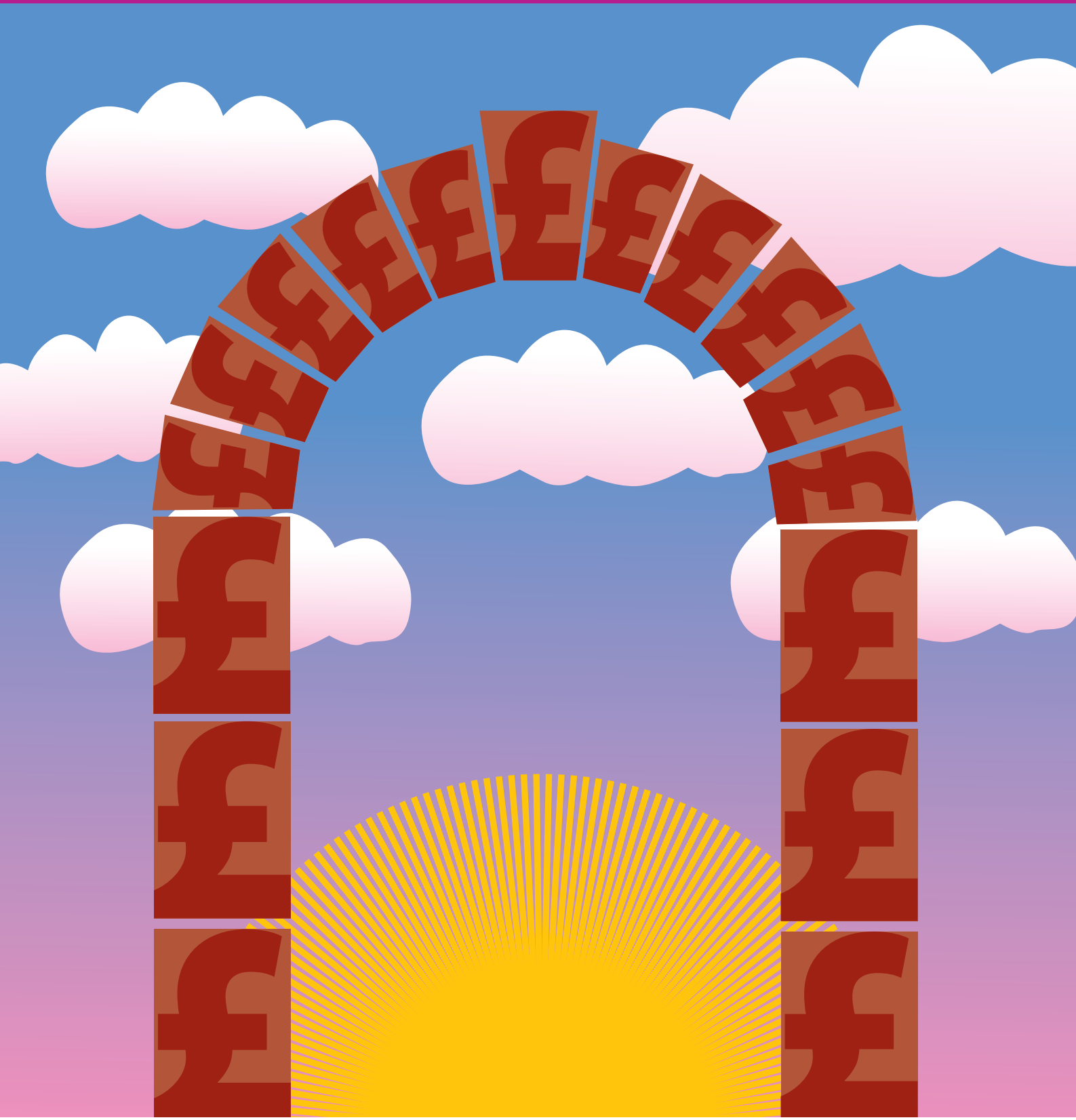


Bricks-Mortar-Money

Property investment as a potential means of securing an additional and sustainable source of revenue



Bricks-Mortar-Money

Property investment as a potential means of securing an additional and sustainable source of revenue



APSE (Association for Public Service Excellence) is a not-for-profit local government body working with over 300 councils throughout the UK. Promoting excellence in public services, APSE is the foremost specialist in local authority front line services, hosting a network for front line service providers in areas such as waste and refuse collection, parks and environmental services, leisure, school meals, cleaning, housing and building maintenance.



CIPFA Property is a leading authority on public sector asset management within the UK and a trusted partner to public finance and property professionals in their delivery of efficient asset management.

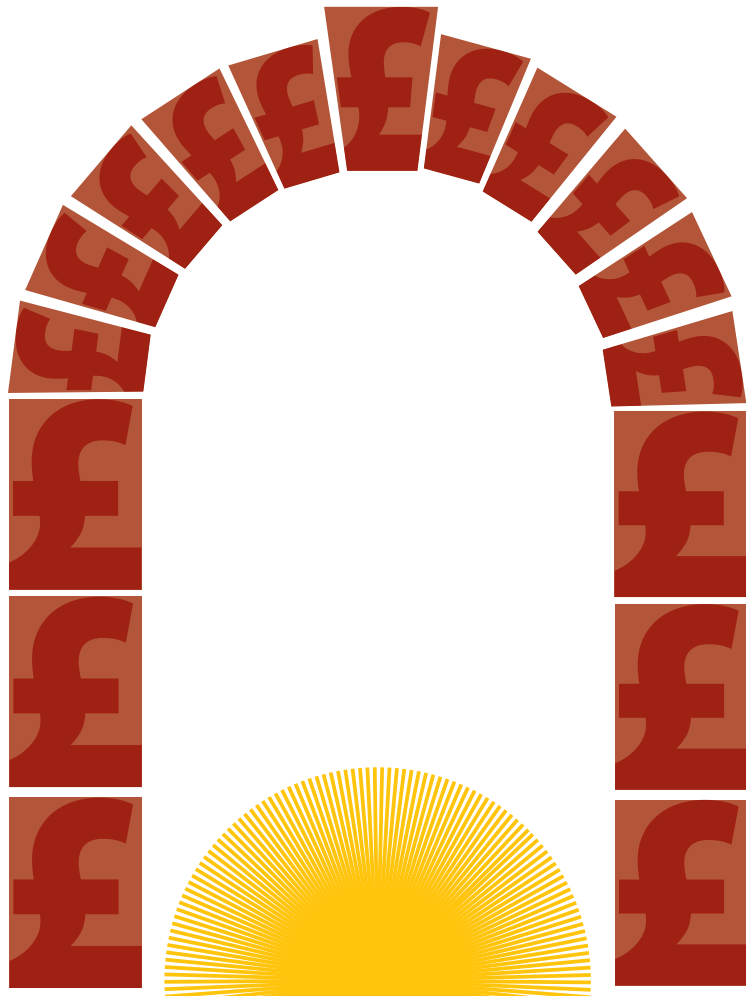
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Foreword

This publication looks at the trend for increased commercialisation of the local government property estate as a means of securing additional income streams.

The aim is to disseminate information across the sector highlighting some of the different approaches taken by local authorities as part of their strategies for addressing the financial challenges they face.

Our research shows that there are a number of different methodologies being adopted. Whilst these may involve different interpretations regarding legislation and powers available to undertake such activities we are not in a position to comment on these interpretations which are based on legal and financial advice obtained by each relevant authority.

Whilst councils will make policy decisions based on individual circumstances, this piece of research is designed to explore and identify how some authorities are facing these challenges and responding.

APSE and CIPFA are not in a position to endorse any of the case studies highlighted, but we hope that by sharing examples of activity it will assist local authorities who are considering venturing into this market.

We would like to thank all the Local Authorities who took time to respond to our survey and those who provided additional information for our case studies, clearly without that active participation research such as this would not be possible.

Paul O'Brien

Chief Executive, APSE

Executive summary

Local Authorities are believed to have spent more than £1bn on property assets in 2016 as part of a strategy to provide income intended to mitigate Central Government funding cuts and the withdrawal of the Revenue Support Grant. Using revenue from such investments has allowed councils to support public services, with a small number of councils claiming that using such income will assist them to become fully independent of national grant funding.

Our research has shown that an ever increasing number of local authorities, of all sizes, are implementing strategies that involve acquiring property purely for investment purposes.

Essentially this is not new, many authorities have successfully carried out similar types of activity over many years. Indeed many councils have inherited or built significant commercial holdings over a substantial period of time. Whilst there are a number of reasons for undertaking such commercial activity, it is most usually entered into for a combination of two purposes; achieving commercial income, and/or promoting local employment or regeneration initiatives. So while being commercial is not new, the current level of intense focus among councils probably is. A much increased focus on local economic regeneration is one aspect of this. However, we are seeing an increasing number of councils investing specifically to secure income yielding assets and this intensity is sparking significant interest in the media. Indeed some authorities are building up an investment portfolio that comprises property well away from their administration area with examples of authorities investing in properties located all around the UK.

There are perhaps three drivers to this new intensity.

- First (and foremost), the impact of austerity with cuts in funding and increasing cost pressures resulting in a search for alternative income sources to at least help soften the impact on services.
- Second, the encouragement for local authorities to strive to be more self-sufficient in their income sources. Again putting the search for alternative income at a premium.
- Third, the urge of local leaders to shape their communities for the better.

All these drivers are deeply embedded in current government policies and amongst other impacts provide an understandable impulse for local councils to act more commercially to grow local economies and also procure commercial assets for the income yield.

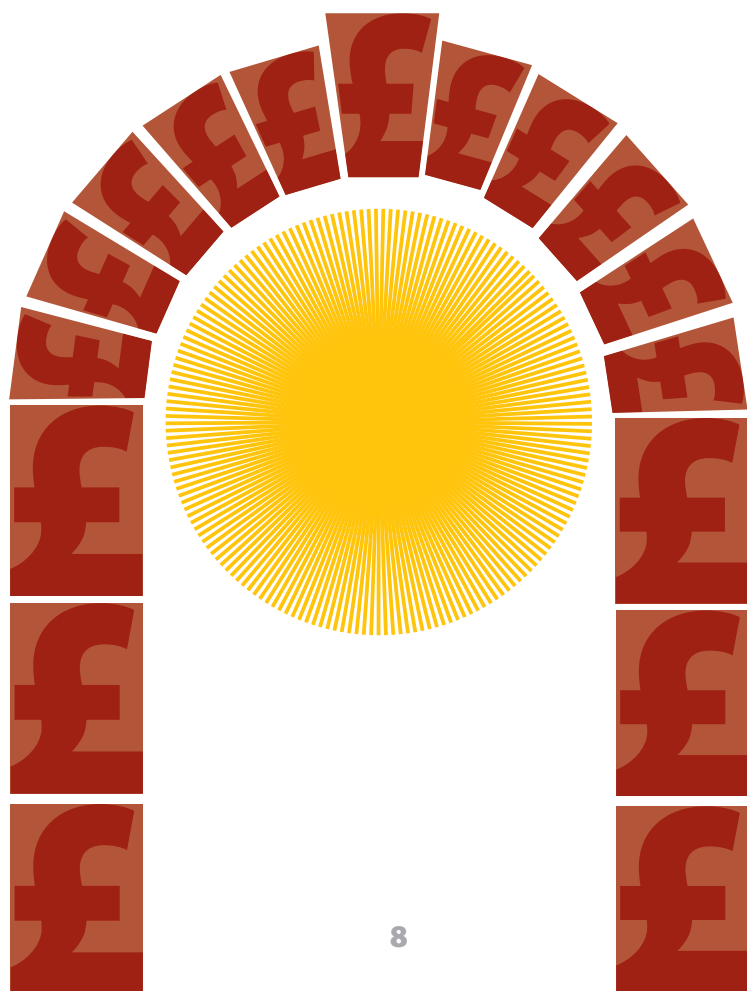
In terms of purchasing commercial assets there are one or two authorities which have made large single investments in excess of £250m. Our research would indicate that this is very much the exception rather than the rule – in the main authorities who are currently active in this area have set up investment budgets of between £10 and £100m, generally to make new investments rather than to fund rationalisation of the existing estate.

Figures indicate that in 2016 some 49 local authorities spent a total of £1.3bn on property assets – a massive jump from the £142m total for 2015. We understand a further £221m had been spent by the end of March 2017, the majority of which has been spent on investment rather than operational property.

Clearly Local Authorities are helped by the fact that they can borrow from the Public Work Loans Board and other lenders at an extremely competitive rate because of the reality of their inherently strong credit position. With property assets tending to yield between 4.5 per cent and 7 per cent this sort of investment appears to make economic sense to help offset the impact of funding cuts elsewhere.

We believe that this entrepreneurial approach has potential as long as local authorities have a clear and transparent strategy. Like many 'in vogue' and 'trending' initiatives it is not a magic bullet and approaches will need to be proportional. This means putting suitable governance arrangements in

place, having access to the necessary skills to understand and manage the commercial risk involved and establishing affordability on the basis of the risks of what could go wrong, not just on the cost of borrowing.



Introduction

Local authorities throughout the UK are concerned that changes to how they are funded will potentially leave a significant shortfall in their revenue budgets on top of the reduction in real terms that are already being experienced.

Research undertaken by the New Policy Institute for APSE in 2016 indicated that with the Revenue Support Grant being phased out by 2020 over 80% of council funding will need to be raised locally mainly via Business Rates and Council Tax but supplemented by other income sources such as charged for services and investment returns.

This is a significant issue because the capacity to raise revenues via Council Tax and Business Rates is seen by many as being uneven. Some areas will do well, others will not. So while core spending power may not decline significantly if the social care precept on Council Tax is utilised, the financial squeeze on services whose funding is not ring-fenced like social care and education could be reduced by 20%. This means that, for a large proportion of local authorities, additional, secure and sustainable sources of ongoing income will be required to maintain services at anything like current levels.

This has encouraged public bodies of all shapes and sizes not only to reassess how they use, and increase the benefit from, their current property portfolio but also to invest in property in non-traditional ways. To see property as a pure investment opportunity or, as they have in the past, to support regeneration and economic development whilst also producing a significant beneficial rate of return on the capital investment made.

The following excerpts from recent job adverts would suggest that more and more local authorities are, or will be, looking for property investment opportunities:

..... we are looking to expand our property portfolio further in order to generate revenue to support council services

..... you will be dealing with and managing a mixed and complex caseload, identifying opportunities for revenue generation.....

..... you will be managing the current and future non-operational estate to maximise revenue in line with the Council's Commercial Investment Strategy the aim being so we can continue to provide efficient and cost-effective services to our local community in spite of public sector austerity.....

..... generate income from property to help mitigate reductions in grant funding by adopting a stronger commercial approach.....

..... our Investment Property Management team currently generates an annual income of £30 million from a wide and diverse portfolio and we are looking to appoint a Chartered Surveyor to contribute to the continuing success of delivering a high quality and efficient service

A few local authorities are also starting to invest in property outside their administrative areas and, occasionally, looking for ways to operate outside the legislative constraints that were traditionally imposed on Local Government but have been relaxed as a consequence of the Power of General Competence granted through the Localism Act 2011.

The economic climate that has existed since 2008 has seen the rate of return from traditional investment routes such as equities and bonds or simply letting capital reserves 'sit in the bank', drastically reduce.

Some Local Authorities are relatively capital rich but revenue poor, however capital cannot simply be used to support a revenue shortfall unless significant service improvements/efficiencies are made as a result, in any event such a policy is clearly unsustainable and authorities are now looking at ways of

making capital work to fund their shortfall in revenue.

Local Authorities currently also have access to relatively low cost and long term borrowing via the Public Works Loans Board and other lenders. Borrowing to invest in property that will not only generate a 6% to 8% return on investment, but also gaining an asset that will potentially increase in value would therefore appear to make good business sense.

There have recently been a number of negative articles in the National Press and some Members of Parliament have questioned and criticised this strategy and likened it to the Icelandic banking crash or LOBO loan fiasco. However much of this criticism has been made on the back of headline grabbing investments made by one or two councils rather than on a balanced view of activities which our research shows are much more common.

Indeed our research shows that in general Councils are very much aware of the potential risks involved and are generally cautious regarding this type of investment. Many are taking external expert advice, particularly when making investment outside their local area and are consciously avoiding the 'all their eggs in one basket' scenario by investing in a variety of property sectors and in various areas of the country.

A simple 10 step approach to getting started

1. Establish what you've got

Local authorities have accumulated a myriad of land and property assets over the years for a range of different reasons. Many of these assets will be 'non-operational' and let to third parties, which can include shops, industrial units, offices and farms. Collectively these are generally known as 'Tenanted Non-Residential Property' (TNRP), however they are often incorrectly referred to as the 'Investment' portfolio. The problem is that TNRP can be held for a variety of reasons besides simply making a return. Whilst some will be held purely for investment, others will contribute to job creation, regeneration and supporting sustainable communities. Some will even be held for historic reasons which may no longer be relevant to the council's activities. As such they are not all investment assets and should be treated differently.

The first step for any local authority is to establish what they already have, and, why do they actually hold it. What is pure investment and what is not?

This undertaking alone is likely to have benefits as authorities start to question why they actually have held assets over a number of years, and whether the original reasons for acquisition are still relevant.

CIPFA property benchmarking over the past few years has highlighted a small number of authorities where costs of managing such property actually outweighs the income generated. If the assets do provide wider social value benefits this might be justified, but if they are purely for investment then obviously this is unsustainable. The problem is that many councils don't actually know how their TNRP does perform or haven't developed a clear understanding of what measures they should be using for assessment.

Type of Asset	Reasons Held
Investment Assets	Purely for rental income or capital appreciation
TNRP Non Investment Assets	Whilst this might include financial income it will only form a part of the consideration. Other reasons could be: Job creation Encouraging sustainable communities Supporting regeneration or development Sustaining the commercial viability of a town centre

2. Measure costs and performance of existing investment assets

The costs and performance of all TNRP should be measured on a regular basis however for pure investment assets this is absolutely critical. The sole reason for holding these assets is financial return, therefore every building, management and support cost needs to be identified and set against the income generated. Performance must be measured accurately to ensure that the best possible return is being made on any investment.

Whilst building costs such as energy and maintenance spend are often taken into account, management and support costs are commonly subsumed or accounted for in wider local authority activity. This makes it difficult to identify and understand the true return and value of the investment estate.

Low costs however do not necessarily add up to good performance. One authority in the North West of England recently undertook an exercise to establish the costs and income of their investment property. This was the first time in some considerable while they had undertaken such an exercise and over the years the differentiation between their pure investment property and wider TNRP had become muddled. What they identified was underfunding within both the management and maintenance functions of their assets, resulting in under occupancy and an overall inadequate return on investment. As a result they developed a strategy to work with a commercial management partner and introduced targeted funding for improved maintenance standards which resulted in the property becoming more attractive to tenants, a strategy that has significantly improved income generation.

3. Strategy

Once councils have established what they already have, they should set out a strategy for the future. This could simply involve improved management of what is already held, but increasingly the focus is on disposing of underperforming areas of the portfolio and acquiring additional property with improved investment potential.

An investment strategy should provide a framework and parameters within which investment decisions are taken and the kinds of assets which will, or will not be invested in.

The strategy is also likely to take into account the return/yield required with the aim of maintaining a clear margin over the cost of capital investment and has the potential to increase through future growth whilst retaining liquidity and preserving if not enhancing capital.

It should also take into account the council's appetite to risk and consider an even balance of risk and return through diversification. It should be remembered that commercial yields can go down as well as up and are intrinsically linked to economic cycles. For local government the reputational risk and damage that follows failure is often much greater than in the private sector.

4. Geography/Boundaries

A key consideration when developing an investment strategy is to decide on how far afield an investment might be made. Some local authorities have made the conscious decision to keep all investments inside their own geographical boundaries, others are prepared to acquire property within their local region but no further, whilst a growing number are seeking opportunities where they present themselves throughout the United Kingdom.

The advantages of constraining an approach to the local area are likely to be:

- market knowledge, regarding both property and potential tenants
- local understanding of the planning regime
- greater political and public acceptance
- awareness of 'up and coming' localities which could see potential growth
- close proximity to assets which is likely to make management activities easier and reduce costs particularly if carried out in-house

The advantages of acquiring assets further afield could include:

- more choice
- greater opportunity to assemble a more balanced portfolio, spreading the risk not only across different types of property, but also between regions
- less likelihood of political interference/influence in investment decisions

5. Funding

A substantial component of any approach is determining the level of funding that will be made available for investment and how this funding will be provided. Whilst some authorities will use their reserves to fund investment acquisitions, more commonly various forms of borrowing are utilised and business cases need to ensure that anticipated returns adequately exceed the costs of servicing any loans. CIPFA's Treasury Management Code stresses the importance of a prudent investment strategy focussing on security, liquidity and then yield. This means that that first and foremost local authorities must ensure the security of their principal sum invested. In other words they can get the capital invested back in full should anything go wrong.

The second step is to consider the liquidity they require, i.e. that they have funds available when needed, and so should consider the length of an investment. Only once these first two are satisfied should the yield or return on the investment be considered.

6. Skills and capacity

A local authority will need to examine the skills and capacity it currently has in place and whether these are sufficient to effectively develop and manage an investment portfolio. Skills may be required in a range of areas, not only the identification and acquisition of investment property, but also those involved in the day to day management of assets, through to treasury management and even legal advice. Elected members and senior managers making decisions regarding investments may also need training to gain a basic understanding of commercial property and property investment.

Once an authority has established which skills it does have in place it must establish where, and how, any gaps will be filled. This could be through the recruitment of dedicated staff if the ambitions of the council warrant it, indeed, as highlighted earlier in this report, there has been a recent spate of job adverts from councils targeting applicants with commercial property expertise. Many councils however will buy in external advice as and when it is required, as there is unlikely to be sufficient activity in this area to justify new, adequately salaried, full time post/s.

7. Delivery models

Many of the previous steps will raise questions within the local authority about the most suitable delivery model to adopt. It is not the intention of this publication to go into the detail, including the legal and tax intricacies of every approach, however the most popular broad options are briefly set out below.

- The simplest, and currently most popular option is through utilisation of existing staff, supplemented by external expertise where required. A local authority will continue to have complete control over direction, there is no sharing of growth or income and total flexibility in decision making. This approach however is not usually very ambitious and unlikely to generate significant change. The commercial skills required are often lacking and/or staff are engaged in other day to day activity reducing their effectiveness in managing the investment estate.
- An increasingly popular approach is to examine and change the current in-house resource to focus more appropriately on investment potential. This is likely to include strengthening and redirecting the current team capacity and capability including changing working practices and reporting requirements. This hopefully will address some of the problems with the first option, but still is often rooted in current operational approaches. A number of councils have cited this as a reason for moving to a wholly-owned and controlled arm's length company.
- An alternative to direct property investment is a property fund where multiple investors' money is invested in a variety of properties. This reduces risk by having a diverse property portfolio in terms of location, property type (e.g. retail, industrial), tenants and size of individual acquisitions. It also

enables relatively larger acquisitions than may otherwise be the case for an individual investor as each investor's capital is pooled. Returns are usually on the basis of dividends and return of capital when the units are sold. The value of the units can go up or down depending upon how well the properties perform.

- Delivery through an arm's length company allows a local authority to retain much of the control of the first two options but without many of the constraints. Decisions can be made outside the normal council approach and there is likely to be a clearer more focussed remit away from other operational distractions. However tax, 'Teckal', state aid and other considerations may come into play which potentially could tilt the balance in favour of one of the in-house solutions.

8. Acquire carefully (Risk Management)

This may seem an obvious step but is worth setting out and considering carefully. Property assets are not commodities and each one is unique. A council may have a sound approach in place but it will need to be applied prudently, and each asset must be assessed carefully before acquisition preferably utilising an agreed scoring and assessment matrix. Any new acquisition should fit into the agreed strategy, and the associated risks must be acceptable.

There is always a danger with a 'war chest' of money burning a hole in an investment budget that decision makers will get caught up in the moment. Councils must be convinced that an asset is right for them, only commit if they are certain, if not happy, walk away.

9. Acquisition and management

This is a dynamic area which generally does not sit well with traditional officer, committee or cabinet meeting schedules and structures. Decisions often need to be made quickly otherwise opportunities can be missed. Our research shows that where councils are active in this investment area there is an increasing level of delegation being authorised to enable them to move quickly when properties come onto the market.

The work doesn't stop once all the assets have been acquired. Approaches will need to be in place for maintenance, rent reviews and collection, valuations etc. This often will be managed under separate arrangements from the remainder of the local authority's estate as commercial tenants may expect a particular standard to be maintained.

10. Monitor, review and adapt

Ongoing performance measurement is the final essential ingredient to ensure an effective investment estate. Monitoring key financial benchmarks will enable a local authority to react if specific assets do not fulfil their anticipated potential, or if local markets change over time. It is important that the investment estate is seen as something that needs to be continually moulded to achieve the best financial return rather than just sitting back and expecting the money to roll in.

Research methodology

In order to better understand the activities being undertaken we initiated a survey of local authorities to understand the appetite for increased investment in property assets.

From within the responses we selected a number as follow-up case studies which have been included within this document. These were supplemented with additional authorities who were known to be active in this area. These case studies involved initial contact by phone or by face-to-face interviews with Asset Managers, Finance Directors and Council Leaders and /or Portfolio Holders as appropriate.

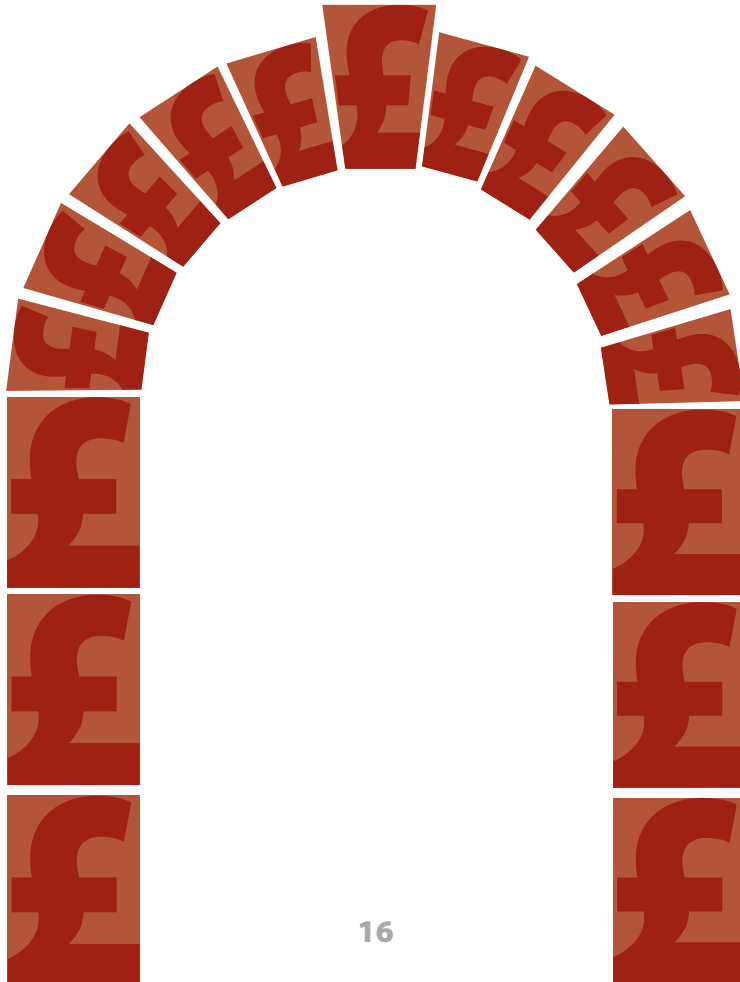
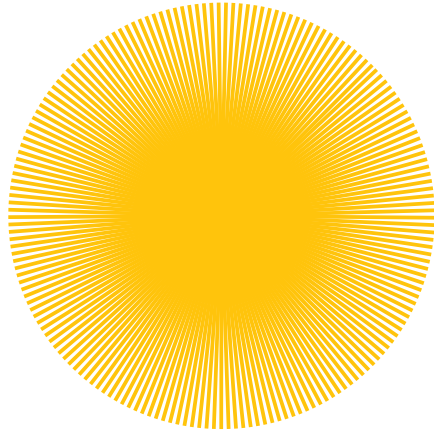
We made this purposive selection in order to speak to a range of local authority types, located in several different regions and where possible with differing investment strategies.

Our initial intention was to look solely at 'Non-Residential Property' leased to third parties and held either solely for investment purposes or held for wider objectives such as part of a community strategy or encouraging development and regeneration whilst still producing an income. Initially we opted to exclude activities regarding residential housing stock, however, during our early research, it became clear that some Local Authorities were looking to invest in residential properties outside their traditional Social Housing activities and we have therefore included examples within the case studies.

Survey results

From our initial survey we were able to identify a cross-section of Local Authorities who were willing to take further part in our research. These comprised a broad mix of: District Councils; Metropolitan Boroughs; County Councils and Unitary Authorities.

- All currently had an investment property portfolio
- 6 held commercial/investment property outside their administrative area
- 5 were actively looking to acquire investment property to purely support their revenue budget
- 12 stated that the acquisition of new investment property was part of a strategy to make the authority less dependent on Central Government financial support
- The approximate capital value of the Investment Property Portfolio ranged from £1.5m to £200m
- The number of assets within the Investment Property Portfolio ranged from 5 to 2000
- The approximate total income from the Investment Property Portfolio ranged from £145k to £11m
- 8 stated that they were actively targeting their 'commercial' property to help drive regeneration or similar activity



Case studies

The following selection of case studies are based upon either follow-ups from our initial survey, contact with authorities known to be active in property investment and articles, documents and committee/ cabinet papers in the public domain or that we have been given access to.

This involved initial contact by phone or by face-to-face interviews with Asset Managers, Finance Directors and Council Leaders and /or Portfolio Holders as appropriate.

By highlighting these Case Studies APSE and CIPFA are not endorsing individual examples or indeed legal interpretations, rather providing information on how a selection of local authorities are approaching this area.

Case Study 1: Mansfield District Council – Commercial Investment Portfolio

Anyone staying at the Travelodge in Edinburgh's Learmonth Terrace, located less than a mile from the City Centre, would be surprised to learn that the property is owned Mansfield District Council.

Together with another Travelodge and associated commercial premises in Doncaster, a leisure gym in Manchester, a commercial vehicle garage in Glasgow and a combined office and residential building in London the Edinburgh property forms part of Mansfield's growing commercial portfolio.

The council has allocated £26m for property investment, of which £20m has been spent so far and Mick Andrews, the Director of Commerce & Customers, explains:

"To ensure that we do not get too reliant on one sector or one area we want a spread of sectors and places for our property investment strategy. We are in two different parts of the leisure sector and are now moving into offices. We are borrowing and investing using the power of general competence and the council's auditor is happy with the move into property.

As Finance Director I have to set a robust budget with reliable rental income, so that income is something you have to build into any risk analysis. Having high quality leases and tenants mitigates that risk, Like a lot of councils, we've always had a property portfolio in our own area and for historic reasons a lot of it has been 1980s and 1990s industrial units now reaching the end of their useful life. The idea has been to sell off those and replace them with fewer and higher quality buildings, not necessarily in the district."

"In London and Edinburgh we expect property prices to be rising so... we would hope that if we sell the buildings they will generate receipts well in excess of the borrowing costs. The less busy property market of Doncaster was chosen because we also need good quality leases and tenants so you have a reliable rental stream. There is some commercial property in that too and there are good guarantees for income from rents."

Opportunities brought to the Council by external agents are assessed against a matrix that tests location, tenants, lease, income and sector. Mansfield's internal staff developed their own scoring matrix, identify potential investment opportunities and close the deals, there has been no need to commission any other external expertise.

The Council has recently assessed all its existing commercial property against its own internal 5Q scoring matrix used to assess new investment opportunities and has identified 13 assets (comprising 41 managed units) for disposal. These assets will all be sold in 2017 with the capital receipts being used to purchase another investment property somewhere in the UK.

Case Study 2: Sevenoaks District Council - Self-sufficiency Plan

Sevenoaks District Council has been the recipient of a number of prestigious awards over the last 12 Months. In addition to being overall winners of the Guardian's Public Service Awards (as well as winners in the Finance Category) and the Local Government Chronicle's Council of the Year they were also declared joint winners, together with Leeds City Council, of the 'Commercialism in the Property Estate' category of the 2016 MJ Awards and joint winners, with Liverpool City Council, of the 'Innovation in Finance' category.

All the awards recognise two key achievements: a ground-breaking financial strategy which has enabled it to become the first local authority in the country to become financially self-sufficient, and the cultural transformation across the council that has enabled this to happen. This means that the authority is no longer reliant on central government to fund its services.

The government's Revenue Support Grant had traditionally formed an important part of Sevenoaks District Council's overall budget with other funding coming from council tax, business rates, interest from savings, income from investments and charges for some services. But in a bid to protect local services, in 2013 the Council set itself the ambitious target of no longer having to rely on the government support grant. With austerity biting, and the council projecting funding would never return to previous levels, it needed to prepare for the challenges ahead. Interest rates remained extremely low, as they still do today, and there were new powers available to local government via the Localism Act 2011. All this combined to persuade historically risk-averse Members that doing nothing was worse than doing something: they decided to put an ambitious strategy in place.

The strategy had several key elements. Setting a 10 year budget (which has delivered a balanced budget each year since 2011), as opposed to an annual one or four year budget term, making significant reductions in the budget very early on (cutting by a third in 2011), and investing in assets that would generate a secure and improved revenue income, with a target of a 6% return.

Unlike many other councils who seek to achieve savings by outsourcing, Sevenoaks takes a different approach. They deliver all their services in-house, including a weekly refuse collection service. The council believes that this enables them to better control their budget and keep costs under control. More importantly, Sevenoaks believes that they are best placed to succeed by investing in their own staff and empowering them to innovate and take risks, in order to improve services. With this in mind, a new Economic and Property Development Team was recruited and a Trading Company established. The decision was also taken to invest in the district and to balance risk by avoiding the higher end of the market where larger investment companies would be active. The investments are also good for the district, with the council now owning office accommodation on two separate sites in Sevenoaks town centre, preventing their conversion to residential use and supporting the local economy. In addition, the council also owns a former Working Men's Club, a petrol station and a supermarket in the north of the district, and has recently acquired retail accommodation on Sevenoaks High Street including land at the rear which will enable them to explore a wider regeneration plan.

Options for the development of the Working Mens Club are ongoing and the other premises are producing income yields in excess of 6%.

The Council initially agreed to set aside up to £5m from a review of reserves for the purpose of property investment which was then supplemented with a further £3m from capital receipts. Since then a further £37m has been allocated from borrowing or from capital receipts received from the sale of existing assets.

Based on the experience from the acquisitions made to date, the current strength of the property market across the district and the type and lot size of opportunities expected to come to the market

it is considered that this level of investment will enable the Council to bid effectively for opportunities that meet the criteria set out in the Property Investment Strategy in order to provide a more balanced investment portfolio and make a further significant contribution to the council's income.

Other initiatives, including a pre-let hotel development are currently on stream and others are being investigated, and further funding through borrowing may be requested once these have progressed to a suitable stage.

All property acquisitions are supported by a thorough business case and approved by Members, with delegated authority to enable the council to move quickly. Clearly when borrowing to purchase an asset, the overall yield on the acquisition will reduce due to interest charges and the repayment of the loan. These details will be included in the business case to give assurance that the purchase still gives financial benefits to the Council.

The Council have also established a wholly owned Trading Company which will enable them to operate property investment/development on a fully commercial basis. Whilst in most cases the Council will itself be able to make investments as this is likely be the most tax efficient way of investing, there may be cases where the Council is not allowed to act. For example, under the Housing Act the Council is not allowed to grant a Shorthold Tenancy Agreement which means that it would not be able to invest in and hold residential property. Therefore, where residential property is involved, the Trading Company is in place to provide the appropriate structure for that type of investment. Every investment is looked at on its own merits to decide whether to purchase via the local authority or the company depending on the taxation, legal and investment implications of what is proposed.

Cllr Peter Fleming OBE, the Council Leader, says: "With ongoing reductions in our government support, we have acted decisively to protect the frontline services our residents depend upon. We have worked hard since 2011 to achieve this ambition, putting us in a better position than most. Being financially self-sufficient means we have greater control over our services while insulating ourselves from further reductions in public spending".

Case Study 3: Southampton City Council – Property Investment to generate a secure income stream

Cllr Simon Letts, Leader of Southampton City Council "it makes sense if we can borrow at 2% and make a return of 6 or 7%. In 2016 we approved a £65m investment pot and established a Development Company. So far we have invested in three properties, one inside and two outside the City that will provide a secure and growing rental income for at least the next 10 years. In addition we are looking at a number of initiatives that include setting up our own Energy Company and developing a modular housing factory in partnership with the Solent Local Enterprise Partnership (LEP)."

Mark Bradbury is Head of Capital Assets at Southampton City Council and former Head of Economic Development & Property at Sevenoaks District Council. Mark has been responsible for the introduction of the Council's Property Investment Business Plan to allow the Council to increase income through strategic property investment and strategic asset management, in response to the current financial pressures, reducing the reliance on Government grants by building an asset and investment portfolio that provides a commercial return. The new investment builds on the Council's existing investment portfolio which had a value of c. £100m at 31st March 2016 and generates a gross annual return of approximately 7%.

The prime purpose of the initiative is to generate income i.e. contributing to a financial 'future-proofing' effect, underpinning financial security for the Council by providing further income independent of Government funding or Council Tax revenues to fund activities. Hence, the investment focus will be on the most appropriate method of delivering income, rather than on location within the city boundary.

In some cases investment assets also offer the potential to unlock future development opportunities, assist the economic well-being of the city and provide extended services. This, however, would be a secondary objective of this particular initiative as other property activity will focus more on development and economic well-being.

Detailed proposals for decision-making and governance form part of the Investment Business Plan. Authority is delegated to the Head of Capital Assets following consultation with the Leader of the Council and the Council's Capital Board to agree and update the Business Plan. Given the need to act swiftly when appropriate opportunities arise, authority to agree the detailed terms of any acquisition or sale is delegated to the Head of Capital Assets, following consultation with the Leader of the Council and the Service Director Strategic Finance and Commercialisation.

Acquisitions to date include offices leased to Nokia in Cambridge, a purpose built parcel distribution depot leased to DPD in Northampton and retail warehouses leased to Wickes and Halfords in Southampton.

Case Study 4: Reigate & Banstead Borough Council - Property Investment and Development Company

Reigate & Banstead Borough Council already has a successful and proven track record in delivering a range of commercial property projects, but has recently taken the bold and innovative step to set up its own property company. This is a key initiative by the Council to help mitigate the impact of the phased abolition of government grants. In terms of scale the Council has faced a 45% reduction in grant since 2010, and it receives no Revenue Support Grant from government as of April 2017. Following a period of reorganisation the Council now believes that further departmental efficiency measures could have a direct effect on frontline services and therefore has chosen to examine alternative revenue generating options. The setting up of its own property company represents a positive response to the challenge the Council faces to counteract the radical changes to its future funding position.

Following a rigorous period of research, scenario testing and option appraisal work, it is considered that a property and investment strategy delivered by a commercial trading company will enable the Council to bring forward its own sites quickly and will also allow the Council to operate in a fast paced competitive market place and in areas where the Council cannot currently operate. The underlying aim of this new company is to promote development of a number of Council owned assets as well as purchasing other assets for investment and development purposes both inside and outside the borough which will enable it to generate and maintain a valuable income stream. To help establish trading activity some existing assets are expected to be transferred to the company to allow this to happen.

In terms of parameters, the company will typically be involved in transaction activity ranging from £1m to £5m lot sizes. These will include a diverse range of use types including residential, offices, industrial and retail. The property vehicle will target a minimum rate of return of 6% with funding being made available from a variety of sources including Council reserves, Public Works Loan Board and/or commercial sources. In appropriate circumstances the company also has the flexibility to establish subsidiary companies which will enable it to deliver individual projects which require a focussed resource and specific governance arrangements (e.g. special purpose vehicles for phased regeneration projects.)

This forward thinking commercial arrangement will deliver a wide range of financial, economic and community benefits however the core commercial benefits are highlighted by the council as follows:

- i) Under the Housing Act the Council is not allowed to grant shorthold assured tenancy agreements which means the ability to invest in and hold residential property is restricted. Therefore where residential property is involved, the company would facilitate the appropriate delivery mechanism for this type of investment activity.

ii) As a purely commercial entity the company is not a body governed by public law for the purposes of the Public Contract Regulations and as such public procurement procedures (including OJEU) will not apply. However it is the company's clear intention to tender significant development opportunities to ensure that value for money can be demonstrated.

The governance arrangements have been structured to enable a fast track decision making capability based on a business plan. However, the company will be directly accountable to shareholders who will scrutinise performance and delivery. In terms of the detail the Trading Company will be a company limited by shares with the Council retaining a 100% shareholding. In addition the company will be a 'controlled company' as defined by the Local Authority Government and Housing Act 1989 and as a result will be subject to the Local Authorities (Companies) Order 1995. The aforementioned business plan will be developed to cover a rolling 5 year period of investment activity (with annual reviews) and will fundamentally set out the direction of travel with specific references to priority project types both inside and outside the borough boundary. Depending on the circumstances these could be delivered through a range of structures including direct investment, special purpose vehicles, JV's and Development Management Agreements. Concerning day to day management, the company will be governed by a small board of senior officers (Property Board of Directors) who will operate within an established structure for Member and Officer liaison on property matters. In addition an Executive Sub-Committee will exercise the Shareholder function of the Council in order to hold the Directors to account for the performance of the Company.

In relation to progress the Council's Executive agreed to set up the company at their meeting on 15th September 2016. Work is now well underway in establishing the company's appropriate governance and funding arrangements.

Case Study 5: Bournemouth Borough Council - Development Company LLP

The property investment boom period of 2002-2007 delivered limited regeneration benefits for Bournemouth town centre whereas other nearby towns were reaping the benefits of the favourable market conditions. It was at this point that the Council decided to intervene and drive investment activity through adopting a new, market facing approach. In taking this key initiative forwards a business case was prepared in 2008 looking at the various delivery options. These ranged from straight forward land sales to forming a joint venture (JV) development business with the private sector. In 2008, Cabinet approved the JV approach with a private sector partner. Following a round of further due diligence a decision was reached to form a separate legal entity from the council which would be owned on a 50/50 basis by the council and a private sector partner (Morgan Sindall Investments) procured through an OJEU compliant procurement process. The form of legal entity chosen was a limited liability partnership (LLP) incorporated under the LLP ACT 2000.

The main advantage of a LLP is that it is a tax efficient structure which in essence means the council does not have to pay corporation tax on the profits it earns through its participation in the LLP. It also enables the council through its membership of the LLP to control the speed and pace of development, the quality of the design, the form of development, and the cost of undertaking the development. The legal agreements also contain what is referred to as a deadlock structure. In practice this means that nothing happens unless both members of the LLP are in agreement. Another advantage of the LLP is that the business objectives can be tailored to meet the council's town centre regeneration objectives. In summary then the LLP structure gives the council a good degree of control and a real seat and voice at the table when all of the key business decisions are made.

One of the crucial aspects of the BDC is its funding structure and the ability to utilise a variety of

financing options in order to optimise delivery and return. These range from receiving a capital receipt for the land at the start of the construction phase on what are termed forward funded schemes to the council's land being used as an equity investment in open market sales schemes. In some situations BDC secures finance for a project using a non-recourse financing technique, but it is also possible to use more traditional sources of finance that is frequently used within the residential development sector. In addition to the funding arrangements other key issues addressed within the LLP structure include:

- **Treatment of Council Land** - Under an open market sales schemes, the council's land is treated as a loan to BDC .The level of the loan is calculated through determining the market value of the site with the benefit of planning permission. For example if planning permission was secured for a 10 storey residential block it would aim to achieve the market value of the site based on that permission rather than its current (existing) use value. The option agreement between BDC and the council, which is an arm's length contract negotiated and agreed as part of the procurement exercise provides that the council's loan is based on the projected development land value which in turn is calculated by reference to the RICS residual valuation technique.
- **Planning Process** - Before BDC can go into planning the council's cabinet is asked to approve the outline proposals for the scheme and the budget to take the scheme through the planning process. Before any of the design consultants are appointed to progress the design, an open market tendering exercise is undertaken and the tender returns are then compared with the budget.
- **Construction Procurement Process** - All 3 of the BDC projects completed to date have been completed within an agreed lump sum fixed price (known as the Contract Sum). Under this method of construction procurement, the contractor takes the majority of the risk in the construction phase which effectively de-risks BDC and in the process creates more certainty over the achievement of the predicted profit. Once the lump sum fixed price contract is signed between BDC and the contractor the risk in delivering the project effectively passes to the contractor. Because the Council needs a high degree of certainty over the construction cost before agreeing to the level of equity investment in BDC (i.e. contributing the value of its land with planning permission in place) an open book tender exercise is undertaken which means that the detailed design of the scheme needs to be more than 80% complete once again adding further time to the pre-construction phase.

BDC is 5 years into a 20 year programme of development in the town centre involving a pipeline of 17 sites. As of September 2016 BDC has completed £40 million worth of development at Leyton Mount and Madeira Road and is currently on site with Berry Court Private Rented Scheme which comprises 113 apartments together with a 217 space multi storey car park (of which 155 space are for public use). BDC has also submitted planning applications on Durley Road and St Stephen's car parks which have a combined gross development value (GDV) in excess of £25 million and is currently working up a planning application for a £150 million mixed use scheme at the Winter Gardens car park. In addition development proposals for a £40-50 million scheme at Bath Road North and South car parks are currently out to consultation.

At the time of writing Bournemouth Borough Council was in the process of revising its Investment Strategy and a report was due to go to Cabinet in July 2017. The report will include a proposal for an increased provision in the Medium Term Financial Plan together with a recommend that the acquisition of a significant additional property asset be approved.

Case Study 6: Canterbury City Council – Acquisition of a 50% share in the Whitefriars shopping centre

Like many local authorities across the UK, Canterbury City Council is facing a challenging financial environment and anticipates that over the next four years it will need to find savings of £5.8 million as its funding from central government is reduced.

In order to help address this situation the Council has looked to its extensive property portfolio and commercial expertise to provide solutions. In terms of its portfolio the Council has an historic and diverse ownership across the city centre however its largest strategic holding is the Whitefriars shopping centre.

In terms of background, the Whitefriars was designed to update and replace an unsympathetic post war development, in order to enhance Canterbury as a retail and tourist destination centre. The Council wished – in line with its long-term strategic approach - to ensure that Canterbury maintained its position in the national retail hierarchy as a sub-regional centre. Detailed planning consent was granted to the developer, Land Securities, in September

1998, and the 475,000sf scheme was opened in the summer of 2006 with the Council securing a 250 year head lease on its freehold interest. The centre now comprises 80 stores, provides over 40% of the prime city retail stock, attracts approximately 13m visitors and is anchored by Fenwick and M&S with a more recent major letting to Primark.

In 2007 Land Securities sold the centre to Henderson Global Investors and Canada Pension Plan Investment Board for £253m. Whitefriars Shopping

Centre is now held by the current Tenant under a number of individual head leases from the Council, the main lease being for the new Whitefriars Scheme for a term of 250 years from 2004.

In assessing its options for the Whitefriars, the Council set out a compelling business case which was based on securing a major stake in the centre through being able to secure long term finance at extremely competitive interest rates. Another key driver was the Council's extensive knowledge and understanding of this strategic asset which is well let to a range of high quality occupiers in the heart of a vibrant city centre.

In June of 2016 the Council purchased a 50% stake in the Whitefriars Centre in a £79 million deal. Albeit now a major stakeholder the Council has agreed that the asset management responsibilities for the centre should remain with Henderson Investors.

In order to fund this major transaction the Council secured finance through the public works loan board (PWLb) and the estimated annual borrowing costs and income are based on an annuity loan of £74 million over 25 years, with borrowing from the PWLB at 2.66%. This compares favourably with a c. 6% investment return that the shopping centre is currently generating. On this basis the rental income is expected to cover the loan repayments and importantly leave a generous surplus to help support the provision of public services. The purchase also fulfils a further strategic objective of enabling the Council to have greater influence over the future of the city centre.

In commenting on this transaction Council Leader Cllr Simon Cook said:

"We're very pleased that the negotiations have reached a successful conclusion. The deal has significant benefits for everybody, from local taxpayers to all those with a specific interest in Whitefriars".

"Such is the quality of the offer in both Whitefriars and the city centre in general, that we are certain that Canterbury has a vibrant future. The purchase is an entirely logical step for us to take and we look forward to playing our full part in decisions on the long term future of the shopping centre."

Case Study 7: The London Borough of Havering - wholly owned Council Development Company (Mercury Land Holdings Limited)

One of the most significant housing changes in the UK housing market in the past decade or more has been the rise in the private rented sector and the decline in owner occupation. It is widely viewed that the relative immaturity of the Private Rented Sector (PRS) offers institutions and larger organisations such as local authorities an opportunity to shape the sector, and the Government is encouraging this activity. Many local authorities are venturing into this market through setting up their own direct delivery housing companies. These include Kings Lynn & West Norfolk; LB of Ealing, LB of Waltham Forest, LB of Enfield and LB of Newham through Red Door Ventures. The LB of Havering through Mercury Land Holdings Limited is another recent entrant into this market place and forms the basis of this case study

The context for Havering's decision to move in this direction is primarily commercially driven and based on taking advantage of anticipated tenant growth through delivering quality, well located and managed PRS developments which delivers a financial return to the Borough, as well as meeting its regeneration and economic objectives. Traditionally, the Council has successfully sold land to housing providers and developers in order to obtain capital receipts, to provide market and affordable housing and to meet borough wide housing targets however the market has moved and a new approach is needed to provide longer term revenue. The key objective of generating a financial return is therefore the underlying driver and in time is expected to place the authority in a more resilient position particularly when making decisions regarding protecting frontline services in the face of substantial cuts in its funding arising from the phased reduction of governments support grants.

The rationale for establishing a wholly owned Council Company are varied and perhaps best summarised below:

- The Council has the power to on-lend funds to Mercury Land Holdings at commercial rates. This is an attractive option, as the Council would make a margin on its own borrowing from the Public Works Loan Board (PWLB), where interest rates are lower, pension investment funds or Council cash reserves.
- In addition to generating a revenue stream for the General fund through interest from loans, revenue income will also be forthcoming from ground rent and dividend payments from the Company. The Council would also in the longer term benefit from any increase in value of the company's assets.
- Dwellings owned by the MLH are not HRA properties and thus will not impact on the HRA borrowing cap and are not subject to right to buy.
- Dwellings owned by MLH will be let on Assured Tenancies and as market rented homes will not be subject to the allocations provisions of Part VI of the Housing Act 1996 (which may have particular significance in relation, for example, to any prospective development for market rent).
- Establishing a Company isolates elements of financial risk as MLH is a limited entity and in addition will provide a flexible operating model to participate in the commercial market place.
- MLH can potentially extend its operations to wider trading functions related to housing development (and subject to Shareholder approval).
- As a pure commercial entity, not created to further public policy, MLH does not need to follow public procurement rules. However, the Directors will determine the company procurement policy in accordance with best practice. The Council within the shareholder agreement will be insisting on a clear best value process to be followed.

Operation of the Housing Company

Mercury Land Holdings will primarily develop a portfolio of homes for market rent and sale however these will not be affordable homes which are primarily available for people on the Council's housing waiting list as these are provided by an in house function of the Council. It is considered that this type of housing delivery strategy will focus on a new generation of tenants who want to rent good quality accommodation from a responsible landlord with security of tenure and quality level of service.

In terms of occupation arrangements the dwellings will be let on Assured Tenancies and will not be subject to Right to Buy. In addition the company will own, manage the market rent units however its role will be as client as the day to day activity is outsourced to a third party provider.

Concerning the general approach to developing larger sites, the Company would usually seek a development partner in order to mitigate risk and introduce additional expertise and resources. However, in relation to those sites that it is felt appropriate to develop on its own, the Company would secure appropriate development expertise and appropriately tender the construction and delivery of units.

The overall direction of travel in terms of types of development opportunities, risk exposure, performance targets and resourcing is governed by a business plan which is prepared annually and presented to the Cabinet for approval.

Concerning progress on the ground, Mercury Land Holdings to date has a fully let 65 unit new-build scheme in Romford town centre which formed part of the former Oldchurch hospital site. In addition the council has achieved planning approval for a 45 unit scheme on North Street in Hornchurch which it will seek a contractor for later this year. Lastly the council is in the process of working up a 150 unit scheme on its Como Street car park site in Romford which will be delivered through a JV partner.

Case Study 8: Bristol City Council - Purchase of the Citypoint building – a long leasehold commercial property investment within the Bristol Temple Quarter Enterprise Zone

The Council already owned the freehold interest in Citypoint, having let the building in 1971 on a long ground lease for a period of 125 years, at a ground rent of £3,500 per annum.

The majority of the building is comprised of serviced offices and a Holiday Inn Express together with a ground floor retail unit and the Reckless Engineer public house. The long leasehold owner, Business Environment City Point, was not in occupation of the building, but receives rents from managing the sub tenants who occupy the building.

The current annual rental income is £735,000 per annum net; the landlord's costs of running the building are recoverable through the building service charge provisions contained in the sub tenancies.

The City Council have now acquired the building and leasehold interest for £9million in order to achieve two main objectives:

- To enhance the Council's current revenue income through the purchase of a long-leasehold property investment that provides a net annual return of 7% rather than the 0.6% currently obtained by holding cash on short term deposit.
- To acquire an interest that provides the Council with increased strategic influence over a key redevelopment site within the BTQEZ - since the Council assumes direct managerial control of the building and sub tenancies

This funding will be provided from prudential borrowing and will form part of the council's overall cost of treasury management. The current cost of borrowing from the PWLB is at a rate of 3.13% for loans offered over 25 years, a cost to the council of approximately £60,000 per year per £1m borrowed.

As part of the deal to purchase the leasehold interest Business Environment City have taken a 15-year unbroken leaseback on the six floors it manages as serviced offices and will be paying 47 per cent of the annual rental.

Bristol Mayor George Ferguson said: "The purchase of this building is another good deal for Bristol and a strategic move to give the Council the opportunity to redevelop this site in the future to meet our aspirations to improve this important gateway to Bristol and the region. This is a long-term plan as there are a number of long lease tenants in the building, so in the short-term until we can realise more ambitious plans the purchase will provide an income for the city at a much better return on investment than we could obtain elsewhere".

Conclusions

Councils have traditionally been cautious. Before the Power of General Competence, they could only do things they were allowed to, rather than do anything they were not forbidden to. This historic constrained culture often means there is still a great deal of caution about activity such as commercial property investment.

However, with increasing pressures coming to bear on local authorities in regard to funding, it is clear from our research and various media reports that an increasing number of local authorities are looking for innovative ways of utilising property investment opportunities to boost revenue streams.

Many local authorities across the UK have, or are in the process of setting-up Property Investment Funds in order to purchase income-producing property as a means of improving their overall revenue positions. Indeed, some are aiming at sufficient income from such funds, and other income-producing methods, so that they are no longer dependent upon Government grant.

The National Audit Office highlighted this as a trend in its June 2016 report on *'Financial sustainability of local authorities: capital expenditure and resourcing'* in which it highlighted that *'Authorities have been prepared to make capital investments if they feel there is potential to secure future revenue income. This reflects recognition that the sector is moving towards a largely self-financing model.* It also highlighted that *'While there was significant interest and activity in these types of schemes, most authorities were in the early stages of setting them up. Furthermore, some authorities felt that their potential to benefit from these initiatives was limited because of the nature of their local economy and property market.*

Whilst local authorities are potentially well placed to take advantage of property investment opportunities, as with all forms of investment there are risks and one of the key issues will be skills and experience. This was of concern to the *House of Commons Public Accounts Select Committee* which highlighted in its investigation on the *Financial sustainability of local authorities* that:

'The Department for Communities and Local Government expects authorities to become more 'entrepreneurial' as it encourages local government to become largely self-financing. But we are concerned that the Department appears complacent about the risks to local authority finances, council tax payers and local service users arising from the increasing scale and changing character of commercial activities across the sector. The Department does not have good enough information to understand the scale and nature of authorities' commercial activities or which authorities are placing themselves at greatest risk and it does not use the information it does have to give it a cumulative picture of risks and pressures across the sector.

Local authorities are increasingly making commercial capital investments aimed at generating revenue income, for example by purchasing properties to lease to businesses, developing houses for market rent, and developing commercial units.

Oversight of these new commercial activities will require skills of elected members that may be in short supply in some authorities. Already some authorities are less confident than others about members' ability to provide strategic oversight of the sustainability of capital programmes. Members receive support from officers but these new ventures may require specialist skills and experience that have not been needed by officers in the past. The market value of the commercial skills and experience required is not a good fit with local authority pay scales. Authorities in straitened circumstances could struggle to fill these gaps.'

Local Government property and finance professionals may not necessarily have the relevant experience or skills to make a sudden foray into the property investment market and will therefore need to rely heavily on commercial partner advice. Those that do already have such expertise in-house may even have the opportunity to offer services to others. We do however see a continued rise in the internal

skill base as more and more authorities recruit specifically with investment property in mind.

There do however seem to be different interpretations of legislation such as the Power of General Competence granted to local authorities in the Localism Act 2011 and whether local authorities would be required to set up companies to engage in commercial activities or to operate outside their administrative area.

Clearly each local authority will need to develop their own strategies and not all will choose to go down a property investment route, but our research shows that a significant number are at least exploring the opportunities either as part of their economic development/regeneration activities or purely for income generation.

One of our case study authorities stated *"The question in my mind at the moment is whether this trend of activity will continue or will the reins be pulled in?"* As we continue to monitor activity in this area it is clear that this is a trend that is growing steadily. Since our original survey was undertaken and case studies developed further research has shown that many additional councils are developing investment policies and strategies for 2017/18 with significant funds (generally between £10-50m per authority) being allocated specifically for this purpose – some of which utilise capital reserves with the remaining being funded via partnerships, joint ventures and prudential borrowing.

Commercialisation and entrepreneurship are key strategies for many councils in responding to the current public sector climate and generating income to avoid or mitigate damaging service cuts is extremely attractive. However carrying more commercial risk inevitable means that some ventures will fail, it is important therefore that any venture into this market will have appropriate due diligence and ongoing governance set in place.

Links

National Audit Office: 'Financial sustainability of local authorities'

<https://www.nao.org.uk/wp-content/uploads/2016/06/Financial-sustainability-of-local-authorities-capital-expenditure-and-resourcing.pdf>

House of Commons Public Accounts Select Committee: 'Financial sustainability of local authorities'

http://www.publications.parliament.uk/pa/cm201617/cmselect/cmpublicacc/708/70806.htm#_idTextAnchor010

Localis: Commercial Council - The rise of entrepreneurialism in local government

<http://www.localis.org.uk/wp-content/uploads/2016/02/Localis-Commercial-Councils-FINAL.pdf>

The Leadership Centre: Commercialisation - Options in Local Government Finance

https://www.leadershipcentre.org.uk/docs/Commercialisation_web.pdf

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