TITLE	**Property Investment Group**
FOR CONSIDERATION BY	Community and Corporate Overview and Scrutiny Committee on 6 January 2020
WARD	None specific
LEAD OFFICER	Deputy Chief Executive - Graham Ebers

OUTCOME / BENEFITS TO THE COMMUNITY

A positive net income stream to fund critical Council services provided to the community.

RECOMMENDATION

Consider the Council's approach and practices with regard to commercial property investment.

SUMMARY OF REPORT

Terms of Reference:
This report has been requested by Overview and Scrutiny Committee for consideration at their meeting on Monday 6th January 2020. The report provides "*an update on the current and future proposals for PIG with facts and figures and the philosophy behind the purchasing choices*".

Please note PIG is the acronym for the Council's Property Investment Group which is the group formulated by the Director of Corporate Services to support him in implementing the Council's investment strategy.

Due to the commercial sensitivity of some aspects of the Council's investment strategy it is necessary to present part of this report as confidential for Committee access. Therefore this report falls into two parts, the first part for general interest and the second part strictly confidential for committee only.

Background

WBC Investment Strategy:
The starting point for the Council's property investment activity is the Investment Strategy which was approved by Executive on 28th Sept 2017. The Strategy document as approved by the Executive is attached at Part 2 of this report.

The Strategy explains the Council's approach to building a balanced investment portfolio for income return using both debt and cash funding to acquire assets in and out of borough. It also sets out the budget, programme and delegated authority to invest in and manage suitable opportunities.

At the time the strategy was approved there were numerous other Local Authorities embarking on this type of activity. This means that we were able to take the opportunity to learn from the experiences of other local authorities before us. Most importantly we were able to meet with and learn from some of the professional advisors that had worked with them in devising and implementing their various strategies.

We were also able to draw on the commercial experience of our officers and members that had worked in the investment market prior to joining WBC. So we had the benefit of developing WBC's strategy with the double benefit of both previous L.A. experience and also the direct experience of our own officers and members who have worked in the commercial sector.

For example the Council's lead property advisor to the project is particularly well qualified for the role:

- First class honours degree in estate management
- Fellow of the Royal Institution of Chartered Surveyors
- 35 years experience of the commercial investment market
- 15 years service on the boards of public and private property companies
- 10 years service in private practice advising investors

The Council's Head of Finance also brings highly relevant experience to the project:

- Previously lead financial advisor and member of the property investment board at Watford Borough Council (portfolio in excess of £100m and active in the investment markets)
- Financial lead on Capital Asset Group (property portfolio) at Vale of White Horse DC
- Chartered Management Accountant
- Formerly director of two LATC at Watford (housing and commercial activities).

In addition to the technical skill of the officer team PIG benefits from the considerable business acumen and experience the Members who apply rigorous scrutiny to all proposals.

Shortly after adopting the strategy in 2017 and before we committed significant funds to the market we were obliged to take on board new Guidance issued by Central Government effective 1st April 2018 ("Statutory Guidance on Local Government Investments 3rd Edition"). This guidance has been interpreted in different ways by a range of other local authorities including many with a more ambitious investment programme than WBC. By contrast WBC has taken a cautious view in consultation with our auditors Ernst and Young.

The new guidance has been kept under constant review by and PIG. A full review undertaken by PIG in February 2019 concluded that the implications of CIPFA and Government guidance would be likely to constrain original ambitions in terms of location and funding of stock and portfolio balance. PIG aims to follow both the letter and the spirit of the new guidance which means, in simples terms:

- Only borrow to invest in borough
- When borrowing to invest also seek stock that satisfies additional policy objectives
- Only spend cash reserves out of borough

As a result of the constrained investment strategy focusing much more heavily on in borough opportunities it will take longer than originally planned to select and acquire suitable stock to expend the target fund. The availability of stock in borough is also likely to impact the risk/return balance of the final portfolio.

Delegated Decisions and Implementation:

The Council's Executive delegated the implementation of the investment programme to the Director of Corporate Services in consultation with three Executive Members. This delegation has become formalised into the Property Investment Group ("PIG) which comprises the following officers and members:

i) Director Corporate Services, S.151 Officer and Deputy Chief Executive
ii) Head of Finance and Deputy S.151 Officer
iii) Associate Director Commercial Property
iv) Head of Investment Commercial Property

v) Leader of the Council
vi) Deputy Leader and Executive Member for Finance
vii) Executive Member for Business, Economic Development and regeneration

PIG is the support mechanism to enable the Director of Corporate Services to implement the Council's Property Investment Strategy. It meets every two months to conduct regular business. But it communicates much more frequently especially when a potential acquisition target is identified or other special events arise that need immediate consideration.

The nature of the business is unpredictable and so the Group has to work flexibly and often to very tight timelines. This is a particular challenge to all Local Authority investment committees. To help overcome these particular challenges PIG has developed a number of reporting procedures and templates that help to streamline complex issues down to key considerations at various stages of the decision making processes.

PIG has been active now for about 21 months. However the first six months of this programme was primarily an enabling phase of research, education and case studies to check that our intended modus operandi would be effective and compliant. Government Guidance emphasises how important it is for Members and Officers to have suitable competence to operate in this area. In this respect WBC was fortunate when it set up the Property Investment Group and was able to draw on a wide range of highly relevant property and business expertise from officers and members.

Nevertheless building an investment portfolio is a challenging commercial venture for any local authority and the Group is constantly improving it's understanding and operations. It will always be particularly challenging to balance the demands of an overtly commercial and competitive business venture with the requirement to remain democratically accountable as a statutory body.

The opportunistic nature of the investment market means that the board is constantly responding to the changing macro political and economic landscape which in turn influences the real estate markets at home and abroad. We are well advised by a range of respected professional firms and draw guidance from a wide range of sources as we weigh up which opportunities to pursue and the majority that we choose to ignore.

Key decisions:

At this early stage of the project the most important decisions relate portfolio balance and then individual stock selection, timing and price.

Acquisition decisions are driven by a consideration of a wide range of market factors. These questions are weighed having regard to internal and external independent advice and thorough investigation of all relevant issues including compliance with the Councils Strategy and Government guidance.

The Board makes a decision to bid to acquire assets based on this advice set out in a formal report to the Group. This report is bespoke to each opportunity in the form of a Purchase Proposal which addresses all the key considerations (as set out in the example report template in Part 2).

Return on investment and transaction costs:

The price paid for each asset reflects the value of the asset and is always capped at the level of an independent market valuation report. The total cost of acquisition includes central government tax and transactional fees and costs. This means the total cost of acquisition exceeds the initial value of the asset. This is the same for any property acquisition and any investment commodity. The required return is achieved immediately on the total purchase cost

of the asset because transaction costs are taken into account when assessing the investment return. As a rule a period of 12-24 months is allowed for the costs of acquisition to be amortised. If there is a marked drop in value then a charge will have to be made to the revenue account to cover any impairment unless offset by another appreciating asset, as with any Council asset.

Investment performance:

The current performance of the portfolio is disclosed on the Council's web site and reproduced below.

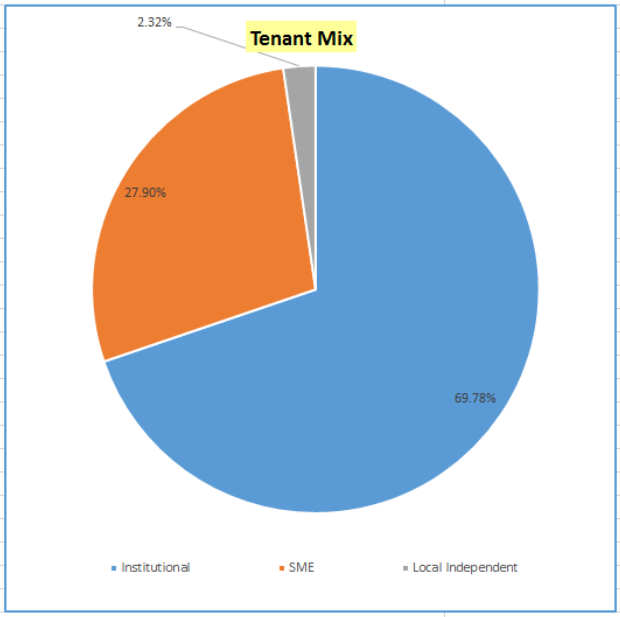
Investment return is reported as net contracted annual rent on gross cost of acquisition (currently 5.26% p.a.) which is the industry norm. But underneath that headline asset performance PIG focuses on true net income. The 5.26% reduces to approximately 2.55% p.a. after funding the interest cost of debt and reduces to approximately 1.88% p.a. after annual capital management (MRP).

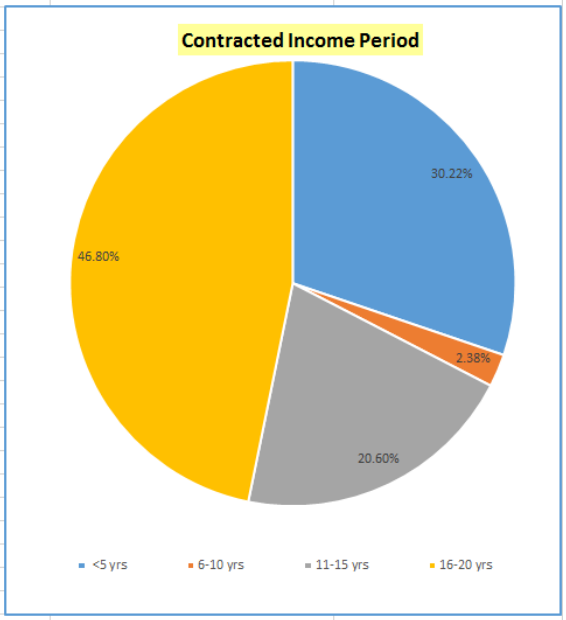
As the portfolio grows and evolves through asset management the return will be measured in terms of net income as a running return on cost. This will then take account of fluctuating rental income over time.

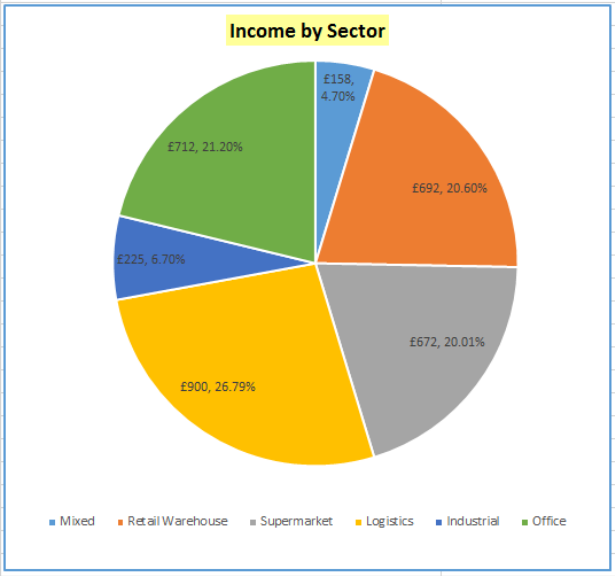
WOKINGHAM BOROUGH COUNCIL
PROPERTY INVESTMENT FUND
HALF YEAR STATEMENT
30th September 2019

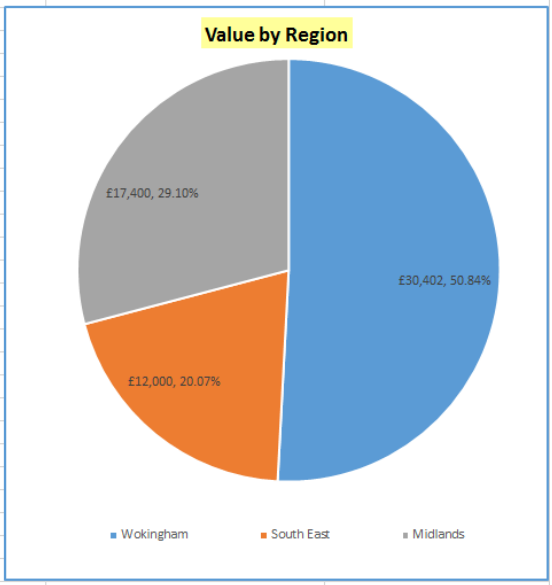
WOKINGHAM BOROUGH COUNCIL

Property	Valuation £ 000's 31/03/2019	Annual Rent £ 000's	Net Yield % (*1)
Barclays Bank Wokingham	£1,595	£80	4.82%
Cox Plastics Wokingham	£3,100	£225	6.52%
Mulberry Business Park Wokingham	£10,000	£712	6.69%
Alexandra Court Wokingham	£837	£78	7.99%
Wickes Basingstoke	£12,000	£692	5.44%
Stapletons Peterborough	£17,400	£900	4.88%
Waitrose Twyford	£14,870	£672	4.22%
* (1) Yield measured as rent return on total acquisiton costs			
TOTAL	**£59,802**	**£3,359**	**5.26%**









Investment risk:

The council has always maintained a wide exposure to the risks of the property market by virtue of owning and managing a wide range of operational, commercial and regeneration assets. To put it in context it is likely that the proposed Investment portfolio will represent between a third and a half of the Councils' overall property holding by value. But because the investment portfolio is chosen specifically for the quality of its long term financial performance (as opposed to community or service benefits) it is expected to perform better in terms of risk management, income return and value. In this way the investment portfolio will moderate the Council's overall risk exposure to real estate.

PIG maintains a sharp focus on property risks which are assessed at every stage of the appraisal and due diligence process. It focuses on the key concerns of market by region and sector, finance costs, estate/building condition, tenant profiles, asset plan, alternative asset plans, acquisition costs, special factors and alternative Council policy objectives. Risks are identified and mitigated in a number of ways principally price adjustment to ensure that the rate of return on gross cost reflects the market view of anticipated risk. This is a market pricing

adjustment managed in partnership with the Council's independent valuers and investment advisors.

Internal and external expert professional advice is the key source of identification and mitigation of a range of investment risks. The key means of identification is the due diligence process which is managed by experts in our Property Team in liaison with fellow officers from related teams as required (finance, insurance, development, planning, legal).

This involves appointing an array of external professionals to undertake investigations tailored to the individual situation (valuation, survey, engineering, environmental, planning, financial, rates, insurance, historic and current etc). Consultants and officers are directed to investigate every aspect of concern (physical, financial, legal) and report their findings to the Property Team who then review and coordinate all information. This becomes an iterative process until all risks have been assessed and understood or mitigated satisfactorily.

Risk mitigation frequently involves adjusting the legal terms of the transaction via the draft contract or transfer, adjusting the price, negotiating retentions or rent top-ups, or asking the seller to make management adjustments pre-sale. This is where the value of our internal expertise pays dividends in understanding, managing and mitigating the overall impact of the asset and the purchase process.

The Due Diligence process also informs the individual asset strategy that is implemented upon acquisition including lease re-gears and renewals and occasional physical works of repair or refurbishment. In the latter case if works are to be funded by the Landlord (as opposed to tenants) then the likely costs are factored into the pricing of the asset before the purchase is finally contracted. Our current assets are subject to ongoing asset management initiatives currently re-gearing leases to extend and enhance income streams. This means that the portfolio is constantly evolving and the rate of return on cost is dynamic.

Income length:

This is individual to every lease of every unit of occupation in each building/property within the portfolio. A healthy portfolio will incorporate a wide range of lease event dates to ensure there is sufficient opportunity to keep pace with market rents whilst balancing the desire for certainty of income.

An analysis of our income streams is published on the public web site as included above. It shows that 46% of our income is secured for between 16-20 years and a further 20% is secured for in excess of 10 years (all with provision for regular rent review). This compares very favourably to the ever decreasing average UK commercial property new lease length of c. 7 years (source BPF 2017).

However it should be noted that short lease lengths are also a positive opportunity for early re-letting at enhanced rents to achieve increased income and higher capital value. Short leases play an important part in balancing a portfolio and that is one key reason why the industrial sector (typically let on short leases without review) is in peak demand in the current market cycle. Compared to the Council's general property portfolio and the average UK lease length the Investment Portfolio provides enhanced security and length of income.

Tenant security:

The core of our fledgling portfolio is let to very secure tenants with the highest Dunn & Bradstreet credit rating of 5A1. This high level of income security is reflected in the relatively low rate of return on our portfolio. This is the result of PIG's deliberate aim to build the portfolio on a foundation of secure long term income streams from strong tenant covenants. This provides stability, security and enhanced liquidity. As we seek to expand the portfolio by acquiring a range of in borough assets we expect to add higher yielding assets to increase the rate of return on investment within acceptable risk margins.

There is a direct relationship between income security and income return on price. The Council is aiming to build a balanced portfolio with a mixture of core income from highly secure tenants with a range of higher risk higher return income streams from less secure covenants probably on shorter lease lengths. The Council has started by building a secure income base before branching into higher yielding assets. The balance between security, risk and return is an individual choice for each investor influenced by a wide range of factors including the opportunity cost of capital employed and need for liquidity.

Property ownership costs:

The risk associated with the particular property, tenant and lease profile is taken into account when assessing the value and price of the asset. Costs through the life of a fully let property are generally paid by the tenants either directly or via a service charge to achieve what is known as a full repairing and insuring ("FRI") lease. This is a foundational concept of the UK institutional property investment market which is a key reason why the UK market attracts so much inward investment from around the world.

Project overhead costs:

General project staff and overhead costs are accounted for at corporate not asset level, as shown in the account attached at Part 2 of this report. The small number of Council directly employed personnel involved in the project serve multiple roles and their costs are spread over a range of budget lines. It is normal for a venture of this kind to retain a relatively small internal client team who work with a range of external agents and professional advisors to deliver the overall investment strategy. The day to day management of the property portfolio is outsourced to independent managing agents and their management fees are paid by tenants through the various service charge accounts under management.

Analysis of Issues

PIG plans to continue to discharge its responsibility for delivery of the Council's approved strategy in light of CIPFA and government guidance. Future acquisitions are expected to be in Borough and debt driven purchases will seek to achieve at least dual Council policy objectives respecting latest government guidance. The Council's strategy aims to achieve a positive 2% portfolio income margin over borrowing costs at date of appraisal and this will continue to govern stock selection.

Once the Investment fund has been fully invested then the emphasis will shift to the crucial role of ongoing asset management and servicing the physical and financial requirements of the portfolio and our ever increasing customer community.

FINANCIAL IMPLICATIONS OF THE RECOMMENDATION

The Council continues to face severe financial challenges over the coming years as a result of reductions to public sector funding and growing pressures in our statutory services. It is estimated that Wokingham Borough Council will be required to make budget reductions of approximately £20m over the next three years and all Executive decisions should be made in this context

	How much will it Cost/ (Save)	Is there sufficient funding – if not quantify the Shortfall	Revenue or Capital?
Current Financial Year (Year 1)	£60m	YES	Capital
Next Financial Year (Year 2)	£40m	YES	Capital
Following Financial Year (Year 3)	n/a	n/a	n/a

Other financial information relevant to the Recommendation/Decision
Funding already provided in MTFP

Cross-Council Implications
Enhances opportunities for service delivery across the Borough

Public Sector Equality Duty
Due regard has been given to Council's the Public Sector Equality

Reasons for considering the report in Part 2
Commercial sensitivity

List of Background Papers
WBC Investment Strategy 2017 (PART 2) Purchase proposal template (PART 2)

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