**East Hampshire District Council**

**Commercial Property Investment Strategy**

**2017 – 2022**

  





**1.0 PURPOSE OF THIS DOCUMENT**

1.1 The purpose of this report is to set out the Council’s Commercial Property Investment Strategy, its objectives, investment criteria and the process which will be followed when acquiring and disposing of strategic property assets for investment purposes. It replaces the previous investment strategy which was part of the Property Asset Management Plan 2012-2017. The strategy is in accordance with the Council’s Property Asset Management Plan, the Medium Term Financial Strategy (MTFS) and the wider goals of the Council’s Corporate Strategy in particular those of achieving financial stability to deliver public service excellence.

**2.0 INTRODUCTION**

2.1 The Commercial Property Investment Strategy (“the Strategy”) aims to provide a robust and viable framework for the acquisition of commercial property investments which can be followed as the Council strives to create a balanced Commercial Property Investment Portfolio, from which to derive a long term, sustainable revenue stream.

**2.2 However, the contents are intended as a guide and any values or % are provided as indicators to the underlying principal of the policy and are not specific requirements. One of the most important underlying principles of the policy is that the policy and the portfolio must be allowed to flex in the required way to react to market conditions.**

2.3 The target investment is to build a balanced portfolio with a capital value of up to £200M which will be financed through prudential borrowing in accordance with the MTFS. This strategy has been designed in accordance with this target.

2.4 Guidance has been issued via CIPFA to support section 151 and other Council officers in how investment portfolios should be built by Local Authorities. This guidance allows for Councils to invest in property to support its overall financial position (as described within the MTFS) within and without its own boundaries. The rationale for investing outside its boundaries needs to be clearly stated. This strategy supports the need for flexibility in acquisition of investment properties outside the district boundary as:

* There are insufficient properties available within the District Boundary that;

o Will enable the investment of £200m within the parameters identified within the strategy

o Will enable the mix of investment property types stipulated (to mitigate risk)

o Will enable the Council to achieve the liquidity required from the investment portfolio

o Will provide the substantial covenant strengths required for long term secure property investment

2.5 The Council will prioritise investing in properties within area however due to the limited amount of commercial property within area which meets the key metrics of the strategy the Council recognises the requirement to look beyond its economic boundaries for suitable investments if the prudential borrowing criteria of prioritising stability and liquidity before yield are to be met.

**3.0 THE KEY OBJECTIVES OF THE STRATEGY ARE: -**

* To invest in commercial property to generate a sustainable and predictable income return to contribute to the cost of delivering public services in East Hampshire.
* To build a balanced Commercial Property Investment portfolio.
* To acquire standing commercial property investments that generate an immediate income, through being let on commercial terms, or, from properties which are contracted to be let.
* To provide an income yield (return) with a clear margin over the cost of capital.
* To achieve an even balance of risk and return through portfolio diversification
* To acquire a suitable grade of properties which possess the characteristics required to retain liquidity and preserve capital (not withstanding market movement)

**4.0 THE CORE PRINCIPLES OF THE STRATEGY ARE: -**

* Investments are to be made only in direct commercial real estate.
* Properties are to be located within District and across England and Wales.
* Investments are to be freehold or long leasehold where a peppercorn (or very low) ground rent is payable.
* Covenant strengths of tenants are to be of a sufficient strength that on balance the property has an institutionally acceptable grade of income.
* The target yield of the portfolio is to achieve a running yield of 6%+ once fully invested.
* No investment in speculative development.
* No investment in areas classed as being within flood zone 3 or with a high land contamination risk.

**5**.**0 PORTFOLIO STRUCTURE**

5.1 To achieve the objectives of the strategy, including achieving the target yield, we will create a balanced property portfolio with a structure that incorporates a risk management strategy comprised of two key components: portfolio profiling and asset diversification.

5.2 In order to manage the risk profile of the portfolio we will adopt a tiered portfolio structure under which assets will be classed into four categories: Core, Core Plus, Value Add and Opportunistic.

5.2 Each of the four categories has different characteristics which combine to form their risk profile. In general terms, risk and return have a direct correlation in that the greater the risk, the greater the expected return should be. The graph below illustrates the risk verses return profile and how the four categories sit within the risk return profile.

**Graph 1 - Risk return profile of the four asset catergories.**



5.3 The characteristics of each category are set out in the table below together with an indicative expected yield. The yield figures are given merely as an indication of anticipated yield. It is important to realise the actual level of return will be property specific and will change according to market movements.

**Table 1 – Characteristice of each asset catergory.**

|  |  |  |
| --- | --- | --- |
| **Categories** | **Characteristics** | **Anticipated Yields** |
| Core | Prime locations, let on long terms, to secure covenants. Buildings tend to be impressive historic fit for purpose or modern purpose-built buildings. This asset class is the most liquid.  | 5.0%+ |
| Core Plus | Similar in nature to Core but weaker in some of the key areas of the characteristics. It therefore may be in a good rather than prime location, or there could be a mix of covenant strengths, or a mix of lease lengths. There may be significant potential to improve value through good asset management. This asset class will be liquid in stable market conditions.  | 6.0%+ |
| Value Add | These opportunities offer the chance to increase the capital value of the property by adding to or enhancing the property. These properties may show a higher level of vacancy rates, be more advanced in terms of building life cycle, requiring a degree of refurbishment or other attributes which can be improved or enhanced. These assets can become illiquid in poor market conditions.  | 6.5%+ |
| Opportunistic | Assets that can be re-positioned through thorough refurbishment, change of use or partial redevelopment or extension. These assets are generally illiquid until the potential is released.  | 7.0%+ |

5.4 The portfolio will be structured in a tiered (pyramid) format with the amount of property held in each category being adjusted according to the required needs of the portfolio at any given time. However, to reflect the cautious, stable revenue-driven approach set out in the objectives of the strategy it is anticipated that the target weightings will be in the region of 55% Core, 25% Core Plus, 15% Value Add and 5% Opportunistic as graphically illustrated below.

**Diagram 1 – Illustration of the pyramid structured portfolio.**



5.5 To further limit risk, while assembling the portfolio, where possible, the Council will adopt the principle of building the portfolio from the bottom up. This means the foundations will be assembled by the acquisition of core properties, with dependable revenue streams, before adding the more risky, higher return categories which may require the support of the revenue generated from the rest of the portfolio.

5.6 To ensure a balanced resilient portfolio is built, asset diversification will be utilised to limit the exposure to various risks. Asset diversification can be achieved in various ways with one of the most obvious being sector spread.

5.7 Generally, sectors of property are considered to fall within three main sector categories namely, Traditional, Alternatives and Other. Within these main sector heading there are numerous sub sectors such as retail, offices, leisure, distribution etc and the Council will seek to invest across a broad spectrum of sectors and sub sectors to limit risk and increase revenue stability.

5.8 In order to accord with the objectives of the strategy it is likely that target weighting of the portfolio will comprise 70 - 80% traditional sectors and the Alternative and Other sectors, when combined, will form the remaining 20 – 30% of the portfolio.

5.9 The table below indicates the sector classification which is to be adopted by the Council to achieve the asset diversification required together with the anticipated target weighting by sector and sub sector. Please note the target weightings are provided for indicative purposes only and it must be realised that actual portfolio weightings will be affected by the timings of different acquisitions and disposal as well as prevailing market conditions.

**Table 2 – Property sector classification.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Traditional or Alternative / Other Sectors** | **Sector** | **Asset description** | **Target Weighting****Range** | **Capital Value per £200M invested** |
| Traditional | Industrial Warehouse & distribution | Single & Multi-let industrial units & estates. Including Warehouse, manufacturing, logistics, distribution and trade parks.  | 20 - 30% | £40-60M |
| Traditional | Offices | Purpose-built offices in regional centres can be good business parks or town centre locations.  | 15 - 25% | £30-50M |
| Traditional | Retail Warehouses / Supermarkets | Out of town retail parks, solus warehouses, regional centres or supermarkets.  | 15 - 25% | £30-50M |
| Traditional | Retail High Street | Prime pitch locations in buildings which could be adapted to accommodate alternative uses in strong regional centres of strong secondary towns.  | 5 - 15% | £10-30M |
| Alternative / Other | Leisure | Leisure parks or standalone buildings incorporating, restaurants, bars, bowling alleys, cinemas etc.  | 0 - 10% | £0-20M |
| Alternative / Other | Health Care / Community Use | Doctors surgeries, dental surgeries, nurseries in regional centres or strong secondary towns. Modern buildings or building suitable for adaption for alternative uses.  | 0 - 10% | £0-20M |
| Alternative / Other | Student accommodation | Purpose built large-scale blocks which are singly let to a specialist provider on long terms.  | 0 - 10% | £0-20M |
| Alternative / Other | Petrol Filling Stations  | Petrol filling stations which include a strong retail offering. | 0 - 5% | £0-10M |
| Alternative / Other | Other/ Energy | Data centres, wind farms or solar farms etc. | 0 - 5% | £0-10M |

5.10 In addition to sector risk, asset diversification is required to limit risk arising from other factors such as regional performance, single asset risk or income risk.

5.11 To limit the risks arising from other factors the following guidelines should be considered when selecting properties for investment:

* Lot size - No single asset should be over 20% of the portfolio value to limit the risk arising from individual assets.
* Income risk – No single tenant should account for more than 20% of total income once full invested to limit the exposure of tenant failure.
* Location – no more than 25% should be invested in a single town or city.
* Regional weighting – No more than 50% should be held in any region at any one time.
* Sector – No more than 35% should be invested in any sector and a balance of traditional and alternative sectors should be broadly maintained in line with the above sector target weighting recommendations.
* WAULT- A weighted average unexpired lease term (WAULT) in excess of 5 years should be maintained across the portfolio to protect against short term fluctuations in tenant demand and to maintain the security level of the revenue stream.

**6.0 INVESTMENT CRITERIA**

6.1 Investment criteria will change according to the specific needs of the portfolio at any given time. From a strategy point of view and at the outset of the portfolio build it is generally considered to be most advantageous to have criteria as wide as possible to identify the most suitable investments to form the constituent parts of the portfolio jigsaw. This is particular true in strong market conditions when demand for good quality, income producing assets is very high.

6.1 To enable the Council sufficient scope to identify suitable properties, to build and maintain a portfolio which can achieve the desired objectives and aims of the strategy the following investment criteria will be used:

**Table 3 – Investment Criteria.**

|  |  |
| --- | --- |
|  1. Location | England and Wales.Strong investment locations - now or with future prospects.Good tenant demand – easily re-lettable. |
| 2. Investment Type | Freehold or Long leasehold with peppercorn or nominal ground rents. Income producing. All commercial sectors, including Traditional, Alternative & Other. Single-let assets let to strong covenants. Multi-let buildings with a mix of covenant strengths.  |
| 3. Lot Size | Individual assets £1m to £40m.Multi-site Portfolios up to £150M. Smaller lot sizes under £1M may be considered within District or if adjacent to an existing land holding.  |
| 4. Building(s) and services | Good quality buildings in good condition.Low maintenance and low obsolescence. |
| 5. Price and Return | Minimum NIY1 5.5%+, but preferably 6%+.Secure medium to long-term income.Good rental and/or capital growth prospects.Price underpinned by vacant possession value or alternative use value. |
| 6. Security | Pre-let to tenants of good covenant on FRI or EFRI terms2WAULT3 - minimum 5 years (although individual leases within multi tenanted investments may have less than 5 years unexpired). |
| 7. Strategic Opportunities | Incoming Producing assets with value add opportunities considered. |
|  | 1. Net Initial Yield
2. Full Repair and Insuring terms or Effective Full Repair and Insuring Terms
3. Weighted Average Unexpired Lease Terms
 |

6.2 As the portfolio becomes populated the investment criteria will be restricted according to need. When required more specific criteria can be circulated to the sourcing agents to inform them of characteristics of the investment properties being actively sought at that moment in time.

**7.0 ANNUAL REVIEW OF INVESTMENT STRATEGY**

7.1 As part of any investment strategy it is very important to keep the investment criteria and guidelines under review. A failure to do so may result in the portfolio under-performing the market or its risk profile increasing due to changes in both the macro-economic and micro-economic position around the real estate market.

7.2 As such the Council will undertake a comprehensive annual review of the strategy which will be completed by a suitably professionally qualified surveyor who is actively involved in the UK property investment market.

7.3 The annual strategy review should cover:

**Section A - Investment**

1. A market update on investment trends, activity and forecasts

2. An update on the occupational markets

3. A review of current investment strategy

4. Re-confirmation of investment criteria and asset target weightings

5. Identification of any re-alignment required to match market changes and forecasts

6. Benchmarking the existing portfolio and asset level investment returns

7. Reporting on performance of the portfolio and individual assets

8. Reporting on any KPI or performance criteria

9. Provision of annual property business plans to evaluate added value opportunities

10. Provision of a review of portfolio activity and the added value created over the previous 12 months

11. An update of five year cash flow forecast

12. An update of Work/Hold/Sell asset designation

**Section B – Management**

1. Reporting on portfolio management performance including rent collection rates, bad debt provision and service charge reconciliations

2. Advice on all critical lease dates, break options, rent reviews and lease expiries

3. Reporting on any health and safety incidents and insurance claims

4. Reporting on dilapidations claims and status

5. Capital expenditure requirements over the preceding 12 months

7.4 This review will provide the Council with a clear understanding of the portfolio’s position and management, its risk and return profile and any latent value that can be driven out through strategic asset management. A regular review of the five-year cash flow is important to understand future working capital requirements, as well as assessing the accuracy of the predicted rental income.

**8.0 PORTFOLIO VALUATION**

8.1 In accordance with the Council’s Asset Management Plan and the International Financial Reporting Standards the investment portfolio is externally valued every year in accordance with the RICS Red Book and the International Valuation Standards.

8.2 Annual valuations are important not only for regulatory purposes but also to ensure that current book values are in line with the prevailing market and this enables individual assets or the wider portfolio to be benchmarked against wider performance of the commercial property sector or market as a whole.

**9.0 ACQUISITON AND DISPOSAL PROCESS**

9.1 All acquisition and disposals of investment properties will follow the rules and procedures of the Council’s wider Asset Management Policy. However, in the case of properties being acquired or disposed of as part of the investment portfolio the following procedures will apply.

9.2 The Investment Acquisition process is as follows:

1. Investment properties are introduced via the Dynamic Purchasing System by a range of Investment Advisers registered on this framework.

2. There is an initial sift undertaken by the in-house team led by the Head of Property to see whether the introductions meet the current investment criteria. At this stage a decision is made to either reject the property or to instruct the agent to provide their initial advice in accordance with the framework brief. The Response timescale is 1-2 working days from the time the property is introduced by the Investment Adviser to the instruction being given to provide the initial advice.

3. The initial investment advice should be provided within 2-3 days of the receipt of instructions and this fuller investment brief forms a key component of the early due diligence.

4. Site inspections take place (in-house team plus advisers), normally within a week of the property being introduced to the Council.

5. If, following inspection, the Investment Adviser recommends that an offer or bid should be made, a Proposal to Bid Report is prepared and reviewed by the Head of Property. If the Head of Property agrees with the recommendations of the Investment Agent’s report, it is circulated to the Director, in consultation with the Leader, Portfolio Holder, and Section 151 Officer who will then either reject the proposals or authorise a bid or offer to be made. The Response timescale for this stage is 3-5 working days

6. Offer process:

a. Auction properties – Head of Property instructs our Investment Adviser to bid on behalf of the Council

b. Non-auction properties – Either a bid is submitted in competition with others (‘best bids’), or an offer is made, and a process of negotiation takes place with the seller’s agent.

 Up to this point, no external expenditure will normally have been incurred. The Investment Adviser’s acquisition fee is success related – no acquisition no fee.

7. If the Council’s bid or offer is accepted, external solicitors will be appointed by the Council’s Monitoring Officer. Solicitors’ fees are based on time expended, whether or not the transaction takes place, although abortive fees may sometimes be charged at lower rates. Often fixed fee estimates can be agreed when solicitors are first instructed.

8. Full due diligence is commenced. This comprises the solicitors undertaking searches, producing a report on title and leases, and raising any required questions with the seller’s solicitor. In addition, the Head of Property commissions the Investment Adviser to undertake an RICS ‘Red Book’ valuation report and Pre-Acquisition (i.e. condition) Survey. The Agent uses specialist teams within its firm (or approved subcontractors) for this work, which is not included in the acquisition fee. Fees for these areas of work are payable whether or not the acquisition completes. At this point the acquisition is still subject to contract and if unexpected items arise the Council can withdraw prior to exchange. If nothing is discovered during the due diligence process to suggest that the Council should not purchase the property, the Head of Property presents to the authorised signatories (Director, Leader, Cabinet Lead and s.151) an Authority to Purchase Form so that the purchase of the property can be formally authorised.

9. Legal completion – Where the transaction successfully passes through all the stages to completion, the asset is added to the Council’s investment portfolio and the Investment Adviser’s and Solicitors’ fees become payable.

10. Indicative overall transactions timescales from introduction to completion of purchase:

a. Marketed private treaty properties – Properties offered for sale on the market. Overall timescale 2-8 weeks.

b. Off-market private treaty – Similar process to marketed, except that the seller’s agent introduces the property informally to a select group of potential buyers. Overall timescale 2-10+ weeks.

c. Auction properties – Completion normally 4 weeks after auction. Overall timescale 7-8 weeks.

9.3 The Investment Disposal process is as follows:

1. Investment properties suitable for disposal are identified by the in-house team or the Investment Adviser undertaking the Annual Investment Strategy Review and a Recommendation for Disposal Report is prepared which will recommend a route for disposal which could be auction, private treaty sale or a formal tender process. Regardless of the route to disposal the Head of Property must have regard to the Council’s requirement to obtain best value for the disposal of its assets.

2. The Head of Property will review the report and if he agrees with the report’s recommendation he will circulate the report to the Director, in consultation with the Leader, Portfolio Holder, and Section 151 Officer who will then either reject the proposals or authorise a disposal above a certain price. The response timescale for this stage is 3-5 working days.

3. If the property is authorised for disposal the Head of Property will instruct an Investment Agent to sell the property and the Council’s Monitoring Officer will instruct a solicitor. In the case of a property to be disposed of via auction the solicitor will be instructed to prepare the relevant auction pack. The Response timescale for this stage is 1-3 working days

4. The property is placed on the market and the marketing of the property in the desired form commences.

5. When a suitable offer or bid is received the sale is agreed and the property is placed under offer or in the case of an auction the property exchanges upon payment of the deposit.

6. Once the property is under offer, in all routes other than auction, the purchaser will undertake their due diligence and surveys and providing they are happy with the results will proceed to exchange contracts which will usually require the payment of a deposit equivalent to 10% of the agreed selling price.

7. Following exchange, legal completion will take place. The period between exchange and completion can vary. It certain circumstance there can be a simultaneous exchange and completion but more commonly there is a period of 10 working days between exchange and completion or in the case of auctions 20 working days. At this point the Investment Agent’s fees and Solicitor’s fees become due and these are normally deducted from the completion monies received by the solicitor as part of the completion process.

8. The management information is transferred to the purchaser and the property is removed from the investment portfolio.

9. Indicative overall transactions timescales from identification to completion of disposal:

a. Marketed private treaty properties – Properties offered for sale on the market. Overall timescale 2-8 weeks.

b. Off-market private treaty – Similar process to marketed, except that the seller’s agent introduces the property informally to a select group of potential buyers. Overall timescale 2-10+ weeks.

c. Auction properties – Completion normally 4 weeks after auction. Overall timescale 7-8 weeks.