**Appendix 1**

# GBC COMMERCIAL PROPERTY INVESTMENT STRATEGY (CPIS)

## 1. Introduction

1.1 This Strategy is designed to provide a framework for GBC to be able to compete with other purchasers in the market. It ensures that governance processes are in place, full assessments are made and risks are minimised. Investment opportunities which are not in GBC ownership can be in demand and if so tend to sell quickly. The Strategy also allows for properties to be acquired at speed.

## 2. Background

2.1 GBC's Senior Leadership Team (SLT) has the responsibility for overseeing the development of this Commercial Property Investment Strategy, and subsequently, for monitoring the performance of the investments at an aggregate level (i.e. the overall performance of the portfolio against an agreed benchmark of performance).

2.2 Investments will be made in line with delegated authority arrangements that have been approved by the Council. These will be monitored by SLT.

2.3 The ability to acquire suitable properties will be dictated by what is available in the market. Clearly the wider the geographic boundaries the greater the chance of finding potential opportunities. The geographic boundary which has been set by members is limited to the D2N2 LEP area.

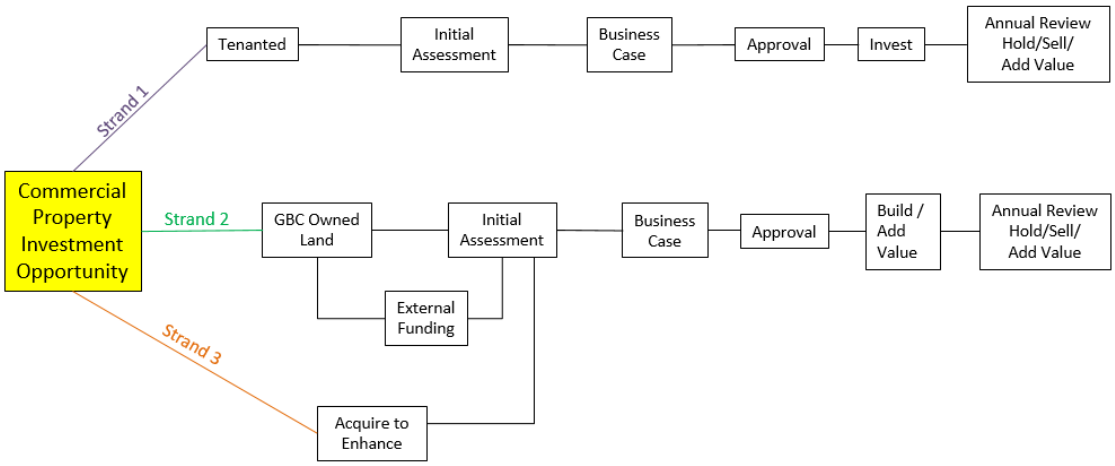
## 3. Key Objectives

3.1 The key objectives are to:

- Acquire properties that provide a net income return to support service delivery and long term capital growth in accordance with GBC's corporate, economic and financial objectives,
- Maximise returns whilst minimising risk through the management processes as outlined in this Strategy,
- Prioritise properties that yield optimal net income return and long term capital growth,
- Protect capital invested in acquired properties,
- Develop a governance framework that enables the Council to move at a timely pace in line with the market,
- Deliver economic benefits to residents.

## 4. The Basis of the Strategy

4.1 The Commercial Property Investment Strategy is made up of three strands, which will individually have their own detailed implementation strategies, and is shown in diagrammatic form below.




4.1.1 Strand 1 – Commercial Property

GBC have identified an initial budget for the acquisition of commercial properties in order to produce a net financial return i.e. after costs and loan repayments. Properties that are most likely to produce the returns required by GBC are typically situated in prime locations with the ability to be let on long leases to tenants with a good covenant strength.

The process for selecting a property under Strand 1 has been fully developed and tested and is attached at Appendix A. It sets out the framework against which commercial property will be purchased, held and sold. Its criteria will only enable the selection of tenanted properties which are located in areas that will give direct economic or social benefits to GBC residents or businesses and which, if held as a portfolio, in aggregate aims to reach the budget target for net revenue income returns.

4.1.2 Strand 2 - GBC Owned Land

GBC owns land which is not currently operationally active. This land could be commercially developed for a financial return whilst meeting the requirement for the maintenance of economic growth in line with the Gedling Plan.

Alternatively, this land could be used to develop properties which increased economic or social growth in the borough. It is likely that creating investments that boost the economic or social growth would have lower, but potentially still positive, returns compared to other options such as those outlined in Strand 1, which may tend towards maintaining rather than boosting the economic and social growth of the borough. There are opportunities to intervene, where the market cannot deliver, to boost the vitality and viability of town/local centres or on industrial parks. This could be through intervening in the market to help SMEs for example through developing business units for their occupation where the market is reluctant to build due to long capital pay back periods, or where the current demand for the properties is uncertain and could improve with the Council's input. A further area for exploration is therefore in relation to land which GBC currently owns. Such land could be developed to create properties which could be let out for financial return and maintain or boost economic growth.

No budget has been set aside for this Strand. The process for selecting a property under Strand 2 will vary because each opportunity will be assessed on it own merits

and amounts allocated will be dependent on the business cases presented and budget approval requested through normal processes.

4.1.3 Strand 3 – Acquire Commercial Property to Enhance

The options under this Strand would include for the purchase of properties to add value to them. Examples include the refurbishment or better management of existing privately-owned buildings or the purchase of land for the development of properties that would be privately let.

No budget has been set aside for this Strand. The process for selecting a property under Strand 3 will vary because each opportunity will be assessed on it own merits and amounts allocated will be dependent on the business cases presented and budget approval requested through normal processes.

## 5. Approval and Governance

5.1 Following the initial assessment of each opportunity under any of the strands, if successful, a detailed business case, including due diligence work, will be produced that outlines all of the costs, benefits and risks associated with the progression of the investment opportunity.

5.2 If an appropriate budget is not in place, then budget approval will be part of the process.

5.3 If approved, and a budget is in place the investment will be made.

5.4 This Strategy sets out the arrangements for the ongoing management and reporting of performance and risk in relation to the investment portfolio at paragraph 7 below. The management of the portfolio will be undertaken by SLT with arrangements for reporting by exception established so that full council is aware at the earliest opportunity of any material increase in risk or threat to ongoing yield.

## 6. Risk Management

6.1 The risks of both the individual investments and the cumulative impact of all investments made will be considered, together with the interaction of individual risks. The overall risk appetite for commercial investments of the Council is defined in the Council's Prudential Indicators approved by Budget Council each financial year. These indicators demonstrate the full scope of commercial property investment plans and set out risk exposure in terms of proportionality of capital investment, borrowing need and revenue budget reliance in the context of the total Council budget.

6.2 Property investment will necessitate exposure to risk, whereby the total invested can exceed the market value. Prices are prone to fluctuation, particularly due to changes in locality, the general economic outlook, or property specific risks, such as tenant failure.

6.3 Furthermore, property investment is relatively illiquid, requiring a longer term approach. In the event of a market crash, property is much less liquid than other assets and can be hard to sell.

6.4 The council's exposure to risk equates to the total amount of capital invested, plus financing costs (such as interest due on loans), repayment of debt, property operational running costs (management, vacant business rates, service charges, professional fees etc.) and legislative compliance. The Council's risk quantum will be defined as this total exposure, less the value of held assets.

6.5 Whilst risk is a natural element of investment that cannot be eliminated, it can be proactively managed.

6.6 The CPIS is built upon a series of conventional measures to manage risk:

- Financing and repayment of debt risk - GBC property investments will require borrowing. Borrowing is currently available with fixed interest for the duration of any loan, via the Public Works Loan Board, mitigating the risk associated with exposure to interest rate fluctuations. In addition, GBC must set aside the Minimum Revenue Provision (MRP) i.e. debt repayment each year from the annual revenue budget. Only properties that are expected to more than cover loan interest repayments and MRP will pass the business case stage.
- Portfolio diversification risk – spreading capital across a variety of asset classes, locations and sectors will reduce the risks of exposure to a single asset, tenant, or market failure.
- An established process to bring forward opportunities, develop and approve outline and full business cases as defined in this Strategy;
- Portfolio management risk – the use of independent consultants to assess properties prior to bidding and during ownership, including the carrying out of due diligence on all physical, financial and legal aspects of the investment will minimise the risk associated with not having all of the in-house expertise or resilience necessary to compete in the private sector.
- Market Conditions and Fair Value Analysis - will be completed to highlight key risks or changes that may affect the security, liquidity and/or yield of the investment portfolio and ensure that underlying assets continue to provide security for capital investment.

## 7. Managing the Portfolio

7.1 In respect of Strand 1, it is thought probable that GBC will not purchase just one commercial property as the risks associated with either tenant or sector failure or any other unforeseen factors are likely to be proved unviable at the business case stage. Consequently GBC will be likely to acquire a portfolio of tenanted properties which will enable better risk management.

7.2 In relation to all 3 strands, once properties have been acquired GBC will seek to add value to the economic, social and financial returns. It will do this by maximising its position as a local authority by being an excellent commercial, economic and social landlord and a key local stakeholder.

7.3 Active management of the portfolio will be key to maximising value. Tenant covenant strength, compliance with lease obligations, such as repair and maintenance, management of the payment of rent and service charge will need to be actively managed. External managing agents could be appointed to manage the investment portfolio properties and to undertake the annual review of the portfolio to enhance the capacity and/or skill set of the existing Property team.

7.4 In addition to ongoing monitoring, a comprehensive annual review, including detailed assessment of key performance indicators - to quantify, monitor and benchmark the portfolio operation and strategic direction, will be undertaken by SLT. The Annual Review will:

<u>Consider The Portfolio</u>

The consideration will include:

- A market update on activity and market conditions and forecasts that may affect security, liquidity and/or yield of the portfolio to identify the need for mitigating

actions e.g. re-purposing or sale of any asset(s), where fair value is no longer sufficient to provide security against loss.

- A review of the current CPIS.
- An external market valuation of the portfolio to monitor and benchmark performance, including meeting financial requirements.
- An updated (five year minimum) cash flow forecast comparing expected rates of return and identifying contingency plans should there be a fall in income.
- An updated (five year minimum) capital expenditure forecast.
- A review of each asset to determine whether it should be retained, sold or repurposed.
- A review of the previous year's performance including any key performance indicators (KPIs).
- A review of the underlying lifecycle of the asset, holding period and future refurbishment expectations.

Produce an Asset Management Report

The report will include:

- Rent collection rates, arrears and service charge reconciliation.
- Advice on all critical lease matters including rent reviews, lease renewals, and lease breaks.
- Dilapidations, health and safety and insurance claims.
- Capital expenditure over the preceding 12-month period.
- Tenant covenant strength monitoring report.
- Tenant compliance with lease terms and any default, or issue.

**APPENDIX A**

**SELECTING A COMMERCIAL PROPERTY – STRAND 1**

Assessment of each opportunity, prior to recommendation to invest, will pass through an initial assessment and then, if successful, a Business Case will be developed.

Firstly the opportunity will have to be shown to contribute towards the economic or social prosperity of the borough itself, or the D2N2 LEP region. Any opportunities that do not meet this criteria will not be assessed further.

Opportunities that contribute towards the economic or social prosperity of the borough itself or the D2N2 LEP region will be assessed against a matrix (Assessment Matrix) that includes the following criteria:

*Covenant -* The "covenant" of the tenant(s) is a factor of both its financial strength and the risk of its business failure. Reports from a nationally recognised referencing agency will be used to assess the covenant strength of the tenant(s). The stronger the covenant the more likely it is that the tenant will be able to pay its rent and comply with other lease obligations up until the end of the lease term.

*Unexpired - lease length/ break* The length of the lease will determine the period over which income will be receivable, provided that the tenants comply with their lease obligations. The longer the term, in most cases, the better and more secure the investment. Break option dates will be considered as if they were the lease-end date. If the current rent receivable is above market rent there are implications for lower future income streams which will be considered.

*Repairing - obligations* The wording of the lease will dictate the amount of repairing and insuring liability that either the landlord or tenant has for the property. It is preferable for the tenant to have the financial burden for all external and internal maintenance, decorations and repairs as well as the liability for insuring the building as this gives more certainty to the predictions on how much of the income receivable can be used to pay off debt/reinvest/support services etc.

*Sector -* The highest growth sectors currently include the office and industrial sectors (industrial also includes logistics). Tertiary sectors are where lesser growth takes place and currently include Retail Warehouses. Much other retail is currently in decline. Investing in a high growth sector makes the premises easier to let if the tenant vacates.

*Tenure -* Freehold ownership creates the best possible interest in a property. Considerations on leasehold periods are liquidity and how marketable properties are as time progresses.

*Expected remaining useful life of the property* - The age and/or obsolescence of a property will determine when major expenditure will be required to keep it in good repair and condition as well as being attractive to prospective tenants.

*Location* - Major Prime locations are in major cities e.g. Nottingham. Minor Prime locations are in smaller cities e.g. Derby. Major Secondary would include growth towns/areas e.g. Colwick and main arterial routes e.g. A60. Minor Secondary locations include Arnold. The better the location the easier it will be to let the property if the tenant vacates.

The Assessment Matrix is shown below. To progress to the Business Case stage of the process, four out of the seven criteria must be graded as green or amber. The Property Department will carry out the assessment of each property with the Assessment Matrix. Each assessment will be recorded for future reference.

| Criteria | Excellent | Very Good | Good | Acceptable | Marginal |
|---|---|---|---|---|---|
| Covenant | Multiple Tenants with an average high covenant strength | Single Tenant with high to moderate covenant strength | Multiple Tenants with average covenant strength | Single Tenant with moderate to low covenant strength | Single or multiple Tenants with average low covenant strength |
| Unexpired Lease Length/Break | 15 years or over | 10-14 years | 7-9 years | 5-6 years | Less than 5 years |
| Repairing Obligations | Tenant Repairs and Insures internal and external | Internal Repairing 100% Recoverable | Internal Repairing Partially Recoverable | Insuring Only | Landlord |
| Sector | Major Prime | Minor Prime | Major Secondary | Tertiary | Other |
| Tenure | Freehold | Long Leasehold with 125 years minimum remaining | Leasehold with <125 years >75 years remaining | Leasehold with <75 years remaining | Leasehold with <50 years remaining |
| Expected remaining useful life of the building | 50+ years | 42-49 years | 34-41 years | 25- 31 years | Less than 24 years |
| Location | Major Prime | Minor Prime | Major Secondary | Minor Secondary | Tertiary |

The passing of the Initial Assessment will initiate the production of a business case.

Due diligence will be carried out at this stage including the assessment of the structural condition of the property and ground conditions as well as the surrounding land uses including any current or proposed planning approvals. If the Business Case is viable approval will be sought to purchase – see Paragraph 5. Management of the investment will be in accordance with paragraph 7.