APPENDIX A

Commercial Property Investment Strategy

1. Introduction

The principle reason for property investment by the City of Lincoln Council is to secure the economic well-being of the City.

Acquisition of assets provides the Council with a financial ‘future-proofing’ effect, underpinning the financial sustainability of the Council by generating a wider asset base providing an alternative source of income, independent of government support and council tax and business rates income, which in turn can be used to support the revenue budget and protect vital services.

Importantly though acquisition of land or property assets is also a direct way of influencing regeneration and the economic development of an area. Councils can, and do, play an important role in regenerating areas where the market alone has failed to deliver regeneration transformation. Through selective involvement this strategy can enable the Council to increase the impact of its place shaping role, acting as a catalyst to encourage economic activity and development potential. A prime example of this is the significant investment the Council made in the Transport Hub development.

This Commercial Property Investment Strategy therefore sets out the Council’s approach to such investment that is in support of its Vision 2020 and Medium Term Financial Strategy as a means of income generation, for provision of services, for the purpose of economic development or regeneration, or a combination of both.

The property investment market is a crowded arena, particularly as local authorities, both locally and nationally appear to be seeking similar investment opportunities in prime locations with long leases and strong covenants

This strategy is designed to provide a framework for the Council to compete in that market on an equal footing enabling the acquisition of properties for investment at pace whilst ensuring that governance processes are in place, full assessments are made and risks are minimised. It forms part of the overall strategic management of the Council’s estate and concentrates specifically on the investment portfolio and commercial property investment decisions.

2. Background

<u>Current Portfolio</u>

In support of its Strategic Plan, Vision 2020, and its Medium Term Financial Strategy the Council is already actively involved with property as a land owner, investor, regenerator and developer. It undertakes property development and acquisition activities and is proactive in using its own resources to deliver significant benefits to the local community.

Over the last 10 years the Council has invested in and developed; The Terrace (Creative Industries), The Lincoln Transport Hub (Bus Station and Car Park), City Hall

Public Sector Hub, and The Think Tank. These assets have been facilitated by direct investment from the Council, supported by external grants and have contributed towards the economic development of the City and generated rental income to support the overall financial sustainability of the Council and deliver its strategic priorities.

Specifically in relation to commercial property investment the Council has in the last two years acquired two tenanted car parks and a Travelodge, all within the City boundary.

These acquisitions have added to the Council's already substantial investment portfolio, currently valued at around £17.044 million (with further investment of £19.7m underway), generating an income stream of circa £0.781 million, representing a gross yield of approximately 3.8%. The portfolio includes the commercial investments above as well as industrial units, shops and a number of grounds leases and agricultural land.

Resource Pressures

Like the majority of other local authorities the Council has since the onset of austerity measures in 2008 experienced fundamental and unprecedented reductions in resources. In response the Council has developed robust plans to maintain a sustainable financial position through its Towards Financial Sustainability Programme (TFS). This approach centres on organisational redesign (The 'One' Council approach), commercialisation, investment/economic development opportunities and service redesign. The direct investment in commercial property and active management of the portfolio, generating new ongoing revenue streams, plays a key role in the delivery of the TFS programme.

Having already delivered a net additional revenue stream of £520k through asset rationalisation (including commercial investments) a further target of £250k by 2020/21 to be achieved through investment/economic development opportunities has now been set.

Adopting such an approach is not dissimilar to many other local authorities, who are taking advantage of favourable borrowing interest rates from the government. 'Prudential Borrowing' interest rates or long term annuities from the government currently run between sub 1% and 2.45%, and with property investment yields generally ranging between 4.5% - 8%, there is therefore a margin which the local authority may benefit from, subject to the requirement for minimum revenue provision (MRP).

In addition to the additional revenue generated, the assets will also increase in capital value in the medium to long term and be capable of re-sale in the future.

Investment Guidance

New guidance on local government investments came into effect from April 2018 to reflect changes in patterns of local authority behaviour. As set out above many authorities are investing in commercial assets with the primary aim of generating profit to support front line services. Others are entering into very long term investments or providing loans to enterprises or the third sector as part of their wider place shaping role.

Consequently the definition of investments has now been extended to cover all of the financial assets of an authority (including lending) as well as non-financial assets that the authority holds primarily or partially to generate a profit, e.g. investment property portfolios.

As part of the guidance Councils are required to have at least one Investment Strategy that should meet all of the disclosures and reporting requirements specified. In addition the revised Prudential Code, updated in line with the Investment Guidance, also introduces the need for an annual Capital Strategy. For the City of Lincoln Council there will be three separate elements to the Strategy;

1. The annual Treasury Management Strategy which covers all cash investments
2. The Commercial Property Investment Strategy which covers the Council's approach to investing in property
3. The annual Capital Strategy which covers the Council's approach to deploying and managing the Council's capital resources, including borrowing in advance of need and proportionality disclosures.

This Strategy sets out how the Council will seek to generate the required additional resource from investment in commercial assets and how the risks and costs associated with such activity will be managed. Further to the need to generate investment returns the Strategy also seeks to aspirationally go beyond this and aid redevelopment and regeneration within the City.

3. Objectives

The key objectives of this strategy are to;

- Deliver sustainable income, to support the continued provision of Council services, by growing the Council's property portfolio in a measured and incremental way.

- Build financial resilience through the creation of a diverse portfolio in order to balance risk and return.

- Acquire land or property for the social and economic wellbeing of the City on a long term investment basis.

- Support the economic development of the City by acquiring assets that encourage local business growth, inward investment and/or new entrepreneurial business start-ups.

- Develop a governance framework that enables the Council to move at a timely pace in line with the market.

4. Investment Portfolio Principles and Decision Making/Criteria

Acquisition Criteria

In order to form a view on the strength of a given investment opportunity it will be essential that the investment opportunity is assessed against a defined and agreed set of asset acquisition criteria.

This assessment will be based on an initial pass or fail criteria in respect of the initial yield. Due to the Council's requirement to generate income through satisfactory levels of return on investments, the net initial yield range that would be expected is between 5 – 8%.

Investments not meeting this criteria will not be considered for acquisition, subject to the caveat below in respect of economic development and regeneration objectives.

Any investments meeting this initial criteria will then be against the scoring criteria shown in the table set out in Appendix A. This criteria includes;

- Tenure
- Covenant
- Occupiers Lease Length
- Building Quality/Obsolescence
- Repairing Obligations
- Location
- Sector
- Rent Review Mechanism

For each investment opportunity it will be assessed against the whole set of criteria and nothing will be considered in isolation. The assessment will be recorded for future reference.

The minimum score should be at least 120 out of a maximum score of 157, this is equivalent to at least the 70th percentile of the maximum score. There will, however, always be a trade-off between the level of return and the score, e.g. a high return would reflect a higher risk and vice versa. A property which scores 'unacceptable' for any of the scoring criteria in the table will be rejected.

The assessment criteria does not assess an investment dependent on whether or not it is located within the City boundary. Acquiring property outside of the City will not be discounted but opportunities should be explored in the following location hierarchy;

1. Lincoln
2. Central Lincolnshire
3. Greater Lincolnshire
4. UK

Inclusion in the City boundary or the impact on the economy of the City will be the deciding factor when all other attributes are equal.

The Council will reserve the discretion to acquire investment property assets that may fall outside the investment criteria outlined above if a strong case can be made that the target property provides an exceptional opportunity to promote the economic development and/or regeneration of the City.

Business Case

An initial business case will be required for each acquisition opportunity which will include the purpose of the acquisition, an initial assessment of how the proposal meets the acquisition criteria as set out in the Appendix One, amount of acquisition cost budget to undertake initial due diligence (to include legal title checks, some survey works, and draft valuations).

Once this initial business case has been prepared and approved a further robust business case will be required which will report on the outcomes of this work and also include a more detailed financial appraisal, detailed valuations, physical appraisals, risk assessments and maximum bid/offer prices. This business case will also consider the overall portfolio and its diversity in order to spread risks via a balanced portfolio, e.g. the use types of properties.

Subject to approval of this business case further due diligence will continue to be taken until the purchase is complete.

It is worth noting that the Council, as a public body, may not wish to invest in properties where the occupiers are generally seen to be undertaking business which is contrary to its corporate values. Such examples would include the following activities;

- Alcohol or tobacco production or sale
- Animal exploitation
- Armaments and nuclear weapons production or sale
- Environmentally damaging practices
- Gambling
- Human Rights Abuse / Oppressive regimes
- Pornography

These subject headings will inform the assessment but will not necessarily preclude the Council from investment in a property asset that has a link to these activities.

5. Acquisition process and governance

Commercial property investment opportunities often arise unexpectedly and it is important to be able to take advantage of opportunities when they arise. The Council needs to be in a position to assess investment opportunities in a systematic manner but should also be able to move quickly when a compelling opportunity arises.

Potential opportunities for investment will be primarily identified through the proactive work of the Strategic Property Manager, but that does preclude other officers from identifying opportunities for consideration. A team of officers consisting of the Strategic Property Manager, Chief Finance Officer and City Solicitor will undertake the legal negotiation and necessary due diligence on all risks and carry out the financial assessment to determine which investments met the criteria outlined in this strategy and present the business cases for these to the Corporate Management Team for consideration and initial approval for referral to the Council's Executive.

A typical timetable for the purchase of commercial property is:

- Negotiation period – 3 weeks
- Heads of Terms agreed – 2 weeks
- Executive Approval – 4 weeks
- Legal implications – 4-6 weeks

Wherever possible a report will be submitted to the Council's Executive for approval to purchase the investments. However, given the timescales above and the 4 weekly frequency of Executive meetings the situation may arise where an offer for an investment meeting the assessment criteria is needed to be submitted. In such cases, and with the agreement of the Corporate Management Team, the following approval process, akin to a virtual Asset Management Group, would be undertaken:

- The Strategic Property Manager in consultation with the City Solicitor, Chief Finance Officer, Leader of the Council, Deputy Leader of the Council and the Portfolio Holder for Economic Growth. shall have authority to submit, offer and negotiate terms to acquire the freehold of land an premises on behalf of the Council with a subsequent report to be submitted to the next available Executive meeting.

6. Risk Management

It is necessary for the Council to take a prudent approach to the management of its financial affairs, it needs to ensure that it strikes the correct balance between risk and reward in a prudent manner so that the cost of funding its commercial property investments do not fall on the public purse.

There are a number of risks the Council should consider, all of which could have an impact on the net return to the Council. These risks not only address issues of investment risk at the point of purchase but also issues of emerging financial risks for owned property over the time the property remains in Council ownership. These include;

- Capital values and rentals values can fall as well as rise
- Borrowing costs could increase
- Voids in the portfolio will reduce average yield. As well as lost rental income the Council may also become liable for on-going costs which a tenant would normally be liable for e.g. empty property business rates.
- Disputes with tenants. Common disputes include ongoing maintenance and repair costs of buildings and the ability to recover those costs from tenants.
- Tenant default
- Further Government intervention and changes to the Prudential Code

The overall investment value and range of properties held needs to represent a good mix and spread of risk across differing sectors.

It is important that the Council maintains an adequate level of reserves and balances to ensure it can manage any down turn in the property market and limit the impact it will have on revenue income.

All forms of investment carry an element of risk and the acceptance of a risk factor is rewarded by the potential for a financial return. The Council will be investing from the public purse and will therefore be seeking investments at the more secure end of the risk spectrum.

7. Management of assets

Property management varies between properties. Managerial issues include rent collection, service charge calculation and collection, building maintenance, security, dealing with tenants, re-letting empty units, negotiating terms of rent reviews, dilapidation claims and the general miscellany of property management.

The means of ongoing management of acquired commercial property investments will be determined on a case by case basis however the default position will be that the properties will be managed through Property Services. In some management intensive cases, such as multi-let properties, day to day management fees may be largely recoverable by way of service charge. However, there does remain a ‘client side’ management function for all owned properties and the time commitment will increase relative to the number and type of properties acquired.

8. Ongoing performance review

The day to day responsibility for implementing and managing the performance of the portfolio will reside with the Strategic Property Services Manager. This will be reviewed by the Chief Finance Officer and will be periodically scrutinised by the Towards Financial Sustainability Board (CMT).

9. Conclusion

In summary the objectives of this strategy are to invest in commercial property for the purpose of securing the economic wellbeing of the City of Lincoln, by generating additional income for the provision of services, for the purpose of economic development or regeneration, or a combination of both.

The Strategy details the financial and business case, including setting out the criteria required, for assessing opportunities and an assessment of the associated risks.

The Strategy also clearly sets out that commercial property investments should in the first instance be within the City boundary in order to fully exploit the economic development and regeneration opportunities. However the Strategy also provides the discretion for the Council to invest beyond the City.

APPENDIX A

APPENDIX A

Scoring Criteria

	Score	4	3	2	1
	Weighting Factor	**Excellent/ Very Good**	**Good**	**Acceptable**	**Unacceptable**
Covenant Strength	**10**	Tenants with strong financial covenant and minimum risk of failure.	Tenants with good financial covenant	Majority of tenants with good financial covenant	Tenants with poor financial covenant
Rent Review Mechanism	**10**	RPI Increases with cap and collar	3 to 5 years upwards only rent review with good prospects of increase	3 to 5 years upwards only rent review with medium prospects of increase	Over 5 years upwards/downwards review, poorly drafted and low prospects of increase
Occupiers Lease Length	**8**	Greater than 20 years	Between 15 and 20 years	Between 15 and 10 years	Less than 10 years or vacant
Location	**8**	Prime	Prime/Secondary	Secondary	Tertiary
Tenure	**5**	Freehold	Lease 100 years plus	Lease between 50 and 100 years	Lease less than 50 years
Building Quality/ Obsolescence	**5**	Newly Built/Land	Recently refurbished	Second hand and likely to continue to be fit for current use for 25+ years	Nearing end of useful life/use unlikely to continue when lease expires

Repairing Terms	**5**	Full repairing and insuring	Full repairing and insuring with service charge for common areas recoverable	Internal repairing with external repairs recoverable	Landlords obligations, not recoverable
Sector	**5**	Thriving/expanding sector	Good stable sector	Emerging sector/stable sector	Declining sector

The key components of the scoring criteria are looked at in detail below:

Yield/Rate of return – the rental return on the capital investment should be at an appropriate level to ensure an increase in rent is secured in the portfolio. This needs to be weighed against risk as the higher the level of return that is required from an investment, the higher the level of risk it will carry. The experience of other local authorities indicates that a gross yield of between 5%-7% is achievable over the longer term and through a full economic cycle. The Council's current investment estate is attaining an average gross return of 3.8%. As a minimum the Council would therefore seek to achieve a net initial yield of 5% with a maximum yield, driven by an acceptable level of risk, in the range of 7-8%.

Covenant Strength - the quality of the tenant and, more importantly, their ability to pay the rent on time and in full is essential. This is particularly important where the Council has borrowed against the investment, and minimum acceptable financial strength for any given tenant will be determined through a financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring.

Rent Review Mechanism – the Council would wish to see periodic rent reviews, taking into account inflation and upward market movements.

Lease length - the unexpired length of the term of the lease is of key importance in ensuring that the landlord's revenue stream is secure and uninterrupted. The Council will take into consideration the risks associated with a tenant vacating and the potential to attract good quality replacements tenants at acceptable rental levels.

Location – this is an important consideration in terms of the area being viewed as economically buoyant and having the ability to sustain financial and economic growth over the life time of the asset. The sector e.g. office, retail, industrial will assist in deciding risks associated with individual properties and the mix of sectors within the portfolio.

Tenure – freehold is preferable but long leasehold interests may also be suitable and more available for certain types of investment.

Building Quality/Obsolescence – this will affect the ability of the Council to let or sell the asset in the future and in conjunction with the lease repairing terms is a consideration in protecting the value of the investment.

Repairing Terms – this is an important consideration as the Council does not want to be exposed to costs incurred in repairing property. Therefore, the only properties suitable will be leases on full repairing and insuring terms or leases on internal repairing and insuring terms with a service charge in place to recover 100% of costs incurred.

Sector – information as to the sector of use of the property will assist in deciding on the risks associated with specific properties and will ensure that it does expose itself to an underperforming sector.