



## PAPER G

Purpose: For Noting

# Committee report

Committee	<b>AUDIT COMMITTEE</b>
Date	<b>30 SEPTEMBER 2019</b>
Title	<b>PROGRESS REPORT – COMMERCIAL ACQUISITION STRATEGY</b>
Report of	<b>DEPUTY LEADER AND CABINET MEMBER FOR RESOURCES</b>

---

### 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 up to 31 March 2019.

### 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 reports should be prepared 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 the 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

### **4. Current fund - statistics**

- 4.1 To date circa £35.1 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 12.2) of the £100 million available has been invested. The acquisition of these properties occurred throughout 2018/19 up to March 2019.
- 4.2 The fund has been successful in acquiring four properties containing nine occupational tenants.
- 4.3 The first investment, Olympic Court, Salford was purchased in April 2018, with the most recent purchase being Metabo Nursling in the final quarter of 2018. Further purchases continue to be explored.
- 4.4 Appendix 1 is a schedule of all assets currently held within the investment fund.

### **5. Rental income**

- 5.1 As at 31 March 2019 and since the first purchase, there have been no rent payment defaults or loss of tenancies across the portfolio. The nine 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;
  - Nedschroef Limited;
  - Stagecoach Group;

- Metabo UK Ltd.

## 6. Portfolio mix

With only four current assets, the mix of the portfolio is still too limited to allow for more detailed reporting. Once more assets have been acquired it will be possible to provide an overview of portfolio by sector, location, and asset mix (single or multi-let).

## 7. Portfolio acquisition review

- 7.1 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.
- 7.2 The current strategy has been kept under review. It is considered that it remains suitable for continuing as an adequate framework for the fund's acquisition programme.
- 7.3 The overarching theory that the relationship between assets reduces risk of the whole, is referred to in simple terms as "diversification". This approach aims to protect the capital invested while maximising the income and has been at the core of decision making on all purchases and will continue to form the basis of future decisions on sales.
- 7.4 To provide sufficient diversification, it follows that a fund of £100 million requires single asset lot sizes of between £6 million and £12 million spread across a UK national geographical area with a suitable sector mix.
- 7.5 The average lot size for individual assets within the fund currently stands at circa £8.2 million.
- 7.6 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.
- 7.7 Discounted cash flow techniques have been utilised, as well as IRR (internal rate of return) in evaluating the expected financial return for each acquisition. These techniques show both actual rate or return, as well as the overall return compared to the alternative of a 'risk free' investment.
- 7.8 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.

## 8. **Current strategy position**

- 8.1 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.
- 8.2 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).
- 8.3 This approach 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.
- 8.4 There remains around £64.8 million (64.8 per cent) of the fund to be invested.

## 9. **Medium to long term strategy**

- 9.1 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.
- 9.2 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 ongoing management of the fund and subsequent decision making.

## 10. **Investment market**

- 10.1 Investment activity in the UK commercial market has slowed in the first half of 2019. Activity has been notably down as investors remain cautious around Brexit outcomes later in the year. Given the lack of market demand, levels of quality stock have been extremely low in the past six months.
- 10.2 All-property equivalent yields have returned to June 2018 levels at around 5.9 per cent, demonstrating the general softening of market sentiment.
- 10.3 Performance continues to be heavily polarised according to sector. Capital value growth for all-property has now turned negative to -1.2 per cent in the year to June 2019. This is predominantly driven by the sharp falls in the retail sector of -9.5 per cent in the 12 months to June. Average capital value growth remains positive for the industrial and office sector at 5.8 per cent and one per cent respectively.

## 11. **Market - outlook**

Investor demand for good quality real estate will remain, although pricing may begin to reduce in certain markets as economic uncertainty continues. Given the rise of on-line retailing, the industrial and logistics sector is predicted to outperform all sectors in the medium term.

## 12. **Resources**

12.1 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 ongoing 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.

12.2 Fees paid to Portsmouth City Council to date in the provision of these services total £139,832, with £82,799 paid as premium payments for acquisitions and £57,033 paid as a management fees to cover the ongoing management of the property portfolio.

## STRATEGIC CONTEXT

13. 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

### 14. **Capital growth**

14.1 The primary objective for the council is to protect its capital base where possible, 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 over the period since inception of the agreed strategy. 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.

14.2 The fund is valued annually on the 31<sup>st</sup> March and at this date it is not possible to measure capital value movement of all the properties until they have been held longer. However, one of the assets that can be reviewed has increased in value over the period March 2018 to March 2019.

	March 2018 value	March 2019 value	Percentage +/-
15. Access 4:20 Aylesford, Kent	£8,625,000	£8,625,000	0%
Olympic Court, Manchester	£10,800,000	£10,970,000	1.57% +
Network Oxford	N/A	£10,000,000	N/A
Metabo Nursing Southampton	N/A	£3,500,000	N/A

During 2018/19 and up to March 2019, the amount of rental income received was £1.0m, properties were acquired between April 2018 and November 2018, so this income does not yet reflect a full year of activity.

15.2 The gross return up to March 2019 was 2.8 per cent. This represents the income received of £1.0m, divided by the acquisition costs of £35.1m.

15.3 It is anticipated the rental income will be £1.6 million per annum in a full year of operation, commencing from April 2019. The gross return therefore is expected to be 4.5 per cent, per annum, this being the rental income divided by the acquisition costs of £35.1m.

15.4 The fund therefore would expect to generate income of £4.5m per annum if the £100m was fully invested. This assumes future acquisitions would generate returns consistent with existing investments.

## 16. Rental Income (Net Return)

16.1 The cumulative net income to the council for the year to 31 March 2019 amounts to £0.2 million, this represents income of £1.0m less costs of £0.8m. For the period up to 31 March 2019, this represents a net yield of 0.57 per cent.

16.2 The council incurred costs of £0.1m relating to service charges which includes the management costs agreed under the strategic partnership

with Portsmouth City Council of £0.06m and services provided by managing agents £0.04m. The council incurred debt costs of £0.6m and contributed towards the commercial property reserve of £0.1m. This reserve will be used to fund potential lost rental income and future property related costs.

- 16.3 The net return for 2018/19 prior to the reserve transfer was £0.3m, this represents a net yield of 0.8 per cent. Properties were acquired between April 2018 and November 2018 so this net yield does not reflect a full year of activity.
- 16.4 As part of the budget setting process for the current financial year (ie 1 April 2019 – 31 March 2020), the net income target has been increased to £0.5m. This represents rental income of £1.6m less fund costs of £1.1m. Fund costs include corporate financing costs £0.9m, transfer to reserves of £0.1m and services £0.1m. This increase reflects the additional net income that can be achieved in a full year of operation. The net yield including corporate financing costs in the current financial year, is expected to be 1.4%.
- 16.5 Whilst the council is able to borrow for investment purposes, it cannot borrow to 'lend on' ie, 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 (eg London Interbank Bid Rate, LIBID, rates) and these have ranged between one to two 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.

## LEGAL IMPLICATIONS

17. 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.
18. 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.
19. Property consultancy support for the purposes of due diligence reporting for proposed acquisitions resulted in the council awarding a contract to Avison Young (previously 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.

20. 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

21. 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

22. 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

23. 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 full potential of such a strategy could see an income stream in the region of £4.5 million 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

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

### APPENDICES ATTACHED

Appendix 1: Schedule of assets held.



## BACKGROUND PAPERS

25. 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>
26. Audit Committee 3 December 2018 – Progress Report Commercial Acquisition Strategy  
<https://www.iow.gov.uk/Meetings/committees/Audit%20Committee/3-12-18/PAPER%20J%20-%20Progress%20Report%20-%20Commercial%20Aquisition%20Strategy.pdf>

Contact Point: Tom Southall, Assistant Director Regeneration – Property and Investment,  
e-mail: [tom.Southall@portsmouthcc.gov.uk](mailto:tom.Southall@portsmouthcc.gov.uk)

CLAIRE SHAND  
*Director of Corporate Services*

COUNCILLOR STUART  
HUTCHINSON  
*Deputy Leader and Cabinet Member  
for Resources*

# APPENDIX 1

Metabo, Nursling, Southampton	Nov 18	£3.5m Vendor: Off-market Rodenhurst Estates
	<p>25,000 sq ft industrial warehouse on Nursling Industrial Estate on the outskirts of Southampton</p> <p>Let to Metabo Tools</p>	
Network Oxford	Oct 18	£10m Vendor: CBRE Investors
	<p>Modern, semi-detached warehouse built in 2008 extending to 30,136 sq ft and a 1-acre concreted yard currently occupied as a transport depot.</p> <p>Multi-let to Nedschroef and Stagecoach</p>	
Olympic Court, Manchester	March 18	£10.8m Vendor: Goldman Sachs
	<p>5 unit multi let industrial estate of 108,639 sq ft</p> <p>2 miles from Manchester City Centre</p>	

Access 4:20 Aylesford, Kent	April 18	£8.6m Vendor: Milton Property
	<p>5 unit multi let industrial estate of 50,000 sq ft</p> <p>High quality industrial warehouse units developed in 2006 close to the M20 motorway</p>	