

PROPERTY INVESTMENT STRATEGY UPDATE REPORT

Finance and Investment Advisory Committee - 21 January 2021

Report of: Deputy Chief Executive and Chief Officer - Finance and Trading

Status: For Decision

Also considered by:

- Cabinet - 11 February 2021
- Council - 23 February 2021

Key Decision: No

Executive Summary:

This report provides an update on the progress of the Property Investment Strategy to date and looks at the future direction of the strategy.

The Property Investment Strategy was approved by Council on 22 July 2014 to support the aim of the council becoming more financially self-sufficient as Government Support continued to reduce.

The acquisitions to date have helped the council achieve this aim. This report provides an update on those acquisitions.

The Government's Spending Review in November included changes to the Public Works Loan Board (PWLB) lending terms and are intended to stop councils that invest primarily for yield from borrowing from the PWLB. These changes will be monitored and may impact on the Council's future ability to undertake property investments.

In a changing property market, it is important to review the criteria of the strategy on a regular basis.

Portfolio Holder: Cllr. Matthew Dickins

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Recommendation to Finance and Investment Advisory Committee:

- (a) That the report be noted.
- (b) Forward comments to Cabinet including recommended changes to the Property Investment Strategy criteria.

Recommendation to Cabinet:

- (a) Cabinet considers any comments from Finance and Investment Advisory Committee and notes the report.
- (b) Any changes to the Property Investment Strategy criteria be recommended to Council.

Recommendation to Council: That Council agrees the Property Investment Strategy criteria recommended by Cabinet.

Introduction and Background

- 1 In recent years Sevenoaks District Council has been faced with ongoing reductions in Government Support culminating in it no longer receiving Revenue Support Grant from 2017/18. This has led to a number of decisions that have been taken through the 10-year budget process to try and ensure that the council remains in a financially sustainable position going forwards.
- 2 On 7 November 2013, Cabinet approved the Corporate Plan which set out key focus areas for the organisation including the need to become more financially self-sufficient. The agreed plan articulated an approach of investing in assets that will generate revenue income to allow less reliance on diminishing Government Support. It goes on to state that this could be done either through the review of use of reserves or through borrowing at low interest rates.
- 3 On 22 July 2014, Council agreed the Property Investment Strategy with specific criteria. The criteria were last updated at Council on 25 February 2020 and the current criteria are included at **Appendix A**.

Funding Agreed to Date

- 4 A total of £50.3m of funding for the Property Investment Strategy (including the Sennocke Hotel) has been agreed to date as follows:
 - a. £5m Council 22 July 2014
 - b. £3m Council 17 February 2015
 - c. £10m Council 21 July 2015

- d. £7.3m (total spend) Sennocke (Premier Inn) Hotel, Council 3 November 2015
- e. £25m Council 25 April 2017

Activity to Date

5 A summary of the expenditure to date is included in the following table:

Date	Activity	Total Cost £000	Annual Income Yield %
Activities achieving the required return			
Apr 2015	Suffolk House, Sevenoaks (including refurb.) (office)	4,892	9.6% (7.1% before refurb.)
May 2015	Swanley Petrol Station and Supermarket	2,566	7.5%
Mar 2017	26-28 Pembroke Road, Sevenoaks (office)	4,673	5.9%
Aug 2018	Premier Inn Hotel, Sevenoaks	7,332	6.3%
Other Activities			
Feb 2015	Swanley Working Men's Club (including demolition)	1,393	-
2016/17	Quercus 7 set up costs	13	-
Feb 2017	96 High Street, Sevenoaks (retail, office) and associated site	4,554	Previously 3.5% Currently 0%
May 2017	Croft Road, Westerham (housing option)	50	
2018/19 onwards	Quercus 7 investments (debt 60%, equity 40%)	5,891	

	Total	31,364	
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- 6 £18.9m of the £50.3m approved is therefore unspent.
- 7 **Swanley Working Men's Club** (February 2015) - The premises were demolished in July 2016. This site will be redeveloped with a neighbouring District Council car park which is underutilised, as part of a new gateway to Swanley. Work is continuing to establish viable redevelopment options for this site which take into account its location in the Town Centre and requirement to meet the Property Investment Strategy return on investment criteria. This work is linked to the sites at 27-37 High Street and White Oak Leisure Centre in Swanley.
- 8 **Suffolk House, Sevenoaks** (April 2015) - This office building is in a town centre location with diminishing levels of office stock in the area. It consists of a total of 16,699 sq. ft of office space over four floors with 84 parking spaces. It is managed by a property management company with costs recoverable under a service charge. All floors have been refurbished to a high standard and the rent per square foot is now significantly higher than when the building was purchased. All space is currently let and a yield of over 9% is being achieved. External repair and maintenance work, particularly to the roof, brickwork and lead works, has recently been undertaken in accordance with the building's planned maintenance programme.
- 9 **Swanley Petrol Station and Supermarket** (May 2015) - The property comprises a 2,789 sq. ft convenience store building with 15 car parking spaces, 8 multi-fuel pump forecourt with jet wash and car wash on a 0.589 acre site. The property is let on a lease expiring in August 2030.
- 10 **Quercus 7 set up costs** - expenditure was approved by Council on 31 March 2015 to be funded from the Property Investment Strategy Reserve.
- 11 **96 High Street, Sevenoaks (February 2017)** - This premises consists of ground floor retail space, 1st and 2nd floor office space with residential potential and development opportunity to rear. The most basic option of refurbishing the office space and selling the land to the rear will give a 7% annual return. The land at the rear is next to a council car park which in turn is next to the bus station and therefore has the potential to be a catalyst for wider development. Work on the options for the site are continuing. which take into account its location in the Town Centre and requirement to meet the Investment Strategy return on investment criteria.
- 12 The ground floor retail space has been vacated by M & Co. New tenants are currently being sought. A 'meanwhile use' is in place for the first and second floors which have been let to the Second Floor Studios CIC, which has converted the space into 19 artists' studios and this agreement lasts until 2021.

- 13 **26-28 Pembroke Road, Sevenoaks (March 2017)** - This is a modern freehold office investment in Sevenoaks town centre. The 10,499 sq. ft building over three floors has 56 car parking spaces is currently fully let on a ten-year lease.
- 14 **Croft Road, Westerham** - This land formally in the Council's ownership was sold to a developer to build 18 residential units which are being built in two phases. The council took up an option to acquire two houses at a discount (based on an agreed price formula), one house in each phase. Construction of the first phase was completed and the option to acquire one house was exercised on behalf of Quercus 7, and it has since been let on an Assured Shorthold Tenancy providing regular monthly income. Consideration of exercising the second option will be given once construction is close to completion of the second phase.
- 15 All of the Council's acquisitions have been supported by a thorough business case and approved by the Improvement & Innovation Portfolio Holder in consultation with the Finance & Investment Portfolio Holder as required by Council.
- 16 **Premier Inn Hotel, Sevenoaks (August 2018)** - The 83 bed Premier Inn was completed in July 2018 and opened for trading on 4 August 2018. The hotel scheme and the funding method were separately approved by Council, but it is recognised as a Property Investment Strategy asset with the income being included in the figures below.

Property Investment Strategy Income

- 17 The 10-year budget approved by Council on 25 February 2020 included net Property Investment Strategy income of £1.428m in 2020/21 and £1.468m in 2021/22.
- 18 Net income of £1.292m is forecast in 2020/21, therefore £136,000 below the budget. This is due to M & Co surrendering the lease on the retail space at 96 High Street, Sevenoaks in September and non-payment of rent earlier in the year. The council will also become liable for business rates on this space if it remains vacant after three months.
- 19 Included in the 2021/22 budget approved by Council in November was a reduction of the Property Investment Strategy net income budget of £96,000 in 2021/22 only (SCIA13). As there is not currently a new tenant in place, it was prudent to assume that rental income would not be received on this site during 2021/22. Therefore, the Property Investment Strategy net income budget for 2021/22 has reduced to £1.372m. Later years remain unchanged.
- 20 The Property Investment Strategy net income budgets included in the 10-year budget approved by Council in November are included in the table below:

2021/22	£1.372m
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2022/23	£1.508m
2023/24 - 2025/26	£1.558m
2026/27 - 2028/29	£1.655m
2029/30 - 2030/31	£1.696m

- 21 The budgets will continue to be reviewed.
- 22 All of the net income budgets proposed are after transferring £100,000 per annum into the Property Investment Strategy Maintenance Reserve.

Funding Sources

- 23 The £31.4m spent to date has been funded by:
- a. Property Reserve and Financial Plan Reserve £11.8m. Funds put aside for the Property Investment Strategy agreed as part of the annual budget setting process including New Homes Bonus.
 - b. Capital receipts £9.4m. Proceeds from the sale of council assets.
 - c. Internal borrowing £4.3m. From council balances. No interest is paid but Minimum Revenue Provision (MRP) is charged. MRP is the minimum amount which must be charged to the revenue account each year and set aside as provision for repaying loans and meeting other credit liabilities. This is a requirement for any form of borrowing so that an amount is set aside to repay the loan. An MRP charge of £150,000 is forecast in 2020/21.
 - d. Internal borrowing £5.9m. From council balances for Quercus 7 investments.
 - e. External borrowing £nil. This funding method would incur interest and MRP costs each year.
- 24 Funding options will be considered on a case by case basis and may be funded by reserves, capital receipts, internal borrowing or external borrowing. Due to current commitments it is likely that a significant proportion will come from external borrowing if allowable. (The PWLB 30-year annuity loan interest rate at 05/01/21 is 1.6%).
- 25 During 2019, a Member Working Group investigated Income Strip Funding as an additional funding source (as requested by Council) and recommended that this should be considered for funding suitable future schemes.
- 26 Each scheme will also be analysed to decide whether it is preferable to proceed as the council or via Quercus 7.

Public Works Loan Board (PWLB) - Changes to Lending Terms

- 27 Included within the Government's Spending Review announcements on 25 November 2020 was the HM Treasury document 'Public Works Loan Board: Future Lending Terms'.
- 28 There has been a number of announcements and guidance notes by Government and CIPFA (Chartered Institute of Public Finance and Accountancy) to react to how some councils have borrowed from the PWLB to fund property investments.
- 29 This document includes changes to the PWLB lending terms to stop councils that invest primarily for yield from borrowing from the PWLB. Councils will still be free to borrow for service delivery, housing, regeneration, preventative action and government priorities. The changes came in with immediate effect.
- 30 In summary, the new rules are:
 - a. As a condition of accessing the PWLB, local authorities will be asked to submit a high-level description of their capital spending and financing plans for the following three years.
 - b. Councils intending to invest for yield will not be permitted to access the PWLB.
 - c. When applying for a new loan, the council will be required to confirm that the plans they have submitted remain current and confirm that they do not intend to buy investment assets primarily for yield remains valid.
 - d. The decision over whether a project complies with the terms of the PWLB is for the section 151 officer or equivalent of the council (Chief Officer - Finance and Trading).
- 31 At the same time as introducing these reforms, HM Treasury lowered the PWLB interest rates by 100 basis points (i.e. 1%).
- 32 If a council wants to go ahead with borrowing from another source to fund commercial investments they can but they will be blocked from accessing the PWLB.
- 33 Officers will continue to liaise with the Government and other bodies to ensure that there is a clear understanding of options and implications available for future use of the Property Investment Strategy by both the Council and Quercus 7.

Future Opportunities

- 34 Due to the number of developments planned for the next few years it is recommended that the emphasis for any further acquisitions are for sites where no further work is required rather than those with development potential.
- 35 As mentioned above, the PWLB changes may impact the available funding of and ability to make further property investments within the strategy.
- 36 Savills latest update on the UK Commercial Property Market is included in **Appendix C**.

Risks

- 37 The risks of the Property Investment Strategy are included in **Appendix B**. The risks are reviewed each year and were initially analysed by the Audit Committee on 9 September 2014.
- 38 The Council's Strategic Risk Register was also agreed by the Audit Committee on 17 September 2019 and the relevant category for the Property Investment Strategy is also included in **Appendix B**.
- 39 Property Investment is inherently more risky than leaving reserves in the bank but this has been taken to account when approving the Property Investment Strategy and setting the investment criteria. Treasury investment returns have previously been below inflation levels resulting in the gradual erosion of funds. A separate report on the Treasury Management Strategy 2021/22 is also being presented at this meeting.
- 40 The risks of each potential investment are considered by carrying out due diligence to include the following:
 - a. Valuation.
 - b. Market conditions.
 - c. Covenant strength of tenants.
 - d. Terms of leases.
 - e. Structural surveys.
 - f. Funding options.
 - g. Future costs.
- 41 It should be recognised that there is likely to be a time when there are business reasons to dispose of assets currently owned and invest elsewhere instead.

- 42 The Scrutiny Committee set up a Property Investment Strategy Member Working Group at their meeting on 5 July 2016 and reported their findings at the Scrutiny Committee on 30 March 2017.
- 43 The Member Working Group concluded that the benefits of the Property Investment Strategy do outweigh the risks, provided that the council remains constantly aware of changes in the market and financial risks.
- 44 Internal Audit completed an audit report on the Property Investment Strategy in 2017/18. The audit opinion given in the report was of full assurance.
- 45 The audit report conclusion was as follows: “Audit fieldwork confirmed effective governance and financial arrangements are in place for the delivery of the Property Investment Strategy. The attainment of set objectives is being achieved. Existing arrangements are fit for purpose for the delivery of the Strategy and comply with Council procedures.”
- 46 The assurances required over the Property Investment Strategy are considered each year as part of the risk-based annual audit planning process.
- 47 The changes to the PWLB lending terms also produce additional risks that did not previously exist.

Property Investment Strategy Criteria

- 48 The annual update report gives Members the opportunity to review the Property Investment Strategy criteria previously agreed. The current criteria are included in **Appendix A**.
- 49 The asset categories currently included in the strategy are industrial, office, retail, trade counter and private residential. Due to the requirement to have a balanced portfolio and recognising the changing market it is asked that Members consider changing it to ‘all categories’ subject to appropriate due diligence and ensuring no asset class exceeds 20% in total value of the approved funding.
- 50 Members have previously had discussions about the location of potential investments. The current criteria restricts this to within a 50-mile radius of the Council’s Argyle Road offices or within Kent and Medway.
- 51 The Property Investment Strategy criteria also applies to Quercus 7.

Key Implications

Financial

As previously stated in this report, the Property Investment Strategy is a major contributor to deliver the aim of the council remaining financially self-sufficient.

It was previously expected that a significant proportion of future Property Investment Strategy funding would be provided by external borrowing, but it should be recognised that this may no longer be possible. Each acquisition will be looked at on a case by case basis to ensure that the most appropriate funding method is used.

Legal Implications and Risk Assessment Statement.

Legal resources would be required to undertake legal pre-purchase due diligence for any future acquisitions. This would be undertaken either internally by the Council's Legal Team or externally and a decision would be made on a case by case basis.

A full risk analysis is included at **Appendix B** to this report.

Equality Assessment

The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Value for Money and Asset Maintenance

Value for money derived from available finances when looked at in conjunction with the Treasury Management Strategy has the ability to be increased via the Property Investment Strategy.

Conclusions

In acknowledgement of the position with Government Support and the continued low returns on investment of reserves, further investment in the Property Investment Strategy, if allowable, will continue to ensure that the Council remains financially self-sufficient.

Appendices

Appendix A - Property Investment Strategy

Appendix B - Property Investment Strategy - Risk Analysis

Appendix C - Property Market Update from Savills

Background Papers

Report to Council 22 July 2014 - Investment Strategy

Report to Audit Committee 9 September 2014 - Investment Strategy Risk Register

Report to Council 17 February 2015 - Budget and Council Tax Setting 2015/16

Report to Council - 21 July 2015 - Property Investment Strategy

Report to Council - 25 April 2017 - Property Investment Strategy Update

Adrian Rowbotham

Deputy Chief Executive and Chief Officer - Finance & Trading