2018/19 to 2020/21

Commercial property investment strategy

NORWICH
City Council

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1. Introduction

This strategy sets out, in a transparent and open way, our approach to buying commercial property investments and the process and due diligence that is undertaken. We are often asked why we are investing in these assets. Councillor Paul Kendrick, portfolio holder for resources, gives the following reasons:

To generate a new net income stream and thereby help protect services that would be at risk of being cut or reduced

Like all local authorities, Norwich City Council is facing further cuts to the money it gets from the government. The council has to make £10m of savings in the next four financial years from a total gross budget of £57m - this is in addition to £33m of savings already made in the last 8 years.

We know the government's revenue support grant is disappearing and further austerity is likely to continue for district councils. Therefore, we must ensure that we are a forward-thinking council with a proactive and ambitious appetite for income generation so that we can help maintain the services that matter most to local people – that is the basis for the commercial property investment strategy.

This commercial approach means the council will be able to lessen the required cuts to council spending and help protect services that would otherwise be at risk.

The council is unable to use the money it is spending on commercial properties to spend directly on services. The property investments will be funded by borrowing money; the law says the council can only spend borrowed money on assets with a life of more than one year and where it is going to make a profit or save on existing costs, meaning some of the money generated or saved can be used to meet borrowing costs. It would be illegal for the council to spend this money on day-to-day council services.

Because commercial property is an attractive long term investment

Section 5 in this strategy shows that commercial property investments are attractive in terms of long term yields compared to other types of investment the council could make, despite the potential risks involved.

In addition, the council can borrow money cheaply, mainly from the Public Works Loans Board, which lends to public bodies at lower rates compared to commercial investors. This borrowed money can be used to buy standing investments - commercial properties with established tenants in place which generate a revenue stream for the council. The council collects the rents from these properties and then, once you take off the borrowing costs, what is left is the profit which can fund council services.

Because the council understands and has experience in managing a commercial property portfolio

We have owned and managed a commercial property portfolio for decades. Excluding car parks, the council owns some 200 investment properties and these have a capital value of £43.5m. These investments generate a gross annual income of £2.5m (net income of £1.9m). The portfolio is managed by the council's joint venture arrangement with NPS Norwich Ltd.

Because it contributes to the council's priority of promoting an inclusive economy

The council's aim, in partnership with others, is to continue to develop Norwich as a strong, vibrant and inclusive economy which is the key driver of growth and prosperity regionally, and one in which the benefits of economic activity are shared by all.

The council, as part of this strategy, will invest in commercial property in Norwich (although not exclusively) so as to generate a new net income stream but also in some circumstances to respond to local market failure and local opportunities, for example by ensuring sufficient commercial spaces are retained and not converted into housing.

Councillor Paul Kendrick
Portfolio holder for resources

2. The council's objectives, investment principles and acquisition criteria

The council's aims for investing in commercial property

2.1 To generate new sustainable income streams, with clear margins exceeding the cost of borrowing.

2.2 To build financial resilience through the creation of a diverse commercial property portfolio to mitigate the potential risk of owning these investments.

2.3 To contribute to the council's priority of supporting an inclusive economy, where suitable opportunities arise.

Status of the investment principles and criteria

2.4 The investment principles set out in this strategy are to be taken as mandatory.

2.5 The criteria for identifying appropriate acquisitions are to be used as a guide in individual investment decisions. Reasonable departures from the criteria can be made as long as the rationale for doing this is articulated and recorded.

Commercial property investment principles

Scope

2.6 The council will, under this investment strategy, acquire established commercial properties generating an immediate secure income profile.

2.7 The investment strategy also includes the potential redevelopment of already-owned commercial property requiring capital expenditure and potential investment in pooled property funds.

2.8 This investment strategy does not include the purchase of housing for the private rental sector (PRS). Given the council has a Housing Revenue Account (HRA), such acquisitions by the council would automatically become social housing rather than PRS and therefore are unlikely to meet the income objective stated in 2.1 above. The investments would also be subject to the right-to-buy legislation.

Tenure

2.9 The acquisitions will be freehold or long leasehold purchases. The acquisition must be assessed by Finance to be an operating, rather than a finance, lease otherwise part of the rental income is a capital receipt (with restricted

permissible uses) rather than an income stream for the council's revenue budget.

Diversification of the portfolio

2.10 The council will buy commercial property outside of the city boundaries in order to mitigate the potential risk of being over reliant on one economic location and in order to be better able to diversify the portfolio in terms of sector and tenancy mix. However, no more than 50 per cent, by value, of the total commercial property portfolio will be located outside of the city's boundaries. This is because local investment ensures the council is best placed to know all the facts surrounding a property, its history, and potential developments in the area.

2.11 The council will acquire a good spread of properties across a variety of asset classes and tenancy sectors including the "alternatives" sector in order to reduce the risks of exposure to a single asset class, tenant or market failure. At this stage the portfolio is heavily weighted into certain sectors and classes. However it is expected that over the life of this strategy no more than 20 per cent (by value of the portfolio) will be retail and of the remaining 80 per cent there will be a mix of industrial, office, and alternatives in roughly equal proportions.

2.12 The council will invest within a range of lot sizes so that one (large) investment does not dominate the entire portfolio holding. Average lot sizes are likely to be in the range £5m to £15m, although this does not rule out smaller or larger lot sizes.

Size of the commercial property investment fund

2.13 The capital budget for commercial property acquisitions and investments will be agreed by the council annually (as part of the overall budget setting process) and total in-year expenditure will not exceed this approved budget figure (unless council is asked and agrees to increase the budget).

2.14 The amount of money the council will invest in commercial property, and the potential risks it takes on in doing so, will be proportionate to the size of the council. The council will publish appropriate indicators, required under MHCLG's (Department for Housing, Communities and Local Government) revised Investment Code, as part of the annual budget setting process. These indicators will show the size of the intended investments in relation to the size of the council's General Fund budget and balance sheet and the proportion of the council's budget that is funded from commercial property rental income. Due consideration will be made of any CIPFA guidance issued.

Required rate of return from the investment

2.15 All investments considered under the delegated approval route must provide income equal to or above (or no more than 0.02 per cent below) the council's required initial net rate of return. This is defined as the return assumed and

stated annually in the MTFS (Medium Term Financial Strategy) **after** taking into account the costs of borrowing for the investment (even if the investment is to be initially funded from internal borrowing (the temporary use of the council's cash holdings) rather than through external borrowing. At the time of writing this strategy the council's required initial rate of return is 2 per cent.

2.16 Council policy, in the case of commercial property investment, is to place the security of the investment first followed, in priority order by yield and liquidity when considering the investment decision (see paragraph 4.14).

2.17 20 per cent of the new net income is credited to the commercial property earmarked reserve to help mitigate the long term financial and cyclical risks that are associated with these investments (see paragraph 4.18). At March 2019 the earmarked reserve was over one million pounds.

Financial evaluation

2.18 The financial analysis will be undertaken on a prudent rather than an optimistic basis and will include:

- the relevant capital and revenue costs and income resulting from the investment over the whole life of the asset including borrowing costs (being interest rate charges and MRP (Minimum Revenue Provision) costs)
- estimated costs of future voids, rent free periods, and landlord repairs
- as a "worse case" scenario, the estimated return to the council where there is no future rental growth
- assume all acquisitions are funded through external borrowing although internal borrowing may be utilised in the short term
- a testing of the impact of increased interest rates on the financial return to the council.

Delegated decision-making process

2.19 Individual property acquisition decisions that fall within these principles will be taken following the delegated process set out in section 6 of this strategy. The key documents constituting the "business case" for the investment are:

- A scored criteria matrix for the potential acquisition (Appendix B).
- Statement of 'other good reason' if required (see paragraph 2.27).
- A purchase report from the council's agent.
- A partial RICS "Red Book" valuation.
- A financial appraisal from Finance.

2.20 Any acquisition that contributes to the promotion of an inclusive economy, or an investment in already-owned commercial property, that does not meet the council's required net rate of return will be considered on its merits by cabinet and council through the submission of a business case. Such investments will not be undertaken using the delegated process set out in section 6.

Ethical and reputational issues

2.21 The choice of investment will take into account ethical considerations relating to the vendors of the property in addition to the intended use of the property and its current or future tenants. The council will not engage with sellers or tenants who may present a significant reputational risk.

Criteria for identifying appropriate acquisitions

2.22 When a commercial property investment opportunity presents itself, the council will undertake an initial screening to assess whether the following activities are involved:

- armaments and nuclear weapons production or sale
- escort services
- environmentally damaging practices and
- the manufacture of tobacco products.

2.23 These will be taken account in the decision as to whether to bid for the property but will not necessarily preclude the council investing in a property that has a connection to these activities.

2.24 A criteria matrix will then be used to score the potential property acquisition, and this score will also inform the decision as to whether to bid for the property. This matrix can be found in Appendix B.

2.25 The matrix gives different weightings to the various factors to be considered. A score of below 120 (out of a possible total of 240) will be deemed to be a below-average investment and will be ignored.

2.26 The factors considered in identifying an appropriate investment are as follows:

- The strength of tenant covenant - which is assessed through CreditSafe and/or Dunn and Bradstreet credit assessments.

- Prospects of re-letting at expiry either with the existing tenant or with others given the location, size and nature of the property, and the demonstrable demand in the locality for similar rental properties.

- An assessment of the exit opportunities at lease expiry – such as disposal or redevelopment.

- Lease length will be determined by market sector forces but the premise will be to maiximise.

- Net Initial yield should be at or above five per cent. (This is not the same as the council's required net rate of return discussed in 2.15 above. The latter is the real initial return to the council's budget whereas net initial yield is simply the rental income from the property at acquisition expressed as a percentage of the acquisition cost (including taxes and fees).

- Macro and micro locations with rental growth, good letting prospects, and with good transport links will be actively sought.

- Specification - properties with a fully usable and flexible space will be preferred.

- Properties with a practical configuration of buildings and land will be preferred to enable easy servicing and access.

- Obsolescence – properties that are in good condition, are high quality and have prospects of lasting over many years with minimal investment will be actively sought.

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

- Single let investments should be on full repairing and insuring (FRI) terms, meaning that usually all costs relating to occupation and repairs are borne by the occupier(s) during the lease term.

- The lease should allow for rent reviews increases linked to the retail price index or open market value. Leases with downward rent review terms should be avoided preferring leases with upward only review terms

- Ideally the market rent should be equal to or higher than the passing (current) rent (indicating prospects for rental growth). Overrented properties, where the market rent is less than the passing rent, are generally avoided unless the purchase price reflects the risk of downward revision.

- Sustainability – properties with a high energy performance certificate (EPC) (BREAM outstanding or excellent - Building Research Establishment Environmental Assessment Method) are preferred. Low energy performance scores can create a challenge upon reletting.

Other good reasons for acquisition

2.27 As referred to in paragraph 2.3 there may be occasions where the council acquires property to contribute to the council's priority of supporting an inclusive economy. In such circumstances it may be acceptable to acquire a property which has a matrix assessment below the threshold score normally considered acceptable (but still meets the council's required net rate of return).

2.28 These other circumstances may include:

1) Where the council is a special purchaser as it will obtain marriage value;

2) Strategic Importance of the land/building
3) Strong links to tenant / vendor
4) Represents model example of socially responsible investing
5) Exemplary green or sustainable factors
6) Synergies with other properties
7) Alternative Use value at reversion
8) Development potential

2.29 In such circumstances the council will record the reasons for departing from the matrix threshold with fully set out reasons so that informed decision making can be made.

3 Commercial property as an investment – a short guide

Definition of commercial property

3.1 The commercial property market is primarily made up of three sectors (retail, office and industrial) and these have traditionally dominated investors' portfolios. Outside the mainstream asset classes is another fast emerging sector starting the "alternatives" sector which is highly sought after by investors.

- **Retail**: Shop units and similar (e.g. restaurants & coffee shops, bank branches, estate agents, etc.), in-town & out-of-town shopping centres, retail warehouses & retail parks (typically occupied by DIY stores, carpet & electronics retailers).
- **Office**: Office blocks, out-of-town business parks, and data centres.
- **Industrial:** Warehouses, light industrial use (e.g. workshops), distribution and logistics, and most types of factory other than structures such as steel works, chemical plants etc.
- **Other commercial property ("alternatives")**: A wide range of miscellaneous building and property types used by profit making businesses including: leisure premises, hotels, petrol stations, car parks, student accommodation, agricultural /horticultural holdings, GP surgeries, data centres self-storage and renewable energy. These can often have very unusual characteristics in terms of risks and income flows.

3.2 Investment returns from commercial property arise from both an increase (or decrease) in the asset value on sale (capital receipt return) and the annual cash flow generated from leasing the property to a tenant (rental income). As a council we are less driven by cyclical changes in the asset value and are primarily concerned with achieving competitive income returns.

Rental income

3.3 The most reliable source of return from commercial property investment is the rent paid by the tenant/s, which they are legally obliged to pay under the terms of the lease until lease expiry.

3.4 Recovering overdue rent is easier than other tenant debts due to self-help remedies available to landlords that do not require a court application but ultimately landlords are usually unsecured creditors.

Demand and supply

3.5 The rent at which a property will let, or the price at which a property will sell, is determined by market forces and the imbalance between supply and demand. Strong demand from prospective tenants for particular buildings will usually lead to an increase in the rental value of that space, particularly if there is a limited supply, e.g. a shop in Bond Street in London's West End.

3.6 A strong tenant demand also means that landlords do not have to offer tenants so much in the way of incentives to take the lease. This is illustrated by looking at rent-free periods at the start of the lease, a common incentive. When market rents are rising rapidly, the length of the rent-free periods being offered falls and the reverse is true when rental values are static or falling. In 2017, the unweighted average rent-free period for all offices was 9.1 months (source: "Understanding UK Commercial Property Investments", Investment Property Forum, 2017) well below the high of 11.4 months recorded in 2010.

3.7 In addition, the amount of time needed to find a replacement tenant and income stream tends to be shorter in a stronger market.

3.8 Capital values increase where there is greater investor demand (as well as greater tenant demand). For example, the capital value of trophy assets in London has grown rapidly in value because of the high level of international investor demand.

3.9 It is important to note that movements in capital and rental values are not perfectly positively correlated, and it is possible (and often the case) for the investment value of an asset to rise faster or slower than its rental value. The occupier and investor markets for commercial property are distinct and have different drivers. The occupier market is connected more closely to the "real" economy and comprise of businesses seeking to expand and contract. Capital investors however are competing for the best fixed income returns that are obtainable from a wide range of investments types including commercial property.

Rent reviews

3.10 UK commercial property leases generally provide for rents to be reviewed every five years and set to the market level where this is above or equal to the rent being paid at the time of the review. If the market rent is below the current rent, the rent would remain unchanged for the next five years. Although a 'five-year, upward-only rent review' is the most common review type in the UK, there are other mainstream provisions:

- **Fixed uplift rents:** these are rents that are uplifted after a pre-established period (e.g. every three or five years) by a set value or percentage as stated in the original terms of the lease.

- **Index-linked rents:** these are rents that are linked to an index such as the Retail Price Index (RPI). They have been increasingly adopted by the UK investment market as they provide inflation hedging.

- **Turnover-related rents:** these are relatively rare these days and comprise of rents that are set as a percentage of the tenant's business activity turnover from occupying the space. These leases are most commonly found in retail shopping centres and in the student accommodation sector.

Lease length

3.11 Commercial property leases in the UK can range between 5 and 15 years in length, but usually 5 to 10 years, with the market average currently being around seven years, compared with 23 years in 1990. Average lease lengths differ across sectors, (e.g. retail warehouse tenants generally want long leases), location and the size of the space (tenants with more floor space are more likely to want a longer lease because of the level of upheaval associated with relocation and the higher capital expenditure on fit out).

3.12 Some leases include a 'break clause' that gives the landlord and/or tenant the option to terminate the lease prior to its expiry date. This can impact on the value of a property because the income stream is no longer certain for the full term of the lease. The number of leases with a tenant break clause has been increasing over recent years and currently some 40 per cent of leases contain such a clause.

Impact of movements in the capital value of the investment

3.13 Local government has a unique financial regulatory framework and, unlike the private sector, any fall in the capital value of the property due to market changes is not a cost to the council's General Fund revenue budget. The principle risk to the revenue budget is lost rental income and potential liability for business rates due to void properties.

3.14 Net gains or losses on property disposals are reversed out of the General Fund balance through capital accounting impairment entries in the Movement in Reserves Statement and posted to the Capital Adjustment Account, Capital Receipts Reserve and Revaluation Reserve (if all appropriate) so not to impact council tax.

3.15 However, if there is still an outstanding debt liability arising from the borrowing undertaken to finance the acquisition of the property, and the capital receipt obtained from the sale is not sufficient to pay off the loan debt, this would have an adverse impact on the council's General Fund budget. In this scenario the council would still have interest and Minimum Revenue Provision (MRP) costs to fund but without the benefit of the rental income stream to cover these costs.

4. Unique features of commercial property as an investment

A tangible asset that requires management

4.1 Property is a tangible asset, usually comprising two elements: land and buildings. While buildings can become obsolete or be destroyed, land remains an asset that generally retains some value because in the UK it is in limited supply and is subject to the restrictions of the land-use planning system.

4.2 Property may also offer the opportunity to increase its value, and hence investment returns, through 'active' management. This can entail such actions as refurbishment or redevelopment, the renegotiation and extension of leases, the 'right-sizing' of tenants (providing them with the optimum sized unit), or acquiring property with rental reversions (i.e. where the rents received for space are less than the rental value of that space).

4.3 The downside of owning a tangible asset like property is management and costs of ownership. The amount of time and cost will depend on the terms of the lease, the state of the market, and the balance of power between the parties to limit their obligations. Although it is common for leases of commercial properties in the UK to make the tenant take responsibility for some or most of the costs of repair, maintenance and insurance of the building, the landlord must still collect rent, settle dilapidations, serve notices, and undertake rent reviews and relets.

4.4 Effective management is essential to maintain income flow and to ensure that a building remains attractive to occupiers. It should be noted that the costs of managing multi-let assets are often considerably more than for single let assets, since the landlord will often retain responsibility for common parts paid for via a service charge recovery. If the lease repair obligations on tenants are internal only then the landlord must arrange, oversee and pay for any external works required. In the case of large buildings, dedicated resources (facility managers, security teams and receptionists) may be needed and not all costs may be recoverable from tenants. In the case of having a unit void in a multi-let property the council would pay the service charge and business rates until a new tenant is found.

4.5 The council intends to implement an improved process for monitoring the total and individual property performance of the portfolio along with a formal annual portfolio review.

4.6 The annual portfolio review will include:

- A market update on activity and forecasts and review of the current commercial property investment strategy.
- An external market valuation of the portfolio to monitor and benchmark performance (undertaken already for the Annual Statement of Accounts preparation).
- An updated five year cash flow and capital expenditure forecast.

- A review of retain, sale, re-purpose or re-gear of each asset.
- Review of previous year's performance including rent collection rates, arrears and service charge reconciliations.
- Review of the underlying lifecycle of the asset, holding period, refurbishment expectations, dilapidations, health and safety, statutory compliance and insurance claims.
- Tenant covenant strength monitoring report and tenant compliance with lease terms and any default/issues.

Diversity and valuation

4.7 The heterogeneous nature of property as an investment is one of its most significant features and is both an advantage and a drawback. On the plus side, it means that an almost infinite range of opportunities exists, each providing distinctive investment characteristics. This offers the prospect for diversification, even within a portfolio of a relatively small number of properties.

4.8 However, the diversity can make asset pricing and an assessment of whether the council is achieving value for money in its acquisitions difficult. For example, unlike equity investments, property does not trade on an exchange with openly quoted prices.

4.9 The Royal Institution of Chartered Surveyors (RICS) Appraisal and Valuation Standards (known as 'The Red Book') are the most recognised professional standards used by valuers in the UK. They are used by RICS members (chartered surveyors), who value most of the investment property in the UK. Properties are valued principally for transaction purposes (buy/sell decisions), financing for borrowing or capital raising purposes, performance benchmarking, and for the preparation of the annual Statement of Accounts.

4.10 The council employs an external expert agent to advise on the pricing strategy for a potential commercial property acquisition. In addition, an independent valuer also undertakes a partial RICS "Red Book" valuation of the property before a bid is made. Procuring a partial Red book valuation is achievable during the condensed timetables of competitive bidding. The full valuation is obtained and reviewed before exchanging contracts on a purchase.

Liquidity

4.11 The process of selling and buying property takes a lot longer than buying financial investments such as equities or government bonds. This is because of the unique nature of every property, its complexity (both physically and from a legal perspective), the large unit size, and the nature of the market in which transactions occur. Even in a buoyant market selling takes a long time and involves lengthy marketing periods that can easily take up to a year to conclude for limited market or complex assets. Investing directly in property therefore involves more liquidity/transaction risk than financial assets such as equities, bonds, and deposits in banks and building societies.

4.12 When investing in commercial property local authorities are obliged "to have regard to" MHCLG's (Ministry for Housing, Communities and Local Government) Investment Code and the complementary Treasury Management Code produced by CIPFA (Chartered Institute of Public Finance and Accountancy). CIPFA issued further guidance "Prudential Property Investment" in November 2019. Whilst this is not a proscriptive set of rules it does set out the risks and mitigating factors councils should adopt such as proportionality and obtaining sufficient external advice to proceed with acquisitions. City will continue to consider these guidelines when undertaking activities and propose any require changes to our strategy in due course. #

4.13 These codes stress the importance and long-held good practice of placing security and liquidity above yield (in that priority order) when making any investment decision. A council can choose to disregard the codes but must articulate its rationale for doing so and what the council's relevant policy will be.

4.13 The council has noted and has had regard to the guidance in the codes. It has decided after careful consideration to depart from the guidance in this instance for the purpose of generating new income streams in order to help maintain a robust and sustainable financial position. The council has set out within this strategy its approach to commercial property investment including risk mitigation, the approach taken to financial modelling of the returns, the due diligence undertaken, and the use of external advisers.

4.14 Council policy, in the case of commercial property investment, is to prioritise the security of the investment followed, in priority order by yield and liquidity when considering the investment decision. The scoring matrix weightings for potential property acquisitions (Appendix B) shows that 45 per cent of the total score relates to the security of the future rental income stream(s) associated with the investment. In terms of commercial property investment these terms mean the following:

- **Security** – security of the investment (primarily term certain i.e. length of lease term remaining, exit strategy, prospects of reletting at expiry or if it were to fall vacant) and strength of tenant covenant
- **Yield** – the net return to the council that is appropriate for the level of risk being assumed, and
- **Liquidity** – to ensure that the property is attractive and marketable for the future.

4.15 The council will implement the recommended practices contained in the Investment Property Forum's "*Readiness for Sale: A guide for streamlining commercial property transactions"*, May 2012) in order to help speed up the sale and purchase process and thereby increase the liquidity of this investment category.

Transaction costs

4.16 The cost of buying and selling commercial property is significantly higher than for a comparable volume of equities and gilts. This is due to much higher levels of stamp duty (stamp duty land tax (SDLT), together with the costs of lawyers, chartered surveyor agents, environmental and condition surveys, Land Registry and other fees, all of which typically add an additional five to seven per cent to direct property acquisition costs (although this is closer to two per cent on a disposal).

4.17 In practice, the high transaction costs associated with buying and selling property mean that investors need to hold property as a long-term investment, with limited opportunities for short-term gains.

The potential risks of commercial property investment

4.18 The key risks associated with commercial are shown below.

Figure 1: **Principal risks associated with commercial property investment**

Potential risks at asset level	Potential risks at market level
Stock specific – there is more risk in owning a property portfolio where there is limited diversification in terms of geographic location and tenancy/type of property owned	**Economic outlook** – property financial performance is closely correlated to national GDP (Gross Domestic Product) growth
Liquidity – commercial property is relatively illiquid which is a risk if the Council ever needs to sell investments quickly in order to raise cash	**Sector and geographic concentration** – an individual property may perform better or worse than other property due to its location and/or tenancy type (for example – retail property is currently under-performing in some areas of the UK)
Valuation – property values are determined by the market. RICS registered valuers provide estimates of market value at any given date but their values do not represent guaranteed transaction prices and this makes it difficult to demonstrate value for money Also the risk that the future value of the property will be less than the amount of loan repayment required upon disposal.	**Investor confidence** – not a constant and shifts in sentiment can have a positive or negative impact on values
Void rental periods – from vacancies (end of lease terms or tenant bankruptcy) and from rent free incentives given to new, and	**Changes in taxation** – can impact value and property's relative attraction as an asset class e.g. increases in stamp duty land tax or VAT

sometimes existing, tenants at lease renewal	
Condition and Environmental – the property itself may not comply with current market standards so requires expenditure to upgrade building fabrics etc Also locational issues, such as risk of flooding	**Availability of debt finance** – the government could stop (or increase the cost of) borrowing from PWLB (Public Works Loan Board) for all (or for out-of-boundary) commercial property acquisitions **Interest rate changes** – affect cost of property borrowing
Potential risks at asset level	**Potential risks at market level**
Litigation – related to acquisition, ownership, management and disposal of property	**Changes in legislation / regulation** – risk that central government could legislate to stop or limit local government buying commercial property Upgrades to older building types can be very costly particularly when the penalty for not complying with statutory legislation is that the property cannot be let as, for example, under MEES (minimum energy efficiency standards).

4.19 The council agreed in February 2018, as part of the budget setting report, to the establishment of a commercial property earmarked reserve. The reserve is held to help mitigate the financial risks of holding commercial property and can be used to fund any future void periods, the granting of rent free periods to new tenants, and any landlord repairs.

4.20 The amount of money in the reserve will be reviewed annually as part of the budget setting process and will take into account the outputs of the annual portfolio review (see paragraph 4.6).

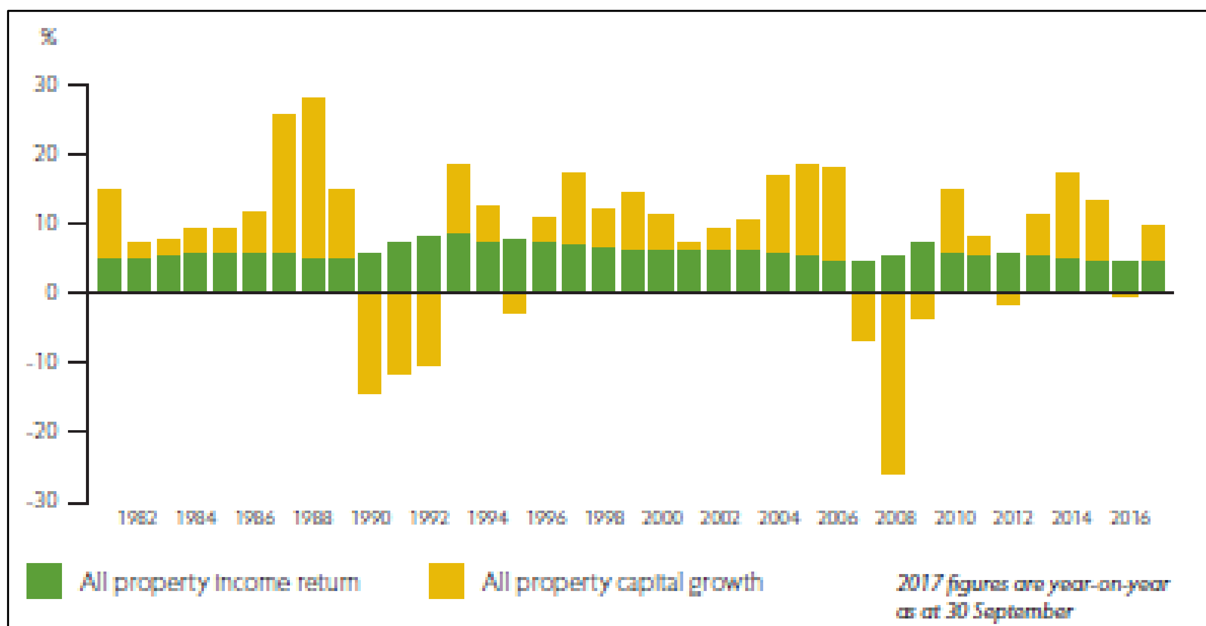
5. Investment returns from commercial property

Income and capital returns

5.1 As previously stated, investment returns (both gains and losses) from commercial property can arise from both an increase (or loss) in the asset value on sale (capital receipt return) and the annual cash flow generated from leasing the property to a tenant (rental income).

5.2 Property rental returns are relatively consistent when compared with capital returns which can rise and fall quite dramatically on a cyclical basis depending on the supply and demand for investment stock at any given time (underlying the importance of timing when deciding to buy or sell property). This is shown in figure 2 below.

Figure 2: **Property: income and capital returns**



Source: "Global Real Estate Performance in 2017" MSCI's IPD® Global Annual Property Index

Inflation

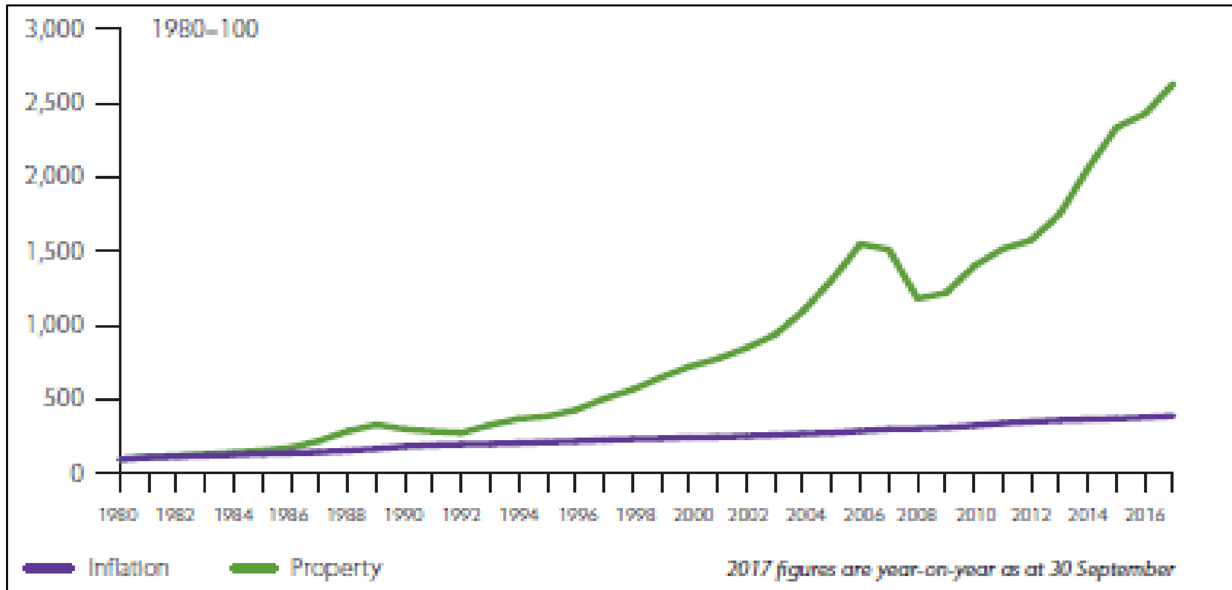
5.3 The Investment Property Forum (IPF) looked at property values and inflation over the long term and found that whilst property is not a hedge against inflation (a 'hedge' is defined strictly as moving at the same time as inflation or reacting to it) property does deliver long-run real returns, as shown in figure 3. The figures show the "total returns" from property which comprise both the annual rental income and the capital value of the asset.

Returns compared to other investment classes

5.4 The investment returns from property are usually compared with those from equities and bonds, both of which are permitted investment choices for local

government (see figure 4). In comparison with income from equities, property rent is generally much more predictable and certain. While conventional bonds (except for those that are index-linked) also provide an assured return, they do not offer the prospect of income growth.

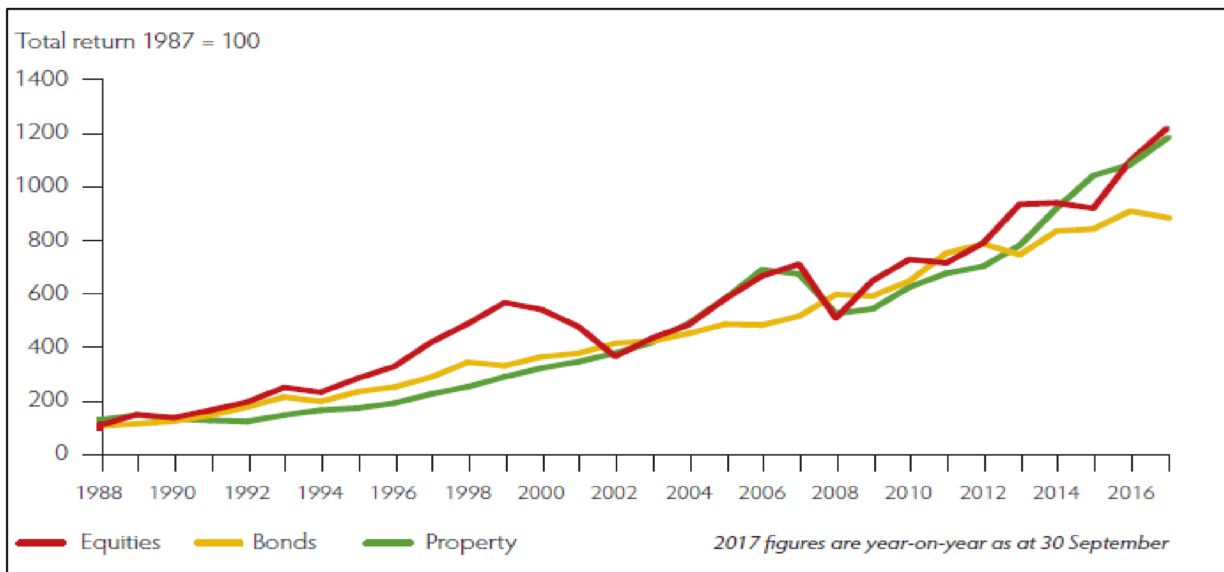
Figure 3: **Property total returns vs. inflation**



Source: Understanding UK Commercial Property Investments, Investment Property Forum (2017)

5.5 In terms of risk profile, property is usually regarded as being between bonds (lower risk) and equities (higher risk) but with the benefit of potential income growth from rental uplifts. However, the liquidity risk of holding property, as mentioned in the previous section, should not be understated, especially in an economic downturn where there can be very few buyers except for the most prime assets.

Figure 4: **Performance of commercial property compared with equities & bonds**



Source: "Global Real Estate Performance in 2017" MSCI's IPD® Global Annual Property Index

6. Acquisition process

Delegated authority for decision making

6.1 Delegated decision making is required so that decisions on whether to bid for and acquire a particular property can be made in a timely and decisive way which is essential in this market. It also allows the council to respond to opportunities as they arise.

6.2 Cabinet agreed at its meeting on 12 April 2017 to delegate authority to invest in commercial property acquisitions to the director of regeneration and growth (now place) in consultation with the chief finance officer, the portfolio holder for resources, and a quorum of three other cabinet members.

6.3 The maximum lot size (purchase price or capital investment in an existing commercial property) under the delegation is £20m. This was agreed by cabinet on 12 December 2018.

Acquisition process

6.4 Appendix A gives a process workflow diagram for the acquisition process showing the six phases of the process (initial screening, detailed investigation and financial modelling, pre-contract due diligence, exchange of contracts, completion and post-completion). The diagram shows when decisions are made, what activities are involved, and who undertakes these activities.

Governance and due diligence

6.5 A formal business case document is not written for every commercial property acquisition as there is often not the time to undertake this. However all the key elements that would go into such a business case are produced and documented in a variety of reports/lists or models.

6.6 The key reports/lists or models are the following:

- A scored criteria matrix for the potential acquisition (Appendix B).
- Statement of 'other good reason' if required (see section 2.27).
- An initial purchase report from the council's agent.
- A partial RICS "Red Book" valuation.
- A financial appraisal from Finance.

6.7 Any decision made to bid for a property is published as a key decision notice and the property details and financial model are also circulated to all elected members on a confidential basis because of commercial sensitivities.

6.8 All key decisions can be called in by elected members for further consideration. Scrutiny committee will consider key decisions that have been called in and can refer the decision back to cabinet.

6.9 A decision to exchange contracts (when the transaction becomes legally binding for both parties) is taken on the basis of:

- A report from NPLaw on the due diligence they have undertaken on title, leases and searches.
- A final purchase report including advice arising from the building and environmental surveys undertaken.
- A full RICS "Red Book" valuation.
- A revised financial analysis from Finance (if this is required).
- A recommendation from NPLaw about the draft contract terms.

6.10 An operational, due diligence checklist is completed for every bid and subsequent acquisition.

Assurance

6.12 As part of the 2017-18 audit of the council's statement of accounts, the external auditors, Ernst & Young LLP, undertook a value for money review on the council's commercial property investments. The audit results report (July 2018) states:

"Management have provided evidence that an appropriate methodology for appraising and analysing the investment opportunities was in place to make a decision to purchase…The investment strategy sets out a number of criteria and key recommendations from the Council's advisors that the council should have regard to in purchasing property. The methodology reviewed follows these areas in helping to formulate a decision…We have compared the data used in the models to market trends and have comfort in the assumptions included…We have concluded proper arrangements were in place during 2017/18 for informed decision making."

Capacity, skills and the use of external advisers

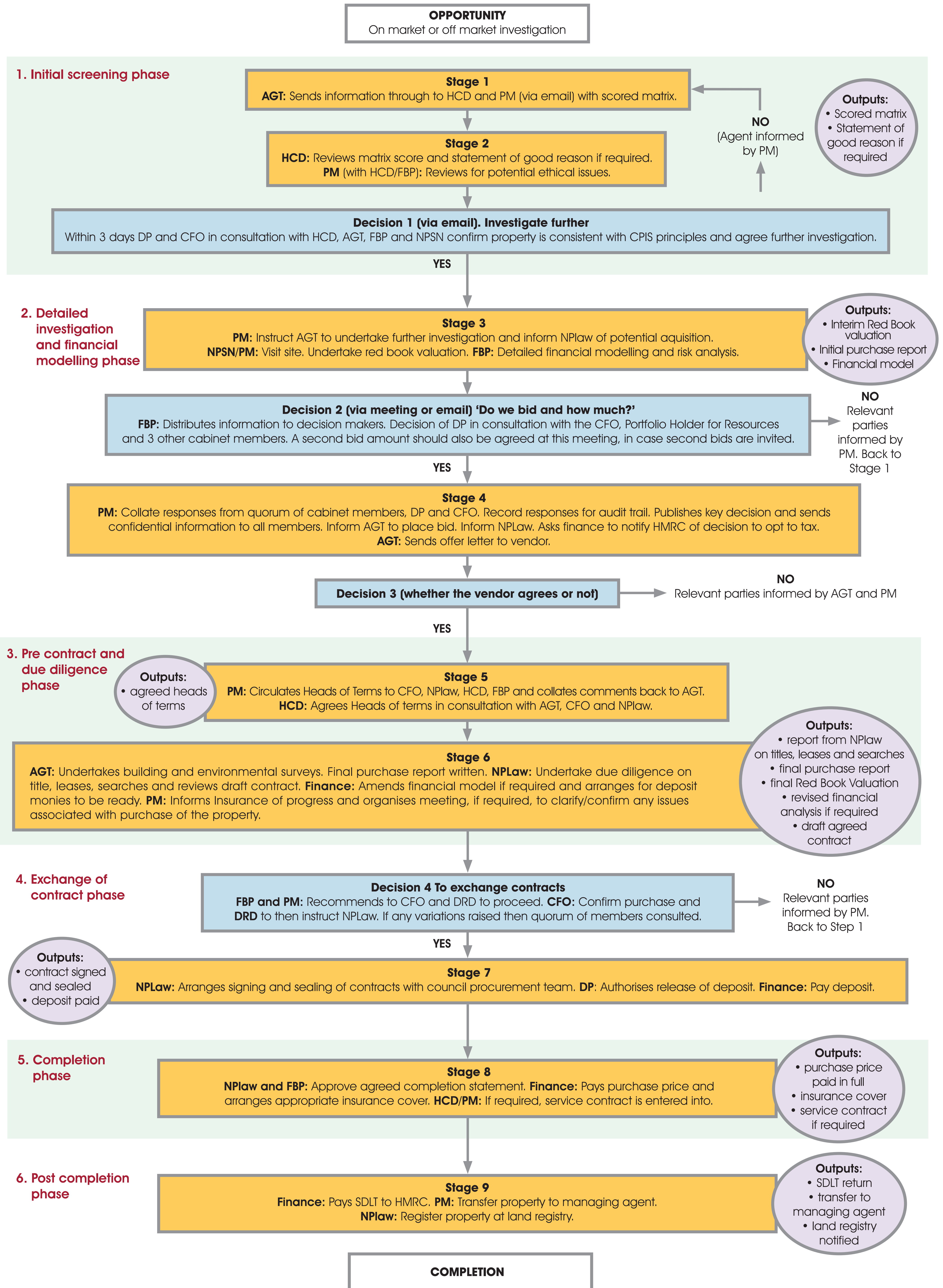
6.13 MHCLG's Investment Code requires that elected members and officers involved in the investment decision making process have appropriate capacity, skills and information to enable them to take informed decisions as to whether to enter into a specific investment.

6.14 The director of place, as project sponsor for the commercial property investment programme, will set out for Asset and Investment Board agreement, a suitable annual training plan for both officers and relevant members.

6.15 The council recognises that investing in commercial property is a specialist and potentially complex area. It will therefore engage the services of professional property, legal, financial and tax advisors where appropriate in order to access specialist skills and resources to inform the decision making process associated with this strategy.

APPENDIX A

Buying investment properties – process workflow



Buying investment properties – process workflow

Assumptions:

- CEO and members on Asset & Investment Board will be informed via email of progress from decision 1 onwards (email from PM).
- NPSN will act in advisory role and NPLaw and Finance will be involved from the start of the process.
- Financial model already built to assist decision making.
- A pre-populated checklist and concise 1 or 2 page proforma notes will be used to inform decisions rather than full business cases to speed up the process, these do however, include all the information needed for a full business case.
- Some of the identified tasks may run in parallel.
- All information will be held on Huddle to which all project team members have access. All emails and documents are held in order to provide an audit trail.
- Net initial yield of the property must be over 5% (state cabinet report 12 April 2017). The real return, after assuming the acquisition is financial by external borrowing, is 2% or above (as per the MTFS assumptions).
- Deputies:

Role	Deputy
Chief executive officer	Head of city development
Director of place	Chief executive officer
Chief finance officer	Director of resources

Key

AGT	agent
CEO	chief executive officer
CFO	chief finance officer
CPIS	commercial investment property strategies
DP	director of place
FBP	Finance business partner
HCD	head of city development
NPLaw	legal team
NPSN	NPS Norwich
PM	project manager

Level of input:

H	High
M	Medium
L	Low

1. Initial screening phase

Level of input	
AGT	H
NPLaw	L
NPSN	H
PM	M
Finance	L
HCD	H

2. Detailed investigation and financial modelling phase

Level of input	
AGT	H
NPLaw	L
NPSN	H
PM	L
Finance	H
HCD	H

3. Pre contract and due dilicence phase

Level of input	
AGT	H
NPLaw	L
NPSN	L
PM	H
Finance	H
HCD	L

4. Exchange of contracts phase

Level of input	
AGT	H
NPLaw	H
NPSN	H
PM	L
Finance	L
HCD	H

5. Completion phase

Level of input	
AGT	H
NPLaw	H
NPSN	L
PM	H
Finance	M
HCD	L

6. Post completion phase

Level of input	
AGT	M
NPLaw	M
NPSN	H
PM	L
HCD	M

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APPENDIX B

Scoring matrix

Parameter (score)	Excellent (4)	Good (3)	Acceptable (2)	Marginal (1)	Not acceptable (0)	Weighting	Max score	% of total score	Comments
Covenant strength	Very low risk	Safe low risk	Moderate risk	High risk	Very high risk	6	24	10%	Based on risk of tenant default or bankruptcy as recorded by Creditsafe™ or equivalent ratings agency
Prospects of re-letting	Within 3 months	3 to 6 months	6 to 12 months	12 to 15 months	More than 15 months	6	24	10%	Anticipated timescale to re-let property (in current market conditions)
Possibility of alternative use **'Exit strategy'**	In demand use; Value of use greater than existing; Planning a near certainty; Minimal or no capital expenditure required	In demand use; Value of use within 90% of existing; Planning consent likely; Modest capital expenditure required	Likely to be in demand use; Value of use within 80% of the existing; Planning consent reasonably likely; Average capital expenditure required	Likely to be in demand use; Value of use less than 80% of the existing; Planning consent uncertain; High capital expenditure required	Little or no alternative use likely due to demand and/or planning considerations; Prohibitively high capital expenditure required	6	24	10%	Prospect that property could be occupied by an alternative use if it was no longer possible to let it in its existing use.
Unexpired lease term	Over 10 years	8 to 10 years	6 to 8 years	3 to 6 years	Less than 3 years	6	24	10%	Lease term defined by expiry date or tenant break if latter exists. Weighted average calculated on multi-let properties
Net running yield	More than 8%	7% to 8%	6% to 7%	5% to 6%	Less than 5%	6	24	10%	Takes account of net initial yield at purchase and yield once rent has reached its estimated rental value

Parameter (score)	Excellent (4)	Good (3)	Acceptable (2)	Marginal (1)	Not acceptable (0)	Weighting	Max score	% of total score	Comments
Location - macro	Major location with excellent access	Strong location with good access	Recognised location with good access	Weak location with poor access	Isolated location	3	12	5%	Use PMA Services Ltd or similar datasets to help inform Needs to take into account future prospects.
Location - micro	Central business district or prime sub-market	Better secondary location	Average secondary location with good transport or footfall	Location with high vacancy levels and/or regeneration required	Location difficult to access and isolated	3	12	5%	Location within the city or town, etc. and impact of local competition
Specification	Top specification (equivalent to grade A)	Better than average or recently refurbished (equivalent to Grade B+)	Average (equivalent to Grade B)	Below average but with clear refurbishment potential	Below average major investment required or too large for market	3	12	5%	Grading based on quality of buildings
Configuration	Very well organised with good access, circulation, productive space and parking (as relevant) and capacity to scale up operations	Organised with sufficient access, circulation, productive space and parking (as relevant)	Satisfactory access, circulation, productive space and parking (as relevant) but with potential challenges over flexibility or growth	Some access, circulation, productive space and/or parking (as relevant) challenges which might limit attractiveness to occupiers	Overcrowded and/or poor access and/or hazardous configuration	3	12	5%	Takes into account negative features of the property's configuration that for example limits a tenants operations or trading functions

Parameter (score)	Excellent (4)	Good (3)	Acceptable (2)	Marginal (1)	Not acceptable (0)	Weighting	Max score	% of total score	Comments
Obsolescence	Building is up to 5 years old	Building is in first quartile of useful economic life (assuming normal levels of repair)	Building within second quartile of useful economic life (assuming normal levels of repair)	Building is within 3rd quartile of useful economic life (assuming normal levels of repair)	Building is in last quartile of useful economic life or has not been adequately maintained	3	12	5%	Age of property
Levels of active management	Minimal active management required Within 20 miles of Norwich	Some active management required Within 50 miles of Norwich	Requires regular but not excessive active management Within 100 miles of Norwich	Requires regular active management	Requires considerable active management potentially requiring dedicated on-sites staff	3	12	5%	Single let properties will generally require less active management. Properties further from Norwich will be more difficult to manage unless say single let and full repairing and insuring (see also below)
Tenant's repairing terms	Tenant effectively responsible for internal and external repairs and insurance	0-5% of costs not recoverable from tenant	5-10% of costs not recoverable from tenant	10-15% of costs not recoverable from tenant	More than 15% of costs not recoverable	3	12	5%	To what extent are repair and insuring costs covered by the tenant
Rent Review provisions	Fixed to greater of upward only market rent or RPI increases	Open market reviews, clauses beneficial to the landlord	Open market review with some restrictive assumptions limiting potential for uplift	Inappropriate, complicated or dated rent review assumptions e.g. gearing	Upwards and downwards or reviews based on turnover	3	12	5%	Terms under which rents can be reviewed as defined in the lease

Parameter (score)	Excellent (4)	Good (3)	Acceptable (2)	Marginal (1)	Not acceptable (0)	Weighting	Max score	% of total score	Comments
Rental value compared with rent paid (for parts let)	Rent paid is >10% less than the rental value	Rent paid is 0-10% less than the rental value	Rent paid = the rental value	Rent paid is 0-10% more than the rental value	Rent paid is >10% more than the rental value	3	12	5%	A very strong covenant and a long unexpired lease may compensate for a property being over-rented
Sustainability - EPC rating	EPC score of A or B	EPC score of C	EPC score of D	EPC score of E but good prospects for upgrade to D	If EPC score is E, F or G	3	12	5%	Government policy moving towards more stringent Energy Performance Certificate (EPC) standards
Total						**60**	**240**	**100%**	

If any parameter scores zero then the property would be rejected and not considered further except if there is an 'other good reason'

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