

Draft Investment Property Strategy

September 2015

Background

In the context of a decision by the Council, as part of its commercialisation strategy, to make investments in property in order to increase its revenue streams, this appendix sets out an appropriate strategy for acquiring properties and setting up and managing a portfolio. The strategy adopted should reflect a suitable balance between the risks inherent in the types of property to be acquired and the financial rewards obtainable from those investments, limiting such risks appropriately. In addition, the portfolio of properties being acquired should be diversified in order to spread risks via a balanced portfolio, such diversification principally being across geographical location and the use type of properties held.

The risks of investing in property may be mitigated through the acquisition of assets with secure, long income streams. This needs to be balanced against the requirement for a given level of income yield on capital invested in a careful and controlled manner, with specific analysis of risk criteria carried out in the 'due diligence' stage prior to the completion of each purchase.

Objective: to invest in commercial investment properties to provide income from commercial property rents with a minimum income return over the medium-term of 7.5% on capital invested, through a balanced strategy of acquisition, retention and management of good quality property investments. Long-term growth of capital values is also a primary objective.

The objective is specifically to acquire income-producing property in order to enhance Council revenue streams as opposed to making investments in potential development sites and development schemes within the Borough.

Scope: Initially £20m has been identified as available for investment.

Strategy: To be subject to a review of the Council's existing portfolio.

The strategy to be adopted should include restructuring and rebalancing of the existing portfolio to achieve a satisfactory spread of properties through the main use sub-sectors (Retail; Offices; Industrial/Warehouse); enhancing the portfolio income levels through disposal of lower-yielding assets and reinvestment in a properly risk-controlled manner in higher yielding properties without introducing unjustified increased risk into the portfolio.

Achieving a spread of risk across a greater number of assets and by acquiring properties across the range of different property asset classes, namely retail, leisure, office and industrial, is to be a fundamental objective of the proposed investment strategy.

The principle of being relatively risk-averse by limiting fresh investment to properties with minimum unexpired lease terms of five years at the date of acquisition, and with tenants of strong financial standing, will be adopted.

Minimum and maximum yield

Acquisitions of assets will be pursued at a target minimum yield of 7.5% and maximum yield of 10.0%. Assets producing initial yields in excess of 10.0% are likely to exhibit high risk characteristics, such as very short unexpired leases, or financially weak or insubstantial tenants, or obsolete buildings and are therefore to be avoided.

Sector spread

Many good quality property investments across the office and industrial sub-sectors will provide an income return of 7.0% or greater. In the retail sub-sector income returns for prime retail property, in which steady long-term returns can be assured, are lower than comparable office & industrial property. Typically retail income yields range between 5.0% and 7.0% at present for high quality in-town retail properties, whereas office income yields typically range from 5.5% in strong city centres up to 7.5% to 8.5% for reasonable quality offices in regional and sub-regional centres and industrial income yields range from 6.0% up to 7.0/7.5%, again for acceptable stock. Therefore it is likely that predominantly office and industrial/warehouse properties will be targeted for acquisition as the income yields for acceptable retail assets may be below the target minimum income return of 7.5% for fresh acquisitions.

Locations

Harrow would be the preferred location for fresh acquisitions of investment properties, so that reinvestment is retained within the local economy and any additional capital expenditure is made in the local area. However, there is a finite and limited supply of property within the local area, and of that supply only a small proportion may be available for purchase at any time.

A wider area should also be considered for fresh acquisitions and it is proposed that the geographical boundaries should extend to an area which can readily be covered by a single day's travel to ensure that management of properties in the portfolio is possible without extensive travel requirements. This area would include the southern half of the country, the Midlands and northern cities including Manchester, Leeds and Sheffield. Properties within three hours travelling distance would fall within the geographical selection criterion. Therefore the proposed area for potential investment would be the following regions; London; South-East; Eastern; East Midlands; West Midlands; South-West (but excluding Devon & Cornwall); Yorkshire/Humberside; parts of the southern section of the North-West including Manchester and Liverpool.

Target assets

The following assets will be sought;

1. Retail investments with the following characteristics;
 - Lot sizes between £1m and £5m
 - Good locations in town centres or in good out-of-town retail clusters/parks
 - Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Income yield range from 7.0% to 8.0%

2. Office investments with the following characteristics;
 - Lot sizes between £1m and £5m
 - Modern specification, likely to be built since 1990
 - Good locations in commercially strong town/city centres or in good out-of-town business parks
 - Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Multi-let properties to be considered with average unexpired lease terms of 3 years, subject to a spread of expiry dates
 - Income yield range from 7.0% to 9.0%

3. Industrial/Warehouse investments with the following characteristics;
 - Lot sizes between £1m and £5m
 - Modern specification with flexible standard layout, built since 1980
 - Good locations on major road routes and good access to motorways
 - Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Multi-let properties to be considered with average unexpired lease terms of 3 years, subject to a spread of expiry dates
 - Income yield range from 7.0% to 10.0%

4. Leisure investments, such as public houses, restaurants and health & fitness centres with similar characteristics as above will also be sought.

5. Mixed-use investments would also be potentially suitable additions to the portfolio. These may include a mixture of commercial uses or a mixture of retail and office use. Again, similar characteristics as set out above for office investments will apply.

6. Residential investment – tends to be significantly more management intensive than the types of commercial property investment envisaged under this strategy and requires specialist residential management expertise, so is proposed to be excluded from the strategy under the proposals set out in this report.

Assessment of risks

A rigorous assessment of all risks is required in each case of fresh investment in order firstly to value each property and then to check its suitability for inclusion in the portfolio. The risks fall into two categories, firstly economic and property market risks in specific property market sub-sectors and locations and secondly asset-specific risks (as set out below). These can be measured and an assessment made of the likely future performance of the investment carried out based on the ranges of likely future rental growth of the property and also the projected disposal price or capital value at the end of the period over which the cash flow analysis is being measured. Financial returns are modelled over a medium-term horizon of say five years, based on proposed offer prices, to determine the acceptability of each investment, and can be compared against general market forecasts. Internal Rate of Return (IRR) calculations will be carried out to model the expected cash flows from each investment. The anticipated returns can be modelled on different bases to reflect the range of risks applicable in each case, to ensure that forecast returns properly reflect the measured risks. In this way a Business Case is put together to support each recommended property acquisition.

Asset-specific risks

Income and capital returns for property will depend principally on the following five main characteristics;

- Location of property
- Building specification quality
- Length of lease unexpired
- Financial strength of tenant(s)
- Rental levels payable relative to current open market rental values

Location – this is the single most important factor in considering any property investment. In the retail sector prime or good secondary locations in major regional or sub-regional shopping centres are likely to provide good long-term prospects, or alternatively prime locations in sub-regional or market towns.

Good quality locations for office properties in the region will include large towns close to the M25 motorway and regional and sub-regional centres such as Reading, Bristol, Birmingham, Leeds, Manchester, Milton Keynes, Cambridge and Nottingham and other substantial office centres

Industrial and warehouse property has a wider spectrum of acceptable locations with accessibility on good roads to the trunk road and motorway network being the key aspect.

Experienced knowledge will be required to ensure that good locations are selected where property will hold its value in the long term.

Building specification quality – In office property especially it is important to minimise the risk of obsolescence in building elements, notably mechanical and electrical plant. Modern, recently-built office and industrial property should be acquired to ensure longer-term income-production and awareness of the life-cycle of different building elements and costs of replacement is critical in assessing each property's merits. For town centre retail property

trends have been towards larger standard retail units being in strongest demand from retailers.

Length of lease unexpired – At present capital values are highest for long-term leased property and values tend to reduce significantly when unexpired lease terms fall below five years, as owners expect significant capital expenditure to be necessary when leases expire and tenants may not renew leases and continue to occupy. Fresh investments should be made ensuring that diminishing lease terms will not either adversely affect capital value or that significant capital expenditure and voids are experienced. A strategy to dispose of investments before unexpired lease terms reach terms of shorter than three years should be adopted.

Financial strength of tenant(s) – assessment will be required of each tenant of potential acquisitions through analysis of their published accounts and management accounts where necessary. Risk of tenant default in rent payment is the main issue but the relative strength of a tenant's financial standing also impacts upon capital value of property which is let to that tenant and careful analysis of financial strength is a key part of due diligence prior to purchase of investments.

Rental levels – following the banking crash in 2007/8 rental levels fell across most occupier markets, particularly in office and retail markets. As a result rents payable on leases that were granted before 2007 may be at levels which are higher than current rental values. Rents in some sub-sectors have recovered back to pre-2007 levels but care is required in all purchases to assess market rents local to each property to check whether rents payable under leases are above or below current levels, as this will impact on whether growth in rents in the future will be fully reflected in the specific property being analysed.

Environmental and regulatory risks

Risks such as flooding and energy performance are taken into account during the due diligence process on every property purchase.

Reputational risks

A policy on specific types of commercial tenant which may not be acceptable to the Council such as tobacco, gambling or alcohol-related companies could be adopted. Properties tenanted by such companies would not then be considered for purchase. However, this would not necessarily protect the Council in the event of a future transfer of any tenancy to a prohibited company.