EXTRAORDINARY COUNCIL
21 NOVEMBER 2016

COMMERCIAL PROPERTY ACQUISITION FUND

Report of the:	Chief Executive
Contact:	Kathryn Beldon/Lee Duffy/Brian Thompson Mark Shephard/Simon Young
Annexes/Appendices (attached):	**Annexe 1** - Property Investment Strategy 2016/17 **Annexe 2** - Revised Prudential Indicators 2016/17 **Annexe 3** - IPD UK Annual Property Index
Other available papers (not attached):	None stated

REPORT SUMMARY

This report presents the Property Investment Strategy 2016-17 and seeks to create a £20m Commercial Property Acquisition Fund resourced from prudential borrowing. It will enable the Council to acquire additional commercial property investments located within the Borough with a view to generating long term secure income streams.

It will assist in supporting the delivery of future Council services and strengthen its long term financial stability.

RECOMMENDATION (S)	*Notes*
(1) That Council endorse the Property Investment Strategy 2016-17 attached at Appendix A for all commercial property investment acquisitions. **(2) That Council approve the creation of a Commercial Property Acquisition Fund of up to £20m, financed from prudential borrowing in 2016/17 and future years.** **(3) That Council approve the creation of a dedicated Investment Property Group (IPG) with delegated authority to make all property investment decisions in compliance with the Property Investment Strategy.**	

(4) That Council approve supplementary capital expenditure for property acquisitions of up to £20m based upon £20m of borrowing commencing in 2016/17 (for economic and social wellbeing purposes and to generate on-going revenue streams). **(5) That Council approve the revised set of prudential indicators which include the operational boundary and authorised limit for external borrowing; these indicators supersede those in the Council's existing Treasury Management Strategy approved by full Council on 19 April 2016.**	

1 Implications for the Council's Key Priorities, Service Plans and Sustainable Community Strategy

1.1 Managing our Resources

- Maximising returns from properties and other investments
- Identify new sources of revenue and maximising our existing income

1.2 Supporting Businesses and our Local Economy

- Supporting developers to bring forward the development of town centre sites

2 Background

2.1 Advised by the Financial Policy Panel at its 27 September 2016 meeting, the Strategy & Resources Committee approved the recommendation that Council accepts the four year funding settlement from Central Government.

2.2 A widely expected phased cut to funding was front loaded and leaves the Council with no Revenue Support Grant (RSG) from 2017/18 onwards, and an overall 66% reduction in funding between 2015/16 and 2019/20.

2.3 Whilst the four year settlement is unfavourable it does provide Councils with a platform from which to plan for the future. The risk of not accepting the settlement would have been to expose the Council to the uncertainty of even greater cuts.

2.4 The acceptance of the settlement still leaves the Council with an anticipated budget shortfall in 2017/18 through to 2019/20 (as previously reported to Council Members). The reductions in RSG have been on-going for a number of years, and this combined with the need to "stand on its own two feet" financially, means it is imperative that the Council focuses on the most effective ways of increasing long term sustainable income sources.

2.5 By way of example, the Council established a £3m Residential Property Acquisition Fund at the beginning of this year (approved at Strategy & Resources Committee on 27 January 2016). We are in the process of acquiring our first properties using this fund. Purchased properties will be used for temporary accommodation which provides a reduction in temporary accommodation costs as well as generating an income stream with long term capital growth prospects.

2.6 The Council currently has a small portfolio of properties, from which it currently derives rental income of around £1.1million. This report proposes a step change to the role of income from properties in helping to fund the delivery of services valued by residents.

3 Commercial Property Acquisition Fund

3.1 The Council now has an opportunity to address these issues through the creation of a £20m Commercial Property Acquisition Fund to exploit commercial property investment opportunities and improve the social and economic wellbeing within the Borough. The property acquisitions, financed from prudential borrowing, will generate long term rental income streams to replace lost RSG funding and assist the Council "stand on its own two feet" financially. It will also facilitate longer term regeneration objectives.

3.2 The Council will borrow from the Public Works Loan Board (PWLB) – a statutory body operating within the UK Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities for their specific needs in line with their affordability.

3.3 Councils are in a strong financial position to acquire property due to their ability to access capital, coupled with the low cost of borrowing.

4 Property Investment Strategy ("the Strategy")

4.1 The Property Investment Strategy 2016-17 (Appendix A) provides a robust and viable framework for the acquisition of commercial property investments. It is designed to stand alongside the Council's existing Asset Management Plan 2012-16 which sets out how property assets are appropriately managed long term.

4.2 The three underlying objectives of the Strategy are to define investment criteria, manage risk and provide an agile decision making framework.

4.3 The Strategy seeks a balanced return from a diversified commercial property portfolio. The preference is towards high quality buildings in good locations with financially strong tenants. A scoring Matrix allows the relative merits of an investment opportunity to be measured and assessed against a target threshold.

4.4 A long term approach to risk management will be adopted by holding property assets for a minimum 50 years (as most properties will have residential potential if their current use becomes obsolete). This will ensure income and capital returns are considered over the long term thereby smoothing out any cyclical economic / property downturns.

4.5 The Council will borrow from the Public Works Loan Board (PWLB). The PWLB offer historically low fixed interest rates (Epsom & Ewell can borrow at circa 2.5% based on rates at this date) thereby protecting the Council from any future increases in financing rates.

4.6 The availability of suitable high quality, low risk investment property is generally limited, and consequently, can generate strong competition when opportunities arise.

4.7 For the Council to compete in the property investment market place, it is essential for it to be able to respond swiftly and decidedly. To accommodate this necessary level of commercial agility, it is recommended that delegated authority to make decisions be given to a dedicated Investment Property Group (IPG). The IPG membership will include the Chairman and Vice-Chairman of the Strategy & Resources Committee together with the Chief Executive, Director of Finance & Resources and relevant Heads of Service (Property, Legal and Financial).

4.8 For a potential property investment to be considered by the IPG, it must achieve a minimum weighted score of 60 (out of a possible 100) from the scoring Matrix. It must also be accompanied by a full business case.

4.9 The business case will be prepared by the Head of Property in consultation with finance and legal colleagues. Each potential property investment will undergo qualitative and quantitative appraisal to establish portfolio suitability and the legal / financial implications of the purchase. The Head of Property will seek external investment / technical expertise where specialist property market knowledge is required.

4.10 All acquisitions will be subject to building survey, purchase report and valuation. In view of the potential value of acquisitions, it is envisaged that the Council will be externally represented for each transaction by a property investment agent and legal firm.

5 Financial and Manpower Implications

5.1 Councils are in a strong financial position to acquire property to safeguard the economic wellbeing of their Boroughs due to their ability to access capital, coupled with the current low cost of borrowing. For example, the Council is able to borrow externally from the PWLB at “certainty” rates of circa 2.5% (as at today’s date). This would be based on a “Maturity” repayment loan (which is a loan repayable in full at the end of its term / maturity).

5.2 In the current climate it is considered prudent to borrow money at these rates (which are at a historic low) rather than rely on already depleted (and mostly committed) levels of capital receipts and/or other sources of restricted capital funding.

5.3 Historically this Council has been debt free, as have others in Surrey. However, in the current fiscal climate most Local Authorities are now increasingly looking to borrow to fund property purchases which attract an on-going income stream and stimulate regeneration and economic development. It is estimated that over the next two years the collective cumulative borrowing levels of all the Surrey Districts and Boroughs will reach nearly £2bn for reasons outlined above in 5.1 and 5.2.

5.4 Councils are able to set whatever borrowing limit they judge to be appropriate. However, under the Prudential Borrowing rules it clearly needs to be prudent and affordable. Importantly, EEBC will need to consider carefully the impact of increasing levels of debt, and its ability to repay the principal element of the loan/s.

5.5 Officers have sought specialist borrowing advice from the Council's Treasury Management advisors; Capita, who are comfortable with the level of borrowing required to sustain a supplementary capital estimate of £20m. They have also recommended that Council does not borrow from the PWLB until a business case is completed, the final acquisition is confirmed and then the physical cash requirement is determined. Accessing borrowing from the PWLB is a fairly straightforward process and can be done within a short notice period (less than a few days) for these levels of borrowing. Capita have also suggested that the Council consider internal borrowing for some of its property acquisitions and this is discussed in para 5.8 below.

5.6 As part of the annual budget setting process, officers are required to produce a set of prudential indictors which include the operational boundary and authorised limit for external debt. These are included in the Council's Treasury Management Strategy that was approved by Council on 19 April 2016. These therefore need to be revised, and an updated set are included at Appendix B for Council approval.

5.7 If the additional capital estimate is agreed, the capital programme will increase in 2016/17 from £1,031,000 to £21,031,000 (reflecting the increase of £20m in this report. As a result, the capital financing requirement (which represents the amount of money needed to fund the new expenditure) and the operational boundary (which is the anticipated maximum level) for external debt in 2016/17 will increase to £20m. In order to cover unexpected eventualities outside the remit of this specific report and 'just in case' scenarios on cash flow fluctuations, it is also deemed prudent to increase the authorised limit for external debt (which is the absolute limit the Council must not go beyond) to £25m. This is purely to provide a safety net for the Council and to minimise risk.

5.8 Whilst external PWLB Borrowing would be the usual vehicle of choice for funding acquisitions it is possible for the Council to use an "internal borrowing" strategy to fund part of the £20m expected capital spend on the property acquisitions. The purpose of internal borrowing is to "address the cost of carry" that the Council would have. In plain speak this can be explained as follows; the Council has short term cash investments of £15m (as detailed in the Council's 2016/17 published Statement of Accounts) which earn on average 0.90% interest as rates are low at the current time. So, rather than borrow from the PWLB at a rate of 2.5%, the Council could choose to re-direct some of these internal monies to fund the capital expenditure for the property acquisitions and thus save interest costs. However, it should be noted that this is a short term solution only as if investment interest rates rise in the future (or PWLB rates decrease) then the positon would be reversed and a switch to PWLB borrowing would be more cost effective.

5.9 The decision to fund internally or externally would have to be made on a "case by case" basis and take into account market factors and the overall financial positon of the Council in terms of its cashflow and short term investment position. Therefore, for the purposes of this report, it is suggested that this is something considered alongside each specific potential purchase on a cost/benefit analysis basis.

5.10 ***Chief Finance Officer's comments:*** *The financial and borrowing implications for creation of the Commercial Acquisition Fund are laid out and explained in the Financial Implications above.*

5.11 *The Council has taken advice from its Treasury Advisors; Capita, in respect of the borrowing implications for the Council and the capital implications of this decision.*

5.12 *As the Council moves from debt free status to a Council with Prudential Borrowing requirements, it will be taking further advice from Capita on its debt management and borrowing requirements and subscribing to their service for this will cost an additional £2k per year which will be funded from existing budgets.*

5.13 *The effects of borrowing in terms of the Minimum Revenue Provision (the amount that has to be set-aside for debt repayment purposes and is chargeable to the Council Tax payer) will be built into the Council's Budget Plans for 2017/18 and onwards and reported to Council.*

6 Legal Implications (including implications for matters relating to equality)

6.1 Pursuant to Section 120 of the Local Government Act 1972 the Council has the power to acquire any land for the purpose of carrying out its functions or for the benefit, improvement or development of the area.

6.2 Section 12 of the Local Government Act 2003 provides a power to the Council to invest a) for any purpose relevant to its functions, or b) for the purposes of the prudent management of its financial affairs. This includes investment in property if it relates, for example, to the economic wellbeing of the Borough (including the regeneration of a town centre).

6.3 Section 1 of the Local Government Act 2003 provides a power to the Council to borrow a) for any purpose relevant to its functions, or b) for the purposes of the prudent management of its financial affairs.

6.4 The Council also has a general power of competence under Section 1 of the Localism Act 2011 to do anything that individuals generally may do. This includes the power to undertake any activity that will support the social, economic or environmental wellbeing of the Borough.

6.5 ***Monitoring Officer's comments:*** *The proposals in this report are considered to fall squarely within the Council's powers. The governance arrangements around the Property Investment Strategy are considered to be sufficient to protect the Council's interests.*

7 Sustainability Policy and Community Safety Implications

7.1 None for the purpose of this report.

8 Partnerships

8.1 None for the purpose of this report.

9 Risk Assessment

9.1 As an asset class property investment provides a better total return (i.e. from both income and capital appreciation) than cash investments, whilst still maintaining a high level of security.

9.2 The Investment Property Databank (IPD) Index tracks retail, office and industrial properties. The Index includes data on actual property transactions from institutional investors and property companies. It produces annual and monthly figures for the total return. The IPD Index is the standard benchmark for investors to analyse the UK commercial property market. In addition, comparable return and risk analysis is provided for other types of investments – bonds and general equities.

9.3 The 2015 IPD UK Annual Property Index (results for the year to 31 December 2015) is attached at Appendix C and recorded a total all property return of 13.1%; split approximately between an income return of 4.8% and a capital return of 8%. In contrast over the same period, bonds returned 1% total return, equities (shares) returned a negative -2.2% and inflation was 1.2%.

9.4 Historically, the All Share Index has returned a dividend yield (i.e. income yield) of approximately 3.5% pa. The negative total return of -2.2% for 2015 was attributable to negative capital growth. It is widely expected the total return for equities in 2016 will be positive.

9.5 IPD calculations confirm that investing in property has the second lowest risk (after bonds) as measured by volatility (standard deviation). Furthermore, commercial property is often viewed as a hybrid asset class in that it exhibits the income security of bonds with capital growth prospects more associated with shares.

9.6 Investment in property is deemed illiquid, that is, invested money cannot normally be accessed at short notice. However, this complements the Property Investment Strategy which specifically adopts a 50+ year investment horizon. This will ensure income and capital returns are considered over the long term thereby smoothing out any cyclical economic / property downturns.

9.7 The Council will borrow from the Public Works Loan Board (PWLB) at historically low fixed interest rates of circa 2.5% - this will protect the Council from any future increases in financing rates.

9.8 All potential property investments will be risk assessed against the Scoring Matrix and mitigated by the proposed governance arrangements.

9.9 Risk will be continually monitored and mitigated as follows:-

Risk	Level	Mitigation
Poor investment decision making.	L	Each investment acquisition will be Matrix scored and include a full business case.
Consequences of proposed investment decisions on borrowing.	L	The Council is required to have regard to CIPFA's Prudential Code for Capital Finance governing borrowing decisions. Revised Prudential indicators are attached at Appendix B.
Economic slowdown in the property market making transactions difficult to complete.	M	Agile governance structure proposed (IPG) to allow the Council to take advantage of prevailing market conditions.
Lack of suitable property investment opportunities in the Borough.	M	The Head of Property will build relationships with local and regional investment agents.
Property values can go down as well as up.	L	Long term holding strategy at fixed loan rates will smooth out market cycles.

Risk	Level	Mitigation
Vacancies – due to tenant going into liquidation / administration or leases not renewed at expiry.	M	Attractive buildings in good locations will assist the re-letting of empty buildings.
Investment opportunities are lost as the Council is unable to act swiftly and decidedly.	L	IPG to be established under the Property Investment Strategy governance arrangements.
Investments are acquired without full knowledge of building or tenant lease obligations.	L	A thorough legal and practical due diligence process will be undertaken.

Key: L – Low; M – Medium; H - High

10 Conclusion and Recommendations

10.1 For services to be maintained at their current levels, it is recognised that the Council must not only continue to identify ongoing operational efficiencies, but also to seek new long term sustainable income sources.

10.2 It is proposed that Council endorse the Property Investment Strategy 2016-17 attached at Appendix A.

10.3 It is further proposed that a £20m Commercial Property Acquisition Fund be established by the Council to exploit commercial property investment opportunities in the Borough. The property acquisitions, financed from prudential borrowing, will generate long term rental income streams to replace lost Revenue Support Grant funding.

10.4 For the Council to compete in the property investment market place, it is essential for it to be able to respond swiftly and decidedly. To accommodate this necessary level of commercial agility, it is proposed that delegated authority to make decisions be given to a dedicated Investment Property Group (IPG) acting in accordance with the Property Investment Strategy 2016/17.

10.5 As part of the annual budget setting process, officers are required to produce a set of prudential indictors which include the operational boundary and authorised limit for external debt. These are included in the Council’s Treasury Management Strategy that was approved by Council on 19 April 2016. It is proposed the revised prudential indicators included at Appendix B are approved.

WARD(S) AFFECTED: All