHIM will source opportunities for acquisition, based upon the parameters set out in the above portfolio strategy. A scoring matrix will be used for initial evaluation to ensure uniform basis of appraisal across different asset classes and locations. The resultant score can then be assessed against a target measure or used for comparison against other opportunities.

Stage2:

Suitable opportunities will be issued by LSHIM to SRBC in a summary format which will ensure there are no conflicts of interest or any historical reasons preventing further due diligence. A decision back from SRBC will be needed within 24/48 hours.

Stage 3:

LSHIM will inspect the property and carry out further due diligence and build cash flow models to establish returns. Assuming the parameters for the portfolio are met, LSHIM will issue a Recommendation to Bid generally within 1 to 2 weeks outlining the key fundamentals along with the maximum recommended offer level. A decision back from SRBC will be needed within 24/48 hours.

Stage 4:

If the offer is accepted and Heads of Terms issued, exchange and completion could be set for within 10 to 15 working days. LSHIM will instruct and coordinate the relevant surveys required for the acquisition and will liaise with the appointed legal advisors. This will include a Building Survey, Environmental Survey and independent Valuation. Prior to exchange, a detailed Investment Report will be issued by LSHIM to SRBC which will provide a detailed analysis and cash flow of the investment but will also provide summaries of all 3rd party advisors reports.

Key to the above is the need for prompt responses by SRBC back to LSHIM, in particular at Stage 2 and 3. Accordingly, delegated authority pathways within SRBC need to be clarified and confirmed.

6/ Reporting

LSHIM will prepare a Quarterly Report on the performance of the portfolio and at each anniversary an Annual Report incorporating a review of the strategy for each property and the portfolio as a whole as well as a performance review.

Chris Hornung MSc FRICS
Managing Director
LSH Investment Management
May 2018