Report to: **Cabinet**

Date of Meeting: **11 September 2017**

Report Title: **Land and Property: Commercial Property Investment Strategy**

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(Chief Finance Officer)

Purpose of Report

This report proposes that the Council makes significant additional investments in Commercial Property for the purposes of economic development and regeneration and for income generation or for a mixture of the two. It will assist in supporting the delivery of future Council services and strengthen its long term financial stability. This strategy excludes housing investment which is the subject of a separate strategy.

Recommendation(s)

1. **The Commercial Property Investment Strategy is approved**
2. **That Council approve supplementary capital expenditure for property acquisitions of up to £29m for the period 2017/18 to 2019/20 based upon £29m of borrowing commencing in 2017/18 (for economic and social wellbeing purposes and to generate on-going revenue streams). This sum will be reviewed on a regular basis.**
3. **The Cabinet to continue to determine the individual property acquisitions, following consideration by the Income Generation Group (Special Cabinet meetings may need to be held at short notice to enable the Council to be sufficiently agile to take advantage of opportunities).**
4. **Delegated authority to remain with the Chief Finance Officer (S151 officer) to meet revenue acquisition costs from reserves that are not chargeable against a Capital budget – to include abortive costs.**
5. **The Council's Asset Management plan is updated to take account of this strategy and that economic development, regeneration and employment considerations continue to be the driving factor behind existing Council property and land development opportunities within Hastings.**
6. **To seek opportunities for commercial acquisitions:**
    a. **Within Hastings and its travel to work area to be procured directly by the Council for both regeneration and income generation purposes.**

b. **Via Council owned property company for acquisitions outside this area undertaken for income generation purposes alone.**

7. **Acquisitions outside the area to be focused on those areas in the South and Midlands where the local economy is likely to offer the A trading company to be established to provide flexibility of approach - the Council is able to invest its own monies under existing investments powers in properties across the country, but anticipates the need to form a company if it wishes to purchase properties outside of the borough for the sole purpose of income generation.**
8. **Appropriate due diligence be undertaken on each and every opportunity.**
9. **Given that the Council's risk appetite will be constantly changing depending upon the risks and opportunities it faces, future funding predictions and economic environment, each commercial property investment must be considered on its merits and the financial position of the Council at the time within an overall borrowing umbrella.**
10. **Further Property Fund investments to be considered as part of the 2018/19 Treasury Management Strategy – to be determined by full Council in February 2018.**
11. **Accept that there are many property related opportunities that present themselves to the Council which are not specifically included within this strategy which may be considered commercial in nature e.g. investment in a new leisure centre. The Council will look to consider all options for investment and the Commercial Property strategy may help to inform the decision making process when alternative options for use of Council resources are being considered.**

Reasons for Recommendations

The Council already has a significant property and land portfolio from which, as well as helping to drive economic development in the Borough, it derives a significant income stream. This directly assists the funding of Council facilities and services

Given the current funding reductions the Council seeks to build upon its existing knowledge and experience to significantly enhance economic and regeneration opportunities within the borough and also enhance its income stream from property or property related investments.

Property investments have been returning higher rates of return than the Council can achieve with purely cash investments. Money from the Council's own reserves invested in property or Property Funds need to be surplus to medium term requirements or there is a risk that the Council would need to sell these at a time when there is the potential for a Capital loss.

The Council holds assets for a variety of purposes, and not purely for income generation. The Council's more commercial property assets such as factories and shops generally achieve a good return (particularly as most are not encumbered by debt). The council does review the assets that it already owns and has been successful in developing land and buildings in its ownership – and will look to continue to do so.

The Council needs to prioritise new Income generation from any review of existing assets.

Purchase of commercial property either in Hastings or beyond its boundaries provides the Council with opportunities to continue economic development and enhance employment prospects as well as develop and enhance income streams to assist in the future funding and delivery of core services.

Purchase of commercial property outside of the Hasting's travel to work areas may be viewed as purely an income generation initiative and a trading activity – if borrowing the money to do so. A separate company would be set up to accommodate this.

Introduction

1. The Council has resolved to introduce a strategy to invest further in commercial property for the purposes of economic development, redevelopment, and in support of its stated aim of income generation, or a mixture of both.

2. The proposed strategy attached lays out the basis for decision making around the acquisition of commercial property. It gives the basis for both members and officers to operate. It forms part of the Council's overall approach to income generation and regeneration.

3. This is not a wholly new activity for this Council and other local authorities, albeit the scale is significantly increasing and likewise the geographical spread of acquisitions is potentially much wider.

4. In February 2017 the budget report included updated forecasts for the future deficits the Council faces. For 2017/18 this amounts to £555,000, 2018/19 some £1.7m and 2019/20 some £2.1m. Given the financial position that the Council faces and the current low returns on investments the yields on good commercial property are attractive, albeit the risks in both the short term and longer term (beyond 10 years) have to be recognised at the outset.

5. The overall income receivable by the Council from its factories/ shops/offices and other land and buildings (excluding HBC operated services e.g. car parks, cliff railways, crematorium, parks, etc) is some £3.7m p.a.

6. The Council has experienced Estates and Surveying teams who are able to lead and support on the initiative, and the Council can build upon this experience and that of the legal and finance teams in respect of acquisition and development of commercial property.

7. Many authorities are making significant investments in Commercial property. More recent examples include New Forest DC (£30m), Basingstoke and Deane BC (£30m), Epsom and Ewell (£20m). These can be funded from the Council's own resources or by taking advantage of its ability to currently borrow at relatively low rates (prudential borrowing) from the Public Works Loan Board (PWLB) for the purposes of Capital expenditure. The strategy is based on the Council using its prudential borrowing ability to fund an enhanced Capital programme.

8. As already experienced Commercial property investment opportunities often arise at short notice and the Council needs to be able to move quickly when called upon to do so. An investment strategy will be helpful in order to be able to assess the individual opportunities.

9. Commercial Property is available through traditional selling routes, through auctions and through off market direct approaches by agents e.g. those working for institutional investors and those wishing to avoid formal marketing processes in order to save time and agents fees. Receivers and administrators of companies in trouble may also look to dispose of assets quickly.

10. The Council has recently purchased industrial land which adjoins existing Council land and will provide more opportunities for development in the future.

11. There are a number of ways of increasing income through property. The attached strategy looks at some of the key ones, but excludes housing given that this is subject to separate consideration. Namely:

    (i) Current property related initiatives and income generation opportunities e.g. Aquila House, rental of town hall, rental of new business units, cafes, kiosks and new factories.

    (ii) Sale and development of existing land, property and assets

    (iii) Acquisition of land and commercial property inside and/or outside of Hastings and the travel to work area.

    (iv) Property Investment Funds

12. The immediate emphasis is on the acquisition of commercial properties. The Council's existing Asset Management plan will need to be updated in the light of the agreement or otherwise of the various proposals coming forward under the umbrella of Income generation.

Risk Management

13. Commercial property can provide secure income streams for as long as the tenants businesses remain profitable and property markets no collapsing. The Council needs to consider these as long term acquisitions, but should not be afraid to dispose of assets where necessary. There will undoubtedly in the years ahead be falls in the property market, there will be void periods, and there will be bad debts, repairs, negotiations on dilapidations, and a myriad of other issues that all arise where property is concerned.

14. The Council will need to ensure that a fall in the property market, voids and non payment of rentals would not jeopardise its ability to repay the borrowing commitments it will take on. As such a careful review of the Council's overall financial position needs to be taken when considering each investment opportunity. An exit strategy needs to be considered, if ever necessary, should the long term viability of the property become questionable.

15. Undertaking the necessary due diligence work on each property should highlight the risks involved prior to purchase.

16. Having an experienced property management team should ensure that the ongoing management of the property does not become problematic.

17. More details of the risks involved are included in the strategy document. The fall back position for the Council is to maintain sufficient reserves to overcome short term problems and be able to attract new tenants or complete an exit strategy.

Environmental Issues

18. These will be considered when considering each acquisition.

Economic/Financial Implications

19. These are detailed in the strategy. In brief the Council would look to enhance the capital programme by £29m. This sum to be spent in the period 2017/18 to 2019/20. It may all be spent in 2017/18 if the right opportunities came forward. The Council would look for financial returns of between 5% and 7% (gross yields) and between 1% and 2% (net yields) after taking account of financing costs. Based on an average returns being achieved income is forecast to be between £290,000 and £580,000 per annum – based on in-house management.

20. This level of investment, along with the £21m (if approved) for other opportunities (housing and energy) over the next three years has the real potential to help close the budget deficits the Council faces.

Organisational Consequences

21. There may be capacity issues in Estates, surveying, legal and finance teams when commercial properties are being acquired due to the sheer volume of due diligence work required in a relatively short period of time. Additionally the Council may need to actively seek opportunity rather than waiting to be presented with it. Even if outsourced there will be capacity issues and a requirement to reprioritise work. The ongoing implications for the organisation are dependent upon the particular deal and the contractual arrangements in place e.g. full repairing and maintenance agreements, number of tenants in situ etc.

Wards Affected

All

Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	Yes
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	Yes
Local People's Views	No
Anti-Poverty	No

Additional Information

Officer to Contact

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Land and Property: Commercial Property Investment Strategy

Introduction

1. The Council has resolved to introduce a strategy to invest in commercial property for the purposes of economic development, redevelopment, and in support of its stated aim of income generation, or a mixture of both.

2. This strategy lays out the basis for decision making around the acquisition of commercial property. It gives the basis for both members and officers to operate. It forms part of the Council's overall approach to income generation and regeneration.

3. This is not a wholly new activity for this Council and other local authorities, albeit the scale is significantly increasing and likewise the geographical spread of acquisitions is wider.

4. In February 2017 the budget report included updated forecasts for the future deficits the Council faces. For 2017/18 this amounts to £550,000, 2018/19 some £1.7m and 2019/20 some £2.1m. Given the financial position that the Council faces and the current low returns on investments the yields on good commercial property are attractive, albeit the risks in both the short term and longer term (beyond 10 years) have to be recognised at the outset.

5. The overall income received by the Council from its factories/ shops/offices and other land and buildings (excluding HBC operated services e.g. car parks, cliff railways, crematorium, parks, etc) is some £3.7m p.a.

6. The Council has numerous initiatives on the go at any one time which involve Council property or have property related issues e.g. White Rock area, West Marina, Ore valley, Summerfields, land purchases and disposals, and some of these will have the potential for the Council to generate income either directly (rentals) or indirectly (business rates/ new jobs/fewer benefit claims) or generate capital receipts.

7. The Council has experienced Estates and Surveying teams who are able to lead and support on the initiative, and the Council can build upon this experience and that of the legal and finance teams in respect of acquisition and development of commercial property.

8. Many authorities are making significant investments in Commercial property. More recent examples include New Forest DC (£30m), Basingstoke and Deane BC (£30m), Epsom and Ewell (£20m) . These can be funded from the Council's own resources or by taking advantage of its ability to currently borrow at relatively low rates (prudential borrowing) from the Public Works Loan Board (PWLB) for the purposes of Capital expenditure.

9. As already experienced Commercial property investment opportunities often arise at short notice and the Council needs to be able to move quickly when called upon to do so. An investment strategy will be helpful in order to be able to assess the individual opportunities.

10. Commercial Property is available through traditional selling routes, through auctions and through off market direct approaches by agents e.g. those working for institutional investors and those wishing to avoid formal marketing processes in order to save time and agents fees. Receivers and administrators of companies in trouble may also look to dispose of assets quickly.

11. The Council has recently purchased industrial land which adjoins existing Council land and will provide more opportunities for development in the future.

Commercial Property Vs Other Investment Opportunities

12. The Council has limits on the amount of borrowing that it is prudent to hold at any one time. This overall limit being determined by the financial position of the Council and its forecast of future income streams. Factors to take into consideration include, the level of risk of individual investments - based upon the type and period of the investment, along with a holistic view of the risks that the Council faces whether it be from reductions in grant, income generation, interest rates, inflation, economy, or claims being made against the Council and the level of reserves held . The Council sets the overall borrowing limits prior to the start of each financial year as part of its Treasury Management Strategy. The overall limits can only be changed in the year by full Council.

13. The Council will need to determine and regularly review the balance of its property portfolio and where it will invest its resources e.g. commercial property, housing or energy or to have a wider portfolio of investments across a number of sectors. This should be undertaken annually to inform the budget setting process and the Treasury Management Strategy.

14. Property related investments, whether it be in land, commercial property or housing investment or housing development, all have the ability to generate income streams as well as capital returns i.e. increases in value over the long term. Each area potentially having different levels of return in the short and longer term. The Council currently has a need for income but can reinvest any capital receipts obtained e.g. from future asset sales to generate interest receipts or income – would then be available to support the revenue budget.

15. The Council is able to use its investment powers to invest existing revenue reserves into a property fund (a diversified portfolio) without this counting as Capital expenditure – subject to selecting the correct fund.

Levels of Investment, Risk and Council Reserves

16. Investing further in property exposes the Council to varying risks. These would include Counterparty risk (defaults in rental payments, bankruptcy), economic downturn (lower market rents in the future), oversupply and competition. If borrowing the money there will be the normal risks of exposure to interest rate fluctuations (can borrow at fixed rates).

17. A large empty property or even a large number of smaller empty properties could leave the Council with significant rates bills, standing charges and maintenance costs. To ensure that these remain affordable the Council would need to retain sufficient reserves to deal with such situations.

18. The levels of borrowing approved by the Council at its meeting in February 2017 are reproduced in the table below as is an estimate of the new borrowing that would be available to support commercial property investment and Income generation.

Prudential Borrowing Limits	**2016/17**	**2017/18**	**2018/19**	**2019/20**
	£'000	£'000	£'000	£'000
External Borrowing Limit	35,000	65,000	75,000	85,000
other long term liabilities	5,000	5,000	5,000	5,000
Total Authorised External Debt Limit	40,000	70,000	80,000	90,000
Available – Property Investment and Income Generation (Est)		**30,000**	**40,000**	**50,000**

19. The level of new borrowing available for investment and income generation is partly dependent upon the level of asset sales (Capital receipts) received in the year in order to fund the existing Capital programme, the Council's plans for asset and land acquisitions, development costs and the levels of investments in respect of, for example, housing and energy initiatives. As such if receipts are not received the borrowing requirements increase and there will be less money available for investment and income generation.

20. For the purposes of this strategy, assuming sums of £5m p.a. are invested in housing in each of the next three years and £2m p.a. in energy it would leave at least £29m for investment at the current time in commercial property in the period 2017/18 to 2019/20. Such sums can be reviewed annually when determining the Council's budget or more frequently if necessary.

Returns on Investments

21. The experience of this and other local authorities indicates a yield of between 5% to 7% (gross) can currently be achieved on the types of commercial property that are likely to be of interest i.e. good quality retail, industrial, office space.

22. The Council is able to borrow monies from the PWLB for long periods at interest rates of below 3% (currently around 2.55% for 40 year money) where these are funding Capital expenditure and are for a lawful purpose.

23. There may well be occasions when a lower return/yield may be acceptable if the credit worthiness of occupiers is much higher than the average – and where long term rental agreements are in place or where there are other significant long term benefits to the Council.

24. The Council will need to consider its overall level of risk across all of its activities, along with that of the property portfolio, in order to properly inform the decision

making process should it wish to increase the overall borrowing limits in future years.

25. The Council is required to set aside a sum each year to repay debt – termed Minimum Revenue Provision (MRP). The borrowing of a sum over 40 years would result in a sum of 2.5% of the principal being repaid in each of the subsequent 40 years together with the interest payable. As a result the net annual return on a property investment may be between 1% and 2% p.a. plus any Capital appreciation and any increase that flows from upward only rent reviews.

26. Assuming minimum net returns of between 1% and 2% on £29m, the additional revenue to the Council in a full year would be between £290,000 and £580,000 p.a. If the life expectancy of the land or buildings is greater the annual return will also be higher. This does exclude the fact that the Council would year on year own more assets and the Council's net worth would be expected to increase significantly over time.

27. In brief there are a number of one-off and on-going costs that would be incurred when purchasing properties

    (i) Agents or finders fee - (generally 1%)
    (ii) Legal fees (0.75%) – so far avoided as using in-house expertise
    (iii) Stamp Duty Land Tax (SDLT) – 0% first £150,000, 2% next £100,000, 5% on the sum above £250,000
    (iii) Finance Costs (between 2.5% and 3%, plus debt repayment costs e.g. 2.5% over 40 years)

28. Against this there may also be a need to update the property and to account for any void periods in terms of loss of rent and business rates. General repairs and maintenance charges will be determined within individual leases and responsibilities and obligations on each party are understood as part of due diligence work prior to purchase.

29. Subject to the number and type of properties purchased and the respective responsibilities within the leases there may be additional staffing requirements. Likewise if properties are purchased outside of the Borough there may be managing agent's fees and a tender process for management and maintenance to consider.

30. The Council is required to take a prudent approach to the management of its financial affairs. Given the funding gap of nearly £1.7m for 2018/19 doing nothing does not remain an option for the Council.

31. When considering the investment opportunities the Council needs to consider arrange of issues, such as ,

    (i) the level of reserves that must be retained,
    (ii) the yield,
    (iii) the life of the asset being acquired,
    (iv) freehold vs leasehold,
    (v) prospects for the economic sector,
    (vi) creditworthiness of tenant

(vii) Fully let ? and length of existing leases,
(viii) repair obligations,
(ix) management fees,
(x) assumptions made for capital and rental growth.

Asset Management – Current and Continuing Activities

32. The Council continues to review its own property and land holdings. Many of the properties owned have derived from historical decisions and one off opportunities which has led to a diversified portfolio of assets which are held for a variety of purposes and reasons. It is managed in an efficient manner.

33. Many of the assets held could be considered as "Commercial Property Investments" with some 63 factories and 37 small business units (100 directly let units in total), a 10% share in Priory Meadow shopping centre, Muriel Matters House and four shops and the recent purchase of the retail park at Sedlescombe Road North.

    In total there are some 342 agreements in place that cover land and property that the Council derives income from. These cover freeholds and ground rents on industrial units, a public house, a petrol station, to licences for ice cream vans. Some of the asset valuations (Capital Values) may be based on historic cost, and some of the assets that are held can't be disposed of at market value e.g. houses at Fairlight. The overall return (gross yield) on the assets held has been estimated at some 6.9% (see below):-

Capital Value	Gross Income	Gross Yield
£53,974,000	£3,735,000	6.9%

34. In terms of managing existing assets, the Council looks to rationalise land and properties and achieve higher returns from assets wherever possible. There has already been considerable success in reducing the level of accommodation occupied by the Council itself and also letting of existing buildings e.g. space in Muriel Matters House, Old Town Hall, seafront lettings. The Council will look to dispose of assets that either do not provide a good return or are surplus to current requirements, or where it can achieve a beneficial deal. For example some more recent disposals include:-

    (i) Small car park, Castle Hill Rd (left hand side) £22k – plus saving of rates/maintenance costs

    (ii) Land near Brunel Rd £60k - enabling local company to expand/ improve local parking issues.

    (iii) Summerfields business park - £650,000 – new housing

35. There have been a number of initiatives undertaken recently, or are in the pipeline, that the Council will seek to obtain an additional income stream from or reduce outgoings, whilst looking to enhance economic development in the broadest sense. For example:-

    a. Kiosk - West of Pier (Promenade) – opened May 2017

    b. Bottle Alley - various units

    c. Industrial Unit land (Brunel Rd) – purchased. This will enable site consolidation with existing land and provide an option to develop land for industrial purposes.

    d. Purchase of Muriel Matters House (previously Aquila House) and 4 shop units

    e. Town Hall – 5 different lessees in situ

    f. Old Town Hall – change of use – business opened May 2017

36. Initiatives such as those above are set to continue, subject to available resources and suitable business plans, and agreed on a case by case basis. It is recommended that the Council update its Asset Management Plan to reflect this strategy and the wider implications arising from income generation.

Asset Management – Sale and Development of Existing land, Property and Assets

37. The Council has a number of sites which are included in the land disposal programme whereby the Council can consider disposing of these or developing these ourselves e.g. Harrow lane, Mayfield E, Bexhill Road, West Marina. There are advantages and disadvantages of developing the council's own sites.

38. Advantages include, potentially more profit, ensuring the site is developed within an acceptable timescale, ability to retain income streams from ground rents, future uplifts in rentals of commercial properties. Disadvantages may include delays in receiving receipts, additional borrowing levels, risk of losses, reputational issues, capacity of the organisation to undertake or oversee the level of development.

39. It is recommended that there should remain a presumption of asset retention until such time as assets are considered on an individual basis and whether or not a business case can be made for retention.

40. Commercial assets that are not considered to be performing adequately and which cannot be enhanced will be included in the disposal programme. For large value land and properties this is included within the budget on an annual basis. In future there may be a need to report more frequently.

41. Assets that are not considered to be providing the Council or community with good value or are no longer considered core investment assets will be disposed of and sale proceeds considered for other property investment opportunities – any such decision to be taken by Cabinet.

42. The Estates team has some 340 property agreements/licences that are generating income for the Council. The average rental income per asset may thus be considered small as may the average capital value. However there are clear merits in the Council having majority interests on the industrial estates whether it be directly renting out properties or through retaining ownership of ground leases.

43. Whilst it will at some stage be appropriate to undertake further analysis and reviews on existing assets and interests the Council needs to maintain focus in the short term on new acquisitions, save where assets are costing the Council money to hold, are particularly staff intensive, or where the community benefit is low.

Acquisition of land and commercial property inside and/or outside of Hastings and the travel to work area.

44. In 2016/17 the Council took its first steps into significantly increasing the value of its property portfolio. It purchased its main administrative offices (Muriel Matters House) and the Retail Park at Sedlescombe Road North.

45. It is recognised that there are unlikely to be sufficient quality commercial investment opportunities within Hastings and hence the Council needs to look more widely – within the travel to work area and potentially nationwide in order to secure good commercial property investments.

46. Purchase or development of commercial property either in Hastings or within travel to work boundaries provides the Council with opportunities to continue economic development and enhance employment prospects for the community whilst also generating income. From the public's perspective there is a visible and tangible benefit of building and developing within Hastings itself.

47. Purchase of commercial property outside of the Hastings travel to work areas may be viewed as purely an income generation initiative and a trading activity – if borrowing the money to do so. A trading company will be set up to allow a flexibility of approach.

48. Nationally there are significant debates and some challenges to councils for investing outside of their areas and also borrowing to do so. Advantages and disadvantages of commercial acquisitions and development within Hastings and the travel to work area include:

    (i)The practical issues and potentially greater costs of managing assets outside of Hastings and travel to work areas. Commercial properties can be managed in-house and issues can be swiftly resolved. Relationships developed and intelligence of respective business requirements gained.

    (ii) In future there may be opportunities to give financial assistance more easily (if ever necessary) to businesses within the area e.g. through rate relief or incentives.

    (iii)Purchasing properties at a distance is more difficult and time consuming, and there are different risks. For example, knowledge of the area and future developments/ competition is not known, appointing agents can be time consuming, the ability to understand the tenants and the local market conditions

would take time and to assist a company in difficulty (if necessary) would not be as easy when remote.

(iv) Purchasing properties outside of the area would enable a geographical spread of the portfolio – increasing diversification and resilience in the portfolio.

(v) Purchasing properties outside of the area may provide the opportunity of better returns – against which are the management and administration costs, control issues, lack of knowledge of the respective area.

(vi) The benefits of not having to form a company include simple and beneficial VAT treatment, tax on capital appreciation, reduced administration.

49. Given the limited levels of borrowing that can be prudently undertaken, the Council will need to determine whether it should potentially be prepared to accept a slightly lower level of return on its investments within Hastings than elsewhere in return for ensuring that the long term economic development benefits and employment prospects remain within Hastings.

50. In looking to determine where the Council can maximise investment returns with the lowest levels of risk, a policy of looking at the more populated and potentially more affluent areas i.e. towards bigger conurbations within the country would help to diversify the portfolio.

51. It is recommended that given that uncertainties surround Brexit and a future independence vote and that different laws govern Scotland and Northern Ireland there are sufficient opportunities for investments to be made solely within England and Wales for the moment.

    It is proposed that the Council acquire properties directly if they are within Hastings and its travel to work area and through a company if opportunity to earn income is found elsewhere. It is likely in looking outside the travel to work area that the major conurbations of the South and Midlands are appropriate places to look for opportunity.

Investment Strategy - Structured Assessment

52. Some local authorities have adopted a structured scoring mechanism to assess acquisition opportunities. The ideal investments would be ones where the Council obtains the freehold, where the tenants are strong e.g. large businesses with high credit ratings, where the service charges are fully rechargeable, where the property running costs are low, yields are high, and where the building is fully let and the unexpired periods of the leases are long (minimum of 10 years), the size of the investment is not excessive when considered against the Council's overall portfolio and the mix of investments.

53. The better investments in the stronger growing parts of the country are likely to result in lower yields (higher cost of purchase) i.e. will be nearer 4.5% to 5%.

54. Commercial investments in offices, retail, or industrial property are available. The prospects for each sector are regularly reported upon by the property and

investment press. Currently in favour are investments in industrial land and property and the larger retail parks. However local conditions and economic growth prospects play an important role in determining the success or otherwise of any investment and as such each opportunity needs to be considered on its merits.

55. Legal Constraints: The Council will need to consider creating a wholly owned property investment company through which to purchase commercial property. If the Council wishes to acquire such property by borrowing solely for the purposes of income generation it can only do so through a company structure. If the Council wishes to invest existing resources in commercial property (inside or outside the district or in a Property Fund) or if the Council continues to act for the purposes of economic development and regeneration within the district using borrowing, then no separate company would be required. If the Council has a mixed purpose of economic development and income generation then provided the economic development was one of the main purposes of the property acquisition this can be undertaken without a company.

56. The Council's preference is for high quality buildings, in good locations with financially strong tenants. A scoring matrix allows the relative merits of an investment to be measured and assessed. The matrix is still a relatively crude tool and will be used to help inform a decision rather than determine it.

57. It is recommended that the Council set up a trading company to enable a flexible approach to be adopted.

Investment in Property Funds

58. One of the easiest and most convenient ways to enter into property investments is through a property fund. The Council having invested £2m of its own reserves in April 2017in the fund operated by CCLA Investment Management ltd (CCLA = Charities, Churches, Local Authorities).

59. The Council is not able to borrow monies to invest in property funds.

60. The returns on such funds in the last few years have exceeded 4.5% (9% once capital appreciation is included). The benefits of these investments, if chosen carefully, are that the revenue monies invested are not counted as capital and hence when returned are not considered Capital Receipts.

61. One advantage of such funds is that expertise is sourced centrally and asset diversification managed by a team. Thus if one asset is performing poorly the risk is spread over all investments. Such funds can invest across the whole of the country and in a wide variety of assets e.g. industrial units, offices, shops, both large and small.

62. Risks of investing in a property fund are very similar to the risks of direct purchases e.g. void periods, liquidity risks, counterparty risks, interest rate risk. However given the ability to enter an already diversified fund (between asset type, location, size, business segment) provides a strong incentive to invest in such a fund rather than look to start from scratch oneself.

63. The Fund benefits from a favourable accounting and regulatory framework, where dividends are treated as revenue income, but the General Fund is protected from fluctuations in the unit price. The acquisition of share capital in a body corporate, including units in unregulated collective investment schemes, normally counts as capital expenditure under section 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as amended). However, as a scheme approved by HM Treasury under section 11(1) of the Trustee Investments Act 1961, and in accordance with section 25(3)(d) of the regulations, the purchase of units in the Fund does not count as capital expenditure in England.

64. The returns achievable are currently in the region of 4.5% if investing in the CCLA property fund. This compares to investment returns of around 0.5%% on the Council's cash investments. The returns on investments in the Property Fund are higher than those of direct investment in property financed by borrowing as there is no interest payable and no sums to be set aside each year for capital repayments.

65. It should be noted that when investing in such funds, as is the case when investing in more expensive property, there is an immediate fall in the value of the book value of the investment - this is the equivalent of Stamp Duty Land Tax. Such investments should really only be contemplated if investment horizons of 5 years or more are acceptable.

66. It is recommended that the Council reviews the level of investments held in Property Funds when considering the Treasury Management Strategy for 2018/19 in February 2018. Such a decision to be based on performance, risks, and the Council's overall financial position.

Staffing Resources

67. There are opportunities to redirect the Council's existing workforce e.g. estates, surveyors, legal and finance at least temporarily onto projects that involve the acquisition and development of assets. This does involve re-timetabling existing works and the renewals and repairs programme for example.

68. The retention of the procurement work, surveying, and legal work inhouse, as far as practical and where such knowledge exists should be a priority if overall returns are to be maximised. The same staff and resources would be available for housing initiatives whether it be identifying houses to buy in conjunction with housing, surveying them, and legal work in acquiring them, and subsequently renting the properties. The skills and knowledge acquired from the commercial property work are readily transferrable skills to the housing market.

69. Should the Council purchase a significant number of new properties, rather than a few larger properties and not divest itself of some of the time consuming work, additional staff resources may be required.

Corporate Governance Arrangements

70. To make investments within a Property Fund full Council agreed amendments to the Treasury Management Strategy and Investment Policy when determining the investment strategy for 2017/18. A review of the future levels of investment and

borrowing will commence with the consideration by the Audit Committee in January 2018.

71. The Council needs to be able to take advantage of opportunities as and when they arise and has shown that it is capable of doing so with the two recent purchases of Muriel Matters House and Sedlescombe Road Retail Park.

72. For clarity, any new capital scheme requires the approval of Cabinet and any such decisions are limited by the Council's overall borrowing limits and Prudential indicators as determined by full Council each year. Such limits can be amended but only by full Council.

73. Any new opportunity is normally channelled through the Council's Estate Manager (the Council's designated Property Manager) and may come from a variety of sources, e.g. agent, Councillor, press article, auction catalogue, direct approach, local knowledge/ discussions on land and development opportunities. The Income generation/development manager is available to work up new opportunities.

74. Where a significant opportunity presents itself an initial report is prepared for the Income Generation Board which outlines the key issues, and estimates of the yield (gross and net) . The report details would aim to cover,

    (i) location
    (ii) tenant issues – strength, creditworthiness
    (iii) tenure – freehold or leasehold
    (iv) Occupiers lease length
    (v) repairing terms – if known (generally full repairing and insuring leases sought)
    (vi) sale price and yield (including estimates of property life)

75. Should the Income Generation Board agree that the opportunity is worthy of further consideration then due diligence work is commissioned – some of the work is at risk to the Council e.g. surveys, whilst other work is at risk to the agent. There is currently no separate budget for this work other than that of the existing Estates and contingency budget – the need for a separate budget will be kept under review.

76. All acquisitions will be subject to a building survey, purchase report and valuation. In view of the potential values and work involved the Council is likely to be externally represented by an agent who will work closely with the Council's Estate Manager.

77. In acquiring commercial property Council's may be bidding against each other and such bids may be being made over the phone and through agents and thereafter confirmed in writing.

78. The processes involved are included in Appendix 2

Policy Implications

79. **Financial Implications**

The strategy recommends £29m of new assets be acquired in 2017/18 and

2018/19. This is in addition to Sedlescombe Road Retail Park and the purchase of Muriel Matters House.

80. For the purposes of this financial projection the acquisition of commercial land and all other commercial lettings, rent reviews, etc are excluded. There will be other initiatives presented to Council over the next 3 years which will involve development of Council land.

Table : Projection of net Revenue Receivable – Acquisitions mid-year

	2017/18	**2018/19**	**2019/20**
	£	£	£
Acquisitions	9,000,000	20,000,000	
Financing Costs (incl MRP)	181,500	766,500.00	1,170,000
Rent Receivable	270,000	1,140,000	1,740,000
Net Revenue	**88,500**	**373,500**	**570,000**
Gross Yield			6.00%
Net Yield			1.97%

81. The above estimates are based on borrowing rates of 2.6% (Annuity). The returns assume the Council does its own legal work and all service charges are fully recoverable and based on full repairing leases with an average gross yield of some 6% overall.

82. The effects of new borrowing and the new income streams will affect the Minimum Revenue Provision (amount to be set aside annually for debt repayment), will affect the property income levels and will affect the borrowing cost lines within the budget. These figures will be included in future budgets, revised budgets and Medium Term financial strategies. The timing of the investments and hence the impact on the accounts will however remain a significant variable.

83. The Council is able to borrow monies from the PWLB for Capital purposes only, and on-lending is not permitted.

84. There may be some due diligence costs incurred when looking at opportunities that are not chargeable against a Capital budget e.g. if purchase is aborted following surveys commissioned. The Chief Finance Officer currently has delegated authority to make payments from a Council reserve. The alternative is to set up a specific budget which may or may not be called upon in future. As such it is proposed that existing arrangements continue and that any unforeseen costs or those not chargeable following an abortive purchase are met from contingency or other designated reserve.

85. The above figures are not necessarily the total additional income that can be derived from new commercial property investments over the period. The Council has purchased industrial land and is progressing development opportunities which will drive additional revenue and business rate growth. Such schemes will be added to income projections when there is a degree of certainty that they can be achieved.

Risk Management

86. The income generation proposals that the Council is looking at will require substantial investments to be made by the Council and will necessitate new borrowing. The levels of new borrowing that the Council can afford to take on board for new commercial property purchases and development, housing and energy schemes, etc, will be dependent upon the individual proposals and credit worthiness of the counterparties involved. Due to the timescales within which some property purchasing and disposal decisions have to be made the Council's existing governance arrangements and delegated authorities may again need to be reviewed.

87. The additional risks that the Council will consider taking will need to be individually considered in the context of the totality of risk that the Council faces e.g. Pier claim, rates revaluation, robustness of income streams, economic downturns, etc. Where there is more risk and volatility in income streams the Council will need to ensure that it maintains sufficient reserves to ensure the Council's ability to deliver key services is not jeopardised.

88. There are many risks faced when purchasing any property, and certainly so given the sums of money involved. There is however a considerable risk to the Council of not investing, and whilst interest rates remain low there is a window of opportunity to lock into ongoing income streams in order to help balance the Council's budget.

89. There are significant potential losses if things do go wrong, but at the level of investments currently proposed, the size of the Council's balance sheet and the level of existing reserves the Council is still able to take on such risks. The expectation is that the Council will hold such assets for a minimum of 40 to 50 years and that the Minimum Revenue Provisions will match the period of the useful life.

90. The common risk areas are voids, creditworthiness, tenant disputes particularly on repair and maintenance obligations, economic downturn, borrowing costs, failure of businesses, location, environmental issues.

91. The Council already has experience of all such risks and will seek to mitigate these by undertaking due diligence before taking on the properties, not taking on too many at any one time, seeking to ensure sufficiently experienced and qualified staff are in place, and identifying an exit strategy should things go wrong e.g. alternative uses for property/site, disposal options.

92. In order to ensure that the Council is able to dispose of properties in the future should the need arise it will always seek to ensure that the Council has clear title to

the property and will always look to purchase the majority of its properties on a freehold basis.

93. The Council will look to employ agents to seek out commercial property acquisitions. There may be a lack of suitable properties. Given the competitive nature of the property market the Council may not be the successful bidder on some occasions.

94. **Organisational Consequences**

The purchase of this level of new property along with the current property activities will place significant additional work on the Estates, legal and finance teams. Work will need to be prioritised and additional external assistance procured where necessary and where available.

95. **Environmental Considerations**

Any environmental impacts will be considered on a case by case basis when considering proposed property investments.

96. **Legal Implications**

The Council has the power to acquire any land for the purpose of carrying out its functions or for the benefit, improvement or development of the area (Section 120 Local Government Act 1972)

97. Section 12 of the local government Act 2003 provides powers for the Council to use its own monies for investment purposes. Firstly for any purpose relevant to its functions and Secondly for the prudent management of its financial affairs. This includes investment in property if it relates, for example, to the economic wellbeing of the Borough.

98. Section 1 of the Local Government Act 2003 provides a power for the Council to borrow for any purpose relevant to its functions or for the purposes of the prudent management of its financial affairs.

99. Under Section1 of the Localism Act 2011 the Council has the general power of competence to do anything that individuals generally may due, save for where there are other specific powers that would override this. This power does support activity which enhances the social, economic or environmental wellbeing of the Borough.

Conclusions

100. It is evident that the Council's funding gap will not be closed quickly without significant income generation or a greater level of cuts to services. There are not expected to be a sufficient number of quality commercial opportunities to satisfy the Council's income generation requirements unless properties are also acquired outside of the Council's area.

101. Investments by the Council for the long term in other areas of the Country would not normally appear to be justifiable when the Council itself is seeking inward investment. It is however more justifiable where investments or development opportunities can be taken in the shorter term for income generation purposes and where diversification of the portfolio or liquidity is also prime concern.

102. The Strategy results in a number of recommendations that would need to be agreed by Council:

(i) The Commercial Property Investment Strategy is approved

(ii) That Council approve supplementary capital expenditure for property acquisitions of up to £29m for the period 2017/18 to 2019/20 based upon £29m of borrowing commencing in 2017/18 (for economic and social wellbeing purposes and to generate on-going revenue streams). This sum will be reviewed on a regular basis.

(iii) The Cabinet to continue to determine the individual property acquisitions, following consideration by the Income Generation Group (Special Cabinet meetings may need to be held at short notice to enable the Council to be sufficiently agile to take advantage of opportunities).

(iv) Delegated authority to remain with the Chief Finance Officer (S151 officer) to meet revenue acquisition costs from reserves that are not chargeable against a Capital budget – to include abortive costs.

(v) The Council's Asset Management plan is updated to take account of this strategy and that economic development, regeneration and employment considerations continue to be the driving factor behind existing Council property and land development opportunities within Hastings.

(vi) Seek opportunities for additional commercial property acquisitions firstly within HHHhHastings and thereafter the travel to work area and thereafter in the larger conurbations of the South East and the Midlands as part of the Council's objective for the continued economic development and regeneration of Hastings, or for income generation for the provision of Council services or a mixture of both.

(vii) A trading company to be established to provide flexibility of approach - the Council is able to invest its own monies under existing investments powers in properties across the country, but anticipates the need to form a company if it wishes to purchase properties outside of the borough for the sole purpose of income generation.

(viii) Appropriate due diligence be undertaken on each and every opportunity.

(ix) An exit strategy be considered for each proposal.

(x) Given that the Council's risk appetite will be constantly changing depending upon the risks and opportunities it faces, future funding predictions and economic environment, each commercial property investment must be

considered on its merits and the financial position of the Council at the time within an overall borrowing umbrella.

(xi) Further Property Fund investments are considered as part of the 2018/19 Treasury Management Strategy – to be determined by full Council in February 2018.

(xii) Accept that there are many property related opportunities that present themselves to the Council which are not specifically included within this strategy which may be considered commercial in nature e.g. investment in a new leisure centre. The Council will look to consider all options for investment and the Commercial Property strategy may help to inform the decision making process when alternative options for use of Council resources are being considered.

(xiii) Decisions continue to be taken using the governance arrangements now in place.

Appendix 1

Commercial Property Investment Strategy – HBC Matrix

Matrices such as the one below are in use by other Councils. This is slightly adapted from those in use elsewhere with a change of emphasis on tenancy strength between multiple and single tenants. It is meant to act as a guide for decision making and not replace judgement.

	Score	4	3	2	1	0
Scoring Criteria	**Weighting Factor**	**Excellent/very Good**	**Good**	**Acceptable**	**Marginal**	**Unacceptable**
Location	12	Major/Prime	Micro Prime	Major Secondary	Micro Secondary	Tertiary
Tenancy Strength	10	Single Tenant with strong financial covenant	Multiple Tenants with strong financial covenant	Single Tenant with good financial covenant	MultipleTenants with majority of good financial covenant	Tenants with poor financial covenant strength
Tenure	9	Freehold	Lease 199 years plus	Lease 125years plus	Lease 50 to 125years	Less than 50 years
Lease Length	5	Greater than 10 years	Between 7 and 10 years	Between 4 and 7 years	Between 2 and 4 years	Less than 2 years/ Vacant
Repairing Terms	4	Full repairing and insuring lease	Internal repairing – fully recoverable	Internal repairing – partially recoverable	Internal repairing- non recoverable	Landlord
Lot Size	2	Between £6m and £12m	Between £4m and £6m or £12m to £18m	Between £2m and £4m or £18m and £20m	Between £1m and £2m or £20m and £29m	Less than £1m or more than £29m

The Maximum score attainable is 168
Marginal for all areas would give a score of 42
Acceptable for all areas would give a score of 84.
The Sedlescombe road retail park would for example have scored 146

A score of 80 or more is considered worthy of further investigation. An opportunity where any criteria scores zero is unlikely to be considered further unless there are other merits to the proposal e.g. development opportunities.

Prime property, much as the name suggests, is good-quality property, usually situated in big towns and cities and attracting a string of top-drawer tenants. Secondary and tertiary property is situated in less prime locations, with high-quality tenants harder to

find. There's a higher yield available from these sub-prime properties, as the risk of void (empty) periods and defaults is higher.

Appendix 2

The Processes Involved in Commercial Property Procurement

1. As identified in the Strategy, there are many ways in which properties come to the market, and depending upon the information available and the type of property or land there will be different assessments to be made and information to be gleaned. The steps and timing of the processes vary significantly but are generally determined by the seller. The general processes are outlined below.

ii. Review of sellers information – sale particulars, freehold, covenants, price, rental streams etc.
iii. Review of site – visit
iv. Financial evaluation – risk- exit strategy
v. Draft report to Corporate Management Group & Income Generation Board to ascertain interest and approval to proceed
vi. Agents appointed – if interested, fees agreed, valuations
vii. Confidentiality agreement – if appropriate
viii. Negotiate and agree price – or ascertain deadline for bids, bidding process
ix. Due diligence – Property, include commissioning of Surveys – building, land
environmental, service and maintenance responsibilities
x. Due diligence -Review of Leases, covenants, title – this may necessitate appointing external legal advisers depending upon workload
xi. Due diligence – Finance – tenants,
xii. Heads of Terms negotiated /agreed i.e. sale price
xiii. Draft report for Cabinet – ascertain Cabinet support or areas for further investigation.
xiv. Contract negotiations
xv. Exchange of contracts – payment.
xvi. Set up new management and maintenance agreements/contracts, collect rent, calculate service charges, etc.

2. There is significant due diligence work involved where large commercial acquisitions are involved and this work is compressed into very short timescales. Other work has to be reprioritised. Even with contracting out, there is considerable involvement from senior management in agreeing terms, leases, contracts and fees.

3. There are significant ongoing responsibilities as a property owner, and these include rent collection, service charge calculation and collection, building maintenance, and a host of operational issues. The Council is well used to undertaking rent reviews but does call in specialists where there is limited experience and national issues e.g. supermarkets.