B&NES Commercial Property Investment Strategy

A Background Paper to inform the budget setting process for 2018-2019

This paper will be updated in accordance with emerging Government guidance

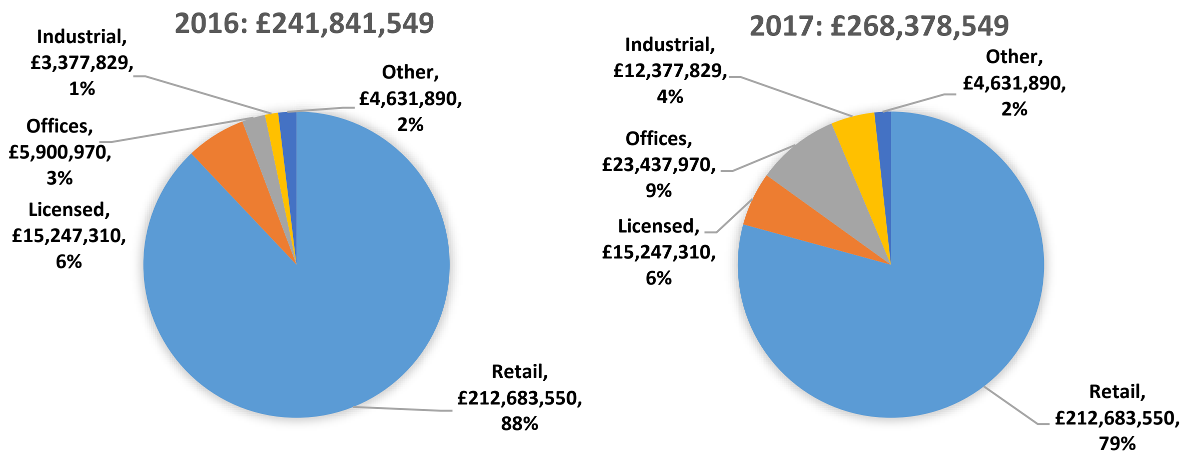
Objective

To provide additional revenue for the Council through direct investment in commercial property, delivering income, rental and capital growth, over the long term. The objective central to the Investment Strategy is the growth of secure net income which will be earmarked to protect specific frontline Council services, notably adult's and children's social care.

The current portfolio

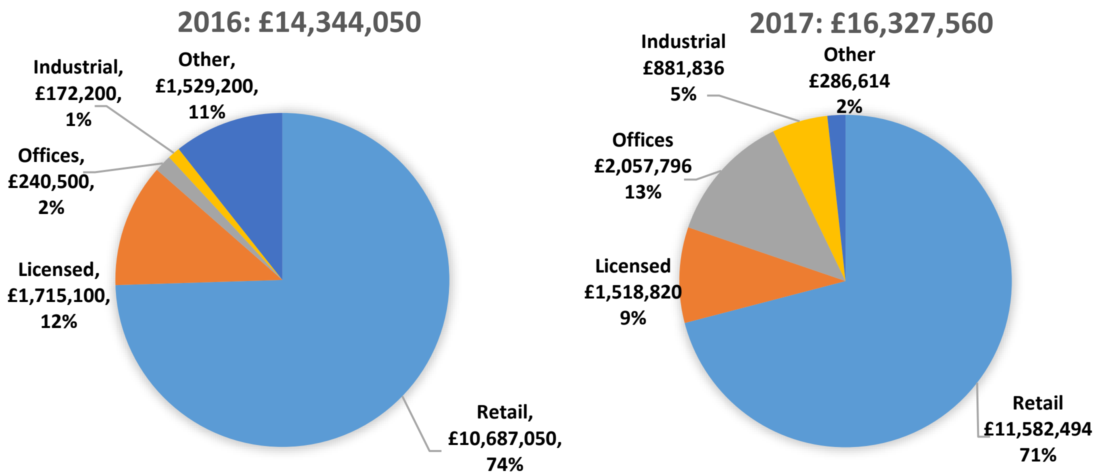
The asset value of the Council's commercial estate at the time of publication of this document is outlined below for the previous two years, the value of the assets is apportioned by property sector:

Value of the Commercial Estate



The revenue from the commercial estate is outlined below for the previous two years, these figures are rental income per annum and apportioned by property sector:

Revenue from the Commercial Estate



The Council invests in different types of commercial property across different property sectors (such as retail, offices and industrial). The vast majority of the portfolio by income comprises high quality retail assets in Bath city centre.

As part of the Investment Strategy the Council will actively manage their existing portfolio to ensure the properties are contributing to the growth of the secure net income that the portfolio generates. Reviewing the existing estate will include prioritising lease renewals and lease extensions, rental increases at rent review where the passing rent has fallen behind market rent, and any other asset management initiatives to support the Council meeting their objectives.

The Council have proactively managed the commercial estate and made strategic investment decisions for many years and the approach outlined in the Investment Strategy is not a new one. The Investment Strategy formalises the approach taken by the Council and will build on what is being done already.

Addressing the threats to the existing portfolio

A key part of the strategy for new investment is consideration of how they will address current imbalances in the estate. One of the threats identified is the fact the estate is over weight in high street retail properties. High Street rents have been rebased in the last 10 years. High street retail is not a sector where rental growth is forecast, going forward this represents a threat to the estate.

Future acquisitions will address sectors where the portfolio is underweight in order to create a more balanced portfolio. One of the aims of the Investment Strategy will be to acquire property in sectors which are seeing rental growth and where rental growth is forecast to continue. This approach will organically grow the secure net income from the estate.

To address the over exposure to the high street retail sector in the last two years the Council has increased their holdings of office and industrial properties investing circa £26million in 3 new properties producing additional income of £1,871,909 per annum. The impact of these acquisitions can be seen in the 2016 and 2017 figures presented in the charts above.

Risk Management Approach

As part of the process of drafting this Investment Strategy the Council has taken the following steps to ensure a proactive approach to risk management:

- <u>Qualified property advice</u>
  The Council have appointed Hartnell Taylor Cook LLP to act as 'Strategic Property Advisor' to supplement the in house property team's expertise. The Council have access to a multi-disciplined team of property professionals at Hartnell Taylor Cook LLP to assist with all aspects of the management of the commercial portfolio, including detailed appraisal of potential acquisitions.

- <u>Gearing level</u>
  Advice has been sought on the appropriate level of gearing for the portfolio and how this should be benchmarked. Staying within the agreed gearing ratio will ensure the Council's portfolio is protected from the risk of fluctuations in the rates of borrowing.

- <u>Business Case for each acquisition</u>
  New properties that are purchased will be supported by a Business Case detailing how they fit the Council's investment criteria, any associated risks and how these can be mitigated

- <u>Legal advice on purchasing commercial properties</u>
  The Council have taken legal advice from Trowers and Hamlins LLP regarding the legal powers available to the Council to acquire commercial properties outside of its geographical area.

Investment approach

The Council is aiming to increase their secure net income from the commercial portfolio and looking to acquire additional commercial property investments in the course of the next year, focusing on:

- Secure assets let on long leases
- Acquiring properties that create immediate income ie properties that are already let
- Institutional quality assets to ensure liquidity
- Diversifying the existing portfolio to address existing threats to the estate
- Investment in alternative property sectors; including hotels, supermarkets, index linked investments

Criteria for evaluating acquisitions

For each new asset the Council will review the structural and risk implications of adding the property to the portfolio. The risks associated with any new acquisition will be appraised prior to the acquisition and the Council will consider the following criteria for evaluating acquisitions:

- Location
- Building quality
- Quality of the income/financial strength of the tenant
- Rental level compared to market level and potential rental growth
- Tenant demand for property were it to fall vacant

The investment criteria has been set out in the attached 'B&NES 2017 Requirements list' as prepared by the B&NES property department. This list will be reviewed on a quarterly basis and modified where appropriate in the context of property market trends and changing investor sentiment.

Asset Selection

In addition to the above considerations the Council will address the following in their appraisal of new assets. Each is a key consideration which needs to be carefully appraised when assessing the price the Council will pay to acquire the property and the income yield that will be generated. Higher yields will be generated where there is greater tenant risk and shorter unexpired terms:

- <u>Tenant Risk</u>

  For each new property a Credit Safe check will be carried out on each tenant. Credit Safe provide a rating for the covenant strength of each tenant based on their last three years financial accounts. The higher the rating the more secure the tenant and the Council will target properties where there is minimal risk of tenant default. Tenants with a low Credit Safe rating will need be carefully appraised.

- Lease expiry (unexpired term)

The Council are aiming to grow secure long term income from their property acquisitions and will target longer leases for their investments. There will be opportunities to buy properties where tenants have a shorter term to their lease expiry, perhaps 2-3 years, and these will still be considered but alongside an asset management plan detailing how the lease could be extended. Through active asset management the Council may well be able to extend the unexpired term. These assets are likely to be acquired for a higher yield initially and if the term of the lease can be extended will represent good value for the Council.

- Opportunity for rental growth

At the point of acquiring the property the passing rent will be assessed in relation to the open market rent. In some cases the rent will be reversionary and the Council will benefit from a higher level of rent at the next rent review or lease renewal. The opportunity for rental growth will be closely linked with tenant demand in the particular location. The Council will consider whether there is currently an undersupply of a certain type of property which could drive rental growth going forward, for example the industrial market which is currently enjoying solid rental growth in the south west.

- Asset management opportunity

The Council will consider for each property acquired whether the tenant covenant can be improved, whether the lease term can be extended or break clauses be removed and whether at rent review there could be an improvement in the rental level. The Council will consider each property at the time of the purchase and the active asset management initiatives that could be undertaken to ensure the property will provide long term secure income in the future.

Appraising property asset life

Central to the appraisal of any new property investment will be considering the repayment period for the loan taken out to purchase the property. The Council will pay back the borrowing over the life of the asset in line with existing Council financial policies. Each new property purchased will be required to justify itself as a standalone investment and will be appraised to ensure it has an asset life in excess of 50 years.

Over the borrowing period there may well be additional capital expenditure required to upgrade and therefore enhance the capital value of the property, which will maintain and improve the income stream generated.

For each new acquisition the estimated cost of works that will be required to the building over the 50 year period will be considered. A building survey will be undertaken which will highlight short, medium and long term items of capital expenditure required to ensure the lifetime of the building is extended and in all cases will extend beyond the borrowing period.

Legal Powers

The Council have taken legal advice from Trowers & Hamlins LLP in relation to the acquisition of commercial properties outside the Borough boundaries. The advice concludes that the Council is able to use its general power of competence so long as it ensures that the purpose of the acquisition of the out of borough commercial properties is not for a commercial purpose.

For each new property purchased the Council will direct the revenue generated into specifically earmarked front line Council services, notably adult's and children's social care. The purpose of the Investment Strategy is to create a revenue stream for the Council's non-commercial functions.

Gearing

The Council will make investment and borrowing decisions mindful of the gearing of the whole portfolio. Gearing is generally described as a company's total debt expressed as a percentage of the value of its total equity. In the case of B&NES, the value of its property portfolio. Individual assets will not stand alone and it is the gearing ratio for the whole portfolio that will be tracked and reviewed.

The portfolio's current gearing is in the order of 21%, which is an acceptable level for a commercial investment portfolio.

The Council's target is to increase borrowing against the value of the entire estate but keep the portfolio gearing below a rate of 35%. This is an acceptable percentage, as an industry standard a gearing ratio of 20-25% is considered to by lowly geared and a ratio above 50% is considered to be highly geared.

Investment Target over the next 12 months

The Council's Budget Document 2018-2019 includes details of the targets of how much money shall be deployed into commercial property investments in the next 12 months. The Budget Document also contains the target for additional revenue to be generated after paying borrowing costs.

The Investment Strategy will enable the Council to meet these targets through strategic property acquisitions.