Property Services Directorate

Property Investment Strategy

2015/16 - 2019/20

June 2015

Contents

1. Introduction

1.1 All City Council owned land and property is held as a corporate resource. Government advice recommends that all local authorities should have an agreed strategy and operation policy for developing, disposing and acquiring land and property.

1.2 All property will be held for a clearly defined purpose, whether that is to support and sustain services, provide revenue or to enhance the Council's strategic role as a place shaper. This strategy focuses **on the acquisition of property as an investment** and sits within the wider Corporate Asset Development strategy.

2. Background

2.1 The Property Investment Strategy aims to provide a viable and sustainable framework for the acquisition of property investments. The purpose of the strategy is to set out:

- The Council's objectives for acquiring property investments
- Criteria for investment acquisition
- Risks to the Council
- The acquisition & disposal process (governance arrangements)

2.2 The Local Government Act 1972 gives the Council powers to acquire any property or rights which facilitate, or is conducive or incidental to, the discharge of any of its functions.

2.3 As described in the budget report to Council on 13th November 2013, the mandate to become less dependent on Government grant was given. At paragraph 8.24, the report is explicit for Portsmouth City Council to become a more entrepreneurial council with one strategy being 'to exploit commercial property acquisition opportunities with a view to generating long term rental income streams to support the delivery of council services in the future.

2.4 The outline Medium Term Financial Strategy - 2104/15 & Beyond confirms that we should 'seek out commercial property opportunities to increase the Council's property portfolio'.

3. Objectives

A. Acquire properties that provide long term investment in accordance with corporate objectives

B. Maximise return whilst minimising risk through prudential management processes as described in this document

C. Prioritise properties that yield optimal rental growth and stable income

D. Protect capital invested in acquired properties

4. Portfolio Structure

4.1 To achieve the budget reports recommendations the acquisition strategy will 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. A direct investment Core and Core Plus approach has been adopted.

Portfolio Mix

4.2 Core & Core+ Opportunities 70 - 80% of total portfolio

4.2.1 Description of Core

"The best property for the sector in an ideal location with long term income to high quality tenants, yields will be equal to or slightly above prime for the sector"

Rental yield (financial return on the capital investment as a percentage) will be lower than the general market but capital and rental growth should be steady and medium-long term risk of void periods and tenant default reduced.

4.2.2 Description of Core-Plus

"Similar properties to Core but in slightly less favourable locations, perhaps with shorter leases and lesser tenant covenants returns will be appropriate for the sector and risk"

Rental yield will be higher reflecting the increase in risk.

The Core and Core Plus mix is essential in providing a balanced but diversified portfolio

4.3 Specialist Sector & Residential Opportunities 20 - 30% of total portfolio

4.3.1 Specialist sector investments such as hotels, public houses, student accommodation, and health care facilities may be considered on merit but do not form part of the "Core" search criteria.

4.3.2 Given the depreciating specialist infrastructure and changes in trends such assets may require substantial future capital expenditure in order to maintain the value of the interest; the risk from this should be fully explored and understood before purchase.

4.3.3 Residential provides a good income diversifier given its limited correlation to commercial property. Returns have been stable over the long term although the level of tenant and property management needs to be carefully considered and allowed for in all appraisals.

4.3.4 The returns on this element of the portfolio will be varied but should in principle be at the upper level or above those of the Core properties.

4.4 Value Add

4.4.1 Value add (vacant or short leases), re-development opportunity or distressed property requiring extensive capital expenditure can reap high capital and yield returns but do not form part of this strategy.

4.5 Holding Period

4.5.1 It is usual for an investment "holding period" before sale to be defined from purchase; this is to counter any significant depreciation eroding value or before the need for re-development arises. The holding period will be determined for each individual property at the appraisal stage.

5 Investment Portfolio Principles & Decision Making Criteria

5.1 Given the varied sector dynamics the criteria of each asset whether core specialised or residential will vary although should follow first principles in that;

5.2 All investments considered must initially provide income (yield) equal to or above the councils required rate of return (RRR) defined by the cost of capital borrowing for purchase.

5.3 Individual properties will be fully financially and physically appraised using industry standard techniques to ensure the return is acceptable for the level of overall risk. This will be specific to each and every property proposed for purchase.

5.4 Further performance measure, portfolio analysis and valuation will be undertaken during the holding period to allow for buy/sell/hold decision making.

5.5 To minimise management and risk; preference will be for single occupancy investments although multi-let properties or multi-unit schemes may be considered.

5.6 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.

5.7 Only Investments with full repairing and insuring (FRI) terms or FRI by way of service charge, meaning that all costs relating to occupation and repairs are borne by the occupier(s) during the lease term will be considered.

5.8 Lease length will be determined by market sector forces but the premise will be to maximise.

5.9 Market rent (MR) should be equal to or above passing rent.

5.10 Market sectors and locations with rental growth and good letting prospects will be actively sought.

5.11 Buildings should have sound structure and designed for use, with good transport links and accessibility.

5.12 Lot size (price paid) should account for the volume of time, labour and cost of individual acquisitions, the level of financial return, the funds overall size, the existing portfolio mix, market dynamics (competition and volume of buyers), sector dynamics and asset/portfolio management decisions.

5.13 The core initial lot size target is £2 million+ for any one individual property. This may change as time progresses and the portfolio grows.

5.14 Market exit (sale) will be intrinsic to the assessment of risk for each individual property.

5.15 The decision to sell stock during the holding period may be triggered by a variety of factors and is not limited to lease events, market forces, portfolio mix, or changes in strategy. The portfolio will be open to continued appraisal and active management with a view to minimising risk and increasing returns.

5.16 The strength of tenant covenant will be concurrent with the overall balance of risk for any given property and in line with the key objectives.

5.17 Minimum acceptable financial strength for any given tenant will be determined through financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring.

5.18 The choice of investment will take into account non-financial; ethical and legal considerations in particular relating to the intended use of the building and its current or future occupants.

Appendix 1 - Risks and their Management

Market forces

To limit risk the criteria for purchase and due diligence will be followed for all transactions; however fluctuations in demand and supply of the individual market and the wider economy will see the value of the investment and the income rise and fall, the council may not recoup the original amount invested in full.

Liquidity

The process of buying and selling commercial property, in relation to some other forms of investment, is complex and can result in transactional delay and uncertainty which carries risk from market shift, abortive transactional costs and in-ability to realise "sale" capital quickly.

This can be managed and improved through good portfolio management and where possible by adopting the IPF's best practice "Readiness for sale - A guide for streamlining commercial property transactions".

Opportunity

The availability of stock is generally limited; there will be times where lack of or lost opportunities through negotiation and competition will frustrate the process. This is often exacerbated by a general lack of transparency and openness in the market creating barriers to entry. It is therefore a possibility that a proportion of the fund remains un-invested during these periods.

To counter this; the role of the "Investment Acquisitions Manager " will be to seek out as many appropriate opportunities as possible, build relationships and communicate to the market the council's requirement and ability to perform.

Management

The portfolio will have the risk of void periods in occupation or tenants may default on payment of rent. The loss of income is a direct result however voids create further holding (and re-letting) costs which if vacant for a prolonged period of time can be substantial. Active portfolio management will be undertaken during the holding period to reduce such risks where possible.

Appendix 2 - Portfolio Acquisition Methodology

Acquisitions will be made in accordance with the guiding principles (principle 4 - acquisitions) within the Asset Development strategy.

Identification, consideration and recommendation of assets suitable for acquisition will be Undertaken by a suitably qualified and experienced 'Investment Acquisition Manager' working within the Corporate Assets Team.

As property acquisitions require timely decisive decision making, it is recommended that the Corporate Asset Development Board review, challenge and recommend or reject the purchase of investments identified to include the sanctioning of formal offers and counter offers which will be guided by the Council's Required Rate of Return.

All investments considered for purchase will undergo qualitative and quantitative appraisal to establish portfolio suitability which will consider rental levels, location, property type, rent review and lease expiry pattern, tenant(s), industry sector, tenure, lease covenants, market exit constraints and physical and environmental factors. In addition 3rd party advice may be called upon where specialist market knowledge is required.

The "Investment Acquisition Manager" will undertake a search of the market which will include approaches and introductions of opportunities direct from the sellers their agents and third parties.

Introductions from third party agents will be accepted on a first come first serve basis by verbal or written communication to the "Investment Acquisition Manager". If after the introduction the council wish to pursue the purchase further written agreement on the "basis of engagement" and fees will be required.

Portfolio Acquisition & Disposal flow

Selling		Buying
• Instruct advisors formulate asking terms and marketing strategy • Review property information anticipate issues devise strategy • Procure energy performance certificate	Offer to market - Heads of Terms	• Appraise property • Offers & counter offers • Agree HOTs • Secure source of funds
• Consider carrying out and providing searches • Make available pre contract legal pack and access to data • Negotiate contract	Pre - Contract	• Instruct legal team • Investigate title • Conduct surveys and reports • Negotiate contract
	Exchange	• Pay deposit

Parties committed to purchase

• Continue to manage property (in accordance with contract) • Preparation of completion statement • Prepare requisitions on title	Pre - Completion	• Pre completion searches • Finalise mechanics for drawdown/transfer of completion monies
• Discharge borrowing liability	Completion	• Pay completion monies • Assume liability for property
	Post - Completion	• SDLT / Land registration • Collation of property information • Portfolio management