REPORT FOR: **CABINET**

Date of Meeting:	10 December 2015
Subject:	Investment Property Strategy
Key Decision:	Yes
Responsible Officer:	Corporate Director of Resources and Commercial
Portfolio Holder:	Councillor Sachin Shah, Portfolio Holder for Finance and Major Contracts Councillor Keith Ferry, Portfolio Holder for Business, Planning and Regeneration
Exempt:	No
Decision subject to Call-in:	Yes, where the decision is not reserved to Council
Wards affected:	All
Enclosures:	Appendix I: Draft Investment Property Strategy Appendix II: Business Case Pro-forma

Section 1 – Summary and Recommendations

Summary:
This report invites Cabinet to consider proposals for the development of an investment property strategy and recommends the implementation of such a strategy with appropriate delegations.

Recommendations:
Cabinet is recommended to:

1. Approve the Investment Property Strategy as set out in in Appendix I
2. Authorise the Corporate Director – Resources and Commercial to establish the most appropriate method of holding the proposed portfolio.
3. Authorise the Corporate Director of Community, following consultation with the Portfolio Holders for Finance and Major Contracts and Business, Planning and Regeneration and the Director of Finance, to acquire an investment property portfolio at a total cost not to exceed £20m with no single purchase to exceed £5m
4. Recommend that Council approve an addition to the capital programme of £20m in order to proceed with the acquisition of the investment property portfolio
5. Recommend that Council agree to amend the treasury management Counterparty Policy in respect of investment in a property portfolio from an upper limit of £10m to £20m
6. Authorise the Corporate Director – Resources and Commercial to enter into an Inter Authority Agreement with Luton Borough Council for the provision of property investment advisory services.

Reason: To progress the Council's Investment Property Strategy in accordance with the requirements of the "Commercialisation Strategy 2015-2018."

Section 2 – Report

Introduction

1. The proposal made in this report is an important part of the Council's "Commercialisation Strategy" which, through producing additional income, will support the delivery of the Council priorities as follows:

    - Making a difference for the vulnerable
    - Making a difference for communities
    - Making a difference for local businesses
    - Making a difference for families

Options considered

2. In the development of the Council's "Commercialisation Strategy" many options for realising additional income were considered. In the preparation of this proposal various options have been considered as to the optimum construction of the portfolio and, as discussed in Appendix I, the strategy recommended is to seek higher yielding, good quality properties and good long term tenants.

Background

3. On 17 June 2015 Cabinet agreed the "Commercialisation Strategy 2015-18." This Strategy is aligned to the "Corporate Plan 2015-2019" and the "Medium Term Financial Strategy 2015/16 to 2019/20." The Strategy was reviewed in detail by Overview and Scrutiny Committee at their meeting on 16 September 2015.

4. Within the Strategy a number of options for realising additional income were considered and one of the twelve "Priority opportunities" included the following:

   Opportunities for investing a portfolio of commercial property will also be explored as well as other potential investment opportunities such as energy generation.

5. At its meeting on 24 September 2015, after consideration by Governance Audit, Risk Management and Standards Committee on 22 July 2015, the Council agreed to expand its "Counterparty List" in which the Council could invest its cash balances to include "corporate bonds pooled funds, other non-standard investments and gilts." The upper limit for such investments was set at £10m.

6. The proposal in this report is the first non-standard investment to be considered and it is recommended that at this stage an investment property portfolio be acquired at a cost not to exceed £20m. At its meeting on 25 February 2016 Council will be asked to increase the upper limit in respect of this investment to £20m.
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7. The source of the Council's current investment portfolio is historic being made up from surplus operational properties, transfers from the winding up of the Greater London Council and areas of land from previous infrastructure projects. It now totals around 50 properties with a value, as stated in the 2014-15 Statement of Accounts, of approximately £30m. All these properties provide income and/or development opportunities.

8. Whilst the portfolio is managed in an efficient manner it has not been constructed primarily with the aim of generating property investment income or capital. Additionally some of the Council's land holdings are now being considered as part of the Council's regeneration proposals. The
   annual income realised from these properties in 2014-15 was £0.8m

Proposal

9. A key part of the Council's "Commercialisation Strategy" is to increase the proportion of its total income from commercial services.

10. It is therefore proposed to seek to manage the current income earning investment portfolio more actively and to further invest in property with the aim of generating returns in excess of those obtainable from the money markets within the current treasury management strategy. The objective will be to obtain a sustainable increase in General Fund revenue income whilst meeting capital receipts requirements.

11. Council officers are aware that Luton Borough Council have made substantial investments to develop a commercial property portfolio to the benefit of their General Fund. Through “peer support” work, funded by the Local Government Association, advice has been received from officers of Luton Borough Council.

12. The Luton portfolio is managed by a professionally qualified and experienced Investment Portfolio Manager (Mr Richard Morgan). He is a Member of the Royal Institution of Chartered Surveyors and has over 30 years relevant experience much of which has been as a property fund investment manager.

13. Over the two financial years since the commencement of their strategy the investments made by Luton have realised the following results:

New purchases in 2013/14 & 2014/15 (gross cost) (Properties x 5)	**£19.9m**
Rental income	£1,650,400p.a.
Income yield (gross before borrowing costs)	8.30%
Assumed borrowing costs:-	4.0% interest ; 2.5% MRP (capital repayment)
Net income	**£359,182p.a.** (1.8% on capital)

14. As a result of the discussions with Luton, attached as Appendix I is a draft Investment Property Strategy prepared in consultation with the Investment Portfolio Manager, Luton Borough Council. The draft strategy covers:

- Background
- Objective
- Scope
- Strategy
- Yield
- Sector spread
- Locations
- Target assets
- Assessment of risks

15. Cabinet is recommended to adopt this as the basis for the Council’s Investment Property Strategy.

16. There are a number of ways in which the Council could deliver an investment property strategy whether in-house, via a property vehicle company or through arms length investment in a property fund. Generally speaking, indirect ownership through a property fund would incur annual charges payable to a fund manager of 0.5 -1.0% and rental returns are typically somewhat lower than the range of returns targeted under the proposed strategy.

17. Cabinet are recommended to delegate authority to the Corporate Director – Resources and Commercial to set up the most appropriate method of holding the portfolio.

18. The Council has in place a team which manages the current non-operational property portfolio and would, with the use of managing agents when necessary, be able to manage an increased portfolio. However, they do not have the expertise to actively acquire and sell investment properties.

19. It is not considered economically viable for the Council to employ additional specialist staffing resources to acquire and sell investment properties and a proposal has been received from Luton offering the services of Mr Morgan with appropriate administrative backup. These services can be supplied under Section 1 of the Local Government (Goods and Services) Act 1972. They would be provided as an Inter Authority Agreement under a contractual arrangement based on the Council's standard commercial services contract or consultancy contract. Cabinet are recommended to authorise the Corporate Director – Resources and Commercial to enter into an Inter Authority Agreement with Luton Borough Council for the provision of property investment advisory services. It is envisaged that the agreement will not exceed three years and will be priced on an hourly basis.

20. Luton Borough Council will provide advice and make recommendations as to investment opportunities, and support the acquisition process. However ultimate responsibility for deciding which investment properties meet the Council's criteria and responsibility for the management of both the existing portfolio and new purchases and sales will rest with the Corporate Director of Community following consultation with the two Portfolio Holders and the Director of Finance.

Staffing resources

21. The successful implementation of the proposal necessitates the availability of people with the necessary experience of operating in the property investment market in order to source suitable property assets for acquisition that match the criteria set under the adopted strategy.

22. As discussed in paragraph 18 above, the Council currently has in place a team which manages the current non-operational property portfolio and would, unless geographical location would limit its ability, be able

to manage a larger property portfolio to include the investment portfolio. However, the Council does not have the in house expertise to actively manage an investment portfolio in terms of market presence, acquisition, disposal, portfolio mix etc and it is proposed that, as discussed in paragraphs 19 and 20 above, investment advice will be provided by officers of Luton Borough Council.

Governance and delegations

23. When a property comes to the market to be bought or sold decision-making needs to fit in to the due diligence processes and timetables usually followed by private sector property owners. This will necessitate the delegation of some powers in order to make decisions within a commercial timeframe.

24. A typical timetable for the purchase of commercial property could be a two to three weeks marketing period, followed by a week for submission of offers and confirmation by the seller of the preferred buyer and preparation of Heads of Terms, followed by a 4-6 weeks' period for due diligence investigations by the buyer and the buyer's solicitor prior to exchange of binding unconditional contracts on the purchase. Completion would usually follow within a further four weeks.

25. It is therefore proposed that the following decision making process be agreed:

    - The maximum purchase commitment of the Council will not exceed £20m and no single purchase will exceed £5m
    - Each property being considered for purchase or sale would be reviewed by the Property Investment Manager (Luton Borough Council)
    - Business case, including all costs, recommending purchase or sale to be prepared by Property Investment Manager and presented to the Council.
    - Business case to be reviewed by officer group comprising the Corporate Director Community, Director of Resources, Director of Finance and Director of Legal & Governance Services and, following consultation with the Portfolio Holders for Finance and Major Contracts and Business, Planning and Regeneration , the Council's decision on the recommendation be conveyed to the Property Investment Manager.
    - When recommendation is accepted formal offer confirmed by Property Investment Manager; property placed under offer, solicitors instructed and due diligence carried out.
    - Property Investment Manager advises Harrow of results of due diligence and, if satisfactory, final approval for sale/purchase given by the Corporate Director of Community following consultation with the Portfolio Holders for Finance

and Major Contracts and Business, Planning and Regeneration and the Director of Finance.

- Property Investment Manager advised of decision and, if appropriate, contracts exchange.
- Cabinet will be advised of developments as part of their quarterly update on commercial activity.

Performance Issues

26. The success of the proposed Investment Property Strategy will have a direct impact on the Council's General Fund revenue income and therefore on priorities and outcomes.

27. The financial performance of the investment property portfolio and of each property within the portfolio will be measured and reported on an annual basis initially to an officer group and subsequently to Cabinet. Performance measurement will be based on external revaluations of the properties and net yield generated. Reports presented to Cabinet will include an analysis of performance with a view to making recommendations concerning sales or purchases and amendments to the adopted strategy to ensure that the main objectives continue to be achieved.

28. Suitable benchmarking can be set up so that the performance of the property portfolio may be measured against an appropriate peer group and against nationally reported indices of property investment performance.

29. Quarterly management reports will be provided for officers discussing any changes in the portfolio and movements in the property markets.

Environmental Implications

30. The matters considered in the report have no direct impact on the environment nor on the delivery of the Council's climate change strategy.

Risk Management Implications

31. As a new initiative, investment in and active management of an investment property portfolio represents a new risk for the Council and is not included in any of the Council's risk registers.

32. However,it is an activity where risks are well understood and they are discussed at some length in the attached Appendix I. In summary risks identified are:

- Economic and property market risks;
- Asset-specific risks – location, building quality, length of unexpired lease, financial strength of tenant, rental levels payable.
- Environmental and regulatory risks
- Reputational risks

33. A business case as detailed in Appendix II will be made for each purchase and sale and risks considered within the case.

Legal Implications

34. Local authorities have broadly drawn powers allowing them to invest and to borrow, in each case either for purposes relevant to the performance of any of their functions or generally for the prudent management of their financial affairs (s1 and s12 of the Local Government Act 2003). They may also acquire property by agreement located either inside or outside of their borough for the purposes of any of their functions, including their investment functions, or otherwise for the benefit, improvement or development of their area (s120 of the Local Government Act 1972). Lastly, they may also take any action (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions, which would again include their investment functions (s111 of the Local Government Act 1972).

35. The council will need to ensure that in exercising its investment and borrowing functions to expand its property portfolio, that any actions are reasonable and proportionate and for proper purposes consistent with the Council's prudential regime and its investment strategy. Investment decisions also need to be taken mindful at all times the council's fiduciary duties to ensure the sound management of the public finances.

36. Legal due diligence will be required on all property acquisitions, to include a review of title and ownership, and searches and enquiries of the vendor, in order to ascertain relevant liabilities and restrictions connected with the subject property. The results of the legal enquiries, and any associated risks, should be considered prior to any decision to enter into contract.

37. On any sale of an investment property the Council will be required to obtain best consideration in accordance with s123 of the Local Government Act 1972. Usually this will be achieved by placing the property onto the open market or otherwise, in respect of a sale agreed off market, demonstrating by way of professional valuation that it is achieving no less than market value for the property.

Financial Implications

Budget

38. The draft budget and MTFS is subject to a separate report on this agenda. The draft report includes proposed savings of £350,000 in both 2017/18 and 2018/19 as a result of investing in commercial properties (RES F04). It is proposed to allocate a sum of £20m to be available for the purchase of an Investment Property Portfolio which will be added to the capital budget and will be funded from borrowing. This £20m capital provision, if invested in accordance with the strategy, is estimated to achieve the proposed £350k MTFS income generation saving for 2017/18. To achieve an additional £350k in 2018/19, a further investment of a similar sum of capital will be required. This further investment will not be added to the capital programme unless the initial £20m investment is seen to achieve a sustainable revenue stream, a key purpose of the Investment Property Strategy.

39. The borrowing will be carried out in consultation with the Council's treasury management advisers at the most appropriate time.

40. It is likely that the source of funds will be the Public Works Loans Board where Interest rates for periods of 25-50 years are currently in the range 3.25 – 3.37%. For illustrative purposes a rate of 3.5% is assumed. Any capital expenditure incurred by the Council necessitates a minimum revenue provision of (say) 2%.

41. When the total of £20m has been borrowed and expended the additional annual costs to the revenue budget will be £1.1m (5.5%).

42. The draft Investment Property Strategy states that a gross yield of 7.5% is required from an investment property to ensure an additional income stream for the authority after accounting for capital financing costs. For illustrative purposes it is estimated that revenue costs to cover payments to Luton Borough Council, internal staffing costs, legal, surveyor's and search fees and ongoing charges including building management and maintenance costs, rates and service liabilities will cost at least £0.05m per year. Therefore assuming a yield of 7.5% and a property portfolio of £20m the indicative income stream is detailed below:

	£'000
Capital financing costs (5.5%)	1,100
Revenue charges	50
Yield (7.5%)	(1,500)
Indicative annual income	**(350)**

Tax

43. If the properties are to be held directly by the Council then there should be no Corporation Tax or Capital Gains issues arising. If a separate trading company was to be established taxation issues could impact on financial returns significantly.

44. There will be various VAT implications which are currently being considered with LAVAT, the Council's VAT advisers, to ensure that optimum arrangements are put in place.

45. Stamp Duty Land Tax (SDLT) will be payable on purchases. For commercial properties this is currently calculated at a 4% rate on purchase prices of £500,000 or more and between 0% and 3% for lower value properties. However, reporting of net yields on purchase costs generally takes account of all purchase costs including SDLT.

Equalities implications / Public Sector Equality Duty

46. It is not considered that that there will be any adverse equalities impacts on persons with protected characteristics arising from the actions recommended in this report.

Council Priorities

The Council's vision:

Working Together to Make a Difference for Harrow

The Property Investment Strategy recommended should provide additional income to the General Fund revenue budget to assist in the Council's priorities as follows:

- Making a difference for the vulnerable
- Making a difference for communities
- Making a difference for local businesses
- Making a difference for families.

Section 3 - Statutory Officer Clearance

Name: Dawn Calvert Date: 30 November 2015	✓	Chief Financial Officer
Name: Matthew Adams Date: 30 November 2015	✓	on behalf of the Monitoring Officer

Ward Councillors notified:	**NO, as it impacts on all wards**
EqIA carried out: **EqIA cleared by:**	**NO** Recommendation concerns the purchase and sale of properties with no direct equalities implications.

Section 4 - Contact Details and Background Papers

Contact: Ian Talbot, Treasury and Pension Fund Manager, 0208 424 1450, ian.talbot@harrow.gov.uk

Background Papers: None

Call-In Waived by the Chairman of Overview and Scrutiny Committee	**NOT APPLICABLE** *[Call-in applies where the decision is not reserved to Council]*