



Epsom and Ewell Borough Council Property Investment Strategy

2016/17



November 2016

Introduction

The Property Investment Strategy (“the Strategy”) aims to provide a robust and viable framework for the acquisition of commercial property investments. The three underlying objectives of the Strategy are:-

- **Investment Criteria** – to identify suitable property investment opportunities.
- **Risk Management** – to balance the requirement for income return with an acceptable level of managed risk.
- **Governance Arrangements** – to provide an agile decision making framework.

The asset management of the Council’s existing property estate (comprising operational and commercial investment properties) is defined in the Asset Management Plan (AMP). The AMP will subsequently apply to all property investments acquired under this Strategy to ensure that assets are appropriately managed long term.

Investment Criteria

In common with all forms of investment at their most basic level, property investment is a trade-off between risk and return. A traditional well diversified property portfolio (spread across different property sectors and geographical regions) will deliver a balanced long term return with minimal risk. It will typically provide a steady income yield of 5%-7% with the additional prospect of capital growth.

The Strategy will adopt the same underlying principle of diversification in acquiring a Borough wide portfolio of property investments offering a similar income yield profile. The three main property sectors will be included (industrial, office and retail) and in turn, these will be diversified on criteria including location, the tenant’s financial (covenant) strength, lease term (income duration) and investment lot size. This will ensure that should a property investment cease to be income producing (for example, it is undergoing refurbishment or awaiting a new tenant), then the loss of income will not adversely affect the portfolio’s return.

A scoring Matrix allows the relative merits of an investment opportunity to be measured and assessed against a target threshold. The Matrix is attached at Appendix A and includes the following scoring criteria:-

- **Location** - property is categorised as either prime, secondary or tertiary in terms of its locational desirability. For example, a shop located in the best trading position in a town would be prime, whereas a unit on a peripheral

neighbourhood shopping parade would be considered tertiary.

- **Tenant Covenant** – the financial strength of a tenant determines the security of the property's rental income. A financially weak tenant increases the likelihood that the property will fall vacant. The minimum acceptable financial strength for any given tenant will be determined through financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring. To minimise management and risk, the preference will be for single occupancy investments wherever possible.
- **Building Quality** – a brand new or recently refurbished building will not usually require capital expenditure for at least 15 years. This is attractive for income investors requiring long term rental income with the minimum of ongoing capital expenditure.
- **Occupational Lease Length** – the lease term will determine the duration of the tenant's contractual obligation to pay rent. The most attractive investments offer a long lease with a strong tenant covenant.
- **Tenure** – anything less than a freehold acquisition will need to be appropriately reflected in the price.
- **Tenant Repair obligations** – under a Full Repairing & Insuring Lease (FRI), the tenant is responsible for the building's interior and exterior maintenance / repair. The obligation is limited to the building's interior under an Internal Repairing & Insuring Lease (IRI). The preference will be to favour FRI terms (or FRI by way of service charge i.e. all costs relating to occupation and repairs are borne by the tenants and administered through a service charge).
- **Lot Size** – to maintain portfolio balance the preference will be for no single property investment to exceed £6m.

High scoring properties will typically be freeholds let long term to a single tenant with a strong financial covenant. Occasionally, opportunities will arise that do not score highly on the matrix criteria; for example, an empty property that falls within the Council's designated Plan E regeneration zone or one adjacent to an existing Council ownership. In these circumstances, the Matrix will not preclude low scoring properties being considered on their own individual regeneration / economic development merits, but the decision to purchase will be taken by either the Strategy & Resources Committee or full Council as appropriate.

Risk Management

Market forces

As with all investments, there are risks that capital values and rental values can fall as well as rise. To mitigate against future unfavourable market forces, acquisitions will be made on the basis that the Council is willing and capable of:-

1. Holding property investments for the long term i.e. 50 years +. This will ensure income and capital returns are considered over the long term thereby smoothing out any cyclical economic / property downturns.
2. Fixing borrowing liabilities. The Council can borrow from the Government's Public Works Loan Board at the lowest fixed interest rates for 20 years. Fixing borrowing rates at historically low levels will protect the Council from any future increases in financing rates.

Management

To mitigate the risk of void periods where the property is either partially / fully vacant or a tenant has defaulted on its rental obligations, the investment portfolio will be actively managed in accordance with the Council's adopted Asset Management Plan.

In addition, the investment criteria specified in the scoring matrix will tend to favour secure property investments i.e. high quality buildings in prime locations - thus mitigating the risk of void periods on re-letting.

Opportunities

The availability of suitable high quality investment property is generally limited and consequently, opportunities may be lost where vendors employ competitive bidding processes. Furthermore, the property investment market is often characterised by "off market" investment activity where, for a variety of reasons, opportunities are not freely marketed.

To mitigate the likelihood of lost opportunities, the Head of Property will actively build relationships with the investment agency community. The ability of the Council to make (and act upon) investment decisions at short notice is a key requirement for seeking out investment opportunities. It is proposed a dedicated Investment Property Group is established by the Council for this purpose.

Governance Arrangements

Investment Property Group (IPG)

A dedicated Investment Property Group will authorise the acquisition of property investments taking account of the overall investment and risk management criteria defined in this Strategy.

Subject to full Council approval, the IPG will receive delegated authority to make property investment decisions up to a defined budget / borrowing facility limit. Any subsequent amendments to the budget / borrowing limit will require full Council approval.

IPG membership will comprise:-

- Strategy & Resources Committee Chairman
- Strategy & Resources Committee Vice-Chairman
- Chief Executive
- Director of Finance & Resources
- Head of Financial Services
- Head of Property
- Head of Legal & Democratic Services

For a potential property investment to be considered by the IPG, it must:-

- 1) Achieve a minimum weighted score of 60 from the investment criteria matrix

and
- 2) Be accompanied by a full business case.

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.

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. In almost all cases, the purchase report and valuation will be provided as part of the property investment agent's introductory fee.

Appendix A – Investment Criteria Scoring Matrix

Criteria	Weighted Score	Excellent	Good	Acceptable	Marginal	Poor
		5	4	3	2	1
Location	20	Major Prime	Micro Prime	Major Secondary	Micro Secondary	Tertiary
Tenant Covenant	20	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenants	Multiple tenants with good financial covenants	Tenants with poor financial covenant strength
Building Quality	15	Modern or recently refurbished with nominal capex required	Good quality with capex likely to be required within the next 20 years	Good quality with capex likely to be required within the next 10 years	Good quality with capex required within the next 5 years	Non-compliant with capex required within the next 5 years
Occupational Lease Length	20	Greater than 10 years	Between 6 and 10 years	Between 3 and 6 years	Between 2 and 4 years	Less than 2 years or vacant
Tenure	10	Freehold	Lease 125 years plus	Lease between 100 and 125 years	Lease between 50 and 100 years	Lease less than 50 years
Tenant Repair Obligations	10	FRI	FRI – partially recoverable	IRI – 100% recoverable	IRI – partially recoverable	Landlord responsibility
Lot Size	5	Between £4m and £6m	Between £2m & £4m or £6m & £8m	Between £1m & £2m or £8m & £10m	Between £500k & £1m or £10m & £15m	Less than £500k or greater than £15m
Maximum Weighted Score	100	100	80	60	40	20