Executive Report
Report of Heads of Economic Development and Financial Services
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Property Acquisition

Recommendation to Council

The Executive is asked to recommend to Council that a supplementary estimate of £15 million be agreed for the 2012-13 capital programme to provide budget approval for property acquisition.

Recommendation to Executive

Subject to Council approval of the above, the Executive is asked to agree that £5 million be added to the 2012-13 approved programme and £10 million to the provisional programme.

Reason(s) for Recommendation:

To allow the Council to increase its investment property holding in support of its financial strategy.

1. Purpose of Report

1.1 This report explains the current make up of the Council's cash and property investment portfolio and examines ways in which returns can be increased by extending the amount invested in property.

2. Strategic Priorities

2.1 The management of the Council's physical assets and cash balances underpin all the strategic priorities.

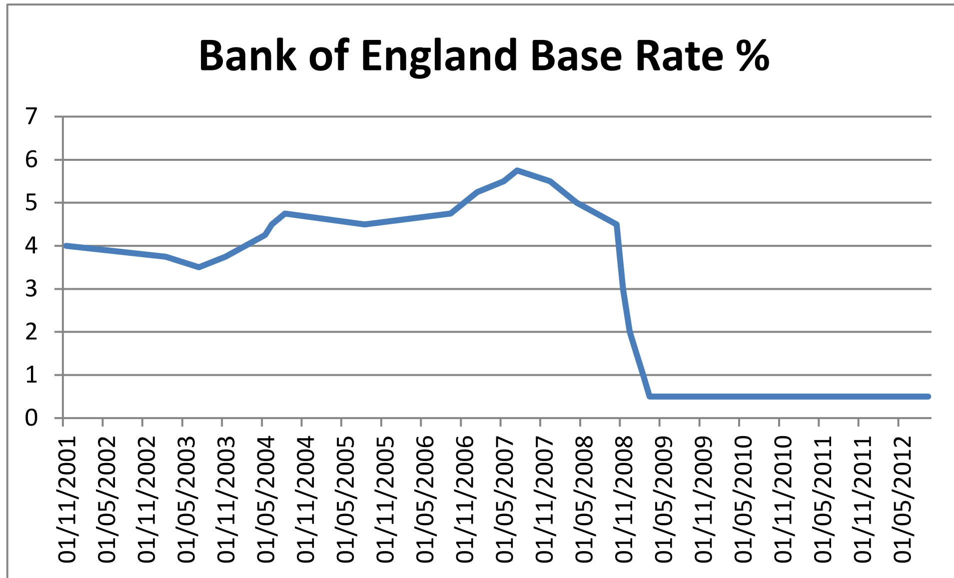
3. Current Treasury (Cash) Management position

3.1 The Council's treasury management function is managed in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) code of practice.

This states that the priorities for treasury management must be security, liquidity and yield in that order.

3.2 Since the economic crisis that started in September 2008 returns from cash investments have decreased significantly. The three main reasons for this are;

- bank base rate has fallen from 5.75 per cent in December 2007 to 0.5 per cent in March 2009 and has been at that level ever since as illustrated in the graph below:



- the number of possible counterparties (organisations that are considered sufficiently secure to lend money to) has been reduced because of the uncertainty whilst investments with some are not possible because of the minimum investment that they will accept. The most secure organisations offer the lowest rates.

- the length of time an investment is placed for has been reduced, again because of security concerns. The shortened duration reduces the return available.

3.3 The table below sets out the returns achieved from the Council's cash investments from 2003-04

Financial year	Weighted average return for fixed investments	Weighted average return for variable investments	Weighted average return for total investments
2003-04	3.17%	3.49%	3.17%
2004-05	4.97%	4.68%	4.96%
2005-06	4.55%	4.51%	4.55%
2006-07	4.58%	5.38%	4.61%
2007-08	5.85%	4.19%	5.15%
2008-09	5.50%	3.81%	5.14%
2009-10	2.87%	3.39%	2.99%
2010-11	1.83%	0.58%	1.54%
2011-12	1.77%	0.23%	1.20%

The return for variable investments includes investment funds

3.4 Officers have looked at the possibility of increasing the Council's exposure to property investment because of the reduction in return from cash investments. Advice from the Council's treasury management advisors (Arlingclose) and sentiment in the financial and property markets all indicate that the base rate is unlikely to rise significantly for several years. Given the outlook for low interest rates, consideration should be given to higher yielding investments than cash in order to gain a better return.

3.5 Increasing the exposure to property could be achieved within the current Treasury Management Strategy, approved by the Council on 9 February 2012, by investing in property based funds (indirect property investment). It could also be achieved by buying the freehold of individual properties, through the General Fund Capital Programme and letting out to generate revenue income (direct property investment).

3.6 As an asset class, property investment provides a better total return (i.e. from both income and capital appreciation) than cash investments, whilst still maintaining a high level of security. Any rental income generated from the property would benefit the Council annually but Councillors will be aware that property values can go down as well as up. Any capital appreciation would not benefit the Council directly until the asset is sold, when a capital receipt would be generated. Property investment is less liquid than some other investments as the property has to be sold to release the cash. However, it is normal for investment portfolios to have some less liquid investments and, in an emergency the Council could take on short term borrowing until a sale is completed.

3.7 The Investment Property Databank (IPD) UK All Property Total Return (which is the income return added to the capital growth) for the past three, five and 10 years has been 8.7 per cent, -0.7 per cent and 6.9 per cent respectively (source: IPD, 31 December 2012). For the 12 months to July 2012 the IPD UK All Property Total Return has been 4.3 per cent (Source: IPD 31 July 2012)

4. Current property investments

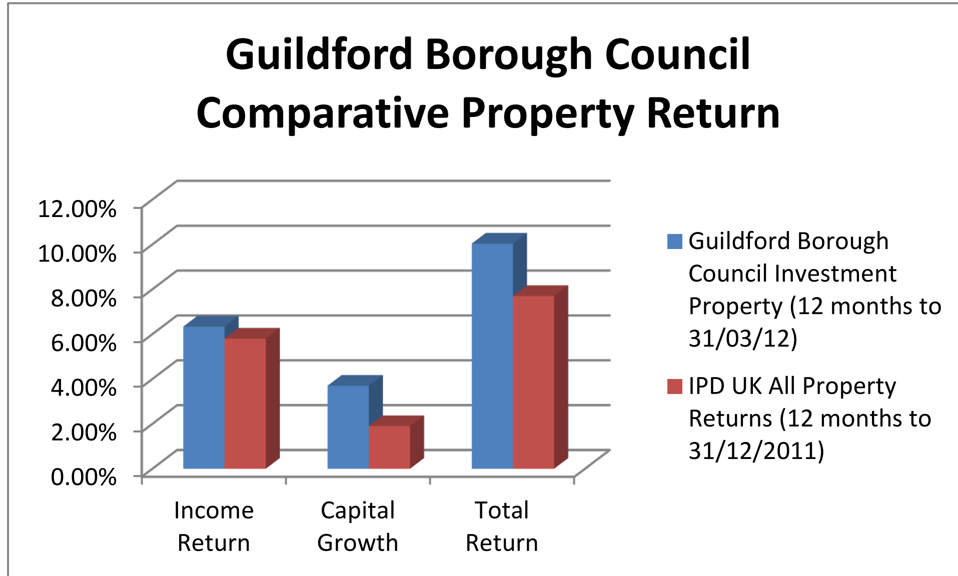
4.1 The Council already has significant exposure to property through its existing investment property portfolio. As at 31 March 2012 the value of this portfolio was £78.9 million. Since 1 April 2012 Middleton House has been purchased for £800,000, bringing the total to £79.7 million.

4.1 The cash investment portfolio varies depending on the time of the year but the closing balance at 31 March 2012 was £63.8 million. The Council therefore already had 55.3 per cent of its investments in property at 31 March 2012. The comparable figures for previous years are:

Financial year	Balance of cash investments at 31 March (£000)	Investment Property value at 31 March (£000)	Total investments in cash and property (£000)	per cent of total investments in property
2004-05	57,323	56,286	113,609	49.54%
2005-06	65,108	70,896	136,004	52.13%
2006-07	72,130	82,016	154,146	53.21%
2007-08	73,290	82,576	155,866	52.98%
2008-09	72,206	79,480	151,686	52.40%
2009-10	64,607	79,872	144,479	55.28%
2010-11	64,689	76,427	141,116	54.16%
2011-12	63,817	78,941	142,758	55.30%

4.2 There is scope for the percentage of investments in property to be increased by purchasing high calibre property. For example the purchase of 14-15 Midleton in December 2011 and Midleton House in June 2012 resulted in a capital value increase of the whole of Midleton Industrial Estate from £1.8 million to £3.8 million. After deducting the cost of the acquisitions of £700,000 and £800,000, this has resulted in a gross capital gain of approximately £500,000 showing a gross return on the additional capital invested of circa 33 per cent. Once fully let the properties are estimated to achieve a rental income of £85,000 per annum and £92,000 per annum showing a rental return of 12.1 per cent and 11.5 per cent respectively.

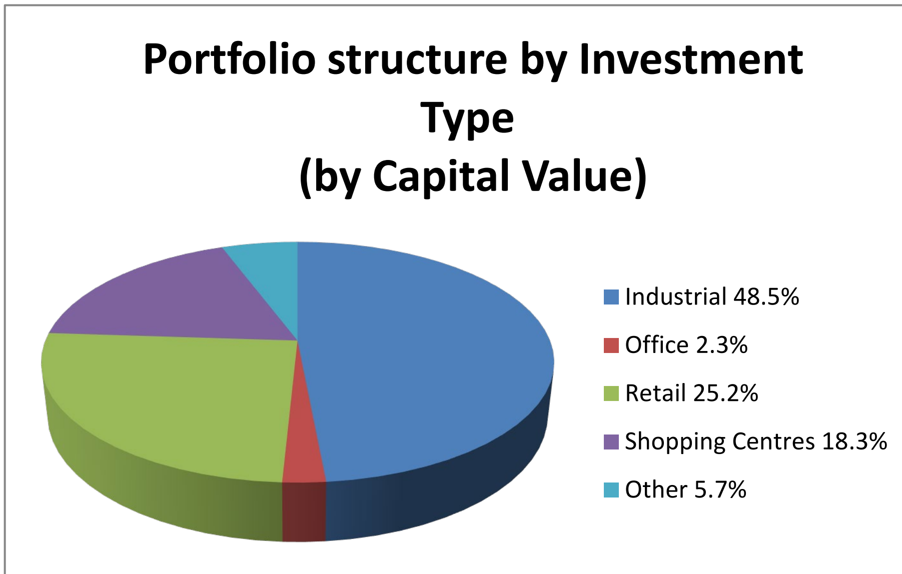
4.3 The value of investment property must reflect market conditions at the balance sheet date. Each year, therefore, the portfolio is assessed and where the carrying amount of a property is likely to differ materially from current market value it is revalued. All investment property is revalued at least once every five years. Values may increase or decrease on revaluation, depending on the market conditions at the time.



As can be seen from the above chart, the Council's investment property portfolio has achieved a total return of 10.04 per cent per annum, significantly outperforming the IPD UK All property total returns at 7.7 per cent per annum. The Council's property investment portfolio has outperformed in respect of both income return and capital growth.

4.4 The analysis of the capital value of our current portfolio shows a high weighting towards Industrial with 48.5 per cent and a very low weighting in office at 2.3 per cent.

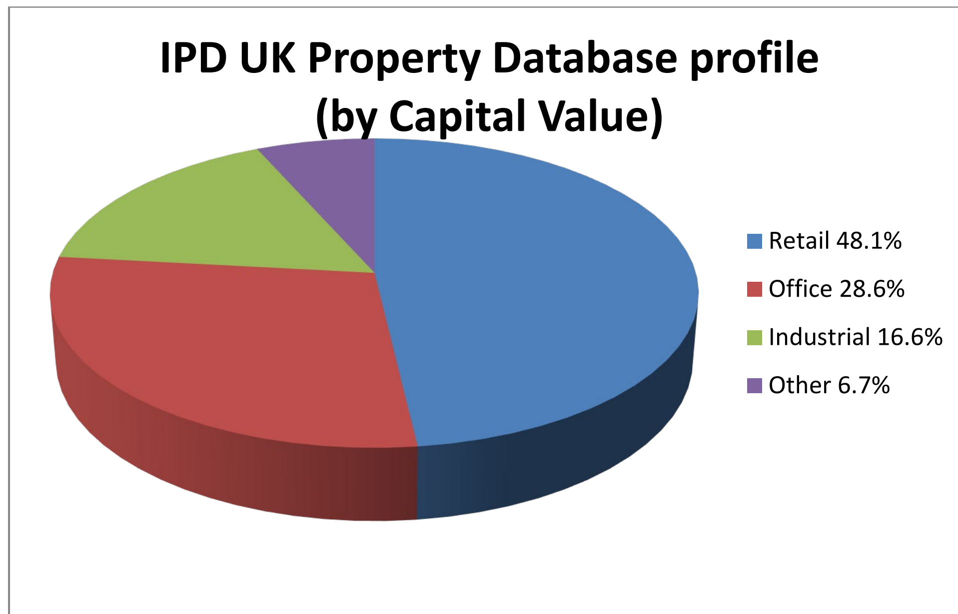
4.5 The chart below shows the sector weightings of the Council's property investments.



As a result of the heavy weighting towards industrial and retail/shopping centres, it would be appropriate when looking at new property investments to increase our weighting within the office sector. Particularly given that the weighting of office investments across the whole of the Investment Property Databank (IPD)

averages at 28.6 per cent as illustrated in the pie chart below. This would have the benefit of diversifying our risk profile across the commercial property sectors which would be considered best practice from a fund management perspective. Office rents are still someway off their peaks of four to five years ago and there is an opportunity for buying at lower capital values. We are not aware of any strong evidence that would indicate that the office market will decline further, however as with any property sector there is the risk that capital values can go down as well as up.

As a comparison the chart below shows the national spread of property uses; data has been taken from the Investment Property Databank and is based on the average portfolio weightings of 1024 property funds. When comparing, it can be seen that our retail including shopping centres is representative, that we are overweight with industrial property and very light on our exposure to office investments.



4.6 Our income return across sectors is representative of the market with a lower yield on retail than the office and industrial sectors. Our industrial properties are largely made up of long term secure ground rent investments, for which you would expect a lower income return yield reflecting the more secure nature of the investments. The shopping centre income return is currently depressed due to an outstanding rent review on the Friary Shopping Centre. Overall the general trend is that the Council’s investment property portfolio has outperformed the benchmark IPD Property Index Income Return.

Guildford Borough Council Investment Properties	Rental Income	Capital Value	Income Return	IPD Property Index Income Return
Industrial subtotal	£2,626,669	£38,282,060	6.86%	6.90%
Office subtotal	£134,350	£1,805,000	7.44%	5.70%
Retail subtotal	£1,229,287	£19,923,800	6.17%	5.80%
Shopping Centres	£707,017	£14,410,000	4.91%	
Other subtotal	£302,464	£4,495,200	6.73%	6.30%
Total/Average	£4,999,786	£78,916,060	6.34%	5.80%

5. Ways to increase property exposure

5.1 There are several ways in which the Council could increase its property investments. From an accounting perspective they fall into two groups; those that count as capital expenditure and those that do not.

5.2 If the investment is classified as capital expenditure and the Council does not have sufficient resources to finance the expenditure from capital receipts or reserves then the expenditure increases our underlying need to borrow, regardless of whether physical borrowing takes place or cash balances are reduced. This borrowing requirement is calculated at 31 March each year when it is known as the Capital Financing Requirement (CFR). The Council's General Fund CFR at 31 March 2012 was £3.653 million. The latest estimate, based on the approved capital programme, is that this will increase to £10.304 million by 31 March 2016.

5.3 The only way in which the benefits of a property investment can currently be achieved without being classified as capital expenditure is by investing in the CCLA Local Authority Property Fund (dealt with further at paragraph 5.8 below). Other ways in which exposure to property can be increased are:

- a property fund that counts as capital expenditure
- purchase of individual property or properties within or outside Guildford

5.4 Investment in property is a long term investment. The money tied up cannot normally be accessed at short notice, even when invested in a fund. Therefore it is important that the cash used to buy or build the asset or make the investment will not be required in the short to medium term.

5.5 The Council's current cash balance has been assessed to identify the core cash that is unlikely to be needed over the next four years and this amounts to £65 million. Core cash is that which is unlikely to be required over the medium term as it relates to balance sheet items such as cash backed reserves or capital receipts that are not expected to be spent in the plan period. It would obviously not be prudent to allocate all of this core cash to property. This estimate is built up by assuming the likely use of the council's reserves and usable capital receipts over an extended period. In recognition of that and in order to leave an adequate protective balance officers recommend that £20 million could be made

available for property investments, raising the percentage of the council's total investments that are property related to around 69 per cent.

5.6 If this cash were to be needed for some urgent, unforeseen circumstance, external borrowing could be taken out to replenish the cash balances. Any external borrowing would further reduce the return made by the interest paid on the borrowing. Borrowing purely to invest is not permissible within the CIPFA Treasury Management Code of Practice so borrowing would not be possible unless there is an underlying capital finance requirement related to the level of approved capital expenditure. This would almost certainly be the case for us; as explained in para 5.2 above the estimated CFR at 31 March 2016 is £10.304 million.

5.7 The relative merits of each type of investment are discussed below.

CCLA Local Authority Property Fund

5.8 The Local Authorities' Property Fund is administered by CCLA Investment Management Limited who are a company specialising in fund management on behalf of Churches, Charities and Local Authorities (CCLA). The Fund was launched in 1972, is currently valued at £88.6 million and has a track record of income distribution yield of around six per cent per annum paid quarterly. The distribution yield is after property management costs and CCLA's fund management fee of 0.65 per cent.

5.9 The fund has outperformed the Investment Property Databank (IPD) Balanced Property Unit Trusts index which is their benchmark over the past 10 years. The fund has a balanced portfolio across property sectors and specialises in prime property led investments as opposed to being driven by portfolio weightings and sector weightings that would be more typical of a larger fund. The fund currently has a strategy of actively managing and investing in prime located properties that are discounted in the current market due to shorter lease lengths. These types of deals are less open to debt driven property investors and therefore the income yields are higher.

5.10 Officers have reviewed this fund as part of the Council's treasury management function and are satisfied that an investment, in place of some of the existing cash investments, fits well with the Council's available resources and is permissible under the existing Treasury Management Strategy and delegation to officers. The Council has therefore expressed an interest in investing £5 million in this fund.

Aviva Lime property fund

5.11 The Aviva Lime Property Fund was launched in July 2004, is valued at £850 million (31 December 2011) and has a lower but steadier return than the CCLA fund of between four to five per cent per annum. The fund is passively managed due to its size and invests in longer dated property investments with typical un-expired lease terms of in excess of 15 years. The Funds aim is to achieve investment returns in excess of 150 basis points (bps) above the Gilt Index by investing in lower risk property assets with secure long term income streams.

5.12 An investment into the fund would be classed as capital expenditure and would therefore generate an increase in the Capital Financing Requirement thus generating a Minimum Revenue Provision charge. It is therefore less advantageous that the CCLA fund and not recommended.

Purchase individual property or properties within or outside the borough of Guildford

5.13 The capital values of the Council's existing commercial properties, which are located within the borough of Guildford, have remained resilient over the past few years, particularly given the back drop of the economic climate. Rental growth has recovered slightly but rents are still at a lower level than their peaks. Yields have remained steady over the past few years, being driven down on the one hand by lower interest rates, but at the same time being held higher due to the market's lack of appetite for risk. Direct property investment could be achieved via external investment advisors introducing prospective investment deals for the Council to consider and then acting on our behalf to negotiate a purchase and acquire the property. Typical acquisition fees of 5.75 per cent would include an acquisition agents fee of one per cent plus VAT, (together with stamp duty land tax and legal fees).

5.14 Our initial selection of a proposed property investment would be assessed on two main criteria on a pass or fail basis.

- 1. Due to the secure nature of the Investment requirement, the initial yield range that we could expect to achieve on the investment is likely to be between 4.0 to 6.0 per cent. In order to pass this initial criteria, the Net Initial Yield should exceed a minimum level of 4 per cent.
- 2. The lease should be classified for accounting purposes as an operating lease rather than a finance lease, to ensure that all rental income can be treated as revenue income rather than as capital receipts. Operating leases are those where the risks and rewards of ownership are retained by the lessor (the Council) and must meet certain criteria, the major ones 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 future rental payments should not amount to value of the property leased

5.15 In addition, the property should be considered against the following scoring criteria shown below in order of priority.

	Score	**4**	**3**	**2**	**1**	**0**
SCORING CRITERIA	**Weighting Factor**	**Excellent / very good**	**Good**	**Acceptable**	**Marginal**	**Unacceptable**
Location	15	Major prime	Micro prime	Major secondary	Micro secondary	Tertiary
Tenancy strength	12	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant	Tenants with poor financial covenant strength
Tenure	11	Freehold	Lease 125 yrs plus	Lease between 50 & 125 yrs	Lease between 20 & 50 yrs	Lease less than 20 yrs

	Score	4	3	2	1	0
SCORING CRITERIA	**Weighting Factor**	**Excellent / very good**	**Good**	**Acceptable**	**Marginal**	**Unacceptable**
Occupiers lease length	6	Greater than 20 yrs	Between 15 & 20 yrs	Between 10 & 15 yrs	Between 5 & 10 yrs	Less than 5 yrs; vacant
Repairing terms	6	Full repairing & insuring	Internal repairing - 100% recoverable	Internal repairing - partially recoverable	Internal repairing - non recoverable	Landlord
Office use	5	100% office use	80% office use	Less than 50% office use	Other use	Vacant
Lot size	3	Between £8m and £12m	Between £5m & £8m or £12m & £15m	Between £3m & £5m or £15m & £17m	Between £2m & £3m or £17m & £18m	Less than £2m or more than £18m

As an example our ideal property investment would be a freehold single let office building in a prime location, with a high quality covenant tenant on full repairing insuring terms with a long unexpired lease term. An investment of this nature would score very highly under the above criteria.

Whilst properties located within the borough of Guildford that fit the criteria may be preferred, there is no reason that the Council should not consider properties that fall outside the borough, particularly if by investing outside the borough the risk is spread and exposure to areas of the commercial property market that are currently unrepresented within the current property investment portfolio is increased. For example, properties within the West End or The City of London, or within strong towns within the South East should also be given consideration. It is important to consider both the macro and micro location of the property. The proposed acquisition would be a property led decision based on the above scoring criteria rather than based primarily on geographical location.

6. Financial implications

6.1 The Council's core cash has been analysed and projected forward four years to 31 March 2016. This takes into account the Councils borrowing and reserves and is split between the General Fund and HRA.

Guildford Borough Council					
Gross to Net Borrowing Requirement (Projections)					
	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16
Gross CFR	200,308	203,622	205,459	208,359	208,127
Less: Deferred Liabilities (nominal value)	0	0	2	4	6
Borrowing CFR	**200,308**	**203,622**	**205,461**	**208,363**	**208,133**
Less: External Borrowing (nominal value)	**-194,545**	**-194,316**	**-194,086**	**-193,856**	**-193,856**
Gross Borrowing Requirement/Internal Borrowing	**5,763**	**9,306**	**11,375**	**14,507**	**14,277**
Less: Usable Reserves	-60,708	-59,497	-71,427	-71,401	-79,231
Net Borrowing Requirement/ -Investment Capacity	**-54,945**	**-50,191**	**-60,052**	**-56,894**	**-64,954**

Guildford Borough Council - Non HRA Balance Sheet Positon					
Net Borrowing Requirement/ -Investment Capacity	**-38,073**	**-23,345**	**-25,217**	**-15,633**	**-15,394**

Guildford Borough Council - HRA Balance Sheet Position					
Net Borrowing Requirement/ -Investment Capacity	**-16,872**	**-26,846**	**-34,835**	**-41,261**	**-49,560**

6.2 The General Fund balances are reducing over the period due to the spend on the General Fund Capital Programme and HRA balances are increasing substantially over the period due to the impact of the HRA reform and the low interest rate achieved on the debt taken on. The HRA balances include the new build reserve which has been set up to help fund investment in additional local authority housing.

6.3 Setting aside £20 million for property related investment would equate to nearly 40 per cent of the estimated core cash shown above at 31 March 2013, falling to 31 per cent in 2016. When the debt take on for the HRA settlement was being agreed the same figure was identified as possible internal borrowing (rather than taking on external debt). In the event variable rate debt was taken on at a very low rate (0.62 per cent) pending a decision on possible property acquisition. If the recommendation in this report is agreed the external debt will be maintained and managed within the treasury management function; the variable debt rate is reset every six months and in September 2012 it went down to 0.54 per cent.

6.4 The Council has pledged £5 million into the CCLA property fund which leaves £15 million for direct property purchase. It is therefore recommended that the Executive should request a supplementary capital estimate of £15 million for 2012-13.

6.5 In order to allow officers to properly assess the suitability of any proposed purchase various checks will need to be completed that will involve incurring expenditure, for example valuation advice. In addition, if investment opportunities are to be acted upon swiftly then a proportion of the allocation needs to be included within the approved programme. It is therefore

recommended that £5 million of the £15 million allocation is included in the approved programme and the remainder in the proposed programme. This would enable officers to act quickly with the first acquisition for which a number of potential investments have been identified, the detail of which would be the subject of a separate report to Executive.

6.6 It is likely that officers will need to move quickly should a suitable asset become available. It is possible that the current delegations and procedures will not be flexible enough to allow a property to be identified, negotiations held and then reports prepared for the Executive without the purchase opportunity being lost. Officers may therefore need to bring a further report requesting delegated authority once we have experience of buying investment property within the current procedures.

6.7 As indicated elsewhere in the report, if the Council were to purchase property this would be capital expenditure and would reduce the General Fund balances shown above by increasing the CFR. Accounting regulations mean that an increase in the CFR would be subject to a Minimum Revenue Provision (MRP) charge and would therefore reduce the return on the investment.

6.8 MRP is a charge to the revenue account each year to write down the value of the asset over its useful life. The MRP policy, approved as part of the annual Treasury Management Strategy Statement by Council in February 2012, states that the asset is to be written down over its useful life on an asset life basis (assuming no residual value). For an investment property the life is likely to be in excess of 50 years and therefore the MRP will be two per cent of the capital cost (as the maximum life that can be attributed to an investment property is 50 years).

6.9 The property would generate an annual rent to the general fund revenue account and would incur an MRP charge. As an example, if we bought a property for £4.5 million and it had a useful life of 50 years the annual MRP charge would be £90,000. If the annual rent is less than this, there would be a cost to the general fund until the MRP had been repaid. To make the investment worthwhile, the annual rent needs to exceed the MRP payable, so if the rental yield was five per cent (£225,000) then net gain to the General Fund would be £135,000 – an overall yield of three percent. This is still well in excess of the interest rates currently available for cash investments.

6.10 There is also the possibility of capital appreciation should the asset be sold. If the property was sold before the MRP was fully repaid, part of the capital receipt from the sale could be used to make a voluntary MRP to repay the remaining balance.

6.11 The property would be purchased to generate a rental income to the Council and will therefore be leased to tenants. A decision as to whether this is treated as a finance lease or an operating lease needs to be made. The accounting treatments are very different. The lease should be classified, for accounting purposes, as an operating lease to ensure that all rental income can be treated as revenue income rather than capital receipts. Operating leases are those where the risks and rewards of ownership are retained by the lessor (the Council) and must meet certain criteria, the major ones 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 future rental payments should not amount to value of the property leased.

6.12 In certain circumstances the subsequent asset management functions arsing from a purchase including tenant liaison and landlord responsibilities will require additional staff resources. It is proposed to engage appropriate commercial surveying firms to undertake this work as part of the asset purchase.

7. Legal Implications

7.1 Investments are allowed by virtue of s12 of the Local Government Act 2003. Section 15 of the same Act requires local authorities to have regard to guidance issued or specified by the Secretary of State. This guidance includes CLG Investment Guidance and the following Chartered Institute of Public Finance and Accountancy (CIPFA) publications:

- Treasury Management in the Public Services; Code of Practice and Cross-Sectoral Guidance Notes
- The Prudential Code for Capital Finance in Local Authorities

8. Human Resource Implications

8.1 It is anticipated that any additional work can be accommodated within Economic Development Service current resources.

8.2 An Equalities Impact Assessment (EIA) scoping report has been carried out and there is no evidence that the proposed property acquisition would have any differential treatment on any of the main protected characteristics with regard to the requirements of the Equalities Act 2010 and so a full EIA is not required.

9. Conclusion

9.1 The report explains the rationale behind increasing the Council's exposure to property by investing in a specialist fund and also purchasing investment property to increase the investment return to the Council. The core cash of the council has been analysed and £5 million pledged to the CCLA property fund under the Treasury Management Strategy and delegated authority. It is recommended that £15 million be used to purchase investment property

10. Background Papers

10.1 Local Government Act 2003

10.2 DCLG Guidance on Local Government Investments

10.3 Treasury Management in the Public Services; Code of Practice and Cross-Sectoral Guidance Notes (CIPFA)

10.4 The Prudential Code for Capital Finance in Local Authorities (CIPFA)

10.5 EIA scoping report

11. Appendices

None