

CABINET

COUNCILLOR MARTIN TENNANT
MAJOR PROJECTS AND PROPERTY
PORTFOLIO HOLDER

04 FEBRUARY 2020

REPORT NO. RP2003

KEY DECISION? NO

COMMERCIAL PROPERTY INVESTMENT STRATEGY

SUMMARY AND RECOMMENDATIONS:

This report sets out a Commercial Property Investment Strategy for the Council and seeks Cabinet's agreement to the approach and establishment of a Property Investment Advisory Group to oversee the strategy.

Recommended that Cabinet agree the Commercial Property Investment Strategy for the Council set out at Appendix A

1. INTRODUCTION

- 1.1 The Council has been acquiring commercial property for a number of years for the purpose of generating additional income to support service delivery. The value of the Council's commercial property portfolio currently sits at £115m. Lambert Smith Hampton Investment Management (LSHIM) was appointed in November 2019 to support the Council in managing this part of the asset portfolio and grow the commercial property portfolio to create further income.
- 1.2 Following a series of workshops at the end of 2019, an Investment Strategy has been developed with LSHIM to guide both the management of the current portfolio and the selection of future commercial property acquisitions.

2. THE STRATEGY

- 2.1 The Council is required to approve an Annual Treasury Management Strategy and Non-Treasury Investment Strategy prior to the start of each financial year.
- 2.2 This sets out how the Council will make investment decisions during the coming financial year, taking into account MHCLG Investment Guidance, the Chartered Institute of Public Finance and Accountancy's (CIPFA) *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code), and with reference to CIPFA's Prudential Property Investment guidance.
- 2.3 The CIPFA Code is the over-arching document, with this strategy (the Commercial Property Investment Strategy) providing a more detailed view on how the Council operates and supports its commercial property portfolio.

- 2.4 The strategy, which is attached at Appendix A aims to ensure that the portfolio will generate sustainable income streams, preserve value and provide an opportunity for capital growth. It sets out a prudent approach to future investment and seeks to manage risk through diversification in both asset type and location.
- 2.5 The strategy explains the future approach to performance measurement and documents a four stage property selection and acquisition process which ensures a regular flow of potential acquisitions combined with a streamlined and effective process for evaluating potential opportunities against the criteria agreed.
- 2.6 Finally, the strategy also proposes the establishment of a Property Investment Advisory Group which will meet quarterly and will support governance and decision making in relation to the investment assets. The group will have the following responsibilities;
- Implement and Monitor the effectiveness of the Council's Investment Strategy
 - Make recommendations to Cabinet as part of an annual review of the Investment Strategy
 - Manage the Council's Investment Property portfolio both in terms of balance and performance and act as a consultative body to the Executive Head in acquiring new properties / in disposing of existing properties in line with the budgetary framework and scheme of delegation
 - Manage the Council's approach to risks within the portfolio following advice from its professional officers and LSH especially in terms of holding properties
 - Increase revenue and capital appreciation from the portfolio year on year
 - Agree a reinvestment programme, determining the level of recycling of receipts into investment yielding assets or to support the Council's capital or revenue budgets
 - Agree income and expenditure from the property reserve as required
- 2.7 It is proposed that the group will be chaired by the Chief Executive and will include of the Leader, Deputy Leader, Portfolio Holder for Regeneration and Major Projects, Portfolio Holder for Corporate Services, the Leader of the Opposition, the Executive Director responsible for Property and the Executive Head of Finance.
- 2.8 LSHIM will attend as the council's advisors providing private sector expertise and performance information along with the Executive Head of Regeneration and Property. Decisions to acquire properties will continue to be made through Cabinet in accordance with the Council's current arrangements and scheme of delegation.

3. ALTERNATIVE OPTIONS

- 3.1 The Council could continue to operate under its current approach, but this would be unlikely to bring forward the benefits and reduce the risks intended by taking forward the strategy.

4. CONSULTATION

- 4.1 Both Cabinet and other members have been engaged in the development of the strategy through a range of meetings and workshops.

5. IMPLICATIONS

Risk

- 5.1 The strategy is a key component in the Council's approach to balancing risk and investment returns from its property portfolio.

Legal Implications

- 5.2 There are no legal implications as a result of this report

Financial and Resource Implications

- 5.3 The investment strategy is linked through other Council strategies including the Treasury Management, Capital Strategy and the Capital Programme. The strategy proposes a gradual expansion of the investment portfolio by up to £67m over the next five years.

- 5.4 Investments will be usually acquired through borrowing or through allocation of capital in the event of capital receipts being available

Equalities Impact Implications

- 5.5 There are no equalities impact implications as a result of this report

6 CONCLUSIONS

- 6.1 In managing and building the Council's property portfolio it is important the Council's acts in a prudent manner and make decisions within an agreed transparent framework. The proposed strategy sets out clear objectives for the direction of the portfolio and puts in place a rigorous process of evaluation against clear criteria for new acquisitions.

BACKGROUND DOCUMENTS:

Annual Treasury Management Strategy and Annual Non-Treasury Non-Treasury Investment Strategy 2020/21 (FIN2004)

CONTACT DETAILS:

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LSHIM
INVESTMENT MANAGEMENT



Commercial Property Investment Strategy

January 2020

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Foreword

Lambert Smith Hampton Investment Management (LSHIM) has been appointed by Rushmoor Borough Council (RBC) to act as Investment and Asset Manager on the current Investment & Legacy Portfolios and in further growing a commercial property portfolio. The objective is to create a balanced property investment portfolio, from which to derive a long term secure revenue stream.

This report outlines the objectives for RBC and what LSHIM perceives to be a prudent approach to invest in commercial property, setting out the recommended investment strategy.

LSH is a leading specialist property consultancy with 43 offices and 1400 staff across the UK. LSH Investment Management (LSHIM) is the investment management arm of the business and will be directly responsible for this mandate.

LSHIM acts for Public Sector, Institutional and Private Investor clients wishing to invest in commercial property. Existing public sector clients of LSHIM include Watford Borough Council, Mansfield District Council, Essex County Council Tewkesbury Borough Council and Hambleton District Council.

LSHIM operates independently of LSH. Whilst able to take advantage of the expertise and experience within LSH it is not obliged to do so and can therefore adhere to a policy of using only 'best in class' advisors and service providers in the acquisition and asset management of its client's investments.

Introduction

The public sector as a whole has been suffering an unprecedented squeeze on capital and revenue budgets following central government “austerity” cuts in Local Authority funding over the last 9 years.

RBC, along with many other local authorities, has not been immune from these budget pressures and with the financial outlook unlikely to change in the short to medium term, the Council needs to find new and innovative ways of creating additional revenue.

In recent years local authorities have spent in excess of £4bn per annum on commercial property across the UK having implemented strategies to acquire income generating assets with the sole purpose of generating additional revenue to support public services. This is quite distinct and not to be confused with buying assets for regeneration purposes and/or promoting local employment. These assets have been purchased both ‘in and out of borough’ meaning that assets are purchased in many cases outside the administrative boundaries of the buying entity.

Importance of Setting a Strategy with Clear Objectives and Governance

In managing and building a property portfolio, it is important that RBC acts in a prudent manner, and is seen to be doing so, to ensure that the makeup of the portfolio will generate sustainable income streams, preserve value and provide an opportunity for capital growth. To do this, the following is needed:

- A clear portfolio strategy to achieve pre-agreed objectives.
- Rigorous evaluation of potential investments that will stand up to scrutiny, against a set of pre-agreed criteria.
- Investment decisions to be taken following professional advice and recommendations from LSHIM.

To facilitate the above and ensure sound governance, we suggest that a Property Investment Advisory Group (PIAG) be established to provide a forum to ensure the strategy is followed and thereafter managed in a proactive and accountable manner.

It is recommended Cabinet approve the Portfolio Strategy on an annual basis.

The responsibility for ensuring that the acquisition and the on-going financial returns meet the performance targets is held by LSHIM which is a specialist role requiring a combination of property and financial skills and access to the property investment markets. LSHIM will maintain a portfolio overview and implement specific actions required and acquisition recommendations to meet the portfolio objectives. LSHIM will be responsible for the identification, selection, acquisition of stock and its asset management.

Objectives

We set out below the key objectives that have been discussed and agreed in an earlier workshop which will underpin the investment strategy:

- To prudently invest over a five year period to develop a £178M commercial property portfolio to generate a sustainable income stream, preserve value and provide an opportunity for capital growth;
- RBC wants to expand its investment portfolio with around £67M of further investment over the next five years.
- To ensure a low risk profile investing only in core/core plus assets – typically long leases and better quality buildings;
- To generate an arbitrage in excess of 0.8% on new acquisitions after costs of finance and MRP;
- To manage risk across the portfolio by diversification in asset type and geography;
- To balance investment returns and risk for new acquisitions and across the existing commercial investment portfolio, known as the Investment and Legacy portfolios which LSHIM have previously reviewed.

Investment Strategy

Executive Summary

Size	<ul style="list-style-type: none"> • Target portfolio size £178M gross (currently totalling £111M) • Capital to be deployed over a five year period but as soon as prudently possible. • The new acquisitions will comprise between 5 – 9 properties. • Asset values of between £5m - £15m. • Maximum weighting of 20% from any one property.
Performance Objectives	<ul style="list-style-type: none"> • To achieve an arbitrage of at least 0.80% after costs of finance and MRP. • Where appropriate to outperform the IPD/MSCI Annual Property Fund Index Benchmark.
Property Type	<ul style="list-style-type: none"> • Create a well-diversified portfolio in properties with good fundamentals and strong tenant demand to ensure the property does not reach obsolescence during the hold period.
Geographic Allocation	<ul style="list-style-type: none"> • Diversified by location with all locations across the UK considered.
Sector Allocation	<ul style="list-style-type: none"> • Diversified by sector with a maximum of 35% in a single sector. • Targeting higher allocations in industrial and office.
Other Restrictions and Guidelines	
Tenants	<ul style="list-style-type: none"> • Maximum rent from any single tenant is 20% of total rental exposure • Tenants are forensically analysed before acquisition to minimise income risk
Lease Structure	<ul style="list-style-type: none"> • Target an average unexpired lease term in excess of the benchmark. • Ensure that expiries in any one year do not account for more than 25% of the total income. • Core income assets have an unexpired lease term of at least 7.5 years at purchase. • Where possible acquire assets with fixed or RPI uplifts to help de-risk income growth.
Development	<ul style="list-style-type: none"> • Not to actively seek development opportunities but to review opportunities existing in the portfolio as appropriate.
Debt	<ul style="list-style-type: none"> • Borrowing through PWLB & MRP.
Environmental	<ul style="list-style-type: none"> • Acquire properties with appropriate EPCs. • Seek to improve EPC ratings wherever financially prudent.

Portfolio Size

Rushmoor Borough Council wants to expand its investment portfolio with £15M of additional investment each year over the next three years followed by a further 2 years of £10M. This combined together with current funding availability provides £67M new investment. LSHIM will aim to invest as prudently and swiftly as possible to create the additional income as soon as possible for the council.

We consider the optimum lot size for acquisitions would be between £5m - £15m in order to diversify the portfolio. This would ensure that no property was accountable for more than 20% based on the aspirational total value of the portfolio. Based on the optimum lot sizes the portfolio will comprise of between 5 and 9 properties of differing values.

Target returns

There are two principal areas of return from commercial property investment – income and capital growth. For Rushmoor, and most other local authorities, maximising revenue along with ensuring that the investment capital is not eroded by inflation are key considerations. Core and Core-Plus assets will be targeted to achieve a return that is balanced between income and capital growth.

In the current market net initial yields are in the region of between 4.00% - 5.50% for industrial and 5.00% - 6.00% for offices for core / core plus assets. Currently alternatives and retail investments are providing greater returns however these returns can vary greatly depending on property specifics.

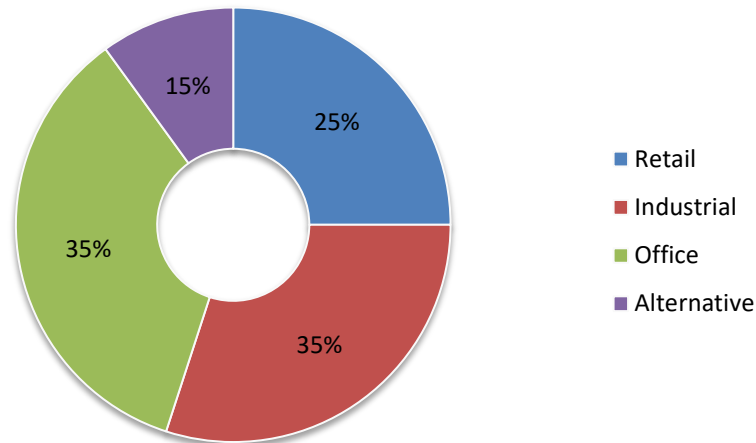
Property Fundamentals

Properties in either prime or good secondary locations will be acquired meaning at end of lease term they should re-let with minimal voids. LSHIM will recommend properties to RBC that have strong fundamentals ensuring that if a property was to become vacant it could be re-let quickly with minimal cost and income downtime for the council. There will be no investment in speculative development as this increases the risk beyond the objectives.

Sector Allocation

Our recommendation for maximum portfolio weightings for a core / core plus portfolio is as follows:

Portfolio Target Weightings



**Retail refers to Retail warehousing (highly unlikely to be High Street unless exceptional circumstances dictate otherwise).*

Tenants

The maximum rent from any single tenant should not exceed 25% of the total rental income. All potential investments will be assessed for strong tenant covenants to meet rental liabilities. LSHIM recommend that for all acquisitions we will instruct a forensic accountant to review the tenant financials for which reliance can be provided. This goes above and beyond the Dunn & Bradstreet reports that we analyse for an initial assessment. This has been very well received by our other local authority clients.

Lease Structure

Investment opportunities will have an average unexpired lease term of at least 7.5 years at purchase. LSHIM will seek opportunities with good rental growth and potential capital value improvement during the hold period through active asset management i.e. lease re-gear, RPI/CPI and open market rent reviews, refurbishment. The strategy will be based on core / core plus investments, the majority of opportunities will be single occupier however two / three tenant properties will also be considered. This approach keeps on-going management and asset management costs to a minimum.

Debt

We understand the acquisitions will be made using PWLB monies with MRP. These finance costs can be built into our cash flow models to provide accurate cash flow appraisals showing the ultimate net income RBC will receive.

Environmental

Properties with appropriate EPCs will be sought (with at least 'D' rating) to reduce the risk of capital expenditure being required to improve the property to a lettable or saleable standard at exit. In addition opportunities to improve EPC ratings wherever financially prudent should be taken through the hold period.

General

For the sake of clarity we would confirm that our definition of 'Retail' includes out of town retail warehouses and retail warehouse parks as well as stand-alone out of town supermarkets. We are very cautious about in-town retail investments in view of the structural changes in that sector other than prime retail units in 'Cathedral cities' where such meet our minimum return criteria.

Some degree of flexibility will need to be built into the process, as if we were to invest say £7M in a single industrial investment, we would not recommend investing the balance of the Industrial allocation (£1M) in a single, small industrial investment. Instead, we would reallocate this to one of the other sectors or add it to any potential second tranche of capital.

We will look to keep the portfolio as balanced as possible during the investment process, this is difficult at the start and will ultimately depend on the opportunities within the market however, the final portfolio will reflect the target ratings as closely as possible.

Maintaining value of existing properties in the portfolio

LSHIM will also initiate and oversee the development, implementation and regular review of individual property strategies (Asset Business Plans), which will be implemented by the Asset Manager. Frequently, asset management initiatives are identified at a pre-purchase stage and can often form part of the rationale for a given acquisition. However, other opportunities may arise later on in the ownership of an asset and might be identified by the Fund Manager and Asset Manager.

A strong and close working relationship between the investment, asset and property managers is essential to identify these opportunities to increase income and add value and this is a core strength of our offer.

LSHIM have developed a 'RAG' traffic light system to categorise assets and prioritise key actions and would form part of the agenda for the portfolio review meetings. The 'Action Lists' created following the reviews of the Investment and Legacy portfolios will be used as a basis and tracker for the review meetings.

Risk Management

Many of the risks within a portfolio are linked to the quality of the assets and the incumbent tenant(s). We have reviewed the existing investment and legacy portfolios and have produced an “Action Plan” to help manage these risks. These considerations are addressed through the due diligence completed by LSHIM and third party professionals. Prior to completion, comprehensive reports will be commissioned from appropriate specialists which will then be reviewed by the Directors at LSHIM and form part of the comprehensive Investment Recommendation (Building Survey, Environmental Report, Measured Survey, Forensic accountant and an Independent Valuation) that LSHIM will prepare for Rushmoor Borough Council.

This due diligence will include building and site specific surveys, estimates of future maintenance costs, estimates of any future capital refurbishment requirements, and the need to understand operational risks. As previously stated, these reports will be commissioned from ‘best in class’ advisors on each and every occasion irrespective as to whether or not they work for LSH.

Performance Measurement

The performance of the portfolio and each investment should be monitored regularly against targets and Key Performance Indicators (KPIs) of benchmarks. These should not be based on just return performance but include rent collection efficiency, arrears and building inspection frequency.

Investment Management KPI's

The table below details the aims we have set out for the portfolio. The investment, legacy portfolios and newly acquired properties will be measured against these aims.

	Portfolio	New Acquisitions
Number of Properties	20 – 30*	4 – 7
Number of Tenancies	90 - 120	4 – 10
Gross Income Yield	Above 4.50%	Above 4.50%
Arbitrage	-	Above 0.80%
Vacancy Rate (% of rent)	Below Benchmark (Currently 6.20%)	
Rent with 5+ years	Minimum 40%	
Rent with 10+ years	Minimum 15%	
Largest property (% of value)	Below 30%	
Largest tenant (% of income)	Below 25%	

*Holder Road & Blackwater Way are identified as a single property each.

A further possible measure once the portfolio has reached full maturity (i.e. all capital has been allocated) is to analyse the portfolio against the MSCI UK Property Index.

Property Management KPI's

The property management and rent collection roles will be performed by various property managers and RBCs in house team. LSHIM will have monthly management meetings with the various property managers to ensure that the KPIs are being meet.

Our suggested indicators for ensuring a well-managed portfolio consistent with best practice are below:

	Rent Collected	Service Charge Collected
At Quarter Day	70%	65%
7 days post Quarter Day	80%	75%
14 days post Quarter Day	95%	85%
21 days post Quarter Day	99%	95%

The above is based on collectable monies and to exclude tenants in administration/liquidation or on pre agreed payment plans.

Aged Debt

- Debt to be no more than 1.5% of annual contracted rent and service charge

Charge Raising & Transfer

- All quarterly rent and service charge invoices to be raised at least four weeks before the Quarter day
- Monies will be remitted to the client within 5 working days of allocation

Service Charge

- Service Charge (including but not restricted to budgets, reconciliation, tenant communication and variances) to be administered in accordance with the RICS Service Charge Code 3rd Edition and updates thereof

Occupier Satisfaction

- Six Monthly Occupier Meetings to be held on multi let properties
- Tenant Satisfaction Survey to be carried out annually and summary reported back to client within 28 days of final response

Acquisition Process and Property Selection Criteria

LSHIM will source opportunities for you with an acquisition (and disposal) strategy based on a thorough understanding of your financial objectives, detailed market knowledge, robust due diligence and rigorous valuations.

There are two principal ways by which we will source investment properties – directly from selling agents and from agent introductions.

We inform selling and introducing agents of our current requirements by circulating quarterly summaries of our

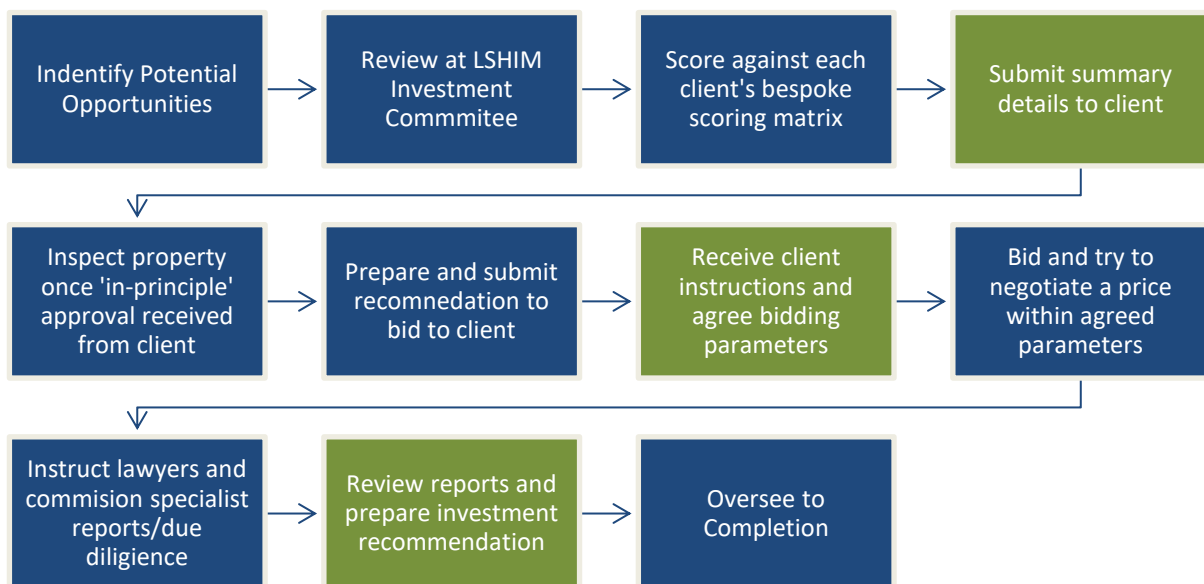
investment criteria by email and more effectively through face to face meetings with investment agents throughout the UK.

This twin-track approach secures a regular flow of potential acquisitions throughout the year and the key to success is to have a streamlined and effective process for evaluating potential opportunities according to the criteria set by and agreed with our clients.

These opportunities may be either on or off market with the latter providing the opportunity to purchase at Market Value but in a non-competitive environment. Frequently, the quid-pro-quo is that the Vendor will expect a quick sale – typically within 15-20 working days from agreeing terms to completion.

The development of the portfolio will be tracked in the Quarterly and Annual reports which set out both portfolio and individual property strategies as well as all the financial data relating to the portfolio.

The chart below summarises the acquisition process:



Investment Board Decision Required

Stage 1:

LSHIM will source opportunities for acquisition, based upon the parameters set out in the above portfolio strategy. A scoring matrix will be used for initial evaluation to ensure uniform basis of appraisal across different asset classes and locations. The resultant score can then be assessed against a target measure or used for comparison against other opportunities.

Stage 2:

Suitable opportunities will be issued by LSHIM to RBC in a summary format which will ensure there are no

conflicts of interest or any historical reasons preventing further due diligence. A decision back from RBC will be needed within 24/48 hours.

Stage 3:

LSHIM will inspect the property and carry out detailed due diligence and build cash flow models to establish returns. Assuming the parameters for the portfolio are met, LSHIM will issue a Recommendation to Bid generally within 1 to 2 weeks outlining the key fundamentals along with the maximum recommended offer level. A decision back from RBC will be needed within 24/48 hours.

Stage 4:

If the offer is accepted and Heads of Terms issued, exchange and completion could be set for within 10 to 15 working days. LSHIM will instruct and coordinate the relevant surveys required for the acquisition and will liaise with the appointed legal advisors. This will include a Building Survey, Environmental Survey, Forensic Accountant and independent Valuation. Prior to exchange, a detailed Investment Report will be issued by LSHIM to RBC which will provide a detailed analysis and cash flow of the investment but will also provide summaries of all 3rd party advisors reports.

Key to the above is the need for prompt responses by RBC back to LSHIM, in particular at Stage 2 and 3.

Reporting

LSHIM will provide formal reporting on the progress of each property and the portfolio as a whole on the following basis:

- A written quarterly report on the performance of the portfolio and new acquisitions;
- A quarterly meeting of the Investment Board or equivalent;
- An annual* report on the performance of the portfolio;
- An annual* review of the asset strategy for each property;
- An annual* review of the investment strategy for the portfolio as a whole;
- Ad hoc decision making meetings arranged as required on specific actions.

*The annual report/reviews will be incorporated into the appropriate quarterly report. These quarterly / annual reports will comprise:

- An update on the Portfolio Strategy;
- A summary of the changes within the portfolio since the last report;
- Updated detail on the portfolio composition and portfolio weightings;
- UK wide commercial property market update;
- Property Management update including an Income Statement, Rental areas;
- Key Performance Indicators;
- Tenancy Schedule – followed by individual property reports on each of the assets.

For the acquisition process LSHIM will provide the following reports:

- **Lightbulb Opportunity** – This will detail the fundamentals of the unit with a brief analysis of the opportunity. This two page document is intended to confirm the council have no conflicts of interest with the property and no historic reasons for not progressing with further due diligence.
- **Recommendation to Bid** – This provides an extensive report following an inspection of the property and in-depth due diligence on the area, property, local market and comparables. LSHIM will run detailed cash flow appraisals and sensitivities and set out the investment rationale. This document will seek your formal approval to bid, up to a maximum agreed level.
- **Investment Recommendation** – If successful in the bidding process, we will prepare this final report which you will receive at least 48 hours prior to completion and which will consolidate the advice of the lawyers, building surveyors and any other professional advisors and provide the formal advice on the basis of which the funds are released from completion.

In addition to the formal reporting LSHIM will also attend the quarterly PIAG meetings covering any acquisitions that have taken place over the last three months, the performance of the portfolio as a whole, potential upcoming issues and general wider market intelligence. In addition we will attend further PIAG meetings as and when planned.

LSHIM will provide a prompt response to any issues raised by Rushmoor and we are available 24/7. Given the importance of this portfolio in contributing to services to Rushmoor Borough Council we will resolve any matters within a reasonable time frame.

