CABINET

Investment Strategy Principles
18 December 2018

Report of Interim Head of Financial Services

PURPOSE OF REPORT					
To update the Cabinet in relation to the principles which will underpin the Property Investment Strategy.					
Key Decision	**X**	**Non-Key Decision**		**Referral from Cabinet Member**	
Date of notice of forthcoming key decision	**3rd December 2018**				
This report is public					

RECOMMENDATIONS OF Interim Head of Financial Services

(1) Cabinet approve the key principles to be adopted in a Property Investment Strategy set out in this report and adopt option 1 in section 3 which is to further develop the Strategy for consideration at the Cabinet on 15 January 2019.

1.0 Introduction

1.1 The Cabinet meeting on 4 December 2018 approved the principles of the overarching financial resilience strategy, *Funding the Future* and their incorporation into the Medium Term Financial Strategy.

1.2 One of the key pillars of the financial resilience strategy is ‘investing for a return or to reduce costs’ which looks to careful risk managed investment in commercial property in order to make a net yield which contributes to the net revenue budget. This reports sets out the principles that will be included in the Council’s Property Investment Strategy.

1.3 It is recognised that Local Authority Commercial Property Investment is a contentious and newsworthy issue at the present time. By setting out the key principles to be adopted in a Property Investment Strategy, this report will provide an opportunity for Councillors to consider the robustness of the recommended approach ahead of the final strategy consideration at 15 January 2019 Cabinet.

1.4 If the Investment Strategy is agreed by Cabinet on the 15 January 2019 it is anticipated this could be considered by full council on the 30 January 2019. This would allow the outcome of full council to be properly considered in time for Budget Council on the 27 February 2019.

2.0 Property Investment Strategy development

2.1 In developing the Strategy, consideration has been given to best practice from other authorities which have developed property investments strategies as well as advice from the Chartered Institute of Public Finance and Accountancy.

2.2 It is proposed that all potential investment proposals will be subjected to three separate tests which are summarised below:

- ***The finance test*** – consideration of the net return from property investment taking account of all purchase costs, rental income and property expenses and undertaking a full sensitivity analysis of all figures.

- ***The outcomes test*** – consideration of Council Plan outcomes which might be achieved from each property investment proposal.

- ***The risk management test*** – thorough consideration of all the risks associated with commercial property management to ensure that such risks are minimised and managed.

The finance test

2.3 Appendix one provides an illustration of the finance test. This provides a full analysis of all purchase costs, rental income and expenses associated with management of the property. Any proposal would be required to provide a full verifiable assessment of all finances. Verified finance figures will be subject to a sensitivity analysis to ensure that yield calculations are tested against scenarios which include cost increases and worsening income projections.

2.4 In terms of expenditure, each proposal would have to provide both for the interest on borrowing associated with the property purchase and for the repayment of the borrowing (known as the minimum revenue provision (MRP)). Other costs might include maintenance and other landlord costs as well as an allowance for the property becoming void.

2.5 The results from the finance test will include calculations for gross yield, net yield and net income. The yield calculations are capable of being benchmarked against other investment properties held by the Council and against sector benchmarks which are available from property market experts.

The outcomes test

2.6 Appendix two provides an illustration of the outcomes test. 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.

2.7 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.

2.8 The Strategy will set out those sectors where the Council is not prepared to invest in any circumstances which will include those sectors deemed to be unethical or detrimental to the Council's values.

The risk management test

2.8 Appendix three provides a schedule of all the risk management considerations each which will have to independently assessed as part of the risk management test. These are summarised as follows:

- ***Portfolio strategy context*** – any new proposal shouldn't be capable of taking the authority's sector exposure to a level greater than 30% based on total portfolio value. There are six sectors; retail, industrial, office, food and beverage, hotel and other.

- ***Location micro*** – assessment of the quality of location in the context of the property sector. For example, a low risk score would be attributed to a retail property in the city centre or to an industrial property close to major transport links.

- ***Tenant Covenant*** – the financial strength of the organisation leasing the property to be calculated by an external financial search company.

- ***Building Quality*** – the condition of the property acquired with a low risk score being attributed to a new building with no refurbishment costs.

- ***Lease Terms*** – the number of guaranteed years rental income conveyed by the lease until break or termination with a low risk score being attributed to a greater number of years of guaranteed income.

- ***Tenants' Repairing Obligations*** – the responsibility for repairs to the property within the lease with a low risk score being attributed to agreements which charge responsibility for repairs to the leaseholder.

- ***Rent Review Mechanisms*** – the provisions within the lease for rent increases with a low risk score being attributed to a lease which provides for rents to be reviewed in line with market rental value for the prescribed use.

- ***Occupational Demand –*** the assessed demand for the property where a low risk would be attributed to properties which are independently assessed as having significant market demand.

- ***Management Intensity –*** the number of tenants with a low risk score being attributed to a small number of tenants.

- ***Liquidity –*** measure of the ease with which the property could be disposed from the portfolio with low risk score being attributed to properties that are independently assessed as being attractive to investors.

- ***Tenure –*** measure of the property's value to the authority with a low risk being attributed to freehold properties or very long leaseholds with peppercorn rent.

2.9 Each of the above risk management considerations will be scored on a one to five scale with one being high risk and five being low risk. The appendix shows how the scored will be assessed and by who. In some cases, the assessment criteria are objective in nature and will be verified either by the Section 151 officer or Monitoring Officer (or nominated representative). Where assessment criteria are more subjective, independent expert advice would usually be sought and a panel (Capital

Strategy Group) consisting of the Assistant Chief Executive, Section 151 Officer, Monitoring Officer and Portfolio Holder for Finance will verify the score.

2.10 Each of the risk factors will be scored and an aggregate (and weighted) score will be calculated. A minimum score would have to be achieved and if the risk is assessed as above average in three or more risk categories, the proposal will be dismissed.

2.11 Where risk scores are unacceptably low then it might be possible to take mitigating action to reduce the risk and the template in appendix three provides for actions to be recorded to improve the risk scoring.

The Governance process

2.12 Each of the tests would be completed for each proposal which would be submitted to the Capital Strategy Group for assessment, verification and scoring. This Group would include the Assistant Chief Executive, Section 151 Officer and Monitoring Officer as well as the Portfolio Holder for Finance.

2.13 The governance process is currently under review. The nature of property acquisition is such that sometimes the authority may have to make speedy decisions and this has to be balanced alongside ensuring that decision making processes are appropriately robust and subject to scrutiny.

2.14 Existing democratic processes associated with financial thresholds, policy and budgetary frameworks and scrutiny call-in are considered to be too lengthy to facilitate effective property investment decisions. The Monitoring Officer has devised a survey for Members considering options for making the decision making processes more timely. Responses from this consultation and further meetings with Councillors will assist in the development of a governance process which achieves a satisfactory balance between speed, risk management, robust evidence led decision making and effective scrutiny.

2.15 Suggested Governance proposals will be provided to Cabinet on the 15 January 2019, to give Cabinet the opportunity to consider the whole strategy and to make the appropriate recommendations to council.

3.0 Options and Options Analysis [including risk assessment]

	Option 1: Develop the Investment Strategy principles into a Property Investment Strategy	**Option 2:** Discontinue work on the Property Investment Strategy
Advantages	The prospect of long term financial resilience to help maintain the provision of good quality council services	None
Disadvantages	New ways of working and adapting reasonably quickly to new approaches.	A series of hard and unpalatable decisions will need to be taken on cuts and service reductions.
Risks	Commercial property investment brings some risks and these are	Potential financial instability delivery of services being reduced

	covered in some detail in this report.	

4.0 Officer Preferred Option (and comments)

4.1 Option 1 Is the preferred option as the development of a robust Property Investment Strategy is the next logical step following the agreement by Cabinet to the principles of the *Funding the Future* Financial Resilience Strategy

RELATIONSHIP TO POLICY FRAMEWORK The policy framework is being developed.
CONCLUSION OF IMPACT ASSESSMENT (including Health & Safety, Equality & Diversity, Human Rights, Community Safety, Human Resources, Sustainability and Rural Proofing) None
LEGAL IMPLICATIONS The Council has the legal power to acquire, use and dispose of land principally under the Local Government Act 1972 and other Acts which give the Council powers to acquire land for a particular purpose. In accordance with section 120(1), Local Government Act 1972, the Council has the power to acquire any land where it is for the purposes of (a) any of its statutory functions or (b) for the benefit, improvement or development of its area. If the Council decides to dispose of land, there is a legal requirement to obtain best value (with very limited exceptions) Depending on the nature of the particular type of property concerned, there may be other statutory requirements or procedures to be undertaken before any acquisition, appropriation or disposal of land.
FINANCIAL IMPLICATIONS The financial implications are covered in this report and appendix. Principally, the development of a Property Investment Strategy will provide a process through which the Council can seek to achieve a positive financial return from property investment to contribute towards the revenue budget in order to protect service delivery and pursue Council priorities.
OTHER RESOURCE IMPLICATIONS, such as Human Resources, Information Services, Property, Open Spaces: None
SECTION 151 OFFICER'S COMMENTS

This is a report from the Section 151 Officer and an important building block of the Medium Term Finance Strategy.

MONITORING OFFICER'S COMMENTS

The Monitoring Officer has been consulted in the drafting of this report and has no further comments.

BACKGROUND PAPERS Matrix and plans	**Contact Officer:** Dan Bates **Telephone:** 01524 582138 **E-mail:** dbates@lancaster.gov.uk