Cherwell District Council

Property Investment Strategy

Assistant Director Property Investment and Contract Management

1 Introduction

1.1 This strategy document in line with the CDC Property Management Strategy sets out the investments the Council holds and the underlying principles supporting those investments and the decision-making process for investing in property to enhance the Council's financial resilience and safeguard services. It places the Council's investments into the context of its overall financial position, outlines the contributions that the different investments will make to service delivery and gives an indication of the performance of those investments.

1.2 This policy sets out Cherwell District Council (CDC) property acquisition investment objectives for the year 2021/22. It also sets out the criteria that will be applied prior to either recommending an investment purchase or recommending substantial investment in an existing asset to the Investment Committee.

1.3 The policy draws a distinction between:

- Investment Property where the principal advantage of ownership is the rental return a property generates
- Regeneration Property where the principle objective of investment is to catalyse the regeneration of an area or halt further decline and
- Operational Property where the rationale for ownership / capital investment is CDC's own occupation to facilitate the more effective delivery of council services.

1.4 The policy will outline in overview the governance structures that will set the framework for decision making (although each investment is assessed on its merits) and also some high-level background on the current investment climate.

1.5 It is intended that the investment strategy is reviewed annually. For the year 2021/22 there will be a presumption against the acquisition of additional Investment Properties and likewise for Operational Properties save where without the newly acquired asset CDC will be unable to deliver core council services within a three-year timeframe. An example of this would be the acquisition of an alternative depot facility in Bicester to replace Highfield Depot. However, there is no funding allocated neither in the capital budget, nor in the revenue budget for borrowing costs in 2021/22 for such acquisition.

1.6 The embedded strategy within the plan is a Plan-Do-Review approach via annual reviews and analysis of the portfolio performance to generate revised Action Plans, Risk Management Strategies and Performance Targets.

2 Policy Details

2.1 Overview of Investments

The Council holds a number of different income-generating investments which can be classified into three main categories:

- Investments held for treasury management purposes (e.g. investment in short-term bank deposits and call accounts, money market funds, and deposits with the UK Government and other Local Authorities)
- Loans to subsidiaries such as Graven Hill Village Development Company Ltd
- Alternative investments: tangible assets such as real estate or asset backed loans.

This document is exclusively focusing on the Council's Alternative / Real Estate investments.

2.2 Alternative Investments

2.2.1 All commercial property investments the Council holds and makes are categorised as Alternative Investments.

2.2.2 The Council has a portfolio of investment properties. These are properties which are held principally for the rental income they generate. They are not intended to be used to deliver services although at times they are occupied by Council Departments, such as Environmental Services at Thorpe Place, an investment property located close to CDC's Banbury Depot or the Customer Services' Link Point in Franklins House in Bicester. The income they generate helps fund the Council's service delivery objectives and its Corporate Priorities. The properties in the portfolio can be split into two groups, those that have been:

- owned by the Council for many years e.g. district centres; or
- purchased more recently by the Council as part of its continued investment programme and with regeneration objectives e.g. Tramway Industrial Estate, Castle Quay Shopping Centre and Castle Quay Waterside

2.3 Contribution to Service Delivery Objectives

2.3.1 All investments the Council holds should contribute in some way to the Council's service delivery objectives and help to achieve the Council's corporate objectives and priorities as defined in its Corporate Plan.

2.3.2 The contribution of the Council's investments to these objectives will not always be immediately evident but the income they generate supports services across the Council. Whilst it is not possible to draw a straight line from commercial rental income to the Council's service outcomes it is clear that their contribution each year towards the Council budget (£5.3m in pre-Covid period) is substantial.

2.3.3 Nor is the contribution of commercial property investment always purely financial. Whilst property returns can generally be described in terms of yield and profit this does not always tell the whole story and targeted investment can support the following Council objectives.

- Thriving local economy

Targeted investment can support the Council's economic development ambitions such as supporting the districts town centres, local businesses and jobs. An example of this is CDC's investment in Castle Quay Shopping Centre.

- Economic benefit or business rate growth

  The investment has assisted in creating new opportunities for local businesses or has increased the Council's business rates base. These investments will generally be linked to projects or developments promoted by the Local Plan, such as Castle Quay Waterfront, or historically Pioneer Square and Franklin's House in Bicester. However, the benefit of business rates growth would only be retained for a time limited period.

- Respond to local market failure

  There may be instances where the Council needs to step in and invest in a development or other entity within the District where, without Council support, the impact on the local economy would be detrimental. Examples of this include our ongoing capital investment in community assets such as Community Halls or more entrepreneurially, the provision of 52 apartments for rent in Crown House, Banbury.

- Regeneration

  The investment will help (or has helped) to drive regeneration. There will generally be a link to the Local Plan when this type of investment occurs. E.g.: Tramway Industrial Estate, Castle Quay Waterfront, or indirect investments such as Crown House or Graven Hill (loans to subsidiaries).

- Better Use of Assets

  The Council own land and buildings with embedded (re)development potential and these which include car parks, retained land and council occupied assets have historically been under-appreciated. Value can be realised either through a sale of these assets or it can be maximised by direct development and we have this expertise and can build upon it (Castle Quay Waterfront, Crown House, Build!, Bicester Eco Centre).

  It is possible for individual investments to meet more than one objective.

2.3.4 However, whilst the Council would like to invest in all of these categories to drive better outcomes for the residents of Cherwell, in practice suitable opportunities are few and far between. With the probable exception of using Council assets for principally residential development investment in regeneration projects or addressing market failure is risky and carries with it an inherent risk of capital loss.

2.4 Investment philosophy

2.4.1 The Property Team have established a set of criteria which are designed to allow the Council to systematically assess risk and consider the likely future performance of the Council's investments. These are summarised in Annex 1.

2.4.2 Security of capital is the underlying objective of all financial investments made by the Council. This means that the safety of the Council's money is the main criteria considered when deciding whether to make an investment.

2.4.3 The yield (or return on investment) is only considered once the appropriate level of security of capital has been determined and satisfactorily met by the proposed investment. However, it is possible for the relative balance between these principles to differ depending on the nature and objectives of the individual investment being made, particularly where regeneration or social factors are prominent drivers of a particular project. It is imperative that the downside financial risks of any such project are appreciated and balanced against the targeted regeneration or social upsides. This balancing of financial risk and non-financial reward is not an exercise that the Property team can undertake in isolation. Quantifying the value of environmental and social good outcomes, possibly at the prejudice of income security / risk and returns, is an exercise that the Property Team can only undertake by working closely with other service teams.

2.5 Market Outlook

2.5.1 The impact the Covid crisis is having on the UK economy is significant and there is little to be gained from rehearsing its evolving consequences in this policy. We are however clearly living through a period of tremendous social and economic turbulence and whilst attempts to quantify Covid-19's long term effects remain uncertain; few would argue that national prosperity and confidence have been severely damaged.

2.5.2 With the exception of one or two important sub-sectors (distribution, for example) this has translated in property terms into declining capital values, a drop in transaction volumes and a fall in both occupier and investor confidence.

2.6 Public Works Loan Board (PWLB) limitations

2.6.1 PWLB is the principle source of borrowing for local authorities but there have been increasing calls from CIPFA and other industry leaders for central government to address what has been seen by many as local authorities taking on disproportionate levels of debt in order to buy investment properties.

2.6.2 Following extensive consultation with local government HM Treasury has issued a summary document titled 'Public Works Loan Board: Future lending terms', whose recommendations became effective 26 November 2020. In the context of this policy to CEDR its two key impacts are:

2.6.3 Interest rates

Interest rates on PWLB lending will be decreased by 100 basis points (bps) (1%). This is essentially a reversal of the 100 bps increase in rates announced in October 2019 and, for example, 40-year annuity rates are at the time of writing this policy set at 1.92%. CDC is a qualifying authority which means that this rate can be reduced by 20 basis points (0.2%) if certain reporting requirements are met.

2.6.4 Ban on cash-flow acquisition

On all new lending the PWLB will ask a local authority's finance director to confirm that there is no intention to buy investment assets primarily for yield at any point in the next three years. This in effect prevents local authorities accessing PWLB funds for any purpose if it is their intention to acquire properties purely to generate income, either with or without debt.

2.6.5 A short extract from the guidance is pasted below:

> 1.10 The main features of the new lending terms are:
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> a) As a condition of accessing the PWLB, LAs will be asked to submit a high-level description of their capital spending and financing plans for the following three years, including their expected use of the PWLB. In order to minimise the administrative burden for LAs, this process is closely modelled on the existing application process that most large LAs follow to access the Certainty Rate (a discounted rate offered by the PWLB).
>
> b) As part of this, the PWLB will ask the finance director of the LA to confirm that there is no intention to buy investment assets primarily for yield at any point in the next three years. This assessment is based on the finance director's professional interpretation of guidance issued alongside these lending terms.
>
> c) It isn't possible to reliably link particular loans to specific spending, so this restriction applies on a 'whole plan' basis – meaning that the PWLB will not lend to an LA that plans to buy investment assets primarily for yield anywhere in their capital plans, regardless of whether the transaction would notionally be financed from a source other than the PWLB.

2.6.6 In simple terms the application of these provisions in a CDC context is to make borrowing costs to finance the purchase of operational property (and probably to fund regeneration projects) more competitive, whilst simultaneously making the use of PWLB funds to acquire conventional commercial property investments virtually impossible.

2.6.7 As a public body CDC's finances are a matter of public record and it is clear that if CDC in the future wish to access PWLB funds as part of its day to day operation, the purchase of income producing assets is effectively no longer currently possible.

2.6.8 However, subject to the principles of prudential borrowing and Minimum Revenue Provision applying, borrowing to acquire property for operational or regeneration reasons remains an option.

2.7 Governance

The Investment Advisory Board, a non-decision-making Working Group, was created in part to facilitate the further growth of the investment portfolio. The Board and its role are noted in the constitution of the council and its powers and constitution is outlined in Annex 2.

2.8 Strategic approach

The Property Investment Strategy aims to provide a clear set of objectives and a framework, compliant with HM Treasury and CIPFA guidance and legislation, by which new projects are evaluated. In doing so it will deliver the Council Objectives/Corporate Priorities with a focus on commercialism – projects that generate a revenue surplus –

but which also deliver wider economic or service objectives e.g. regeneration / job growth.

2.9 Real Estate Investment and Disinvestment

Investment

2.9.1 In a commercial property investment market currently characterised by falling capital values and Covid uncertainty local authorities will have a general presumption against making new investments. This decision is reinforced by what is in effect a moratorium on investing in lower risk assets which is a consequence of the new PWLB lending regime.

2.9.2 Therefore, the focus will instead be on maximising the embedded development potential of the Council's existing portfolio and for the 2021/22 financial year this will principally be on its retained land assets where residential value can be released. This approach is explored in the Strategic Property and Asset Management Plan where the land portfolio is examined on a site by site basis.

Disinvestment

2.9.3 The ongoing suitability of CDC's operational properties for continued occupation is under constant review and this too has been discussed in the Strategic Property and Asset Management Plan. Given the current market uncertainty it is not envisaged that the Council would divest in any of its current property assets.

3 Conclusion

3.1 Subject to the above the following principles will underpin the CDC Property Investment Strategy:

- There should be a general presumption against investing purely for yield in the year 2021/22 as the property market and the economy is too volatile to confidently predict the direction of capital values. Furthermore, these types of investments would limit the Council's ability to borrow from the PWLB.

- Wherever possible investment for regeneration or social good should be directed to land and buildings currently owned by the Council. This will optimise profits and reduce capital risk.

- Investments that relate to regeneration should be pursued only when through vigorous stress testing the risk of capital loss is judged to be extremely low, and the social benefits are tangible.

- All acquisitions that have planning risk will only be acquired on a subject to planning basis.

- Whilst there should be a general presumption against the disposal of income producing assets in line with the Strategic Property and Asset Management Plan this presumption will be reviewed on an asset by asset basis at the start of each quarter. This reflects the uncertainty of the occupational property market due to Covid and at present the retail and leisure focused investments are thought to be particularly vulnerable to further movement which may precipitate a review of this presumption.

Annex 1 – Investment Decision Factors

- Compatibility and ability to balance the existing portfolio

  Compared with cash investments, property is relatively difficult to sell and convert to cash at short notice and market conditions can impact on how long a sale can take. In order to mitigate against this, the diversity of the portfolio will be maintained to ensure that if there is a need to sell an asset to release cash, the Council can take advantage of the different market conditions for the different sectors.

  Generally new investments will add diversity and balance to the existing portfolio as well as providing yield.

- Market value

  External advice is sought to gain assurance over the market value of a potential purchase to ensure that the price sought by the vendor is not inflated. The advice will include an analysis of current value, lettability in the event of tenant failure and what possible alternative uses are available for the property or site if the current tenant vacates. This enables the Council to take a view on future values in the event of a change in circumstances.

  External advice will usually take the form of a Purchase Report from a retained agent and a third party wholly independent valuation.

- Credit rating of the tenant

  The strength of the existing tenant(s) within a proposed acquisition is assessed. A strong tenant is important as there is less chance of them defaulting on lease payments and thereby putting the Council’s income stream at risk. Credit reference agencies along with Companies House searches are used to carry out this area of due diligence.

- Length and terms of the lease

  In order to minimise the risk of rental values going down following the renewal of a lease, the Council will prefer to invest in properties which have long term leases in place and strong tenants. The Council also ensures that leases place the onus for insurance, repairs and maintenance on the tenant so that the Council does not incur any additional or unforeseen costs.

  The reality is that these characteristics will not be available in assets bought for regeneration purposes and that lease length can be less important in multi-let assets and in asset classes where vacancy rates are low.

- Location

  The Council‘s present and future commercial investments will all be within the District. When future investments are evaluated social good and regeneration potential will always be considered.

- Diversity of the commercial property portfolio
  To minimise the risk of changes in the performance of particular sectors of the commercial property market (i.e. the retail, office and industrial sectors) impacting on the Council's income, investment decisions are taken in the context of the existing nature of the portfolio and whether or not the property to be acquired complements the existing mix of portfolios. The Council will seek to maximise the diversity of its overall portfolio and not concentrate new investments in any one sector or area.

- Yield

  The Council will consider the return it will get on its investment (the yield). The Council has a minimum yield expectation that covers the costs of borrowing and will only invest in a property below this level if it fulfils other strategic interests. The yield calculation takes into account any costs incurred if the investment is to be funded by borrowing.

- Investment cover ratio

  This ratio compares the total net income from property investments to any interest costs associated with borrowing to make those investments. This demonstrates the Council's ability to meet borrowing costs. The Council's assets are unencumbered but adopting a notional level of gearing can a useful indicator of the robustness of an investment.

- Loan to value ratio

  This is the amount of debt the Council currently has compared to the total asset value. In this instance, the asset value is the total value of the Council's commercial property portfolio. This illustrates whether or not the Council has assets of sufficient value to repay debt if required. Again, the Council's assets are unencumbered but adopting a notional level of gearing can a useful indicator of the robustness of an investment.

- Target income returns

  This is net revenue income from commercial properties compared to the value of the property or stapled to it's price on acquisition when it is known as the running yield. The target will be set by the Investment Advisory Board.

- Gross and net operating income (NOI)

  The income received from the Council's investment portfolio at a gross level and a net level (after the deduction of costs) over time.

- Operating costs

  This is the trend in operating costs of the property portfolio over time. It gives an overview of the impact of commercial property investments on the costs of running the portfolio.

- Property vacancy levels

  The lower the level of vacant properties (voids) the better the property portfolio is being managed to ensure that rental income is maximised as much as possible.

Annex 2 – The Investment Advisory Board and Governance

The Investment Advisory Board is made up of:

Investment Advisory Board	
Members	Officers
• Leader of the Council • Portfolio Holder for Finance • Portfolio Holder for Property, Economic Development, Regeneration • Chair of the Audit Committee • Leader of the Opposition	• Chief Executive (CEX) • Director of Finance (S151) • Corporate Director of Assets and Investments (CDAI) • Assistant Director Property Investment and Contract Management (AD PICM) • Investment Consultant • Director of Law and Governance (Monitoring Officer)

The primary purposes of the Investment Advisory Board are twofold:

- To consider recommendations from officers regarding the potential purchase of a property asset, prior to submission of a bid. The Investment Advisory Board review the officers' investment valuation, sanction expenditure on further due diligence and ultimately whether to submit a bid or not, and at what value.

- To consider the results of pre-acquisition due diligence following acceptance of an offer from CDC to purchase an asset, and ultimately to consider whether to endorse the purchase and proceed to exchange of contracts.

The Investment Advisory Board is authorised to sanction all offers. All recommendations relating to offers to purchase are reported to the next available meeting of the Council and their consent is required prior to any exchange of contracts.

Given the short notice that could often be inevitable in convening meetings of the Investment Advisory Board, all members would be able to nominate substitutes if they are unable to attend, or meetings could be held on a 'virtual' basis. For similar reasons, a quorum is not recommended, (particularly as the Investment Advisory Board is not decision making), although a meeting should include:

- at least two of the Officers: CEX, S151, MO, CDAI and AD PICM.
- at least two of the Members: Leader of the Council, Portfolio Holder for Finance, Portfolio Holder for Property, Economic Development

Other directors and assistant directors will be invited to participate when they have distinct operational needs that can only be addressed through the acquisition of additional premises.

As well as considering investment recommendations the Investment Advisory Board responsibilities also include:

1. Setting the threshold target return that investment properties should reach before they can be considered for investment.

2. Setting target volume of investments, expressed in capital and income terms, and subject to an investment timeline.

   For the avoidance of doubt CDC Property are well placed to identify, evaluate and rank assets that might meet the two criteria identified above, but the criteria themselves are not necessarily property dependent; they will be a function, inter alia, of the Council's need for income, appetite for risk, quantum of reserves, Minimum Revenue Provision and capacity to take on additional debt, and the interplay of property with other treasury investments.

3. Managing the progress of an investment decision through the governance process including interaction with the wider Council.

4. The extent of interaction and co-investment between CDC and OCC.

5. The extent to which regeneration and the climate crisis, for example, should play a part in investment decisions.

6. The use of external suppliers, particularly lawyers and external valuers.

7. Retaining agents on acquisition and how this might impact on procurement protocols.

8. Geographic investment boundaries i.e. is there an area of economic influence that extends beyond the council's boundaries?

9. Preferred sectors and investment characteristics (lease length, covenant strength etc vs lettability).

10. Cashflow horizons.