East Devon District Council

Commercial Investment Framework

Contents

Appendices

1.0 <u>Introduction</u>

1.1 This Framework addresses the opportunity that by investing circa £20,000,000 in commercial property between 2019/2020 and 2020/2021, £10,000,000 within the income only fund and £10,000,000 within the income plus fund, the Council could expect to receive a net return of circa £450,000 per annum, broken down broadly as follows:

- £10,000,000 for investment in commercial property **(income only fund - IOF)**. The objective of this investment is solely to derive a direct commercial return (income) and therefore the objectives and selection criteria will be firmly based on balancing income versus risk. There may be other District benefits as an outcome but these are not a key driver. A minimum of a 3% net return should be achievable therefore generating at least £300,000 net income per annum.

- A separate fund of £10,000,000 **(income plus fund - IPF)** for investment in a different portfolio of assets with the objective of providing a net income but also providing other District benefits e.g. micro and small business growth with local and rural economy benefit, regeneration, New Homes Bonus and Business Rates. In this instance there are different objectives and therefore assessment criteria comprising factors wider than just income versus risk. A net return of 1.5% as a minimum should be achievable generating at least £150,000 net income per annum.

  Note: Ultimately these return forecasts depend on the level of risk and ambition the Council is prepared to consider.

1.2 Local Authorities are on a pathway to financial self-sufficiency. A quarter of the Council's funding comes from Council Tax and that sum is, to all intents and purposes largely spent on our waste and recycling services. All our other services in the main will be funded from fees and charges or other income sources and as Rate Support Grant diminishes there will be an increasing reliance on realising the dividend from growth by securing revenue streams such as New Homes Bonus, Business Rates, increased rental returns and fees and charges. Increased rental returns will be generated through proactive and commercial management of the existing portfolio but predominately through direct commercial investment in new assets to provide a net return over and above the holding costs. There are different types of commercial investment which will be explored within this Framework to ensure a more balanced risk profile.

1.3 Whilst this Framework focusses on property investment, this same Framework can be utilised for investing in other types of income generating asset e.g. energy provision or Peer To Peer loans.

1.4 The benefits of commercial property investment by the Council are as follows:

- Positive net rental return / loan return
- Regeneration benefits to District (if in District)
- Additional Business Rates income (if in District)
- New Homes Business (if in District)
- Employment and prosperity (if in District)

- Unlocking of sites and opportunities that others might not invest in*
- Accelerating delivery of sites*

1.5 East Devon has numerous sites approved within the Local Plan that can deliver significant revenues to the council from New Homes Bonus and Business Rates but are complex, slow to come forward or stalled. The Commercial Investment Framework can over time contribute towards unlocking of those opportunities but in short / medium term the focus needs to be on investment to achieve a financial return in-year. These 2 benefits (with * above) are unlikely to materialise from early investment.

1.6 This Framework contributes to the Council's Transformation Strategy.

Key Theme 4 - Maximise the value of our assets through commercial thinking with a focus on income generation, sustainability and developing local economies

1.7 The Council has an anticipated budget shortfall as per the table below:

General Fund	2019/20 £000	2020/21 £000	2021/22 £000	2022/23 £000	2023/24 £000	2024/25 £000	2025/26 £000	2026/27 £000	2027/28 £000	2028/29 £000
Budget Shortfall	665	1,952	279	159	112	125	632	137	309	276

1.8 This budget shortfall is to be addressed through a number of different means through the Council's Transformation Strategy themes 1-5.

1.9 There is a clear preference, irrespective of whether using the IOF or IPF to invest at this stage within District unless:

a) The level of return required necessitates investment in a wider geographical area – possibly to include the wider Greater Exeter area.
b) The availability of investment opportunities within East Devon limit the availability to invest.
c) A wider geographical spread is needed to ensure acceptable balance of property investment portfolio risk.

Note: A recent survey by The Local Government Chronicle found that of those authorities investing in commercial property, 37% invested outside of area.

What is fundamental to this approach is that a net return of £450,000 is recognised as a key element of the Transformation Strategy by 2020/2021 and decisions will need to be made with this in mind.

1.10 It is anticipated that direct investment intervention by the Council can also unlock and / or accelerate development by third parties at the same time as:

- Generating a good level of rental return
- Enabling the Council to benefit from marriage value where perhaps the Council already has an interest in land.
- Enable increases in NHB and Business Rates income to the Council.

This is a key benefit of direct commercial investment but is a medium term objective due to longer lead-in time but demonstrates how targeted investment can not only deliver an annual return but also an uplift in capital values on other assets.

1.11 This aligns with the Council's objectives in Regeneration, Enterprise Zone delivery and the employment and productivity priorities of HOSW LEP, GESP and Local Plans. IOF and IPF are a practical means by which the Council will have a direct role in delivery of wider strategic and policy ambitions.

1.12 The shorter term objective of £450,000 by 2020/21 needs to be realised by investment in assets which can generate a return in-year whilst at the same time developing an ambitious pipeline of future investment which supports not only income generation but other Council objectives around growth in productivity, place making, sustainable communities, economic development and regeneration. This future pipeline is envisaged would require further financial commitment.

1.13 Investments can be financed through Public Works Loan Board (PWLB), capital receipts or internal borrowing. The Council's current favoured route is generally through PWLB.

1.14 Since 2015, an estimated £2.7 billion (recorded and as at Summer 2018) has been invested by Local Authorities in commercial property transactions across the country. See attached Appendix A – Strategy and Transactions Examples.

1.15 Commercial property investment opportunities often arise unexpectedly and it is important to be agile in terms of allocation of resource (internal and external) but also decision making to take advantage of opportunities when they arise. The Council therefore needs to be in a position to assess investment opportunities in a systematic manner but should also be able to move quickly when a compelling opportunity arises and to do this through a dedicated Investment Assessment Team of Officers and Councillors with the necessary delegated authority in place to progress acquisitions which meet the objectives agreed by the Council.

2.0 Legal & Regulatory Powers

2.1 The Council has a range of legal powers that can be relied on to invest in commercial and other types of property, and to borrow in order to do so. Whilst it is clear that the Council has such powers, their application should be considered as part of the decision-making process when specific investment opportunities arise.

2.2 The Council has the power to acquire through s.120 of the Local Government Act 1972 and to invest through s.12 of the Local Government Act 2003.

2.3 The Council has statutory powers to invest for:

a) any purpose relevant to its functions; or

b) the purposes of the prudent management of its financial affairs.

2.4 This power does not place a geographic limit on where the investment activity can take place; together with the associated power to acquire property under section 120, Local Government Act 1972, there is clear authority for purchasing land within and outside of the Council's area.

2.5 Potential investments would need to be considered in light of:

a) The Statutory Guidance on Local Government Investments (3rd Edition), which came into force from 1st April 2018

b) The Prudential Code

c) The Treasury Management Code

2.6 The use of the above powers should be considered in conjunction with the framework for borrowing as the Council may borrow from the Public Works Loan Board to fund acquisitions. As a local authority, it has a clear power to borrow for "any purpose relevant to its functions or for the purpose of the prudent management of its financial affairs".

3.0 Key Objectives of Commercial Investment Framework

3.1 In summary, the key objectives of this Commercial Investment Framework are:

- Income generation to contribute to reducing future funding shortfall
- Investing in and optimising the effectiveness of the existing council asset and new acquisitions
- Promoting new opportunities for local economic growth, wealth creation and productivity improvement
- Applying a clear, costed, risk managed and structured programme of investment using rigorous criteria and with appropriate decision making capabilities to respond to market opportunities in an agile but safe manner.

3.2 The shorter term objective is to generate a net return of £450,000 per annum by 2020/21 to be realised by investment in assets which can generate a return in-year whilst at the same time developing an ambitious pipeline of future investment which supports not only income generation but other Council objectives around growth in productivity, place making, sustainable communities, economic development and regeneration.

4.0 Different Types of Commercial Property Investment

4.1 There are potentially 5 different forms of investment the Council can consider under this Framework, as follows:

1. Management of Existing Assets
2. Acquisition for Commercial Income (IOF)
3. Acquisition for District wide benefits (IPF)

4. Direct Development – both Housing & Commercial (IPF)
5. Strategic Partnerships and Joint Ventures (IPF)

4.2 This Framework should not be viewed in isolation from the management of the existing portfolio. Whilst opportunities might be more limited, income can be increased either through greater commercialism in respect of ensuring market rents are generated for a greater number of assets (and kept current), assets are void for shorter times, but also through managing costs more robustly, including through more proactive capital planning, and recovering costs from tenants via service charges. There is also potential through developing out opportunities within the existing portfolio e.g. Colyford Road and Fosseway Park (both Seaton) although the driver for these will not be purely income generation.

4.3 The investment criteria and risk / reward profiles are different for each category; particularly where local social / economic benefits can be reflected alongside commercial considerations. As such, there is a different scoring matrix prepared for each of the above, excluding the 1st.

5.0 <u>Informing Investment Criteria</u>

5.1 Reflecting the different aims and objectives for each type of investment, a matrix approach has been adopted to determine what is / what is not generally acceptable in terms of anticipated risk/ reward. Also, in shaping the Commercial Investment Framework, consideration must also be given to achieving a balanced portfolio of different investments, reflecting the Treasury Management Code which prioritises, in order of importance:

- Security – protecting the capital sums invested from loss
- Liquidity – ensuring the funds invested are available when needed i.e. asset could be disposed
- Yield – an acceptable rate of return from investment

5.2 The portfolio will take time to grow and ensure the longer term ideal split of asset types is achieved.

5.3 The Council is to be very mindful of which market sectors it chooses to invest in. Different market sectors carry different risk profiles, discussed in section 6 of this Framework, but also different wider benefits and levels of return. In considering different market sectors, for the IOF, this will predominantly be about return versus risk, along with capital growth but for the IPF this will include the socio-economic benefits and level of added value and catalytic effect. Priority market sectors are likely to change over time with general trends in the market but for the IOF at this stage are likely to include large distribution, smaller workshop and office / innovation whilst for the IPF likely to be geared more towards innovation and high technology, smaller workshop space, leisure, food and beverage or tourism. What is key is that few market sectors will be disregarded completely and opportunities will be considered on their merit. That said, the very nature of the market sector the opportunity relates to, will impact on the scoring within the appropriate scoring matrix – particularly in respect of market failure, lease potential and socio-economic benefits. It will be the scoring matrix that takes precedent as the first step of considering investment opportunities.

5.4 The Council could potentially borrow funds from PWLB at a rate of around 3%, use internal borrowing or capital receipts.

5.5 One-off and on-going costs would be incurred in order to deliver the Framework, including, where acquiring assets, estimated average costs as follows:

- Finders Fees (0.5-1% if appoint consultants)
- Legal Fees (0.5%-0.75% if external)
- Stamp Duty (0% up to £150,000, 2% for the amount between £150,001 and £250,000, and 5% for the amount over £250,000)
- Finance Costs (circa 3% PWLB) on borrowed funding
- Business Rates (should be covered by tenant as long as not void)
- Repairs and maintenance (should be covered by tenant through service charge as long as not void)
- Running costs of building, including building management (depending on lease type, again probably covered by service charge)
- Additional staff costs or consultant fees if acquisition is externalised
- Ongoing management costs – staff costs or consultant costs

5.6 The Council will also need to consider the level of reserves that should be maintained, the effect of borrowing on its credit score and its overall borrowing limits. In short the Council must get the right balance between risk and reward in a prudent manner to ensure the costs from commercial investment does not fall on the tax payer.

5.7 Ongoing management of acquired assets. The scale of this task and importance depends on the nature of assets and importance of service charge regimes for recovery of costs. Based on the nature of assets a decision needs to be made on whether this would be dealt with in-house or by consultants who would be experienced at maximising value and have the skillsets and systems to do so.

5.8 Exit strategy. Assets should have good and marketable title although along with this, success in disposing of the asset will depend on market conditions at the time. It should be acknowledged that disposal of assets can be a protracted and uncertain process.

6.0 <u>Risks</u>

6.1 Property investment brings with it the potential for significant risk if things go wrong. Risks can be mitigated but ultimately some risks are externally driven.

Listed below are typical risks:

- Voids – these will reduce average yield. In addition to lost rental income, the Council could find itself liable for on-going costs which would otherwise be the tenant’s responsibility and including maintenance liabilities.
- Disputes with tenants – particularly in respect of service charge type issues.
- External factors such as failure of tenants, micro and macro market downturns and increased borrowing costs.

- Where the Council is seeking to develop or change a use, it needs to be mindful of the planning process, inevitable delays and public perception. With planning, there is rarely absolute certainty.
- Government support for local authorities investing in commercial assets to derive an income to support essential services being withdrawn.
- The opportunity cost of investing these funds here rather than elsewhere on other income generating opportunities
- The impact on the Council's borrowing limit.

6.2 The Council must take a prudent approach to the management of its financial affairs and therefore when assessing investments will need to consider such factors as the security against loss, the liquidity of the investment, the yield and risk of change of interest rates, property values and voids.

6.3 Assessing the risk of individual investment opportunities will be a key element of both the Outline Business Case and Full Business Case detailed within section 10 of this Framework.

7.0 Required Skillsets

7.1 Whilst an initial assessment of potential opportunities will be managed in-house, additional specialist investment agency, valuation and building surveying services might need to be procured through external consultants. As for specialist finance and legal advice, again external consultants might be needed.

7.2 Once the investment fund is established and investment criteria confirmed, external property investment agents can be appointed to assist in sourcing, evaluating and completing the acquisition process. Furthermore, the Council should consider retaining an external property management company to pro-actively manage future commercial assets going forward. In return for a fee of typically 5-10% of the rental income, the management company would deal with all landlord & tenant matters, lease events, rent collection and service charge arrangements in addition to dilapidation claims.

7.3 Notwithstanding the need to engage with specialist advisors, it will remain vitally important that the Council retains commercial property expertise in-house and can operate as an effective "informed client" in all negotiations with appointed advisors and to understand the implications of the advice provided. This role will be undertaken by the Council's Senior Manager – Property & Estates along with other colleagues as necessary but will impact on staff resourcing.

7.4 The Council will track internal resource required when considering investment opportunities and whilst potentially abortive, will ensure this is factored alongside ongoing management costs when assessing the performance of an investment opportunity. Furthermore, these costs will be included in the £20,000,000 investment fund to truly understand the level of return.

8.0 Management of Existing Assets

8.1 Opportunities need to be identified to:

- Increase revenue income
- Reduce costs – smaller but better performing asset base in terms of both financial and non-financial return
- Invest wisely – component replacement or wider investment by being proactive and by identifying where both financial and non-financial returns can be improved. By being proactive there will be better management of future capital returns.
- Identify poor performing assets and dispose.

9.0 <u>Assessment of Investment Opportunities – Weighted Scoring Matrices</u>

9.1 To ensure investment opportunities can be considered in a structured and objective manner, all such opportunities will be considered using one of the four weighted scoring matrices included in the attached Commercially Confidential appendix B.

10.0 <u>Assessment of Investment Opportunities – Process & Governance</u>

10.1 Commercial property investment opportunities often arise unexpectedly and it is important to be agile in terms of allocation of resource (internal and external) but also in decision making to take advantage of opportunities when they arise but doing so in a safe, accountable and democratic way. Other Local Authorities with investment portfolios have taken this exact same approach and the proposal set out below is a proven model.

10.2 The process is as follows:

1. Relationships with external agents be developed to ensure that this Council is understood by the market to be an investor.
2. Officers led by Senior Manager – Property & Estates working with external agents, colleagues and Councillors identify investment opportunities. All commercial property investment opportunities will be channelled through the Council's Senior Manager – Property & Estates.
3. Any investment opportunity if considered feasible is considered alongside the criteria of this Framework, and if consistent is then scored against the relevant Scoring Matrix.
4. If the investment opportunity fails to deliver the necessary score and / or indicative return then it is dismissed.
5. If the investment opportunity achieves the necessary score and indicative return then it progresses to a dedicated Investment Assessment Team of Officers (with support of consultants if necessary), these being existing staff with the right skillset and aptitude to think commercially. This Investment Assessment Team is to comprise of:
    - Deputy Chief Executive
    - Strategic Lead – Governance and Licensing
    - Strategic Lead – Finance
    - Senior Manager – Property & Estates
        - ………. Other Officers on a case-by-case basis
6. Outline Business Case is prepared and presented to SMT along with Portfolio Holders for Asset Management, Finance and Economy.

7. If the Outline Business Case is to proceed then a Full Business Case is prepared to enable a final decision to be made on whether to invest is made following consideration by the Commercial Property Investment Decision Making Group. The decision to invest is delegated to Deputy Chief Executive (up to £5,000,000 per transaction) in consultation with Leader, Portfolio Holder for Asset Management, Portfolio Holder for Finance and Portfolio Holder for Economy (Investment Decision Making Group). If an investment opportunity exceeds this £5,000,000 limit then the Council's normal decision making route will apply.

10.3 This approach will ensure that resources are focussed on delivering realistic investment opportunities rather than being diverted onto others that don't meet the agreed investment criteria. The approach will also ensure investments can be delivered in line with market expectations and in accordance with commercial confidentiality.

10.4 For avoidance of doubt, any investment that does not satisfy the objectives and scoring requirements of the Framework can only progress subject to standard decision making arrangements within the constitution.

10.5 Wider reporting on investment decisions and performance of investment assets will be through 6 monthly reports to Council, updates to Asset Management Forum and to Senior Management Team.

10.6 The decision making and reporting arrangements are shown in appendix C – Commercial Investment Governance.

10.7 The key drivers to successful delivery of this Framework are as follows:

- Relationships with key players in the investment market
- Officer expertise to identify and progress opportunities
- Of greatest importance – Robust but swift decision making