Investment and Regeneration Fund

Assessment Criteria

September 2018 revision

Background

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 with an additional “multiple benefit” to the Council
- “Investments – Loans or Co Investment” .These are loans to business for capital expenditure where the objective is to increase rental income and/or interest returns to the Council. Co Investment is where Council with another investor provides finance or jointly purchases.
- “Regeneration” – these are property purchases, private sector or Council development projects within Torbay with the aim of increasing regeneration within Torbay.

This appendix sets out an outline for the management of the Investment Fund including purchases/investments and loans. The approach adopted should reflect a suitable balance between the risks inherent in the types of property/investments and loans 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.

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.

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, will be adopted.

Properties will be acquired to hold rather than to dispose. However all properties will be reviewed by nominated officers on a quarterly basis to review each property for potential disposal or investment depending on both current and future asset values and rental streams. Officers to include Monitoring Officer, Chief Finance Officer and lead Council officer for asset management. These officers to use external support as required.

Minimum and maximum yield

	Investment - Yield	Investment- loans & co investment	Regeneration
Yield	Rental	Loan repayments or rental	Rental
Target Yield Required	1.25% above forecast borrowing costs and forecast relevant ongoing costs Yield to be an average of an appropriate initial five year period	If capital loan 2% above forecast borrowing rates and forecast relevant ongoing costs Yield to be an average of an appropriate initial five year period	0% above forecast borrowing costs and forecast relevant ongoing costs Yield to be an average of an appropriate initial five year period Forecast to be subject to sensitivity analysis of estimates to ensure a 0% return can be realistically achieved.
Maximum Yield	10%	10%	n/a

Assets or loans 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 are therefore to be avoided. 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.

Sector spread

	Investment - Yield	Investment- loans & co investment	Regeneration
Sector Diversification – retail, leisure, office & industrial	Yes - retail, leisure, office and industrial	Yes - retail, leisure, office and industrial	Yes - retail, leisure, office and industrial

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 unless it forms par tof an overall investment or loan.

Locations

	Investment - Yield	Investment- loans & co investment	Regeneration
Location	National (UK)	Torbay	Torbay
Location – Diversity	25% in any Council area	100% Torbay	100% Torbay

Torbay would be the preferred location for fresh acquisitions of investment properties, so that reinvestment is 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. A wider area should also be considered for fresh acquisitions. Regeneration, loans and co investments will be for investments only within the Torbay area.

Assessment of risks

	Investment - Yield	**Investment- loans & co investment**	**Regeneration**
Independent Valuation of asset	Yes	If applicable	If applicable
Condition Survey	Yes	If applicable	If applicable
Independent Assessment of Asset Life	Yes	If applicable	If applicable
Independent Assessment of Residual value	Yes	If applicable	If applicable
Independent Assessment of legal issues in relation to site	Yes	If applicable	Yes
Independent Assessment of future rental	Yes – future rent reviews and on lease break/expiry	If applicalbe	Yes – future rent reviews and on lease break/expiry
Security required	-	Yes – minimum 75% of investment/loan such as parent company guarantee and charge on assets	-
Financial Assessment of tenant or loanee	Yes	Yes	Yes
Pre commitment required	Existing Lease	-	Existing lease or pre let
Risk Appetite	Risk averse	Risk averse	Risk neutral
State Aid Consideration	-	Yes	Yes
“Green Book” Financial profile over life of asset (IRR)	Yes	Yes	Yes
MRP	Yes – over asset life	No – of loan expected to be repaid – annual assessment required	Yes – over asset life

Assessment of impact on Council of any potentially abortive costs and how funded	Yes	Yes	Yes
Assessment of impact on Council of default or significant loss in value and how funded	Yes	Yes – Impairment (or contingency for) to be assessed on annual basis by CFO	Yes
Allowance for future costs, income shortfall and management of assets (see note)	0.25% - indicative value on total purchase costs per annum	-	0.50% - indicative value on total purchase costs per annum
Lease	Tenants of strong financial standing and minimum 5 year unexpired lease term	Loanee of strong financial standing	Tenants of strong financial standing and minimum 20 year lease term
Loan	-	Maximum 10 year loan Interest rate to be linked to assessed financial risk Enforceable security required on all loans Interest required on a quarterly basis from start of loan Loan to be on a repayment basis as soon as possible	-
Reputational Issues	No "sin" assets or tenants	No "sin" assets or tenants	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 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.

Allowance for future costs, income shortfall and management of assets

For each purchase or development an allowance is to be made to cover the following issues:

- Future management costs of the asset – both ongoing costs such as liaison with tenants, asset inspections, insurance arrangements, service charge management, lease term

enforcement and management of site but also cyclical costs such as rent reviews, marketing of vacant space, investment in assets and potential disposal.
- Future void or rent free periods on asset
- Future landlord R&M and investment costs in asset
- Abortive costs or set up/feasibility costs not chargeable as capital expenditure a purchase associated with the potential purchase or development of assets

The table above gives an indicative value based on a percentage of total purchase costs to be set aside each year. The CFO will vary this percentage depending on an assessment of future issues and costs relevant to each asset – e.g. the expectation of an extended rent free period.

In addition the Council will employ an Investment Fund manager, working under the direction of the Executive head of Business Services, to manage its Investment Fund and its Investment Property portfolio including Investment Properties owned prior to September 2016 when the Fund was established.

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.

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.