Appendix A

DRAFT – Asset Investment Strategy

Introduction

Local authorities are under unprecedented pressure to reduce expenditure whilst improving services for an ever growing and demanding population. Property acquisitions for long term investment is a recognised strategy for generating long term revenue income to support front line services and the Council's operation.

As part of the Financial Strategy in September, Asset Investment will be identified as one of the key strategies for ensuring that the Council has a clear strategy for managing its budget over the next four years.

Background

Historically the Council has not actively pursued the acquisition of properties purely for investment return purposes. Acquisitions have been made of properties for other reasons that have subsequently been managed and transformed into investments that are providing a good return. An example of this would be Davis House

The existing Asset Management Plan makes reference to investment assets and the need to review and develop a more formal policy and the current Asset Strategy emphasises the need to increase income through better use of the property portfolio as a key financial objective.

However, it is recognised that a more formal approach specifically relating to the acquisition of commercial property assets for investment purposes is required to ensure decisions are made in a clear and transparent way.

The Chartered Institute of Public Finance and Accountancy (CIPFA) has recognised that commercial investment is an option for local authorities for future financial sustainability. The Prudential Code was developed as a professional code of practice to support local strategic planning, asset management planning and option appraisal for local authorities when developing their programmes for capital investment in fixed assets. These help local authorities to demonstrate that they are acting responsibly. Reference has also been made to feedback that CIPFA have given to council's with existing property investment strategies so that areas of good practice can be included within the proposed strategy

A market appraisal report from CBRE has been commissioned to inform the investment strategy and to assist the Council with developing a medium term plan and portfolio mix to generate the most beneficial outcome from investment.

Section 120 of the Local Government Act 1972 gives the Council the power to acquire property by agreement for the purpose of any of its functions or for the benefit, improvement or development of the borough.

The Council also has the power to invest for the purpose of the prudent management of its financial affairs under section 12 of the Local Government Act 2003.

Section 1 of the Localism Act 2011, enables a local authority to do anything that an individual generally may do (subject to prohibitions, restrictions and limitations in existing statute which are not applicable in the circumstances set out in this report) The provisions also enables the authority to exercise the power anywhere in the United Kingdom for commercial purposes. This would therefore enable the Council to acquire assets outside of the Borough if it wanted to.

Current Position

Although the Council currently generates income in excess of £4m pa this is largely derived through the letting of two key assets, Bernard Weatherill House (BWH) and Davis House together with a number of smaller community assets. With the exception of BWH most of the properties are now ageing, are management intensive and are likely to require capital investment in the medium term to maintain income streams

Governance and Delegation

The acquisition of property is not new to the Council, but the existing governance arrangements need to be streamlined for purchases in what is a very competitive and commercial fast moving market. This will necessitate the extension of existing delegated authorities in order to allow decisions to be made within commercial timescales.

A typical timetable for the purchase of commercial investments would be a two or three week marketing period followed by a further week for the submission of bids and then a 3-4 week period for due diligence investigations by the buyers solicitors prior to exchange of unconditional contracts. Completion may be simultaneous or within 2-4 weeks of exchange.

All acquisition proposals will be channelled through the Head of Asset Management and Estates who will then prepare an initial investment report where the opportunity is considered to align with the Council's policy. This will be considered by an officer panel before with any final decision being made by the Cabinet Member for Finance and Resources in consultation with the Leader of the Council.

Each investment will be appraised against a clear and transparent set of criteria by the Head of Asset Management. The criteria will test the rationale for making the acquisition and ensure that the proposed return is realistic and achievable.

Property Acquisitions Criteria

The objectives of the Asset Investment Strategy are to: -

1. Acquire properties that provide a medium to long term investment return in accordance with the Council criteria
2. Reduce risk by building a diverse and balanced property portfolio
3. Support regeneration where appropriate
4. Protect capital invested in properties through proactive asset management

The primary focus will be to acquire investments within borough. Acquisitions will generally be made on the basis that they present a strong long-term income stream. However, acquisitions may be made on the basis that they provide a strategic benefit or support regeneration.

When assessing investments, the Council will carefully consider the activities that are undertaken within the property or portfolio as part of the overall appraisal and specifically consider the following activities: -

- Alcohol and / or tobacco production or sale
- Gambling establishments, including betting shops and casino's
- Pornography or adult entertainment
- Fast food establishments (where these are the sole tenant but may be acceptable as part of a wider portfolio mix)
- Any form exploitation or environmentally damaging operations

The existance of these activities within an investment will not preclude the Council from pursuing the acquisition if they form a small part of a wider portfolio, such as a single shop within a parade or centre.

The Council will aim to build a diverse property portfolio across a range of property types and locations to ensure that risk is balanced against yield and that the Council is not over exposed to one property type or location. The primary focus will be to acquire properties within borough, however out of borough properties will be considered and evaluated on a case by case basis.

Investment opportunities will be assessed and considered against the following criteria: -

1. Location
2. Covenant strength
3. Property Tenure
4. Occupiers Lease length
5. Lease terms including Repairing obligation
6. Existing condition
7. Lot size
8. Net yield (Property and against borrowing)
9. Occupiers activities
10. Portfolio "fit"

Each investment opportunity will be considered against **all** the criteria by the Head of Asset Management and a recommendation made on the viability and opportunity. All reviews will be recorded using an agreed template and held for future reference and audit.

Assessment - Location

The location of each investment is an important factor in understanding its present and future performance. The advantage of sourcing properties within borough is that officers have a detailed knowledge and understanding of the location and future and factors that may affect property within that location. Specific areas will be assessed based on the property type and factors that are likely to affect that property type.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Location	Croydon Prime	Prime locations in District Centres	Croydon Tertiary	Out of Borough where this supports key Council Objectives
Example	Prime industrial estates, East Croydon offices	Town Centre locations or strategic industrial locations in District Centres	Secondary retail parades, offices near transport hubs or major regeneration sites	Good Secondary locations likely to support Education or Adult services

Assessment – Covenant Strength

The strength of an organisation's financial standing is the "covenant strength" and effectively is the ability and probability of the organisation being able to pay the demanded rent to the landlord. A long-established Plc or Ltd company with large cash reserves and strong cash flow would be considered an excellent covenant, whereas a new limited company with limited or no cash reserves would be considered a very weak covenant. Full consideration will be given to the payment history of the tenant to establish whether there are any know issues regarding delays/non-payment of rent

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Covenant	Single tenant with strong financial status	Single tenant with good financial status or multiple tenants with strong financial status	Multiple tenants with good financial status	Any tenants with average or weak financial status
Example	Large, strong Plc or Ltd company with	Large, strong Plc or Ltd with excellent	Multiple tenants (Plc or Ltd) with	Secondary retail parades in adjoining

	outstanding financial status	financial status or multiple tenants (Plc or Ltd) with outstanding financial status	outstanding financial status	boroughs, offices near transport links

Assessment – Property Tenure

Property tenure is extremely important assessment when considering investments. The majority of investment purchases should be unencumbered registered freehold titles providing the Council with ultimate control, however long leaseholds should be considered where the head lease does not have onerous terms and covenant is considered to be strong. All freeholder covenants and clauses together with the occupational lease will be carefully considered by a legal expert before deciding to pursue an acquisition.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Tenure	Freehold	Leasehold in excess 125 years	Leasehold in excess of 75 years	Leasehold in excess of 50 years
Example	Freehold without any onerous conditions/restrictions	Long lease with limited landlord covenants	Medium term leasehold, would need to consider market for resale and cost of extension	Short team, serious consideration to cost of extension and covenants

Assessment – Occupiers Lease length

The length of lease needs to be considered within the assessment of the investment to determine the likelihood of any break or lease renewal. The lease length is critical in determining the income stream. However, where there is an established tenant who is trading well and showing strong profits, a shorter remaining lease term may be acceptable.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Lease length	20 Years +	15 Years + or shorter if under rented and offering regear opportunities	10 Years +	5 Years +
Example	Longer term income stream creating very	Medium term income stream providing good security of	Medium term security providing fair security of income. Any	Short term investment, weak security of income. Serious

	good security of income. Any breaks should be considered.	income. Any breaks should be considered.	breaks should be considered.	consideration of lettable should tenant not renew

Assessment – Lease Terms including Repairing Obligation

Repairing obligations within a lease will assist with understanding the likely cost impact of acquiring the investment. Onerous repairing obligations for the landlord can be both costly in financial terms but also resource intensive for any staff or managing agent that is responsible for day to day operational matters.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Repairing Obligation	FRI (Full repairing & Insuring	Internal Repairing and Insuring	Internal Repairing and Insuring – fully or partially recoverable	Landlord responsible for all repairs
Example	Tenant responsible for everything, best option for landlord.	Landlord responsible for external and structure only with full recovery through service charge	Lease will specify landlord and tenant responsibility and some or all charges may be recoverable or subject to cap	Landlord responsible for everything and therefore costs likely to be high and property difficult to manage.

Assessment – Existing Condition

New or recently fully refurbished buildings will have a premium attached to their purchase, however they are less likely to suffer major maintenance issues and are potentially more marketable to potential tenants. Conversely, properties that require major refurbishment or plant replacement can be attractive as long-term investments properties.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Existing Condition	New build or recent refurbishment including all major M&E	Recent fabric refurbishment or new plant installation	Plant and major structural elements less than 15 years old	Plant and major structural elements more than 15 years old or requiring major refurbishment / replacement
Example	New construction or entire property refurbished	Major structural replacements and fabric refurbishment or full new	Major structure elements and plant is in good working condition and has been	Landlord responsible for everything and therefore costs likely to be high

	including replacement plant	plant installation and upgrade	regularly maintained	and property difficult to manage.

Assessment – Lot Size

A strong portfolio will have a good mix of lot sizes and risk will be spread across the portfolio to ensure that the Council is not over exposed to lots of small lots or one or two very large lots.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Lot Size	£10m-£20m	£5m-£10m & £20m - £30m	£30m + Under £2m-£5m	Under £2m
Example	A reasonable number of medium size lots present low risk within good size portfolio	One large or a few smaller purchases would present low to medium risk within portfolio	One very large or several smaller lots would present medium risk and management strain to portfolio	Lots of small purchasers would present major resource requirement for managing

Assessment – Net Yield

Consideration to the property yield is a key factor in considering investment assets and should be considered on two basis:

Looking at the net property yield (i.e. the acquisition costs including Stamp Duty, agents fees, legal acquisition advice) and of more importance to the Council the return on the cost of borrowing to acquire the asset including acquisition costs (i.e. the difference between the cost of borrowing and income received). Consideration should be given to both elements.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Net property Yield	5.0 – 6.5%	4.99- 4.25%	4.25% –4.0% or above 6.5%	Less than 4.0% or over 8%
Net return on borrowing	2.5% and above	2.0 -2.49%	1.5-1.99%	Less than 1.5%

Assessment – Occupiers Activities

As a public body the Council is committed to certain ethical standards and therefore the activities that take place in any property owned by the Council will need to be carefully considered from both a reputational perspective and ethical perspective. Whilst the Council cannot necessarily influence what its residents do, eat or how they spend their money the Council as a landlord can be seen to promote businesses that maybe don't support activities that are in conflict with Council campaigns.

Assessment – Portfolio "Fit"

The Council will build a mixed and balanced property portfolio. Target property types will be developed to ensure that the Council is not over exposed to any one group.

Criteria	**Excellent**	**Good**	**Fair**	**Marginal**
Portfolio Fit – Property Type	Meets target property type	Acquisition would exceed target property type	Acquisition would majorly exceed target property type	Does not meet any of target group
Example	Target property type is 40% and acquisition would bring portfolio to within 5% of target	Target property type is 40% and acquisition would exceed portfolio target by 10%	Target property type is 40% and acquisition would exceed portfolio type by 25% of target	Property type does not fit target groups

Full Risk & Return Assessment Matrix

Criteria	Excellent	Good	Fair	Marginal
Location	Prime Croydon	Good Secondary Croydon (major district centres)	Secondary district centres	Tertiary/out of borough
Covenant	Single tenant Strong Financial strength	Single Tenant Good Financial Covenant	Multiple tenants Strong Covenant strength	Multiple tenants Good Covenant strength
Lot Size	£5-12m	£12-20m	£20m+	£1-5m
Lease length	15 years plus	10-15 years	5-10 years	Less than 5 years
Tenure	Freehold	Long Leasehold 125 years plus	Leasehold 75-125 years	Leasehold less than 75 years
Repairs	FRI	Internal repairing but 100% recovery	Internal repairing partial recovery/capped service charge	Internal repairs no fix recovery

Condition	New build or recent refurbishment including all major M&E	Recent fabric refurbishment or new plant installation	Plant and major structural elements less than 15 years old	Plant and major structural elements more than 15 years old or requiring major refurbishment / replacement
Redevelopment Potential	Prime site in Opportunity area	Prime site	Good location (non-industrial area)	Secondary location
Portfolio Fit	Meets Target property type	Acquisition would exceed target mix	Acquisition would majorly exceed target mix	Does not meet any of target group
Yields: net property yield Net return on borrowing	5.0 – 6.5% 2.5% and above	4.99- 4.25% 2.0 -2.49%	4.25% –4.0% or above 6.5% 1.5-1.99%	Less than 4.0% or over 8% Less than 1.5%

1. Target Portfolio

The Council will aim to build and develop a diverse investment portfolio consisting of a mix of property types, lot sizes and yields. The target portfolio will aim to reduce risk and exposure to any single property type and ensure that the council will has the best opportunity to derive a steady income to support service delivery.

The borough is experiencing unpresented levels of inward investment and this is due to continue over the next decade. Major developments in and around East Croydon and the town centre has included office blocks, residential units and will soon also include a major new retail centre with the Hammerson and West Field development.

To ensure that a balanced investment portfolio is built this strategy sets out a target for each mix by property type, location, lot size and yield.

Property Type

High street and industrial retail units are struggling nationally with multiple closures or rent reductions being negotiated for established brands and companies As a result, in the change of demand high street retail units are suffering high vacancy levels and long void periods. Within Croydon the major retail led development by Westfield & Hammerson will also have an impact in the town centre. The target for high street type retail units as part of the investment portfolio will be restricted to 10% and will largely be in tertiary / secondary locations where yields will be higher, but risk of business failures higher and weaker covenants will exist.

The target property type is as follows: -

Offices	30%
Industrial	20%
Other *	40%
Retail	10%

*Other will mainly include leisure type facilities e.g. hotels, leisure and food retailers

Location

Prime locations are where businesses want to carry out their activities to maximise efficiency and ultimately profit. In property terms this would generally be interpreted as property in locations that are in demand for that sector and type and traditionally this would be retail units in town centres, offices near major transport hubs and town centre locations and industrial units on estates close to major arterial roads and motorways. Regard will also be had to the location of existing Croydon assets where there is a potential of “added value” from the acquisition of adjoining properties

For the Council’s property investment portfolio, it will be critical to reach a balanced mix of prime property investment which is likely to generate a smaller yield to investing in locations that are likely to be up and coming and see growth and secondary / tertiary areas where housing estates may be located and subject to regeneration. As the property portfolio is being developed for investment the primary objective is income generation and therefore the targets have been set as follows: -

Croydon Prime	70%
Croydon Secondary	25%
Out of Boundary Good Secondary	5%

Lot Size

Lot size refers to the capital acquisition cost of each investment (and subsequent capital value). To ensure that a balanced portfolio is built with an acceptable level of risk it is important to have a target mix of lot sizes. The number of investments (and subsequent number of occupiers) will inform the likely resource requirement and effort required in managing the investment portfolio.

For the Council’s property investment portfolio, a carefully selected range of lot sizes should present a steady income stream with an acceptable level of risk. For example, two or three high value low yield lots will present a steady income stream with moderate resources required to manage the tenants, however if two of the tenants were to vacate or cease trading then the Council would very quickly lose a large income stream. Where consideration is being given to the acquisition of retail/industrial estates, consideration will be given to the individual tenant lot sizes as this will reduce the risk especially if this represents a mixture of uses.

Yield

Like Lot size and location, a balanced range of investment yields will provide the Council with a steady, consistent and predictable return on investment. High yield volatile investments may provide a good short-term investment opportunity; however, they are likely to present a higher level of risk. Low yield investments will generate smaller returns but are likely to present more secure long-term investment streams. A balance of risk to reward is required and therefore a target of yield spread as follows; -

Yield Catagory	% of portfolio
Excellent	30%
Good	30%
Fair	30%
Poor	10%

Acquisition Process

The process map below sets out the high-level acquisition process and approval procedure.

- Opportunity Identified
- Fully Appraised against Matrix
- Obtain Valuation report from suitably qualified Chartered Surveyor
- Request copy of latest Fire Risk Assessment and carry out check/challenge process where appropriate
- Carry out initial financial checks against tenant(s)
- Prepare recommendation report
- Signed off by Executive Director and S151 officer and cabinet member for Finance and Resources
- Offer/counter offer
- Heads of Terms agreed
- Instruct Legal Team – Title due diligence, Contract negotiations
- Instruct surveys (Building, M&E, specialist reports) if not available as part of the Sellers pack. Where reliance can be taken from surveys provided, internally check and seek further advice where necessary
- Funds secured through treasury for whole amount including SDLT with timescales
- Register for VAT/ TOGC as required
- Set up management contract if required
- Final searches and completion including registration with Land Registry

Portfolio & Performance Management

The investment portfolio will be subject to separate management requirements from the Council's own property portfolio. The day to day operational management requirements will be outsourced to a third-party specialist that have the expertise and resources to manage tenants. The provision of any service charge regimes will also be outsourced to a specialist due the legal regulation and specialist skills required to maintain a service charge programme. The cost will be market tested periodically and depending on the lease the majority of administrative and insuring can be recovered from tenants.

External repair costs will be separately budgeted for against the commercial rental income and annual liabilities included within any projected income stream for each investment. Major capital investment and refurbishment programmes to address obsolescence will be subject to the Council's standard capital bid procedure whereby a business case setting out the requirement will be required and subject to officer and member review as appropriate and in accordance with the scheme. It is important that these are accounted for separately from BAU property funding due to the legal obligations to the tenants and the need for investment in the properties to maintain their investment potential

In addition to quarterly high level update reports to the Members Asset Group a more detailed Portfolio Performance Reports will be developed annually and issued to the Executive Director Resources and Cabinet Member for Finance and Treasury to review. The report will include the following performance measures: -

1. Total return – net yield plus capital growth of portfolio as a percentage
2. Effective return – income net of borrowing and other costs as a percentage
3. Growth in asset value – percentage increase
4. Income growth – absolute increase in gross income per year (£)
5. Vacancy rate – by floor space, expressed as a percentage of lettable space and by number of vacant units
6. Lost rental income due to voids / vacant units – actual loss of income (£)

The performance report will include a commentary and narrative on property performance and will include separate reports against the target property types and locations. The narrative will include a more general market commentary which will highlight over and under-performing property types and market sectors to help inform the future strategy and support any proposed disposals or acquisitions.