LANCASTER
CITY COUNCIL
Promoting City, Coast & Countryside

ERRATUM

Council

Wednesday, 30 January 2019

The Property Investment Strategy (Appendix to Item 14) was accidently omitted from the agenda papers for the meeting. It is now attached.

APPENDIX ONE

Lancaster City Council

Property Investment Strategy

2019 – 2024

1.0 Introduction

1.1 This Property Investment Strategy has been developed for the period 2019 to 2024 to reflect the aspiration in *Funding the Future* and the Medium Term Financial Strategy (MTFS) to seek a return from commercial property investments in order to contribute to the revenue budget and protect service provision.

1.2 This strategy is designed to provide a framework for Lancaster City Council to compete in that market on an equal footing enabling the acquisition of properties for investment at pace whilst ensuring that governance processes are in place, full assessments are made and risks are minimised.

2.0 Background

2.1 The Council recognised, some time ago, that it needed to move towards a more commercial way of operating if it was to move towards its aim of being more financially independent. To that end, the Council agreed its *Funding the Future* strategy as part of the MTFS – a four pillared approach to challenge existing budgets around outcomes, seek efficiencies, consider more commercial approaches to service delivery and invest for a return.

2.2 In order to deliver the Property Investment Strategy as well as other aspirations with respect to capital investment and property management, a Corporate Asset Management Group (CAMG) has been constituted with representation from Regeneration, Property, Finance and Legal.

2.3 The CAMG, or whichever arrangement supersedes it in due course, has the responsibility for overseeing the development of this investment strategy and, subsequently, for monitoring the performance of the investments at an aggregate level (i.e. the overall performance of the portfolio against an agreed benchmark of performance).

2.4 This Strategy is to be agreed by the Council and will set the strict parameters within which property investment activity will take place. These parameters are designed to ensure that investments are ethical, that all risks are assessed and managed and that effective due diligence takes place in establishing the financial business case as well as any link to corporate priorities. Governance and management arrangements are covered in section 5.

3.0 Strategy Objectives

3.1 This Strategy forms part of the *Funding the Future* plan within the Medium Term Financial Strategy which aims to secure the financial sustainability of Lancaster City Council and provide a good level of resources to meet corporate priorities in spite of significant funding reductions. As such, the objectives outlined below focus on building a risk managed, balanced property portfolio to deliver a financial return to the General Fund Revenue Budget.

3.2 The key objectives of the Strategy are to:

- Acquire properties that provide long term investment in accordance with the Councils corporate and financial objectives,
- Maximise return whilst minimising risk through the management processes as outlined in this strategy,
- Prioritise properties that yield optimal rental growth and stable income, Protect capital invested in acquired properties,
- Develop a governance framework that enables the Council to move at a timely pace in line with the market.
- Build a balanced property investment portfolio

4.0 **Investment Principles and the Decision Making Process**

4.1 In order to maximise returns from investment whilst minimising risk, each investment proposal will be subjected to a detailed review which will include:

- Full Gross and Net Yield Calculation including scenario analyses
- Risk Assessment Matrix
- Outcomes Matrix

Yield Calculator

4.2 The yield calculator is included as appendix one to this strategy. It covers total costs of acquisition, income from rental of the property and all expenses associated with holding the property including the cost of borrowing and a provision to repay the borrowing. The appendix details the rigour that will be adopted in completing the financial information and the importance of ensuring not only that the information is complete and accurate but the need to consider scenarios in which income may fall or expenditure increase to ensure that the property holdings can endure downturns in economic conditions.

4.3 The results from the yield calculator will be used to compare returns with other properties in the portfolios and industry benchmarks in order to assess the relative attractiveness of return.

Risk Assessment Matrix

4.4 The risk assessment matrix is included as appendix two to this strategy. It will ensure that every potential acquisition is scored against a number of factors which reflect the relative risks and mitigations of holding each asset. Each of the factors will be weighted and scores will be assigned according to pre-agreed definitions of what constitutes low and high risk. Every proposition would have to achieve a minimum score in order to satisfy the requirement to minimise the risk to the Council of holding the property.

4.5 The majority of factors will be assessed on a five point scale (set out in appendix two) from excellent to poor; these are summarised in paragraphs 4.10 to 4.19. Paragraph 4.6 deals with those proposals in which the Council will not invest on ethical grounds. Additionally, there are two binary assessments; paragraphs 4.7 and 4.8 detail how only proposals based inside the Council's area will be considered and paragraph 4.9 outlines that only proposals that maintain a balance portfolio will be considered.

Exclusions

4.6 There are a number of types of tenants that the Council would not want to support, on ethical grounds, with respect to property investments. The list below, which will be reviewed, outlines those sectors in which the Council will not invest:

- Tobacco production
- Animal exploitation
- Armaments
- Environmentally damaging practices
- Bookmakers
- Human Rights Abuse / Oppressive regimes
- Pornography

Property Location

4.7 A number of local authorities have invested outside of their boundaries as this provides an increases the opportunities for acquiring good yields. However at this early stage, it is recommended that the authority focusses its efforts on properties inside the Lancaster City Council boundaries. Once a balanced portfolio is achieved, members might choose to extend these boundaries to cover wider areas such as LEP boundaries and this is something which will be reviewed when the Strategy is refreshed each year.

4.8 The Government has expressed concerns about commercial property investments outside of an authority's boundaries and this strategy's focus on local properties will not be subject to any risks of potential Government sanctions on out of area investments.

Portfolio Strategy

4.9 There are six recognised types of property investment. These are retail, industrial, commercial, food and beverage, office and other. In order to ensure that the authority is not over exposed to any one sector, a limit of 30% exposure, both in terms of property value and rental income, will be set. No future investments will be considered where they take the portfolio exposure over these limits.

Additional evidence should be provided in each proposal with respect to particular market segments. This should include information on wider sector performance, local and national competition, and for retail product lines/market and exit proposals.

Location - Micro

4.10 This factor is designed to assess the quality of the individual location with regard to the property use. This will change according to the property sector. For example, excellent links for a retail proposal would cover footfall where a central city centre location might be deemed excellent whereas for an industrial location, proximity to transport links might be assessed as more important. As there is a degree of subjectivity to this assessment, the proposal will be scored by the Capital Strategy Group

Tenant Covenant

4.11 This is an assessment of the financial strength of the tenant which will be undertaken using a recognised company search agency. The assessment will be objective as it will use the search agency's independent risk scoring.

Building Quality

4.12 This factor is designed to assess the quality of the building. A building which is new or recently refurbished scoring highly. As there is a degree of subjectivity to this assessment, the proposal will be scored by the Capital Strategy Group. Any refurbishment costs to improve the scoring would have to be factored into the yield calculator.

Lease Term

4.13 This factor is designed to measure the longevity of the income to the council with longer lease terms scoring more highly. The assessment will be based on a Weigthed Average Unexpired Lease Term (WAULT) calculation and as such is objective.

Tenants Repairing Obligations

4.14 This factor is designed to determine the authority’s responsibility and liability for property repairs with a higher score attributable to those properties where all responsibilities are passed to the leaseholder. This is an objective assessment which will be made by the Monitoring Officer or nominated representative.

Rent Review Mechanisms

4.15 This factor is designed to determine the robustness of the rent review process where more regular rent reviews based on open market rental values scoring more highly. As this will be specified in the lease, the assessment will be made by the Monitoring Officer or nominated representative.

Occupational Demand

4.16 This factor is designed to determine demand for the property. It will usually be determined by external advice and will be assessed by the Capital Strategy Group.

Management Intensity

4.17 This factor measures the number of tenants that the Council will deal with for each property with lower number of tenants, and therefore less complexity, scoring more highly. This is an objective criteria and will be assessed by the Monitoring Officer or nominated representative based on the number of leases issued.

Liquidity

4.18 This factor considers the attractiveness of the property to other investors if the Council was to seek to dispose of the property. As it is a partially subjective assessment, the authority will seek independent external advice which will be assessed by the Capital Strategy Group.

Tenure

4.19 This factor considers the tenure of the property with freehold and long leaseholds scoring more highly. The is an objective criteria which will be clear from the property deeds and as such the assessment will be made by the Monitoring Officer or nominated representative.

Outcomes Matrix

4.20 The outcomes matrix is included as appendix three to this strategy. This provides an analysis of any outcomes and impacts that will be delivered by property acquisition. Outcomes should be reconcilable to corporate plan priorities and importantly be measurable both before and after the acquisition so that the benefits accruing can readily be identified.

4.21 Practically, there may be an inverse relationship between the finance and outcomes tests. The Council may choose to accept a lower yield where an investment is capable of delivering favourable outcomes in respect of its priorities.

5.0 Processes and Governance

5.1 Commercial investment proposals will usually be developed by the Regeneration Team who will be required to complete the assessment appendices for yield, risk and outcomes. All assessments will be considered by the Capital Strategy Group which comprises the Assistant Chief Executive, Monitoring Officer, Section 151 Officer (and/or nominated representatives) as well as representatives from the Property and Regeneration teams. The meetings will be open to the Portfolio Holders for Regeneration and Finance and the Chair of Overview and Scrutiny.

5.2 Governance processes are set out in appendix four (appendix to be added following consideration by Cabinet on 15 January 2019).

5.3 All formal decisions made will be formally recorded and supporting information held for subsequent scrutiny.

5.4 A separate monitoring of the effectiveness of the Property Investment Strategy will be incorporated into the quarterly financial and performance monitoring processes.

Appendices

Appendix One – Financial Yield Calculator

Appendix Two – Risk Matrix

Appendix Three – Outcomes Matrix

Appendix Four – Governance arrangements (to follow once considered by Cabinet on 15 January 2019)

Appendix 2 - Yield

Property: Illustration Only

PURCHASE COSTS		
Property Purchase Price		3,000,000
Stamp Duty		0
Valuation Fees		3,000
Survey Fees		10,000
Legal Fees		3,000
Refurbishmet Fees		
Other Purchase Costs		
Total Purchase Cost		3,016,000

PROPERTY INCOME		
Annual Rent		225,000
Service Charge		0
Total Annual Income		225,000

PROPERTY EXPENSES		
MRP	2%	60,320
Interest Charge	2.99%	90,178
Landlord Costs	-	
Repairs and Maintenance		
Ground Rent		0
Insurances		0
Utilities payable by Landlord		0
Other Landlord Costs		5,000
Void Allowance	5%	11,250
		166,748

GROSS YIELD	**7.46%**
NET YIELD	**1.94%**
NET CASH	**£58,252**

Appendix 3 - Risk Management Tests

<table>
<tr><td rowspan="3">Portfolio Strategy Context</td><td colspan="2">Does the acquisition take the exposure of the whole portfolio to over 30% in either of the six sectors:
- retail - office - food and beverage
- industrial - hotel - other</td></tr>
<tr><td>YES</td><td>NO</td></tr>
<tr><td>Proposal to be scored using risk matrix below.</td><td>Over exposure to one of the six sectors. Proposal cannot proceed without a review of existing portfolio to ensure that Council is not over exposed to any one sector.</td></tr>
<tr><td>How will this be assessed?</td><td colspan="2">Proposal document will be required to provide specific detail on location and assess advantages and disadvantages with respect to property sector (retail/industrial/food and beverage/office/hotel/other). This is a partially subjective assessment and will be challenged by the Capital Strategy group. Particular reference will be given for proposals on wider sector performance, local and national competition, and, for retail, product lines and the relative current and anticipated future strength of that retail sector.</td></tr>
<tr><td>Who will assess?</td><td colspan="2">Capital Strategy Group</td></tr>
</table>

	Excellent	Good	Acceptable	Marginal	Poor
Location - Micro	5	4	3	2	1
	Excellent links	Good links	Reasonable links	Poor links, but prospects of improvement	Location with limited benefit
How will this be assessed?	Proposal document will be required to provide specific detail on location and assess advantages and disadvantages with respect to property sector (retail/industrial/food and beverage/office/hotel/other). This is a partially subjective assessment and will be challenged by the Capital Strategy group.				
Who will assess?	Capital Strategy Group				

	Excellent	Good	Acceptable	Marginal	Poor
Tenant Covenant	5	4	3	2	1
	Excellent financial covenent	Strong financial covenant	Good financial covenant	Poor but improving financial covenant	Poor financial covenant

How will this be assessed?	The financial covenant of the tenant (s) will be assessed using an external search company which will provide us with a company report on the financial health of the company. The scoring will be based on the search company's assessment of financial health and is therefore objective.
Who will assess?	Section 151 Officer or nominated representative based on externally produced score

	Excellent	Good	Acceptable	Marginal	Poor
Building Quality - State of Repair	5	4	3	2	1
	New, modern or recently refurbished	Good quality, no spend required for 20+ years	Good quality but spend required in 10-20 years	Spend required in 5-10 years	Tired, Spend required in next 5 years
How will this be assessed?	The quality of the building assessment is partly subjective and so will be challenged by the Capital Strategy Group. The submission should detail any improvement/refurbishment works that will improve the score and the cost of any such works, and the cost of any ongoing maintenance requirements, will be incorporated into the yield calculator.				
Who will assess?	Capital Strategy Group				

	Excellent	Good	Acceptable	Marginal	Poor
Building Quality - EPC Rating	5	4	3	2	1
	A/B	C	D	E	F/G
How will this be assessed?	The EPC is an extrenally calculated and accredited rating and as such is objcetive. The Capital Strategy Group will seek confirmation of the rating.				
Who will assess?	Capital Strategy Group				

	Excellent	Good	Acceptable	Marginal	Poor
Lease Term	5	4	3	2	1
	Greater than 15 years	Between 10 and 15 years	Between 6 and 10 years	Between 2 and 6 years	Under 2 years
How will this be assessed?	The assessment will be based upon a Weighted Average Unexpired Lease Term calculation which provides an objective assessment of the number of guaranteed years of rental income until the end (or break clause) within the lease.				
Who will assess?	Section 151 Officer or nominated representative based on accepted calculation				

Tenants Repairing Obligations	Excellent	Good	Acceptable	Marginal	Poor
	5	4	3	2	1
	Full repairing and insuring	Full repairing and insuring - partially recoverable	Internal repairing	Internal repairing - partial recovery	Landlord responsible
How will this be assessed?	The lease terms will allow this to be an objective assessment to be made by the Council's legal representative.				
Who will assess?	Monitoring Officer or nominated representative based upon final lease				

Rent Review Mechanisms	Excellent	Good	Acceptable	Marginal	Poor
	5	4	3	2	1
	Open Market Rental Value every 5 years		Consumer Price Index/Retail Price Index		No proper review mechanism
How will this be assessed?	The lease terms will allow this to be an objective assessment to be made by the Council's legal representative.				
Who will assess?	Capital Strategy Group based upon advice from the Monitoring officer.				

Occupational Demand	Excellent	Good	Acceptable	Marginal	Poor
	5	4	3	2	1
	Demand from many tenants	Demand from a few tenants, but low number of competing buildings	Reasonable prospect of securing new tenants	Poor demand	Landlord responsible
How will this be assessed?	The occupation demand is partially subjective but the proposal should seek to include external advice with respect to the level of demand. The Capital Strategy Group would seek to rely on any such external advice in coming to its assessment of the proposal.				
Who will assess?	Capital Strategy Group based upon any independent expert advice offered.				

Management Intensity	Excellent	Good	Acceptable	Marginal	Poor
	5	4	3	2	1

	1-2 tenants	3 -5 Tenants	5 - 9 tenants	10 - 15 tenants	16 plus tenants
How will this be assessed?	This is an objective assessment based upon the number of leases included within the proposal. As such the assessment will be made by the Council's legal representative.				
Who will assess?	Monitoring Officer or nominated representative based upon number of leases issued				

	Excellent	Good	Acceptable	Marginal	Poor
Liquidity	5	4	3	2	1
	Lot size and sector attractive to investors	Lot size not attractive to investors but sector is	Lots size attractive to investors but sector is not	Generally unattractive	Attractive to niche investors only
How will this be assessed?	This is a more subjective criteria and a such the assessment should, where possible, seek external independent advice with respect to lot size and attractiveness				
Who will assess?	Capital Strategy Group based upon any independent expert advice offered.				

	Excellent	Good	Acceptable	Marginal	Poor
Tenure	5	4	3	2	1
	Freehold	Long leasehold 125+ years / peppercorn ground rent	Lease between 100 and 125 years / peppercorn ground rent	Lease between 50 and 100 years	Lease less than 50 years and/or high ground rent
How will this be assessed?	This is an objective criteria that will be clear from lease paperwork.				
Who will assess?	Monitoring Officer or nominated representative based upon information held within lease agreement.				

Appendix 4: Outcomes

Example: Conversion of previously empty shop unit to 3 retail units (Illustration only)

Outcomes and Impact Matrix

Council Priority: A Thriving and Prosperous Economy

Success Factor:

Outcomes:

The likely achieved short-term and medium-term effects from the commercial investment

Measures: before

Measures: after

Impact

The likely longer term effects produced, directly or indirectly, from the commercial investment

Measures: before and after

Social Value Outcomes

This matrix should capture all of the non financial benefits accruing from the potential property investment. Reference should be made to the Council's 'Ambitions' Corporate Plan and any other strategic plan arising from the Ambitions plan (eg. Economic Growth strategy). This matrix should provide a good level of clarity on additional benefits that may accrue such as business rates, impact on a high street frontage, detail on any social impact such as employment and how this would be measured.