READING BOROUGH COUNCIL

REPORT BY DIRECTOR OF ECONOMIC GROWTH AND NEIGHBOURHOOD SERVICES

TO:	**POLICY COMMITTEE**		
DATE:	**10 JUNE 2018**		
TITLE:	**COMMERCIAL INVESTMENT STRATEGY**		
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SERVICE:	**PROPERTY ESTATES AND VALUATIONS / FINANCE**	**WARDS:**	**BOROUGH WIDE**
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1 The Council is required to have both an approved Treasury Management and Investment Strategy under Statutory Guidance on Local Government Investments (3rd Edition, issued February 2018) which themselves shall also have due regard to CIPFA guidance (both the Treasury Management Code of Practice and Prudential Code for Capital Finance).

1.2 The strategy relating to Treasury Management investments has been incorporated into the overall Treasury Strategy, considered and approved by Council in February 2019. This commercial investment strategy forms part of that overall Treasury Strategy and should be read in the context of it offering further detail and specific qualification to that overall strategy.

1.3 The purpose of this report is to seek Policy Committee's approval to adopt the Commercial Investment Strategy and supplements the previously approved Treasury Management Strategy.

1.4 In December 2016 Policy Committee agreed a Property Acquisitions Strategy. This report provides a summary of the principal changes to that strategy and the development of the draft Commercial Investment Strategy attached at Appendix 1.

1.5 The full report and strategy is on the agenda as a closed session item as some elements of the strategy remain commercially sensitive. As much of the report and strategy as possible has been made available in the public domain.

Appendix 1: Commercial Investment Strategy April 2019.

2. RECOMMENDED ACTION

2.1 That the Committee approve the adoption of the Commercial Investment Strategy attached at Appendix 1.

3. POLICY CONTEXT & CURRENT POSITION

3.1 The Council approved its Medium Term Financial Strategy (MTFS) at Full Council on the 26 February 2019. The MTFS is informed by and supports delivery of the Council's Corporate Plan priorities and seeks to ensure that the Council is 'fit for the future' with sound finances that allow the Council's future funding challenges and pressures to be met.

3.2 In the context of the Capital Strategy, the Council is using capital to invest in property to support regeneration and / or generate a revenue income stream. This is one of a number of approaches the Council is adopting to mitigate demand pressures and maintain services in the context of reduced government funding. The MTFS includes a capital budget of £150m in its three year capital programme (2019/20 – 2021/22) for the acquisition of new investment property. The resultant net income from these investments is assumed in the MTFS. Failure to deliver this additional income will create a shortfall in the Council's budget position.

3.3 Alongside the MTFS Full Council also approved the Council's Treasury Management Strategy (TMS) 2019/20. The TMS sets out the Council's planned Treasury activity during 2019/20. The TMS reflects the Council's Capital Programme 2019/20 to 21/22. The successful identification, monitoring and control of financial risk is central to the Strategy. Non-Treasury investments are reflected in this document.

3.4 In July 2016 Policy Committee approved the Council's Corporate Asset Management Plan. One of the principal aims of the Plan was to maintain an effective property-based investment portfolio, to help sustain the Council's on-going financial position.

3.5 At its meeting of 5th December 2016 Policy Committee approved the adoption of a Property Acquisition Strategy to further its strategic objectives of facilitating regeneration, economic growth and housing delivery, as well as remaining financially sustainable. The policy provided a framework within which potential investment acquisitions could be objectively assessed.

3.6 Nationally, local government has invested significantly in the property investment sector in its own right, making use of preferential borrowing rates to acquire income producing assets as part of a balanced investment portfolio in order to facilitate regeneration and economic growth and contribute to achieving the Council's wider strategic objectives.

3.7 It is now timely to review the adopted Property Acquisition Strategy (December 2016) and adopt a revised Commercial Investment Strategy.

Current Investment Portfolio:

3.8 Since 2016 the Council has purchased the following investment properties.

Address	Rental income (gross pa) £,000	Capital Value £,000	Purchase Price £,000	Net Annual Income *(after MRP) £,000
Kennet Wharf, Queens Road	1,295	20,100	20,091	453
Adelphi House, Friar Street	744	12,327	11,432	222
160 -163 Friar Street offices, public house and retail	729	12,650	11,230	259
Four 10 TVP	1,660	36,197	32,914	621 (MRP not applicable in the first year. £162k from 20/21).

In addition to the above, the Council has a number of historic investment properties.

4. WAY FORWARD

4.1 The Commercial Investment Strategy:

- Sets out the Council's objectives in acquiring property assets for investment purposes.
- Identifies the issues of the economy, the general property market and the possible risks for the Council in acquiring investment property.
- Clarifies the legal powers used to operate the Strategy and ensure continued compliance.
- Identifies criteria for acquiring and owning property assets for investment purposes to ensure risks are minimised.
- Outlines the due diligence and decision making process involved in acquiring property assets for investment purposes.

4.2 Acquisition for investment purposes to generate an income stream is a natural progression from acquisition for regeneration purposes. The two can also be combined, securing an income stream and the future regeneration of a site.

4.3 Historically, property has proved to be one of, if not the best, investments in terms of Capital growth over the last 50 years. If the Council owns the property for 20 years or more, and the property is managed and maintained appropriately, the Council can expect to see an increase in the value of the property as well as a net annual surplus of revenue.

4.4 The reasons for buying and owning property investments are primarily to:

- Facilitate and steer the regeneration of the town, contribute to meeting housing need, support economic prosperity and help deliver wider community benefits; and
- Generate a net positive revenue income stream to support delivery of services to local people

4.5 A net positive revenue income stream can be achieved by buying property that has been well maintained, has a tenant with a good financial covenant occupying the property on a full repairing lease who pays a market rent to the council as landlord.

4.6 The Property, Finance and Legal teams undertake due diligence of both the property and the tenant before considering whether a property should be pursued for purchase. This involves independent property advice on the value of the property and the potential risks of re-letting it if the tenancy finishes. Advice includes an assessment of potential void periods, investing in the property and costs of maintaining the property if it is empty. These variables are input into a financial model and sensitivities modelled to determine whether or not the Council should proceed alongside assessing the performance of the property in the marketplace and ensuring there are no legal risks associated with the purchase.

4.7 In 2018, the Council's external auditor EY was asked to undertake a review of the property acquisition process and the associated financial model to ensure its robustness going forward. The conclusions of the review have informed a range of improvements to the process and the associated financial model.

4.8 As well as addressing the proposed improvements to processes and the strategy for investment property acquisition, this updated strategy sets out the changes which need to be considered in light of two new sets of statutory guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) in February 2018 relating to Minimum Revenue Provision and Local Government Investments.

4.9 The updated guidance on Minimum Revenue Provision (MRP) prevents local authorities purchasing investment properties or other capital assets without subsequently setting aside revenue funding to repay debt.

4.10 The guidance on Local Government Investments requires councils to approve an annual Treasury Strategy which addresses the security / liquidity and return (in that order of priority) of all investments; as well as risk and appropriate mitigations. In particular the guidance stresses councils do not have the power to "borrow in advance of need purely in order to profit from the investment of the extra sums borrowed" – this includes borrowing to purchase investment properties for the sole purpose of generating a revenue income stream. It goes on to state where a council chooses to disregard this latter requirement, the Strategy should clearly explain why it has ignored the Guidance and how risks of not achieving expected yields will be managed.

4.11 The Commercial Investment Strategy and associated protocol takes on board the new statutory guidance issued by MHCLG in February 2018.

4.12 All other things being equal, the Council would see its cash balances grow over the MRP life of the asset such that at the end sufficient cash is available to repay the loan.

4.13 After the estimated holding period for the asset the Council will have built up sufficient cash resources to repay the outstanding borrowing and thus incur no further debt management costs. However, it will still hold an asset with a likely considerable value. Even if the building requires impairment, the land value itself is likely to have risen by inflation. The investment appraisal model recognises this residual value by assuming a capital receipt, which is then used to reduce existing debt and thereby future MRP charges. Any actual decision to dispose of or retain the property would be made at the appropriate point in the future and would take into account the overall capital and revenue position and outlook at that time.

4.14 Any impairment that occurs during the holding period is offset by a statutory override to general accounting practice that prevents any valuation reduction impacting on unusable reserves rather than usable balances. As such any net impairment only impacts the Council’s overall position at the eventual disposal date and would impact on the value of a capital receipt ultimately achieved.

Location

4.15 The Council has up until now only invested in or near to the borough but could consider investing within a wider area in order to spread risk and where the investment meets the relevant criteria. The due diligence process to evaluate investment properties is the same regardless of the location of the property. The full report in Appendix 2 sets out a number of reasons why it is not advisable to look to acquire in just one location.

4.16 It is therefore proposed that the current position be amended to enable the Council to make strategic investment acquisitions outside of the Borough and Greater Reading area to include the Thames Valley Berkshire LEP area, adjoining LEP areas and other locations where the investment would support the overall aims of the Strategy

Joint Investments

4.17 It is also proposed that the Council may wish to consider approaching other Councils or local investment institutions with a view to sharing in future acquisitions, to spread risk and facilitate larger purchases which would otherwise be beyond the Council’s available funding. The Strategy provides support to such an approach.

5.0 POLICY CONTEXT

5.1 The Council’s policy context and priorities are set out in its Corporate Plan. The adoption of a revised Commercial Investment Strategy primarily supports three of those priorities:

- Securing the economic success of Reading
- Improving access to decent housing to meet local needs
- Ensuring the Council is Fit for the Future

6.0 FINANCIAL IMPLICATIONS

6.1 The Council's Capital Programme provides a budget of £150m in its three year Capital Programme (2019/20 – 2021/22) for the acquisition of new investment property. The resultant net income from these investments forms part of the assumptions in the MTFS. Failure to deliver this additional income will create a shortfall in the Council's budget position. The MTFS contains provision for risk and contingency (which includes the potential for some commercial income not to be secured as planned). Any failure to to achieve income taregts could potentially therefore be offset in the short to medium term by such provision. However, it will be entirely dependant on the delivery of other MTFS savings and there being sufficient headroom in the contingency sum. In the longer term the disposal of the asset or redevelopment to an alternative use would be considered.

6.2 A detailed due dilgience process is undertaken to ensure the investment meets the Council's financial objectives and provides surety in relation to all legal and property matters.

6.3 The Council's 19-20 MTFS includes a net income target (after provision for repayment of debt) of £750k, for rental income across the portfolio of investment properties. This represents just 0.54% of the overall net budget for the Council so does not pose a significant risk to the overall finances of the council.

6.4 Investment properties are re-valued in the accounts annually at fair value. Any fall in value is reversed out of the revenue account under statutory regulations. The Council has created a provision to manage potential liabilities in relation to its commercial property holdings.

6.5 By providing fully for MRP, the Council will repay the overall debt of the investment regardless of its annual valuation.

7.0 BACKGROUND PAPERS:

- Treasury Management Strategy 2019 /2020.

COMMERCIAL INVESTMENT STRATEGY

1.0 As Place-maker, the Local Authority plays a pivotal role in facilitating and contributing to the regeneration and economic prosperity of the Borough. Along with setting a strong vision for the area the Council has successfully used its land holdings, often in partnership with the development industry, to deliver well-balanced and sustainable development and infrastructure to meet the needs of the residential and business community.

2.0 The Council has a proven track-record in optimising its strategic property holdings to enable wider regeneration and economic growth. The Council needs to continue this role and make strategic land and property acquisitions that will both contribute to and be an enabler of economic growth and regeneration thereby delivering the Council's wider objectives.

3.0 The importance of regeneration in meeting Reading's future needs and securing the wider economic success of the sub-region area is best demonstrated by the new Reading Borough Local Plan. The Plan identifies 194 hectares of new development across the Borough, and sets an ambitious target to deliver 671 new homes per annum during the plan period to 2036, in order to meet objectively assessed needs. The need is for 406 of these new homes per annum to be affordable, which presents a significant challenge give local housing market conditions.

4.0 The constrained and predominantly urban nature of the Borough means it is inevitable that a significant element of future additional housing stock will come from either the redevelopment or conversion of existing commercial properties across the town. It is therefore appropriate for the Council to invest in suitable properties to secure a potential pipeline of suitable homes into the future.

5.0 At the same time, it is important that Reading provides a range of types of commercial floorspace to support economic development and growth, be that multi-national business, green tech companies or other SMEs. The Council already provides small flexible industrial start-up units at its Acre Road Business Park, but needs to expand and diversify its offer to support local businesses and to spread the risk across its portfolio.

6.0 The Council is currently working in partnership with the Thames Valley LEP to develop a new Local Industrial Strategy for Berkshire, and Reading is the principal sub-regional economic hub for the Thames Valley. The objectives of the BLIS will further inform the range and type of property investment that the Council should consider in order to achieve its wider objectives.

7.0 The Council will continue to keep its property portfolio under active review to ensure it remains appropriately balanced and incorporates a range of uses and property types in order to spread risk and therefore reduce any possible of over-reliance on one particular sector. This will require a proactive asset management regime that not only maximises letting of existing space, but involves purchasing and disposing of particular assets at any one time to maintain the risk spread across the portfolio and in order to respond to changes in the commercial property market.

8.0 This is a long-term property investment strategy intended to ensure a well-balanced property portfolio with an over-all low risk spread that can contribute to achieving the Council's objectives, commercial property investments should ensure that the associated rental income is sufficient to cover the costs of borrowing and repayment. Ultimately, at the end of the loan period, the council will own outright a considerable physical asset and can choose to release the value of that asset if it so chooses.

9.0 The introduction of a streamlined framework within which the Council pursue strategic acquisitions and manage its existing holdings will enable the Council to maximise the value of its existing asset base, acquire land and property that will make a significant contribution to the town centre's regeneration and future development, increase business rates and council tax receipts and in the medium term, provide an income stream that could contribute to the provision of front line services.

10.0 **The Investment Property Market**

10.1 The UK commercial property investment market is very well established, attracts global investors and is defined as a 'mature asset class' with a range of new and established investors including institutions, pension funds, specialist property companies, charities, family trusts and individuals.

10.2 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines investment property as "…used solely to earn rentals or for capital appreciation or both…". Returns from property ownership can be both income driven (through the receipt of rent) and by way of appreciation of the underlying asset value (capital growth). The combination of these is a consideration in assessing the attractiveness of a property for acquisition.

10.3 Property prices and returns are a function of the property type, condition, use and location, together with the lease structure and covenant strength of the tenant (in the case of a let property).

10.4 When investing in property the Council seeks to produce the best returns possible, whilst carrying an acceptable level of risk. <u>The full vesion of the strategy provided in Part 2 of the agenda sets out the main mitigation measure in managing risk</u>.

10.5 Any property asset coming onto the market could be for a number of reasons. Investors seek to buy and sell in many different circumstances – rebalancing their portfolio, seeking cash to influence balance sheet or share price, requirement for a more "liquid" asset, short term investment taking advantage of small capital growth, moving into different property classes, etc.

10.6 There is a risk to the Council regarding the liquidity of these investments based on how quickly they could be sold and if the price would be above or below market value. However, investment is made with the intention of retaining the properties in the long-term and not to gain a capital receipt at a later date, which does partly mitigate the risk. If a decision was made to sell one or more of the properties it is likely to take in the region of six months to a year before a capital receipt was received and any sale made based on a need to generate a receipt would be subject to the fluctuations of the market.

11.0 **Approach**

11.1 The factors the Council takes into account when considering the acquisition of property for investment purposes are set out in the full vesion of the strategy provided in Part 2 of the agenda

12.0 **Risk Analysis**

12.2 All potential acquisitions will be assessed using the following Criteria.

Risk	Mitigating action	Opportunities
Property, legal and finance matters are not fully interegated and understood.	Due diligence process including the use of third party experts in relation to property, legal and financial matters	
Loss of future rental income - due to void periods. Appetite for risk in dealing with voids when a tenant vacates is a key factor. Balancing potential rental growth and increased capital value against short term loss of rent and possible capital costs prelet.	The use of a prudent financial model is adopted that makes allowances for potential void and rent-free periods, as well as making provision for periodic capital investment to maintain the property to retain attractiveness. Ensure that covenant strength and lease length is acceptable and will contribute positively to spreading and mitigating risk across a diverse and balanced investment portfolio.	Market conditions can go up as well as down, with the Council benefitting from increased returns during an upturn.
Property market fluctuations – Property is a riskier asset than other asset classes because of its physical characteristics, which need to be managed and maintained. The Council may not achieve its target returns if market conditions significantly worsen or there is a marked change in a	Undertake appropriate due diligence and appoint specialist independent advisers and agents to act on behalf of the Council. Application, where appropriate of factors such as 'smoothing' which spreads an average income over a set period to mitigate the financial impact of	Market conditions can go up as well as down, with the Council benefitting from increased returns during an upturn, as well as an asset increasing in capital value over the medium term.

particular sector.	vacancy or rent free periods. Target assets/locations where income is secured and rental growth identified. Proactively manage the investment portfolio through both disposal and acquisition to ensure a well-balance and diverse portfolio that spread risks against various asset criteria.
Abortive costs – It is almost inevitable that some transactions will not proceed and there will be abortive costs.	Good market intelligence and preliminary due diligence using an independent specialist adviser/agent should help mitigate this risk.
Communications – perception the Council is spending in a time of austerity.	The Council cannot borrow to run services and the benefits of such investments help to providing core services.

The Council's exposure to risk of income shortfall or value falls is mitigated by the use of prudent modelling, contingency provisions and the full provision to repay debt over the life of the asset. In addition, the Council's overall exposure to risk from commercial investment property is mamaged by the limit imposed on the total value of assets set out in the approved capital programme.

13.0 Current Investments

13.1 The full vesion of the strategy provided in Part 2 of the agenda sets out the total value of the recent acquistions including the purchase of a property which is due to complete in ealry April.

13.2 The Council's adopted MRP policy determines the use of the annuity method in calculating the provision for debt repayment – in a similar manner to a private householder's repayment mortgage, the amount of principal repaid is lower in the early years but gradually increases year on year. Given that rental yields are likely to rise at each rent review / lease renewal date such a policy more closely matches capital financing costs to revenue income streams.

14.0 Acquisition Process & Protocol

14.1 The full vesion of the strategy provided in Part 2 of the agenda sets out the acquistion process and refers to Appendix A and B setting out the detailed purchase process to be followed and initial evaluation matrix.

15.0 **General Principles**

15.1 The full vesion of the strategy provided in Part 2 of the agenda sets out the general princples and the requirements of the appraisal and business case

16.0 **Resourcing**

16.1 The Council should identify potential acquisition opportunities through a combination of in-house knowledge of the local market and selling agents that present potential investment opportunities. The appropriateness of a particular opportunity will be assessed by the Council's retained and independent specialist advisors, as part of the adopted acquisition protocol.

16.2 As the investment portfolio grows and diversifies, specialist resources will be retained to undertake proactive portfolio asset management to ensure that the return on investment is optimised and risk is managed.

The full vesion of the strategy considered in closed session provides two appendices setting out the detailed purchase process to be followed and initial evaluation matrix.