Newport City Council

Property Investment Strategy

2019-2024

1.0 Introduction

1.1 In April 2019, as part of developing its commercialisation strategy, Full Council approved the establishment of a £50m property investment fund in order to create a net income stream for the Council.

1.2 This strategy sets out the framework and parameters to be followed when considering the acquisition by Newport City Council (NCC) of an interest in property for the purposes of inclusion in the property investment fund.

1.3 It applies to the acquisition by The Council of all interests in non-operational property including freeholds, leaseholds, easements and options. However, it does not apply to acquisitions under compulsory purchase procedures.

2.0 Background & objectives

2.1 Over the past number of years, as government funding to support local government services has failed to keep pace with cost pressures, authorities have looked at alternative ways of delivering financial sustainability. As a result, an increasing number of councils have focused on generating new sources of income, often outside core activities, to support ongoing service delivery.

2.2 Investing in commercial property has been identified as one way in which the Council can support service delivery by creating a source of alternative income. An investment board will be established to enable the delivery of this strategy and will be a sub set of cabinet and function as a public committee with all the associated governance. The membership will be as follows:

Investment Board

Members:	Leader Deputy Leader Cabinet Members x 3
Advisors:	Chief Executive Strategic Director (Place) Head of Regeneration, Investment & Housing Head of Law & Regulation (Monitoring Officer) Head of Finance (Section 151 Officer) Supported by NORSE as specialist professional advisors

2.3 The investment board will be responsible for ensuring decisions are made in line with the framework set out in this strategy.

2.4 The Investment Board will follow the Governance & Purchase Flow Chart as shown in Appendix 1, and undertake regular review of the investment portfolio as detailed in section 5.

2.5 The key objectives of the strategy are to:

- ✓ Acquire properties that provide long term investment in accordance with the Councils corporate and financial objectives,
- ✓ Maximise return whilst minimising risk through the management processes as outlined in this strategy,
- ✓ The desired income yield (return) to provide a clear margin over the cost of capital, other direct costs related to the investment and where appropriate, contribution to life-cycle costs in a form which is sustainable, and has potential to increase through future rental growth
- ✓ Protect capital invested in acquired properties, by acquiring investment grade properties possessing characteristics that retain liquidity and preserve capital (notwithstanding market movement).
- ✓ Develop a governance framework that enables the Council to move at a timely pace in line with the market,
- ✓ Build a balanced property investment portfolio.
- ✓ Promote the economy of the city in key sectors, as identified by the Newport Economic Network
- ✓ Create employment through appropriate investment

2.6 **Legal framework**

2.6.1 The Council has a general power to invest for the purposes of discharging its functions or for prudent financial management under section 12 of the Local Government Act 2003 and can prudentially borrow for this purpose, subject to compliance with Prudential and Treasury Management Codes and the capital strategy.

2.6.2 Section 120 of the Local Government Act 1972 enables the Council to acquire land and property, either within the Newport area or elsewhere, for investment purposes. Section 123 of the Act provides a corresponding statutory power to dispose of land and property assets.

2.6.3 Section 2 of the Local Government Act 2000 gives the Council a general power of "well-being" to do anything (including incurring expenditure) which is likely to promote or improve the economic, social or environmental well-being of the area.

2.6.4 The combined effect of these statutory powers is to give the Council a wide discretion to acquire investment assets, both inside and outside the area, provided there is a tangible benefit to the citizens of Newport.

2.6.5 Full Council has resolved to establish a £50m property investment fund and has approved a revised capital strategy as part of the policy framework under the Constitution. Any investment decisions will be an executive function for the Investment Board, which will be established as a sub-committee of Cabinet, with delegated powers. This Investment Strategy sets out the framework and parameters for the Board to take investment decisions, having regard to the security and liquidity of any investments and the appropriate balance of risk and reward.

3.0 Criteria and assessment

3.1 This section provides a 'hand-rail' that will help guide the decision making process when investment opportunity. Its principles are to create a balanced commercial property investment portfolio with intrinsic risk diversification.

3.2 All proposed investments will be subject of a Business Case which will be created in conjunction with the Council's Finance Team. This will then be subject to evaluation by the Council's Investment Board. All potential acquisitions will be assessed against the following investment criteria:

- Location
- Covenant strength
- Lease length and terms
- Tenure
- Repairing obligations
- Net yield
- Other Factors to consider including Lot Size and Sector Weightings
- Contribution to local economy
- Opportunity to create local employment

For each investment opportunity; each will be assessed against the whole set of criteria and nothing will be considered in isolation. The assessment will be recorded by the Investment Board for future reference.

3.3 All acquisitions will be subject to:

- An independent valuation report supporting the purchase price
- Satisfactory building survey and assessment of economic life
- Satisfactory report on title

3.3.1 <u>Location</u>

First assessment of location should take into account the location based on the following hierarchy:

Preference	Location
1	Newport
2	South East Wales

3	South West & Wales region i.e. to include Bristol and surrounding areas
4	UK

Where the asset is located away from the City boundary or has specific management skill requirements, external agents may be instructed to manage it on our behalf, all costs incurred will be deducted from the gross annual return.

The second assessment of location should look at the type of location being invested in:

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Location	**Major Prime**	**Macro Prime**	**Major Secondary**	**Macro Secondary**	**Tertiary**
Examples	This includes Central London followed by the big seven cities (Birmingham, Manchester, Bristol, Leeds, Cardiff, Glasgow and Edinburgh)	Macro prime can be on edge of Major Prime cities or other major cities	Includes major town centres.	Includes all other towns but still within an area of growth	Relates to areas of little financial growth or investment.

3.3.2 Covenant strength

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Covenant	**Single Tenant with Strong Financial Covenant**	**Single Tenant with Good Financial Covenant**	**Multiple Tenants with Strong Financial Covenant**	**Multiple Tenants with Good Financial Covenant**	**Tenants with Average Financial Covenant**
Examples	The covenant of the tenant(s) is considered in terms of both financial strength and risk of business failure. The financial standing of the tenant is considered utilising Dun & Bradsheet and CreditSafe whom are internationally recognised financial referencing agency. Other due diligence methods such as assessment of business plans and accounts may also be utilised.				

3.3.3 Lease length

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Lease length	**> 10 Years**	**7-10 Years**	**4-7 Years**	**2-4 Years**	**< 2 Years**
Examples	The length of the tenants / occupiers lease will determine the fixed term of guaranteed rental income. The longer the term remaining, in most cases, the better and more secure the investment. Break option dates need to also be considered as if they were the lease end date.				

3.3.4 Tenure

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Tenure	**Freehold**	**Long Leasehold (125 years minimum)**	**Leasehold (<125 years >75 years)**	**Leasehold (<75 years)**	**Leasehold (<50 years)**
Examples	Freehold creates the best possible interest in the property and would be in perpetuity.	Considerations on leasehold periods are liquidity and how marketable properties are as time progresses.			

3.3.5 Repairing obligations

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Repairing Obligations	**Full Repairing and Insuring**	**Internal Repairing 100% recoverable**	**Internal Repairing Partially recoverable**	**Internal Repairing Non recoverable**	**Landlord Repairs**
Examples	The tenant has responsibility for all external and internal maintenance, decorations and repairs as well as liability for insuring the building.	The tenant will have narrower liability for maintenance, decorations, repairs and insurance confined to the internal parts of the property they occupy. Such costs are recoverable through a service charge. The landlord retains responsibility for structural and external repairs without reimbursement.			The landlord is responsible for all external and internal repairs

3.3.6 Net Yield

All investments considered must initially provide income (yield) at a positive net rate of return defined by the cost of capital borrowing for purchase. The acquisition costs where relevant will include Stamp Duty, investment acquisition agent fees and legal acquisition advice and will form part of the purchase cost.

A fund will be created to top slice net rental income to manage repairs, maintenance, staff resources and improvements, to prevent the portfolio becoming a net cost to the authority.

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Net Yield	**5%+**	**4% - 4.99%**	**2.5% - 3.99%**	**2% - 2.49%**	**<2%**
Examples	The Net Return is determined by subtracting the (i) borrowing costs (interest and MRP) from the Net Yield (quoted as a % return on investment) (ii) other direct/relevant on-going costs and (iii) contribution to life-cycle costs where appropriate. The Yield is determined by the quality of the investment and is a factor of location, property type, tenant covenant, lease term and repairing responsibilities as well as demand for the specific type of investment. The more desirable the investment the typically lower the yield. **The net returns of any project need to be sufficient to have a positive net return**				

3.3.7 Other factors

Sector Weightings

Sector	Target Weighting	Asset Profile
Industrial / Warehouse	Up to 40% of the portfolio	Logistics hubs, light industrial, trade parks
Offices, hotels & others	Up to 40% of the portfolio	Offices, business parks, hotels, cinemas, wind farms, petrol stations
Retail	Up to 40% of the portfolio	Small supermarkets, restaurants, retail warehouses, shops

Individual investment Size – No single asset should be over 40% of the fully invested portfolio by value. To reduce risk of exposure to single asset.

3.3.8 Summary

Below is a summary of the factors that will be evaluated collectively by the Investment Board when making a decision on acquiring an asset for commercial purposes.

The matrix below can be used as a checklist for the board in which to appraise each proposal as well as being able to 'map' each investment when reviewing the overall position of the Council's portfolio.

Criteria	Excellent	Very Good	Good	Acceptable	Marginal
Location	Major Prime	Macro Prime	Major Secondary	Macro Secondary	Tertiary
Covenant	Single Tenant with Strong Financial Covenant	Single Tenant with Good Financial Covenant	Multiple Tenants with Strong Financial Covenant	Multiple Tenants with Good Financial Covenant	Tenants with Average Financial Covenant
Lease length	> 10 Years	7-10 Years	4-7 Years	2-4 Years	< 2 Years
Tenure	Freehold	Long Leasehold (125 years minimum)	Leasehold (<125 years >75 years)	Leasehold (<75 years)	Leasehold (<50 years)
Repairing Obligations	Full Repairing and Insuring	Internal Repairing 100% recoverable	Internal Repairing Partially recoverable	Internal Repairing Non recoverable	Landlord Repairs
Net Yield	5%+	4% - 4.99%	2.5% - 3.99%	2% - 2.49%	<2%
Other factors:					
Contribution to local employment & economy	Qualitative assessment of contribution to the local economy and employment				
Other	Appraisal will also need to take into account sector weightings, individual investment size and assessment of the balance of the investment risk vs financial return.				

3.3.9 Referral to full Cabinet

Whilst these guidelines are focussed on the criteria to use when assessing individual investment opportunities and can be used to compare differing opportunities, they do not set any 'minimum criteria' other than that related to diversification of the investments and the requirement to make a positive net financial return. As this guideline applies to commercial investment and the use of the Council's Investment Fund, the latter issue is an absolute requirement. In the case of the former issue, where the Investment Board wish to deviate from this criteria and guidelines, then any decision will be referred to the full Cabinet for review and consideration.

4.0 Ongoing Review

4.1 The investment criteria and guidelines within this strategy, as well as the ongoing performance of the investment portfolio will require ongoing regular review.

4.2 As good practice, quarterly and annual reviews between NCC and Norse will be held to ensure that the portfolio does not under-perform the market or its risk profile increase due to changes in both the macro and micro-economic position around the real estate market.

4.3 This will provide NCC with a clear understanding of the portfolio's position and management, its risk return profile and any latent value that can be driven out through strategic asset management.

4.4 A regular review of the five year cash flow is important to understand any future working capital requirements, as well as assessing the accuracy of predicted rental income.

4.5 The quarterly and annual strategy review will cover:

Quarterly	**Annual**
Investment: 1. Brief market update – investment trends, activity and forecasts 2. Brief update on operational markets 3. Review of current investment strategy 4. Report on performance of the portfolio and individual assets 5. Provide a review of portfolio activity and the added value created over the previous period 6. Update Invest/Hold/Sell asset designation	**Investment:** 1. Market update on investment trends, activity and forecasts 2. Update on the occupational markets 3. Review of current investment strategy 4. Re-confirm investment criteria and asset target weightings 5. Identify any re-alignment required to match market changes and forecasts 6. Benchmarking the existing portfolio and asset level investment returns 7. Report on performance of the portfolio and individual assets 8. Report on any KPI or performance criteria 9. Provide annual property business plans to evaluate added value opportunities 10. Provide a review of portfolio activity and the added value created over the previous 12months 11. Update five year cash flow forecast

	12. Update Invest/Hold/Sell asset designation
Management: 7. Report on portfolio management performance including rent collection rates, bad debt provision and service charge reconciliations 8. Advise on all critical lease dates, break options, rent reviews and lease expiries 9. Report on any health and safety incidents and insurance claims 10. Report on dilapidations claims and status 11. Capital expenditure requirements over the preceding quarter	**Management:** 13. Report on portfolio management performance including rent collection rates, bad debt provision and service charge reconciliations 14. Advise on all critical lease dates, break options, rent reviews and lease expiries 15. Report on any health and safety incidents and insurance claims 16. Report on dilapidations claims and status 17. Capital expenditure requirements over the preceding 12 months

Appendix 1 Governance & Process Flowchart