

Title of meeting: Cabinet

Date of meeting: 9th October 2018

Subject: Property Investment Fund

Report by: Tom Southall - Assistant Director Property & Investment

Wards affected: All

1. Requested by

- 1.1 This information report has been produced to comply with the resolutions contained within the report to Full Council at its meeting of 7th July 2015 which included a requirement to; *"That an annual report be submitted to Cabinet summarising the activity within the Property Investment Fund including the fund's financial position".*

2. Purpose of report

- 2.1 This report summarises the activity within the Property Investment Fund including the funds financial performance as stated in the report to Full Council in July 2015.

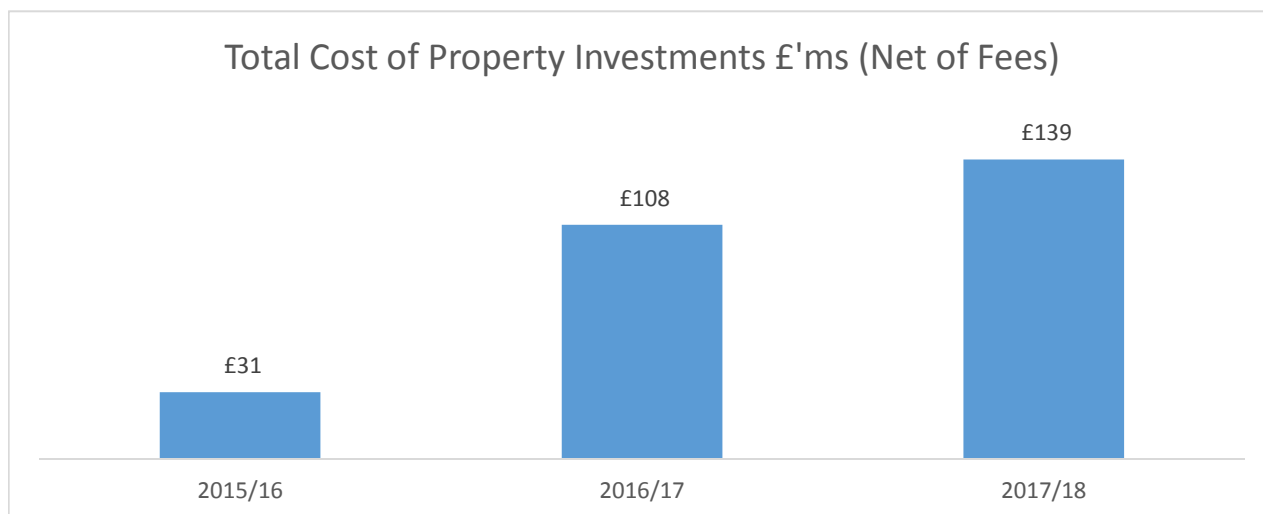
3. Information Requested

- 3.1 The Full Council meeting of the 7 July 2015 approved the amendment to the Capital Programme to permit the formation of the Property Investment Fund. The minutes of the relevant meeting record that the actions within the Property Investment Fund would be reported to council.
- 3.2 There have been several additions to the original member report; these additions have created a fund with circa £183 million to invest. This is made up of both equity (£73 million) and debt (£110 million prudential borrowing).
- 3.3 The Property Investment Strategy 2015/16 - 2019/20 (PIS) approved by members in July 2015 has been used as a framework for acquisitions. The approved strategy included strict criteria to be used when determining the property to acquire; those criteria have been adhered to and included the following:
- To create a balanced commercial property portfolio that provides long term rental returns and growth.

- A core portfolio of property assets will be sought with a view to diversification on individual assets by sector (industrial, offices and retail), location and risk.
- Core assets being the best property for the sector in an ideal location with long term income to high quality tenants.
- All investments considered must initially provide income (yield) equal to or above the councils required rate of return (IRR).
- Prioritise properties that yield optimal rental growth and stable income.
- Protect capital invested in acquired properties.
- Location will be dictated by opportunity to acquire investments that meet the strategy, proximity to the city of Portsmouth will be a deciding factor when all other attributes are equal.

Current Fund - Statistics

- 3.4 To date circa £146 million (inclusive of all costs) of the £183 million available has been invested and is generating an income of £8.4m per annum, leaving a further £37m of funding available for future property purchases.
- 3.5 To the 31st March 2018 (valuation and performance date) circa £114 million (inclusive of all costs) had been invested, generating £6.7m of income.
- 3.6 The fund has been successful in acquiring 13 properties containing 31 occupational tenants. The majority of transactions have been the purchase of standing investments whether on or off market.
- 3.7 The first investment, Schlumberger, Gloucester was purchased in December 2015, with the most recent Queens House, Manchester having completed in April 2018.
- 3.8 Appendix 1 is a schedule of all assets currently held within the Property Investment Fund.
- 3.9 The graph below shows the cumulative investment made by the Council since the fund started in 2015 to date.

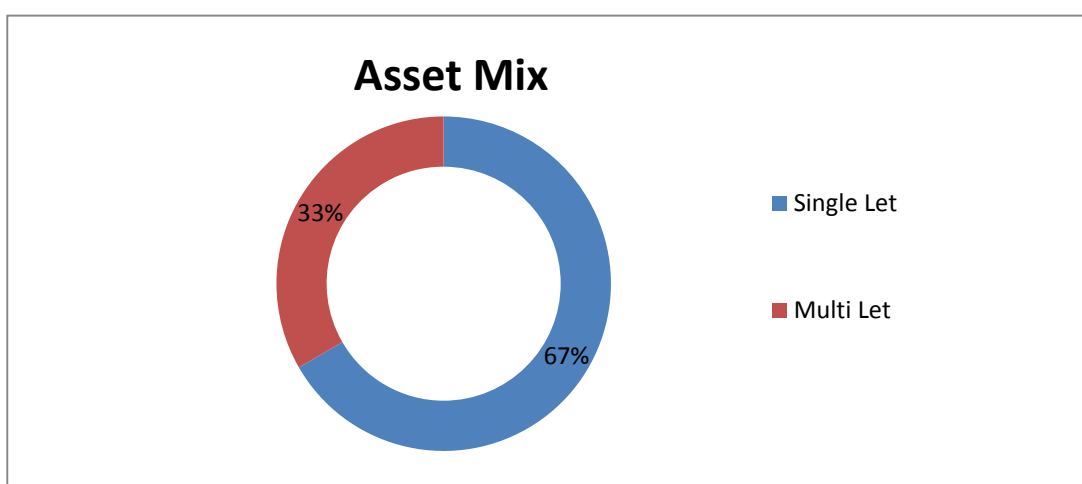
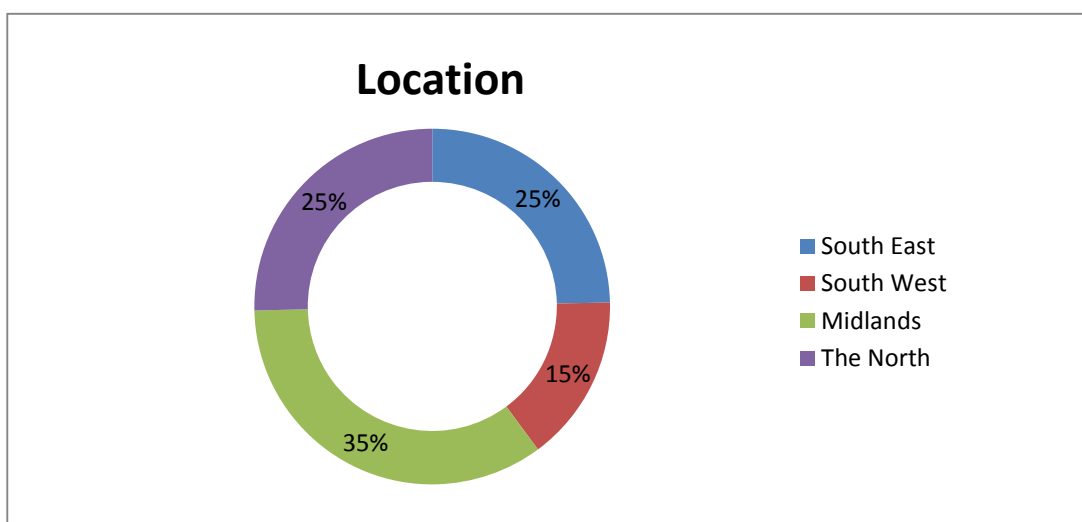
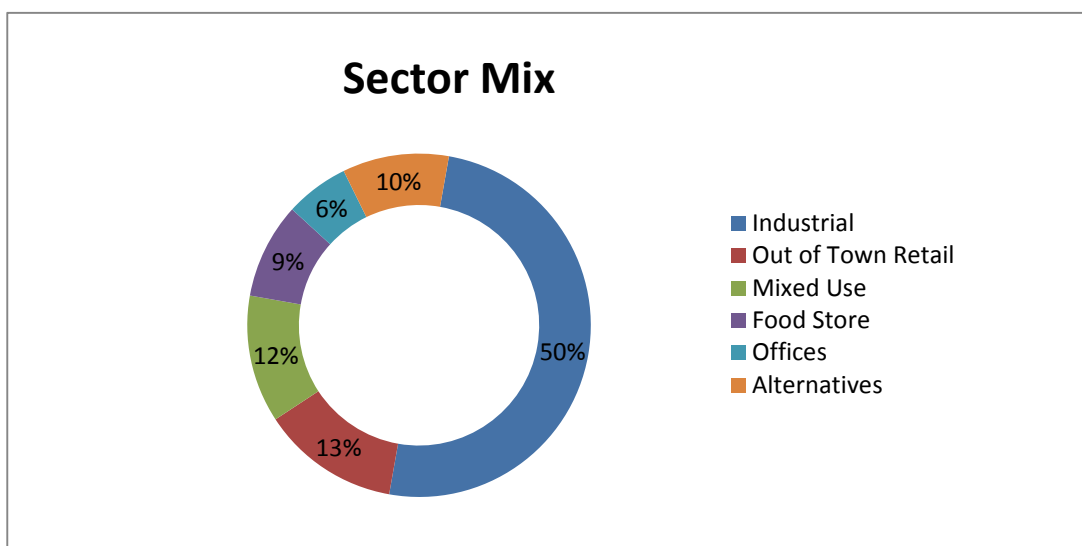


Rental Income

3.10 As of the June 2018 quarter date and since the first purchase there have been no rent payment defaults or loss of tenancies across the portfolio. The top ten tenants are:

- Schlumberger (Oilfield Services)
- DHL
- Saint-Gobain
- Sharps
- RS Components
- Waitrose
- BSS (Travis Perkins)
- UPS (United Parcel Service)
- Antalis
- PTS (Plumbing Trade Supplies)

Portfolio Mix September 2018



Portfolio Acquisition Review

- 3.11 Portsmouth City Council has demonstrated its technical knowledge base and performance and is considered by the wider market as an established well-structured and highly knowledgeable purchaser.¹
- 3.12 The original strategy has been reviewed and continues to be an adequate framework for the funds acquisition programme at this time.
- 3.13 The overarching theory that the relationship between assets reduces risk of the whole is referred to in simple terms as “diversification”. This theory which aims to protect the capital invested whilst maximising the income has been at the core of decision making on all purchases and continues to form the basis of future decisions on sales.
- 3.14 To provide sufficient diversification, it follows that a fund of £183m requires single asset lot sizes of circa £8-18m spread across a UK national geographical area with a suitable sector mix.
- 3.15 The average lot size for individual assets within the fund currently stands at £10.5m, with the minimum lot size of £4.9m and a maximum lot size of £16.2m.
- 3.16 Purchases have been in-line with the strategy of core & core plus across a variety of sectors and UK locations.
- 3.17 The fund has been weighted to the best performing sectors in the market as of the date of this report but has maintained the diversification (location / sector / tenant) required to create a well-balanced sustainable portfolio including a mix of multi-let and single let property.
- 3.18 To achieve diversification and properly manage risk for a portfolio of this size of financial investment requires the portfolio to be built over the whole UK geography..
- 3.19 Financial risk and how it combines within the wider portfolio were considered during assessment and appraisal stage of each individual property.
- 3.20 We have used Discounted Cash Flow techniques as well as IRR (internal rate of return) in evaluating the expected financial return for each acquisition. The level of detail within the cash-flows are detailed at appendix 2. These techniques show both the actual rate or return as well as the overall return compared to the alternative of a "risk free" investment.
- 3.21 Our investment analysis considerations take into account UK location, sector, tenant, age, size, lease length, building condition, environmental, future capital expenditure, rental growth prospects, investment hold period and asset liquidity to name but a few. These are cross referenced against associated market sector drivers such as micro and macro demographics, technology, consumer and business trends, and the wider economic position, and form our basis for investment appraisal.

¹ testimony has been received from leading Agents confirming this

Current Strategy Position

- 3.22 The fund requires several more purchases to become a fully invested UK wide fund and balance the property risk to an acceptable level whilst maximising the overall return.
- 3.23 The fund has a medium risk attitude achieved through a progressive risk-adverse to risk-seeking strategy over time (often described as moving up the curve).
- 3.24 This leverages diversification benefits by buying into lower yielding/lower risk assets at the beginning; as this is where the most property risk in the portfolio lies, the portfolio risk should decrease as appropriate located assets are added.
- 3.25 There remains around £37m circa 20% of the fund, which given the current level of risk in the portfolio is now targeted (progressively) towards somewhat higher yielding and where appropriate value add assets with sound property fundamentals. Subject to availability, individual lot sizes and hold periods may reduce to allow for the additional risk in the final 20%.

Medium - Long Strategy

- 3.26 The overriding fund principle is to create long term sustainable income whilst protecting the capital invested. Asset replacement is required in commercial property portfolios in order to prevent depreciation of value over time.
- 3.27 A fund of this size and type requires a substantial level of continued management and monitoring to ensure the overriding principles are achieved. The ability to trade property (asset and portfolio liquidity) and to purchase further assets within the UK to replace and rebalance the inherent risk to capital and income is fundamental and is at the forefront of the on-going management of the fund and subsequent decision making.

Financial Performance

- 3.28 Performance on property investments are measured by the overall return; that being the increase (or decrease) in capital value plus the income generated expressed as a percentage.
- 3.29 The fund is valued annually on the 31st March and therefore financial performance has been measured using holdings to this date. Further purchases have been made after this date which will be captured in the 2018/19 review.

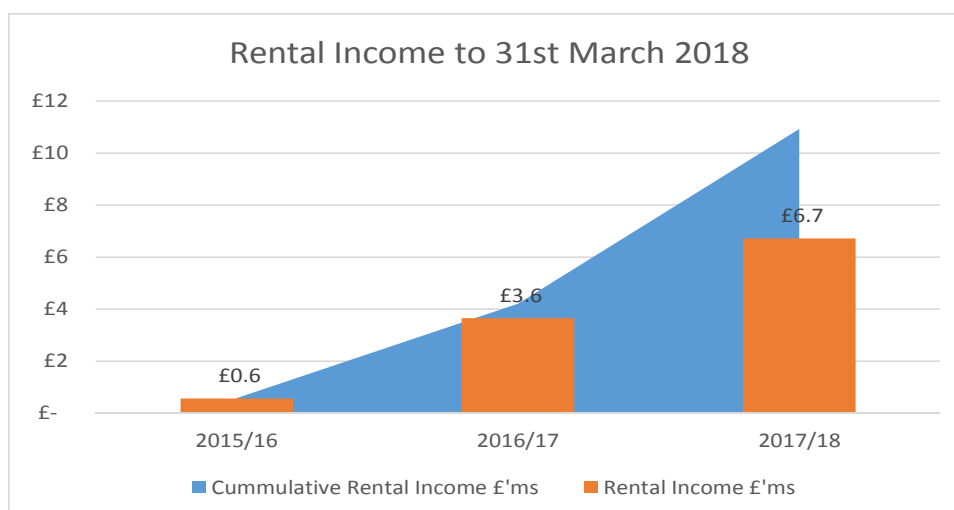
Capital Growth

- 3.30 The primary objective for the Council is to protect its Capital base, maximise income and create a long term sustainable income stream.

- 3.31 All properties market values are either equal to the purchase price, or have increased value ranging between 0.64% and 17.2% (net of costs), see appendix 3.
- 3.32 The Council, as at 31st March 2018 has spent £114m of the fund on property which includes all related costs of purchase, the market value of properties held as at 31st March 2018 has increased by 5.47% to £114m therefore the capital value of the holding is now equal to the total cost of acquisition.
- 3.33 The fund is in very early stages and as such there has been a significant number of purchases over a short period as the fund becomes fully invested. As it matures over several years and rental income grows, acquisitions will be less frequent and the impact of acquisition costs on overall performance should decrease.
- 3.34 At least half have achieved market growth that exceeds the gross purchase price since purchase. It should be noted that this does not include the benefit of income received during the period.
- 3.35 Sustainable commercial property investment is long term, fluctuations in capital values given either market forces or lease events during the hold period are normal and have been considered as part of the financial due diligence.
- 3.36 The confidential exempt appendix 3 shows the growth in Market Value of each property measuring the Cost of the Property and Acquisition Fees against the Market Value of the property as at 31st March 2018.

Rental Income (Gross Return)

- 3.37 In 2017/18 the amount of rental income received was £6.7m which represented a return against total capital investment (including costs) of 5.85% of holdings as at the 31st March 2018.



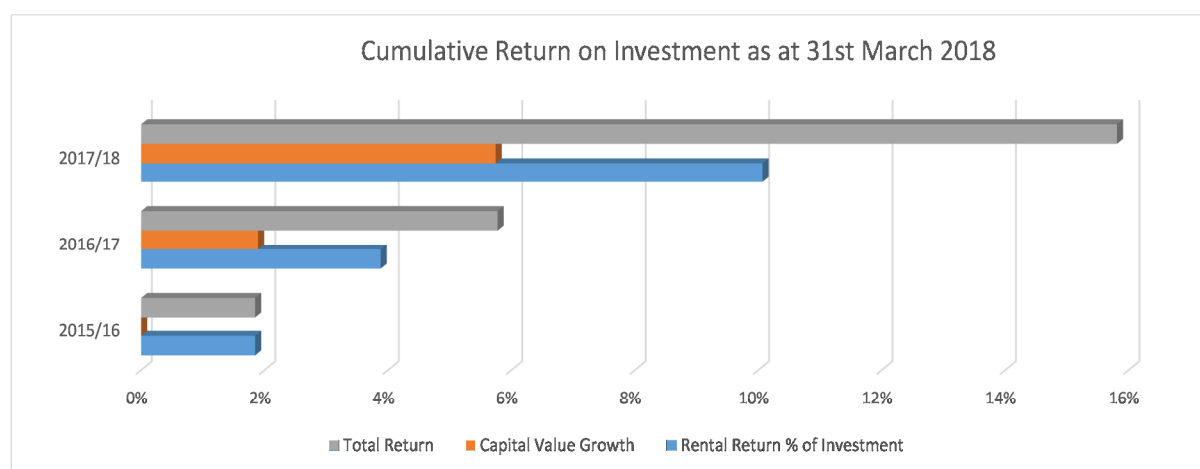
- 3.38 Since the introduction of the fund the growth in Rental income has been steep, this is mainly because of the rate at which the Investment Portfolio has grown.

Rental Income (Net Return)

- 3.39 The cumulative net income return to the Council (after all borrowing costs) since the Funds inception to 31st March 2018 amounts to £10.9m. The net income return for 2017/18 alone amounts to £5.5m, representing a net yield of 4.76%. This comprises a net return of debt financed acquisitions of 4.66% and equity funded acquisitions of 4.85%.

Overall Performance

- 3.40 In order to measure the performance of the Property Investment Fund we need to consider both the effect of the Market Value growth of the fund, plus the rental income generated. The Graph below shows the cumulative gross % return on initial investment. As at the 31st March 2018 this was 16%.



- 3.41 Whilst the Council is able to borrow for investment purposes, it cannot borrow to "lend on" i.e. borrow simply to then place borrowed funds on the money markets in order to make a return. Nevertheless, as a benchmark for the Council's alternative of a "risk free" rate of return, the prevailing money market investment rates are often used as a proxy (e.g. LIBID rates) and these have ranged between 1% to 2% over the period. The Council could however, have invested the equity element of the fund into money markets at that level of return.

Investment Market

- 3.42 Investment activity in the UK commercial market has been significant over the past 12 months as the UK continues to be considered a “safe haven” in the global property market.
- 3.43 All-property yields have continued to move downwards it now stands at 5.9%, the lowest level since October 2007.
- 3.44 Performance is heavily polarised according to sector Investment Property Databank (IPD) reports that industrial has performed exceptionally well with total return rising by an impressive 15.5% over the 12 months to March. In contrast, the office sector saw values rise by 3.6% constrained by continued poor demand in regional markets and supported by performance in the London, Manchester, Birmingham CBD districts. Retail values increased by just 1.0% skewed by the extremely poor performance of the high street which is likely to continue in the long term.
- 3.45 Given the performance of the market and the associated pricing increase it has become harder to source suitable investment acquisitions with the weight of money in the market creating very strong competition on all assets.

Market - Outlook

- 3.46 Investor demand for high quality real estate will remain strong and competitive. Given the continued rise of e-tailing the industrial and logistics sector is predicted to outperform all sectors in the medium term.

Resources

- 3.47 The investment / acquisitions manager had been recruited specifically for fund creation and on-going management and continues in that role at this time, given the complexity of the fund internal skills of this type are essential in order to maintain the core principles and a balanced portfolio over time.
- 3.48 Core tasks include:
- Sourcing of suitable investments
 - Performance review and on-going management decisions
 - Buy / sell / hold recommendations
 - Stock screening, selection and scrutiny
 - Access both occupational and capital market intelligence
 - Implement investment strategy
 - Financial investment analysis
 - Due diligence on acquisitions

- Preparation for sale on exit

External Advisors

- 3.49 We continue to use the services of GVA for due diligence reports under the HCA framework.
- Building surveys
 - Formal valuations
 - Environmental studies
- 3.50 A panel of external legal advisers was set up following a procurement exercise by competitive bid when the fund was created. The panel comprises five law firms. The choice of law firm to deal with any particular transaction is not just dependant on their quote. Some firms have more expertise in particular areas than others such as taxation or construction and so the nature of the specific transaction is very relevant.

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Signed by Director of Regeneration:

Appendices:

Appendix 1 - Asset Schedule
Appendix 2 - Cash Flow Inputs
Appendix 3 - Exempt Confidential

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location

Appendix 1

Enza Building, Warrington	April-18	£4.9m
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38,000 sq ft Mercedes van & truck dealership with alternative use options.

Located on the M62 at Warrington. Let to Roanza Limited until October 2023.

Queens House, Manchester	April-18	£8.9m
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Multi-let city centre office over 6 floors in the heart of Manchester business district.

23,000 sq ft let to 6 tenants creating an average unexpired lease term of 5 years

Portsmouth Retail Park	May - 18	£16.2m
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Off - market purchase of 70,000 sq ft multi-let retail scheme with 9 tenants with a WAULT of circa 10 years.

Scheme completed in May 2018

Travis Perkins Magna Park	Dec-16	£15.7m	
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Off - market purchase of 153,000 sq ft BSS Group HQ (Travis Perkins) Located on the M1 at Magna Park, Lutterworth.

Let to Travis Perkins for a term of 15 years from 2014.

Dunelm & Lidl Redditch	Dec-16	£8.3m	
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Off - market purchase of a two unit 32,000 sq. ft. retail warehouse scheme in central Redditch.

Let to Lidl and Dunelm on a average lease expiry of 8 years.

Sharps Bedrooms Bilston	Dec-16	£11.5m	
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Off - market purchase of the 151,000 sq ft Sharps Bedrooms manufacturing HQ.

Located to the north of Birmingham close to the M6 motorway. Let to Sharps until 2026.

UPS Dewsbury	Dec-16	£7.25m		
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Off - market purchase of 111,000 sq ft UPS distribution hub close to the M1 / M62 interchange.

Let to UPS with a lease expiry in 2026.

City Park Leeds	Dec-16	£13.75m		
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Multi-let industrial/trade counter scheme of circa 193,000 sq ft.

Located on Leeds city fringe with immediate access to M621. Let to a variety of national occupiers.

Mercedes Southampton	Jul-16	£8.74m		
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Off - market purchase of a 31,000 sq ft Mercedes dealership.

Located at the entrance to Southampton Airport with a circa 11 year un-expired lease.

DHL Minworth

Jun-16

£12.6m



Off - market. Speculatively built 102,000 sq ft industrial unit developed/funded by Rockspring.

Located on the new Pro-logis Park at Minworth the property was let to DHL prior to PC on a 15 year term.

Schlumberger

End 2015

£8.0m



100,000 sq ft industrial warehouse let to Schlumberger Plc with 6 years remaining on the lease.

Located on Quedgeley West Business Park, adjacent to the M5 at Gloucester.

Matalan Swindon

End 2015

£9.7m



Off -market. Purchase of a 42,000 sq ft retail warehouse let to Matalan with 12 years remaining.

The property forms part of M&G's Greenbridge Retail Park in Swindon.

Waitrose Crewkerne	End 2015	£13.1m	Vendor:
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A 31,000 sq ft supermarket located in an affluent regional town.

Built in 2007, let to Waitrose with circa 14 years remaining on the lease.

Appendix 2

Type of information	Current data	Forecasts
Tenure	<ul style="list-style-type: none"> Title, including headlease details (if applicable) Outgoings Head rents Unfulfilled statutory obligations 	
Physical attributes	<ul style="list-style-type: none"> Floor areas (net and gross) Ancillary areas and car parking Building specifications Tenants' improvements 	<ul style="list-style-type: none"> Planned or possible changes in areas/ parking provision
Lease/sublease and occupational interests	<ul style="list-style-type: none"> Tenancy details Lease expiry dates Break clauses Rent review dates Rent review terms 	<ul style="list-style-type: none"> Lease events forecasts, including probability of breaks being operated and leases renewed Duration of future voids Perpetual void allowance
Rental value	<ul style="list-style-type: none"> Rents passing (including stepped rents) Estimated rental values 	<ul style="list-style-type: none"> Growth in rental value for the location to model refurbishment/ redevelopment options Growth in actual property rents
Costs of property ownership and holding costs	<ul style="list-style-type: none"> Vacancy/void costs Unrecoverable service costs Unrecoverable management costs Letting and review costs Purchase and sale costs 	<ul style="list-style-type: none"> Inflation in maintenance and running costs Future periods on lease expiry and periods of refurbishment
Redevelopment/ refurbishment	<ul style="list-style-type: none"> Costs of redevelopment/ refurbishment Dilapidations 	<ul style="list-style-type: none"> Inflation in building costs
Finance	<ul style="list-style-type: none"> Loan details Break costs 	<ul style="list-style-type: none"> Changes in interest rates
Gearing	<ul style="list-style-type: none"> Level of debt Return on equity employed 	
Taxation	<ul style="list-style-type: none"> Income and capital gains VAT election Capital allowances 	