Mole Valley District Council

Agenda Item 8

Executive Member	Lynne Brooks
Strategic Management Team Lead Officer	Nick Gray
Author	Nick Gray
Telephone	01306 879307
Email	Nick.gray@molevalley.gov.uk
Date	7 February 2017

Ward (s) affected	N/A	**Key Decision**	No

Subject	Asset Investment Criteria

RECOMMENDATIONS

Following further consideration by Scrutiny Committee of the Asset Investment Criteria, the Executive is asked to either:

a) Endorse the Investment Criteria set out in this report, or;

b) amend them as appropriate.

The Executive has the authority to determine the Recommendations

1.0 Background

1.1 At its meeting of 11 October 2016, The Council approved an Asset Investment Strategy and the consequent addition of £48.5m to the Capital Programme for the purchase of investment assets.

1.2 In approving this Strategy the Council also agreed that it would helpful to have further scrutiny of the detailed criteria for undertaking asset purchases, before these were formally adopted.

1.3 The following paragraphs, (1.4 to 1.9), therefore re-state the proposed Investment Criteria for consideration by Scrutiny Committee and subsequently Executive:

Criteria for selecting investment assets

1.4 Asset acquisitions will need to meet a number of investment criteria. It is recommended that the initial selection of an asset be assessed on two main criteria on a pass or fail basis.

a) due to the Council's requirement to generate income through a satisfactory level of return, the Net Initial Yield, (NIY), should exceed a minimum level of 5.0% and the Internal Rate of Return, (IRR), should exceed a minimum level of 7.0%. The IRR is typically higher than the NIY, since it gives an overall level of return over the holding period of the investment. This is calculated using a discounted cash flow and can allow for rental growth, void periods, refurbishment expenditure and so on.

b) If purchasing a lease, it should be capable of being classified, for accounting purposes, as an operating lease rather than finance lease. If classified as a finance lease, a proportion of the rental income from the lease would need to be treated as a capital receipt, rather than income, thus reducing the net benefit to MVDC's income budget. This will be tested as part of the initial evaluation of a potential purchase.

1.5. Any asset meeting these first two criteria will pass to the next stage for consideration. Subject to paragraph 1.6 below, an asset that does not meet these two main criteria would not be considered further.

1.6 Assets passing the first two criteria will be tested against a comprehensive set of Investment Evaluation criteria, shown in the table below. The minimum score should be at least 100 out of a maximum score of 168. No project will be considered further if it fails the weighting test, unless the yield is high enough and the additional risk can be balanced within the portfolio; this is explored in the next paragraph as there will sometimes be a trade-off between the yield, (NIY), and the Investment Evaluation score.

1.7 For example, a project might provide a higher NIY but might reflect higher risk and probably a consequently lower Investment Evaluation score. Conversely, a lower NIY would reflect a lower level of risk and a higher Investment Evaluation score. It is therefore proposed that if a particular investment shows an NIY of more than 6%, the Evaluation score benchmark be set at 90 rather than 100, although in order to ensure a balanced portfolio these projects should represent no more than 25% of the overall portfolio value.

	Score	**4**	**3**	**2**	**1**	**0**
Investment Evaluation Criteria	**Weighting Factor**	**Excellent**	**Very Good**	**Good**	**Acceptable**	**Marginal/ Barely Acceptable**
Location	**12**	Major prime	Micro prime	Major secondary	Micro secondary	Tertiary
Tenancy strength	**10**	Single tenant with strong financial covenant	Single tenant with good financial covenant	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant	Tenants with poor financial covenant strength
Tenure	**9**	Freehold	Lease 125 years plus	Lease between 50 & 125 years	Lease between 20 & 50 years	Lease less than 20 years
Occupiers lease length	**5**	Greater than 10 years	Between 7 and 10 years	Between 4 & 7 years	Between 2 & 4 years	Less than 2 years; vacant
Repairing terms	**4**	Full repairing & insuring	Internal repairing - 100% recoverable	Internal repairing - partially recoverable	Internal repairing - non recoverable	Landlord
Lot size	**2**	Between £6m and £12m	Between £4m & £6m or £12m & £18m	Between £2m & £4m or £18m & £20m	Between £1m & £2m or £20m & £25m	Less than £1m or more than £25m

1.8 These Evaluation Criteria are proposed as entirely fixed, and should not be deviated from, by the Asset Investment Working Group.

1.9 As an example, the ideal property investment would be a freehold in a primary town centre, let to a tenant with a strong financial covenant for a long term on a full repairing and insuring lease. An investment of this nature would score very highly under the above criteria.

2.0 Options

2.1 It is important that the Council has a clear set of criteria for undertaking asset investments. These will need to be rigidly applied for individual purchases, although they will be subject to regular review to ensure that they continue to support the Council's objectives into the medium term.

2.2 The Executive can choose to a) adopt the criteria as set out above, or b) amend them as appropriate following consideration by Scrutiny Committee.

2.3 The above criteria are based on industry standards and have been developed following advice from property investment consultants and a review of best practice in other local authorities.

2.4 Consequently, the criteria as set out above are recommended.

3.0 Corporate Implications

Monitoring Officer commentary

The Monitoring Officer is satisfied that there are no legal implications arising directly from this report

S151 Officer commentary

The purpose of the Asset Evaluation Criteria is to confirm the appropriate relationship between financial return and risk in relation to MVDC's Asset Investment Strategy. The Initial Yield and Internal Rate of Return define the financial return to the Council, while the criteria considered in the 'grid' give a measure of the level of risk associated with an investment. The criteria recommended are based on a combination of professional external advice and best practice in other local authorities. They are felt to represent a relatively cautious approach, reflecting a desire for a relatively low level of risk. The key question this raises is whether the fairly ambitious financial targets can be achieved with this relatively low risk level. (Broadly there is a trade off between financial return and risk – the more risk an investor is prepared to take, the greater the financial return they will receive). Ultimately, this will only be confirmed by future experience of the property investment market. The criteria will need reviewing at regular intervals, (say in 18 months time), or if it becomes apparent that investment opportunities are not available which can achieve the required financial return within the defined level of risk.

Risk Implications

An analysis of risk was undertaken and included in the Asset Investment Strategy report to Council on 11 October 2016.

For each potential purchase, whether for financial return or for other benefits, a risk analysis should be part of the business case and evaluation processes.

Equalities Implications

There are no direct equality implications involved in the adoption of the Asset Investment Criteria. Equality considerations will need to be taken into account on a case by case basis when considering investment opportunities, to ensure that MVDC is complying with its Public Sector Equality Duty obligations.

Employment Issues

None arising directly from this report.

Sustainability Issues

None arising directly from this report.

Consultation

None for the purposes of this report.

Communications

None for the purposes of this report.

Background Papers

None