Investment Property Acquisition Strategy

2014 - 2018

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1. Purpose

1.1 The purpose of this strategy is to set out the following:

1. The Council's objectives for acquiring property assets for investment purposes.

2. A commentary on the current economic climate, the general property market and the role of property acquisition within that, including possible risks for the Council.

3. The existing strategic framework into which asset acquisition fits.

4. Investment objectives and criteria for asset acquisition.

5. The acquisition protocol (Appendix 1).

2. Background

2.1 Increasing pressure is being applied on the public sector to improve the strategic management and operation of their property assets and to take a more commercial approach to property investment decisions. This strategy outlines how that can be achieved.

2.2 The strategy relates to the acquisition of new properties for investment purposes only and should be read in conjunction with the Estates Strategy.

2.3 The Property Investment Market

2.3.1 The UK commercial property investment market is defined as a 'mature asset class'. It has a wide range of new and established investors including institutions, pension funds, specialist property companies, charities, family trusts and individuals. In recent years, Local Authorities (directly and indirectly via pension funds) have also entered into the market.

2.3.2 Returns from property can be both income driven (through the receipt of rent) and by way of appreciation of the underlying asset value (capital growth). The combination of these is known as the Total Return and this will be a consideration in assessing the attractiveness of a property for acquisition.

2.3.3 Property prices and returns are a function of the property type, age and location, together with the lease structure and covenant strength of the tenant (in the case of a let property).

2.3.4 Within the property investment market there is a wide spread in financial returns (known as yields) on offer, which relate to the particular characteristics of the asset in question.

2.3.5 The yield represents the risk that investors associate with ensuring a long term income, including the potential for growth. For the past few years the wider property investment market has been somewhat fragile and, as a result, there has been a reduction in property values. This, in turn, has resulted in a reduction in interest from potential buyers, especially those with lower risk profiles. Investors have however sought out the most secure investments and, as confidence returns, yields are starting to fall through prices rising.

2.3.6 Yields can range from 2% (low risk) for prime London property to over 20% (high risk) for dated property in secondary locations with high vacancy rates. The oldest parts of Bradley Fold would fall into the latter category.

2.3.7 Typical yield ranges for Investment properties would be:

2-4%	prime retail.
4-7%	retail / office let to blue chip / high covenant strength tenants on with over 10 years unexpired.
7-8%	prime offices (city centres) or retail within established town centres
8-12%	prime industrial and offices in established locations
12-20%	secondary/ tertiary industrial

2.3.8 Section 4 (below) outlines the main factors that investors take into account when looking at property as an investment. It is a combination of these factors that determine the yield.

2.3.9 It is estimated that most of the Council's existing non-operational portfolio is classed within the yield range of 10-15 % (some higher) and this brings with it inherent risks.

2.3.10 In order to create a more balanced property portfolio, it is necessary to dispose of some of the higher risk/poorer performing properties and to acquire properties with a significantly lower risk, in order to redress the risk balance.

2.3.11 What should be sought by the Council are property investments which produce the highest yields possible, whilst carrying an *acceptable level of risk*. The main mitigation measure in managing risk is to target investments which are let to 'blue chip' tenants and on relatively long leases. In this way, the Council will be primarily buying a secure income stream and the buildings themselves become almost secondary considerations.

2.3.12 The risks associated with property acquisition itself are outlined later in this strategy.

3. Why Hold Property Investments?

3.1 Property is usually described as a low to medium risk asset. Its returns invariably lie between those produced by equities and those produced by bonds. Properties leased long term to companies of good covenant strength have a lower risk of default and will produce secure income streams. Consequently their risk profile is much nearer to that of bonds than of equities.

3.2 If income streams from property streams exceed the cost of borrowing required to initially acquire the property, surpluses will be generated. Such surpluses can be used to assist in funding frontline services, or to pay off the capital borrowed, or a combination of the two.

3.3 The Council has access to capital resources at advantageous borrowing rates through the Public Works Loan Board, which increases the prospects of such surpluses being achieved.

3.4 The purpose of acquiring and holding property for investment purposes is primarily to generate income.

3.5 The Council needs to act to strengthen its funding base by building asset portfolios that provide a greater commercial return. It is envisaged that a better performing Let Estate will assist the Council in reducing its reliance on central Government grants.

3.6 The Council has a need to strengthen the revenues it generates from the non-operational ‘Let Estate’ in order to both rebuild the losses in revenues seen over the last few years and to replace the assets that are deemed surplus to requirements and disposed of.

3.7 Vacant sites and assets will only be considered as investments where there is a clearly identifiable value in holding the property, particularly in relation to future development – it is likely that this type of site will be rare.

3.8 Most investments that the Council will consider will therefore relate to property that is already occupied by way of a lease or a number of leases and therefore generates income.

4 Key considerations when acquiring property as an investment

4.1 The key considerations for the Council when acquiring property interests for investment purposes are (in order of importance):

1. *Covenant Strength* - in the case of a let property, the quality of the tenant and, more importantly, their ability to pay the rent on time and in full. This is particularly important where the Council has borrowed against the investment. It is however 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.

2. *Lease length* - in the case of a let property, the unexpired length of the term of the lease is of key importance in ensuring that the landlord's revenue stream is 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.

3. *Rate of return* - the rate of return from the property (e.g. through annual rental incomes) will need to be equivalent or better to the returns that could be earned from alternate investments, such as placing monies on deposit, following adjustment for risks and potential growth.

4. *Risk* - return is one side of the coin; risk is the other. In general, the higher the sought level of return from an investment, the higher level of risk that it carries. For example, if a property is let at an attractive rent which would create a good return, it could still be risky if the tenant does not possess good covenant strength and could default at any time.

5. *Growth* - property has the potential for both revenue and capital growth. The Council will take into account that potential when assessing the strength of the investment opportunity. Property values can fall as well as rise and mechanisms to minimise revenue reductions should be identified.

6. *Sector* - information as to the sector of use of the property (e.g. office, retail, industrial, leisure) will assist

in deciding on the risks associated with specific properties and the mix of sectors within the portfolio.

7. *Building Age and Specification* - in the case of a let property, whilst the Council, as an investor, may be principally concerned with the characteristics of the tenant and lease, the age and specification of the property will also affect the ability of the Council to let or sell the property in the future. It must also be taken into consideration in respect of the cost of protecting the investment. An example of this would be the undertaking of repairs and refurbishment if the cost cannot be fully recovered from the tenant.

8. *Location* - the location of the property will ideally enable the Council to be able to undertake inspections and to deal with any management issues without the need to employ specialists or agents. In essence, whilst location is not a critical factor, preference should be given to properties located within Greater Manchester or in the wider north west of England.

4.2 In summary, the strategy for acquiring investment property assets for holding within the "Let Estate" is therefore to:

- Maximise rental income and minimise management costs to ensure the best return is generated.

- Pursue opportunities to increase returns and improve the investment value of commercial assets.

- Promote collaborative working with adjoining owners and Developers to maximise value.

5 PWLB borrowing

5.1 Depending on the particular circumstances, the Council will fund acquisitions utilising prudential borrowing, or by releasing cash investments, or by a combination of both. It is worth noting that the borrowing of monies by local authorities is subject to the prudential borrowing regime and, in certain cases, is limited by Central Government credit controls.

5.2 The Council has the ability to borrow funds via the Public Works Loan Board (PWLB) both quickly and at competitive fixed rates. It also has substantial cash investments (which back up the Council's reserves and provisions).

5.3 This potentially places the Council ahead of many other potential bidders for investment property and this advantage should be exploited where appropriate.

5.4 By way of an example, the Council could borrow funds over a 20-year period at a fixed rate of 3.75% for the 20 year duration and, using those funds, the Council could purchase a modern building which is let for a long unexpired term to a tenant or tenants with strong covenant strength achieving a return of approximately 4-6%.

5.5 The difference between the rate of borrowing and the rate of return generated by the investment is effectively a surplus which may be used to fund front line services or pay off the capital borrowed, or a combination of both.

5.6 It should be remembered that the Council cannot, and will not, borrow to fund revenue expenditure, nor can it use surplus cash to fund services.

6 Objectives for Property Acquisition

6.1 Based upon three year averages, all property purchased by the Council should achieve, *at the lowest possible risk*:

- The average benchmarked performance for that property type and location and
- Collectively produce an annual return in excess of the cost of PWLB borrowing (interest only).

6.2 It is also recommended that the Council grows its portfolio slowly and incrementally, with a variety of different property assets in order to spread sector risk. This is reflective of a relatively low-risk approach to acquisition.

7 Financial implications

7.1 This Property Acquisition Strategy is a framework designed to secure long term and sustainable income streams for the Council and to increase its financial resilience over time, so that it is less reliant on declining funding from Central Government.

7.2 The Council will fund acquisitions by borrowing funds from the Public Works Loan Board (PWLB) or by running down cash investments.

7.3 The financing costs, which will include interest and possibly principal repayments, will need to be met from the income stream generated by each investment.

7.4 Given the specialist nature of investment acquisitions, the Council will obtain advice from appointed agents with a proven track record in this field.

7.5 Other costs would include legal fees, at approximately 1.5% of the purchase price, Stamp Duty Land Tax, at 4% and Land Registry fees. Certain vendors may also request payment of the seller's advisers' costs by the buyer, although that should be resisted wherever possible.

7.6 Advice will be taken on a case by case basis, but the Council should be VAT neutral, especially when acquiring a going concern.

7.7 All of the costs described will be accounted for within each business case for an acquisition.

8. Key Risks

8.1 Acquisition Risk

8.1.1 The property market has, for several years, been in recession; however there are signs of increased competitive activity in the market as confidence begins to return.

8.1.2 The Council will be targeting low risk, low management investments and those which, despite the recession, have continued to remain occupied and attractive to tenants, landlords and investors.

8.1.3 Interest in this type of property investment has remained strong and the Council will often find itself as one of several potential bidders. This means that there will be instances when the Council will be unsuccessful in its bids. All concerned should be aware of this possible outcome and the potential for abortive costs (see paragraph 8.2.1 below).

8.1.4 Due to the nature of the property market, decisions may need to be taken quickly in order to put offers forward. However, offers can be made on a conditional basis and contracts for sale would not be exchanged until the usual due diligence process has been satisfactorily undertaken.

8.2 Cost Risk

8.2.1 Abortive costs may be incurred in forming unsuccessful bids, or failing to reach exchange of contract as a result of due diligence undertaken. These may include feasibility studies, ground investigations, advisers' costs, legal costs, survey fees and officer time.

8.2.2 This is a risk which is inherent to the property market and should be managed at the earliest stage of each potential acquisition.

8.3 Property Market Risk

8.3.1 As has been evidenced by the economic downturn, Property investment clearly carries inherent risks due to wider economic conditions beyond the immediate control of the Council. Other property related risks, such as those relating to physical defects and characteristics, can be assessed and therefore managed.

8.3.2 It is not uncommon for potential investment opportunities to be offered directly or via limited / targeted marketing to specific clients and those opportunities may never be advertised to the wider market. In those circumstances, the ability of the Council to act quickly is key. Increased knowledge of investment opportunities can also be achieved through adopting a proactive approach with property owners and specialist property investment agencies.

8.3.3 The process of due diligence being undertaken prior to completion is key to the mitigation of most property risks.

9. Environmental and Sustainability:

9.1 Whilst the main criteria in assessing the attractiveness of the investment will be in respect to financial return and risk, the Council should give due consideration to those property investments which display higher levels of environmental sustainability.

Appendix 1 - Acquisition Protocol

Purpose

To ensure that there is a consistency of approach involving appropriately qualified officers, the Council should adhere to a formal Acquisition Protocol.

This protocol will apply to all non-operational acquisitions of land and property for the purpose of inclusion within the Let Estate.

Definition of an Acquisition

An acquisition is defined the purchase of a legal interest in land and property, (by way of freehold, leasehold or license) for strategic or investment purposes.

The Local Government Act 1972 gives the Council powers to acquire any property or rights which facilitate, or are conducive or incidental to, the discharge of any of its functions or for the benefit, improvement or development of the local area. Although not yet fully tested, the Localism Act 2011 may also provide extended powers to local authorities.

Local authorities do, however, have wider fiduciary roles and can face criticism or challenge if they do not have robust business cases for all purchases.

Property Acquisition by the Council

As part of the Estates Strategy, the Council's Estates team will continually assess the mix of properties it holds and will look at its overall exposure to risk, including any over-reliance on specific property sectors. It will consider options to increase or decrease that exposure and to minimise the management time and costs of its Let Estate.

It is likely that synergies will arise from acquiring new assets which have physical proximity to existing assets (including the marriage value of merging adjoining legal interests). They may also be derived from achieving a more commercially focussed approach to the management of the entire portfolio, as outlined in the Estates Strategy.

Acquiring property can also have a regeneration investment effect and support areas of decline. However, the must be a clear and objective focus on the reasons for acquiring any property.

Property Acquisition Funding

It is recommended that an earmarked capital reserve (named the Property Asset Acquisition Fund) is created to fund property acquisitions. This will be achieved and maintained through a combination of:

(a) Releasing monies already held in other low performing investments (these would only be realised once funding was required) and transferring these monies into the fund;
(b) Prudential borrowing/use of cash available for investment;
(c) Replenishing the fund through ring fencing capital receipts arising from the sale of non-operational properties identified through the Estates Strategy.

The Property Asset Acquisition Fund will also need to meet the borrowing costs associated with acquisitions until such time a sustainable income stream from the asset is achieved.

Acquisition Criteria

The following criteria will be considered to help make decisions as to the use of the Acquisition Fund:

Each acquisition will be looked at on its own merit and all recommendations for funding will require a supporting Business Case.

Key elements of each business case shall include:

<u>Investment Acquisitions</u>

- The key financial benefits (with a projected return of at least 2% above borrowing/investment rates) n.b. initial returns may not immediately provide this level dependant on where the property is within the rent review cycle.

- Level of financial security. Acquisitions should normally be pre-let to tenants of good covenant ideally on fully repairing and insuring terms (or inclusion of full cost recovery mechanisms) with an unexpired term of at least five years.

<u>Strategic Acquisitions</u>

- How the acquisition fits with current or proposed policies and assists in strengthening the Borough’s economy?

- Measurable benefits attained through ownership. (This may also include consolidation of existing ownerships to enable future sales, modernisation of the Borough’s business infrastructure encouraging inward investment, benefits associated with re-location and business start-up within the Borough)

- How direct intervention will expedite agreed key strategies for the Borough?

- Partnering arrangements?

- Any potential conflicts with the Economic Strategy or the strategic planning policies?

Where a proposed property acquisition demonstrates both investment and strategic value to the Council, some of the above criteria may be relaxed..

The Process of Acquiring Property Assets

The Council’s present approach involves the assessment of acquisition opportunities most often presented by selling agents, who bring potentially suitable properties to our attention.

Given the specialist nature of the investment properties market, it would be difficult for the Estates and Regeneration team to actively identify and evaluate suitable opportunities. Consequently the Council will appoint look to appoint external consultants to provide the specialist advice needed in each business case.

The primary role of the investment advisers will be to identify the most suitable investment opportunities and present them to the Council for consideration. It is also envisaged that, by using their market facing position, they will advise the Council on issues such as:

- The range of appropriate values for the investment
- The approach to forming offers, bidding and achieving best value
- Sector specific advise in particular risks associated with specific occupiers, sectors and locations.
- Prospects for rental growth
- Capital growth prospects and liquidity (the last two factors are particularly important, as consideration also needs to be given to what happens to assets in the future).

All acquisition proposals will be channelled through the Regeneration and Estates Manager, who would then draft an outline business case in those instances where it was felt that the investment opportunity merited further consideration. The business case for the acquisition will include an indexation score for the property in accordance with the assessment criteria set out in the Estates Strategy.

To ensure that good investments are not lost through delays in the process, it is recommended that a Property Appraisal Group which will comprise both Members and officers is established to consider recommendations in a timely manner.

Once an acquisition is approved by the Group, it is likely that the appointed advisers will also act as the Council's agents in respect to the bidding process, deal negotiation and final purchase. The agents will be given specific parameters for the terms of each purchase.

All valuations must be carried out, or verified, by a fully qualified member of the Royal Institution of Chartered Surveyors with sufficient current local knowledge of the particular market, and the skills and understanding necessary to undertake/verify the valuation competently.

All acquisitions will be carried out in accordance with rules laid down by any relevant professional bodies and laws (in particular, in compliance with all relevant Public Sector and Local Government Legislation, Statutory Instruments, Government Circulars, and existing Council procedures, policies and the Constitution).

Approval Process

The Group will be chaired by the Leader of the Council, and include the Cabinet Member for Resources and Regulation, the Executive Director for Resources and Regulation and the Head of Property and Asset Management (or where appropriate nominated substitutes).

A quorum of at least 3 members of the Group will be required to conduct business.

When a property is identified as a potential investment, the Regeneration and Estates manger will submit to the Group an acquisition appraisal and recommendations.

The Group shall have delegated authority to instruct the Estates and Regeneration manager to complete negotiations (subject to existing delegation limits)

It should be recognised that, in some instances it will be necessary for the Council to make a conditional offer on acquisitions where time is limited. This will be after consultation with the Cabinet member for Resources and Regulation and in line with the agreed principles. Any final offers will be subject to approval from the Group and/or Cabinet.