Joint Strategic Committee
10 July 2018
Agenda Item 10

ADUR & WORTHING COUNCILS

Key Decision [No]

Ward(s) Affected:All

Commercial Property Investment Strategy

Report by the Director for the Economy

1. Purpose

1.1 The purpose of this report is to set out a robust commercial property investment strategy, with the specific objective of supporting the Councils' strategic income generation objective, building upon previous Strategic Property Investment Fund (SIF) reports.

1.2 The Strategy will provide a basis for the expansion and management of each Council's portfolio, detailing: -

- Robust parameters to guide and support the development of risk managed, financially resilient, income generating commercial property portfolios.
- Governance criteria to facilitate diligent analysis and transparency, supporting an informed decision making process.

2. Recommendations

2.1 The Joint Strategic Committee is recommended to:

i) To **recommend** to Adur District Council and Worthing Borough Council to adopt the Property Investment Strategy.
ii) Agree the suggested delivery and governance model.

3. Context

3.1 Due to ongoing reductions in central government grant funding, local authorities are increasingly reliant upon income generating services. This has led many local authorities to implement strategies to generate additional income, as a means to address funding challenges, to support ongoing service delivery.

3.2 Adur and Worthing Councils have to jointly make £7.1M of savings over the next 4 financial years, of which £1.9M is due for the financial year 2019/20.

3.3 The Outline Forecast and Budget Strategy (2017/18 to 2021/22) presented to the Joint Strategic Committee (JSC) on 13 September 2016 set out changes to council funding over the next few years, detailing our strategic response and increasing reliance upon income generation. The paper illustrated that either income growth, or significant savings, will need to be delivered to balance the budget. Property investment was identified as an option to generate *“a return of between 2% and 3%... after financing costs”*.

3.4 Direct Property Investment is now commonly undertaken by local authorities, acquiring assets both within and outside of their governance boundaries. Public Works Loan Board (PWLB) long term lending is at very preferential rates (c.2-3%), when compared to commercial investors. Property investment is capable of generating returns above PWLB rates, creating positive income. This can be used to fund current services and mitigate the impact of ongoing cuts to council services, protecting services that would otherwise be at risk.

3.5 The Council approved the establishment of a Strategic Property Fund (SPF) following a report to JSC in July 2015. Subsequent SPF reports in February 2016, July 2016 and July 2017, built upon the initial strategy, containing a series of approved contributions to increase the budget to the current £75M per Council.

3.6 To date, a total of £23.04M has been spent on investment property across Adur and Worthing, generating a net income after borrowing costs of £795,000 per year, from 7 assets. This equates to a net return of 3.45%, after financing costs.

3.7 Adur and Worthing Councils propose raising capital through the PWLB to invest directly in the UK property market, in order to generate a long term revenue stream, to mitigate the impact of government funding reductions, to support service delivery.

3.8 The Councils have a statutory ability to borrow from the PWLB on long term preferential fixed interest terms, typically below rates available in the wider market. Borrowing is subject to guidance and regulations to ensure appropriate assessment, overview and scrutiny, in relation to any borrowing activity.

3.9 The 31 May 2018 Joint Governance Committee report, *"Managing investment opportunity and risk when investing in Commercial Property"*, details how both council's are managing risk in the acquisition of property and the implications of the changes to both the regulatory framework and the associated guidance.

3.10 This report sets out the Property Investment Strategy (**Appendix 1)** for Adur and Worthing Councils, which is built upon developing two portfolios of commercial investment property that will be maintained and managed with the express function of income generation.

3.11 The strategy provides a defined set of evaluation criteria for the assessment of investment properties, accounting for the statutory guidance. This details how the property strategy should be constructed, providing a basis for balance, diversification and risk management, whilst generating a long term sustainable income. The strategy includes provision for an annual review and continuing asset management of the portfolio, to ensure ongoing performance monitoring and proactive risk and opportunity management to maximize values.

3.12 The main body of the report, as set out below, provides: -

- 4.0 Statutory Guidance and the Property Investment Fund
- 5.0 Investment Evaluation Process
- 6.0 Property Investment Governance
- 7.0 Risk Management
- 8.0 Annual Performance Monitoring
- 9.0 Scope of Investment
- 10.0 Corporate Implications
- 11.0 Legal Implications

4. Statutory Guidance

4.1 When investing in property, local authorities must comply with statutory guidance. This includes the Ministry for Housing Communities and Local Government (MHCLG) February 2018 publication, providing updated statutory guidance on capital finance (on local government investments and on minimum revenue provision (MRP)). Two codes of practice (Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes and The Prudential Code for Capital Finance in Local Authorities) issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) contain additional investment guidance, which complements the MHCLG guidance.

4.2 This guidance includes requirements for councils to: -

- Prepare an annual investment strategy which must be approved before the start of the forthcoming financial year. This document must include:
    1. details of the processes used to ensure effective due diligence, defining the authority's risk appetite, including proportionality in respect of overall resources.
    2. Independent and expert advice and scrutiny arrangements.
    3. Disclose the contribution that investments make *"towards the service delivery objectives and / or place making role of the local authority".*
    4. Propose indicators that enable councillors and the public to assess the authority's investments and the decisions taken.
- The investment guidance is clear that Councils may not "borrow in advance of need" to profit from the investment of the sums borrowed. The definition of investment has recently been extended to include investment in property and the granting of loans to third parties.

- In recognition of the importance of commercial income to councils at a time when government funding is steeply declining a council can choose to disregard the Prudential code and this part of the guidance. In this case its investment strategy should set out why this is the case and what the council's relevant policies are.

4.3 The implications of the revisions to the guidance are that in future the Councils will need to have least one Investment Strategy ("the Strategy"). This Strategy should meet all the disclosures and reporting requirements specified in this guidance. For Adur and Worthing Councils, there will be two separate elements to the Strategy:

i) The annual treasury management investment strategy which covers all cash investments
ii) The annual Property Investment Strategy, which covers the Councils' approaches to investing in property

The annual Treasury Management Investment Strategy was approved by the Councils in February 2018. 2018-19 is a transition year and the guidance expects the new requirements to be met by the end of the financial year at the latest.

This document comprises Business Case and annual Property Investment Strategy (**Appendix 1)** which is recommended to be approved by the respective Councils.

4.4 The strategy provides a defined set of evaluation criteria for the assessment of investment properties, accounting for the statutory guidance.

5. Investment Evaluation Process

In consideration of the statutory guidance for local authority property investment, which sets out guidance for due diligence assessment processes and necessitates a consistent and robust evaluation process, the recommended approach is set out below: -

5.1 Proposed investment opportunities are reported by suitably qualified and experienced in-house MRICS (Member of the Royal Institute of Chartered Surveyors) professionals, in a risk matrix (**Appendix 2**). This risk matrix provides analysis of a set of key criteria against which every prospective purchase is evaluated. The presentation of information highlights fundamental matters such as tenant covenant strength, lease length and location, in a transparent and consistent format, to support clear scrutiny and decisions.The risk matrix provides a basis for scoring and weighting risk, to support the analysis of potential acquisitions and qualify overall suitability for inclusion in the portfolio. A minimum score threshold is set, below which it is not recommended to proceed. The score threshold is not an absolute, but set to guide decisions, reflecting the **Fund Structure** detailed in the Property Investment Strategy (**Appendix 1**), which assumes a low risk profile. The process is further supported by the inclusion of a Strength, Weakness, Opportunities, Threat analysis (SWOT).

5.2 To ensure arms-length objectivity, external agents provide professional market analysis, data and advice, in the context of the Property Investment Strategy (**Appendix 1**), to support the evaluation and internal reporting process.

5.3 Since tenant default is a significant threat to the performance of the property investment fund, in-house reports are undertaken by Credit Safe, providing company accounting reports, with additional Dun and Bradstreet covenant strength checks, prior to acquisition. This is augmented by additional internal assessment of tenants' covenant and likely future performance, where relevant.

5.4 If a decision is made to proceed, in-house surveyors lead negotiations, via the introducing/retained external agents, who are professional property firms.

5.5 To ensure independent and expert advice and scrutiny, all technical due diligence is undertaken by arms-length external professional advisors, including:

- To support internal analysis, externally appointed agents, who are professional RICS property firms, data as detailed under 5.3 above to assess a purchase rationale. Additional information is sought, tailored for each prospective investment, such as future demand, yield and rental movement, optimal holding periods for the property and data to support profitability modelling.

and if terms are formally agreed to acquire, (subject to internal reporting and approvals): -

- A valuation, in accordance with the RICS Red Book, Professional Valuation Standards, issued by RICS as part of their commitment to promoting and support high standards in valuation delivery worldwide. The publication details mandatory practices for RICS members undertaking valuation services.
- A Building Survey report, as part of the proposed purchase for investment purpose, including preparation of a Site Environmental Assessment and preparation of a Reinstatement Cost Assessment for insurance purposes.

5.6 The above is reviewed by the Asset Portfolio Manager as an experienced in-house MRICS (Member of the Royal Institute of Chartered Surveyors) professional, with support from the internal multi-disciplinary property teams, for final decision by the Head of Investment and Major Projects, on whether to proceed.

5.7 The Head of Investment and Major Projects receives regular updates on market activity, trends, forecasts and occupier activity from RICS firms and in-house surveyors to support the decision process.

5.8 It is recommended that all members and officers involved in the decision process are provided with at least annual updates on the commercial investment market, including occupier activity and trends.

5.9 A separate paper will be presented in due course, detailing a proposal for a disposals strategy.

6. Property Investment Governance

6.1 Clear, robust and transparent governance is critical to the strategy, meeting the statutory guidance and ensuring an appropriate level of due diligence and scrutiny is applied, together with objective arms-length external advice where appropriate. It is also important to ensure any decision process retains fluidity, so officers are empowered to respond promptly and competitively, to investment opportunities in the market and avoid missing opportunities through delay.

6.2 The current Scheme of Delegations provides that the authority to acquire or dispose of land, is vested in the Head of Major Projects and Investment, and where the land is purchased through the Strategic Investment Fund, the delegation is only exercisable in consultation with the relevant Leader, Executive Member for Resources and the Chief Financial Officer.

6.3 It is proposed that a formalised staged governance approach is adopted in relation to Strategic Investment Fund (SIF) purchases, as follows:

Stage 1

Asset Portfolio Manager identifies suitable opportunity in the market, having undertaken appropriate investigative and due diligence assessment, in accordance with the above “Investment Evaluation Process”.

Stage 2

The opportunity is reported in writing, with all supporting information as detailed in the “Investment Evaluation Process”, to the Head of Major Projects and Investment, in consultation with the Chief Financial Officer/s151 officer, notifying the Head of Legal Services, Director for the Economy and Chief Executive. The report will include: -

1. A risk matrix & SWOT analysis
2. A financial appraisal
3. A summary of the investment, including a request for authority to bind the Council to a range of terms and indicating an acceptable price point for acquisition.

If the proposal is supported, the potential acquisition will progress to Stage 3.

Stage 3

Subject to Stage 2 approval to proceed, the Asset Portfolio Manager will progress negotiations, seeking to formally agree Heads of Terms with the vendor, including price and basis/terms of acquisition. If negotiations lead to the agreement of acceptable terms, final approval to proceed will be sought in accordance with Stage 4.

Stage 4

A recommendation will be reported in writing to the Head of Major Projects and Investment. In making any decision to purchase, the Head of Major Projects and Investment will carry out a consultation, as provided for in the Scheme of Officer Delegations, with the relevant

Council Leader, Executive Member for Resources and Chief Financial Officer.

The relevant Council for any acquisition will be determined, applying the principles in the Property Investment Strategy (**Appendix 1**) in relation to financial resilience and risk diversification requirements, to support the development of a balanced portfolio.

Subject to approval, written authority to proceed, will be provided by the Head of Major Projects and Investment to the Asset Portfolio Manager, who will then seek to acquire the asset, which will be subject to an external red book valuation, building surveys and legal reports and conveyancing, providing pre-acquisition due diligence.

A decision notice will be completed and published in accordance with the Officer Decision Making Protocol.

<u>Stage 5</u>
Completed purchases will be reported to the next available Joint Strategic Committee meeting for noting.

Should any proposal to purchase prove abortive, this will also be reported to the next available Joint Strategic Committee meeting for noting.

7. Risk Management

7.1 Property investment will necessitate exposure to risk, whereby the total invested can exceed the Market Value. Prices are prone to fluctuation, particularly due to changes in locality, the general economic outlook, or asset specific risks, such as tenant failure. Furthermore, property investment is relatively illiquid, requiring a longer term approach. In the event of a market crash, property is much less liquid than other assets and can be hard to sell.

7.2 The council’s exposure to risk equates to the total amount of capital invested, plus financing costs (such as interest due on loans), property operational running costs (management, vacant business rates, service charges, professional fees etc.) and legislative compliance. The Council’s risk quantum will be defined as this total exposure, less the value of held assets.

7.3 Whilst risk is a natural, necessary, part of investment that cannot be eliminated, it can be proactively managed.

7.4 The Property Investment Strategy is built upon a series of conventional measures to manage risk, reflecting the key objective:

"To adopt a structured and measured approach to property income generation, pro-actively managing the risk inherent to investment, creating a balanced portfolio delivering long term sustainable income, for the purpose of supporting the continued provision of Council Services."

7.5 The Property Investment Strategy (**Appendix 1**) **Fund Objectives** and **Fund Policy** build upon this key objective, providing a series of controls to direct the Investment Strategy towards a prudent low risk fund with a cautious perspective on investment, limiting exposure to unnecessary capital risk, whilst generating a return.

7.6 Financing property investments is based upon utilising reserves, capital receipts and borrowing. Borrowing is currently available with fixed interest for the duration of any loan, via the Public Works Loan Board funding, mitigating the risk associated with exposure to interest rate fluctuations.

7.7 The Minimum Revenue Policy (part of the treasury management strategy statement) details the Council's position and deals with the Minimum Revenue Provisions (MRP) that must be made to mitigate that risk. The MRP is the amount the Councils must set aside each year from the annual revenue budget for the repayment of debt.

7.8 The Property Investment Strategy (**Appendix 1**) **Financial Resilience** section details a series of measures to guide decisions, based around spreading capital across a variety of asset classes, locations and sectors. This diversification reduces the risks of exposure to a single asset, tenant, or market failure.

7.9 Funds that are excessively concentrated in one particular sector or region increase risk, whilst a good spread of properties across retail, office and industrial diversify sector-specific risks and varying the locality, reduces local market risk.

7.10 The average property size is a measure to ensure the fund does not only hold a very small number of large properties, which increases risk, such as a single large tenant failing. This measure also assumes a number of properties will be transferred into the fund from the existing asset portfolio, to create a sufficient number of properties within the fund to generate diversity.

7.11 The Council's exposure to investment risk can also be profiled by defining the acceptable parameters. The Property Investment Strategy (**Appendix 1**) **Fund Structure** details a series of different segments that provide a basis for dividing commercial property investments, based upon their position at differing points on the risk v return spectrum. **Appendix 3** provides further detail on these segments.

7.12 The fund has been structured to include some allocation toward more risk exposed investment. This will enable the fund to respond fluidly, should a suitable opportunity arise, particularly where there is an opportunity for socio-economic benefits to residents. The proposed Investment Strategy distribution of purchases across the above four categorisations is weighted heavily toward more institutional lower risk assets.

7.13 This reflects the Property Investment Strategy (**Appendix 1**) **Fund Objectives** and **Fund Policy** targets to adhere to a cautious perspective on investment, generating a return, whilst, insofar as possible, limiting exposure to unnecessary capital risk.

7.14 The ability to vary the distribution of purchases between each of the above four categories, is a common portfolio investment tool. This provides flexibility to respond fluidly to opportunities and changes in the economy, market climate and differing performance across asset classes, as the fund evolves. Such agility is key to maximising operational efficiencies.

7.15 The proposed portfolio weighting offers a lower return, which reduces overall exposure to invested capital risk. This portfolio profile favours acquiring premises leased to strong covenant tenants in established markets, which are typically more attractive to investors, thus easier to sell if required, when compared to higher risk investments.

7.16 Whilst acquiring properties offering higher returns may appear attractive, the additional yield typically reflects higher risks such as tenant default, low liquidity, obsolescence and market risk. These increase the prospect of the investment generating an income and capital loss.

7.17 The Property Investment Strategy (**Appendix 1) Annual Review** sets out a series of measures to provide detailed analysis of investment performance. This is to ensure detailed periodic arms-length objective monitoring is undertaken, using conventional measures, as a means to identify any emerging hazards or opportunities. This will support proactive management, which is key to driving a successful strategy and managing risk.

8. Annual Performance Monitoring

8.1 Active management of the portfolio is key to proactively maintain the buildings to maximise value and monitor occupiers. Tenant covenant strength, compliance with lease obligations, such as repair and maintenance, management of the payment of rent and service charge needs to be actively managed. External Managing Agents are in the process of being appointed to manage investment portfolio properties and to undertake the Property Investment Strategy **Annual Review** (**Appendix 1**).

8.2 In addition to ongoing monitoring, the Property Investment Strategy details a series of measures to undertake a comprehensive annual re-evaluation, including detailed assessment of key performance indicators, to quantify, monitor and benchmark the portfolio operation and strategic direction.

9. Scope of Investment

9.1 A holistic approach to property income generation will be undertaken. In addition to acquiring investment property, the Councils are already successful commercial landlords and will build upon this: -

- Retaining existing assets where appropriate, to generate income, investing where necessary to enhance returns.
- Re-evaluate the existing property portfolio to identify opportunities to maximise the financial benefit.
- The Investment Surveyor will review the existing portfolio and report any of the existing property portfolio that fit the investment criteria, recommending transfer into the Property Investment Fund, whereby they will be funded and managed with an express

focus upon income generation. This will support a more tailored approach for relevant premises that is proactive and focussed solely upon income, as opposed to wider socio-economics drivers, that apply to the existing estate.

- Any capital return generated from the investment fund, will be ring fenced for future property investment, after deduction of financing costs and professional fees.

9.2 A Disposal Strategy will be provided as part of a separate report, subject to the adoption of the Property Investment Strategy and any conditions or amendments following consultation.

10. Corporate Implications

10.1 Long term appropriately resourced strategic investment portfolio management is key to the successful delivery of a sustainable property investment fund that will continue to deliver a sound return into the future.

10.2 It is fundamental to performance that acquired property is proactively managed to address risk and opportunity, including investment holding periods, whilst developing the strategy to meet changes in the market. Failure to effectively manage the investment portfolio may have severe implications for longer term fund performance and investment return, impacting upon the authorities finances.

10.3 It is proposed to allocate 5% of the investment income to increasing capacity and resources within the Head of Major Projects and Investment team to undertake the commercial property investment work covering: -

- Fund an investment surveyor post to support delivery of investment opportunities and growth of the investment portfolio.
- Establishment of in-house investment "intelligent client" function, led by an appropriately qualified surveyor, to govern the management of the investment portfolio,
- Monitoring, remit guidance and, where appropriate, challenge of any externally appointed managing agents to report in accordance with the Property Investment Strategy (**Appendix 1**) **Portfolio** and **Asset Management** guidance.

- Analysis, interpretation and reporting internally, to proactively drive necessary investment decisions, ensuring they are timely and appropriately informed.
- Ongoing optimal holding period scrutiny.
- Increase capacity to enable proactive review and reporting of income generation opportunities from the existing portfolio.
- Deliver investment opportunities, to enhance portfolio development.
- Govern and manage the appointments of external managing agents for the Investment Portfolio.
- Provision of specialist property IT system and data access tools to provide market data to support evaluation, analysis and valuation (e.g. Circle and Investment Property Bank).

11. Engagement and Communication

11.1 This report builds on the previous Strategic Property Investment Fund report taken to JSC on 2 February 2016

11.2 Consultations have taken place with legal and finance and there comments are contained within.

12. Financial Implications

12.1 The Councils' approved budget strategy recommended the investment in good quality commercial property to produce additional income for the Councils for the future. This was part of a combined strategy to ensure that the Council would meet the financial challenges ahead with a mix of:

- Investment in commercial property;
- Generation of additional income from existing commercial activities each year;
- Investment in a new digital and customer strategy to generate business efficiencies;

12.2 With this in mind, the Councils have released significant capital funding over the 5 year period to 2020/21.

Strategic Property Investment Fund						
	2016/17	2017/18	2018/19	2019/20	2020/21	Total
	Actual	Actual	Budget	Budget	Budget	
	£	£	£	£	£	£

Adur	0	11,579,360	38,420,640	25,000,000	25,000,000	100,000,000
Worthing	3,222,082	9,464,254	45,000,000	25,000,000	25,000,000	107,686,337

However, in light of the new prudential code, the JSC will be asked to consider the maximum level of borrowing on this type of activity that will then be recommended to Council to approve.

12.3 It is expected that overall the income generated via the developing portfolio will contribute a significant percentage of the savings required over the next 5 years as follows:

Adur:	2018/19 £'000	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000
Annual shortfall	1,333	643	1,226	215	420
Net additional income per year from property investment (after borrowing costs and provision for void rentals)	493	200	250	200	150
Additional income as a percentage of the savings target	36.98%	31.10%	20.39%	93.02%	35.71%
Worthing:					
Annual shortfall	1,853	1,257	1,825	707	830
Net additional income per year from property investment (after borrowing costs and provision for void rentals)	420	260	208	217	160
Additional income as a percentage of the savings target	22.67%	20.68%	11.40%	30.69%	19.28%
Amount of capital investment required to make income target per Council per year	£15m - £20m	£10m - £15m	£10m - £15m	£10m - £15m	£10m - £15m

13. Legal Implications

13.1 S.111 Local Government Act 1972 provides the Councils with 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 rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions."

13.2 s.1 of the Localism Act 2011 provides the Councils with the general power of competence to do anything that an individual may do.

13.3 The Scheme of Officer Delegations includes the following delegation to the Head of Major Projects and Investment at paragraph 3.13.2: "To acquire land in connection with the Council's functions and to take leases, easements, licences and wayleaves of, in, or over buildings or land in connection with the Council's functions. (Where acquisition of land is purchased through the Strategic Investment Fund, the delegation is to be exercised in consultation with the Leader, Executive Member for Resources and the Chief Financial Officer).

13.4 The Officer Decision Making Protocol in each Council's Constitutions provides a procedure for Officer Decisions and the publication of Decision Notices.

13.5 Any decisions made to acquire under the Strategic Investment Strategy are subject to scrutiny by the Council's Joint Overview and Scrutiny Committee in accordance with the Joint Overview and Scrutiny Procedure Rules in each Council's Constitutions.

Background Papers

JSC Report 2 February 2016 - Strategic Property Investment Fund - Investment Strategy

Platforms for our Places - Platform 1 - Our Financial Economies.
1.4.2 Use the Councils' Strategic Property Investment Fund to deliver new revenue streams and support investment projects.

Ministry for Housing Communities and Local Government (MHCLG) February 2018 publication
Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes
The Prudential Code for Capital Finance in Local Authorities

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Sustainability & Risk Assessment

1. Economic

The proposal forms part of the Councils' Capital Strategy to produce additional income

2. Social

2.1 Social Value

Matter considered and no issues identified.

2.2 Equality Issues

Matter considered and no issues identified.

2.3 Community Safety Issues (Section 17)

Matter considered and no issues identified.

2.4 Human Rights Issues

Matter considered and no issues identified.

3. Environmental

Matter considered and no issues identified.

4. Governance

This aligns with the Councils' Capital Strategy. Investment in good quality commercial property to produce additional income is part of a combined strategy in the Councils' approved budget strategy.

APPENDIX 1

THE PROPERTY INVESTMENT STRATEGY

Contents

The Property Investment Strategy

1. Objectives

The key objective:-

> ***"To adopt a structured and measured approach to property income generation, pro-actively managing the risk inherent to investment, creating a balanced portfolio delivering long term sustainable income, for the purpose of supporting the continued provision of Council Services."***

This key objective will be delivered through the application of the following principles: -

- ❖ To invest in commercial property to generate a sustainable income, with clear margins exceeding the cost of capital and borrowing.

- ❖ To build financial resilience through the creation of a diverse portfolio to balance risk and return.

- ❖ To acquire established commercial properties generating an immediate stable income and preserve capital (not withstanding market changes).

- ❖ Supporting economic growth within the District and Borough, where suitable opportunities arise, provided the return covers the costs of an associated financing.

- ❖ Re-evaluate the existing property portfolio to maximise the financial benefit.

- ❖ Retain the existing property portfolio, where appropriate to maximise long term revenue generation.

2. Fund Policy

- ❖ Retain existing assets where appropriate, to generate income, investing where necessary to enhance returns.

- ❖ Review the benefits of an investment vehicle, such as a holding company, to retain acquired assets.

- ❖ Capital receipts from the sale of Strategic Investment Fund (SIF), or other council properties, to be considered for: -
  - Reinvestment in SIF, to sustain income generation and maximise opportunities
  - Repayment of capital borrowing to improve the return on existing assets.

- ❖ Allocation of new purchases between Adur and Worthing Portfolios, to be recommended in consideration of fund diversification risk management.

- ❖ We will not engage with occupiers who may present a significant unmitigated reputational risk.

3. Financial Resilience

We will always undertake thorough due diligence to ensure risks associated with any proposed acquisition are understood and mitigated.

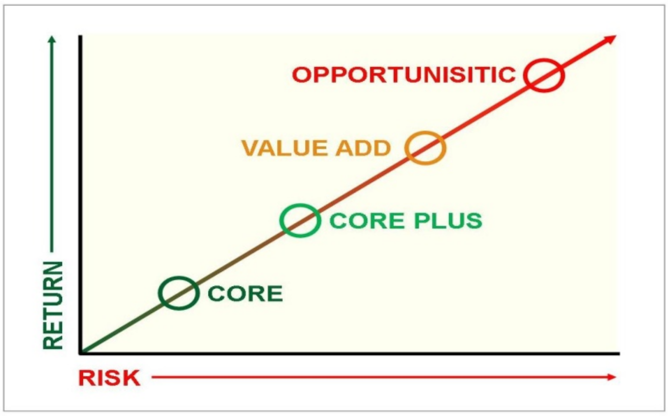
The following table details a series of guiding principles, employing conventional measures that are intended to assist decisions to create a balanced portfolio, by providing a basis to manage risk through diversification.

Risk Diversification		
Geographical Diversification	Maximum of 30% of the Target Fund size is invested in any single town.	Given the relatively small size of the funds, initially concentrating on outer London and the wider South East area, with consideration given to wider geographical diversification, as the funds grow and approach their target sizes.
Asset Class/Sector Mix	Industrial/Warehouses 25% Offices 30% Retail 20% Alternatives 25% (e.g. car parking)	To ensure a spread of risks, acquisition across office, retail and industrial sectors. At the outset, the portfolios will be heavily weighted into certain sectors and classes, driven by opportunities and market performance. It is expected weightings will progress towards targets as the portfolio matures in the longer term.
Average Property Size	Guide Size c.£5-15m	Assuming a combined fund size of £150M, this will support a spread of investments. Acquisition outside the guide sizes will be considered where they offer a good return, support diversity within the portfolios and do not create over exposure to a large single tenant/asset.
Leases Expiring within 5 years	Maximum 30%	Spread and diversity sought in future lease expiries across acquisitions to protect revenue streams
Target Return	A return exceeding the cost of borrowing	Initial return exceeding the cost of borrowing, preferably by 2%. Lower returns considered if there is a viable business case/portfolio fit.
Target Fund Size	£150M	In order to make a meaningful contribution to the financial challenge, the Councils has agreed to build a portfolio that will generate an initial yield of at least 5%.
Capital Expenditure Allowance	20% of the rental income	Held in a fund to support future management and Capital Expenditure for the portfolio, such as voids, maintenance and/or refurbishment. Surplus income will be set aside into a revenue account and capacity within the annual revenue budget to support this will be built over the next 3 financial years.

It is important to acknowledge that the above principles are ongoing long term objectives and attaining balance will progress as the fund matures.

4. Fund Structure

Commercial property investments can be divided into different segments, based upon their position at differing points on the risk v return spectrum.



The following guideline Fund Structure is the basis of investment, adopting a prudent, income focused, strategy: -

	%	
Core	50% (+/- 10%)	Modern, or extensively refurbished buildings, fully let on long leases to good covenant tenants in major core markets.
Core plus	30% (+/- 20%)	Single or multi-let buildings, with various lease lengths and tenant covenant. Opportunity to add value.
Value Add	Max 15%	Higher risk assets that can be re-purposed to generate income.
Opportunistic	Max 5%	

5. Purchase Guidelines

- Target area UK wide, with focus upon the South East.
- Commercial real estate.
- Freehold, or long leasehold nominal rent purchases.
- Income producing properties, leased on conventional terms, secured against good covenant tenants.

6. Annual Review

To monitor performance and ensure proactive risk and opportunity management, the Annual Review will consider: -

Portfolio

- Market update on activity and forecasts to identify any re-purposing of any asset(s)
- Review of the current investment strategy
- An external market valuation of the portfolio to monitor and benchmark performance, meeting financial requirements.
- An updated three -year cash flow forecast
- An update of three-year capital expenditure forecast
- A review of retain, sale, re-purpose or re-gear of each asset
- Review of the previous year's performance including any (Key Performance Indicators) KPIs
- Review of the underlying lifecycle of the asset, holding period and refurbishment expectations.

Asset Management

Report to include: -

- Rent collection rates, arrears and service charge reconciliation.
- Advise on all critical lease matters including rent reviews, lease renewals, lease breaks and re-gearing opportunities.
- Dilapidations, health and safety and insurance claims.
- Capital expenditure over the preceding 12-month period.
- Tenant covenant strength monitoring report.
- Tenant compliance with lease terms and any default, or issue.

INVESTMENT PROPOSAL

Property Name/Location:
Vendor:
Tenure:
Category:
Price:
Rent per annum:
Rent Free:
Initial Yield:
VAT Election:
EPC:
Net Return After Borrowing

	Criteria	Criteria Description	Comments	Weighting	Weighted Property Score	Excellent	Good	Acceptable	Marginal	Poor
LOCATION	Location: Macro	Quality of the location (town, city, area) with regard to the property use		3	0					
	Location: Micro	Quality of the individual situation of the property within the macro location, with regard to the property use		3	0					
	Building Quality	Quality of the building compared to the Industry standard Grade A for the property type		3	0					
OCCUPANCY	Tenant Covenant	Ability of the tenant/s to pay the rent for the duration of the lease. Credit rating of the tenant		3	0					
	Tenure	Freehold / Long Leasehold. Consideration of any ground rent obligations		2	0					
	Lease Term	Length of the secured income.		3	0					
	Lease Structure	Tenant repairing obligations, rent review mechanisms		3	0					
	Rental Growth Prospects	Opportunity / Likelihood to increase passing rent/ ERV		3	0					
	Occupational Demand	Anticipated level of demand from alternative occupiers if the tenant/s were to vacate		3	0					
STRATEGY	Management Intensity	Complexity and cost of managing the property		2	0					
	Liquidity/Exit Strategy	The degree to which the property can be quickly sold in the market without affecting the price. Please provide specific commentary on exit strategy.		2	0					
	Alternative Use / Underlying Value	The value of the land and the opportunity to explore a change of use should this be required		2	0					
	Asset Management Opportunities	Opportunities to add value to the property		1	0					
	Financial Return (risk v reward)	The forecast gross financial return considering the risk profile of the property and in accordance with the sector with a focus upon income v capital values at lease expiry		4	0					
	Portfolio Strategy Context	The extent to which the property meets the strategy and contributes to the achievement of a diversified portfolio		3	0					

Weighted Score		A property will be expected to score at least 140 out of 200 (70%) on the above matrix unless there are other economic / wider benefits to be delivered.	0	

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Investment Decision Guide for fillingin matrix

example considerations

Criteria	Criteria Description	Maximum Weighted Score	Excellent	Good	Acceptable	Marginal	Poor
Scoring numerically between 1 and 5 as detailed in this guide							
SCORE TO APPLY TO EACH COLUMN			5	4	3	2	1

Shading denotes client to fill in

SCORING GUIDE

			SCORING CONTROLS				
Portfolio Strategy Context	The extent to which the property meets the strategy and contributes to the achievement of a diversified portfolio	15	Under-represented sector				Sector already heavily represented
Location: Macro	Quality of the location (town, city, area) with regard to the property use	15	Major Prime	Prime	Major Secondary	Micro Secondary	Tertiary
Location: Micro	Quality of the individual situation of the property within the macro location, with regard to the property use	15	Excellent transport / footfall				Location with limited benefit
Tenant Covenant	Ability of the tenant/s to pay the rent for the duration of the lease. Credit rating of the tenant	15	Excellent financial covenant	Strong financial covenant	Good financial covenant	Poor but improving covenant	Poor financial covenant
Building Quality	Quality of the building compared to the Industry standard Grade A for the property type	15	New, modern or recently refurbished	Good quality- no spend required for 20 years+	Good quality but spend required in 10 years	Spend required in 5 years	Tired / Significant spend CapEx likely
Lease Term	Length of the secured income.	15	Greater than 15 years	Between 10 and 15 years	Between 6 and 10 years	Between 2 and 5 years	Under 2 years / vacant
Lease Structure	Tenant repairing obligations, rent review mechanisms	15	Full repairing and insuring	Full repairing and insuring-partially recoverable	Internal repairing	Internal repairing-partially recoverable	Landlord responsible
Rental Growth Prospects	Opportunity / Likelihood to increase passing rent	15	Fixed uplifts at frequent intervals				Significantly over-rented (tenant paying above the
Occupational Demand	Anticipated level of demand from alternative occupiers if the tenant/s were to vacate	15	In demand from many tenants		Reasonable prospect of securing new tenants		Niche with limited demand
Management Intensity	Complexity and cost of managing the property	10	Single Tenant				Multiple Tenants
Liquidity	The degree to which the property can be quickly sold in the market without affecting the price	10	Lot size & sector attractive to investors				Attractive to niche purchasers only
Alternative Use / Underlying Value	The value of the land and the opportunity to explore a change of use should this be required	10	Favourable location / planning				No opportunity to change use
Tenure	Freehold / Long Leasehold. Consideration of any ground rent obligations	10	Freehold	Long Leasehold 125 years + / peppercorn ground rent	Lease between 100 and 125 years / peppercorn ground rent	Lease between 50 and 100 years	Less than 50 years and/or high ground rent (10%+)
Asset Management Opportunities	Opportunities to add value to the property	5	Significant opportunity to add value				No opportunity
Financial Return (risk v reward)	The forecast gross financial return considering the risk profile of the property and in accordance with the sector.	20	Return higher than expected for sector / the risk profile				Return lower than expected for sector / risk profile

Weighted Score		200	A property will be expected to score at least 140 out of 200 (70%) on the above matrix unless there are other economic / wider benefits to be delivered within or to the county.

SWOT

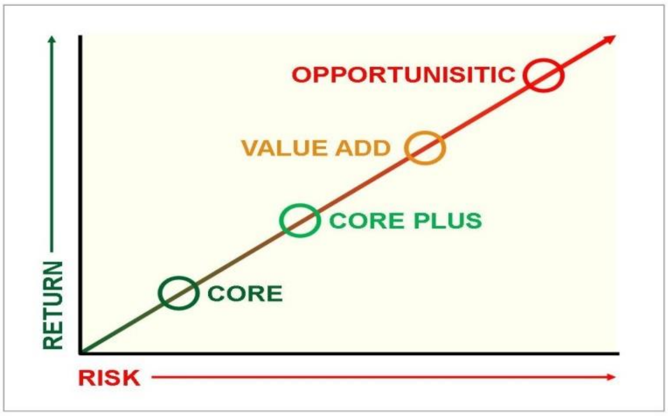
Strengths
Opportunities

Weaknesses
Threats

THE PROPERTY INVESTMENT STRATEGY

FUND STRUCTURE

Different fund structure segments provide a basis for dividing commercial property investments, based upon their risk profile, as illustrated in the below table.



These segments can be defined as follows: -

Core investments: - comprise the bedrock of a diversified portfolio and present minimum risk, being the least risky investment segment. Typically they comprise fully leased, secure investments to strong covenant tenants, in urban locations/markets that tend towards strong demand.

Attractive for the lower level of risk they provide compared to other investment types, which is reflected in the lower yield when compared to more risky property investments.

Typical property characteristics: -

- subject to long leases to strong covenant tenants on fully repairing terms.
- buildings are typically modern, in good repair and condition.
- the buildings have reduced depreciation and obsolescence, providing a stable relatively predictable income.

This type of investment suits investors who seek capital preservation and long hold periods. This type of investment is typically the most liquid, on the basis they are generally attractive, marketable assets when compared to the following segments.

Core Plus: - similar to core, but not quite as high quality in terms of tenant(s) locality or property. As a consequent, Core Plus presents a low to moderate risk profile, being slightly more than Core.

Typical Property Characteristics: -

- single let, or multi let, with varying tenant covenants
- Opportunities to improve buildings.
- Fairly liquid in a stable market.

Value Add: - More risky investments reflected in the potential for higher return by increasing property value.
Typical property characteristics: -

- Potentially vacant, partially vacant, or close to lease expiries, creating opportunities to make improvements.
- Opportunities to increase value could include physical improvements, such as refurbishment, or re-development, letting vacant space to stronger covenant tenants on more investor attractive terms, lowering operating expenses.

These properties carry more risk due to the property not operating to its full potential when acquired, commonly with less secure income. If the business plan to increase value does not succeed, a tenant fails, or vacates, there is potential for reduced return, or losses.

Opportunistic: - similar approach to value add, with additional risk due to property typically requiring substantive work to increase value.

Typical property characteristics: -

- Part of fully vacant when acquired.
- No income when acquired, with ongoing vacant running costs.
- Typically distressed property, requiring substantial investment.

These properties are considered high risk, with failure of a business plan typically resulting in financial losses.