

Acquisition and Investment Strategy

Background

1. The Council Plan 2017-2020 identifies economic development within the Borough as one of six priorities the Council intend to focus on. Supporting business is incredibly important for Redditch Borough Economic Development and Regeneration the Council will continue to support new and established businesses to grow.
2. The Council Plan also includes a priority for the financial stability of the Council. At a time of reduced Government support it is essential to look for income generation as well as budget savings.
3. The Acquisition and Investment Strategy combines these two priorities to achieve economic development as well as generate income potential achieved through an Investment Portfolio Fund.

The Acquisition and Investment Strategy

4. The purpose of the Acquisition and Investment Strategy is to guide the use of the Investment Portfolio Fund to make commercial property investments to support economic redevelopment or regeneration in the Borough, achieve income generation and in some cases may be complimentary to the delivery of Council services. An Investment Portfolio Fund of £20m has been designated for the years 2018/19 to 2019/20.
5. Commercial property investment opportunities often arise unexpectedly and it is important to be nimble in order to take advantage of opportunities when they arise. The Council's Corporate Director of Finance and Resources will be responsible for identifying suitable opportunities and developing the viability appraisal and business case for the Council to invest; the Acquisition and Investment Strategy is important to provide a framework to guide the Council in identifying appropriate investment opportunities. Examples of where the Council may need to respond without delay include the traditional route of a selling agent and bidding process, through auctions and even "off market" through direct approaches from prospective sellers who want to circumnavigate the formal marketing process in order to save time and risk of abortive costs. Receivers or administrators of distressed sellers may also seek offers for commercial property assets quickly. The Acquisition and Investment Strategy will provide a systematic assessment investment opportunities so that it is able to move quickly when a compelling opportunity arises.
6. At this stage the Acquisition and Investment Strategy is limited to investment propositions that are within the boundary of Redditch Borough Council or investments that are within the area of Districts that are contiguous to the Borough. Other local authorities have widened the area to include the Local Enterprise Partnership (LEP) and there is merit in considering this option where the objective is purely income generation. As the Council becomes more experienced this may become an option.
7. There will projects where there will a strong business case and this will generate private investor interest. Although the Strategy will allow the Council to participate in these transactions it will have more economic development impact on projects that are unlikely to appeal to the private investor because the returns are lower. The principle principal consideration is to support economic regeneration with an essential

requirement that the business case cover the costs of the Council's borrowing and minimum revenue provision and generated a minimum revenue return.

10. Economic development is defined in its widest sense and will include investments in Bromsgrove that create retail, industrial, office and housing assets including working in partnership with other developers.

The Criteria for Investing

11. It is necessary for the Council to take a prudent approach to the management of its financial affairs and when assessing investments the Council will need to carefully consider the balance of risk and reward and in doing so will consider such factors as the security against loss, the liquidity of the investment, the yield, affordability of the loan repayments, change in interest rates and property values, see table 1 below:-

TABLE 1

Criteria	Excellent / very good	Good	Acceptable	Marginal	Unacceptable*
Location	Major prime	Micro prime	Major secondary	Micro secondary	Tertiary
Tenancy strength	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant	Tenants with poor financial covenant strength
Tenure	Freehold	Lease 125 years plus	Lease between 75 & 125 years	Lease between 10 & 75 years	Lease less than 10 years
Occupiers lease length	Greater than 15 years	Between 10 and 14 years	Between 9 & 6 years	Between 3 & 5 years	Less than 2 years or vacant
Repairing terms*	Full repairing & insuring	Internal repairing - 100% recoverable	Internal repairing - partially recoverable	Internal repairing - non recoverable	Landlord
Building Quality/ Obsolescence	Newly Built	Recently Refurbished	Average condition and likely to continue to be fit for current use for 25+ years	Aged property with redevelopment potential	Nearing end of useful life/ use unlikely to continue when lease expires
Investment size	Between £10m & £15m	Between £5m & £10m	Between £2m & £5m	Between £250k & £2m	Less than £250k

* unless there is an overwhelming case for investment that exceeds the Council's expectations

12. The overall investment value and range of assets acquired needs to represent a good mix and spread of risk, size and location across differing sectors to ensure that the portfolio is resilient to change that might lie outside the Council's control. It is important that the Council maintains an adequate level of reserves and balances to ensure it can manage any down turn in the property market and limit the impact it will have on revenue income.

13. The investment size provides limits on each category with more being allocated to the lower risk categories and lower sums to higher risk categories (but potentially higher yield).

Rate of Return

14. The experience of investment business case development elsewhere indicates that a gross yield of upwards of 5% on the value of the investment will be necessary for the investment to be of interest to the Council, taking into account its borrowing costs and other overheads.

15. The Acquisition and Investment Strategy will require an indicative minimum net return of 1.25%. The minimum rate of return would be limited to business cases meeting the excellent/very good investment criteria in table 1 or having strong economic development grounds and good/acceptable investment criteria. Business cases outside of this will require a net rate of 2% return. These indicative rates are similar to those achieved by the many other Councils with developed property portfolios and whilst modest are thought to be realistic. Officers will continue to modify them based on professional advice and prevailing market conditions. Table 2 illustrates that this could make a contribution towards closing the funding gap of between £250,000 to £400,000 per annum.

16. In considering its costs against a gross return the Council may need to consider any of the following when developing the business case for investing. It is worth noting that they may not all apply to the investment being considered:

- Finders Fees approx. (0.75%)
- Legal Fees approx. (0.5%)
- Survey and Valuation and due diligence fees approx. (0.5%)
- Stamp Duty (5% on freehold purchases over £250K)
- Finance Costs including minimum revenue provision (circa 5%)
- Void Business Rates/Council Tax (tenants should be covering these in occupied units)
- Repairs and maintenance (depending on lease type (probably covered in a service charge)
- Running costs of building, including building management (depending on lease type again probably covered in a service charge)
- Opportunity cost of alternative use or sale of the asset
- Staff Costs to manage the portfolio (non-recoverable)

TABLE 2

Rate of Return Requirement	Minimum 1.25% net rate of return	2% rate of return
Basis Investment before Stamp Duty and costs	£18,735,000	£18,375,000
Acquisition Costs at 6.75%	£1,265,000	£1,265,000
Total Investment Fund	£20,000,000	£20,000,000
Rate of Return Calculation		
Financing Costs – Public Works Loans Board (PWLB) @ 3% annuity	£777,000	£777,000
Annuity includes minimum revenue provision requirement		
Administration Costs	£60,000	£60,000
Total Costs	£837,000	£837,000
Net Rate of Return	£250,000	£400,000
Gross Rate of Return Required	£1,087,000	£1,237,000
Gross rate of return on £20m	5.44%	6.19%
Breakeven rate of return	4.19%	4.19%

17. The Council may hold property assets either directly or indirectly. Direct property investment gives the Council full control over the property and responsibility for its management and the business cases brought forward so far for investment are envisaged to be held in this way. Indirect property investment is where the asset is held through an arm's length trading company and will be necessary where the Council holds investments solely for income generation or where that is the most effective way for the Council to act in the private rented housing market. This commercial activity can be authorised through the General Power of Competence under sections 1 and 4, Localism Act 2011. The power does require the Council to act through a company.

Selection of Investments

18. The Council will select investments for the purpose of income generation, economic development (including housing) or a mixture of both. The Council may acquire and hold properties directly or through a trading company; all of these factors will be determined on a business case by case basis. The Council only invest in projects within Redditch Borough Council. The Council may invest in the development of its own assets or acquire assets for development.

19. Investment property acquisitions need to be subject to the agreed parameters of the Council's Acquisition and Investment Strategy and will be led by the Council's Corporate Director of Finance and Resources in consultation with the Corporate Management Team. The initial selection of an asset will be assessed on two main criteria on a pass or fail basis:

I. The Council will need to ensure a satisfactory level of return on its investments and may decide to evaluate purchases on a balance between income yield and economic redevelopment and regeneration. The minimum rate of return of 1.25% will be limited to

business cases meeting the excellent/very good investment criteria in table 1 or having strong economic development grounds and good/acceptable investment criteria. Business cases outside of this will require a net rate of 2% return.

ii. Leases should be classified, for accounting purposes, as an operating lease rather than finance lease, to ensure that all rental income can be treated as revenue income (rather than a mix of capital receipt and revenue income). Operating leases are those where the risks and rewards of ownership are retained by the lessor (the Council) and must meet certain criteria. The main criteria being that the lease term should not be for the major part of the property's economic life unless the price paid is underpinned by the sites redevelopment potential and at the start of the lease; the total value of minimum lease payments (rents) should not amount to a significant proportion of the value of the property.

20. Officers will continue to monitor prevailing market conditions to enable the Council to reserve discretion to acquire assets that may fall outside the investment criteria outlined above if a strong case can be made that the investment provides an exceptional opportunity to promote the Council's strategic priorities.

21. For investments that pass the first two criteria, further evaluation will then be undertaken against a comprehensive set of defined property specific criteria as set out in table 2. The Council will consider these criteria and seek to achieve the appropriate balance of risk and reward proportionate to the size of the investment being considered. The ideal property investment would be a freehold in the town centre, let to a tenant with a strong financial covenant for a long term on a full repairing and insuring lease.

22. It is also important that the Council actively manages the investment portfolio... Such work will include issues include rent collection, service charge calculation and collection, building maintenance, security, dealing with tenants, re-letting empty units, negotiating terms of rent reviews, dilapidation claims and the general miscellany of property management. In terms of strategic management this will fall to the Corporate Director of Finance and Resources to ensure that the portfolio is delivering the investment returns that were envisaged and to always act in the interests of the Council's financial interest which will also include appropriate disposal of investments that are underperforming or no longer meet the Council's objectives, as well as acquisition.

23. The Corporate Director of Finance and Resources will also be responsible for providing regular reports on management issues and the performance of the Council's investment portfolio. The Council's Cabinet and Corporate Leadership Team will receive a report from the Corporate Director of Finance and Resources bi-annually which will update on both the individual asset management plans as well as the overall asset investment portfolio against expectations at the time of purchase and performance against prevailing market conditions. These reports can be made available to other meetings of the Council as required.

Risk and Mitigation

24. In terms of management of risk it is understood that there are inherent risks associated with investments and each business case will be required to identify the risks associated with that investment proposal and the Council will need to balance risk and reward proportionate to the scale of the investment proposed. It is to be expected that some of the risks the Council will be expected to consider will be:

Recession Risk

25. There is a risk of the property market going into recession, capital values and rentals can fall as well as rise. Although this not seen as a significant risk at the moment it needs to be factored into long terms decisions. The Acquisitions and Investment Strategy criteria (table 1) will target low risk; low management investments that will better withstand any downturn and remain occupied and attractive to tenants, landlords and investors.

24. Operating as a commercial function will entail making good decisions quickly in order to put offers forward. However, these can be made as conditional offers and contracts for sale need not be exchanged until the full due diligence and the necessary governance procedures have been completed.

Abortive Cost Risk

25. Abortive costs will be incurred in making bids that do not succeed, or from choosing (as a result of due diligence) not to continue to exchange of contract. These costs may include feasibility studies, ground investigations, advisers' costs, legal costs, survey fees and Officer time.

26. This risk is inherent to property investment and the focus will be on ensuring that potential problems are identified at the earliest possible stage of each acquisition.

Interest Rate Risk

27. The PWLB borrowing rates have been consistently below 3% for some time but the market can change. To mitigate his risk of interest rate change the borrowing required for a business case will be undertaken and fixed at the time the scheme is committed.

28. A change in interest rates would require an update of Table 2 on the gross rates of return.

Knowledge of the Market Risk

29. Property investment involves clear risks due to wider economic conditions, which are beyond the control of the Council. However, other property related risks, such as those relating to the condition of the property or complications with leases are more easy to assess and manage.

30. The property market is driven by prompt responses to opportunities that may not be offered on the open market. The Council should be able to increase the potential to be offered access to such opportunities by engaging specialist external advisors. However, the ability to act quickly is critical and the Council will need to use its own knowledge of the Borough, combined with the wider market understanding of (external) specialists, to ensure that it adopts a proactive approach with property owners and specialist property investment agencies.

Operational Risk

31. Property management has many inherent operational risks including:-

- Vacancies (voids) in the portfolio will reduce average yield. As well as lost rental income on vacant units, the Council could find itself liable for a share of on-going costs which a tenant would normally pay such as empty property rates.
- Disputes with tenants. Common disputes include ongoing maintenance and repair costs of buildings and the ability to recover those costs from tenants.
- Tenant default, and that financing costs could rise.

32. These risks will be mitigated through the quality of the property and tenant. The criteria in table 1 will allocate most funds to the excellent/very good category.

Capacity Risk

Operating a dynamic property investment function calls on a knowledge base and skill set which the Council does not currently have. Although some relevant expertise does exist within the Council, existing workloads and ongoing projects make it unlikely that this could be released at the level required to support this type of commercial activity.

Nevertheless, in order for Redditch Borough to successfully implement its property investment strategy, it will need access to the type and level of expertise that can support robust and timely decision-making. It is likely that this will be best achieved by contracting with external property investment advisors who will do the following:

- Identify potential investment opportunities and evaluate values.
- Carry out necessary due diligence and advice on risks.
- Prepare individual business cases.
- Undertake commercial negotiations.
- Manage Freehold and leasing arrangements.
- Evaluate prospects for rental growth and capital appreciation.

This use of external advisors will need to be carefully and consistently managed by the Corporate Director of Finance and Resources.

Change of Government Policy Risk

The Council will use the General Power of Competence to undertake the acquisition and investment strategy. There is a risk that the Government could introduce limits to this power. If this was to happen it would restrict future investment, including business cases in progress but is unlikely to be retrospective.

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