PAPER C

Purpose: For Decision

Committee report

Committee	**COUNCIL**
Date	**20 SEPTEMBER 2017**
Title	**COMMERCIAL PROPERTY AS INVESTMENT**
Report of	**DEPUTY LEADER AND CABINET MEMBER FOR RESOURCES**

EXECUTIVE SUMMARY

1. This report proposes a methodology for the council to begin a programme of property acquisition. This is consistent with the medium term financial strategy (MTFS) and is intended to exploit commercial opportunities and secure a pipeline of income that will contribute to the council's future financial sustainability.

2. The council has previously approved the establishment of a £100 million commercial property acquisition fund. However, this was subject to a subsequent approval of a suitable commercial property acquisition strategy. This report now recommends that the full council be asked to formally approve a commercial property acquisition strategy and that Cabinet agree the method to be adopted for its implementation.

BACKGROUND

3. At its meeting on 19 October 2016, full Council approved a medium term financial strategy (MTFS). The overall aim of the MTFS is to ensure that "In year" expenditure matches "in year" income over the medium term, whilst regenerating the Island economy and providing essential value for money services for our businesses and residents. To do this, the strategy describes an approach which seeks to maximise the capital resources available and then target the investment of those resources to those areas that will both stimulate the Island economy and improve the council's overall financial position.

4. The budget report to full Council in February 2017 made clear that as part of the Government's drive to repair the national public finances, local government has experienced unprecedented reductions in government funding. Simultaneously, the council has also experienced accelerating costs associated with essential care services resulting in an estimated budget deficit of £20 million over the three-year period 2017/18 to 2019/20. The financial challenge is considered to be the single biggest risk to sustainable public services on the Island and the council therefore needs to resolutely maximise

the deployment of available resources (revenue, capital, property and staff) towards driving additional income/funding and cost savings to secure council services for the future.

5. As a matter of strategic priority and importance, since the MTFS was approved in October 2016, the council moved quickly to appoint a director and assistant director of regeneration to underpin the stimulation of the Island's economy, has undertaken research into key sites on the Island that are most suitable for development and will deliver most potential for new housing, businesses and employment. A resulting regeneration strategy has recently been launched, with delivery against it, now underway.

6. Another component of the MTFS designed to help improve the council's financial sustainability, was the proposal to create a £100 million commercial property acquisition fund (subject to the approval of a property acquisition strategy) with a portfolio of assets of different size, across sectors and geographies with strong covenants and in strategic growth locations. It is with this in mind, that attention is now being focussed on enabling its successful and timely delivery. This element of the MTFS was again set out in the report to the budget meeting of the Council on 22 February 2017 where it was stated that:

> The director of finance (section 151 officer) will bring forward a commercial property acquisition strategy to the council in the near future with a recommended approach to the following:
>
> - The overall size of the portfolio
> - The typical range of asset sizes
> - The asset types
> - The covenant strength
> - The sectors of the economy within which assets should be acquired and their diversification
> - The geographic diversification of the portfolio, including strategic growth locations.

7. The draft commercial property acquisition strategy is now set out, for Cabinet to consider and then recommend to full Council, at appendix A.

8. It is important to note that this strategy is in addition to, and completely separate from, the council's recently launched regeneration strategy and existing asset management strategy that deals with the management of the council's existing property portfolio.

9. The council, as encouraged by central government and the Local Government Association, needs to consider alternative and innovative ways in which to increase its income stream and this approach is one of the tools available to us. The principle is that the council utilises its borrowing capabilities to purchase investment properties to secure a long term and reliable income stream for the council. This income stream can then be used by the council to support services hence reducing the need to rely on other sources of council funding for such services.

10. This is an approach that has been adopted by at least 50 other councils across the country who (in 2016), were investing in the region of £1.3 billion in such property acquisitions. Generally, councils are realising net returns in the order of over 5 per cent. On a £100 million investment this equates to an additional potential income of some £5 million a year.

11. It is necessary, as has been recognised by various research in this area and most significantly by the Association of Public Service Excellence (APSE) and Chartered Institute of Public Finance and Accountancy CIPFA (in a joint publication: Bricks-Mortar-Money – http://www.apse.org.uk/apse/assets/File/Bricks%20Mortar.pdf) that such investments must be seen purely as commercial investments to secure a beneficial financial return. In practice, this means that it is necessary to treat it as an initiative entirely separate to any strategy for investment in land or buildings required for service delivery or regeneration strategy for growing the Island's economy.

12. The APSE/CIPFA report also highlights that using revenue from such investments has allowed councils to generate an income stream that supports public service delivery during an on-going period of local government financial reform. It is also reported that a small number of councils are using such income to assist them to become fully independent of any national grant funding. The research has shown that an ever increasing number of local authorities, of all sizes, are implementing strategies that involve acquiring property purely for investment purposes.

13. The council's first priority is to safeguard public funds. Accordingly, the draft strategy has been prepared to ensure that the council's investment is broad and mixed with the aim of maximising the return whilst ensuring that risks are kept to a minimum. For example, the majority of the portfolio up to the maximum of 100 per cent will comprise of the best property for the sector in an ideal location with long term income to high quality tenants, yields will be equal to or slightly above prime for the sector. The remaining portfolio, up to a maximum of 30 per cent of the total, will comprise of properties of a slightly higher risk, where the returns will be varied but should in principle be higher than those for the majority of the portfolio.

14. The next priority is the consideration of the most efficient and cost effective method for the delivery of such a strategy if it is agreed. It will be necessary to move at speed in order to secure the best possible financial outcomes for the council at the earliest possible opportunity, ideally so that it is possible to secure properties in the current financial year in order to secure an income stream for the next financial year. In doing so, it is also necessary to take into account that delivery will require specific skills and knowledge of this investment sector and the ability to access property opportunities that are not necessarily widely advertised. It is an area of activity where once offers are made sellers will need to have the confidence that the purchaser can complete the transaction within short timescales. Credibility in the marketplace is crucial to being offered the best opportunities and a swift and decisive process will also be required to be able to successfully compete. All decisions will need to be supported by a detailed due-diligence process by a range of experts, but once this has been completed then a decision to buy or

sell needs to be agreed within as short a time scale (measured in days) as is possible. A more formal and lengthy decision making process (of reports to cabinet etc) will mean that the council would be unable to operate in such an environment.

15. With that in mind, as properties are identified for possible investment it is proposed that following proper due diligence and completion of a robust and detailed financial appraisal, that the authority for decision making to acquire investment properties in accordance with the strategy, is delegated to the chief executive and section 151 officer, in consultation with the Cabinet member for resources, to enable investment opportunities to be secured and transactions completed in accordance with market requirements.

16. Such due diligence will need to evaluate that any proposal not only delivers best value but also meets the criteria contained within the proposed commercial property investment strategy and has proper regard to the following:

    (a) The relevant capital and revenue costs and income resulting from the investment over the whole life of the asset.
    (b) The extent to which the investment is expected to deliver a secure ongoing income stream.
    (c) The level of expected return on the investment.
    (d) The payback period of the capital investment.

17. For auditing purposes, it would also be proposed that a report be prepared on a six monthly basis for submission to 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 as a result of this policy.

18. There are a number of ways in which the council could deliver the strategy, if approved. In summary, these are:

    (a) Undertaking a competitive tendering exercise to secure a property investment company.
    (b) Utilise the council's in-house property team.
    (c) Entering into a strategic partnership with another authority.

19. There are various advantages and disadvantages for each approach which in summary are as follows:

    (a) Undertaking a competitive tendering exercise to secure a property investment company:

        (i) There are a number of companies who will provide this service either as the council directly owning individual properties, or the council purchasing units in an established property investment fund. These companies will be well known in the field and will have good contacts to the various agents and will have the agility to work quickly and the expertise upon which to draw from. Given this, it is also possible that they may well be aware of the more attractive investments earlier. Undertaking a competitive tendering exercise in accordance with Public Contracts Regulations 2015 to secure such a provider would enable the council to fully evaluate the most economically advantageous tender.

(ii) Conversely, they may be less familiar with the public sector operating environment and may also have a different approach to risk than might be desirable which could result in a number of investment opportunities being declined by the council. However, this could be mitigated by an investment management mandate that sets out the council's risk attitude and which the provider will need to comply with as part of the competitive tendering process. They will also provide this service to a number of clients which may mean that the council does not receive the level of priority attention that it would wish to have. As commercial organisations, they could be a more costly option, particularly as fund based options do tend to charge annual management fees based on fund value.

(iii) To initiate a competitive tendering exercise would require officer resource with the requisite knowledge to undertake the preparation of the specification, conduct the necessary tender process and subsequent evaluation and to mobilise the new contract. At best this could take a minimum period of three months to complete and would inhibit an early start to acquisition in order to derive income for the next financial year.

(b) Utilise the council's in-house property team:

(i) The council's in-house team will fully understand the environment within which the council operates and will be focussed 100 per cent of their time on the delivery of the portfolio. Knowing the local context may well also mean that the in-house team can act more swiftly than an external provider.

(ii) However, whilst there is some expertise within the current team this is a specialist area of work and additional staffing resource with the necessary expertise and relevant skills would need to be sourced at this juncture. This is likely to take time (having allowed for a period of advertising, undertaking interviewing and successful candidate serving out their notice) and at best a minimum period of around four to five months to complete. It may well also be relatively expensive option for the council as such skills will be in demand across the country, if able to successfully recruit at all. This approach would also detract valuable staffing resources away from the delivery of the council's regeneration strategy and existing asset management strategy which are discrete packages of work with strategic importance and priority for delivery, if this option were to be pursued at this point in time.

(c) Entering into a strategic partnership with another authority:

(i) Utilising the power to trade under section 1 of the Local Authorities (Goods and Services) Act 1970, which provides for a local authority to enter into an agreement with any public body for the supply of administrative, professional or technical services, this is an approach that would provide a route to secure operational delivery within a relatively short period of time. This would be a particularly attractive option if the strategic partner has an established team with a good track record, has a network of third party arrangements with specialist advisors and already holds credibility within the market. Being an existing local authority department, they will also have a better understanding of the legal and financial environment in which local authorities work and a partnership arrangement could be put in place very quickly. However, conversely, it could be deemed that they may not be as well integrated into the industry of property investment and hence may not be aware of all the options available but it is well known nationally that local authorities are increasingly investing in properties and hence the agents seeking to sell or buy suitable properties will make contact with such teams.

(ii) The downside to this option is that the power to enter into a strategic partnership under section 1 of the Local Authorities (Goods and Services) Act 1970 does not override the need to comply with procurement regulations. Where an arrangement amounts to a contract for relevant goods, services or works under the Public Contracts Regulations 2015 and the contract value exceeds the statutory threshold, the purchasing public authority is obliged to competitively tender the contract. It is considered that this type of work will be caught by this regulatory requirement. This would require officer resource with the requisite knowledge to undertake the preparation of the specification, conduct the necessary tender process and subsequent evaluation and to mobilise the new contract. At best this could take a minimum period of three months to complete and would inhibit an early start to acquisition in order to derive income for the next financial year.

(iii) Portsmouth City Council already have a property investment team in place that has successfully delivered a property portfolio for the council that is already delivering a net profit of £4.3 million on a portfolio of £108 million. Portsmouth City Council team have private sector fund investment experience and has built its own portfolio entirely from off-market transactions, taking specialist advice through its networks where necessary. Portsmouth City Council is prepared to enter into an agreement with the council to provide these services.

(iv) To comply with the Public Contracts Regulations, it would be possible to enter into an agreement for Portsmouth City Council to deliver this service for a period of twelve months through the granting of a waiver against the council's contract standing orders (up to the statutory limit of contract value of £164,176). This option would provide the opportunity to expedite the speed at which (subject to approval of the investment strategy) to secure property acquisitions in the current financial year in order to generate and deliver an income stream for the council in the next financial year. This process could also be completed within a relatively short period of time. It would also provide the opportunity to determine the feasibility of developing the in-house property team and if not for a competitive tendering procurement exercise to be undertaken.

(v) To provide assurance that this option would in the short term demonstrate value for money, the costs of an alternative private sector provider have been compared over a ten year period to coincide with the expected life of the fund and are set out in the table below:

Estimated Costs	**Portsmouth City Council**	**Company**
Management Charge	0.25 per cent of purchase price	1.5 per cent of purchase price
Due Diligence Checks	1.5 per cent of purchase price	1.5 per cent of purchase price
Strategic Management	£15,000 per quarter	£35,000 per quarter
Total Cost (10 years)	£2,218,000	£4,145,000
Total Cost NPV (10 years)	£2,059,946	£3,829,235

For comparison purposes, it has been assumed that the rental income streams associated with both options are identical. The ten year cost saving of option (c) compared to option (a) is £1,927,000 (cash) and £1,769,289 (in NPV terms). In order for Option (a) to be more advantageous than option (c), it would require an additional rental return of 1.9 per cent (in NPV terms)

(Net present value is a measure of monetary value in today's terms. It takes account of the "time value of money", essentially a method that provides a like for like comparison of options with different cash flows in different periods. The method recognises that a more favourable cash flow position of one option over another has a value in that that difference in cash flow can be invested and make a return (or avoids a borrowing cost). Alternatively explained as £1 today is more valuable than £1 in a year's time as todays £1 can be invested to earn interest.)

STRATEGIC CONTEXT

20. As set out above, this approach features as part of our medium term financial strategy agreed by full Council in October 2016, and is one of the approaches that the council has adopted to secure an increase in income for the council.

The approach was prepared under the previous administration and with the support of opposition members. The present administration considers the approach to be necessary and sound. The policies outlined in this report endorse and build upon the decisions made in October 2016.

21. The proposed approach is also clearly aligned with priority four of the existing 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".

CONSULTATION

22. This report is primarily internally focussed as it is about the determination of a strategy and establishing the necessary processes to deliver an agreed policy direction as set out in the council's medium term financial plan and budget. Both the medium term financial plan and approved budget were subject to their own consultation processes and hence no further consultation has needed to be undertaken.

SCRUTINY COMMITTEE OR PANEL VIEW

23. Both the medium term financial strategy and the budget recommendations were considered by the scrutiny committee prior to consideration by the cabinet. The scrutiny committee made no particular comment on this proposal, which was detailed in both reports, at that time.

FINANCIAL / BUDGET IMPLICATIONS

24. The medium term financial strategy, as agreed by full Council on 19 October 2016 sets out the council's future financial position and includes a range of strategies to meet the expected financial shortfall against a reducing central government grant. One of these strategies is the development of £100 million commercial property portfolio utilising the council's ability to borrow at low interest rates and then to procure secure and strong yielding property to produce a beneficial surplus. Such investments will, over time, produce a healthy income to the council. The cost of borrowing for this initiative is already built into the medium term financial strategy.

25. To achieve this, the full Council needs to formally agree the commercial property investment strategy at Appendix A and the Cabinet need to approve the method of delivery for property investment transactions to be undertaken.

26. It is critical to note that this investment fund is entirely separate from the capital funds available to deliver essential capital works, service improvement or investment (or even purchase if necessary) of service related buildings.

27. If the council were not to make these investments then the lost opportunity cost, once fully invested, could amount to circa £4 million to £5 million per annum depending on the level of interest rates that prevail at the time of acquisition. This level of "lost" income would need to be found from additional savings (alternative additional income and reduced costs).

28. All the associated costs in addition to the cost of acquisition, such as taxes due, (stamp duty and VAT etc) and conveyancing will all be met from within the allocated £100 million investment fund.

LEGAL IMPLICATIONS

29. 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.

30. In order to lawfully implement the investment strategy, each proposal (including the funding strategy for purchases) should be reviewed as part of a decision to purchase or sell, and tested for value for money, and regulatory compliance.

31. Utilising the power to trade under section 1 of the Local Authorities (Goods and Services) Act 1970, a local authority has the power to enter into an agreement with any public body for the supply of administrative, professional or technical services. However, this power does not override the need to comply with procurement regulations. Where an arrangement amounts to a contract for relevant goods, services or works under the Public Contracts Regulations 2015 and the contract value exceeds the statutory threshold, the purchasing public authority is obliged to competitively tender the contract. Under the contract standing orders, it is possible to waive the requirement for competitive tendering up to a statutory maximum contract value of £164,176 in exceptional circumstances, including the need for urgency.

EQUALITY AND DIVERSITY

32. 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 there will be any negative impact on any of these protected characteristics. However, the initiative is one that will be a valuable income stream to the council that may be used to support those with protected characteristics and as such this proposal could have a positive impact on them.

OPTIONS

33. The options are:

(a) That no further action be taken on this proposal.

(b) That full Council be recommended to:

Approve the commercial property investment strategy as set out in Appendix A and that all purchases of investment properties must comply with this strategy.

(c) That an alternative property investment strategy be developed and approved.

(d) That subject to full Council agreeing the commercial property investment strategy, the Cabinet delegates to the chief executive and the Section 151 officer, in consultation with the Cabinet member for resources that following proper due diligence, the authority to acquire investment properties in accordance with the approved investment strategy.

(e) That Cabinet agrees, subject to a waiver to contract standing orders being granted, to enter into a twelve-month agreement with Portsmouth City Council to commence the acquisition of a property portfolio.

(f) That another approach to the delivery of the investment portfolio be pursued, either through:

(i) Initiating a competitive tendering procurement exercise or

(ii) Utilising the in-house team by securing the necessary internal expertise.

(g) That a report be prepared on a six monthly basis for submission to audit committee, setting out the progress of the property investment fund, including the total income that will be accrued by the council on an annual basis as a result of this policy.

<u>RISK MANAGEMENT</u>

34. Failure to develop a property investment portfolio will mean the non-delivery of one of the key strands of the medium term financial strategy and will deny the council a possible income stream of something in the order of £4 million to £5 million a year and as a potential source of income to assist the council in securing its future financial sustainability.

35. All investments carry a risk, however the development (and agreement) to a commercial property investment strategy will ensure that the risk is minimised in return for the appropriate level of return.

36. Should any properties purchased ultimately not deliver the expected return then the council will be in a position to sell the property and thus mitigate any risk. There will always be a level of risk to the council, as it is not possible to be 100 per cent certain on the rate of return. However, the level of risk will be assessed during the due-diligence process before any purchasing decisions are made.

37. The portfolio will be developed so that it has synergy to enable the whole portfolio to be sold as one lot should the nature of the commercial property

market change to such an extent that the predicted returns are not received across the whole portfolio.

EVALUATION

38. There is a clear significant financial benefit to the council in developing a commercial property investment portfolio. The nature of the market means that the council will need to be particularly agile and efficient in its decision making to ensure that opportunities that present themselves can be actioned extremely quickly. As each investment decision will have to be in accordance with the attached proposed strategy and will also have detailed and thorough due diligence undertaken, it is considered that in line with the medium term financial strategy this is the preferred approach.

39. In order to secure the earliest possible pipeline of income, it is necessary to secure a delivery method that both offers assurance of value for money as well as to commence property acquisition at the earliest opportunity. The means to do this can be achieved by entering into a twelve-month agreement with Portsmouth City Council, as an organisation with credibility and a good track record of investment thus far, (subject to the approval of a waiver to contract standing orders being granted). This would provide the opportunity to secure property in the current financial year in readiness for an income stream to be delivered in the 2018/19 financial year whilst also affording the longer term delivery options to be secured.

RECOMMENDATION

40. The recommendation is options (b); (d), (e) and (g) as reproduced below:

(b). That full Council be recommended to:

Approve the commercial property investment strategy as set out in Appendix A and that all purchases of investment properties must comply with this strategy.

(d) That subject to full Council agreeing the commercial property investment strategy, the Cabinet delegates to the chief executive and the section 151 officer, in consultation with the Cabinet member for resources that following proper due diligence, the authority to acquire investment properties in accordance with the approved investment strategy.

(e) That Cabinet agrees, subject to a waiver to contract standing orders being granted, to enter into a twelve-month agreement with Portsmouth City Council to commence the acquisition of a property portfolio.

(g) That a report be prepared on a six monthly basis for submission to audit committee, setting out the progress of the property investment fund, including the total income that will be accrued by the council on an annual basis as a result of this policy.

APPENDICES ATTACHED

41. Appendix A – commercial property investment strategy.

BACKGROUND PAPERS

42. Full Council 19 October 2017: Medium Term Financial Strategy 2016/17 to 2020/21 and efficiency plan – Paper B
https://www.iwight.com/Meetings/committees/mod-council/19-10-16/Paper%20B.pdf

43. Full Council 19 October 2017: Minutes – Paper A
https://www.iwight.com/Meetings/committees/mod-council/19-10-16/minutes.pdf

44. Full Council 22 February 2017: budget and Council Tax Setting 2017/18 and future years forecasts – Paper B
https://www.iwight.com/Meetings/committees/mod-council/22-2-17/Paper%20B.pdf

45. Full Council 22 February 2017: Minutes – Paper A
https://www.iwight.com/Meetings/committees/mod-council/22-2-17/minutes.pdf

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