

## PROPERTY INVESTMENT STRATEGY UPDATE REPORT

Council - 21 February 2023

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

**Status:** For Decision

**Also considered by:**

- Finance & Investment Advisory Committee - 10 January 2023
- Cabinet - 12 January 2023

**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.

Due to Government changes in the way councils can access Public Works Loan Board (PWLB) borrowing and the changes to CIPFA's Prudential Code, the Property Investment Strategy is no longer included in the capital programme therefore the Council cannot currently borrow to make any more property investments purely for yield.

In a changing property market and regardless of any limitations on financing, it remains important to review the criteria of the strategy on a regular basis.

**Portfolio Holder:** Cllr. Matthew Dickins

**Contact Officer(s):** Adrian Rowbotham, Ext. 7153

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**Recommendation to Finance and Investment Advisory Committee:**

- (a) That the report be noted.
- (b) Forward comments to Cabinet including any 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:**

Council agrees the Property Investment Strategy criteria recommended by Cabinet.

## **Introduction and Background**

- 1 In recent years Sevenoaks District Council was facing 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.
- 2 On 7 November 2013, Cabinet approved the then Corporate Plan which set out key areas for the organisation, including the need to become financially self-sufficient. The agreed plan articulated an approach of investing in assets that would generate revenue income to allow less reliance on diminishing Government support. It went on to state that this could be done either through reviewing the use of reserves or through borrowing at low interest rates.
- 3 On 22 July 2014, Council agreed the Property Investment Strategy. The Strategy's criteria were last updated at Council on 22 February 2022 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 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
- 5 £35.451m has been spent. However, as the Property Investment Strategy has now been removed from the Capital Programme, the Council is unable to make any further property investments purely for yield, therefore the unspent element of the £50.3m is no longer available for the Council to spend on the Property Investment Strategy.

## Activity to Date

- 6 A summary of the income producing expenditure to date is included in the following table:

Date	Activity	Total Cost £000	2022/23 Income Yield %
Apr 2015	Suffolk House, Sevenoaks (including refurb.) (office)	4,892	7.3%
May 2015	Swanley Petrol Station and Supermarket	2,566	7.5%
Mar 2017	26-28 Pembroke Road, Sevenoaks (office)	4,673	3.9%
Aug 2018	Premier Inn Hotel, Sevenoaks	7,332	6.4%
	Total	19,463	

- 7 **Suffolk House, Sevenoaks** (April 2015) - This office building is in a town centre in which there are diminishing levels of office stock. 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. External repair and maintenance work, notably to the roof, brickwork and lead works, has recently been undertaken in accordance with the building's planned maintenance programme.

- 8 **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.
- 9 **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 and is currently partially let to Towergate Insurance, who previously occupied the whole building. Heads of terms are currently being negotiated with a new tenant for a lease for 20 years.
- 10 **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 in paragraph 23.
- 11 The following amounts within the strategy have funded Quercus 7 investments.

Date	Activity	Total Cost £000	2022/23 Income Yield %
2016/17	Quercus 7 set up costs	13	
2018/19 onwards	Quercus 7 investments (debt 60%)	5,987	4.5%
2018/19 onwards	Quercus 7 investments (equity 40%)	3,991	
	Total	9,991	

- 12 Quercus 7 was set up to enable the Council to invest in property on a commercial basis across a range of asset categories, ensuring a sustainable income for the Council. The company is able to invest in commercial properties outside of the district and hold residential property, which the Council is not allowed to do.

- 13 The Council, which is also the Shareholder of the Company, wishes Quercus 7 to prioritise return on investment, whilst also recognising that as a public body there are sometimes wider considerations and sensitivities that the Council must consider.
- 14 The investments adhere to the principles set out in the Property Investment Strategy.
- 15 The Council as a whole holds the only share in the Company and has delegated its responsibility for overseeing the trading activities of the Company to a Trading Board, and the Leader of the Council has been nominated as the shareholder representative.
- 16 The Quercus 7 Business Plan includes a £50,000 dividend payable to the Council annually from 2023/24.
- 17 In addition, strategic expenditure has been undertaken to secure longer term returns. These items are listed in the table below:

Date	Activity	Total Cost £000
Feb 2015	Swanley Working Men's Club (including demolition)	1,393
Feb 2017	96 High Street, Sevenoaks (retail, office) and associated site	4,554
May 2017	Croft Road, Westerham (housing option)	589
	Total	6,536

- 18 **Swanley Working Men's Club** (February 2015) - The premises were demolished in July 2016. In June 2022, The Council made a planning application for 93 apartments arranged over 4 to 6 storeys on this site, together with the adjacent car park and land owned by West Kent Housing Association. The planning application was refused permission and options for the site are being reviewed in light of the decision. Aside from planning, the recent increase in interest rates and higher build costs are making it difficult to bring forward development at the current time.

- 19 **96 High Street, Sevenoaks (February 2017)** - This premise consists of ground floor retail space, 1<sup>st</sup> and 2<sup>nd</sup> floor office space. The land at the rear is next to a District Council car park which in turn is next to the bus station and therefore has the potential to support the Council's regeneration ambitions. Discussions have taken place and are ongoing with KCC to include land in their ownership to bring forward a larger scheme. Consultants have been appointed with a masterplan and feasibility study prepared to establish appropriate mix of uses, values and with a view to agreeing terms with a private sector development partner. The ground floor retail space is occupied by Hospice in the Weald on a short-term lease, subject to a developer's break clause on a rolling basis. The second floor is still in occupation by Second Floor Studios CIC and their lease is being made co-terminus with that on the ground floor.
- 20 **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. The option to acquire the house in the first phase was exercised on behalf of Quercus 7, and it has since been let on an Assured Shorthold Tenancy providing regular monthly income. The option to acquire the house in the second phase was exercised by the Council, and the house was sold on the open market for £640,000, realising a return on investment of around 7%.
- 21 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.

### Property Investment Strategy Income

- 22 The 10-year budget approved by Council in February 2021 included net Property Investment Strategy income of £1.372m in 2021/22 and £1.508m in 2022/23.
- 23 Net income of £1.252m is forecast in 2022/23 - £265,000 below the budget. This is due to a void period and associated business rates costs.
- 24 An annual dividend of £50,000 will be received from Quercus 7 from 2023/24
- 25 The Property Investment Strategy net income budgets included in the 10-year budget approved by Council in February are included in the table below:

Year	Net Income Budget
2022/23	£1.568m
2023/24 - 2025/26	£1.668m
2026/27 - 2028/29	£1.765m
2029/30 - 2032/33	£1.806m

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

### **Funding Sources**

- 28 The £35.5m 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 £4.4m. 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 £9.9m. From council balances for Quercus 7 investments.
  - e. External borrowing £nil. This funding method would incur interest and MRP costs each year.
- 29 Funding options are considered on a case-by-case basis and may be funded by reserves, capital receipts, internal borrowing or external borrowing, subject to the constraints referred to in the Executive Summary and below.
- 30 During 2019, at the request of Full Council, a Member Working Group investigated Income Strip Funding as an additional funding source and recommended that this should be considered for funding suitable future schemes.
- 31 Each scheme is assessed to consider whether it is preferable to proceed as the Council or via Quercus 7.

### **Public Works Loan Board (PWLB) - Access to Borrowing**

- 32 In November 2020, HM Treasury published the document 'Public Works Loan Board: Future Lending Terms'.
- 33 This document included changes to the PWLB lending terms designed to discourage councils from investing primarily for yield by restricting access to the PWLB. Under the new rules, councils are still free to borrow for service delivery, housing, regeneration, preventative action and delivery of government priorities.

- 34 The main points are:
- a. As a condition of accessing the PWLB, local authorities are now 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 are not permitted to access the PWLB.
  - c. When applying for a new loan, councils are required to confirm that the plans they have submitted remain current and reaffirm that they do not intend to buy investment assets primarily for yield.
  - 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).
- 35 Schemes within the agreed capital programme are funded by PWLB borrowing. This therefore means that the Council is currently unable to invest in property purely for yield such as through the Property Investment Strategy.
- 36 There have been a number of announcements and guidance notes from the Government and CIPFA (Chartered Institute of Public Finance and Accountancy) considering how some councils have borrowed from the PWLB to fund property investments and proposed changes to the Prudential Code.
- 37 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**

- 38 As mentioned above, the PWLB and Prudential Code changes will impact the opportunities to make further property investments within the strategy.
- 39 It is therefore recommended that the focus of officers time on the delivery of the Property Investment Strategy should be on development of the strategic assets listed in paragraph 17, realising their revenue potential, whilst recognising that the higher cost of finance and build cost inflation together with a deteriorating market for residential sales (demand for lettings has gone up) may result in a delay to the delivery of major development projects.

### **Risks**

- 40 The risks of the Property Investment Strategy are included in **Appendix B**. The risks were first assessed by the Audit Committee on 9 September 2014 and have been reviewed each year.



- 41 The Council's Strategic Risk Register was last considered by the Audit Committee on 22 September 2022 and the relevant extract is also included in **Appendix B**.
- 42 In terms of short-term variations in capital value, property investment is inherently more risky than leaving reserves in the bank but this was taken into account when establishing the Property Investment Strategy and setting the investment criteria. Treasury investment returns have long been below inflation levels resulting in the gradual erosion of those funds. A separate report on the Treasury Management Strategy 2023/24 is also being presented at this meeting.
- 43 The risks of each potential investment are considered by carrying out due diligence, including 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.
- 44 It should be recognised that there may be times when there are business reasons to dispose of assets held as part of the Property Investment Strategy and invest elsewhere instead.
- 45 The Scrutiny Committee set up a Property Investment Strategy Member Working Group at their meeting on 5 July 2016 and reported their findings on 30 March 2017.
- 46 The Member Working Group concluded that the benefits of the Property Investment Strategy do outweigh the risks, provided that the council remains alive to of changes in the market and financial risks.
- 47 Internal Audit completed an audit report on the Property Investment Strategy in 2020/21. The audit opinion given in the report was of reasonable assurance.
- 48 The audit report conclusion was: "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."

- 49 The assurances required over the Property Investment Strategy are considered each year as part of the risk-based annual audit planning process.
- 50 The changes to the PWLB lending terms also produce additional risks that did not previously exist.

### **Property Investment Strategy Criteria**

- 51 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**.
- 52 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 the Council remaining financially self-sufficient.

All other financial information can be found in the report.

#### Legal Implications and Risk Assessment Statement.

Legal resources would be required to undertake legal pre-purchase due diligence for any future acquisitions. Likewise, with disposals. 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.

Proceeding with further pure property investments would add additional risks in light of the changes made and expected by Government and CIPFA.

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.

#### Net Zero Implications

The decisions recommended through this paper have a remote or low relevance to the Council's ambition to be Net Zero by 2030. There is no perceived impact regarding either an increase or decrease in carbon emissions in the District, or supporting the resilience of the natural environment.

#### 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**

The investments previously made through the Property Investment Strategy continue to provide a reliable revenue income stream above the rate on cash reserves (although the gap has narrowed due to higher interest rates), with the potential for income and capital growth, in the long term. This will assist the Council to remain financially self-sufficient.

Commercial property is being repriced/revalued because interest rates have risen, linked to high inflation. In the short term, property capital values will be negatively affected with a greater reliance on current income for performance. The Council is not currently able to make further investments purely for yield, but the situation will continue to be monitored with the aim to make further investments via the Council or Quercus 7 in future.

#### **Appendices**

Appendix A - Property Investment Strategy

Appendix B - Property Investment Strategy - Risk Analysis - to Follow

#### **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**