COUNCIL
14 FEBRUARY 2017

INCREASING THE COMMERCIAL PROPERTY ACQUISITION FUND

Report of the:	Chief Executive
Contact:	Kathryn Beldon, Lee Duffy, Brian Thompson, Mark Shephard, Simon Young
Urgent Decision?(yes/no)	No
If yes, reason urgent decision required:	N/A
Annexes/Appendices (attached):	**Annexe 1** - Property Investment Strategy 2016/17 **Annexe 2** - Revised Prudential Indicators 2016/17
Other available papers (not attached):	Commercial Property Acquisition Fund (Agenda Item 2, Extraordinary Council 21 November 2016)

REPORT SUMMARY

This report outlines and recommends an increase to the Commercial Property Acquisition Fund ("the Fund") of a further £60m to be funded from Prudential Borrowing.

At its 21 November 2016 meeting, Council agreed the creation of a Commercial Property Acquisition Fund with a fund limit of £20m financed from Prudential Borrowing. Following the successful completion of two recent commercial property acquisitions, the Fund is almost exhausted and leaves no capacity to assess, consider and negotiate future opportunities from 2017/18.

An increase to the Fund will enable the Council to acquire additional commercial property investments located within the Borough with a view to generating revenue income streams. These will assist in supporting the delivery of future Council services and strengthen its long term financial stability.

The acquisitions will form part of a balanced property portfolio which also takes into consideration the social and economic wellbeing within the Borough.

	Notes
RECOMMENDATION (S) **It is recommended that Council:** **(1) Approves an increase to the Commercial Property Acquisition Fund of a further £60m to be funded by Prudential Borrowing.**	

(2) Approves a supplementary capital expenditure estimate of £60m for the financial year 2017/18 for (1) above for economic and social wellbeing purposes and to generate on-going revenue streams. **(3) Approves the revision of the Council's Prudential Indicators to reflect the additional £60m of Prudential Borrowing limits.** **(4) Notes that a mid-year appraisal update report will be made to Strategy & Resources Committee on the strategy, portfolio performance and status of acquisitions made from the Commercial Property Acquisition Fund.** **(5) Notes that a new regular update report will be made to the Financial Policy Panel on the financial status of the commercial property investment portfolio and rental income profile.**	

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 At its 21 November 2016 extraordinary meeting, Council agreed the Property Investment Strategy 2016-17 and the creation of a Commercial Property Acquisition Fund with a fund limit of £20m financed from Prudential Borrowing.

2.2 The Fund would enable the Council to acquire additional commercial investment properties located within the Borough, with a view to generating a balanced property portfolio and also producing longer term revenue streams. Additional revenue streams could:-

- Assist in replacing the lost Revenue Support Grant funding from Central Government. The Council's published Medium Term Financial Strategy and Efficiency Plan projects a current deficit position for the Council up to 2019/20.

- Assist in supporting the delivery of Council services.

- Strengthen the Council's long term financial stability.

2.3 Furthermore, the acquisition of additional commercial properties (in line with the Council's approved Property Investment Strategy 2016-17) would assist in the alignment of the Borough's social and economic requirements. For example, the Borough has witnessed numerous office buildings legitimately converted to residential use through permitted development rights. This poses a significant risk to the Borough's office supply and the Council would always look to safeguard office use where it acquires commercial property investments.

3 Commercial Property Acquisition Fund Governance

3.1 The Property Investment Strategy 2016-17 ("the Strategy") underpins the Fund and provides a robust and viable framework for the acquisition of commercial property investments. A copy of the Strategy is included at Annexe 1.

3.2 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.

3.3 To accommodate the necessary level of commercial agility, an important element of the Strategy was the creation of the dedicated Investment Property Group (IPG). Authority to make commercial property investment decisions is delegated to the IPG on behalf of Council.

3.4 IPG membership includes 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).

3.5 A scoring Matrix allows the IPG to measure and assess the relative merits of an investment opportunity against a minimum weighted threshold score of 60%.

3.6 In addition, the IPG requires each commercial property investment opportunity to be accompanied by a full business case prepared by the Head of Property in consultation with finance and legal colleagues.

4 Increasing the Commercial Property Acquisition Fund

4.1 Shortly after the creation of the Fund, the Council completed on its first acquisition - the purchase of 70 East Street, Epsom; a high quality, refurbished four-storey office building in the heart of Epsom.

4.2 The building is let in its entirety to Epsom & St Helier University Hospitals NHS Trust and provides the Council with a secure net income from an established tenant.

4.3 70 East Street achieved a high 86% on the Scoring Matrix reflecting the quality of the building, its location and the financial strength of the tenant.

4.4 The total cost of the acquisition was approximately £5.7m and provides a net income to the Council (that is, after the deduction of borrowing costs from the rent), of approximately £130k per annum. It should be noted that a proportion of this £130k will be prudently set-aside by the Council to provide a contingency for any future costs of this property – see paragraph 4.11 which refers.

4.5 On 30 January 2017, the Council completed on its second commercial property acquisition; a prominent, high quality Epsom town centre office building offering more than twice the accommodation of 70 East Street.

4.6 Whilst a confidentiality agreement prevents the building being identified, it is let in its entirety to a financially strong tenant and achieved a high 80% on the Scoring Matrix. The property provides the Council with a net income of approximately £210k per annum. Again, the Council will prudently set-aside a proportion of this £210k as a contingency for any future unforeseen costs for the property. See paragraph 4.11 which refers.

4.7 The two acquisitions have almost exhausted the £20m Fund and this leaves no real working fund or flexibility to consider future acquisitions in 2017/18. In practical terms, it means the Council could miss out on opportunities if it could not act quickly enough on property investment matters – for example, if it had to wait for further approvals of funding from Council.

4.8 It is therefore recommended that a further amount of £60m be approved by Council to ensure the Fund has sufficient financial standing for potential new acquisitions in 2017/18. This will increase the overall fund limit to a value of £80m and this would again be funded from Prudential borrowing by way of loans from the Public Works Loan Board.

4.9 For the avoidance of doubt, all potential purchases made under an increased Fund will follow exactly the same robust scrutiny process set out in section 3 above.

4.10 It is also proposed to provide the Strategy & Resources Committee with a new mid-year update report on the strategy, status, and portfolio performance of the Fund (which will also be available for scrutiny by the Council's auditors). This will further strengthen the governance and internal control arrangements around the Fund and the processes for making acquisitions.

4.11 Similarly, it is proposed to introduce a new regular report to the Financial Policy Panel on overall property investment performance and rental income profile. This will also include updates on the provisions that the Council will be setting aside as a contingency against future voids and enhancement costs associated with the acquired properties. The funding of these provisions will be created by prudently setting aside an element of the net revenue streams that arise from the rental income from each property.

4.12 It should be noted that although it is recommended to increase the limit to £80m, this does not necessarily mean that the full £80m will be spent - it is a limit only, and specific recommendations for any acquisition will follow the same robust scrutiny process outlined in section 3 above.

4.13 It is standard practice for Councils to ensure they have sufficient "headroom" limits for prudential borrowing to avoid having to make repeated requests to Council for smaller incremental increases.

4.14 To provide the Fund's additional borrowing facility of £60m, it is proposed that Council approves the necessary amendments to the Council's prudential indicators.

4.15 It is essential that any future borrowing is affordable and within the limits of Prudential Borrowing and parameters of the Medium Term Financial and Efficiency plan of the Council.

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. The Council is currently able to borrow externally from the Public Works Loan Board (PWLB) at "discounted certainty" rates of circa 2.9% (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 at these rates (which are still 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 In fact the Public Works Loan Board is in the process of increasing its overall lending limits to the public sector as it is aware that many Councils nationwide are looking to borrow to fund property purchases and attract vital income streams.

5.4 Historically this Council had been debt free, as had others in Surrey. However, in the current fiscal climate most Surrey Districts/Boroughs are increasingly looking to borrow to fund property purchases which attract an on-going revenue stream to stimulate regeneration and economic development. A recent survey showed that borrowing levels alone within the area of Surrey District's exceeds £2bn and this is expected to significantly increase in 2017/18.

5.5 As part of the annual budget setting process, officers are required to produce a set of prudential indicators which include the operational boundary and authorised limit for external debt. These are included in the Council's Treasury Management Strategy that will also be approved by Council on 14 February 2017. These indicators need to be amended if the additional £60m is approved. An updated set are thus included at Annexe B for Councils approval.

5.6 If the additional capital estimate is agreed, the capital programme will increase in 2017/18 from £1,249 to £61,249,000 (reflecting the increase of £60m 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 will increase to £80m (representing the full £20m and £60m in the Fund). 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 £85m. This is purely to provide a safety net for the Council and to minimise risk.

6 Chief Finance Officer's comments:

6.1 *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.*

6.2 *It is important to note that this report is increasing the Fund and overall Council borrowing limit only. Any specific acquisition is subject to a full business case, matrix assessment and approval by the Investment Property Group (IPG).*

6.3 *The financial effects of the borrowing will be built into the Council's Medium Term Financial Strategy and Efficiency Plan and the Capital Programme.*

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

7.1 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.

7.2 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).

7.3 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.

7.4 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.

7.5 ***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.*

8 Sustainability Policy and Community Safety Implications; Partnerships

8.1 No implications 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 Council will borrow from the Public Works Loan Board (PWLB) at historically low fixed interest rates - this will protect the Council from any future increases in financing rates.

9.3 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.

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

9.5 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 Annexe 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.
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.

L – Low; M – Medium; H - High

10 Conclusion and Recommendations

10.1 The Council has already committed the majority of the Commercial Property Acquisition Fund limit of £20m before the end of this financial year. The commercial property market is fast-moving, and there are opportunities to grow our investment property holdings. In accordance with the approved investment criteria matrix of the Property Investment Strategy 2016-17, we will only consider high-scoring properties where the full business case favours acquisition. The sooner we make acquisitions, the sooner we will be able to reap the benefits of the accompanying rental income. It is therefore also proposed that we increase our borrowing ceiling, in order to facilitate further acquisitions.

10.2 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. It is proposed the revised prudential indicators included at Appendix B are approved. These Prudential indicators supersede those in the Budget report 2017/18 to Council which is also on the agenda at this Council meeting.

WARD(S) AFFECTED: All