Epsom and Ewell Borough Council
Property Investment Strategy

2017-20

September 2017

Introduction

The Property Investment Strategy ("the Strategy") aims to provide a robust and viable framework for the acquisition of commercial and residential property investments.

The purchase of suitable commercial property investments will assist the Council generate additional income to support the delivery of the Council's services by investing in a diversified and balanced property portfolio. It will improve the financial resilience of the Council and support its longer term ambition to become financially self-sufficient from central government funding.

The Strategy governs the acquisition of both directly held Council investment property as well as indirect purchases made through the Council's 100% wholly owned property trading company - Epsom & Ewell Property Investment Company Ltd.

The three underlying objectives of the Strategy are:-

- **Investment Criteria** – to identify suitable property investment opportunities.

- **Risk Management** – to balance the requirement for income return with an acceptable level of managed risk.

- **Governance Arrangements** – to provide an agile decision making framework.

The asset management of the Council's existing property estate (comprising operational and commercial investment properties) is defined in the Asset Management Plan (AMP). The AMP will subsequently apply to all property investments acquired under this Strategy to ensure that assets are appropriately managed long term.

Investment Criteria

In common with all forms of investment at their most basic level, property investment is a trade-off between risk and return. A traditional well-diversified, prime property portfolio spread across different property sectors will deliver a balanced long term return with minimal risk.

A balanced portfolio of prime property (i.e. high quality buildings let to financially strong tenants) will typically provide a steady income yield of 4.5%-6% with the additional prospect of capital growth.

The Strategy will adopt the same underlying principle of diversification in acquiring a balanced portfolio of property investments offering a similar income yield profile. The three main property sectors will be included (industrial, office and retail) and in turn, these will be diversified on criteria including location, the tenant's financial (covenant) strength, lease term (income duration) and investment lot size. This will ensure that should a property investment cease to be income producing (for example, it is undergoing refurbishment or awaiting a new tenant), then the loss of income will not adversely affect the portfolio's total return.

Underpinning the Strategy's diversification is a confidential Property Investment Portfolio Policy report prepared for the Council by Knight Frank Research. The confidential Part II report is attached at Appendix A.

The Knight Frank report considered the following key elements in building a diversified and balanced property investment portfolio:-

- Real estate portfolio theory and types of risk.

- Historic performance of the UK commercial real estate market.

- Forecasts for the UK commercial property market.

- Implications for portfolio composition, asset selection and flexibility.

Of particular relevance to the Council's income driven strategy, the Knight Frank report demonstrated that:-

- UK real estate has a very stable income return, in part due to long lease contracts and upwards only rent reviews. Average lease lengths have gradually reduced over the past decade and there is some variation between property sectors. However, tenants generally do not exercise break options, leading to the possibility that tenant risk can be overstated in a portfolio.

- Chasing the highest level of total return (income and capital growth combined) can increase portfolio risk and may lead to the inclusion of lower income assets, which may not be appropriate for an income driven strategy. In contrast, property types that are less reliant on capital growth for returns are typically compensated with a higher income return component.

- The biggest gains in risk reduction come at the early stages of portfolio diversification, involving a small number of properties, and therefore, loosely pursuing a diversification strategy can still be worthwhile. Applying a deep understanding of the market to make well-informed purchasing decisions can enhance the rate at which risk is reduced.

- Diversification amongst property sectors within a region is better for risk reduction than diversifying solely within a property sector. This suggests that investors with local market knowledge should prioritise their intelligence advantage over regional expansion.

- For some property assets that become vacant in the future, the optimal use may no longer be commercial, but residential. The conversion to residential use, where permitted, may be seen to provide an added level of security in relation to the capital values of specific assets in the portfolio.

- Research shows that there can be benefits to risk reduction from investing in larger, better quality stock over smaller, poorer quality stock. However, investors have to weigh these benefits against the downsides of larger lot sizes, which naturally reduce the number of assets that a portfolio of a finite size can purchase, and therefore the scope for diversification.

In pursuing a well-balanced diversified portfolio, a Scoring Matrix allows the relative merits of an investment opportunity to be measured and assessed against a target threshold. The Matrix is attached at Appendix B and includes the following scoring criteria:-

- **Location** - property is categorised as either prime, secondary or tertiary in terms of its locational desirability. For example, a shop located in the best trading position in a town would be prime, whereas a unit on a peripheral neighbourhood shopping parade would be considered tertiary.

- **Tenant Covenant** – the financial strength of a tenant determines the security of the property's rental income. A financially weak tenant increases the likelihood that the property will fall vacant. The minimum acceptable financial strength for any given tenant will be determined through financial appraisal of company accounts and the use of appropriate methods of risk assessment and credit scoring. To minimise management and risk, the preference will be for single occupancy investments wherever possible.

- **Building Quality** – a brand new or recently refurbished building will not usually require capital expenditure for at least 15 years. This is attractive for income investors requiring long term rental income with the minimum of ongoing capital expenditure.

- **Occupational Lease Length** – the lease term will determine the duration of the tenant's contractual obligation to pay rent. The most attractive investments offer a long lease with a strong tenant covenant.

- **Tenure** – anything less than a freehold acquisition will need to be appropriately reflected in the price.

- **Tenant Repair obligations** – under a Full Repairing & Insuring Lease (FRI), the tenant is responsible for the building's interior and exterior maintenance / repair. The obligation is limited to the building's interior under an Internal Repairing & Insuring Lease (IRI). The preference will be to favour FRI terms (or FRI by way of service charge i.e. all costs relating to occupation and repairs are borne by the tenants and administered through a service charge).

- **Lot Size** – to maintain portfolio balance the preference will be for no single property investment to exceed £20m. However, there may be exceptional circumstances in which an acquisition greater than £20m will be considered – for example, a prime property let on a long lease (greater than 15 years) to a financially secure tenant. Exceptional circumstances will be justified in the individual property's business case and considered as part of the overall risk management process.

High scoring properties will typically be freeholds let long term to a single tenant with a strong financial covenant. Occasionally, opportunities will arise that do not score highly on the matrix criteria; for example, an empty property that falls within the Council's designated Plan E regeneration zone or one adjacent to an existing Council ownership. In these circumstances, the Matrix will not preclude low scoring properties being considered on their own individual regeneration / economic development merits, but the decision to purchase will be taken by either the Strategy & Resources Committee or full Council as appropriate.

Risk Management

Market Forces

As with all investments, there are risks that capital values and rental values can fall as well as rise. To mitigate against future unfavourable market conditions, acquisitions will be made on the basis that the Council is willing and capable of:-

1. Holding property investments for the long term i.e. 50 years +. This will ensure income and capital returns are considered over the long term thereby smoothing out any cyclical economic / property downturns.

2. Fixing borrowing liabilities. The Council can borrow from the Government's Public Works Loan Board at the lowest fixed interest rates for 20 years. Fixing borrowing rates at historically low levels will protect the Council from any future increases in financing rates.

Management

To mitigate the risk of void periods where the property is either partially / fully vacant or a tenant has defaulted on its rental obligations, the investment portfolio will be actively managed in accordance with the Council's adopted Asset Management Plan. This includes identifying property for disposal where opportunities arise or the portfolio requires rebalancing to achieve acceptable risk diversification.

In addition, the investment criteria specified in the Scoring Matrix will favour secure property investments i.e. high quality buildings in prime locations - thus mitigating the risk of void periods on re-letting.

Opportunities

The availability of suitable high quality investment property is generally limited and consequently, opportunities may be lost where vendors employ competitive bidding processes. Furthermore, the property investment market is often characterised by "off market" investment activity where, for a variety of reasons, opportunities are not freely marketed.

To mitigate the likelihood of lost opportunities, the Head of Property will actively build relationships with the investment agency community. The ability of the Council to make (and act upon) investment decisions at short notice is a key requirement for seeking out investment opportunities. It is proposed a dedicated Investment Property Group is established by the Council for this purpose.

Governance Arrangements

Investment Property Group (IPG)

A dedicated Investment Property Group will authorise the acquisition (and disposal where appropriate) of property investments taking account of the overall investment and risk management criteria defined in this Strategy.

The IPG will apply to both directly held Council investment property as well as indirect purchases made through the Council's 100% wholly owned property trading company - Epsom & Ewell Property Investment Company Ltd (EEPIC Ltd).

Subject to full Council approval, the IPG will receive delegated authority to make property investment decisions up to a defined budget / borrowing facility limit. Any subsequent amendments to the budget / borrowing limit will require full Council approval.

IPG membership will comprise:-

- Strategy & Resources Committee Chairman
- Strategy & Resources Committee Vice-Chairman
- Chief Executive
- Section 151 Finance Officer
- Head of Property
- Head of Legal & Democratic Services

The IPG will ensure that all investment opportunities appraised and undertaken by EEPIC Ltd are subject to the same degree of scrutiny as those that the Council would undertake in its own capacity.

The Chief Executive will call IPG meetings to discuss and respond to investment opportunities as they arise. The Chief Executive approves the agenda for each meeting and ensures subsequent actions are recorded.

Full transparency between the Council and EEPIC Ltd is maintained at all times as IPG members have the following dual EEPIC Ltd roles:-

- Shareholder representative (Strategy & Resources Committee Chairman)
- Shareholder representative (Strategy & Resources Committee Vice-Chairman)
- Chair of Board of Directors (Chief Executive)
- Managing Director (Head of Property)
- Director (Section 151 Finance Officer)
- Director (Head of Legal & Democratic Services)

This is entirely consistent with a trading company operating at “arm’s length” where the staff of the shareholder may also be the appointed company directors.

For a potential property investment to be considered by the IPG, it must:-

1) Achieve a minimum weighted score of 70 from the investment criteria matrix

   and

2) Be accompanied by a full individual business case.

The business case will be prepared by the Head of Property in consultation with finance and legal colleagues. Each potential property investment will undergo qualitative and quantitative appraisal to establish portfolio suitability and the legal / financial implications of the purchase. The Head of Property will seek external investment / technical expertise where specialist property market knowledge is required.

All acquisitions will be subject to building survey, purchase report and valuation. In view of the potential value of acquisitions, it is envisaged that the Council will be externally represented for each transaction by a property investment agent and legal firm. In almost all cases, the purchase report and valuation will be provided as part of the property investment agent’s introductory fee.

A flow chart detailing the process for acquiring property is shown overleaf.

Process for Acquiring Property

Property comes to market Finding a property	Head of Property's role to look at potential investment opportunities
Assess cost /benefits	• Initial assessment • Risk assessments • Financial modelling • Matrix completed must be over 70%
Proposal to the Investment Property Group IPG)	Proposal by the Managing Director to the IPG for consultation Property business case for each new property with input from Finance & Legal Subject to due diligence
Loan rate & structure of loan	Determined by the Section 151 Finance Officer
Submit Bid	Maximum bid level agreed with IPG and decision recorded in consultation with S&R Chairman Submit/negotiate bid Undertake legal and survey due diligence
Exchange & Completion of contracts	As agreed with agent Inform relevant staff and members Communication Plan
Transfer of funds	Finance team to arrange transfer of funds/loan to the company Shares issued from Company

Appendix A (Part II Confidential)

Property Investment Portfolio Policy

Knight Frank Research

Appendix B – Investment Criteria Scoring Matrix

Criteria	Weighted Score	Excellent	Good	Acceptable	Marginal	Poor
		5	4	3	2	1
Location	20	Major Prime	Micro Prime	Major Secondary	Micro Secondary	Tertiary
Tenant Covenant	20	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenants	Multiple tenants with good financial covenants	Tenants with poor financial covenant strength
Occupational Lease Length	20	Greater than 10 years	Between 6 and 10 years	Between 3 and 6 years	Between 2 and 4 years	Less than 2 years or vacant
Building Quality	15	Modern or recently refurbished with nominal capex required	Good quality with capex likely to be required within the next 20 years	Good quality with capex likely to be required within the next 10 years	Good quality with capex required within the next 5 years	Non-compliant with capex required within the next 5 years
Tenure	10	Freehold	Lease 125 years plus	Lease between 100 and 125 years	Lease between 50 and 100 years	Lease less than 50 years
Tenant Repair Obligations	10	FRI	FRI – partially recoverable	IRI – 100% recoverable	IRI – partially recoverable	Landlord responsibility
Lot Size	5	Between £10m & £15m	Between £5m & £10m or £15m & £17.5m	Between £2.5m & £5m or £17.5m & £20m	Between £1m & £2.5m or £20m + (subject to otherwise high matrix scoring)	Less than £1m
Maximum Weighted Score	**100**					