



## PAPER J

Purpose: For Noting

# Committee report

Committee	<b>AUDIT COMMITTEE</b>
Date	<b>3 DECEMBER 2018</b>
Title	<b>PROGRESS REPORT – COMMERCIAL ACQUISITION STRATEGY</b>
Report of	<b>DEPUTY LEADER AND CABINET MEMBER FOR RESOURCES</b>

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### EXECUTIVE SUMMARY

1. This noting report provides members of the audit committee with an overall summary of progress in the delivery of the council's commercial property acquisition strategy.

### BACKGROUND

2. The council's medium term financial strategy, designed to help improve the council's financial sustainability made provision for a £100 million commercial property acquisition fund, subject to the approval of a commercial property acquisition strategy. Full Council at its meeting of the 20 September 2017 gave its approval to such a strategy. The report recommending the strategy also proposed that a report should be prepared on a six monthly basis for submission to the audit committee, setting out the progress of the property investment fund, including the total income that has or will be accrued by the council on an annual basis.
3. Portsmouth City Council, as commissioned by the Isle of Wight Council has been managing the property investment fund. The commercial property acquisition strategy approved by members in September 2017 has been used as a framework for all acquisitions. The approved strategy included strict criteria to be used when determining the property to acquire. Those criteria have been adhered to and included the following:
  - To create a balanced commercial property portfolio that provides long term rental returns and growth.
  - A core portfolio of property assets will be sought with a view to diversification on individual assets by sector (industrial, offices and retail), location and risk.

- Core assets being the best property for the sector in an ideal location with long term income to high quality tenants.
- All investments considered must initially provide income (yield) equal to or above the councils required rate of return (IRR).
- Prioritise properties that yield optimal rental growth and stable income.
- Protect capital invested in acquired properties.
- Location will be dictated by opportunity to acquire investments that meet the strategy, proximity to the Isle of Wight will be a deciding factor when all other attributes are equal.

## PROGRESS TO DATE

### **Current fund - statistics**

4. To date circa £20.7 million (inclusive of all costs associated with purchase, including land registry fee; legal expenses due diligence and agreed costs to Portsmouth City Council as set out in paragraph 30) of the £100 million available has been invested and is generating an income of approximately £0.9 million per annum in a full year of operation.
5. The fund has been successful in acquiring two properties containing six occupational tenants.
6. The first investment, Olympic Court, Salford was purchased in April 2018, with the second purchase Access 4:20, Aylesford taking place shortly thereafter. Further purchases are currently being worked on.
7. Appendix 1 is a schedule of all assets currently held within the investment fund.

### **Rental income**

8. As of the June 2018 quarter date and since the first purchase there have been no rent payment defaults or loss of tenancies across the portfolio. The six occupational tenants are:
  - Mettler-Toledo Safeline Limited
  - In the Style Fashion Limited
  - Betterstore Self Storage Properties III Limited
  - Eriks Industrial Services Limited
  - Sunwin Services Group (2010) Limited
  - Go Installations Limited

### **Portfolio mix**

9. With only two current assets the mix of the portfolio is very limited. Reporting once more assets have been acquired will look at; sector, location, and asset mix (single or multi-let).

## **Portfolio acquisition review**

10. The Isle of Wight Council through its partner Portsmouth City Council has demonstrated its technical knowledge base and performance and is considered by the wider market as an established well-structured and highly knowledgeable purchaser.
11. The current strategy has been kept under review and is considered to continue as an adequate framework for the funds acquisition program at this time.
12. The overarching theory that the relationship between assets reduces risk of the whole is referred to in simple terms as “diversification”. This theory which aims to protect the capital invested whilst maximising the income has been at the core of decision making on all purchases and will form the basis of future decisions on sales.
13. To provide sufficient diversification, it follows that a fund of £100 million requires single asset lot sizes of between £6 -12 million spread across a UK national geographical area with a suitable sector mix.
14. The average lot size for individual assets within the fund currently stands at £9.75 million, with the minimum lot size of £8.625 million and a maximum lot size of £10.875 million.
15. To achieve diversification and properly manage risk for a portfolio of this size of financial investment requires the portfolio to be built over the whole UK geography.
16. Discounted cash flow techniques have been utilised, as well as IRR (internal rate of return) in evaluating the expected financial return for each acquisition. The level of detail within the cash-flow can be seen at appendix 2. These techniques show both actual rate or return as well as the overall return compared to the alternative of a "risk free" investment.
17. Our investment analysis considerations take into account UK location, sector, tenant, age, size, lease length, building condition, environmental, future capital expenditure, rental growth prospects, investment hold period and asset liquidity to name but a few. These are cross referenced against associated market sector drivers such as micro and macro demographics, technology, consumer and business trends, and the wider economic position, and form our basis for investment appraisal.

## **Current strategy position**

18. The fund requires significantly more purchases to become a fully invested UK wide fund and balance the property risk to an acceptable level while maximising the overall return.
19. The fund has a medium risk attitude that will be achieved through a progressive risk-adverse to risk-seeking strategy over time (often described as moving up the curve).

20. This leverages diversification benefits by buying into lower yielding/lower risk assets at the beginning; as this is where the most property risk in the portfolio lies, the portfolio risk should decrease as appropriate located assets are added.
21. There remains around £79 million (79 per cent) of the fund to be invested.

### **Medium to long term strategy**

22. The overriding fund principle is to create long term sustainable income while protecting the capital invested. Asset replacement is required in commercial property portfolios in order to prevent depreciation of value over time.
23. A fund of this size and type (once all funds are invested) requires a substantial level of continued management and monitoring to ensure the overriding principles are achieved. The ability to trade property (asset and portfolio liquidity) and to purchase further assets within the UK to replace and rebalance the inherent risk to capital and income is fundamental and is at the forefront of the on-going management of the fund and subsequent decision making.

### **Investment market**

24. Investment activity in the UK commercial market has been significant over the past 12 months as the UK continues to be considered a “safe haven” in the global property market.
25. All-property yields have continued to move downwards it now stands at 5.9 per cent, the lowest level since October 2007.
26. Performance is heavily polarised according to sector Investment Property Databank (IPD) which reports that industrial property has performed exceptionally well with total return rising by an impressive 15.5 per cent over the 12 months to March. In contrast, the office sector saw values rise by 3.6 per cent constrained by continued poor demand in regional markets and supported by performance in the London, Manchester, and Birmingham central business districts. Retail values however, increased by just 1.0 per cent skewed by the extremely poor performance of the high street which is likely to continue in the long term.
27. Given the performance of the market and the associated pricing increase it has become harder to source suitable investment acquisitions with the weight of money in the market creating very strong competition on all assets.

### **Market - outlook**

28. Investor demand for high quality real estate will remain strong and competitive. Given the continued rise of e-tailing the industrial and logistics sector is predicted to outperform all sectors in the medium term.

## **Resources**

29. Portsmouth City Council continues to manage the fund, providing fund management and acquisition/disposal service on behalf of Isle of Wight Council. Core tasks include:
- Sourcing of suitable investments
  - Performance review and on-going management decisions
  - Buy / sell / hold recommendations
  - Stock screening, selection and scrutiny
  - Access both occupational and capital market intelligence
  - Implement investment strategy
  - Financial investment analysis
  - Due diligence on acquisitions
  - Preparation for sale on exit
30. Fees paid to Portsmouth City Council to date in the provision of these services total £60,783, with £48,750 paid as premium payments for acquisitions and £12,033 paid as a management fee (being the payment for first quarter) to cover the on-going management of the property portfolio.

## **STRATEGIC CONTEXT**

31. The commercial property acquisition fund is a feature of the council's medium term financial strategy agreed by Full Council in October 2016. The subsequent commercial property acquisition strategy was approved by Full Council in September 2017. Both the fund and strategy are clearly aligned with priority four of the council's corporate plan in that it contributes to "ensuring that all the resources available to the Island are used in the most effective way in achieving the Island's priorities".

## **FINANCIAL / BUDGET IMPLICATIONS**

### **Financial performance**

32. Performance on property investments are measured by the overall return; that being the increase (or decrease) in capital value plus the income generated expressed as a percentage.
33. The fund will be valued annually on 31 March and therefore financial performance will be measured using holdings to this date. It is not possible to measure current performance on this basis as the assets have not been held for a long enough period of time.

### **Capital growth**

34. The primary objective for the council is to protect its capital base, maximise income and create a long term sustainable income stream. The fund is still in its very early stages and as such there has been a steady flow of purchases in a relatively short period of time as the fund becomes fully invested. As it matures over several years and rental income grows, acquisitions will become

less frequent and the impact of acquisition costs on overall performance should decrease.

35. At this point it is not possible to measure capital growth until the assets have been held for a longer period. Once the assets have been re-valued, the capital value statistics can be produced.

### **Rental income (gross return)**

36. During 2018/19 and up to 29 September 2018, the amount of rental income received was £0.3m.

### **Rental Income (Net Return)**

37. The cumulative net income return to the council since the fund's inception to 29 September 2018 amounts to £0.2m. If this is to be extrapolated to the end of the financial year the net income return for 2018/19 would represent a predicted net yield of 3.3 per cent.
38. While the council is able to borrow for investment purposes, it cannot borrow to "lend on" i.e. borrow simply to then place borrowed funds on the money markets in order to make a return. Nevertheless, as a benchmark for the council's alternative of a "risk free" rate of return, the prevailing money market investment rates are often used as a proxy (e.g. LIBID rates) and these have ranged between 1 to 2 per cent over the period. The council could however, have invested the equity element of the fund into money markets at that level of return.

### **Overall performance**

39. In order to measure the performance of the fund we need to consider both the effect of the market value growth of the fund, plus the rental income generated. As it is not possible to report the capital performance at this time this assessment will be reported at a later date, after the valuation date of 31 March 2019.

### **LEGAL IMPLICATIONS**

40. The council is empowered to buy and sell land pursuant to section 120 of the Local Government Act 1972. Section 1 of the Local Government Act 2003 provides a power to the council to borrow for the purposes of any enactment.
41. In order to lawfully implement the investment strategy, each proposal (including the funding strategy for purchases) is reviewed as part of a decision to purchase or sell, and tested for value for money, and regulatory compliance. All acquisitions are reviewed by the council's in-house legal and finance teams as a means to maintain oversight of transactions being completed.
42. Property consultancy support for the purposes of due diligence reporting for proposed acquisitions resulted in the council awarding a contract to GVA Services, following a procurement exercise and utilisation of the Housing and Communities Agency (HCA) Framework. Such reports include:

- Building surveys
- Formal valuations
- Environmental studies

43. Legal advisors with the necessary capacity to deal with and respond to acquisitions have been engaged on each transaction to assist the Isle of Wight.

#### EQUALITY AND DIVERSITY

44. The council as a public body is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation. It is not considered that the content of this report has any impact on any of the protected characteristics.

#### RISK MANAGEMENT

45. All commercial property investments carry a risk, however the commercial property investment strategy ensures that any risk is minimised in return for an appropriate level of financial gain. There are clear protocols, authorisation processes (overseen by the Director of Finance and Section 151 Officer) and due diligence checks in place that allow for risks associated with acquisition to be fully evaluated prior to sale completion.

#### EVALUATION

46. Full council agreed the commercial property acquisition strategy in line with the medium term financial strategy in September 2017, in order to secure an income stream that would contribute to the overall aim of future financial sustainability of the Island's public services. The potential of such a strategy could see an income stream in the region of £4 - £5 million pounds a year. While still very early days, it can be seen that good progress has already been made in the delivery of this strategy together with the establishment of a regular base income that will contribute to the council's overall financial sustainability.

#### RECOMMENDATION

47. To note the progress in the delivery of the council's commercial property acquisition strategy

## APPENDICES ATTACHED

48. [Appendix 1: schedule of assets held.](#)
49. [Appendix 2: Cash flow monitoring information.](#)

## BACKGROUND PAPERS

50. Full Council 20 September 2017 – Commercial Property as Investment – Paper C  
<https://www.iow.gov.uk/Meetings/committees/mod-council/20-9-17/Paper%20C.pdf>

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