

Committee: Cabinet

Date of meeting: 3 July 2019

Subject:	Investment Property Portfolio Annual Report
Lead Officer:	Sarah Selvanathan, Strategic Director & Deputy Chief Executive
Portfolio Holders:	Resources: Councillor C Sadler
Link to Council Priorities:	All
Exempt information:	None
Delegated status:	For recommendation to Council on 17 July 2019
Key decision:	N/A

Executive Summary:

The Council's strategic framework for investment supports the development of new income streams to strengthen the financial resilience of the Council. The financial returns achieved from these investments will help ensure that the Council continues to deliver quality services for our residents.

This is the second annual report on the Council's Investment property portfolio and includes investment properties purchased since the Property Acquisition Strategy was approved in 2012.

The report notes the good progress made with the delivery of the strategy and detail performance of the Investment Property Portfolio (IPP) using the indicators adopted for its monitoring and reporting.

Recommended: that Cabinet note the:

- (a) Progress that has been made in implementing the Property Acquisition Strategy.**
- (b) Strategic aims of the Council's investment Property Portfolio continues as set out in this report.**

Report:

1. Background

- 1.1 In 2012 a report was presented to Cabinet to consider innovative ways of generating regular revenue streams, this was against a backdrop of Local Authorities facing a difficult financial climate with ever decreasing funding from Central Government. The paper considered the strategy for acquiring or developing investment property assets in order to strengthen the Council's long-term financial stability. In some cases, Property investments also offer the potential to unlock future development and regeneration opportunities and provide extended services.

1.2 Last year a paper was presented to Cabinet demonstrating how the investment strategy had been implemented and the progress that had been made since the investment strategy was adopted in 2012. The paper considered some of the key considerations (in addition to affordability) when acquiring land and property interests, such as:

- There is secure rental income, so prudent borrowing can be considered for purchases (if required) taking into account the risk associated with security of future payments.
- Vacant sites and assets be considered where there is a strategic value of the property, particularly in relation to future development.
- There is an identified current or future service need.

The paper concluded the strategy was still relevant and should still be adopted with no changes at present, it was recommended that the investment strategy should be reviewed on a regular basis moving forward say every 3-5 years.

2. Current Property Acquisition / Investment Strategy

2.1 To re-cap the criteria for the considering investments is as follows:

- Acquisition to be within Borough boundaries;
- Acquisitions will enable the Council to be proactive in the property market to assist in strengthening the Borough/local economy;
- There are measurable benefits (in addition to financial) within a maximum period of 15/20 years;
- Effective intervention will expedite agreed key strategies for the Borough;
- Acquisition may involve partnering arrangements;
- Acquisition will consolidate the Council's existing land holding portfolio to facilitate larger developments;
- Acquisition will assist in the modernisation of the Borough's business infrastructure and/or encouraging inward investment, re-location and business start-up within the Borough;
- Acquisition is not in conflict with strategic planning policies;
- Acquisition will not increase the Council's on-going revenue costs in the longer term;
- Acquisition type; Good quality commercial property in traditional sectors, i.e. retail, office and industrial;
- Return of at least 2% above borrowing costs bearing in mind there will be exceptions depending on future potential;
- Security; Medium to long-term strategy – Acquisitions should normally be pre-let to tenants of good covenant on fully repairing and insuring terms, with an unexpired term of at least 5 years;
- Each investment will have to be looked at on its own merit; and
- Strategic value; Where a property has strategic value to the Council, some of the above criteria may be relaxed e.g. land capable of development or required to enable development;

The Council's Property Investment Strategy provides the Council with the ability to make investments that have the potential to support economic growth or deliver economic regeneration within the Borough of Elmbridge. This may mean that acquisitions with lower returns are considered however all investments will need to demonstrate a return in excess of the cost of capital in order to be affordable to the Council. The council is also able to purchase properties that provide for long-term future service use, whilst delivering an investment return. These assets provide flexibility in the estate whilst delivering an investment return for the Council.

2.2 Current Property portfolio

The current investment property portfolio has been established over a number of years with the rate of growth increasing more recently. The Council has a good reputation in the market demonstrating our ability to complete acquisitions to agreed timescales. This means the Council is invited to consider various potential acquisitions, including some that are off-market. The Council's ability to grow the portfolio further will be dependent upon the right opportunities coming to the market.

This report focuses on the Investment properties and does not cover any operational or community properties. There are currently 12 Investment properties within the portfolio and at the end of March 2019, the investment properties held by the Council were valued at £91.8 million. At the end of March 2018, the value of investment properties held was £76.5 million with the increase mainly attributed to the purchase of the Weybridge Estate in January earlier this year. There has also been some movement of assets in the last year, River mole is now re-classed as an operational property since the community services team occupies the first floor of Unit 1 of the property. Furthermore, following the decision to not implement the planning permission at Cobham garages, this is no longer a standalone investment and forms part of the Cobham high street investment.

The gross rental income received during 2018/19 was £3.9 million compared to £3.1 million in 2017/18, a 26% increase. This increase is largely down to good asset management by officers in Asset Management & Property Services (AMPS) in terms of settling rent reviews and lease renewals promptly where possible and dealing with lease expiries and new lettings proactively. In addition, the purchase of the Weybridge Estate in January 2019 contributed to the income.

In 2019/20, these properties are expected to produce a total of £4.3 million gross annual income.

- 2.3 There are no restrictions on the Council's ability to realise the value inherent in its investment property or on the Council's right to income and the proceeds from sale.
- 2.4 Capital expenditure includes all costs associated with each acquisition including the costs of purchase, in particular stamp duty. The capital expenditure incurred will inevitably be higher than the value of the property purchased unless the

value increases over time. The purpose of the Investment strategy is to deliver an annual income stream in support of the Council's services and in doing so the Council is not assuming any gain from the value of the underlying assets. Instead a long-term view is being taken since the value of the property may decrease as well as increase over time. The properties are revalued each year for the purpose of reporting in the financial accounts

Valuation and Gross Income from current property investments held in the portfolio:

Property	Sector	Valuation as at 31/3/2019	Expected income for 19/20
Old Post Office, Esher	Offices	£2,175,000	£110,000
Fairmile House, Esher	Offices	£1,800,000	£112,410
Consort House, Weybridge	Offices	£5,375,000	£350,000
Unit 1&2 Vickers Drive	Industrial	£16,165,000	£772,800
Thomas Hardy House, Weybridge	Offices	£6,275,000	£385,500
26-38A High Street Cobham	Retail/ Residential/ Garages	£7,265,000	£400,400
21 High Street, Weybridge	Retail/Residential	£900,000	£54,180
Weybridge estate, Weybridge	Retail/Residential/ Offices	£18,197,000**	£570,500
North Weylands Industrial Estate, Walton *	Industrial	£2,925,000	£134,180
Elm Grove Walton upon Thames*	Mixed Use	£650,000	£52,000
50-68a High Street Weybridge	Retail/Offices	£15,610,000	£763,170
Sandown Industrial Estate	Industrial	£14,525,000	£605,430
Total		£91,862,000	£4,310,570

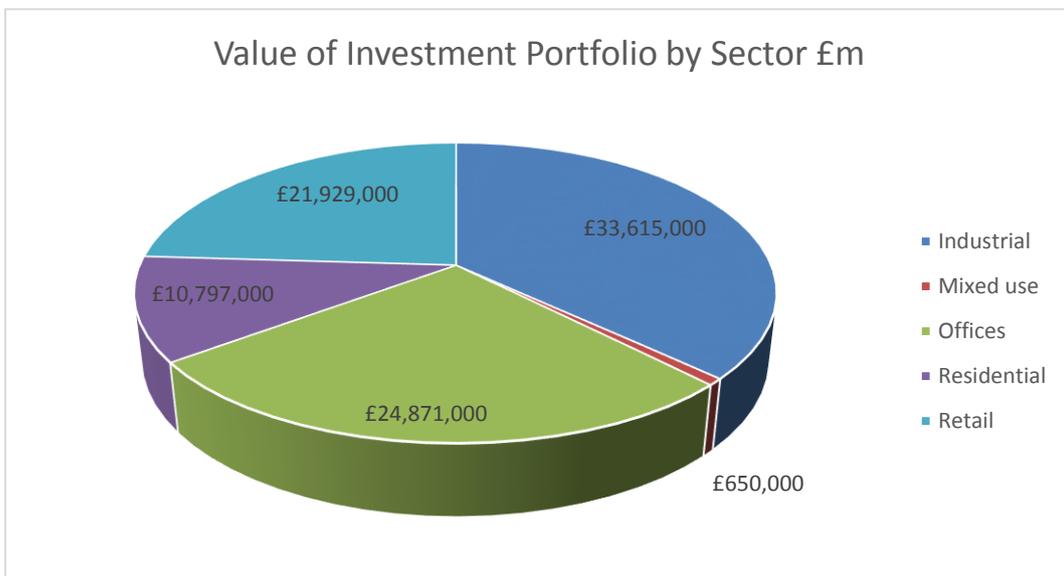
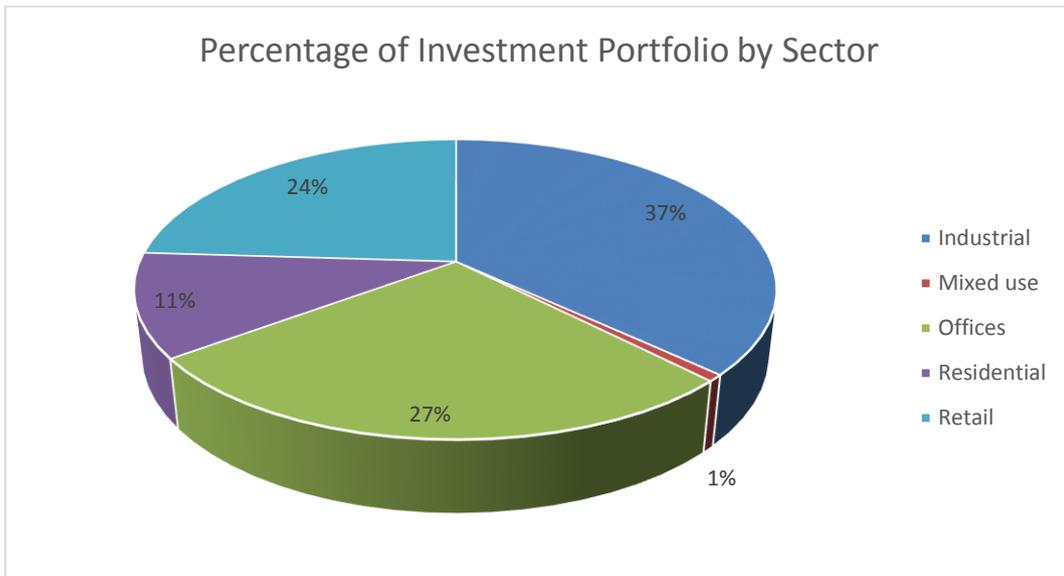
* Assets already owned by the Council as Investment Properties prior to 2012

** This value includes the cost of purchase as stated in the accounts.

The following graphs demonstrate the breakdown of the Investment Portfolio to show how the portfolio is split.

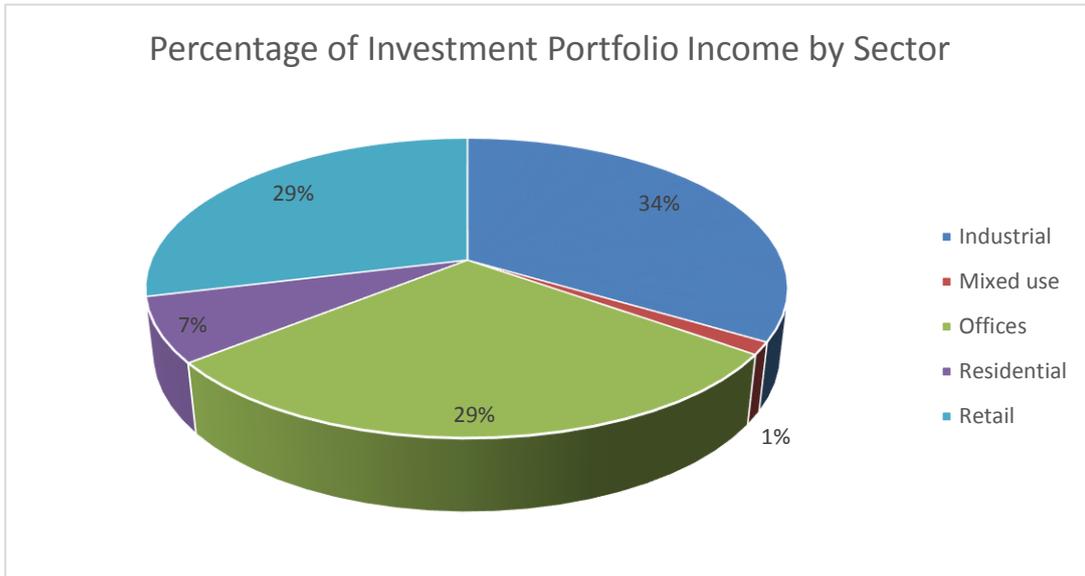
Value of the investment portfolio by sector

The graphs below show how the investment portfolio is weighted by value and income.

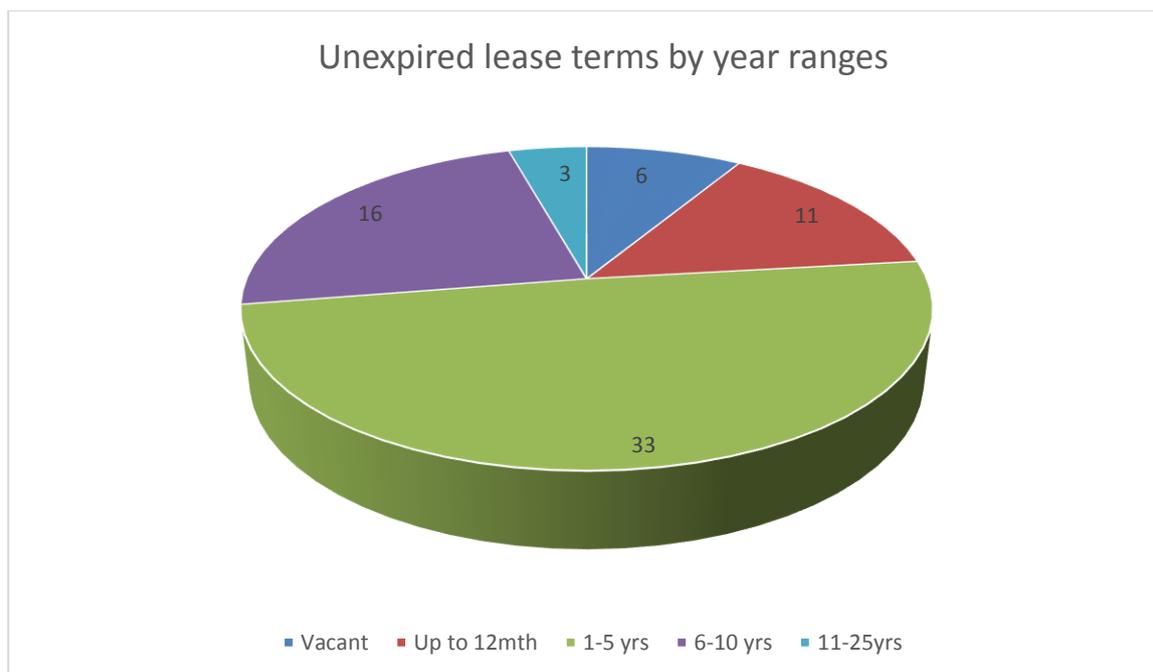


The changes in the portfolio over the last 12 months demonstrate the portfolio is more equally weighted and therefore balanced between the three main investment sectors, Retail, Offices and Industrial. Whilst the council does not set a weighting structure in its Investment strategy, in these uncertain times it is considered a benefit to not be overly weighted to a particular sector.

Percentage of Investment Portfolio income by sector (at 2019/20 levels)



The graph above demonstrates the average unexpired lease term for the investment properties within each sector, compared with the average lease term granted. The industrial numbers are slightly skewed as there are two leases which have a lease length of over 50 years. In addition, there are a number of assets that are held for potential regeneration and therefore we have allowed the leases to remain short.



The above graph shows the majority of the leases within the Investment portfolio have an unexpired lease term less than 10 years, a number of short leases are in assets where future regeneration is being considered.

Key Information and Indicators

	2018/19 £'000		2018/19 £'000
Asset Value at 31 March 2019	91,862	Gross Income	3,893
Purchase Costs	89,975	Less: Direct Exp	507
		Less Borrowing costs	957
		Less MRP	859
Capital Appreciation	1,887	Net Contribution to Council	1,570
Asset Value at 31 March 2019	91,862	Average length of borrowing*	36 years
Less: Borrowing @ 31.3.19	61,482	Average rate of borrowing*	2.44%
	30,380	(*As at 31 March 2019)	
Gearing Ratio	67%		

The following key indicators can also be used to monitor the portfolio performance as reported below:

- 1) Effective Return – Income received less costs, expressed as a % of capital value

Year	Asset Value (£'000's)	Gross Income (£'000's)	Gross Effective Return %	Net Income (£000's)	Effective Return (net income) (%)
2016/17	42,700	1,984	4.65	1,250	2.93
2017/18	76,515	3,092	4.04	1,732	2.26
2018/19	91,862	3,893	4.24	1,570	1.71

- 2) Increase in Asset Value- Percentage increase by year including new asset purchases.

Year	Asset Value (£'000)	Asset Growth (%)
2013/14	18,493	
2014/15	19,780	6.95
2015/16	28,160	42.36
2016/17	42,700	51.63
2017/18	76,515	79.19
2018/19	91,862	20.06

- 3) Income Growth – Percentage increase in gross income per year

Year	Gross Income (£'000)	Income Growth (%)
2015/16	1,369	
2016/17	1,984	44.92
2017/18	3,092	55.85
2018/19	3,893	25.91
2019/20 (budgeted)	4,310	10.51

- 4) Vacancy Rate expressed as a percentage where units are vacant

Property	Vacancy Rate	Potential rental (estimated) £'000	Comments
Cobham Garages	50%	8	Held vacant for development, now reconsidering options
Quadrant Court, Weybridge	35%	45	Actively marketing
Barnet House, Weybridge	100%	40	This is held vacant for residential PD
50-68 High Street, Weybridge	9.9%	90	Actively marketing

Performance of the portfolio is stable and consistent, the assets in the portfolio have generally held up well in the uncertainty surrounding the property market particularly considering Brexit. There have been challenges as tenants are affected by the strains in the economy, however, the asset management team work with the tenants to resolve any rental issues to ensure problems are not compounded.

When looking at the property management of the Councils investment portfolio the priority of the Council is to retain or increase income. In exceptional circumstances, particularly in the current market, in order to retain a tenant a reduced rental level may need to be agreed with a tenant. Whilst, there will be a small impact on the income there is a cost benefit from allowing the space to become vacant and therefore incur running costs, lease incentive costs and potential capital costs.

Assets purchased with a view to development /regeneration purposes will not produce an immediate income stream and there will be occasions when a tenant triggers their break clause or vacates at the end of the lease resulting in a potential letting void. The Council holds a Contingency and Rent Risk reserve which can be used to mitigate rental shortfalls due to voids.

3. Asset and Property Management

- 3.1 Currently, as you will be aware, the majority of the property owned by the council is managed in-house within the Asset Management and Property Services team, however, the multi-tenanted investment properties are increasingly managed by external managing agents. These external managing agents have the expertise and resources to deal with the intensive nature and large service charges often attributed to these types of assets. Having said that the estates surveyors work with the managing agents and the tenants, to ensure effective management arrangements are in place.

However, as the portfolio has grown over the years and is approaching a £100m portfolio, it is prudent to consider employing a best in class managing agent to undertake the management of all the investment properties. This will ensure a consistent best in class service allowing the council to continuously benefit from changes in best practice when managing properties. In addition, this will allow the internal team to focus on asset management allowing the assets to be worked harder and projects. Procurement options are currently being considered.

- 3.2 A sinking fund is an amount set aside to cover any major work which is needed on a property in the future. As the Council increases the Investment Property Portfolio and as assets age, it is essential that a sinking fund is established to meet any major works required. Industry recommendation is between 5% and 10% of gross income is set aside annually for this purpose. During 2018/19, £200,000 has been allocated to the sinking fund and any future allocations will be made from property rental income.
- 3.3 When acquiring properties, officers will use external agents to advise on the purchase which provides an independent view and benefit from their external expertise, to ensure the best result is achieved and the council's position is fully protected.

- 3.4 In respect of managing the asset management process a new property management system has been purchased (Tech Forge), the introduction of this database will enable the team to manage the accuracy of the data and to ensure the properties are managed efficiently and effectively. It is expected that this system will be operational in the summer 2019, the final stages of data cleansing are currently underway.
- 3.5 In addition, individual property asset management plans are produced for each of the investment properties to help manage the asset.
- 3.6 These asset management plans set out a brief synopsis of the key criteria of the investment property, including tracking the value of the property and sets out a clear short to medium term strategy for each individual property.

4. Governance

- 4.1 The decision to purchase a property is made by the Full Council following a recommendation from Cabinet. All Property Investments are approved in accordance with the Property Investment strategy and on the basis of a robust business case, developed using appropriate specialist property investment advisors giving proper consideration of the balance between risk and reward and an underlying security of the investment. In order that the Council can undertake borrowing in accordance with the Prudential code which requires that borrowing to be affordable, sustainable and provide value for money, all investments are required to demonstrate a return in excess of the cost of capital and other associated costs.
- 4.2 A Property Appraisal Group made up of Councillors are consulted on any potential property purchases by officers before recommending any purchase to Cabinet.
- 4.3 A narrative report providing details of the property including, for example, its location, age and tenure, highlighting keys risks and information about the tenants and their financial covenants, a summary of expected returns and a recommended offer price is presented to the Property Appraisal Group.
- 4.4 This report will also include a financial analysis demonstrating a long term expected income return for the purchase.
- 4.5 The Property Appraisal Group will consider all the information presented to them carefully and give their recommendations. If decision is made to proceed then the officers will make the offer/negotiate and continue to do property, legal and financial due diligence.
- 4.6 The Property Appraisal Group is an advisory body and it is Cabinet that makes the recommendation to Council to make the final decision.

5. **Property Market outlook**

5.1 **General UK Views**

The UK economy grew 0.5% quarter on quarter in Q1 2019, up from 0.2% q/q recorded at the end of 2018. Stockpiling had a limited activity as a lot of the stockpiling was imported causing a net trade drag on GDP growth. Business investment returned to growth however, it is expected consumer spending to slow as previous growth was due to temporary factors. The Office of Budget Responsibility expects GDP growth to slow from 1.8% to 1.2% this year. Furthermore, CPI rose above the Bank of England's target of 2% in April for the first time since the end of 2018, largely as a result of gas and electricity prices. The sterling/dollar exchange rate has been fairly stable over the past few months, but sterling has depreciated by around 4% since the start of May.

The consensus in the property market is that it will be a challenging year for UK real estate' due to Brexit uncertainty, weak growth and international risks from trade, 'populist' governments and debt. Furthermore, many predict that slow growth will have a 'negative impact on the occupational markets' due to lower corporate activity. Clearly, until a deal is agreed or not with the EU, is it difficult to determine and predict whether there will be growth in the UK property market.

Sector Views within Elmbridge

Retail

The retail sector is under extreme pressure with many operators struggling to combat the online market. Zone A rents have noticeably cooled, even in key towns such as Esher and Cobham where demand was previously exceptional. Restaurant and Bar operators are also under pressure with some of the major chains seeking to minimise their rental position.

Offices

Elmbridge has not operated an Article 4 Direction hence there has been less erosion of office space in this sector, unlike other nearby areas. Rental levels have steadied after significant increases over the previous 3 to 4 years. Headline rents for grade A & B+ space in Esher at £35 psf. Weybridge rents are at early £30 psf and Walton on Thames at late £20 psf. Demand is steady but patchy. There is still a reasonable amount of available space in Weybridge and business parks.

Leisure

Still a reasonable demand in this sector but constrained by suitable premises providing an appropriate consent. Gym operators and health users consistent in seeking premises.

Industrial

The industrial and warehouse sector has performed well in recent years, this is mainly driven by limited availability of stock which has led to significant rental increases. There are few new industrial developments whilst demand remains strong. This suggests rental levels will continue to steadily increase for the immediate future.

Investment

With uncertainty over the Brexit outcome we have seen major funds hold back from further acquisitions since the start of the year. However, there still remains a strong level of buyer interest from property companies, high net worth individuals, mainly from overseas, and local authorities looking at opportunities. The perception is that the South West M25 sector is more resilient to downturns and will retain a good level of interest with yield profiles remaining low and unchanged. There is particular interest for industrial estates.

Residential

The overall market locally and nationally appears to have stalled, mainly due to uncertainties over Brexit and the economy. The top end of the market has been particularly impacted with notable discounts in values over the last 24 months. Demand is still reasonable for flats, but the overall view is that the residential market will remain challenging for the foreseeable future.

6. Property Acquisition Strategy

- 6.1 The previous report in 2018 discussed whether the investment strategy was still valid, and it was agreed the investment criteria set out in 2012 was still valid. Furthermore, the report surmised that the hold period of any investment acquisitions should be considered as part of the purchase process. This remains true.
- 6.2 However, due to the uncertain economic times and the nervousness around some sectors of the property market it is clear that any potential investment acquisitions are approached with caution, having said that there may be opportunities to acquire good solid investment assets. The Council should be prepared to buy assets where there is long term solid income streams, with or without long term change of use possibilities or assets that are clearly beneficial and key to regeneration projects in the Borough.

Financial implications:

Since 2012 the Council has invested £88 million in purchasing investment properties. Around 71% of the purchase price was funded from borrowing and the balance from Council Reserves.

Minimum Revenue Provision (MRP) and debt interest payments are correctly accounted for in the relevant periods.

Ministry of Housing, Community and Local Government (MHCLG) guidance on investments and CIPFA's Treasury Management code places some restrictions on continuing to invest in commercial properties. However, the Council's Property Acquisition strategy supports investment within the Borough boundaries and there are no adverse implications as a result of the changes.

Given the forecast of the various property sectors, it will prove difficult to purchase properties with a return of 6% which also benefits from a strong tenant covenant. Therefore, it should be noted that the criteria "return of at least 2% above borrowing costs" will become increasingly difficult to achieve in the coming months/years.

Environmental/Sustainability Implications:

There are none identified in this report.

Legal implications:

There are no legal implications in this report.

Equality Implications:

There are none identified in this report.

Risk Implications:

A separate ear marked reserve is held on the Council's balance sheet which can be used for voids and rent-free periods and one-off costs relating to the investment property portfolio such as necessary improvement works to properties.

MRP and debt interest payments are correctly accounted for in the relevant periods.

When investing in Property, careful consideration is given so that too much reliance is not placed on one specific sector which helps to spread the risk across all sectors, albeit still within Elmbridge Borough boundaries

Community Safety Implications:

There are none identified in this report.

Principal Consultees:

Portfolio Holder for Resources.
Council Management Board.

Background papers:

None.

Enclosures/Appendices:

None.

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