

REPORT TO	ON
COUNCIL	25 July 2018



TITLE	PORTFOLIO	REPORT OF
Investment Property Strategy and associated funding	Assets and Transformation/ Finance	Deputy Chief Executive/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?	Yes
Is this report confidential?	No

1. PURPOSE OF THE REPORT

- 1.1. Cabinet, at its meeting of 21 June 2018, approved the Investment Property Strategy. In approving the strategy, Cabinet gave consideration to increasing the available funds to support the strategy from £3.8m to £4.6m through the utilisation of general reserves. This report seeks the approval of Full Council to move £0.8m from general reserves to the Investment Property Reserve.

2. PORTFOLIO RECOMMENDATIONS

- 2.1. Council is asked to approve movement of £0.8m from general reserves to the Investment Property reserve.

3. REASONS FOR THE DECISION

- 3.1. The council identified investment in commercial property as an opportunity to grow its income base as part of the development of the 2017/18 budget and the Medium Term Financial Strategy. An Investment Strategy and appropriate governance was developed over the following months and agreed at Cabinet on 6th December 2017. At that time £3.8m of the council's reserves were set aside to support the strategy.
- 3.2. Since then, the council has procured specialist support from Lambert Smith Hampton Investment Management (LSHIM) to identify and select investment opportunities for the council to consider. The key themes of the strategy are that the funding is aimed at low risk, long term investments with a sustainable income stream that preserves capital. Each investment acquisition will be subject to the rigour of a business appraisal and associated due diligence. Appendix A details the Investment Strategy developed in consultation with members and has identified that an increase in the Investment Property reserve would generate better and more sustainable investment opportunities.

- 3.3. At the end of 2017/18, the council delivered an overall underspend on its revenue budget of £0.770m. This was greater than anticipated throughout the year and meant that reserves for the council increased. It is recommended that this underspend is utilised for Investment Property purposes.

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. 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 reflected in the Investment Property Strategy. Adding £0.8m to the Investment Property Strategy would support the council's ambitions of increasing its rate of return without adversely affecting the current financial strategy.
- 5.3. It should also be noted, that as part of the medium term financial strategy, the council built in additional income of £0.1m for investment property returns into its 2018/19 budget. This increases to £0.3m in 2019/20. Failure to achieve these income targets will impact adversely on the council's financial strategy. The advice from LSHIM to increase the level of funding available for property investment takes into account the council's income targets.

6. HUMAN RESOURCES AND ORGANISATIONAL DEVELOPMENT IMPLICATIONS

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

7. ICT/TECHNOLOGY IMPLICATIONS

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

8. PROPERTY AND ASSET MANAGEMENT IMPLICATIONS

- 8.1. 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.

9. RISK MANAGEMENT

- 9.1. 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.

10. EQUALITY AND DIVERSITY IMPACT

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

11. RELEVANT DIRECTORS RECOMMENDATIONS

- 11.1. Council is asked to approve movement of £0.8m from general reserves to the Investment Property reserve

12. COMMENTS OF THE STATUTORY FINANCE OFFICER

- 12.1. This report is intended to realign reserves to facilitate the acquisition of investment properties and does not in itself commit the council to incur expenditure. As the Council embarks on its Budget Strategy 2019/20, an exercise will be undertaken to assess the adequacy and alignment of reserves to risk and to strategic priorities. This approval is a precursor to that approach and serves as an enabler to facilitate greater commercialisation within the council and create a financial rate of return that in turn will contribute to the overall financial resilience of the Council.

- 12.2. Decisions in relation to any acquisition have been taken at Cabinet 21 June 2018 where the Investment Strategy was approved with delegation to enter into any investment arrangement given to the S151 Officer and Corporate Property Officer in consultation with the relevant portfolio holder(s). Any decision taken will be subject to appropriate scrutiny and challenge applying business appraisal and due diligence methods to ensure Council is satisfied with associated risks.

13. COMMENTS OF THE MONITORING OFFICER

- 13.1. Legal services have previously advised on the Investment Strategy. In a nutshell we were comfortable with what was proposed. The specific proposal here requires a decision of Full Council.

13.2. BACKGROUND DOCUMENTS

Cabinet on 6th December 2017
Cabinet on 21 June 2018
Cabinet on 21 June 2018

Investment Property Strategy
Investment Property Strategy
Budget Out-Turn 2017/18

14. APPENDICES

- 15.1 Appendix A Investment Strategy

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DRAFT

South Ribble Borough Council

Commercial Property Investment Portfolio Investment Strategy

May 2018

DRAFT

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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