



Fit  
for  
the  
future

creating a prosperous and healthy Torbay

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Investment Fund Strategy

DRAFT Version 6

# Investment Fund Strategy

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## 1.1 Background

As part of its efficiency plan and transformation programme the Council needs to increase its future local taxbase income (Council tax and NNDR) 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.

As clarification 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 Council with another investor provides finance or jointly purchases.

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

This Policy Framework document sets out the strategy for the management of the Investment Fund including purchases/investments. The strategy reflects a suitable balance between the risks inherent in the types of property/investments to be acquired and the financial rewards obtainable whilst limiting risks appropriately. In addition, the portfolio of investments being acquired should be diversified in order to spread risks via a balanced portfolio, such diversification principally being across geographical location and the use type of properties held. Existing investments that fall within the remit of the Investment Fund Strategy shall be included in the portfolio to assist in creating a balanced portfolio, as well as other suitable assets held by the Council.

The risks of investing in property may be mitigated through the acquisition of assets with secure, long income streams. This needs to be balanced against the requirement for a given level of income yield on capital invested in a careful and controlled manner, with specific analysis of risk criteria carried out in the ‘due diligence’ stage prior to the completion of each purchase.

## 1.2 Objective – Investment Fund

To invest in commercial investment properties for the benefit, improvement or development of the area whilst also delivering a significant income return over the medium-term of at least 2% above capital costs on capital invested, through a balanced strategy of acquisition, retention and management of good quality property investments, with that income being used to support wider Council services.

The improvement or development of the area will not be constrained by the boundaries of Torbay as there is an evidence base that demonstrates that investment within the South West Local Enterprise Partnership (LEP) Zone area has a positive impact on Torbay's economy. LEPs were established around functional economic boundaries which reflects both labour market and wider economic interdependence. This can be evidenced through the Heart of the South West Strategic Economic Plan (see <http://heartofswlep.co.uk/wp-content/uploads/2016/09/SEP-Final-draft-31-03-14-website-1.pdf>) and the Torbay Economic Strategy (see <http://www.torbay.gov.uk/DemocraticServices/documents/s35783/Torbay%20Economic%20Strategy.pdf>). However opportunities in any geographic location will be considered where it can be demonstrated that there is a benefit to, or improvement or development of Torbay. **This will not prevent the Council**

investing in national opportunities which have a sufficient yield by the Council or through a wholly owned company of the Council, if supported by the Monitoring Officer and the Head of Finance.

### 1.3 Scope

The maximum total level of investment shall be **£100m for the Investment Fund** ~~£50m to assist in diversifying the investment portfolio.~~

### 1.4 Strategy

**This Policy Framework sets out that decisions to allocate monies in accordance with this policy are not Executive decisions, and the Council has previously delegated this to the Investment Committee who shall make all decisions up to £10m in respect of the General Investment Fund.** The maximum individual investment to be approved by Investment Committee shall be £10m including estimated purchasing costs, however Full Council approval is not restricted in terms of value.

Achieving a spread of risk across a greater number of assets and by acquiring properties across the range of different property asset classes, namely retail, leisure, office and industrial, is to be desired, however it has to be recognised that opportunities to do this may not arise, and ultimately if individual business cases are robust, groupings in any individual property class should not pose any increased risk to the Council.

The principle of being relatively risk-averse by limiting fresh investment to properties with minimum unexpired lease terms of five years at the date of acquisition, and with tenants of strong financial standing, should be adopted if possible. Clear consideration will need to be given to yields where investments do not have fully repairing and insuring (FRI) terms or FRI by way of service charge, meaning that all costs relating to occupation and repairs are borne by the occupier(s) during the lease term to ensure that these costs are recovered.

The investment portfolio will include acquiring some properties to hold and some properties to dispose of depending on the anticipated lifespan of the asset, so as to ensure that the Council has a rolling stock of investments in order to achieve maximum **benefit** ~~income~~ for the Council.

## 1.5 Minimum and maximum yield

	Investment held for asset life	Investments/assets held for defined period (maximum 10 years)
Minimum Yield Required (before costs)	2% above estimated borrowing costs (interest and MPR or if capital loan prevailing borrowing rates + 2%)	2% above estimated borrowing costs (interest only or if capital loan prevailing borrowing rates + 2%)

Acquisitions of assets will be pursued at a target minimum yield (before costs) of 6.5% and, as a guide to potential risk, yields of 10.0% or more are unlikely to be appropriate for investment. Assets producing initial yields in excess of 10.0% are likely to exhibit high risk characteristics, such as very short unexpired leases, or financially weak or insubstantial tenants, or obsolete buildings and would therefore require a higher level of due diligence to be carried out to assess the benefits and risks. Assets with a projected yield of over 10% will be discounted unless officers can demonstrate that risk characteristics are acceptable and avoid very short unexpired leases, financially weak tenants or obsolete buildings.

## 1.6 Sector spread

Traditionally the highest returns come from the office and industrial sub-sectors. Currently offices can provide an income return of 5.5% in quality in-town areas and between 7.5% and 8.5% for reasonable quality offices in regional and sub-regional centres. Industrial income yields can range from 6.0% up to 7.5% for acceptable quality assets. The retail sub-sector for prime retail property is lower than comparable office/industrial assets with typical yields ranging between 5% and 7% for high quality in-town properties. On this evidence it is likely that predominantly office and industrial/warehouse will be targeted for acquisition with a lesser emphasis on retail. Leisure and mixed use investments will also be eligible under the strategy.

Residential property tends to be management intensive and requires specialist expertise. It is therefore proposed that this sector is excluded from the Investment Fund strategy.

## 1.7 Locations

Torbay would be the preferred location for fresh acquisitions of investment properties, so that reinvestment is directly retained within the local economy and any additional capital expenditure is made in the local area. However, there is a finite and limited supply of property within the local area, and of that supply only a small proportion may be available for purchase at any time. The wider South West Local Enterprise Partnership area should also be considered for fresh acquisitions as there is an evidence base that demonstrates that investment in this area has a positive impact on Torbay's economy. However opportunities in any geographic location will be considered where it can be demonstrated that there is a benefit to, or improvement or development of Torbay. **This will not prevent the Council investing in national opportunities which have a sufficient yield by the Council or through a wholly owned company of the Council, if supported by the Monitoring Officer and the Head of Finance.**

We will consider opportunities for co investment with partner organisations of good financial and reputational standing.

## 1.8 Target assets

Commercial assets will be sought with lot sizes of £500,000 plus with income yields of 2% or more above borrowing costs. However consideration will always need to be given to the number of smaller investments held by the Council, in pursuance of this Strategy and the burden of administering each investment before a decision is taken.

1. Leisure investments, such as public houses, restaurants and health & fitness centres will also be sought.
2. Mixed-use investments would also be potentially suitable additions to the portfolio. These may include a mixture of commercial uses or a mixture of retail and office use.
3. Residential investment – tends to be significantly more management intensive than the types of commercial property investment envisaged under this strategy and requires specialist residential management expertise, so are excluded from this strategy.

## 1.9 Assessment of risks

	<b>Investment, Loans &amp; Co Investment</b>
Independent Valuation of asset	Yes (if applicable)
Condition Survey	Yes (if applicable)
Independent Assessment of Asset Life	Yes (if applicable)
Independent Assessment of Residual value	Yes (if applicable)
Security required	Yes if loan
“Green Book” Financial profile over life of asset (IRR)	Yes (if applicable)
Reputational Issues	No “sin” assets or tenants

A rigorous assessment of all risks is required in each case of fresh investment in order firstly to value each property and then to check its suitability for inclusion in the portfolio. The risks fall into two categories, firstly economic and property market risks in specific property market sub-sectors and locations and secondly asset-specific risks (as set out below). These can be measured and an assessment made of the likely future performance of the investment carried out based on the ranges of likely future rental growth and voids of the property and also the projected disposal price or capital value at the end of the period over which the cash flow analysis is being measured.

Financial returns are modelled over a medium-term horizon of five years, based on proposed offer prices, to determine the acceptability of each investment, and can be compared against general market forecasts. Internal Rate of Return (IRR) calculations will be carried out to model the expected cash flows from each investment. The anticipated returns can be modelled on different bases to reflect the range of risks applicable in each case, to ensure that forecast returns properly reflect the measured risks. In this way a Business Case is put together to support each recommended property acquisition.

This modelling will be used to make an assessment on how long the asset should be retained for, taking into account the likely future value of the asset at the proposed time of disposal, any over-renting and potential voids in the leases. Where the value of the asset is likely to be less than the amount paid, including stamp duty and purchasing costs, Minimum Revenue Provision (MRP) will be applied to recover these costs. MRP will be assessed on a case by case basis by the Head of Finance in line with the Council's MRP Policy.

The Head of Finance reserves the right to refer any proposed investment decision (irrespective of value) to the Council for consideration where he deems this is in the best interest of the Council.

### **Asset-specific risks**

Income and capital returns for property will depend principally on the following five main characteristics;

- Location of property
- Building specification quality
- Length of lease unexpired
- Financial strength of tenant(s)
- Rental levels payable relative to current open market rental values

**Location** – this is the single most important factor in considering any property investment. In the retail sector prime or good secondary locations in major regional or sub-regional shopping centres are likely to provide good long-term prospects, or alternatively prime locations in sub-regional or market towns.

Industrial and warehouse property has a wider spectrum of acceptable locations with accessibility on good roads to the trunk road and motorway network being the key aspect.

Experienced knowledge will be required to ensure that good locations are selected where property will hold its value in the long term.

**Building specification quality** – In office property especially it is important to minimise the risk of obsolescence in building elements, notably mechanical and electrical plant. Modern, recently-built office and industrial property should be acquired to ensure longer-term income-production and awareness of the life-cycle of different building elements and costs of replacement is critical in assessing each property's merits. For town centre retail property trends have been towards larger standard retail units being in strongest demand from retailers.

**Length of lease unexpired** – At present capital values are highest for long-term leased property and values tend to reduce significantly when unexpired lease terms fall below five years, as owners expect significant capital expenditure to be necessary when leases expire and tenants may not renew leases and continue to occupy. Fresh investments should be made ensuring that diminishing lease terms will not either adversely affect capital value or that significant capital expenditure and voids are experienced. A strategy

to dispose of investments before unexpired lease terms reach terms of shorter than three years should be adopted or the leases to be renegotiated before this time.

**Financial strength of tenant(s)** – assessment will be required of each tenant of potential acquisitions through analysis of their published accounts and management accounts where necessary. Risk of tenant default in rent payment is the main issue but the relative strength of a tenant’s financial standing also impacts upon capital value of property which is let to that tenant and careful analysis of financial strength is a key part of due diligence prior to purchase of investments.

**Rental levels** – following the banking crash in 2007/8 rental levels fell across most occupier markets, particularly in office and retail markets. As a result rents payable on leases that were granted before 2007 may be at levels which are higher than current rental values. Rents in some sub-sectors have recovered back to pre-2007 levels but care is required in all purchases to assess market rents local to each property to check whether rents payable under leases are above or below current levels, as this will impact on whether growth in rents in the future will be fully reflected in the specific property being analysed.

**Environmental and regulatory risks** - Risks such as flooding and energy performance are taken into account during the due diligence process on every property purchase.

**Reputational risks** - A policy on specific types of commercial tenant which may not be acceptable to the Council such as tobacco, gambling or alcohol-related companies should be adopted. Properties tenanted by such companies would not then be considered for purchase. However, this would not necessarily protect the Council in the event of a future transfer of any tenancy to a prohibited company.

## 1.10 Financial Assumptions

	Investment - Yield	Investment - Taxbase	Investment-loans & co investment
MRP ( <b>Minimum Revenue Provision</b> )	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% <b>0.25%</b> of purchase price	0.50% <b>0.25%</b> of purchase price	0.50% <b>0.25%</b> of loan or investment
"Green Book" Financial profile over life of asset (IRR)	Yes	Yes	Yes
<b>**VRP (Voluntary Revenue Provision)</b>	<b>0.5% of purchase price</b>	<b>0.5% of purchase price</b>	<b>0.5% of purchase price - co-investment only</b>

\*Normally for each investment an annual payment of 0.5 **0.25%** of the purchase price or loan or investment, subject to a case by case evaluation and decision by the **Head of Finance** Chief Finance Officer, will be held in a central fund to cover the following:

- external advice for future investments;
- known or expected one off future costs, such as costs associated with future negotiation or renegotiation of leases;
- ~~void periods;~~
- bad debt provision;
- irrecoverable estate costs;
- management of assets; and
- maintenance or redevelopment costs associated with future leases.



**\*\*Consideration will be given in respect of each asset of a VRP (Voluntary Revenue Provision) of 0.5% of the cost of the purchase price before costs, which will be funded from the surplus income generated and placed in a reserve to contribute towards deminuation of the value of the asset etc. Reports will also include details in respect of paying off or writing off the purchase costs.**

**\*\*\*The Chief Executive, in consultation with the Executive Lead for Finance, the Investment Committee and Chief Financial Officer is authorised to amend the Fund Management and VRP percentage parameters from time to time to ensure an adequate and prudent asset management strategy is maintained.**

**Investment Fund Business Case for Investment**

1. Investment Name and Address

2. Strategy Objective

**2.1 “Investments – Yield”**

**2.2 “Investments – Tax Base”**

**2.3 “Other” for example “Investment- loans & co investment”**

3. Compliance with Strategy Objective – Non-Financial:

- Sector and target assets
- Location
- Building specification
- Management and maintenance obligations
- Lease arrangements
- Quality of tenants

4. Compliance With Strategy Objective – Financial (Completion of Appendix with commentary as below):

- Purchase price with an independent valuation
- Estimated exit value and proposed timescale for disposal
- Building survey results
- Rental income assessed over asset life linked to assessment of future market trends of both the asset sector and location
- Outgoings (**to include how the purchase costs will be written off**)
- Estimated voids
- Cashflow - **table to include the following:**

<b>A</b>	<b>Purchase Price</b>	<b>£,000</b>	<b>£,000</b>	<b>£,000</b>	<b>£,000,000</b>
<b>B</b>	<b>Purchase costs at ??%</b>				
<b>C</b>	<b>Total Purchase Price (A+B)</b>				
<b>D</b>	<b>Average Rental Income</b>				
<b>E</b>	<b>Finance costs @ ??% of total borrowed</b>				
<b>F</b>	<b>Write off of purchase costs</b>				
<b>G</b>	<b>Available Funds (D-E-F)</b>				

<b>H</b>	<b>Fund Management Costs &amp; ongoing client costs (normally 0.25% of purchase price - A)</b>				
<b>I</b>	<b>MRP (if applicable)</b>				
<b>J</b>	<b>VRP (0.5% of purchase costs = G-H-I-J) (if applicable)</b>				
<b>K</b>	<b>Net Initial Yield</b>				
<b>L</b>	<b>Average Yield</b>				

- Costs including stamp duty, legal fees, survey fees, letting costs
- Management and maintenance obligations
- ~~Internal Rate of Return (IRR) Calculation~~
- Diversity – how this investment fits in with existing investments and loans by sector

5. Legal Issues (to Include):

- Review of title and ownership
- Liabilities and restrictions

6. Risk Assessment

- Economic and Property Market
- Asset-specific –e.g. location, building quality, length of lease, financial strength of tenant, rent payable
- Environmental and regulatory
- Reputational

7. Recommendation

8. Review

- ~~Chief Finance officer~~ **Head of Finance**
- Monitoring officer