

SOUTH KESTEVEN – Commercial Property Investment Strategy

March 2017

Background

As an integral part of the Council's approach to maximising financial resources to deliver its outcomes, this strategy sets out a framework in order to make investments in property to increase its revenue streams. The strategy adopted should reflect a suitable balance between the risks inherent in the types of property to be acquired and the financial rewards obtainable from those investments, limiting such risks appropriately. In addition, the portfolio of properties 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 investments are to be made using capital from the General Fund into which the resulting rental revenue streams will flow. Any capital receipts arising from subsequent sales will also be returned to the General Fund for use into further capital investment.

Objective: to provide income from commercial opportunities with a minimum income return over the medium-term of 5.5% - 7.0% on capital invested, through a balanced strategy of acquisition, retention and management of good quality commercial investments. Long-term [retention/growth] of capital values is also a key objective.

The objective is specifically to acquire income-producing commercial properties in order to enhance Council revenue streams as opposed to making investments in potential development sites, development or re-generation schemes within the district. These types of development are a distinct activity with very different risks and financial considerations which are not within the scope of this strategy.

Performance measurement

The financial performance of the commercial property investments portfolio will be measured and reported on an annual basis. Performance measurement will be based on annual external revaluations of the properties. Reports will be presented to the Executive including analysis of the performance with a view to making recommendations concerning amendments or alterations to the adopted strategy to ensure that the main objectives continue to be achieved. Suitable benchmarking may be established so that the performance of the commercial property portfolio may be measured against a suitable peer group or against nationally reported indices of property investment performance.

In the event of a failure to achieve the performance targets in the case of individual assets, the business plan for the commercial property will be reviewed and amended as necessary to address the underperformance noted, or alternatively the asset can be disposed of.

Scope: The proposed quantum of investment is a capital allocation of £5 million from the General Fund with subsequent annual allocations of further tranches thereafter, subject to annual performance reviews of the portfolio and the adopted strategy.

It is suggested that the geographical spread of acquisitions is to encompass the East Midlands and South Yorkshire including (but not limited to) Lincolnshire, Nottinghamshire, Leicestershire, Northamptonshire, Rutland and Cambridgeshire.

Strategy: To continue the review of the Council's existing asset portfolio.

The strategy to be adopted should include restructuring and rebalancing of the existing portfolio to achieve a satisfactory spread of properties through the main use sub-sectors (Retail; Offices; Industrial/Warehouse); enhancing the portfolio income levels through disposal of lower-yielding assets and reinvestment in a properly risk-controlled manner in higher yielding properties without introducing unjustified increased risk into the portfolio.

Achieving a spread of risk across a greater number of assets and by acquiring properties across the range of different commercial property asset classes, namely retail, leisure, office and industrial, is to be a fundamental objective of the proposed investment strategy. Whilst the portfolio remains relatively small, rigid target percentages for the main commercial property sub-sector allocations are not appropriate. It is suggested that investment is spread initially in approximately equal proportions across the three main sub-sectors, namely retail/leisure, offices and industrial/warehouse.

Minimum and maximum yield

Acquisitions of assets are targeted at a minimum yield of 5.5% and maximum yield of 10.0%. 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.

Sector spread

Many good quality commercial property investments across the office and industrial sub-sectors will provide an income return of 6% or greater. In the retail sub-sector income returns for prime retail property, in which steady long-term returns can be assured, are lower than comparable office & industrial property. Therefore it is likely that predominantly office and industrial/warehouse properties will be targeted for acquisition as the income yields for acceptable retail assets may be below the target minimum income return.

Locations

Given the current difficulty in identifying suitable sites within the vicinity of South Kesteven, it is necessary to broaden the geographical scope of the strategy to encompass a wider area of the East Midlands. Whilst it is still the ambition to invest within the local economy, the primary objective of the strategy is to secure commercial investments and an enhanced asset portfolio. Therefore the strategy is flexible to ensure the primary objective can be delivered.

Target assets

The following assets will be sought;

1. Retail/convenience food retail investments with the following characteristics;
 - Lot sizes between £1m and £5m
 - Good locations in town centres or in good out-of-town retail clusters/parks

- Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Income yield range from 5.5%% to 8.0%
2. Office investments with the following characteristics;
- Lot sizes between £1m and £5m
 - Modern specification, likely to be built since 1990
 - Good locations in town centre or in good out-of-town business parks
 - Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Multi-let properties to be considered with average unexpired lease terms of 3 years, subject to a spread of expiry dates
 - Income yield range from 5.5%% to 9.0%
3. Industrial/Warehouse investments with the following characteristics;
- Lot sizes between £1m and £5m
 - Modern specification with flexible standard layout, built since 1980
 - Good locations on major road routes and good access to motorways
 - Well let to sound tenants on leases with a minimum of five years unexpired terms
 - Multi-let properties to be considered with average unexpired lease terms of 3 years, subject to a spread of expiry dates
 - Income yield range from 5.5%% to 10.0%
5. Mixed-use investments would also be potentially suitable additions to the portfolio. These may include a mixture of commercial and residential uses, or a mixture of retail and office use. Again, similar characteristics as set out above for office investments will apply.

Assessment of risks

A rigorous assessment of all risks is required in each case of fresh investment in order firstly to value each commercial property and then to check its suitability for inclusion in the portfolio. The risks fall into two categories, firstly 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 to determine the ranges of likely future rental growth of the commercial properties and also the disposal price. Financial returns are modelled over a medium-term horizon of say five years, based on proposed offer prices, to determine the acceptability of each investment, and can be compared against general market forecasts.

Asset-specific risks

Income returns for commercial properties 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 commercial 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 commercial 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 commercial property trends have been towards larger standard retail units being in strongest demand from retailers.

As part of the due diligence process to be undertaken in respect of every commercial property acquisition surveys will be undertaken by Council-appointed building surveyors and mechanical & electrical engineers to assess the quality of specification of the building and its current condition.

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. Annual reviews of unexpired lease terms across the portfolio should be undertaken.

Financial strength of tenant(s) – assessment will be required of each tenant of potential acquisitions through analysis of their published accounts and management accounts. Such assessment forms part of the due diligence process prior to acquisition and may be carried out by Council-appointed or in-house accountants. 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 the commercial 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.

Sourcing of investment commercial properties

Generally speaking property investment markets are controlled by national and regional commercial agencies and establishing links and relationships with a number of such property agents is the best method of sourcing suitable properties for acquisition in accordance with the adopted strategy.

Staffing resources will need to be made available consisting of officers with the necessary experience of operating in the property investment market in order to source suitable property assets for acquisition that match the criteria set under the adopted strategy. This

can be done either by recruitment into the existing Council property estates management team or by employing external expertise.

Governance and decision making

Owing to the normal processes when a property comes to the market and is bought and sold, decision-making on property purchases needs to fit in to the due diligence processes and timetables usually followed by private sector property owners. This may require urgent items being brought to the Executive for approval prior to bids or offers being submitted. A normal timetable in the purchase of commercial property would be a two to three week marketing period, followed by a week for submission of offers and confirmation by the seller of the preferred buyer and preparation of Heads of Terms, followed by a 4-6 week period for due diligence investigations by the buyer and the buyer's solicitor prior to exchange of binding unconditional contracts on the purchase. Completion will usually follow within a further four weeks.