Appendix B

Property Investment – Supporting Information

1. Introduction/Background

1.1 As a result of the financial head winds facing local government, West Berkshire Council, resolved to create a UK wide Commercial Property Investment Portfolio in order to generate a new revenue income stream through direct commercial property investment.

1.2 The Councils Corporate Programme Board adopted a Property Investment Strategy prepared by property consultants JLL (dated March 2017) on 9 May 2017.

1.3 The Council works as an 'Informed Client' with enhanced capability provided by Property Consultants Montagu Evans (appointed for both Capital Markets and Property Management during August 2017).

1.4 Intrinsic within the adopted strategy is a mechanism for a regular review of the Strategy, on a day-to-day basis utilised by the Councils Property Investment Board (PIB), to ensure its compatibility with market conditions and the Councils Investment Objectives.

1.5 Mindful of the above, the Strategy has been 'pressure tested' to ensure its suitability. A number of minor amendments are now recommended so as to ensure the portfolios exposure to a wider range of suitable properties, whilst maintaining a defensive, balanced commercial property investment portfolio, from which to derive a long term, sustainable revenue stream.

1.6 A revised Property Investment Strategy (West Berkshire Council – Property Investment Strategy (revised), January 2018) has been prepared to build upon the adopted JLL document should the Council resolve to adopt the recommend amendments within this document.

1.7 This report outlines the minor amendments to the Strategy, which it is recommended the Council adopt.

1.8 Included within the recommendations is increasing the lot size of individual acquisitions from £10M to £15M. It is recommended to increase the current approved threshold for Delegated Authority of the Head of Legal Services to £15M to align with this.

2. Supporting Information

2.1 The Councils Investment Strategy consists of 'Core Objectives', 'Investment Policy' and 'Investment Guidelines'. Whilst the existing 'Core Objectives' and 'Investment Policy' remain robust and fit-for-purpose, it is now apparent that the rigidity of 'Investment Guidelines' is limiting access to suitable defensive opportunities and retarding the deployment of the Councils funds.

2.2 In reality, the £50m committed by the Council over an 18 month timeframe equates to portfolio of circa. 8-12 properties (dependant on lot size). This is a particularly pertinent consideration when reviewing 'Sector' and 'Geographical' allocations.

2.3 Competition for Strategy compliant properties, generally derives from Private Wealth/Equity, Pension Funds/Institution and from other Local Authorities. New entrants to the market currently benefit from cheap money adding to the competition.

2.4 Further, uncertainty caused by Brexit and the macroeconomic climate has led many investors to rebalance their portfolios seeking longer term income. Those funds are increasingly willing to accept lower yields to acquire suitable assets which has led to yield compression and subsequently higher prices.

2.5 The table below illustrates the strength of the market and competition since May 2017:

Property	Quoting Price / Yield	Achieved Price / Yield
Stoke Park, Eastleigh	£8.55m (6.50% NIY)	£10.2m (5.45% NIY)
Clarion House, Maidenhead	£9.86m (6.50% NIY)	Under offer at sub-6.3%
McDonalds, Watford	£3.1m (6.00% NIY)	£4.09m (4.50% NIY)
Hobbycraft, Basingstoke	£4.81m (6.00% NIY)	£5.5m (5.25% NIY)
Cheshire Oaks Leisure Park (Due diligence undertaken but was not taken to PIB)	£5.95m (5.25% NIY)	£6.58m (4.75 % NIY)

2.6 The Net Initial Yield (NIY) referred to in the table above is the initial net income (rent) at the date of purchase, expressed as a percentage of the gross purchase price including the purchase costs (legal and surveyor fees, VAT and stamp duty).

The NIY is not to be confused with the portfolio yield (Net Yield) referred to in the Strategy which is the running yield of the annual net income (essentially gross rent excluding costs such as management fees, cost of finance etc.) of the total portfolio investment divided by its current market value.

2.7 Competition is driving increasingly competitive pricing, limiting the potential for value-for-money, and reducing the availability of stock which is in turn making it challenging to deploy funds in a timely manner to meet the Councils target.

2.8 Since May 2017, Montagu Evans (ME) have undertaken detailed analysis of over 80 investment opportunities on behalf of the Council. The Council has completed on one property acquisition (retail sector - Eastbourne); exchanged contracts on a second (retail sector - Cleveland Gate); and, has successfully bid on a property during December 2017 (alternative sector – Dudley Port, Tipton) and a further property during January 2018 (retail sector – Lincoln High Street). ME are now engaged with managing the properties within the portfolio.

2.9 In short, the market is crowded and competition robust. The Strategy employed by the Council needs to be appropriate flexibility whilst maintaining good investment discipline.

2.10 The overall portfolio objective is to generate net proceeds, which is the cash returned to the Council as an investor after all of the costs associated with property investment and management are deducted. The existing Strategy targets a net yield of 6% once fully invested (net of purchase costs).

2.11 Based on an assumed prudential borrowing rate of 2.53%, the investment model illustrates that a £50m gross portfolio (£46.6m net) will return circa. £1m net per annum once fully invested (excluding internal WBC costs).

2.12 The recommended amendments to the Investment Guidelines help ensure the attainability of the portfolio's target 6% net yield whilst providing the PIB with enhanced agility to deploy the funds resources and realise a sustainable income stream sooner.

2.13 It is recommend that the minor amendments to the Investment Guidelines are incorporated into the adopted Strategy, as set out in the 'West Berkshire Council – Property Investment Strategy (revised), January 2018', so as to ensure the portfolios long term success.

3. Options for Consideration

3.1 Option 1: To maintain the status quo. Whilst the existing strategy is robust, its rigidity combined with the financial resource committed, is delaying the deployment of funds, limiting exposure to investment opportunities and subsequently, impeding the inflow of revenue.

3.2 Option 2: Adopt the minor amendments to the Investment Guidelines recommended within this paper and supporting documents, so as to provide greater flexibility and ensure exposure to a wider range of suitable properties. The Council will continue to own a defensive, balanced commercial property investment portfolio, from which to derive a long term, sustainable revenue stream.

4. Proposals

4.1 Asset Categorisation - It is recommended that an appropriate alternative categorisation which suitably reflects the council's objectives be introduced, this being 'Prime' and 'Good Secondary' as set out below:

Prime	Net yield of 6% or lower, established location, very strong tenant covenant, unexpired lease term of 9 years or more
Good Secondary	Net yield of higher than 6%, good location, strong tenant covenant, unexpired lease term commensurate with prevailing market conditions

4.2 This would broaden the flexibility of the strategy and consequently access to stock.

4.3 Geographical Weighting – Allowing greater flexibility to invest more heavily in stronger, more robust areas will provide tangible benefit for the portfolio. In particular this is the case for London and the South East where a defensive portfolio would naturally carry greater weight. A narrower split of regions and some flexibility on the maximum allocation as set out below:

Region	**Max weighting**
South East	Up to 60% (£30m)
South West & Midlands	Up to 35% (£17.5m)
North	Up to 35% (£17.5)
Scotland & Wales	Up to 35% (£17.5m)

4.4 Sector Weighting – the current investment strategy categorises six sectors. To comply with this allocation in a relatively small fund is challenging. Simplifying the sectors provides flexibility whilst maintaining the principles of balance and diversification, such as suggested below:

Sector	**Max weighting**	**Examples**
Industrial / Warehouse	Up to 40% (£20m)	Logistics hubs, light industrial, trade parks
Retail	Up to 40% (£20m)	Small supermarkets, restaurants, retail warehouses
Offices, Alternatives and Other	Up to 35% (17.5m)	Offices, business parks, hotels, cinemas, petrol stations, wind farms

4.5 Lot Size – the current strategy puts a cap on any single lot of 20% of the portfolio value (£10m). This limits the potential to expose the fund to a number of interesting and suitable assets which occupy a space in the market that is less competitive but which carries strong investment stock. £10m represents the investment ceiling for many private wealth and local authority investment funds; £15m generally being the smallest lot size considered by the larger funds.

4.6 In order to allow the fund to access this less competitive area of the market, it is recommended extending the upper limit on a single lot size to £15m.

4.7 It is recommended that the current minimum lot size of £3m is removed in order to allow access to slightly smaller lots. It is not envisaged that the portfolio will include many assets below £3m.

4.8 Income Risk – income risk is currently managed through a 10% cap of total income to be accounted for in any one tenant, once fully invested. Assuming a portfolio net yield of 6.00% and a portfolio value of £50m, this cap is equivalent to £300,000 per annum, per tenant.

4.9 It is recommended that the cap is increased to £750,000 per annum, per tenant. This is a significant increase on the current guidance, but would give the fund the flexibility, in an exceptional situation, to acquire a £15m lot at a 5% yield (this would equate to a rent of £750,000 per annum, before costs). It is recognised that this reduces the capacity for the fund to diversify, but provides the potential to acquire a stable, long income asset around which to structure a portfolio of complementary assets.

4.10 To mitigate the risk, such investments would be subject to the tenant having a Dunn & Bradstreet rating of 5A1 and with a minimum unexpired term of 9-10 years.

4.11 The table below sets out a summary of current Guidelines and recommended amendments:

CURRENT GUIDELINES		**RECOMENDED AMMENDMENT**	
Asset Categorisation (capital allocation and weighting):			
Core **Core +** **Opportunistic**	Current adopted structure: Core @ 50%, 5%+ yield; Core+ @ 33%, 6%+ yield; Opportunistic @ 17%, 8%+. Adopted structure is commonly adopted by many large funds. However, Opportunist exposes the fund to significant income risk which is not aligned to the Councils defensive strategy or size of fund. The structure restricts acquisition flexibility and limits investment opportunities. Capital is spread too thinly for size of the fund.	**Prime** **Good Secondary**	Simplified structure allows pragmatic acquisition and flexibility, appropriate to the size of resource committed by the Council. Remains aligned with the Councils defensive fund strategy. Prime - 60%, net yield of 6% or lower, established location, very strong tenant covenant, unexpired lease term of 9 years or more. Good Secondary - 40%, net yield of higher than 6%, good location, strong tenant covenant, unexpired lease term commensurate with prevailing market conditions. Removes the funds exposure to Opportunistic income risk.

Geographical weighting:			
Town/City **Region**	Town or City – maximum of 25% (£12.5m) in any one town/city. Region – maximum of 35% (£17.5m) in any one region. Current policy is commonly adopted by larger funds however restrict exposure to good opportunities in the SE/ London which should form a platform for a defensive portfolio.	**South East** **South** **West/Midlands** **North** **Scotland/Wales**	South East maximum exposure of 60% (<£30) South West & Midlands maximum exposure of 35% (<£17.5m) North maximum exposure of 35% (<£17.5m) Scotland & Wales maximum exposure of 35% (<£17.5m) Risk remains balanced however, increased exposure to strong investment opportunities in the SE and London markets.
Sector Weighting:			
Industrial / warehouse **Alternatives** **Retail – warehouse / supermarket** **Offices** **Retail – high street** **Other**	Industrial/warehouse – 25% (£12.5m) Alternatives – 20% (£10m) Retail (warehouse/supermarket) – 20% (£12.5m) Offices – 20% Retail (high street) – 10% (£5m) Other – 5% (£2.5m) The current structure is appropriate for larger funds. Current structure spreads the funds resources thinly whilst not necessarily reducing risk.	**Industrial / warehouse** **Retail** **Offices & Other**	Industrial/Warehouse maximum of 40% (£20m). Retail maximum of 40% (£20m) Offices & Other maximum of 35% (£20m) Appropriate for size of the resource committed by the Council – simplified structure provides flexibility whilst balancing risk.

Lot Size:			
Max £10m	Current lot ceiling puts the acquisition strategy in direct competition with local private equity buyers, local buyers and other LA's.	**Max £15m**	Opens up investment opportunities.
Income Risk:			
Max £300k / tenant / annum	Cap @ maximum of 10% (£300k / tenant per annum). Current cap restricts investment opportunities.	**Max £600k / tenant / annum**	Cap @ maximum of 20% (£600k / tenant per annum). Increased access to strong investment opportunities. To off-set increased income risk, tenants will require a minimum of 5A1 D&B covenant strength and 10 years to lease expiry.

4.12 Conclusion – the Property Investment Strategy in its current form represents a very solid base from which to build. The Councils experience in the market since May 2017 emerging market trends and the stock availability, have provided the basis for amending the Investment Guidelines in the strategy in order to provide flexibility in terms of lot size, weighting and income spread. Doing so will expose the fund to a broader range of potential investments which will better enable it to deploy its funds efficiently and defensively to deliver the fund's overall target return of 6%.

5. Consultation and Engagement

5.1 Montagu Evans

5.2 Property Investment Board

Background Papers:

1. Jones Lang LaSalle (JLL) Strategy document and guidance document;
2. Montagu Evans, strategy revision document.

Subject to Call-In:

Yes: ☐ No: ☒

The item is due to be referred to Council for final approval ☒

Delays in implementation could have serious financial implications for the Council ☒

Delays in implementation could compromise the Council's position ☐

Considered or reviewed by Overview and Scrutiny Management Commission or associated Task Groups within preceding six months ☐

Item is Urgent Key Decision ☐
Report is to note only ☐

Wards affected:

None

Strategic Aims and Priorities Supported:

The proposals will help achieve the following Council Strategy aims:

☒ **SLE – A stronger local economy**
☒ **MEC – Become an even more effective Council**

The proposals contained in this report will help to achieve the following Council Strategy priority:

☒ **MEC1 – Become an even more effective Council**

The proposals contained in this report will help to achieve the above Council Strategy aims and priority by generating additional revenue income streams.

Officer details:

Name: Richard Turner
Job Title: Property Services Manager
Tel No: 01635 503653
E-mail Address: Richard.Turner@westberks.gov.uk