Officer Executive Decisions

Acquisition and Disposal of Land and Property

The Cabinet considered a report on 12 January 2016 regarding proposals for the Council's rules on the Acquisition and Disposal of Land and Property:

http://democracy.medway.gov.uk/mgIssueHistoryHome.aspx?IId=16071

Delegation from Leader and Cabinet and date:

The Cabinet noted that the Leader of the Council would delegate authority to the Assistant Director Legal and Corporate Services (in consultation with the Leader, Portfolio Holder for Resources and Chief Finance Officer) to agree a strategy and robust set of criteria for future investment in non-operational property to be funded from provision made for this purpose in the Council's Capital Programme.

Decision: At a meeting on 3 February, The Chief Legal Officer (Previously the Assistant Director of Legal & Corporate Services) in consultation with the Leader, Portfolio Holder for Resources and Chief Finance Officer agreed the council's property investment strategy and its criteria for considering the acquisition of investment properties (see Appendix 1 for details).

Reasons for Decision: So that the council has a clear strategy for the purchase of investment properties and a robust set of criteria to use when considering the purchase of investment properties.

Date of Decision: 3 February 2016.

Officer: Perry Holmes, Chief Legal Officer, T: 01634 332133, E: perry.holmes@medway.gov.uk

Details of any other options considered and rejected:

1. The option of buying investment properties outside of England was rejected.

Conflicts of Interest: None

Officer Executive Decisions

Appendix 1

Investment Strategy and criteria for the purchase of investment properties by Medway Council.

A. **Points to note/Disadvantages and advantages of investing in property.**

Disadvantages.

1. Property investment needs to be seen as a long term investment.
2. The costs of purchasing and selling property investments are high.
3. Property is not very liquid and the time involved in buying and selling it is high.
4. Property is not a transparent investment (unlike Bonds and shares.)
5. Proof of ownership and due diligence can be problematic/expensive.
6. The amount of capital required to buy property is high and investments are often indivisible.
7. Property is expensive and time consuming to manage and re-let and when empty, not only is rental income lost, but there is the need to pay empty rates and void management costs.
8. Property is prone to interference in the form of legislation and this can damage its value as an investment and the income which it produces.
9. All property is heterogeneous (i.e No two properties tend to be exactly alike.)
10. Property is prone to obsolescence.

Advantages.

1. The yield on property investments tends to be higher than other investments to reflect the points raised above.
2. The capital value of property tends to increase over time (apart from during recessions when values can reduce) and taking out the impact of recessions, property can be a “hedge” against inflation
3. Property can produce capital growth and income or both.
4. Property can be less volatile than other investments.

B. Measurement of Investment Performance.

1. Income on cost yield.
2. Income yield on value.
3. Likely capital appreciation.
4. Likely income appreciation.
5. Likely rental growth.
6. Reversionary potential. (Potential at the end of the lease e.g. from an increase on rent or redevelopment.)
7. Internal rate of return.

Officer Executive Decisions

C. Investment Strategy/Criteria:

For use by the council when considering whether to buy a property or not.

1. **<u>Security of income.</u>** **Weighting 30%**

For the Council the income (or revenue savings) which are likely to be generated by the investment is the most important element of the investment. This will be governed by the Lease(s) which is/are currently in place. To assess this, the quality of this should be considered using the following sub categories:

<u>Rental income:</u> Measured using Internal Rate of Return (IRR) techniques, the rental income from the property should preferably provide a net return (after estimated management costs) of at least 7% on the capital expended (including fees) although exceptions can be made where:

- There is the opportunity for rental growth soon.
- The opportunity for capital growth.
- There are opportunities on reversion.
- The investment is a secure ground lease, where the void risks are not on the council.
- The investment is underpinned by redevelopment value.
- There are regeneration/community benefits
- Acquisitions which will help to consolidate the council's existing land holdings to facilitate development.
- Acquisitions which compliment Corporate or Planning aspirations.
- The acquisition will result in the council reducing its revenue costs (for instance in the form of reduced rents.)

<u>Lease Length/terms</u> The length of the current contractual agreement in place and the period of time over which rent is paid. On the whole, the longer the lease the better.
Also preferably the landlord's covenants within the lease should not be onerous, as this will reduce the net return.

<u>Rent Review Pattern:</u> The frequency and method by which the passing rent can be reviewed. Rent reviews linked to any increase in market rents or in the Retail Price Index (RPI) are desirable and rent reviews should preferably be at least every 5 to 7 years depending on the type of investment.

<u>Break Options:</u> Preferably, the lease should **not** contain a tenant break clause, as this will reduce the certainty of income.

<u>Risk of Vacancy</u>: If the current tenant defaults or breaks the lease:

- What are the annual costs of managing the property likely to be as a percentage of the capital value? (The higher the costs, the higher the risk in event of tenant default.)
- What are the prospects of re-letting, selling or redeveloping the property?
- What is the rent likely to be on re-letting? (If the rent will be lower than the current rent, then a low score and if higher then a better score.)
- What incentives would the council be likely to need to offer to let the property? (The higher value the lower the score.)

<u>Management:</u> The level of need for the council to manage the investment and the estimated annual cost as a percentage of rent for doing this. With the higher the percentage of rent, the lower the score. For example, a property let on a ground lease with no landlord's covenants is far more desirable than a multi-let property where the council will be responsible for the building and common parts.___Also, properties which are management intensive and not in the Medway or Kent area will score even lower. This can be reflected in the IRR calculation but there remains the issue of the council's capacity to manage the property.

2. <u>Tenant</u> Weighting 20%

The financial standing of the Tenant must be rated using a recognised rating agency. Is there a guarantor? If so the tenant will score better, provided that the financial standing of the guarantor is good.

3. <u>Location/Sector</u> Weighting 15%

a) Macro:

Due to ease of management, practicalities of buying locally and local knowledge, the Council's location preference is as follows:

1) In Medway.
2) In Kent.
3) The South East.
4) The rest of England (Not Wales or Scotland.)

b) Micro:
The investment should be in an area, which is economically buoyant and has the potential for sustainable financial and economic growth, over the ownership of the asset. The Council's micro location preference is within established commercial locations and is in the following order:
   1) Prime (e.g Successful town Centre/Business Park).
   2) Secondary (e.g Smaller town Centre, Local Centre.)
   3) Tertiary.

The quality of the location will depend on the sector. For example an office on Medway City Estate would score lower than one at Chatham Maritime, a shop in Strood would score lower than one in Chatham and a hotel in Chatham Maritime or Rochester would score higher than one in Rainham.

4. <u>The Property.</u> Weighting 10%

The tenure, age and construction of the building should also be considered, including the potential for obsolescence, requirement for the council to have to carry out repairs/improvements during and at the end of the lease. On the whole, the more modern, well-constructed and energy efficient a building is, the higher it will score. The Council should ideally be buying a freehold, but if it is considering buying leasehold, then there should be very little in the way of covenants on the Council, the lease should be long and capable of alienation or the council should already own the freehold.

5. <u>Any other benefits</u>. Weighting 5%

For example, ability to enhance capital value, regeneration or environmental benefits.

6. <u>Security of Capital/Scope for Capital appreciation.</u> Weighting 20%

Based on all the factors above, an assessment should be made on the security of capital and the scope for capital appreciation in respect of the investment. Properties which will be worth far more than their current value at the end of the lease (e.g Reversionary investments) will score high and those that are likely to be worth less than their current value, will score low.

7. **Scoring**:

5: Excellent.
4. Very good.
3. Good.
2. Acceptable.
1. Marginal.
0. Unacceptable.

8. **Scoring Matrix:**

	Score	5/5	4/5	3/5	2/5	1/5	0/5
Criteria	Weighting						
1.Security of income	30%						
2.Tenant	20%						
3.Location/sector	15%						
4.The property	10%						
5. Any other benefits	5%						
6.Security of Capital	20%						
	Total score						

Properties with a score of under 50% overall, would not usually be considered except in where there are additional considerations/benefits to the purchase. (See 9 Below.)

9. **Additional considerations/benefits (for example) :**

- The opportunity for capital growth.
- The investment is underpinned by redevelopment value.
- There are regeneration/community benefits
- The acquisition will help to consolidate the council's existing land holdings/ to facilitate development.
- Acquisitions, which help deliver Corporate or Planning aspirations.