

**Pendle Borough Council**

**Property Investment Strategy**

**2019-2022**

**DRAFT**

## **Introduction**

1. This Property Investment Strategy ('The Strategy') has been developed to provide a framework for Pendle Borough Council to acquire investment properties as part of a strategy to generate net additional income to support its General Fund Revenue Budget. In the context of the financial challenge faced by the Council, this in turn is intended to provide the financial capacity to maintain service delivery so that the Council can deliver its strategic objectives.
2. The Strategy sets out the criteria that will be considered when investment opportunities are identified so that each opportunity is properly evaluated and that there is an appropriate consideration of the risks associated with investment. It also sets out the governance arrangements that will be established to consider opportunities acknowledging that this kind of activity must operate at pace given the nature of the property investment market.

## **Background**

3. Historically, the Council has invested in property but primarily for the purposes of economic development. For example, the Council still retains ownership of a range of commercial properties including shops and various industrial estates.
4. Like most local authorities, Pendle Borough Council has been the subject of significant funding reductions. In light of the funding challenges faced by the Council, there is a recognition that, as part of a strategy to maintain service delivery, there is a need to graduate towards a more commercial way of operating if it is to become more financially independent. Indeed, in December 2018, the Policy and Resources gave approval to a Commercial Strategy which, amongst other matters, advocated investing in property for a commercial return.
5. To that end, rather than investing in properties just for the purposes of economic development, this Strategy proposes acquiring properties for the purpose of generating net additional income as part of a strategy of supporting the Council's General Fund Revenue Budget and sets out both the governance and investment frameworks in which this will be done.

## **Key Objectives of the Property Investment Strategy**

6. The fundamental objective of this Strategy is to acquire properties that provide a long term investment return to support the delivery of the Council's strategic and financial objectives whilst protected the Council's capital investment.
7. The financial objective of the Strategy is to acquire commercial investment properties that provide the Council with:-
  - a net income streams with a minimum Internal Rate of Return (IRR) of **[5.00%]** for non-regeneration opportunities;

- a net income stream with an Internal Rate of Return of at least [2.00%] for regeneration opportunities.
8. In support of these objectives, the purpose of this Strategy is to:-
- set out a governance framework (incorporate appropriating risk management measures) that enables the Council to move in a timely manner in line with the property investment market;
  - provide an investment framework that will:-
    - optimise the return whilst minimising risk through the management processes as outlined in this strategy;
    - prioritise properties that yield optimal rental growth and stable income;
    - protect the capital invested in acquired properties and, where possible, seek growth in that capital investment;
    - build a balanced property investment portfolio to mitigate against sectoral risks.
9. These objectives will be subject to annual review as part of the Council's annual refresh of its Capital Strategy and in conjunction with the Annual Treasury Management Strategy.

## **Governance Framework**

### ***Property Investment Panel***

10. It is acknowledged that property investment must be undertaken within a sound decision making process that identifies and, where possible, mitigates risk.
11. A Property Investment Panel will be established which will consider property investment opportunities. The role of the Panel will be to evaluate opportunities against the investment framework set out within this Property Investment Strategy. **Subject to the outcome of each evaluation, the Panel will make acquisition recommendations to the Policy and Resources Committee.**
12. The Property Investment Panel will comprise:-
- Housing, Health and Engineering Manager (as the Council's Corporate Property Officer);
  - The Chief Financial Officer;
  - The Head of Legal Services;
  - Estates and Property Manager (as provided by Liberata);
  - Specialist external advice (to be commissioned on an 'as required' basis).

13. Each and every potential investment opportunity will be evaluated using the Investment Framework set out below and will be accompanied by a full business case.
14. The Full Business Case will be prepared by a core team of Officers and will include a qualitative and quantitative appraisal to establish portfolio suitability and the legal and financial implications of the purchase. Where necessary, the Core Team will engage with external investment and/or technical expertise where specialist property market knowledge is required.
15. All acquisitions, where relevant, will be subject to a building survey, purchase report and independent valuation.

## **Investment Framework**

### **Overview**

16. As with other forms of investment at the most basic level, property investment is trade-off between risk and return. A traditional well diversified property portfolio (spread across different property sectors and geographical regions) should deliver a balanced long term return with minimal risk.
17. The Investment Framework set out in this Strategy will endeavour to adopt the same underlying principle of diversification in acquiring property investments offering a similar return profile. Three main property sectors (industrial/warehouse, office and leisure) will be considered and, in turn, these will be diversified depending on a range of factors including location, the tenant's financial (covenant) strength, lease term (income duration) and investment lot size. This will protect the Council's portfolio return should a property investment cease to be income producing (for example, it is undergoing refurbishment or awaiting a new tenant).

### **Investment Criteria**

18. Investment criteria allow the relative merits of an investment opportunity to be measured and assessed against target thresholds established by the Council. For the purposes of this Property Investment Strategy, the Investment Criteria Matrix provided at Appendix 1 is proposed. These criteria reflect the following:-
  - **Location** – property is categorised as either Prime (Major or Minor), Secondary (Major or Minor) or Tertiary in terms of its location desirability. For example, a shop located in the best trading position in a Town would be prime, whereas a unit in a peripheral neighbourhood shopping parade would be considered tertiary;
  - **Tenant Covenant** – the financial strength of the tenant determines the security of the property's rental income. A financially weak tenant increases the likelihood that the property will fall vacant and/or there will be a regular turnover of tenancies. The minimum acceptable financial strength for any given tenant will be determined through a financial appraisal of a

company's accounts and the use of appropriate methods of risk assessment and credit scoring. To minimise management risk and costs, the preference will be for a single occupancy investment wherever possible;

- **Lease Terms** – Is the lease free from unencumbered/onerous terms? Is the rent periodically reviewed to take into account inflation and upward market movement?
  - **Occupational Lease Length** – the lease term will determine the duration of the tenant's contractual obligation to pay rent. The most attractive investments offer a long lease with a strong tenant covenant. The lease term may reflect any tenant break clauses.
  - **Building Quality** – a brand new recently refurbished building will not usually require significant capital expenditure for at least 15 years. This is attractive for income investors requiring long term rental income with the minimum of ongoing capital expenditure.
  - **Tenure** – anything less than a freehold acquisition will need to be appropriately reflected in the price.
  - **Tenant Repair Obligations** – under a Full Repairing and Insuring Lease (FRI), the tenant is responsible for the building's interior and exterior maintenance/repair. The obligation is limited to the building's interior under an Internal Repairing and Insuring Lease (IRI). The preference will be to favour FRI terms (or FRI by way of service charge, ie all costs relating to occupation and repairs are borne by the tenants and administered through a service charge).
  - **Lot Size** – to maintain portfolio balance, the preference will be for no single property investment to exceed **[£3m]**.
19. In addition to the above criteria, the Property Investment Panel will, when assessing the merits of an investment, specifically consider whether it involves any of the following activities:-
- Alcohol or tobacco production or sale (where the latter is the primary purpose of the property);
  - Animal exploitation;
  - Environmentally damaging practices;
  - Gambling;
  - Pornography;
  - Anything that does not uphold basic human or labour rights.
20. The above subject matters will inform the evaluation but will not necessarily preclude the Council from investment in a property asset that has a link to these activities.

### ***Other Core Principles***

21. Given the varied sector dynamics the criteria for each asset will vary but should follow the core principles of:-

- Individual properties will be financially and physically appraised in full using the risk and return matrix. This will be specific to each and every property proposed for purchase;
- Minimising management and risk. Preference will be given to single occupancy investments although multi-let properties or multi-unit schemes will still be considered;
- Location will be dictated by opportunity to acquire investments that meet this strategy. Inclusion in the Borough of Pendle or the impact on the economy of the Borough of Pendle will be a deciding factor when all other attributes are equal;
- Lease length will be determined by market forces but the premise will be to maximise the lease duration;
- Market Rent (MR) should be equal to or above passing rent;
- Market sectors and locations with rental growth and good letting prospects will be actively sought;
- Further performance measures, portfolio analysis and valuation, as required, will be undertaken to allow for a purchase or not purchase decision given they may impact on value and whether or not the opportunity to acquire is pursued. This could include, for example:- include:-
  - The fabric or structural condition of the property;
  - The ground conditions;
  - The surrounding land uses;
  - planning approvals of that and any other surrounding developments, in-situ or proposed.

## **Target Assets**

### *Geography*

22. The Council will consider property investment opportunities across all regions of the United Kingdom.

### *Sector*

23. The Council will consider property investment opportunities within the following business sectors:-
- **Industrial/Warehouse** Investments with the following characteristics:
    - Good location on major road routes/networks
    - Single-let properties with unexpired lease terms of a minimum of 5 years OR over [75%] let to sound tenants on leases with a minimum average of 7 years unexpired
    - Modern specification with flexible standard layout
    - Lot size between £1m and £3m
  - **Office** Investments with the following characteristics:
    - Good location in Town Centres (with consideration given to out-of-town business parks)
    - Single-let properties with unexpired lease terms of a minimum of 5 years OR over [75%] let to sound tenants on leases with a minimum average of 7 years unexpired
    - Modern specification
    - Lot size between £1m and £3m
  - **Leisure (including food and drink)** Investments with the following characteristics:
    - Good location in Town Centres.
    - Single-let properties with unexpired lease terms of a minimum of 5 years OR over [75%] let to sound tenants on leases with a minimum average of 7 years unexpired
    - Modern specification
    - Lot size between £1m and £3m
  - **Residential** Investments will NOT be considered.
  - **Retail** Investments will NOT be considered (unless they are incidental to a larger mixed use development).

## **Risk Management**

24. As with all investments, there are risks that capital values and rental values can go down as well as go up. It is vital, therefore, that the risks associated with the Council's property investments are properly considered and mitigations against such risks are employed as required.
25. The Council's appetite for risk is 'Open' as set out in the Risk Management Strategy. This means that the Council is **'willing to consider all potential delivery options and choose one that is most likely to result in successful delivery whilst also providing an acceptable level of reward (and value for money)'**.
26. For the purposes of this Strategy, this means that the Council will consider property investments in line with requirements of this strategy.

#### *Market Forces/Interest Rate changes*

27. To mitigate against the negative impact of market forces, acquisitions will be made on the basis that the Council is willing and capable of:-
  - holding property investments for the long term, ie 25yrs and longer. This will ensure income and capital returns are considered over the long term thereby smoothing out any cyclical economic/property downturns;
  - Fixing borrowing liabilities. Currently, the Council can borrow from the Public Works Loan Board at historically low levels thus protecting the Council from future increase in financing rates

#### *Portfolio Management and Monitoring*

28. To mitigate the risk of void periods where a property is either partially or fully vacant, or a tenants has defaulted on its rental obligations, the investment portfolio will be actively managed by the Estates Team in Liberata.
29. In addition, the investment criteria specified in the scoring matrix provided at **Appendix 1** will tend to favour secure property investments, ie high quality buildings in prime locations thus tending to mitigate against the risk of void periods on re-letting.
30. Monitoring the performance of the investment portfolio will be undertaken by the Asset Management Group (and will be incorporated into the Council's Asset Management Plan) and, as required, reported as part of the Council's monitoring information to the Policy and Resources Committee.
31. Whilst each investment will be expected to yield a net return at the levels set out earlier this report, at this stage no net income has been assumed in the Council's budget as a consequence of this activity. Subject to investments being made, consideration will be given to reflecting the financial implications of those investments in the Council's accounts as required.



32. Annually, as part of the production of the Council's Statement of Accounts, a fair value estimate will be produced of the assets within the investment portfolio and disclosed as required by the CIPFA Statement of Recommended Practice (SORP).

### *Resources*

33. Property investment markets are, in general, controlled by national and regional commercial property agencies and establishing links and relationships with a number of such property agents is the best method of sourcing suitable properties for acquisition.
34. Liberata's Estates Team have an existing relationship with these commercial property agencies and will therefore be able to source suitable property assets for acquisition that match the criteria set under this Strategy.

### ***Financial Evaluation***

35. To reflect the potential risk that may arise as a consequence of undertaking commercial property investment and to provide sufficient financial contribution to the Council's General Fund Revenue Budget, a minimum Internal Rate of Return of [5.00%] is required.
36. The Council may still consider pursuing a property acquisition if the IRR is positive but less than [2.00%] and a Regeneration opportunity is identified.

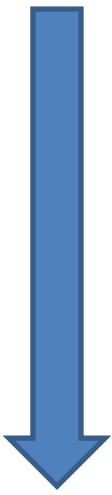




### ***Holding and Managing Property Assets***

37. This strategy recognises that as the portfolio grows, the skills and the capacity of the property team will need to change to ensure that it can satisfy the requirements as outlined in section six above.
38. It will also be important to bring in specialist property investment advice and other specialist advice as and when required
39. Appendix 2 to this strategy outlines the acquisition process to be undertaken.

## Appendix 1 – Property Acquisition Evaluation Criteria

Criteria	Weighted Score	Excellent	Very Good	Good	Acceptable	Marginal
		5	4	3	2	1
Location	15	Major Prime	Minor Prime	Major Secondary	Minor Secondary	Tertiary
Tenant Covenant	20	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong Financial covenants	Multiple tenants with poor financial covenants	Tenant(s) with poor financial covenant
Lease Terms	15	Unencumbered Lease	Encumbered lease (but not considered onerous)	Encumbered lease	Some onerous lease terms	Excessive onerous lease terms
Occupational Lease Length	15	Greater than 20 years	Between 15 and 20 years	Between 10 and 15 years	Between 5 and 10 years	Less than 5 years or vacant
Building Quality	10	Modern or recently refurbished with nominal capex required	Good quality with capex not likely to be required within next 20 years	Good quality with capex not likely to be required within next 15 years	Good quality with capex not likely to be required within next 10 years	Good quality with capex not likely to be required within next 5 years
Tenure	15	Freehold	Lease 125 year plus	Lease between 100 and 125 years	Lease between 50 and 100 years	Lease less than 50 years
Tenant Repair Obligations	10	Full Repair and Insure (FRI)	FRI – Partially recoverable	IRI – 100% recoverable	IRI – partially recoverable	Landlord responsibility
	100					

## Appendix 2 – Property Acquisition Flow

Pre-Commitment to Purchase		
<p>Heads of Terms</p> 	Opportunity Identified	
	Fully appraise against matrix	
	Business Case Produced by Property Investment Panel and considered by Policy and Resources Committee	
	Offers & Counter offers	
	Agree Heads of Terms	
	Secure Source of funds	
<p>Pre-Contract</p> 	Instruct Legal Team	
	Investigate Title	
	Conduct surveys & reports	
	Negotiate contract	
<p>Exchange</p> 	Pay deposit (if required)	
Committed to Purchase		
<p>Pre-Completion</p> 	Pre-completion searches	
	Finalise draw down of funds	
<p>Completion</p> 	Pay completion	
	Assume liability for property	
<p>Post-Completion</p>	Land registration	
	Collation of property information	
	Portfolio Management	

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