Southampton City Council – Property Investment Fund

Draft Business Plan 2016 - 2020

Introduction

The financial objective of the Property Investment Fund is to achieve a 6% income return. Different types of investment will provide different levels of return, income and capital.

Historic data shows that a 6% income return from property is achievable over the longer term and through a full economic cycle.

Various factors will affect the level of income return a property investment strategy will deliver over time including;

the **general economic environment** (driving rent growth or reductions)

interest rates (low rates drive prices up and property yields down)

investment demand (high liquidity drives prices up and property yields down)

The Investment Property Database (IPD) 2015 analysis of global property performance, reflecting different methods of investing in property (direct, unlisted funds and listed property company shares) and analyses the returns and risks associated with each over various time periods. In addition comparable return and risk analysis is provided for other types of investments – bonds and general equities.

This shows:

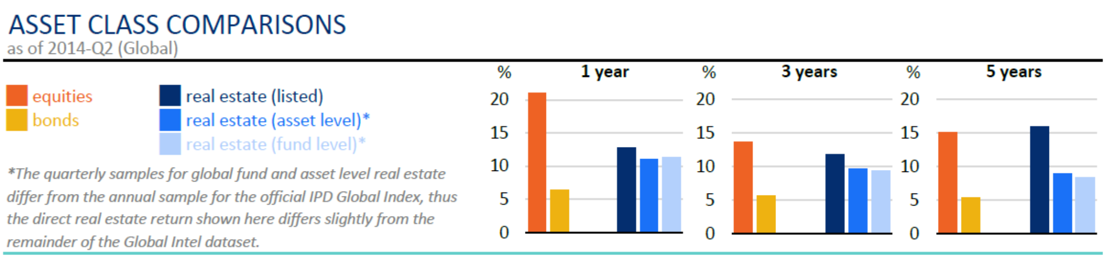
a) investing in direct property has the second lowest risk (after bonds) as measured by volatility (standard deviation)

b) for property investment options:

higher returns can be earned from investing in listed property shares and property funds

over a five year period listed real estate gave materially the highest absolute and risk adjusted returns

over a 10 year period listed real estate gave the highest absolute return (just) but as a result of high volatility direct property gave materially the highest risk adjusted returns



Investment Objectives

PIF requirement	Reason for requirement	Potential approach taken to inform PIF and impact on performance
Low risk initially moving to higher risk over time	Recognising that benefits will need to be evidenced to demonstrate value to stakeholders and the wider community	Identify potential lower risk sources of revenue initially, moving to a more balanced risked portfolio over time Levels of return initially may be low
Focus on revenue (rather than capital)	To meet revenue funding gap	Consideration for investing in existing property funds Acquire to hold, rather than to dispose Re-invest any capital receipts
Short term revenue generation	To meet short term funding requirements	Seek to invest initially in current revenue generating assets or property funds in the short term In the medium term, identify opportunities for greater return on investment (ROI) by taking a longer term approach e.g. acquisition of vacant properties or development to realise a revenue stream
Ability to make quick decisions	The Council's current governance structure does not allow the Council to react quickly to investment opportunities	Consideration of amendments to the levels of delegated decision making
Stakeholder buy-in	Recognising that the PIF needs long term stability and cross political support to be successful	Consultation and engagement throughout the development of the PIF Communications Strategy Regular reports and reviews of PIF performance
Transparency	Meets the Council's audit and scrutiny requirements	Business cases required to support all investment decisions

	Demonstrates basis of investment decisions and value for money	Independent appraisal and evaluation Regular reporting and review of PIF performance
Commercial and political sensitivity	Recognising that the set up and operation of the PIF may create conflicts of interest As a public body, there are reputational risks that may impact upon the nature and type of investments	Review governance structure for the PIF to mitigate any obvious conflicts of interest Consider the reputational risks for the Council within any investment opportunities

Investment Criteria

The objectives of the Property Investment Fund will be met in accordance with the following Investment Criteria: -

- The Council will invest in a balanced portfolio of property assets with a focus on traditional, lower risk sectors including offices, retail, industrial and residential with a focus on Freehold (or Long Leasehold) property in lot sizes of between £2 and £10 million.
- The portfolio will be developed through a range of means including acquisition of existing investments, development and investment in property funds and shares.
- Development opportunities that exploit existing Council assets and the Council's knowledge of the City to maximise competitive advantage will be prioritised.
- Investments will achieve an overall target yield of 6% although a balance of lower and higher yielding investments will be considered on their merits to ensure an appropriate balance between risk and return.

Achieving Greater Return

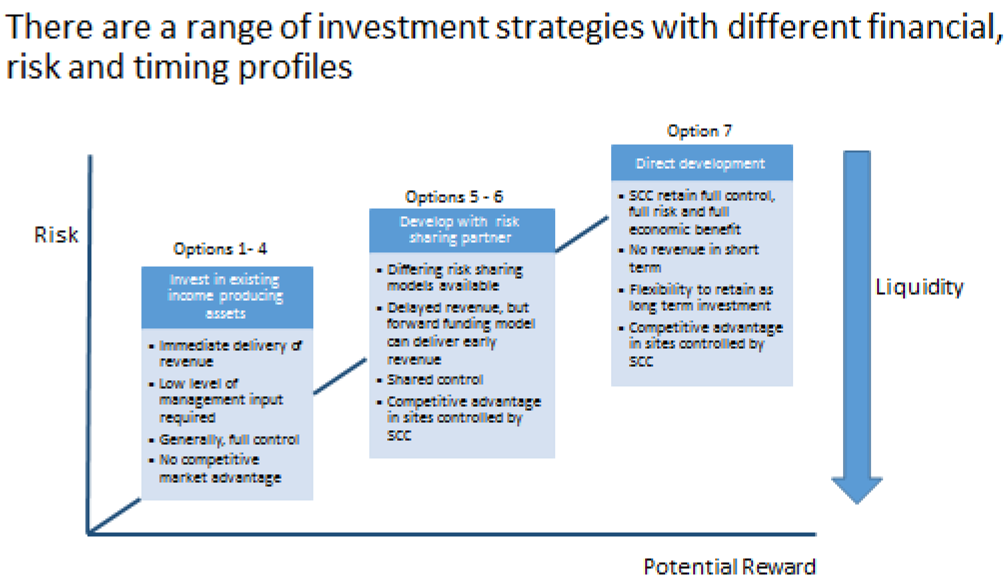
SCC is planning for a growing shortfall in Central Government funding which may result in a desire to achieve greater than a 6% income return on its initial PIF investment over time. This can potentially be achieved in two ways.

Firstly by increasing the amount of PIF investment while still achieving a target 6% income return, and

Secondly by taking greater risk in the investment strategy.

A potential model for taking progressively, and measured, increased risk over time is shown below. The intention is that a blend of risk profiles are employed and that the proceeds of higher risk (and shorter term) activities are partly redeployed back into the lower risk, long term sustainable "core" investment strategy.

It also envisages that additional funds can be made available after the first three year investment period.



Leveraging the Investment Pot

Whilst there are a number of potential constraints imposed upon the Council, which will result in the PIF operating in a slightly different way to a commercial property company, there are areas of competitive advantage over the private sector, which should be leveraged to enhance the performance of the PIF, or create/ identify opportunities that are not open to others.

1. Use of Prudential Borrowing – The Council can access funding at significant lower rates than the private sector. Comparatively, this results in better return on investment or improved development margin.

2. Tax Efficiencies – there may be opportunities where investment can be made directly through the Council which is potentially more tax efficient than private sector delivery vehicles.

3. Access to Public Sector Grants – whilst recognising potential State Aid issues, there is potential to use sources of public sector grant to support and benefit investment made through the PIF.

4. Use of existing assets – there will be opportunities to optimise the value of existing assets through acquisition of neighbouring sites using the PIF. The ‘marriage value’ of existing and acquired sites is likely to be greater than individual sites.

5. Strategic acquisitions – whilst mindful of potential conflicts of interest with the role of Local Planning Authority, the Council is in a unique position to make investments with the benefit of foresight of future development.

Resources

It is proposed that the Head of Capital Assets will manage the Investment Business Plan and programme delivery. This will be using resources and expertise primarily from within that team and the SSP, however, where specialist external advice is needed, this work will be commissioned on an ‘as required’ basis, funded from the income from the Leaders portfolio Property Management budget (PA120 and

PA130). This approach will be reviewed regularly as part of the Investment Business Plan.

The detailed market searches and acquisition process will be undertaken either by the Valuation and Estates Service in Capita, as this work is covered by the Strategic Services Partnership, or by use of external agents. After acquisition the new property will form part of the Council's Investment Property Portfolio, which is currently managed on a day-to-day basis by Capita.

Governance Arrangements

In considering the optimal governance arrangements for the Property Investment Fund the Council will need to decide what decisions are most appropriately made by Committee (through existing procedures) and under delegated authority. The following decision structure is proposed: -

Committee Decisions

Purpose – defining the purpose and criteria of the PIF

Capital structure – how much finance to put into the PIF and on what terms?

Distribution policy – is all income or development profit to be returned to the General Fund or is any retained for future investment and/or running capital?

Business plan – agreeing the general investment targets for the period and an associated budget.

Delegated Decisions

Specific investment transactions – acquisitions, sales, borrowing (if applicable) and other key transactions

Appointment of service providers – lawyers, valuers, due diligence advisors, property managers, etc.

Delegated decisions sit with the Council's Capital Board and Head of Capital Assets in consultation with the Service Director – Finance and Commercialisation and the Leader (as Portfolio Holder).

Monitoring and Review

The day-to-day responsibility for implementing and managing the performance of the portfolio will reside with the Head of Capital Assets. This will reviewed by the Service Director -Strategic Finance & Commercialisation and will periodically be scrutinised by the Council's Management Team.

A Portfolio Performance Report will also be published at least bi-annually for Member scrutiny and will inform future iterations of the Investment Business Plan.

Communications

A communications strategy will be developed to ensure that Portfolio Holders, ward Councillors and wider stakeholders are informed of decisions, acquisitions and disposals at appropriate times without compromising commercial confidentiality.

Delivery Options

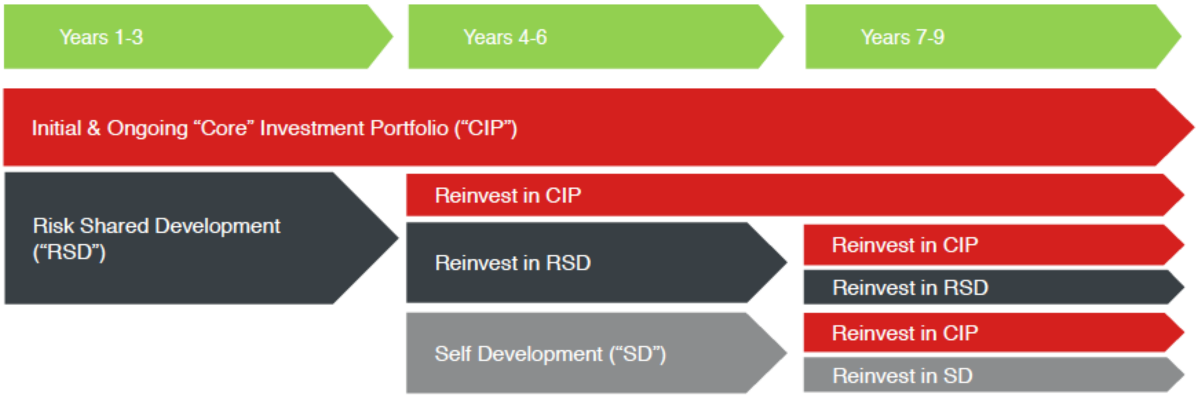
Given the PIF objectives the recommendations are as follows:

1. The PIF be flexible enough to allow all seven potential delivery methods as described in this report.
2. To generate immediate income, initial investment is proposed into the most liquid categories of delivery methods, namely 3 and 4 (property funds and shares). In this way, capital can be deployed quickly and flexibly. In the event

further allocations do not become available for future projects, these investments can be readily realised and redeployed.

3. As suitable opportunities arise investments will then be focussed on delivery methods 1 and 2 (direct property investment and joint ventures).

4. Higher value adding/risk activities (delivery methods 5 to 7) are focussed initially within the City. SCC's knowledge of the District creates a competitive advantage and allows it to better manage risk and deliver wider SDC objectives. A pipeline of opportunities is already under consideration.



Risks

This is a medium to long-term strategy for the Council.

Investment in property and the carrying out of development activities carries risks at both macro and micro levels. Property rentals, values and occupancy rates typically fluctuate broadly in line with the regional, national and increasingly, the global economy.

The timing of acquisitions and sales can thus have a significant impact on the rate of return as can complementary investment in lower risk or countercyclical investments such as Private Rental Residential property.

Historically, however, property rentals and capital returns have delivered growth and as it is the Council's intention to be a long term investor it is considered that these risks can be mitigated through a balanced portfolio approach.

Individual Investments will be the subject of pre-acquisition due diligence and risk assessments and regular updates to the Council's Capital Board.

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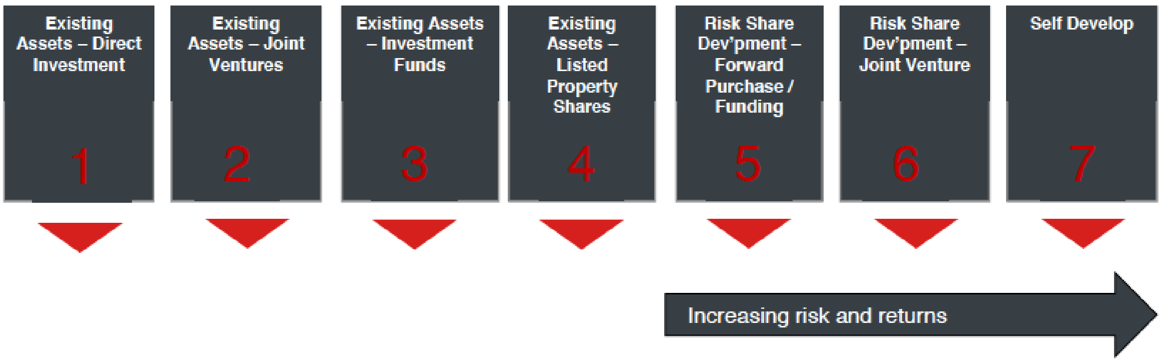
Options Appraisal

The Options Appraisal considers the relative benefits and limitations of seven investment options as follows:-



These are assessed against eight criteria

Financial Objective
Revenue Delivery
Risk
Control
Liquidity
Management Oversight
Performance
Diversification

Existing Assets – Direct Investment

What is it?

- The Council acquires and manages freehold or leasehold properties.

How does it work?

- The Council uses property professionals to identify market opportunities.
- After deciding on price and clearing appropriate internal approvals, bid for assets.
- Using appropriate advisors (legal, surveying, valuation) undertake due diligence and complete legal acquisition documentation.
- Establish on going management arrangements (internal or outsourced).
- Regular asset reviews to determine business plan and exit strategy.
- Process required on an asset by asset basis.

Benefits

Financial Objective	Depending on property type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the property acquisitions
Risk	Low risk option
Control	High level of control
Liquidity	Reasonable liquidity, subject to usual property market timings
Management Oversight	Relatively light requirement – high involvement at key decision points (buying and selling)

Limitations

Performance	Low return option and no competitive market position
Diversification	Desired diversification unlikely to be achieved given current potential capital allocation

Existing Assets – Joint Ventures

What is it?

- The Council acquires and manages freehold or leasehold properties together with a partner.

How does it work?

- The options are to approach this on a case by case basis or create a strategic relationship with a trusted partner.
- The Council will wish to select a partner or partners on the basis of their demonstrated expertise and ability to co-invest with the Council (assume 50/50). The Partner will carry out much of the management role.
- The Partner will identify market opportunities.
- The JV will include governance allowing Council input on key decisions, including acquisitions and sales.
- The Partner is responsible for on going management arrangements.
- Council rights to review business plan and exit strategy.

Benefits

Financial Objective	Depending on property type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the property acquisitions
Risk	Lower risk option – JV partner risk added
Control	Medium level of control
Liquidity	Reasonable liquidity, subject to usual property market timings and governance of JV
Management Oversight	Light requirement – JV partner undertakes most of the direct acquisition, management and sales work

Limitations

Performance	Low return option. Partner selected to bring track record and potentially competitive market position
Diversification	Diversification improved given additional Partner capital contribution but still unlikely to be at desired level

Existing Assets – Investment Funds

What is it?

- The Council invests in an unlisted property fund which owns a range of diversified property investments.

How does it work?

- The Council will undertake a process of reviewing available fund options and the track record of the fund managers.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The fund documentation will set out the rights of the Council to redeem its investment and/or to sell it on the secondary market. The nature of these rights will vary depending on the type of fund.

Benefits

Financial Objective	Depending on fund type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the fund investment – generally a shorter time than investing in direct property
Risk	Risk is determined by the nature of the fund. Additional risks relate to the fund structure, principally the performance of the fund manager
Performance	Returns are related to the specific investment strategy of the fund and manager performance.
Diversification	Fund investment can spread risk over a large number of underlying assets.
Control	High level of control of fund interest
Management Oversight	Very light requirement

Limitations

Liquidity	Unlisted investment funds generally have a low level of liquidity, particularly in market downturns.

Existing Assets – Listed Property Shares

What is it?

- The Council invests in listed property shares in a fund or a separate account mandate managed by a specialist fund manager.

How does it work?

- The Council will undertake a process of reviewing managers and available fund options and selecting an appropriate investment strategy.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The mandate with the fund manager can be structured to allow an immediate liquidation of the investment portfolio if required.

Benefits

Revenue Delivery	Generates revenue from the day the property shares are acquired – share transactions can be effected in a short time period
Liquidity	The highest level of liquidity
Risk	The risk and return level is flexible and can be altered over time by reference to the agreed investment strategy
Diversification	Risk can be spread over a large number of underlying property companies/assets.
Control	High level of control
Management Oversight	Very light requirement

Limitations

Performance	Higher volatility than direct property. Longer term performance correlates to property but short term can correlate to general equity markets
Financial Objective	Dividend yields generally lower that direct property yields – to be investigated further.

Risk Share Development – Forward Purchase Funding

What is it?

- The Council enters into an agreement with a developer to fund part of the development cost and/or acquire a development on completion.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The Council will be able to determine the risk profile it wishes to take on in entering the arrangement with the developer (e.g. after planning permission has been secured and construction packages have been tendered).
- During the construction stage the Council will likely require monitoring rights.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment activity, so at least a 6% income return dependent on property type
Performance	A higher level of performance than investment activity
Risk	The risk of development is highly mitigated by the forward purchase/funding arrangements
Control	High level of control
Management Oversight	Moderate level once the transaction is agreed

Limitations

Revenue Generation	Revenue can accrue to the investment when funded, but this will only occur during or at the end of the development period
Diversification	Desired diversification unlikely to be achieved given currently contemplated level of investment
Liquidity	Low liquidity during the development period, thereafter as per the general property market

Risk Share Development – Joint Venture

What is it?

- The Council enters into a JV agreement with a developer to carry out a specific development.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be shared 50/50 between the Council and the Developer.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type
Performance	A higher level of performance than investment and forward purchase/fund development activity
Risk	The risk of development is mitigated by careful partner selection and development stage oversight
Control	Strong level of control through JV documentation
Management Oversight	Meaningful level of oversight required

Limitations

Revenue Generation	Revenue will only accrue once the development is completed and leased (or sold).
Diversification	Diversification improved given Developer 50% capital contribution, but still unlikely to be at desired level
Liquidity	Low liquidity during the development period, thereafter as per the general property market

Self Development

What is it?

- The Council undertakes a development itself, appointing a development manager.

How does it work?

- The Development Manager will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be taken 100% by the Council.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type
Performance	The highest level of performance – the Council retains all development profit
Risk	The risk of development is mitigated by appointment of expert development manager and adoption of thorough risk management strategy
Control	Complete control with the Council

Limitations

Management Oversight	High level of oversight required
Revenue Generation	Revenue will only accrue once the development is completed and leased (or sold).
Diversification	Desired diversification unlikely to be achieved given the currently contemplated level of investment
Liquidity	Low liquidity during the development period, thereafter as per the general property market