ST HELENS
BOROUGH COUNCIL

Investment Land & Property Acquisition Strategy

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Appendix 1 – Acquisition Protocol

1. Purpose

1.1 The purpose of this strategy is to set out the following:

1. The Council's objectives for acquiring property and land assets for investment purposes.

2. A commentary on the economic climate, the general property market and the role of property acquisition within that, including the need to define the risk profile for the Council.

3. The strategic framework that will guide asset acquisition.

4. Investment objectives and criteria for asset acquisition.

5. The acquisition protocol (Appendix 1).

2. Background

2.1 Good practice within the public sector is to improve the strategic management and operation of property assets and to manage the risks associated with taking a more commercial approach to property investment decisions. This strategy outlines how St Helens intends to achieve this asset management improvement.

2.2 The strategy relates to the acquisition of new properties and land for investment purposes and where it furthers the economic prosperity of the borough. For the purposes of this document the term property will refer to both buildings and land.

2.3 The Property Investment Market

2.3.1 The UK commercial property investment market is defined as a 'mature asset class'. It has a wide range of new and established investors including institutions, pension funds, specialist property companies, charities, family trusts and individuals. In recent years, Local Authorities (directly and indirectly via pension funds) have entered the market.

2.3.2 Returns from property can be income driven, through the receipt of rent and asset value by way of appreciation of the underlying asset value (capital growth). The combination of these is known as the Total Return and this will be a consideration in assessing the attractiveness of a property for acquisition.

2.3.3 Property prices and returns are a function of the property type, age and location, together with the lease structure and covenant strength of the tenant (in the case of a let property).

2.3.4 Within the property investment market there is a wide spread in financial returns (known as yields) on offer, which relate to the particular characteristics of the asset in question.

2.3.5 The yield is representative of the risk that investors associate with ensuring a long term income, including the potential for growth. Investors will undoubtedly seek out the most secure investments which in turn will influence price with corresponding lowering of yields.

2.3.6 Yields can range from 2% (low risk) for prime London property to over 20% (high risk) for dated property in secondary locations with increasing vacancy rates. Much of the office space and secondary shopping centres in the borough would fall into the latter category.

2.3.7 Typical yield ranges for Investment properties would be:

2-4%	prime retail.
4-7%	retail / office let to blue chip / high covenant strength tenants on with over 10 years unexpired.
7-8%	prime offices (city centres) or retail within established town centres
8-12%	prime industrial and offices in established locations
12-20%	secondary/ tertiary industrial

2.3.8 Section 4 (below) outlines the main factors that investors take into account when looking at property as an investment. It is a combination of these factors that determine the yield.

2.3.9 It is estimated that most of the Council's existing non-operational portfolio is classed within the yield range of 10-15 % (or higher) and this brings with it inherent risks.

2.3.10 Effective estate management strategies will seek to dispose of some of the higher risk/poorer performing properties and to acquire properties with a significantly lower risk, in order to redress the risk balance.

2.3.11 The ultimate aim for the Council is to have property investments that produce the highest yields possible, whilst carrying an acceptable level of risk. The main mitigation measure in managing risk is to target investments which are let to 'blue chip' tenants and on relatively long leases. In this way, the Council will be primarily buying a secure income stream and the buildings themselves become almost secondary considerations.

2.3.12 The risks associated with property acquisition itself are outlined at section 8 of this strategy.

3. Why Hold Property Investments?

3.1 Property is usually described as a low to medium risk asset. Its returns invariably lie between those produced by equities and those produced by bonds. Properties leased long term to companies of good covenant strength have a lower risk of default and will produce secure income streams.

3.2 If income streams from such investments exceed the cost of borrowing required to initially acquire the property, surpluses will be generated. Such surpluses will be used to pay off the capital borrowed, the cost of borrowing, with any additional surplus being available to assist in funding frontline services or further investments.

3.3 The Council currently has access to capital resources at potentially advantageous borrowing rates through the Public Works Loan Board (PWLB), this therefore can increase the prospect of surpluses being achieved. However, it should be noted that borrowing rates can and do fluctuate; however, historical trends have demonstrated that they are generally below commercial market rates.

3.4 The purpose of acquiring and holding property for investment purposes is primarily to generate income. However, there may be other strategic reasons for purchasing property, particularly where it furthers the economic prosperity and regeneration of the borough.

3.5 The Council has the ability to strengthen its funding base by building an asset portfolio that provides a greater commercial return, providing the Council with the opportunity to reduce its reliance on central Government grants. To comply with guidance, the size of the investment asset portfolio, and the commercial income generated from property investments, must be proportionate to the Council's overall financial position.

3.6 The Council currently has a need to strengthen the revenues it generates from its non-operational estate, which is in general terms low income producing, high risk, secondary and tertiary assets.

3.7 Vacant sites and assets will be considered as investments where there is a clearly identifiable value in holding the property, particularly in relation to future development – it is not expected that this type of purchase will be common.

3.8 Most investments that the Council will consider will therefore relate to property that is occupied by way of a lease or a number of leases and is therefore income generating.

4 Key considerations when acquiring property as an investment

4.1 The key considerations for the Council when acquiring property interests for investment purposes are (in order of importance):

a). Covenant Strength - in the case of a let property, the quality of the tenant and, more importantly, their ability to pay the rent on time and in full. This is particularly important where the Council has borrowed against the investment. It is worth noting that the Council, as a public body, will not wish to invest in properties where the occupiers are generally seen to be undertaking business which is contrary to its corporate values.

b). Lease length - in the case of a let property, the unexpired length of the term of the lease is of key importance in ensuring that the landlord's revenue stream is uninterrupted. The Council will take into consideration the risks associated with a tenant vacating and the potential to attract good quality replacements tenants at acceptable rental levels.

c). Rate of return - the rate of return from the property (e.g. through annual rental incomes) will need to be equivalent or better to the returns that could be earned from alternate more secure investments, such as placing monies on deposit, following adjustment for risks and potential growth.

d). Risk - return is one side of the coin; risk is the other. In general, the higher the level of return from an investment, the higher the level of risk that it carries. For example, if a property is let at an attractive rent which would create a good return, it may be a high risk if the tenant does not possess good covenant strength and therefore may default at any time.

e). Growth - property has the potential for both revenue and capital growth. The Council will take into account that potential when assessing the strength of the investment opportunity. Property values can fall as well as rise and mechanisms to minimise revenue reductions should be identified.

f). Sector - information as to the sector of use of the property (e.g. office, retail, industrial, leisure) will assist in deciding on the risks associated with specific properties and the mix of sectors within the portfolio.

g). Building Age and Specification - in the case of a let property, whilst the Council, as an investor, may be principally concerned with the characteristics of the tenant and lease, the age and specification of the property will also affect the ability of the Council to let or sell the property in the future. It must also be taken into consideration in respect of the cost of protecting the investment. An example of this would be the undertaking of repairs and refurbishment if the cost cannot be fully recovered from the tenant.

h). Location - the location of the property will enable the Council to be able to undertake inspections and to deal with any management issues. Preference should be given to properties located within the borough.

4.2 In summary, the strategy for acquiring investment property assets for holding is therefore to:

- Ensure security of funds invested, considering the security of the initial investment, and the security of rental returns.
- Maximise rental income and minimise management costs to ensure the best return is generated.
- Pursue opportunities to increase returns and improve the investment value of the commercial asset base of the Council.
- Promote collaborative working with adjoining owners and developers to maximise value.
- For income to exceed the cost of acquiring and holding the asset unless the asset has a long-term regenerative benefit for the Borough.

5 Funding of Acquisitions

5.1 Depending on the particular circumstances, the Council will fund acquisitions either by utilising borrowing, or utilising reserves, or by a combination of both. It is worth noting that local authority borrowing from PWLB to fund commercial investments is currently under review and is therefore liable to additional Government guidance in the future. There is an element of speculation to this approach which means the Council will have to manage the risk profile of its asset base.

5.2 The Council has the ability to borrow funds via the Public Works Loan Board both quickly and at competitive fixed rates. This potentially places the Council ahead of many other potential bidders for investment property and this advantage should be exploited where appropriate. However, PWLB borrowing is not the only borrowing option available for the Council and other options should be outlined and considered as part of the decision-making process.

5.3 The difference between the rate of borrowing and the rate of return generated by the investment is effectively a surplus which will be used to pay off the borrowing costs and the capital borrowed, with any additional surplus being available to assist in funding frontline services or to fund additional investment

5.4 Certain acquisitions may not produce a large enough return to cover the capital borrowed and costs of borrowing, particularly where the purchase is of a more strategic, regeneration nature. In this situation, other funding options will be considered and the financial implications for the Council will be set out in the business case that is produced to inform the decision making process.

6 Objectives for Property Acquisition

6.1 All property purchased by the Council should achieve, at the lowest possible risk:

- The average benchmarked performance for that property type and location and
- Collectively produce an annual return in excess of the cost of borrowing, in order pay back the capital plus interest costs over a defined period.

6.2 It is also recommended that the Council grows its portfolio slowly and incrementally, with a variety of different property assets in order to spread sector risk. This is reflective of a relatively low-risk approach to acquisition.

6.3 For the purposes of this strategy, acquisitions will predominantly be confined to the borough of St. Helens, except in exceptional circumstances.

7 Financial implications

7.1 This Land & Property Acquisition Strategy is a framework designed to secure long term and sustainable income streams for the Council and to increase its financial resilience over time, whilst ensuring the security of Council funds. It will also provide the ability to invest in strategic acquisitions that further the economic prosperity of the borough. This may be through individual property purchases or by entering into effective land or property partnership arrangements.

7.2 The financing costs, which will include interest and principal repayments, will need to be met from the income stream generated by each investment.

7.3 Given the specialist nature of investment acquisitions, the Council will obtain advice from appointed agents with a proven track record in this field.

7.4 Other costs would include legal fees, at approximately 1.5% of the purchase price, Stamp Duty Land Tax, which at present rates is 4%, and Land Registry fees. Certain vendors may also request payment of the seller’s advisers’ costs by the buyer, although that should be resisted wherever possible.

7.5 Advice will be taken on a case by case basis, but the implications for the Council should be VAT neutral, especially when acquiring a going concern.

7.6 All of the costs described will be accounted for within each business case for an acquisition.

8. Key Risks

8.1 <u>Acquisition Risk</u>

8.1.1 More recently, the property market has seen increased performance in the logistics and grade A office markets; however, property investment can by their nature be volatile and therefore the business case at the time for purchase should outline any known risks both in the short and medium term.

8.1.2 The Council will target low risk, low management investments and those have continued to remain occupied and attractive to tenants, landlords and investors.

8.1.3 Interest in this type of property investment has remained strong and the Council will often find itself as one of several potential interested parties. This will give rise to unsuccessful bids. All concerned should be aware of this possible outcome and the potential for abortive costs (see paragraph 8.2.1 below).

8.1.4 Due to the nature of the property market, decisions may need to be taken quickly in order to put offers forward in a timely manner and ahead of potential competitors. To mitigate risk, offers can be made on a conditional basis and contracts for sale would not be exchanged until the usual due diligence process has been satisfactorily undertaken.

8.1.5 An investment budget and delegated decision making will need to sit alongside this strategy to ensure that the maximum opportunities are to be achieved.

8.2 Cost Risk

8.2.1 Abortive costs may be incurred in forming unsuccessful bids or failing to reach exchange of contract as a result of due diligence undertaken. These may include feasibility studies, ground investigations, advisers' costs, legal costs, survey fees and officer time.

8.2.2 This is a risk which is inherent to the property market and should be recorded, managed and necessary mitigations identified at the earliest stage of each potential acquisition.

8.2.3 It should also be noted that strategic acquisitions may be regarded as "unlocking" redevelopment or regeneration and may therefore demand a premium . on this basis often these cases will be negotiated as a "off market" transaction.

8.3 Property Market Risk

8.3.1 Property investment carries risks due to wider economic conditions beyond the immediate control of the Council. These can include downside risks due to adverse movements in the underlying value of the asset. Other property related risks, such as those relating to physical defects and characteristics, can be assessed and therefore managed appropriately.

8.3.2 It is not uncommon for potential investment opportunities to be offered directly or via limited / targeted marketing to specific clients and those opportunities may never be advertised to the wider market. It is therefore prudent that the Council adopt a proactive approach with property owners and specialist property investment agencies. This will give the Council the ability to act quickly from a position of knowledge and understanding.

8.3.3 The process of due diligence being undertaken prior to completion is key to the mitigation of property risks.

9. Environmental and Sustainability

9.1 Whilst the main criteria in assessing the attractiveness of the investment will be in respect to financial return and risk, the Council will also give due consideration to those property investments which display higher levels of environmental sustainability to maximise our contribution to the Borough's carbon neutral target.

Appendix 1 - Acquisition Protocol

Purpose

To ensure that there is a consistency of approach involving appropriately qualified officers, the Council should adhere to a formal Acquisition Protocol.

This protocol will apply to all non-operational acquisitions of land and property for both investment and strategic property within the borough.

Definition of an Acquisition

An acquisition is defined as the purchase of a legal interest in land and property, (by way of freehold, leasehold or license) for strategic or investment purposes.

The Local Government Act 1972 gives the Council powers to acquire any property or rights which facilitate, or are conducive or incidental to, the discharge of any of its functions or for the benefit, improvement or development of the local area. Although not yet fully tested, the Localism Act 2011 may also provide extended powers to local authorities.

Local authorities do, however, have wider fiduciary roles and can face criticism or challenge if they do not have robust business cases for all purchases.

Property Acquisition by the Council

The Council will continually assess the mix of properties it holds and will look at its overall exposure to risk, including any over-reliance on specific property sectors. It will consider options to increase or decrease that exposure and to minimise the management time and costs of its commercial property portfolio.

It is likely that synergies will arise from acquiring new assets which have physical proximity to existing assets (including the marriage value of merging adjoining legal interests).

Acquiring property can also have a regeneration investment effect and support areas of decline. However, there must be a clear financial or regenerative benefit and a objective focus on the reasons for acquiring any property.

Property Acquisition Funding

It is recommended that an earmarked capital reserve, “The Property Acquisition Fund”, is created to assist in funding property acquisitions. This will be achieved and maintained through a combination of:

(a) Use of reserves available for investment;
(b) Replenishing the fund through ring fencing capital receipts arising from the sale of surplus assets held by the Council.

The primary source of funding acquisitions will be prudential borrowing but a business case for each acquisition will be required. This business case will identify how the purchase is to be funded. The Property Acquisition Fund will also need to meet the borrowing costs associated with acquisitions until such time that a sustainable income stream from such assets can be achieved.

For the purposes of establishing The Property Acquisition Fund,. Delegated decision-making will be required for this fund to ensure timely and responsive ability to take advantage of appropriate commercial opportunities and achieve best value.

Acquisition Criteria

The following criteria will be considered to help make decisions as to the use of the Acquisition Fund:

Each acquisition will be considered on its own merit and all recommendations for funding will require a supporting Business Case.

Key elements of each business case shall include: Investment Acquisitions

- The key financial benefits (with a projected return of at least 2% above borrowing/investment rates) n.b. initial returns may not immediately provide this level dependent on where the property is within the rent review cycle.

- Level of financial security. Acquisitions should normally be pre-let to tenants of good covenant ideally on fully repairing and insuring terms (or inclusion of full cost recovery mechanisms) with an unexpired term of at least five years.

Strategic Acquisitions

- How the acquisition fits with current or proposed policies and assists in strengthening the Borough's economy.

- Measurable benefits attained through ownership. (This may also include consolidation of existing ownerships to enable future sales, modernisation of the Borough's business infrastructure encouraging inward investment, benefits associated with re- location and business start-up within the Borough).

- Where direct intervention will expedite agreed key strategies for the Borough.

- Where the acquisition furthers the development of strategic partnership arrangements and furthers the Council's growth agenda.

Where a proposed property acquisition demonstrates both investment and strategic value to the Council, some of the above criteria may be relaxed.

The Process of Acquiring Property Assets

The Council's present approach involves the assessment of acquisition opportunities most often presented by selling agents, who bring potentially suitable properties to our attention.

Given the specialist nature of the investment properties market, it would be difficult for the Council to actively identify and evaluate suitable opportunities. Consequently, the Council will appoint suitably qualified and experienced investment agents and consultants to provide the specialist advice needed in each business case.

The primary role of the investment advisers will be to identify the most suitable investment opportunities and present them to the Council for consideration. It is also envisaged that, by using their market facing position, they will advise the Council on issues such as:

- The range of appropriate values for the investment
- The approach to forming offers, bidding and achieving best value
- Sector specific advice in particular risks associated with specific occupiers, sectors and locations.
- Prospects for rental growth
- Capital growth prospects and liquidity (the last two factors are particularly important, as consideration also needs to be given to what happens to assets in the future).

All acquisition proposals will be presented to the Executive Director of Place, who in those instances where it was felt that the investment opportunity merited further consideration, would instruct officers to prepare a business case for consideration. The business case for the acquisition will include an appropriate indexation score for the property in accordance with the assessment criteria.

To ensure that investments are not lost through delays in the process, it is recommended that an Investment Property Acquisition Group comprising of relevant Cabinet members and officers is established to consider recommendations in a timely manner.

Once an acquisition is approved by the Group, the appointed advisers will act as the Council’s agents in respect to the bidding process, negotiations and final purchase. The agents will be given specific parameters for the terms of each purchase.

All valuations must be carried out, or verified, by a fully qualified member of the Royal Institution of Chartered Surveyors with sufficient current local knowledge of the particular market, and the skills and understanding necessary to undertake/verify the valuation competently.

All acquisitions will be carried out in accordance with rules laid down by any relevant professional bodies and laws (in particular, in compliance with all relevant Public Sector and Local Government Legislation, Statutory Instruments, Government Circulars, and existing Council procedures, policies and the Constitution).

Approval Process

The Group will be chaired by the Leader of the Council, and include the Deputy Leader, Cabinet Members for Finance & Governance, Regeneration and Planning and the Executive Director of Place and Executive Director for Corporate Services with other appropriate officers.

A quorum of at least 3 members of the Group will be required to conduct business.

When a property is identified as a potential investment, the Executive Director of Place will submit to the Group an acquisition appraisal and recommendations. The Group shall have the authority to instruct officers, under delegated powers, to progress negotiations.

It should be recognised that; in some instances, it will be necessary for the Council to make a conditional offer on acquisitions where time is limited. Any final offers will be subject to approval from the Group and progressed under delegated authority.