

Committee: Cabinet

Date of meeting: 4 July 2018

Subject:	Investment Property Portfolio Report
Lead Officer:	Sarah Selvanathan, Strategic Director & Deputy Chief Executive
Portfolio Holders:	Resources: Councillor R Mitchell
Link to Council Priorities:	All
Exempt information:	None
Delegated status:	For recommendation to Council on 18 July 2018
Key decision:	N/A

Executive Summary:

This is the first annual report on the Council's Investment property portfolio and includes investment properties purchased since the Property Acquisition Strategy was approved in 2012.

The report notes the good progress made with the delivery of the strategy and detail performance of the Investment Property Portfolio (IPP) using the indicators adopted for its monitoring and reporting.

Recommended: that cabinet note the:

- (a) Progress that has been made in implementing the Property Acquisition Strategy.**
- (b) Strategic aims of the Council's investment Property Portfolio continues as set out in this report.**

Report:

1. Background

- 1.1 In 2012 a paper was presented to Cabinet to consider innovative ways of generating regular revenue streams, this was against a backdrop of Local Authorities facing a difficult financial climate with ever decreasing funding from Central Government. The paper considered the strategy for acquiring or developing investment property assets in order to strengthen the Council's long-term financial stability. In some cases, Property investments also offer the potential to unlock future development opportunities and provide extended services.
- 1.2 Furthermore, the paper considered some of the key considerations (in addition to affordability) when acquiring land and property interests:
 - There is secure rental income, so prudent borrowing can be considered for purchases (if required) taking into account the risk associated with security of future payments.

- Vacant sites and assets be considered where there is a strategic value of the property, particularly in relation to future development.
- There is an identified current or future service need.

This paper also presented the acquisition protocol, which is followed when acquiring Property.

Governance and decision-making arrangements for purchasing investment properties were approved initially in 2012 and then again in 2014 as part of the Council's Asset Management Plan. This included a member led Property Appraisal Group to take responsibility for reviewing Officer recommendations on property investment opportunities and support any recommendations to Cabinet and Council where final decisions are made.

2. Current Property Acquisition / Investment Strategy

2.1 In 2014, as part of the corporate plan, the corporate asset management plan was developed which expanded on the key considerations above and set out the criteria in which the council would consider potential future investment opportunities. Below is an extract from the plan setting out the criteria:

- There are measurable benefits (in addition to financial) within a maximum period of 15/20 years;
- Effective intervention will expedite agreed key strategies for the Borough;
- Acquisition involves partnering arrangements;
- Acquisition will consolidate the Council's existing land holding portfolio to facilitate larger developments;
- Acquisition will assist in the modernisation of the Borough's business infrastructure and/or encouraging inward investment, re-location and business start-up within the Borough;
- Acquisition is not in conflict with strategic planning policies
- Acquisition will not increase the Council's on-going revenue costs in the longer term;
- Acquisition type; Good quality commercial property in traditional sectors, ie retail, office and industrial;
- Return of at least 2% above borrowing costs bearing in mind there will be exceptions depending on future potential;
- Security; Medium to long-term strategy – Acquisitions should normally be pre-let to tenants of good covenant on fully repairing and insuring terms, with an unexpired term of at least 5 years;
- Each investment will have to be looked at on its own merit;
- Strategic value; Where a property has strategic value to the Council, some of the above criteria may be relaxed eg land capable of development or required to enable development;
- Further to the Corporate Asset Plan being developed these criteria have been used to identify potential opportunities and undertake a number of property investments. As stipulated above all acquisitions have been made within Borough Council boundaries.

Through the investment purchasing process, it is fair to say the Council have developed a good relationship with key investment agents and have gained a good reputation in the market of completing transactions within agreed timeframes and in a commercial manner, this has led to Elmbridge being offered more investment opportunities and increasingly more off market opportunities.

2.2 Current Property portfolio

The properties managed by Asset Management and Property Services are split into a number of categories, Investment properties, Operational properties and Community properties. The focus of this report is the Investment properties. Currently there are 13 Investment properties within the portfolio and at the end of March 2018, the investment properties held by the Council were valued at £74.015 million. At the end of March 2017, the value of investments properties held was £42.7 million with the increase mainly attributed to the two new properties purchased during 2017

The gross rental income received during 2017/18 was £3.1 million compared to £1.9 million in 2016/17, a 63% increase mainly to do with the properties purchased during the year.

At 2018/19 rent levels, these properties produce a total of £3.8 million gross annual income.

- 2.3 There are no restrictions on the Council's ability to realise the value inherent in its investment property or on the Council's right to income and the proceeds from sale.

Gross Income from current property investments held in the portfolio:

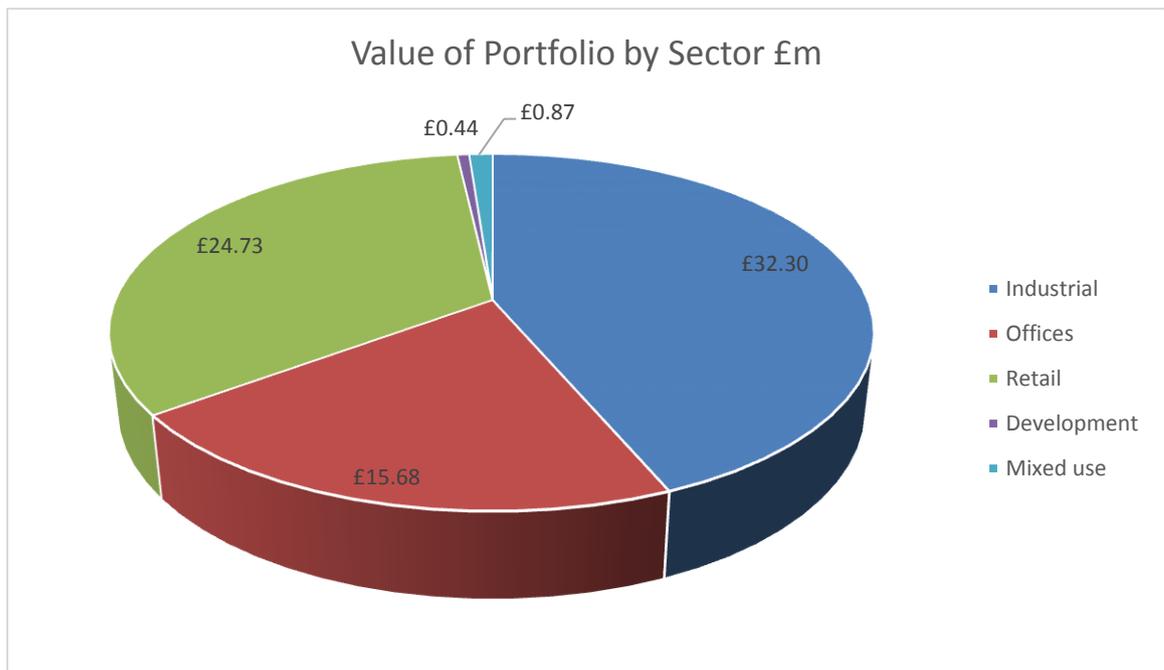
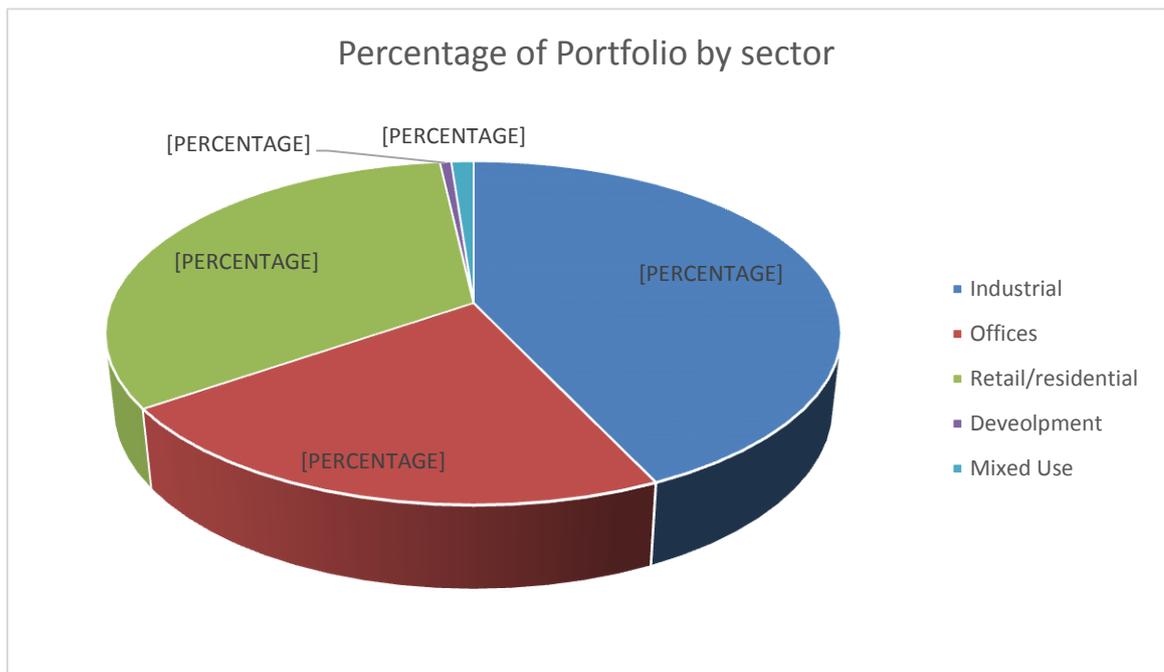
Property	Sector	Annual income at 18/19 Rental levels
Old Post Office, Esher	Offices	£139,000
Fairmile House, Esher	Offices	£105,326
Consort House, Weybridge	Offices	£350,000
Unit 1&2 Vickers Drive	Industrial	£772,856
Thomas Hardy House, Weybridge	Offices	£385,500
26-38A High Street Cobham	Retail/ Residential	£454,300
Garages Cobham	Garages/Development	£0
21 High Street, Weybridge	Retail/Residential	£54,940
River Mole Business Park, Esher *	Industrial	£52,725
North Weylands Industrial Estate, Hersham *	Industrial	£134,180
Elm Grove Walton upon Thames*	Mixed Use	£52,500
50-68a High Street Weybridge	Retail/Residential	£760,471
Sandown Industrial Estate	Industrial	£551,932
Total		£3,813,730

* Assets already owned by the Council as Investment Properties prior to 2012

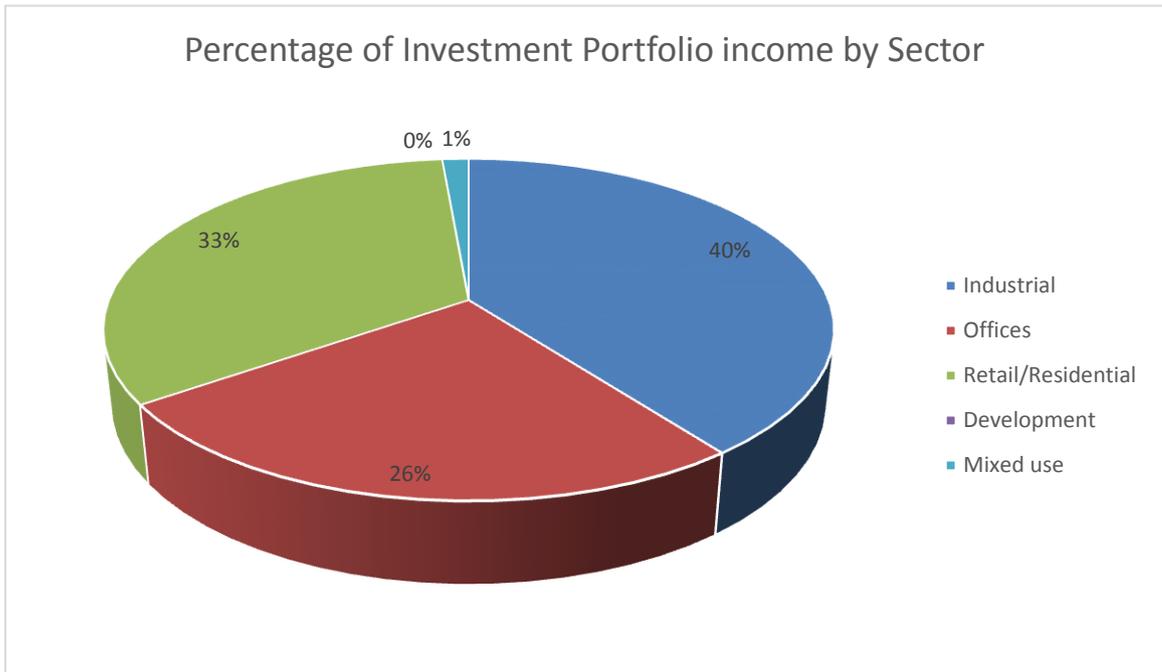
The following graphs demonstrate the breakdown of the Investment Portfolio to show how the portfolio is split.

Value of the investment portfolio by sector

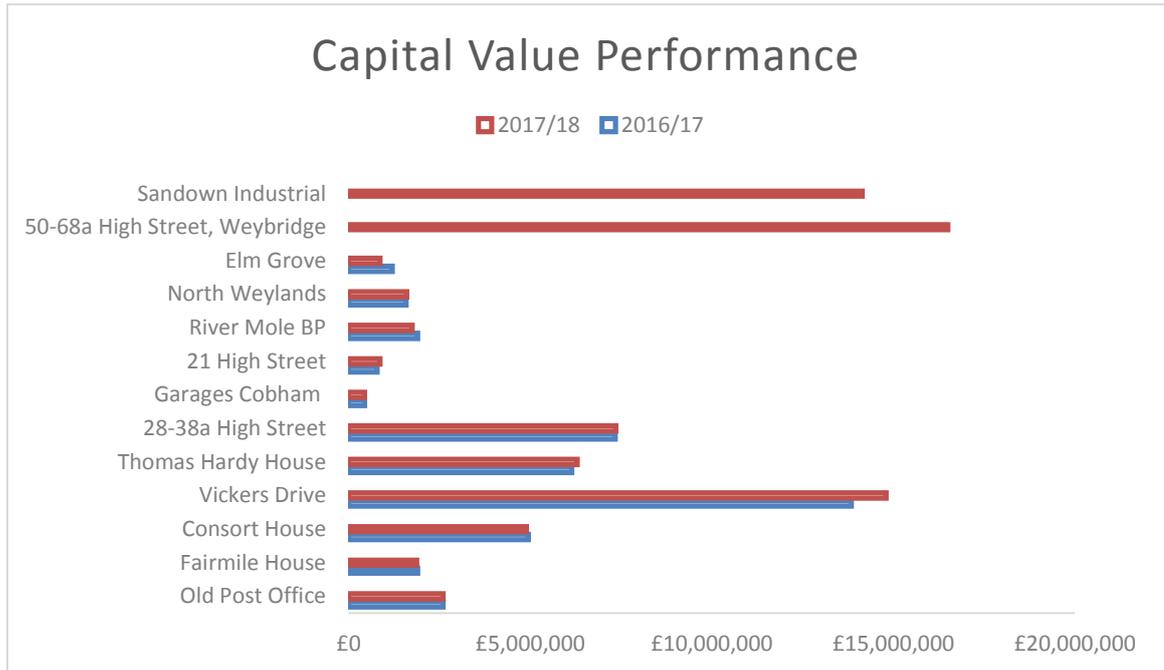
The graphs below show how the investment portfolio is weighted by value and income



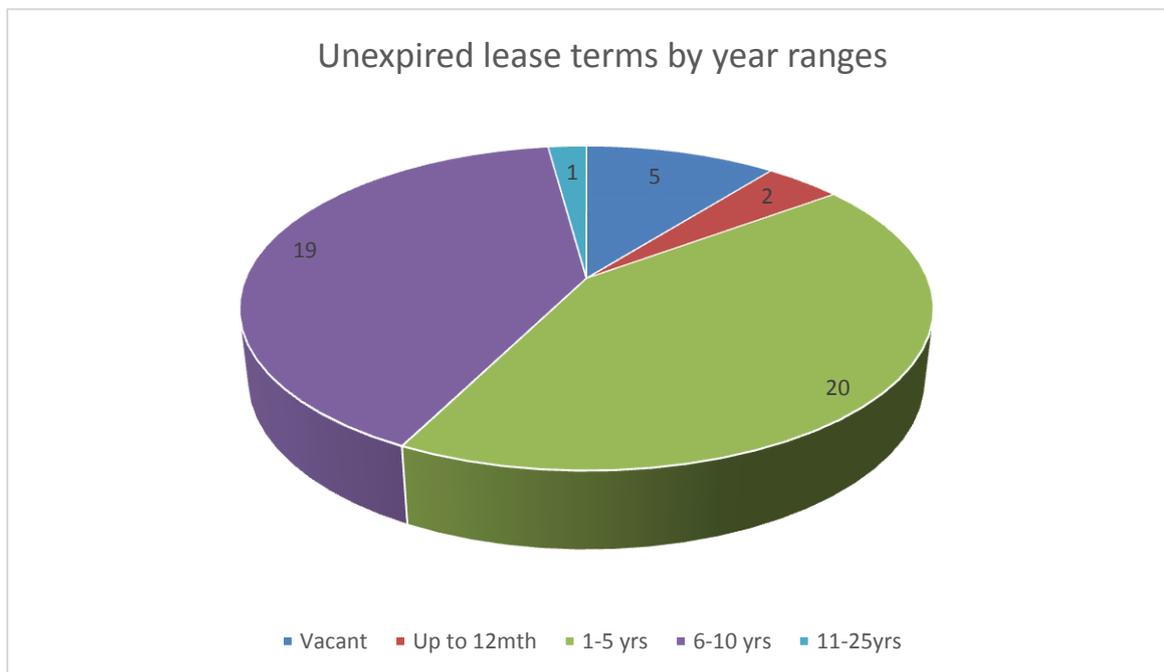
Percentage of Investment Portfolio income by sector (at 2018/19 levels)



The graph above demonstrates the average unexpired lease term within each sector, compared with the average lease term granted. The industrial numbers are slightly skewed as there are two leases which have a lease length of over 50 years.



The graph above shows how the assets have changed in value over the last two years.



The above graph shows the majority of the leases within the Investment portfolio have an unexpired lease term less than 10 years, approximately 50% of these leases are in assets where future regeneration is being considered.

Key Indicators

The following key indicators can also be used to monitor the portfolio performance as reported below:

- 1) Effective Return – Income received less costs, expressed as a % of capital value

Year	Asset Value (£'000's)	Gross Income	Gross Effective Return %	Net Income (£000's)	Effective Return (net income) (%)
2016/17	42.700	1,984	4.6	1.25	2.93
2017/18	74.015	3,092	4.1	1.732	2.34

- 2) Increase in Asset Value- Percentage increase by year including new asset purchases.

Year	Asset Value (£'000)	Asset Growth (%)
2013/14	18,493	
2014/15	19,780	6.95
2015/16	28,160	42.36
2016/17	42,700	54.6
2017/18	74,015	73.3

- 3) Income Growth – Percentage increase in gross income per year

Year	Gross Income (£'000)	Income Growth (%)
2015/16	1,369	
2016/17	1,984	44.9
2017/18	3,092	55.5
2018/19 (budgeted)	3,813	23.3

- 4) Vacancy Rate expressed as a percentage where units are vacant

Property	Vacancy Rate	Potential rental (estimated) £'000	Comments
Cobham Garages	100%	14	Held vacant for development
River Mole	57%	56	Considering internal use
50-68 High Street, Weybridge	9.9%	90	Actively marketing

Performance of the portfolio is strong and monitoring over a few years will enable the Council to better gauge relative performance in any one year and identify an area of the portfolio that requires specific action. There are industry wide indicators for investment properties such as the IPD index (Investment Property Databank) and acts as a useful reference point for assessing the performance of the Council's portfolio. Further indicators will be developed and reported in future reports.

Although the uncertainty attached to the outcome of the Brexit negotiations will continue to adversely affect the value of UK commercial property market, the investment sentiments towards UK commercial real estate remains positive and is viewed as a "safe haven" which is evidenced by the continuing flow of capital into the UK. It is considered that strong demand for distribution warehouses will continue to drive rental growth in this area.

Overall, there will be pressure on risk premiums on property to increase which would continue to hold down growth in asset value and consequently expect total returns to halve compared with 2017. The key strategy for the Council's own Portfolio remains maintaining revenue income levels through minimising vacancies and seeking revenue growth through rent reviews and asset management interventions.

3. Asset and Property Management

- 3.1 The majority of the property owned by the council is managed in-house within the Asset and Property Services team, however, the multi-tenanted investment properties are increasingly managed by external managing agents. These external managing agents have the expertise and resources to deal with the intensive nature and large service charges often attributed to these types of assets. Having said that the estates surveyors work with the managing agents and the tenants, to ensure effective management arrangements are in place.
- 3.2 When acquiring properties, officers will use external agents to advise on the purchase which provides an independent view and benefit from their external expertise, to ensure the best result is achieved and the council's position is fully protected.
- 3.3 In respect of managing the asset management process a new property management system has recently been procured, Tech Forge, the introduction of this database will enable the team to manage the accuracy of the data and to ensure the properties are managed efficiently and effectively. It is expected that Tech Forge will be operational in the summer 2018.
- 3.4 In addition, individual property asset management plans are produced for each of the investment properties to help manage the asset.
- 3.5 These asset management plans set out a brief synopsis of the key criteria of the investment property, including tracking the value of the property and sets out a clear short to medium term strategy for each individual property. These asset plans are reviewed and updated on a quarterly basis, and provide a clear picture of the property, it's strategy and what we are looking to achieve moving forward.

4. Property Market outlook

- 4.1 Total property trading volumes in 2017 exceeded £65bn, up more than a quarter of trading volumes in 2016. The biggest growth area was the Industrial sector which saw trading volumes exceed £10bn and accounted for 17% of all activity. Offices accounted for 37% of all activity and Retail fell to account for only 18% of all transactions. Interestingly overseas investors continued to account for nearly half of all transactions undertaken in 2017.
- 4.2 Looking forward to 2018, Colliers International's research report forecasts commercial property returns of 6.1% for 2018, down from 10.2% in 2017, this is broken down in to 1.2% capital growth and 4.9% income return. At 5.6% the all property equivalent yields are expected to remain unchanged against 2017 as investment demand remains steady. However, they believe that total returns will slow further to 4.9% in 2019.
- 4.3 The industrial market is expected to perform well with total returns forecast to reach 12.5%, with all regions performing well but particularly London. The office and retail sectors are forecast to see much weaker returns in 2018. The Office sector is anticipated to see total returns on 4.2%, with South East Offices seeing a total return of 7.5%. The Retail sector will struggle in 2018 with weak consumer confidence and increased costs. Total returns are forecast to be 3.5%.

5. Future Property Acquisition Strategy

- 5.1 The previous sections have set out the investment criteria, the changes and current position in the investment portfolio. However, the investment criteria were agreed nearly five years ago and in accordance with good portfolio management it is prudent to review the criteria and address any changes that need to be considered in light of any changes in the Elmbridge Borough Council's Corporate plan and with Property Market trends and outlook.
- 5.2 Having considered all of the above it is recommended that the investment criteria set out in the 2014 Corporate Asset plan is still valid. Although, the Council has decided not to look at specific sector weightings for the investment properties held, consideration should be given to not place too much reliance on a specific sector to ensure a balance is created and the risk is spread across all sectors, albeit still within Elmbridge Borough boundaries
- 5.3 In addition, an increased focus should be on regeneration benefits of purchasing certain assets within the borough, this is not necessarily at the expense of income on the asset but an additional consideration/benefit in considering whether to purchase an asset. Furthermore, the hold period of an asset should be considered on purchase and part of the approval process, whether short term to meet regeneration requirements or long term where a single let investment provides a long term stable rental income for the Council.

Financial implications:

To date, the Council has invested £ 70 million in purchasing investment properties. Two thirds of the funding has come from borrowing (£47 million) and the balance (23 million) from Council Reserves.

Minimum Revenue Provision (MRP) and debt interest payments are correctly accounted for in the relevant periods.

Ministry of Housing, Community and Local Government (MHCLG) guidance on investments and CIPFA's Treasury Management code places some restrictions on continuing to invest in commercial properties. However, the Council's Property Acquisition strategy supports investment within the Borough boundaries and there are no adverse implications as a result of the changes.

Given the forecast of the various property sectors, it will prove difficult to purchase properties with a return of 6% which also benefits from a strong tenant covenant. Therefore, the criteria "return of at least 2% above borrowing costs" will become increasingly difficult to achieve in the coming months/years.

Environmental/Sustainability Implications:

There are none identified in this report.

Legal implications:

There are no legal implications in this report.

Equality Implications:

There are none identified in this report.

Risk Implications:

A separate ear marked reserve is held on the Council's balance sheet which can be used for voids and rent-free periods and one-off costs relating to the investment property portfolio such as necessary improvement works to properties.

MRP and debt interest payments are correctly accounted for in the relevant periods.

When investing in Property, careful consideration is given so that too much reliance is not placed on one specific sector which helps to spread the risk across all sectors, albeit still within Elmbridge Borough boundaries

Community Safety Implications:

There are none identified in this report.

Principal Consultees:

Portfolio Holder for Resources.
Council Management Board.

Background papers:

Enclosures/Appendices:

None.

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