	AGENDA ITEM 6
	CSC/18/17

Report title: Property Investment Fund – Investment Criteria	
Report to: Corporate Policy & Scrutiny Committee	
Report author: Nicole Wood, Director, Finance and Procurement	
Date: 24th October 2017	**For:** Discussion
Enquiries to: Nicole Wood – Director, Finance and Procurement or Rob Manning, Head of Finance email Robert.manning@essex.gov.uk , telephone 0333 013 0215	
County Divisions affected: All Essex	

1. Purpose of Report

1.1 Essex County Council faces significant financial shortfalls between demand and available funding. Cabinet has allocated £50m capital for the purpose of investment in UK commercial property to generate income to help deliver the outcomes key to residents and business in Essex.

1.2 The report outlines the investment criteria (upon which the transactions will be assessed).

2. Recommendations

2.1 Discuss and note the investment criteria as set out in this report, upon which Commercial Property transactions will be compared and scored.

3. Summary of issue

3.1 ECC continues to explore opportunities to develop sustainable income streams to help fund ongoing and new services. If ECC can secure alternative sources of income then ECC will be financially more sustainable and will have greater ability to provide services for our residents.

3.2 An agreed way of doing this is by investment into commercial property.

Proposed Investment Criteria

3.3 It is proposed that ECC should adopt the following strategy :

3.3.1 Acquisition of properties located throughout the UK, this will mitigate the risk of declines in the property market in any one geographical area.

3.3.2 No single asset should be acquired at a value of greater than £15m. This avoids the risk of a catastrophic event leading to significant loss of income.

£15m is 30% of the initial programme, but would be 10% if the programme increases to £150m. Any decision to increase the programme would be taken by Cabinet.

3.3.3 It is proposed to acquire only UK commercial property based on the following indicative split, to ensure that ECC is not over exposed to one sector of the property market.

- Offices 35%
- Retail 35%
- Industrial 30%
- Alternatives 10%

3.3.4 These percentages add up to 110% because these are indicative maximum percentages although it is acknowledged that in practice the percentages will vary. The plan is to ensure that once the portfolio is acquired, the percentage of money invested in each sector does not exceed the percentages above. The precise split will depend on the opportunities available for purchase. Should an exceptional opportunity arise that deviates from this spread it can be considered on its own merits, but a key principle will override: that is not to concentrate too much risk into any one asset. The decision making will remain transparent for high value transactions through a Cabinet Member action.

3.3.5 The average weighting balance for a) the IPD (MSCI) Monthly Index which tracks the performance of £45.9 billion of UK commercial investments held in a number of funds/portfolios and b) Association of Real Estate Fund (AREF) All Balanced Funds Index which covers the pooled property fund market.

3.3.6 The average sector weightings for the IPD(MSCI) Monthly Index are as follows :

- Retail 36%
- Offices 35%
- Industrials 21%
- Alternatives 8%

3.3.7 The average sector weightings for the Association of Real Estate Fund (AREF) All Balanced Funds Index are as follows :

- Retail 31%
- Offices 31%
- Industrials 22%
- Alternatives 9%
- Cash 7%

3.3.8 The above data supports the proposed weightings for the Commercial Investment Portfolio. Industrial has now become a far more attractive sector over the past couple of years (due to the significant shift in retail shopping patterns with internet retailing) and this is why the % weightings for industrial in the IPD and AREF indexes are behind the curve and we will see the weighting balance in industrial increase over the coming years.

3.3.9 The portfolio will target prime established assets of value between £3m to £15m, on an initial property programme targeted at around £50m.

3.3.10 Investment decisions will be taken on commercial grounds only based on advice from external professionals. This is similar to the existing Essex Pension Fund property portfolio.

3.3.11 The target gross rate of return for portfolio assets will be 5% - 7%. This is based upon advice from external consulting experts, as well as the intelligence of the specialist officers and leadership. This is a target only. The projected rate of return over a 5 to 10 year holding period will inform the individual purchase decisions.

3.3.12 LSHIM have researched the IPD (MSCI) Quarterly Universe Income Return data which is as follows:

- 1 Year 4.7%
- 3 Year 4.8%
- 5 Year 5.1%

3.3.13 ECC have a set a target gross rate of return which is a gross operating income/return of between 5% to 7%. This is marginally different to the IPD figure as this figure is measured net of all irrecoverable costs incurred by the investor i.e. property management costs and other irrecoverable expenditure. Nevertheless, it appears local authorities investing in commercial property use a variety of return target criteria with some often being as simple as a target net initial yield and these vary from between 4.5% up to 7.5%.

3.3.14 All investors in the market have their own target return criteria depending on risk appetite, borrowing availability and costs, time and preference for income or capital growth. ECC have set a gross income target of between 5% to 7%, which LSHIM recommend to be reviewed annually, as ECC will not want to compromise the risk balance of the portfolio with incorrect return criteria. i.e. to achieve the above income return, ECC would have to buy properties with shorter lease terms or poorer covenants.

3.3.15 The decision on investments will be taken by the Executive Director for Corporate and Customer Services (Section 151 Officer) or by the Cabinet Member for Resources. Performance will be reported within the existing quarterly Cabinet Finance reports.

3.3.16 The independent professional advisors will develop a detailed risk matrix for the initial evaluation of potential investments. This will ensure all key risks are highlighted and evaluated on an identical basis across all opportunities and cover the following

- Lease Terms

- Covenant strength
- Economic Conditions
- Loan to value
- Portfolio and Property Management

3.3.17 Each proposal will be accompanied by detailed analysis of those items outlined paragraph above, as well as a full financial model with professional input on specialist areas such as refurbishments and repair costs.

3.3.18 The property manager will have completed a site visit prior to any opportunity being provided to the Council, to prevent any unforeseen issues that may not be clear from the data provided by the agent themselves, including discussions with existing tenants and neighbouring businesses also where feasible, to ascertain economic conditions and any localised risks.

3.3.19 The Executive Director for Corporate and Customer Services and the Cabinet Member for Resources will consider the opportunity, in consultation with officers with professional experience, with a view to making a bid within a few days of the initial report from the fund manager. This will enable ECC to have credibility with the market and act with appropriate speed to acquire the right investment opportunity.

3.3.20 A formal decision to acquire would be taken by the Executive Director for Corporate and Customer Services (under £2m) or by the Cabinet Member (over £2m) before a formal bid is made.

3.3.21 Subject to the bid being accepted in principle, the property advisers will draw up heads of terms and appropriate surveys will be undertaken. This should be complete within 10 days and subject to that being satisfactory, lawyers can be instructed and the aim would be to complete within 20 days.

4. Risk Implications

4.1. As with any investment, the asset value can decrease as well as increase. A review of benchmark information over the last 15 years illustrates that there are years of capital and income decreases as well as growth – however the evidence over the long term – in recent years - is one of capital and income growth. This is not simply a national benchmark but has been a key component of Essex's existing Pension Fund and also Treasury Management Strategy (ECC already invest cash into an existing property fund vehicle in accordance with the approved Treasury Management Policy). It is important to understand the inevitability of investment asset volatility, but this should be understood in the context of the long term nature of these investments and the opportunity to generate investments at a higher rate of return than would otherwise be the case.

4.2. A significant and material decrease in an asset value could potentially impact the revenue budget and balance sheet through the deterioration of asset values, as could falls in rental yield or voids. However the margin between the gross income yield and cost is sufficient to mitigate some volatility. If there was a catastrophic collapse of the UK property market, then ECC will still own the asset but more fundamentally, any such collapse would cause a significant issue to all local government finances, tax revenues and services.

4.3. The potential of Brexit clearly represents a risk to the performance of any investment portfolio; at this point there is no detail known of the terms of Brexit or the implications for the economy. The margin on the cost versus rental income is sufficient to accommodate volatility in rental income, but there could of course be ramifications for asset values. Those asset values can go up as well as down as a result of Brexit (and the purchases be made at low points in the market too should assets prices fall). However, the proposal is that of a long term outlook: the fundamentals of UK market supply and demand and current low long term fixed interest rates, mean that the commercial asset sector remains an attractive long term investment, and source for new commercial income. The entry into the market will be considered carefully for each proposed investment and if the evidence (borne of the prevailing economic outlook) is such that market entry looks to be high and the investment criteria cannot be met, then then purchasing will be suspended.

4.4. Many of the risks around this type of investment are linked to the quality of the asset being purchased and the incumbent tenant, which is addressed through the due diligence completed by the property advisors. The prospectus for each site will be comprehensive and lean heavily on the advisors' consideration of the evidence and professional judgement with which the Executive Director for Corporate and Customers Services and the Cabinet Member for Resources will use to aid their decision making. This due diligence will include site specific maintenance costs, capital refurbishment needs, and the need to understand operational risks (for example if ECC becomes responsible for the direct management of any common areas such as shared car parks).

4.5. All acquisitions will be subject to a rigorous due diligence process, overseen by LSHIM, as thorough as that carried out for any of their private or public sector clients. This will include providing or commissioning:

- an independent valuation, validating the purchase price.
- Full Legal report from lawyers appointed by ECC
- Building and Environmental surveys
- Measured survey
- Assessment of local economy and key risk indicators

All the above are reported upon in a Purchase and Recommendation Report prepared by LSHIM.

4.6. The inclusion of structural void (at an assumed 5 %) within the modelling means that ECC is protected against periods of non-rental to achieve the MTRS target, however there would have to be around a 50% reduction across all rental income for the total portfolio to not cover costs. As mentioned in section 5.9, such a fundamental property market collapse would signal far greater economic issues for ECC then this rental income. However, this can be partially mitigated through good due diligence of sites and a wide geographically split portfolio to spread the risk.

4.7. By directly investing in property ECC becomes liable for the asset. This means that ECC reaps any reward from the increase in property values but it also means that it suffers any loss if the value of the asset diminishes. The asset value can diminish as a result of changes to market conditions, or as a result of failure to invest (such as capital expenditure) or as a result of a catastrophic incident (such as a fire). Such an event can give rise to claims for compensation as well as a loss of the asset. It is therefore extremely important to ensure that ECC has appropriate insurance arrangements in place. ECC has been advised that investors with large portfolios typically bear the risk of rent voids arising from catastrophic events and ECC does not propose to insure against risk of loss of rent. This risk will be mitigated by having a broad range of assets and strong management of the portfolio, so any loss of rental is likely to represent a small share of the total income from the investment portfolio.

5. Legal implications

5.1. The Council has the power to acquire property for any of its functions under the Local Government Act 1972. It also has the power to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or right) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions: Local Government Act 1972 s 111(1). Section 12 of the Local Government Act 2003 gives the Council the power to invest for any purposes relevant to its functions or for the purposes of prudent management of its financial affairs. The term ‘invest’ is not defined in the 2003 Act.

5.2. It is therefore likely to be lawful to invest in property for the purposes of the prudent management of its financial affairs. Where ECC acquires property for the purposes of achieving an income stream, the importance of undertaking appropriate checks taking appropriate advice cannot be overstated. There are risks inherent to any investment and the key risks associated with this project are set out in the risk section above. This project appears to offer the opportunity to take some risk but earn the opportunity to receive significantly higher income than would otherwise be achievable. In deciding whether or not to proceed with this scheme the Cabinet will need to balance the risks with the benefits.

5.3. It should also be noted that any owner of commercial property is required to invest in that property from time to time in order to ensure that the property remains marketable in order to retain existing tenants and, when necessary, attract new ones. It is important that any assessment takes account of this continuing requirement to invest.

6. Equalities

6.1. The Public Sector Equality Duty applies to ECC when it makes decisions. The duty requires us to have regard to the need to:

(a) Eliminate unlawful discrimination, harassment and victimisation and other behaviour prohibited by the Act. In summary, the Act makes discrimination etc. on the grounds of a protected characteristic unlawful
(b) Advance equality of opportunity between people who share a protected characteristic and those who do not.
(c) Foster good relations between people who share a protected characteristic and those who do not including tackling prejudice and promoting understanding.

8.2. The protected characteristics are age, disability, gender reassignment, pregnancy and maternity, marriage and civil partnership, race, religion or belief, gender, and sexual orientation. The Act states that 'marriage and civil partnership' is not a relevant protected characteristic for (b) or (c) although it is relevant for (a).

8.3. The equality impact assessment indicates that the proposals in this report will not have a disproportionately adverse impact on any people with a particular characteristic.

9. List of Appendices

10. List of Background papers

All background papers include exempt information on the grounds of commercial sensitivity.