Commercial Acquisitions Strategy

1. Introduction

1.1. The financial challenges faced by the Council have been well documented. Reducing central funding coupled with growing demand for services has resulted in the Council having to look innovatively at everything it does. The Council established the Assets and Investments Committee during 2016 to drive a more commercial approach within the organisation and to deliver better financial returns from its property and asset holdings. Following the elections in May of this year the Council agreed to extend the remit of the Committee.

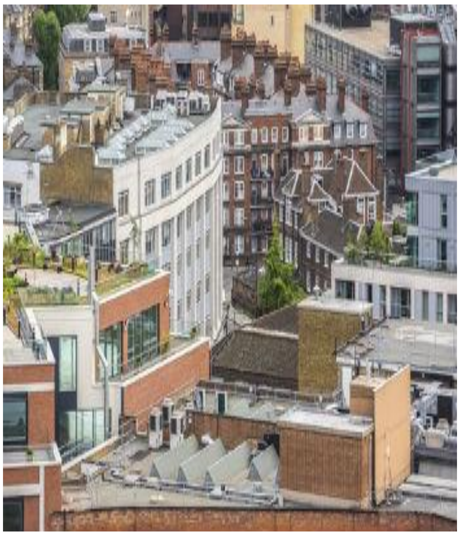
1.2. The remit of the Committee now includes driving all aspects of the Council's commercial agenda. As a consequence the Committee have agreed that as part of this programme it will develop a strategic approach to commercial acquisitions. Any commercial acquisition carries with it a degree of risk and as this involves the investment of public funds the rationale for engaging in such activity should be clear. The Council is not intending to invest in commercial activity for the sake of it but to mitigate against the implications of increasing budgetary pressures. The Council will not meet the financial challenges it faces through transforming services alone. The approach will require a mix of transformation, additional revenue sources, and a reduction in service levels. By focussing resources on the first two, the need to utilise the latter option will be minimised.

1.3. This report sets out a framework and a set of processes within which commercial acquisition decisions can be made. Whilst some may question whether this is appropriate, we are clearly not the pioneers in this field. A recent survey undertaken by Localis showed that entrepreneurial activities currently make up 6% of council budgets. However respondents indicated that by 2020 this figure will rise to 18% - a sum potentially worth upwards of £27bn. It was estimated that this would generate up to £2bn of additional income each year; a sum equivalent to £100 off each 2019/20 council tax bill.

1.4. Furthermore locally we know that at least Cambridge and Peterborough City Councils, and Huntingdonshire District Council have been undertaking such acquisitions for some time. This does of course mean that local authorities could well end up competing against each other for the same opportunities thereby potentially pushing up the purchase price.

1.5. The following is an extract from the July LocalGov publication which further re-enforces the quantum of commercial investments being undertaken by local authorities as means of negating the financial challenges faced by the sector:

Councils spent £1bn on property assets last year to boost income



Local authorities spent more than £1bn acquiring property in 2016 as a way of generating new revenue, according to a new report published today.

The report, published by APSE and the Chartered Institute of Public Finance and Accountancy (CIPFA), shows that more councils are purchasing property for investment purposes.
It shows how some councils are using this revenue to support public services, with a small number arguing it will allow them to become fully independent of national grant funding.

1.7 Whilst we are not at the forefront of using commercial investments as a means of mitigating the financial challenges we face, it is important that the approach is aligned to the Council's corporate objectives. The following paragraphs summarise references within the Council's key strategic documents that provide the assurance that it is.

2. Strategic Framework

2.1 The Council's overarching strategic approach is set out in the Council's Strategic Framework. The Council's overarching vision is to create the right environment where every resident is proud to refer to the county as a great place to call home.

2.2 Developing the economy for all is one of the three strategic priorities within the Strategic Framework. Whilst this strategy may support this priority, it is not the key rationale for it. Recognising that with a growing, and ageing, population the demand for Council services is only going to increase at a time when central government resources are reducing, the Council needs to seek alternative revenue streams in order to support its strategic outcomes.

3. Medium Term Financial Strategy

3.1 In the face of these challenges the Council launched a transformation programme in 2016. This was supported with £20m of pump priming resources in order to secure the investment and capacity required to deliver it. The overarching programme was to deliver over £100m of revenue savings over the life of the medium term financial strategy.

	VERTICAL PROGRAMMES (1-5)				
CROSS CUTTING PROGRAMMES (6-11)	1. Adult services	2. Children's services	3. Environment, transport & economy	4. LGSS & CCC Phase 1 – IT & digital	5. Public health
6. Finance & budget review	✓	✓	✓	✓	✓
7. Customers & communities	✓	✓	✓	✓	✓
8. Assets, estates & facilities management	✓	✓	✓	✓	✓
9. Commissioning	✓	✓	✓	✓	✓
10. Contracts, commercial & procurement	✓	✓	✓	✓	✓
11. Workforce planning & development	✓	✓	✓	✓	✓

The programme contained a number of themes to assist focus and prioritisation. One of these themes included creating a more commercial culture within the organisation and using the council's ability to influence markets to reduce the overall operating cost base of the Council.

3.2 As a consequence commercialism has been introduced as a key enabler for the delivery of the programme, alongside income generation and asset utilisation. Commercialism can mean slightly different things to different people. This will range from how the Council generates income to alternative delivery vehicles to the acquisition of business opportunities.

3.3 There are a number of reasons why the Council should agree a commercial acquisitions strategy:-

- This is not an activity the Council has previously engaged in
- The Council does not have the internal expertise/experience in this area
- It has become a very competitive market place
- The Council would need to borrow to finance the acquisition costs
- Business failure will be a Council reputational risk
- The on-going economic success of tenants is beyond the direct control of the Council

- To provide a clear framework within which investment decisions can be made

3.4 In addition to setting out a strategic framework this document also proposes a set of governance arrangements. These are intended to mitigate the potential risks associated with developing a portfolio of this nature whilst ensuring that agile decisions can be made.

4. Objectives

4.1 The objectives of the investment portfolio can be set out quite succinctly:-

- Acquire properties that provide long term investment to support the delivery of the Council's corporate objectives
- Delivery of a portfolio which balances risk and rewards aligned to the Council's risk appetite
- Prioritise properties that yield optimal rental growth and stable income
- Protect capital invested in acquired properties

5. Legal Powers

5.1 The legal powers available to a local authority to create an income stream through investment in commercial property can be analysed in three ways:-

- the power to invest
- the power to borrow
- the power to undertake an activity for a commercial purpose

5.2 Power to invest

5.2.1 Pursuant to the powers set out in s.12 Local Government Act 2003, the Council may invest either for:
"any purpose relevant to the Council's functions under any enactment", (s. 12(a))
or
"the purposes of the prudent management of its financial affairs" (s. 12(b))

5.2.2 The power to invest given in s.12 should in principle include the power to invest in commercial property. However, the power to invest in commercial property must be used either for a purpose relevant to a function of the Council, for example the regeneration of an area, for economic development outcomes, or for the prudent management of the authority's financial affairs. Investing purely to create a return is not viewed as a function of an authority.

5.2.3 It is therefore important that the primary objective of the strategy is to support the strategic objectives of the Council. It is also important to ensure that public funds are not exposed to unnecessary or unquantified risk. Clearly any investment can decrease, as well as increase, in value and therefore it is imperative that the Committee establishes a robust framework against which individual opportunities can be assessed.

5.2.4 In exercising the power to invest under s.12(b) a local authority should have regard to the CLG Guidance on Local Government Investments. The Guidance advocates the preparation of an investment strategy which the Council will be expected to follow in its decision making process unless a sensible and cogent reason is articulated for departing from it.

5.3 Power to borrow

5.3.1 Section 1 of the Local Government Act 2003 gives each local authority a power to borrow money for:

(a) any purpose relevant to its functions under any enactment

(b) the purposes of prudent management of its financial affairs provided it does not exceed its affordable borrowing limit under s.3 Local Government Act 2003 (s.2(1) and 2(4))

5.3.2 These powers mirror those in s.12 Local Government Act 2003 referenced above.

5.3.3 The powers within the LGA 2003 are unlikely to be considered wide enough to permit local authorities to borrow to invest purely in order to benefit from a financial return. However, the Localism Act 2011 was drafted to encourage councils to develop new and innovative business models. This legislation gives councils the General Power of Competence, which means a local authority has powers to do anything that “for the benefit of the authority, its area or persons resident or present in its area”. The power does not enable an authority to carry out activities that were not permitted by legislation in force before the Localism Act 2011.

5.4 Commercial activity

5.4.1 The General Power of Competence may allow an authority to invest in property for a return but this activity is likely to be characterised as an activity for a commercial purpose and cannot therefore be undertaken directly by the authority (s.4 Localism Act 2011). It may be pursued through a company formed for that purpose and being within the meaning of S.1(1) Companies

Act 2006. There will be attendant corporation and income tax liabilities which will need to be addressed in a business case. The formation of a company requires the preparation of a thorough and detailed business case and these and other considerations such as the financing of the company and any state aid issues would need to be addressed in that document.

6. Funding

Commercial acquisitions are treated as capital expenditure. There are a number of ways in which items of capital expenditure can be funded:-

6.1 Revenue Contributions to Capital Outlay

6.1.1 This requires a direct charge to revenue. Given the Council's overall financial position this would require further savings to be identified within the revenue budget to the same value as the charge and therefore this funding route is not a realistic option for the Council.

6.2 Reserves

6.2.1 This would involve the use of non-earmarked reserves. The General Reserve is operating at the minimum level agreed within the Medium Term Financial Strategy and therefore cannot be utilised for this purpose. The Council could use the Transformation Fund but this would remove the ability to use this resource to fund pump priming operational transformation. If the entire Transformation Fund was used the additional revenue generated would only create a revenue stream of around £1.25m, albeit the Council would retain ownership of an asset with a value of £20m.

6.3 Capital Receipts

6.3.1 Until relatively recently the Council used to sell assets that became surplus to operational need. This created a pipeline of useable capital receipts that were used towards funding of the capital programme thereby reducing the need to borrow. For the last two financial years the Council has retained ownership of surplus assets rather than dispose of them and has sought to create revenue streams from their use instead – Castle Court being the highest profile of such examples. Occasionally the asset is not appropriate for redevelopment, or leasing, and in such cases these assets are sold.

6.3.2 On this basis it would appear that there is little opportunity for funding new acquisitions through the use of capital receipts. However the Council will shortly start to sell assets to Cambridgeshire Housing and Investment Company (CHIC). This will generate useable capital receipts for the Council albeit these will not be cash backed sales. The assumptions within the Business Plan are that these receipts will be used to support the existing capital programme and thereby reduce the level of additional borrowing, rather than prudential borrowing, to fund the capital programme. However they could instead be used to finance the cost of commercial acquisitions. The net impact on the revenue budget will be the same as new borrowing to fund the cost of the capital programme, as would otherwise have been the case.

6.3.3 There is however some logic to using capital receipts for the funding of new commercial acquisitions from the sale of assets to CHIC as the Council would be acquiring new assets on its books to replace those sold.

6.4 Borrowing

6.4.1 The other source of funding is borrowing which is predominantly undertaken through the Public Works Loan Board. It is likely that any debt associated with that investment would need to be defrayed to revenue over the economic life of the asset. Any residual profit or loss on disposal would then be taken to revenue at that point. This point is currently being evaluated in more detail as it would be in the Council's interests not to have to charge minimum revenue provision (MRP) on any debt taken to support commercial acquisitions.

6.5 Use of a separate vehicle

6.5.1 CHIC was incorporated as a company to enable it to trade in commercial investments as well as housing. The Council could therefore use this as the delivery vehicle. As with the housing development programme the Council would finance the acquisition through the form of a loan and would gain a margin on the level of interest charged.

6.5.2 Each acquisition would be subject to a loan application that the Committee would need to approve and would include similar due diligence/governance requirements as if it were the Council acquiring the asset. CHIC would need to establish a separate company and thereby create a Group structure as the tax implications will be different than that for housing development. Any profits generated by the Company would of course be subject to corporation tax, however given the debt gearing of the vehicle this could be minimised.

6.5.3 The Council could of course set up a completely different vehicle and this matter is set out in more detail below.

7. Delivery Options

7.1 There are a number of differing vehicles that the Council could use to deliver the commercial objectives of its acquisition programme. A summary of these are summarised below:-

7.2 Investment Funds

7.2.1 The Council could invest in a property fund which could either be listed, or unlisted. This would involve a cash investment in a fund managed by a third party. The Council would establish an acceptable risk profile and would then select a fund that matched the outcome requirements for the investment. Having made this selection and agreed the cash investment the Council thereafter would have no direct engagement in the investment process. The fund manager would report and pay distributions to the Council on a regular basis.

7.2.2 The benefits of this approach are that risks are spread across a wide range of investments thereby minimising concentration risks. It requires less direct Council management intervention and accumulates revenue from the point of the investment.

7.2.3 Disadvantages of this approach are that generally the funds are relatively illiquid particularly in market downturns (less so for listed funds). The fund manager takes a management fee which reduces the overall return on the fund. The Council could not use the fund to support any other corporate objectives. Listed funds generally have a lower net yield compared to directly managed portfolios.

7.3 Acquisitions

7.3.1 In this situation the Council would acquire and manage freehold or long term leasehold properties. The Council would engage the services of a commercial property expert in order to identify market opportunities. An agile governance for considering proposals would be implemented and individual proposals would be processed through those arrangements. The Council could use advisors to undertake robust due diligence and complete sale documentation. On-going management arrangements would be put in place and these could either be internal or outsourced arrangements.

7.3.2 The benefits of this approach is that the returns are likely to be in excess of fund arrangements. Revenue would be generated from the point of acquisition and with proper due diligence risks are mitigated. There is a reasonable level of liquidity and management costs are relatively low.

7.3.4 The disadvantages are that the Cambridgeshire market generates relatively low returns due to competition and security of tenure which will mean looking further afield to generate higher returns. At least initially, there will be a concentration risk until a diverse portfolio is developed.

7.4 Development

7.4.1 In this scenario the Council would either carry out development itself or enter into an agreement with a developer to fund all or part of a development. This could be enacted as a direct commercial arrangement with a developer or could be delivered via a joint venture arrangement. Working in conjunction with a developer an opportunity would be identified. Risk and reward arrangements would be established and agreed with the developer. In a JV scenario the level of risk would mirror the level of reward that each partner will derive. This would normally be 50:50 however other scenarios could be developed. If the Council were to develop the investment itself and simply seek a provider to construct to a defined specification, it would of course not share any of the benefits – but neither would it share any of the risks.

7.4.2 The benefits of this type of commercial arrangement are that the developer could bring skills to the arrangement that the Council does not hold internally. The investment should deliver a premium over and above straight investment however it therefore carries with it proportionately greater risk. Selecting the right development partner is essential for success. Self-development would bring greater financial rewards and would ensure that the Council remains in control of the development. However the Council would need to invest to ensure that it had the right skills and capacity to manage such an investment programme as these do not currently exist within the Council.

7.4.3 The disadvantages are that revenues are only accrued once the development has been completed. Land acquisition and other costs will be incurred long before any revenue stream commences. There is very low liquidity during construction and diversification of portfolio would be low. The self-development route would expose the Council to procurement and construction risks which would need to be mitigated by the 'buying in' of the appropriate and necessary skills.

8. Budget Provision

8.1 If the investment is made direct by the Council (as opposed to through a different vehicle) the acquisition must be treated as a capital cost and should therefore form part of the capital programme. Members will be aware that where capital expenditure is funded through borrowing that debt has to be defrayed through the revenue account by a charge known as minimum revenue provision. The Council has an agreed policy on the period that loans are discharged based on different asset classes which it reviews on a periodic basis. As these assets would be acquired as investment, rather than for operational purposes, it was considered whether the same rules applied. Although we do not yet have a conclusive position on this issue it would appear that the same rules do apply – albeit the period of the defrayment could be over an extended period given the nature of the asset class.

8.2 As the Council is 'selling' land to CHIC in order to develop the housing portfolio it will be receiving significant capital receipts from the Company over the coming years. Although these are not cash backed receipts they do convey with them capital spending power. This would enable the Council to use these funds to support the commercial acquisitions thereby avoiding the need to charge MRP in relation to acquisitions funded in this way. Whilst this would enable the full return on capital to be recognised in relation to these specific investments, the Council's Business Plan forecasts have already assumed that the receipts generated through sales to CHIC will be used to reduce the amount of notional debt incurred in delivering the overall capital programme.

8.3 The net effect is that the actual net revenue Business Plan benefit will have to take into account debt repayments, which make the returns very low.

8.4 The other mechanism for acquiring assets would be to undertake the acquisitions through a different vehicle. This could either be through CHIC or through the establishment of a separate vehicle. This would enable the Council to provide loans to the Company to acquire the assets and would enable the Council to gain a margin on loans incurred and loans charged. This will however restrict the net benefit to the revenue account to the margin on the loan – which effectively will be around 3%. The Company will not need to defray the debt to revenue in the same way, as the Council does and can deal with any debt and changes in value of the asset on disposal. The Company would of course be subject to corporation tax but would be able to benefit from tax allowances associated with major investments in the fabric of the building during its ownership of the assets.

8.5 The impact on the Council's net revenue budget is very similar whichever route is taken. Therefore to make any significant impact on the Council's overall financial position the Council will need to invest heavily. Based on a margin of 3% the Council would need to invest £0.5bn to generate an annual revenue benefit of £15m.

8.6 There is currently no provision within the current capital programme for such acquisitions. As the level of acquisitions could not be predicted with any accuracy in advance it would be impossible to include an accurate assessment of the potential investments within the capital programme. Therefore some form of blanket cover would be required without any specific revenue cost/income associated with the acquisition. This is probably more effectively managed through retrospective Business Plan adjustments but will need to be supported by appropriate governance approvals which are dealt with below.

9. Governance Processes

9.1 The decision to invest public funds in commercial acquisitions is one that should not be taken lightly. Any investment carries with it a degree of risk and the level of returns are directly proportionate to the risk of the investment made. Balancing risk and reward is dealt with elsewhere in this Strategy. Whilst it is important to ensure that due and proportionate governance is followed, the market for commercial investments is such that agile decision making is also important. This is particularly the case where the Council wish to acquire commercial opportunities before they hit the market and thereby avoid bidder competition which tends to escalate the sales price.

9.2 There is a fine balance in ensuring appropriate due process has been undertaken and not having governance requirements that result in opportunities being missed. As a consequence it is unlikely that any acquisition proposals could be considered within the democratic cycle of meetings.

9.3 If the Committee agree to the principle of investing in commercial opportunities it will need to agree how any such proposals can be considered, evaluated and pursued within an agile, yet transparent and accountable, framework.

9.4 It is clear that the Council will need to work with a partner organisation in developing the portfolio. Officers have neither the skills nor capacity to access market opportunities. There are many professional advisors in the market and if this strategy is agreed, a working group of the Committee will be established to appoint a provider of services.

9.5 Having considered the issues set out in this strategy it is proposed to establish a tiered decision making process as follows:-

Investment/Loan Value - £m	Decision Making Arrangements
Less than £10m	Deputy Chief Executive/CFO in consultation with Chairman of Commercial and Investments Committee
Greater than £10m but less than £25m	Commercial & Investment Committee Investment Working Group
Greater than £25m but less than £50m	Commercial and Investment Committee
Greater than £50m	General Purposes Committee

9.6 The Commercial and Investment Committee Investment Working Group would be proportionately representative and therefore it is suggested that it be a membership of five Members (3 Conservatives, 1 Liberal Democrat, and 1 Labour Member). The meetings of the Group could be undertaken virtually if circumstances deemed it necessary.

10. Managing Portfolio Risks

10.1 The structure of a property portfolio has a significant bearing on the portfolio's inherent risk and return profile. A key objective of the portfolio strategy is to create diversification within the portfolio in order to manage exposure to the risks of concentrating too much activity in any particular sector. Risks in the portfolio can be categorised in a number of ways. The following highlight the key risks of a portfolio of this nature.

10.2 Income Risk

10.2.1 The main risk in a commercial portfolio is tenant vacancies and the resultant loss of income. The costs of holding a vacant property include non-domestic rates, insurance, utilities, security, inspections and management. In addition, there would be the cost of marketing the property, the agent's disposal fees and legal fees for completing the lease documentation for re-letting the premises.

10.3 Yield Risk

10.3.1 The aim of the majority of investments is to provide a secure return on income. The Council will manage its commercial property as a single portfolio, ensuring that the collective returns achieved on the investments meet the overall financial target that is set. It is therefore important that any purchasing decisions also contribute positively to the performance of the portfolio, both financially and in minimising the overall risks.

10.4 Concentration Risk

Concentration risk can be categorised into a number of constituent risks:

10.4.1 Sector Concentration: The main property sectors are retail, office, industrial and leisure/healthcare. The portfolio will aim to spread its investment across the sectors to limit exposure to any volatility in a particular area. Like geographic diversification, industry diversification must be sensitive to the diversification requirements of the overall portfolio. The value of industrial real estate holdings is sometimes adversely affected by changes in environmental legislation, and such holdings should probably be limited in overall investment portfolios.

10.4.2 Geographical Concentration: As this strategy is being driven by investment return, the need for the acquisition to be in Cambridgeshire is not an issue. The strength of the investment opportunity will dictate the wider locations which may be considered, as opposed to the location being the driving force. It is important for the Council to understand the future economic viability of localities which will be influenced by a number of local and national economic factors. For example future major transport infrastructure investment could significantly influence the economic viability of an area and therefore the future value of investments in that locality. Engaging the services of an expert will therefore be an essential prerequisite of the strategy.

10.4.3 Property Concentration: Diversifying a real estate portfolio by property type is similar to diversifying a securities portfolio by industry. Different property types cater to different sectors of the economy. For example, office property generally responds to the needs of the financial and services-producing sectors; industrial property to the goods-producing sectors; retail property to the retail sector; and hotels to the travel and tourism sectors, employment growth, and the business cycle. Understanding the return and risk factors attendant to different property types requires understanding the factors affecting each property type’s user groups.

10.4.4 Tenure Concentration: The portfolio can be managed to ensure that it contains a broad spread of tenants. This analysis can be driven by credit ratings, nature of business, lease length, and the value of the leaseholds. It is important to evaluate tenant credit ratings according to the senior corporate debt of the lessees. Leases can be compared with regard to their length (including renewal options), which may vary considerably, typically from ten to twenty years.

10.5 Due Diligence

10.5.1 The risks associated with a specific investment are mitigated by carrying out robust due diligence of the individual acquisition. This process includes the following activities:

- Valuation
- Market conditions
- Covenant strength
- Terms of leases
- Structural surveys
- Future costs
- Other issues

11. Property Management

11.1 Management of Property: Properties with fully repairing and insuring leases shall be sought as a preference for investment, in order to minimise the cost of management and maintenance. Exceptions could be made for properties that are purchased for specific development or planning reasons. In order to minimise management overheads, use of an external property management firm would be considered to handle the day to day operational issues with the portfolio, particularly for properties which are outside the county.

11.2 Tenure: Assets acquired with tenants in place may be subject to sub-leases granted within the security of tenure provisions of the Landlord and Tenant Act 1954. This may be less attractive if assets are purchased for future development possibilities as ending the tenancies will require the Council to satisfy one of the grounds under the Act to take back possession. Conditions of tenure will therefore be a further important consideration in any investment decision.

11.3 “Exit Strategy”: There will be a need in the future to dispose of property investments. This may happen because of the need to return the investment to cash for other purposes, or it could be due to poor financial performance of a particular property, etc. So, while it is likely that the majority of investments will be held for a medium to long term in order to achieve the required return and to justify the cost of the acquisition, it is important to understand the opportunities to dispose of any investment at the outset. Therefore, as part of the investment decision, consideration must be given to the potential ways in which the Council could “exit” from the investment, such as sale to another investor, sale for redevelopment, etc. An investment would only proceed where there is a clear exit strategy, should it be required

12. Market Conditions

UK PROPERTY INVESTMENT YIELDS | JUNE 2017

- The UK general election campaign did not unduly affect markets, and the longer term consequences of the election result and Brexit negotiations are still to be resolved. The markets will be watching closely to see how the new Government settles down over the coming weeks.
- There are still more buyers than sellers for good quality properties, with the industrial sector remaining the star performer due to robust rental growth prospects. The secondary retail sector remains under pressure.

	June-16	Sept-16	Dec-16	Mar-16	June-17	Trend
HIGH STREET SHOPS	%	%	%	%	%	
Prime	4.00	4.25	4.00	4.00	4.00	Stable
Good Secondary	6.50	6.75	6.75	6.75	6.75	Stable
Secondary	9.00	9.00	9.00	9.00	9.00	Weaker
SUPERMARKETS						
Prime (25 yrs,3.5% pa cap RPI)	4.25	4.50	4.50	4.50	4.50	Stable
SHOPPING CENTRES						
Prime	4.50	4.65	4.65	4.65	4.65	Stable
Best Secondary	6.25	6.75	6.75	6.75	6.75	Stable
Secondary	7.25	7.75	7.75	8.00	8.25(8.00)	Weaker
RETAIL WAREHOUSES						
Park - Open A1 (inc fashion)	4.35	4.75	4.75	4.75	4.75	Stable
Park - Prime - Bulky User	5.35	5.50	5.50	5.50	5.50	Stable
Solus - Prime - Bulky User	5.75	5.75	5.75	5.75	5.75	Stable
Park - Secondary	6.75	7.25	7.25	7.25	7.25	Weaker
LEISURE PARKS						
Prime	5.00	5.00	5.00	5.00	4.85(5.00)	Stronger
OFFICES						
West End	3.50	3.75	3.75	3.75	3.75	Stable
City	4.00	4.25	4.25	4.00	4.00	Stable
M25/South East	5.25	5.25	5.25	5.25	5.25	Stable
Regional Cities	5.25	5.25	5.25	5.25	5.25	Stable
Good Secondary	6.50	6.50	6.50	6.50	6.50	Stable
Secondary	9.00	9.00	9.00	9.00	9.00	Weaker
INDUSTRIAL						
Prime Distribution	5.00	5.00	5.00	5.00	4.85(5.00)	Stronger
Prime Estate (GL ex HTW)	5.00	5.00	5.00	4.75	4.50(4.65)	Stronger
Prime Estate (Ex Greater London)	5.25	5.25	5.25	5.00	4.75(4.85)	Stronger
Good Secondary	6.25	6.25	6.25	6.00	5.75	Stronger
Secondary Estate	8.25	8.25	8.25	8.00	7.25(7.50)	Stronger
FINANCIAL INDICATORS						
Base Rate	0.50	0.25	0.25	0.25	0.25	↔
5 Year Swaps	1.10	0.53	0.95	0.89	0.81	↔
10 Year Gilts	1.28	0.65	1.38	1.22	1.03(1.11)	↓
RPI	1.30	1.90	2.00	2.50	3.50(3.10)	↑
CPI	0.30	0.60	0.90	1.80	2.70(2.30)	↑

VALUED INSIGHT

Join our upcoming monthly index call as we provide a review of the key trends and performance of commercial property, considering potential challenges and opportunities for the real estate market. To find out more and register your interest click here.

NB Prime yields refer to the equivalent yield for a prime (well specified, well located and rack rented) property let to financially strong but not Govt, on a lease with 15 years unexpired and open market rent reviews. Last month's figure in brackets if changed.

CBRE

The Council will need to develop a balanced portfolio of investments whichever delivery vehicle is used for the acquisition. This will include both geographical and market segmentation spread. The attached table sets out the relative performance of the various sectors over the last 12 months. The returns generated will vary geographically and will be influenced by the stability of the markets in those localities. We know for instance that Cambridgeshire is seen as a solid investment locality. Therefore proposals with good occupation and tenancy lengths are attractive to funds who are looking for long term security of investment – such as pension funds. This drives the purchase price up and the level of returns down.

12.1 This strategy focuses on buying new assets, some of which will be located in the county, and therefore will support local employment. However the local commercial market whilst generally offering low risk investments also offers low levels of returns which making those investments less attractive.

12.2 An example of this was highlighted in a recent article on retail centres:

Cambridge has been named the UK’s best place to shop after rising through the ranks of Harper Dennis Hobbs’ top 1,000 retail centres in the UK.

The retail specialist’s Vitality Index measures the “retail health” of locations across the UK based on factors such as the vacancy rate, proportion of upmarket and value-led shops, the proportion of undesirable shops such as pawnbrokers and bookmakers.

These variables are also compared to the demographic composition of the centre’s catchment area, with a greater score is given to areas whose retail mix is adapted to the local community.

In this year’s report, which has been expanded to 1,000 from 500 centres last year, Cambridge jump six places to be awarded the UK’s healthiest retail centre. The university town also came top of Lambert Smith Hampton's index released earlier this year of towns best placed to support economic expansion, further supporting these findings.

Vitality Rank	Centre	Prime Zone A Rental Rank (1 = Highest)	Market Size (Weighted Retail Expenditure)	Change Since 2014
1	Cambridge	20	£1,513,016,237	+6
2	Westfield London	6	£2,192,438,446	-1
3	Knightsbridge	3	£633,482,231	0
4	Chelsea	4	£764,265,134	-2
5	Bluewater	9	£1,946,420,654	+3
6	Wimbledon Village	164	£88,843,941	New Addition
7	Richmond	28	£404,623,870	0
8	Canary Wharf	10	£368,953,691	-3
9	Marlborough	229	£113,319,198	New Addition
10	Bath	42	£1,328,625,901	+2
11	Sloane Street	1	£206,106,322	New Addition
12	Westfield Stratford	5	£1,765,198,912	+5
13	Reigate	200	£131,328,606	New Addition
14	London West End	2	£9,141,226,044	+2
15	St Albans	73	£507,678,384	+7
16	Berkhamsted	252	£113,697,055	New Addition
17	Edinburgh	38	£2,346,843,910	+5
18	Kingston upon Thames	13	£2,107,118,547	0
19	Cobham	200	£101,534,296	New Addition
20	Cribbs Causeway	11	£1,126,748,715	+1
21	Chiswick	99	£253,761,350	+11
22	Brighton	34	£1,902,344,776	+6
23	Harrogate	56	£826,855,386	+3
24	Guildford	11	£1,385,378,494	-7
25	Henley-on-Thames	150	£206,782,026	New Addition
26	Bristol - Clifton	229	£117,811,673	New Addition
27	Sherborne	228	£114,903,538	New Addition
28	Meadowhall	15	£1,741,402,629	+4
29	Ilkley	190	£174,778,586	New Addition
30	Sevenoaks	289	£193,322,362	+8
31	Chichester	62	£717,782,616	0
32	Islington - Upper Street	99	£501,574,370	-6
33	Kensington	31	£685,114,699	-14
34	Birmingham	19	£3,738,666,154	+31
35	Leeds	28	£3,180,292,167	+4
36	Muswell Hill	99	£142,886,468	New Addition
37	Tenterden	229	£103,728,550	New Addition
38	Glasgow	69	£4,260,877,222	+30
39	Marlow	83	£174,047,714	+7
40	Fulham Road	43	£213,427,596	New Addition
41	Wilmslow	229	£197,659,173	+2
42	St. Ives (Cornwall)	371	£97,121,316	New Addition
43	Chester	34	£1,678,594,102	-4
44	Hampstead	43	£89,398,650	+1
45	Trafford Centre	8	£1,851,676,699	-12
46	York	54	£1,396,532,968	+4
47	Liverpool	26	£3,102,829,857	0
48	Oxford	38	£1,478,546,453	-10
49	Lakeside	15	£1,633,327,360	-3
50	Holborn	74	£171,628,390	New Addition

12.3 The investment strategy will provide continual evaluation of the investment portfolio to meet the Council’s priority to ensure that the investment portfolio is fit for purpose. A larger and more balanced portfolio will help achieve the Council’s aim of increasing income to support the delivery of services throughout the county.

13. Developing the Portfolio

13.1 If it is agreed to create a commercial portfolio it will need to be developed over time to avoid the concentration risks set out earlier in this report. This will result in a balanced portfolio of investments across sectors and across geographical locations. In the first instance, of course, the first acquisition will result in 100% concentration in all risks.

13.2 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.

13.3 Core Acquisitions:

13.3.1 As a new investor in this area of activity it is proposed to take a relatively low risk approach to acquisitions at this point in order to develop a sound real estate investment portfolio. This will reduce the level of return that can be generated and therefore the Committee may wish to review this approach. It is proposed to target investments with yields of around 6% to 7%.

13.3.2 Investments in this area would include 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.

13.3.3 This segment can also include properties that contain similar properties to those above but in slightly less favourable locations, with shorter leases and lesser tenant covenants returns will be appropriate for the sector and risk. Rental yields in this area will be higher reflecting the increase in risk.

It is suggested that this category should ultimately form 75% of the overall portfolio.

13.4 Specialist Sector & Residential Opportunities:

13.4.1 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.

13.4.2 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.

13.4.3 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.

13.4.4 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 element of the portfolio.

It is suggested that ultimately this category should form 25% of the overall portfolio.

13.5 Specialist Acquisition:

13.5.1 Vacant or short leases, re-development opportunities or distressed property requiring extensive capital expenditure can reap high capital and yield returns. However they also carry with them higher risks. Whilst not a specific investment segment it is proposed that opportunities should be considered as they arise but the due diligence associated with any such proposal be extensive.

13.6 Investment Portfolio Principles & Decision Making Criteria: The following principles will be followed when considering acquisition opportunities;

- All investments considered must initially provide income (yield) equal to or above the councils required rate of return (RRR)
- 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.
- Preference will be for single occupancy investments although multi-let properties or multi-unit schemes will be considered.
- Location will be dictated by opportunity to acquire investments that meet the strategy.
- Only investments with full repairing and insuring (FRI) terms, or FRI by way of service charge, will be considered.
- Lease length will be determined by market sector forces but these will be maximised.
- Market rent (MR) should be equal to or above passing rent.
- Market sectors and locations with rental growth and good letting prospects will be actively sought.
- Buildings should have sound structure and designed for use, with good transport links and accessibility.
- A 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.
- 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.
- 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.

12.7 In order to facilitate the decision making process it is proposed to establish a ready reckoner for a key criteria. A statement setting out the anticipated costs and benefits over time, including the expected effects of inflation, will be produced. The period covered should equal the expected life of the investment and should include any residual value of the assets at the end of the investment period. The initial criteria proposed are as follows:-

Criteria	**Definition**	**Notes on use**
Payback Period	Number of years required to repay the original investment in nominal (cash) terms	This can be helpful in more straight forward investments. It does not take account of the time value of money and will be less useful for more complex proposals
Return on Investment	Percentage gain in nominal terms on top of the recovery of the initial investment	Straight forward and assists a ready reckoner initial assessment
Total Return	Total nominal gain over the course of the investment	Absolute value would be used to distinguish between projects with similar relative returns
Internal Rate of Return	The discount rate applied in a Net Present Value calculation that gives an NPV of 0	The measure takes account of the time value of money and will thus be appropriate for long term major investments
Net Present Value	Discount rate to calculate the present value of future cash flows	Should be considered together with the IRR