Meeting: Policy Development and Decision Group (Joint Operations Team)

Date: 14 September 2016

Wards Affected: All Wards in Torbay

Report Title: Capital Investment Fund

Is the decision a key decision? Yes

When does the decision need to be implemented? Immediately

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1. Proposal and Introduction

1.1 Building on the Council approval of a £10m investment fund in February 2016 and linking to the Efficiency Plan and the Transformation Programme, this report expands the fund proposal by £40m and provides criteria for both the investments made by the fund and details the proposed governance arrangements around the management of the investment fund. In addition the report proposes investment to increase future NNDR revenues within Torbay.

1.2 Examples of good practice used by other local authorities with similar funds have been incorporated into this document.

2. Reason for Proposal

2.1 To make investments in property (within and outside Torbay) in order to increase revenue streams, this report sets out an appropriate strategy for acquiring properties and setting up and managing a portfolio.

2.2 To make investments in Torbay to increase its revenue stream from NNDR, this report sets out an appropriate strategy for acquiring properties, making investments and capital loans.

3. Recommendation(s) / Proposed Decision

It is proposed that the following recommendations will be made to the Council at its meeting on 22 September 2016:

3.1 That the Investment Fund be increased by £40 million to a total of £50 million to be initially funded by prudential borrowing, with the revenue costs associated with that borrowing (MRP and interest costs) to be funded from the investment returns or higher NNDR income.

3.2 That the Investment Strategy for the fund as detailed within Appendix 1 be approved.

3.3 That the governance of fund as detailed within paragraph 7.4 be approved.

3.4 That the Chief Executive be delegated authority to set up a delivery team including sourcing external support if required, to be funded from the investment returns.

3.5 That the Chief Executive be delegated authority to make any changes to the Strategy, in consultation with the Mayor, Group Leaders, Section 151 Officer and Executive Head of Business Services.

The Policy Development and Decision Group (Joint Operations Team) is asked to report directly to Council on any recommendations it may have following its consideration of this report.

4. Background Information

4.1 Council approved prudential borrowing of £10 million to enable acquisition of properties (both within and outside Torbay), with the borrowing costs to be funded from future rental income in February 2016.

4.2 In addition, as part of its efficiency plan and transformation programme, the Council intends to use this Investment Fund to increase its future NNDR taxbase income by investing capital resources within Torbay to stimulate growth. Capital resources could be a combination of asset purchase, co-investment in projects or capital loans.

4.3 For the sake of clarity the following descriptions have been used;

- “Investments – Yield” .These are property purchases where the objective is to increase rental income to the Council

- “Investments – Taxbase” .These are property purchases where the objective is to increase NNDR or Council tax income to the Council

- “Investments – Loans or Co Investment” .These are loans to business for capital expenditure where the objective is to increase rental income to the Council or to increase NNDR or Council tax income to the Council. Co

Investment is where the Council with another investor provides finance or jointly purchases a property.

- “Property Purchase” – property to include purchase of land and/or buildings.

4.4 To provide a significant boost, show clear leadership and ambition for growth, and to achieve a greater scale of return it is proposed to increase the fund value by £40 million to £50 million.

4.5 A detailed Business Case will be required for every investment/acquisition, setting out the potential future performance of the investment/asset together with projected disposal price or capital value at the end of the borrowing period. An example template shown is attached at Appendix Two. Internal Rate of Return calculations will be carried out to model expected cash flows over the term.

4.6 The Council will have to borrow to fund this strategy. Currently (July 2016) Public Works Loan Board (PWLB) rates are at historic lows. If borrowing is taken at the current low rates in advance of cash flow requirements there will be a short term “cost of carry” as the borrowing rates are approx 1.5% above current money market investment returns, however in the long term this provides a greater opportunity for significant return on investments

4.7 Any investments arising from “Masterplan” delivery will be approved and funded outside of this Fund. In addition any investments made under the Treasury Management Strategy (such as money markets, property funds etc) are outside of this Fund.

4.8 It will be essential to realise future income that sufficient capacity is allocated to manage this Investment Fund as soon as Council approval is given. The net returns assume that the ongoing costs of the fund management will be met from future returns. In the short term there will be some initial management costs which will be funded from the Invest for Income reserve, up to a value of £50,000.

4.9 This report sets out the proposed investment strategy (appendix 1) and covers the following:

- Background
- Objective
- Scope
- Strategy
- Yield
- Sector spread
- Locations
- Target Assets
- Assessment of Risks

4.10 Inevitably the Strategy will be subject to revision as the Council’s knowledge and experience of operating such a fund increases. It is proposed that the Chief Executive is given delegated authority by Council to revise the Strategy if it is in the best interests of the Council in consultation with Mayor, s.151 Officer and Group Leaders.

4.11 A summary table of the key considerations for the Fund is set out in the table below:

	Investment - Yield	**Investment - Taxbase**	**Investment- loans & co investment**
Objective	Increase revenue streams	Increase NNDR & Council Tax income	Increase revenue streams Increase NNDR & Council Tax income
Governance			
Business case (see appendix two for example)	Yes	Yes	Yes
Review by S151 & Fund Manager	Yes	Yes	Yes
Legal Due Diligence	Yes	Yes	Yes
Decision maker	Chief Executive	Chief Executive	Chief Executive
Consultees	S151, Mayor, Group Leaders	S151, Mayor, Group Leaders	S151, Mayor, Group Leaders
Informed	OSB Chair	OSB Chair	OSB Chair
Reporting Performance	Quarterly to SLT, MEG, OSB & Investment Board (Audit Committee)	Quarterly to SLT, MEG & OSB & Investment Board (Audit Committee)	Quarterly to SLT, MEG & OSB & Investment Board (Audit Committee)
Criteria			
Scope	Maximum £50m in total		
Maximum individual Purchase	£5m	£5m	£2m
Valuation of asset	Yes	Yes	If applicable
Condition Survey	Yes	Yes	If applicable
Assessment of Asset Life	Yes	Yes	If applicable

Independent Assessment of Residual value	Yes	Yes	If applicable
Security required	-	-	Yes – minimum 75% of investment/loan
Target Assets for Acquisition	Yes – in strategy	-	-
Yield	Rental	NNDR	Loan repayments or rental
Minimum Yield Required (before costs)	6.5% of purchase price (or 2% above estimated borrowing costs)	Increased NNDR income (after multiplier) and/or rental yield equivalent to 6.5% of purchase price	6.5% of investment value (or 2% above estimated borrowing costs) If capital loan prevailing borrowing rates + 2%
Benchmarked Yield (linked to rate/size)	Yes	Yes	Yes
Sector Diversification – retail, leisure, office & industrial	Yes - retail, leisure, office and industrial	Yes - retail, leisure, office & industrial	Yes - retail, leisure, office and industrial
Risk Appetite	Risk averse	Moderate risk – linked to NNDR yield	Risk averse – linked to security
Lease	Tenants of strong financial standing and minimum 5 year unexpired lease term	Tenants of strong financial standing and minimum 5 year unexpired lease term	If applicable
Location	National (UK)	Torbay	Torbay
Location – Diversity	25% in any one Council area	100% Torbay	100% Torbay
Reputational Issues	No “sin” assets or tenants	No “sin” assets or tenants	No “sin” assets or tenants
Financial Assumptions			
MRP	50 years land and 40 years buildings or life of asset	50 years land and 40 years buildings or life of asset	As applicable

Interest Costs used in appraisal	New Borrowing Rates	New Borrowing Rates	New Borrowing Rates
SDLT & other purchase costs	Part of purchase price	Part of purchase price	-
Fund Management Costs & ongoing client costs	0.50% of purchase price	0.50% of purchase price	0.50% of loan or investment
"Green Book" Financial profile over life of asset (IRR)	Yes	Yes	Yes

5.0 Other Councils

5.1 Other Councils have started similar investment funds including Luton and Harrow Councils. Details of Harrow's Fund and Investment Strategy are available on their website:

http://www.harrow.gov.uk/www2/documents/s131517/Invest%20Property%20Strategy%20-%20Main%20Report.pdf

5.2 Analysis of Investment Funds already set up by other Local Authorities has been used in preparing this report. For illustration, the figures declared for one such fund over a two year period are given below:

New purchases (gross, 5 properties)	**£19,900,000**
Rental Income per annum	£1,650,000
Gross Income yield	8.30%
Assumed financing costs (4% interest; 2.5% MRP)	£1,290,800
Net Income	**£359,200** (1.8% on capital)

5.3 Eastleigh Council has been used as a LGA case study. The LGA summary stated the following:

"Eastleigh Borough Council's main area of commercialisation has been in respect of property. They have actively been pursuing the purchase of a range of property assets which generate a high investment yield. By 2015, expenditure (financed principally by borrowing) will have reached over £100 million and includes a range of assets such as shops, banks, pubs and offices (one of which, following refurbishment, is now their headquarters).

Its innovative to property management now means the Council is landlord to a high profile mix of businesses including B&Q, Lloyds Bank, Wetherspoons, Matalan, Halfords, Pets at Home, Costa Coffee and Travelodge as a result of the freehold purchase of land and buildings over the last five years .

The most ambitious acquisition has been the Ageas Bowl, home of Hampshire Cricket, where the council is investing £40 million, including the construction of a 4 Hilton Hotel.*

Assets owned by Council have risen, according to the latest valuation, from £55 million to £188 million. Revenue surplus after borrowing and other costs is almost £2.5 million per annum. The assets contribute to regeneration, economic and employment objectives. For example, the Ageas Bowl alone is forecast to generate £55 million in direct and indirect economic benefits annually and 500 additional jobs".

6 Existing Investment Properties

6.1 The Council already holds a portfolio of non-operational properties within Torbay for investment purposes, managed on its behalf by the Torbay Economic Development Company (TDA) with the client function undertaken by the Executive Head of Business Services.

7. Staffing, Management and Delegation

7.1 Existing expertise within the TDA (and/or expertise to be recruited to by the TDA) is best placed to provide management of the Investment Fund (subject to an agreement between the two parties) supported where required by the Council's Finance and Legal sections with the client function undertaken by the Executive Head of Business Services.

7.2 It is proposed that a valuation be obtained for each property purchase and consideration needs to be given to further obtaining specialist expertise to actively manage market presence, acquisition & disposal and portfolio mix for this larger investment.

7.3 The above costs and any other associated purchase costs such as legal fees, property searches etc will be met by applying a 1% (of purchase price) one off cost, to be funded from the estimated return.

7.4 The following decision making process is proposed:

a) The Chief Executive is given delegated authority by Council to approve any investment or purchase within the fund in consultation with Mayor, S151 Officer, Group Leaders and Executive Head of Business Services. The Overview and Scrutiny Co-ordinator will be informed prior to any investment/purchase.

b) Any use of the Investment Fund is to be in line with approved criteria as outlined in the Investment Strategy. (Appendix 1)

c) Audit Committee and the Mayor (as Executive Lead for Finance) be requested to meet as an Investment Board to review the performance of the Investment Fund on a quarterly basis.

d) All investments or purchases to be subject to a (documented) review by S151 Officer, Monitoring Officer, Fund Manager and Executive Head of Business Services.

e) The Chief Executive is given delegated authority by Council to revise the Strategy if it is in the best interests of the Council in consultation with Mayor, S151 Officer, Group Leaders and Executive Head of Business Services.

8. **Legal**

8.1 Local authorities have broadly drawn powers allowing them to invest and to borrow, in each case either for purposes relevant to the performance of any of their functions or generally for the prudent management of their financial affairs (s1 and s12 of the Local Government Act 2003).

8.2 They may also acquire property by agreement located either inside or outside of their borough for the purposes of any of their functions, including their investment functions, or otherwise for the benefit, improvement or development of their area (s120 of the Local Government Act 1972).

8.3 Furthermore, they may also take any action (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions, which would again include their investment functions (s111 of the Local Government Act 1972).

8.4 The council will need to ensure that in exercising its investment and borrowing functions to expand its property portfolio, any actions are reasonable and proportionate and for proper purposes consistent with the Council's prudential regime and its investment strategy. Investment decisions also need to be taken mindful at all times the council’s fiduciary duties to ensure the sound management of the public finances.

8.5 Legal due diligence will be required on all property acquisitions, to include a review of title and ownership, and searches and enquiries of the vendor, in order to ascertain relevant liabilities and restrictions connected with the subject property. The results of the legal enquiries, and any associated risks, should be considered prior to any decision to enter into contract.

8.6 On any sale of an investment property the Council will be required to obtain best consideration in accordance with s123 of the Local Government Act 1972. Usually this will be achieved by placing the property onto the open market or otherwise, in respect of a sale agreed off market, demonstrating by way of professional valuation that it is achieving no less than market value for the property.

8.7 In all purchases, in particular on any loans, State Aid implications will need to be assessed.

9 **Financial Implications**

9.1 The potential income from this investment Fund has been estimated as follows. These figures will be included in the Efficiency Plan and as applicable included in future year budget proposals.

Year	Investments In year £m	Income Return @ 1.5% over costs £000's	Cumulative Income Return £000's
2016/17	5	75	75
2017/18	10	150	225
2018/19	15	225	450
2019/20	20	300	750
Total	**50**		

9.2 The 1.5% return above costs is considered to be a prudent target, although returns above this level will be aimed for.

9.3 It is proposed to allocate a sum of £50m (an increase of £40m) to be available for the purchase of an Investment Fund which will be added to the capital budget and will be funded from prudential borrowing with the ongoing revenue costs funded from future income.

9.4 It is likely that the source of funds will be the Public Works Loans Board where Interest rates for periods of 45 years are currently in the range around 2.0% (2.5% used as prudent). Where possible the TDA will support the Council in using LEP support to gain access to the lower PWLB rate (by 0.2%) for projects that meet certain criteria. Any capital expenditure incurred by the Council necessitates a minimum revenue provision (MRP) of 2% if the principal repayment is spread equally over 50 years. If asset life is assessed as lower, then the MRP period will be adjusted accordingly.

9.5 As a guide if £50m is borrowed and expended the additional annual costs to the revenue budget will be £2.250m (4.5%). If long term borrowing rates increase then the costs may rise accordingly.

9.6 The draft Investment Strategy states that a minimum gross yield of 6.5% (or 2% above borrowing costs) is required from an investment property to ensure an additional income stream for the authority after accounting for capital financing costs. 0.5% of the return will be allocated to an earmarked reserve to cover any “asset” costs associated with the purchase, ongoing portfolio management and legal, repair, void costs etc.

Cost	% Rental	% NNDR	% Loan	Costs per annum for £1m Cost
Minimum Target Return	6.5%	6.5%	4.5%	£65,000
Less:				
MRP	2%	2%	-	£20,000
Interest Costs	2.5%	2.5%	2.5%	£25,000
Asset Costs	0.5%	0.5%	0.5%	£5,000
Net Return	**1.5%**	**1.5%**	**1.5%**	**£15,000**

9.7 For loans, where there is a clear assumption that the loan will be repaid then no MRP will be applicable, therefore the minimum interest rate will be 2% above interest costs (subject to state aid compliance).

9.8 For purchases to increase NNDR, the target return is still 6.5% however this will need to be assessed for each purchase linked to the estimated increase in the Council's 49% share of NNDR collected. In addition, as DCLG is currently consulting on reforms to the NNDR retention scheme leading to the Council by end of Parliament retaining at least 98% of NNDR income, each scheme will need to be reviewed in light of any DCLG proposals.

9.9 In relation to tax; if the properties are to be held directly by the Council then there should be no Corporation Tax or Capital Gains issues arising.

9.10 VAT implications will be considered in all purchases to ensure that optimum arrangements are put in place.

9.11 Stamp Duty Land Tax (SDLT) will be payable on purchases which will be included in the purchase cost of the investment.

9.12 On all purchases financial due diligence will be undertaken with all partners, and tenants and where applicable appropriate security/guarantees will be obtained.

Appendices:

Appendix 1: Investment Strategy
Appendix 2: Business Case for Investment Template

Background Documents:

Capital Investment Plan – Council February 2016