COMMERCIAL PROPERTY INVESTMENT STRATEGY 2020

PURPOSE OF THE STRATEGY

The purpose of the Commercial Property Investment Strategy 2020 “the strategy” is to provide a robust and viable framework for the acquisition of commercial properties. This strategy sets out the Council’s objectives, investment criteria and the process which will be followed when acquiring, disposing and managing property assets for investment purposes. It replaces the previous Asset Investment Strategy and business case – September 2014.

KEY OBJECTIVES

1. To invest in properties that provide a sustainable income in accordance with the Councils corporate and financial objectives
2. To maximise return whilst balancing risk through the management processes outlined in this strategy
3. To acquire investment grade properties possessing characteristics that retain liquidity and preserve capital (notwithstanding market movement)
4. To develop a governance framework that enables the Council to move at a timely pace in line with the market

STRATEGIC DRIVERS

A larger and more balanced property portfolio supports all the fundamental themes of the Corporate Plan and the Council’s strategic priorities and will help achieve the Council’s aim of increasing income to support the delivery of services. The acquisitions search will concentrate on properties within the Borough of Guildford (and exceptionally the wider LEP region), particularly on assets that would provide a longer-term strategic benefit as well as financial return.

The types of assets that are likely to meet the Council’s criteria include leased properties let to local businesses as well as national or international firms that contribute to growth in the local economy. The acquisition of property interests in order to consolidate leasehold and freehold ownerships (i.e. buy back in long leaseholds) will also qualify. In such cases, the Council will buy the asset, refurbish and upgrade them, where appropriate, and lease them to good quality tenants.

FIGURE 1: CORPORATE AND REGULATORY FRAMEWORK

Where rental income and/or capital appreciation are a substantial consideration in the decision whether to enter into the transaction attention must be given to the Council's investment objectives contained in the capital and investment strategy.

This strategy, therefore, sits in conjunction with the Council's Capital and Investment Strategy 2020/21 – 2024/25 as well as satisfying the requirements of the Prudential Code and Statutory Framework with regard to property investments.

GOVERNANCE

SOURCING ACQUISITIONS

The Council may either approach a vendor directly or through third party agents to notify its interest in a property investment / proposal. The Council will also accept unsolicited introductions from agents in respect of individual properties.

If the Council receives an initial introduction from an agent and wishes to pursue the opportunity further, it will expect to pay an introductory fee on successful completion. Introductory fees are usually 1% of the agreed purchase price.

It is also possible that an opportunity may arise for the Council to enter into a joint venture with another local authority, developer or investor.

In order to ensure the Council is made aware of the latest and best opportunities, officers will need to maintain relationships with external agents and build credibility as a good performing purchaser / vendor and an excellent organisation to do business with.

The Council's main point of contact for all acquisitions / disposals will be the Deputy Head of Asset Management.

PORTFOILIO STRUCTURE / DIVERSIFICATION

The Prudential Code states that a Council must invest its funds prudently and have regard to the security (protecting capital sums from loss) and liquidity (keeping money readily available for expenditure when needed or having access to cash) of investments before seeking the highest rate of return, or yield.

The Capital and Investment strategy sets out the Council's risk appetite and states that the Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Investment properties have a very different balance of security, liquidity and yield from most financial investments – the potential volatility of income will be particularly important when balancing the revenue budget on an annual basis. Property acquisitions should, therefore, be subject to enhanced decision making and scrutiny as a result of the additional risk being taken on and the potential impact on the sustainability of the authority.

A major objective of the property investment strategy is to invest in assets that support the strategic priorities set out in the Corporate Plan or provide sustainable income, whilst balancing a portfolio diversified enough to provide protection against underperformance in any one sector.

From a strategy point of view, it is generally considered to be most advantageous to have criteria as wide as possible to identify the most suitable investments to form the constituent parts of the portfolio jigsaw and be able to react to structural changes in the market. This is particularly true in strong market conditions when demand for good quality, income producing assets is very high. As such, this strategy has not set target weightings for any specific asset sectors although sector diversification will be monitored.

Diversification by risk will also be considered (within the guidelines of the Council's Capital and Investment Strategy). In general terms, risk and return have a direct correlation in that the greater the risk, the greater the expected return should be. The last 20 years has seen a significant reduction in lease length and the increasing prevalence of break options. This represents a significant shift of risk from tenant to landlord. By having a net initial yield target that increases as the matrix criteria score decreases allows us to appropriately price the risk around lease length and covenant strength exposure (as well as other criteria) (see Appendix 3 for more details).

In addition, to limit the risks arising from other factors the following guidelines will be considered when selecting properties for investment:

- Lot size - No single asset should be over 20% of the portfolio value to limit the risk arising from individual assets.
- Income risk – No single tenant should account for more than 20% of total income once full invested to limit the exposure of tenant failure.

SELECTION OF INVESTMENTS / DISPOSALS

To enable the Council sufficient scope to identify suitable properties and to build and maintain a portfolio which can achieve the desired objectives and aims of the strategy, properties will be assessed against a set of financial and qualitative criteria. To summarise this will include:

FINANCIAL	
Lease Classification	The lease should be classified, for accounting purposes, as an operating lease rather than a finance lease, to ensure that rental income can be treated as revenue[1]
Internal Rate of Return (IRR);	The internal rate of return (IRR) should exceed a minimum level of minimum IRR is 3.5% or 2% above projected borrowing cost (incl. interest + MRP[2])whichever is the higher. The internal rate of return is typically higher than the initial yield, since it gives an overall level of return over the holding period of the investment. This is calculated using a discounted cash flow and can allow for rental growth, void periods, refurbishment expenditure and so on.
Net Yield (NIY)	Due to the Council's requirement to generate income through a satisfactory level of return, whilst still reducing the level of risk, a minimum net initial yield that we could expect to achieve on the investment will be set and increase on a sliding scale as the risk return matrix score reduces.
QUALITATIVE	
Location	Dictated by the opportunities available but concentrating on properties located in prime or near-prime locations
Tenancy strength	Preference will be given to single occupancy investments let or lettable to financially secure tenants with a good covenant, although multi-let properties will be considered.
Tenure	Freehold or long-leasehold
Occupiers lease length	Longer lease length - lease length will be determined by market forces, but the premise will be to maximise
Repairing terms	Preference for strong tenant repairing obligations shifting the risk from Landlord to Tenant
Lot size	The main target will be lot sizes representing 5 – 15% of the over portfolio.
Building condition	Good quality, sustainable buildings in good condition or that can be put into good condition Low maintenance and low obsolescence.
Strategic Value	Contribution to the Council's strategic priorities identified in the corporate plan or other strategic value (economic, social or environmental). Economic propositions (jobs, business, community etc) Social Value (health, wellbeing, sustainability, community etc) Environmental measures (carbon footprint / emission impact, recycle / reuse profile, etc)

[1] Operating leases are those where the risks and rewards of ownership are retained by the lessor (the Council) and must meet certain criteria. The main criteria being that the lease term should not be for the major part of the property's economic life and at the start of the lease, the total value of minimum lease payments (rents) should not amount to a significant proportion of the value of the property.

[2] Minimum Revenue Provision

Full details are in Appendix 3.

CONDITIONS TO PURCHASE

Further conditions to purchase will be:

- the investment is in line with the Council's strategies and policies;
- the ethical position of the investment is strong;
- the investment or disposal is within the Council's legal powers;
- the investment or disposal is reasonable[3];
- it has properly considered advice from its professional advisors, whether internal or external;
- the business case is sufficiently strong;
- proper consideration has been given to the balance between risk and reward;
- making the investment or disposal would not be a breach of the Council's fiduciary duty;
- making the investment or disposal will represent value for money; and
- the proposed funding method provides the best value for money after considering all relevant financial considerations, including taxation.

APPROVAL PROCESS TO PURSUE OPPORTUNITY

All acquisitions / disposals are to be approved by the Investment Property Fund Management Group (IPFMG) which includes the Director of Resources, Lead Specialist (Finance), Head of Asset Management, Deputy Head of Asset Management and Asset & Property Managers.

The IPFMG (which meets monthly) will review each proposal in respect of each of the conditions to purchase and decide if the business case in favour of investment / disposal is sufficiently strong. If the group are happy with the proposed acquisition disposal it will be referred to the member and officer represented Property Review Group (PRG) for approval.

If either group cannot meet in time then the matter will be approved by the Lead Member for Finance, Asset Management and Customer Service, Director of Resources, and Head of Asset Management.

All investments will be approved on the basis of a robust business case which will give due consideration to the balance between risk and reward, an assessment of the underlying security of the investment. As a minimum this will include:

- a basic purchase report (including details of the opportunity, location, age, tenure, tenant covenant, lease terms, exit strategy, etc.);
- an investment risk and return matrix (a score matrix based on the chosen criteria);
- a financial analysis (a cashflow analysis demonstration the long-term income and costs based on a number of different risk scenarios); and
- the percentage of total income of the portfolio against covenant strength
- potential exit strategies.

See Appendix 1 – Acquisition Flow Chart

[3] The exercise of the powers must be 'reasonable'. Consideration must be given to the Wednesbury principles. CIPFA, *Prudential Property Investment* (2019), pg. 17.

RISK MANAGEMENT MEASURES

Property has some significant different characteristics and risks compared to other types of investment. Mitigation proposed for these risks include diversifying the portfolio (portfolio mix) to include investments that perform differently over the economic cycle.

The evaluation criteria, approval processes, due diligence tests, and internal / external advice are also proposed to address property specific risks.

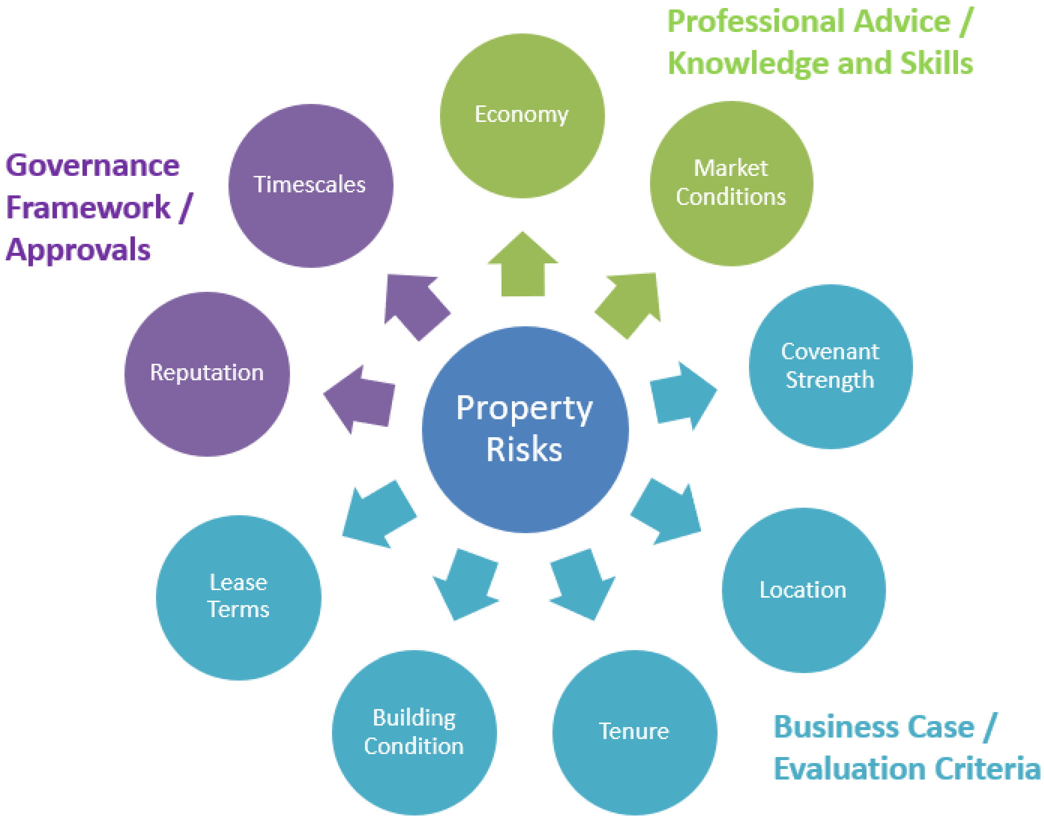


FIGURE 2: PROPERTY RISK GROUPS

Business Case / Evaluation Criteria
Officers will seek to mitigate the risk by preparing robust business cases including detailed cash flow models for different risk scenarios and scoring matrices**.**

Governance Frameworks / Approvals
Clear governance arrangements and scrutiny procedures for the acquisition, disposal, management of commercial property and decision-making powers will enable the timely and decisive decision making that is essential in this type of market to respond to opportunities as they arise. This will also enhance the Council's reputation as a good performing purchaser / vendor.

Due Diligence
Acquisitions will also be conditional on full due diligence, including:

- full title report and legal pack to be produced by external solicitors;
- a review of the tax implications;

- an independent surveyor's valuation of the property and detailed purchase report to support the purchase price; and
- satisfactory surveys.

Profession Advice / Knowledge and Skills

The complexities of investment in property mean that it is vitally important for the Council to be competent to take decisions to acquire, hold and dispose of land and buildings. This does not require all the expertise and experience to be in-house, but members and officers must have sufficient competence to understand and evaluate the advice they are given and make reasonable decisions in relation to it or to overseeing the decisions taken by others.

The Council is satisfied that we currently have internal staff with the requisite skills and experience to undertake these investments. The Council will also engage the services of professional property, legal and financial advisors, where appropriate, to access specialist skills and resources to inform the decision-making process associated with this strategy.

The Council recognises it is responsible for property investment decisions at all times and will ensure that undue reliance is not placed upon external service providers and will maintain sufficient in-house expertise to manage the procurement of investments through the Asset Management Team.

PORTFOLIO MANAGEMENT / REVIEW

A larger and more balanced portfolio will help achieve the Council's aim of increasing income to support the delivery of services throughout the Borough. However, the acquisition of property is only the first step in achieving the objectives of the strategy. It is essential that the portfolio is correctly managed, and value added. This will take the form of:

- Negotiating leases on the best possible terms.
- Preparing for and having an action plans for all lease critical dates, break options, rent reviews and expires.
- Enforcing tenant covenants (e.g. repairing obligations).
- Investing where necessary to retain property value.
- Reducing risk by requesting rent deposits / guarantees and undertaking continual analysis of covenant strength.
- For all buildings to be sustainable and held to a high standard of repair, by undertaking regular condition surveys and linking the output of the condition survey to an identifiable programme of works.
- For all properties to be fully compliant with statutory requirements including health and safety and energy efficiency regulations.
- Continual evaluation of properties against the evaluation criteria and the Council's priorities and ensure it is fit for purpose and categorising into Retain / Retain with improvements / Dispose.
- Pursuing individual strategies for top 5 properties by value or high-risk properties, as necessary.
- Selling high cost or underperforming assets (see Appendix 2 – Disposal Decision Tree).

Management of the Council's assets is covered more in the council's asset strategy and framework

PERFORMANCE REPORTING

To ensure the assets are being correctly managed performance monitoring will be reported initially through the IPFMG, the PRG and then the Executive as part of the Capital Investment Outturn Report.

Annual performance reporting will include:

- A market update on investment trends, activity and forecasts
- An update on the occupational markets
- A review of current investment strategy
- Benchmarking the existing portfolio and asset level investment returns
- Reporting on performance of the portfolio and individual assets
- Provision of a review of portfolio activity and the added value created over the previous 12 months
- An update on individual asset reviews and Keep/Improve/Sell asset designation

The IPFMG will also consider the following, as and when required:

- Re-confirmation of investment criteria;
- identification of any re-alignment required to match market changes and forecasts;
- advice on all critical lease dates, break options, rent reviews and lease expiries (especially in relation to the top 5 assets); and
- any health and safety incidents and insurance claims.

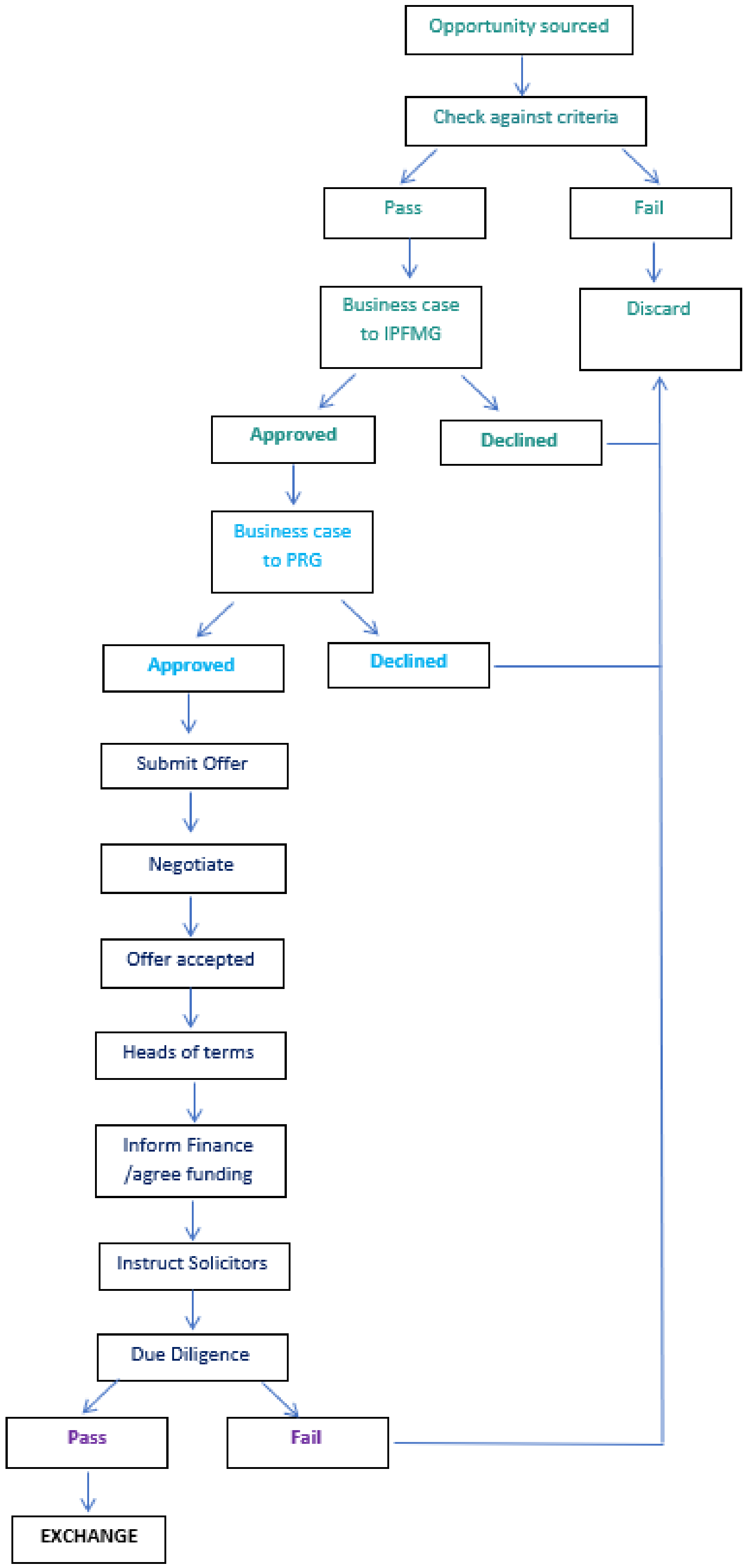
This will provide a clear understanding of the portfolio's position and management, its risk and return profile and any latent value that can be driven out through strategic asset management.

PORTFOLIO VALUATION

In accordance with the International Financial Reporting Standards the investment portfolio is externally valued every year in accordance with the RICS Red Book and the International Valuation Standards.

Annual valuations are important not only for regulatory purposes but also to ensure that current book values are in line with the prevailing market and this enables individual assets or the wider portfolio to be benchmarked against wider performance of the commercial property sector or the market as a whole.

APPENDIX 1 – ACQUSITION FLOWCHART



APPENDIX 2 – DISPOSAL DECISION TREE