Mole Valley District Council Asset Investment Strategy Annual Report to Council for 2018/2019

Issued in accordance with the statutory guidance on Local Authority Investments (3rd edition)

January 2019

Version	Date	
1.0	29 January 2019	Issued for Audit Committee 07.02.19

1. INTRODUCTION

1.1 Mole Valley District Council's (**MVDC**) Medium Term Financial Strategy (**MTFS**), approved in 2013, set out MVDC's approach to managing its financial position over the period 2014/2015 – 2020/2021. The themes of the MTFS included:

- Make best use of assets: through projects that use MVDC land and property to improve services and generate income;
- Improve returns on investment: without unduly compromising on security and liquidity, seek to diversify investments to obtain a better yield, with particular consideration of property and property related funds;
- Capital spend to generate income: opportunities to invest MVDC capital in a way that generates benefits for MVDC's revenue budget.

1.2 In order to keep pace with increasing demands for services in the face of ongoing reductions in the Government Revenue Support Grant (**RSG**), MVDC identified the acquisition of property assets as a means of meeting MVDC's budget pressures and the Asset Investment Strategy (**AIS**) was approved at a meeting of Full Council on 11 October 2016.

2. THE ASSET INVESTMENT STRATEGY

2.1 MVDC, like many other authorities, is an experienced property manager. Prior to the approval of the AIS in October 2016, MVDC already owned a variety of investment property in Leatherhead and Dorking. These properties had been acquired over a number of years to facilitate the economic development of the district and to also generate a rental income stream which supported the wider financial position of MVDC.

2.2 The AIS set out a comprehensive framework for the acquisition of additional property investments, covering the acquisition criteria, the governance and decision making processes, and the legal framework, including the incorporation of one or more property investment company or companies. The total funds allocated to the AIS in October 2016 were £48.5 million, with a target rental contribution to MVDC's revenue budget of £0.75 million per annum by 2019/2020. This target rental contribution was based on a 5.75% yield, capital financing costs of 4% and portfolio administration costs of 0.15%.

2.3 In February 2018, the addition of a further £51.5 million to the Capital was approved at a meeting of Full Council. This increased the funds allocated to the Asset Investment Strategy (**AIS**) to £100 million. In addition, the scope of the AIS was extended to include property funds as a possible investment class. A number of amendments to the evaluation criteria were also approved to enable a more diverse portfolio to be acquired. These amendments were:

- the Internal Rate of Return was amended from a hurdle rate of 7% to a target of 6%;
- a revised Investment Evaluation Matrix as set out in Appendix B1.

2.4 The report to Full Council in February 2018 adjusted the target contribution to MVDC's revenue budget from the AIS to reflect the changes identified to the assumptions underpinning the October 2016 forecast. Based on a £100 million total investment allocation, the forecast contribution was £1.35 million per annum by 2019/2020. The adjusted forecast took account of the impact of a higher rate of borrowing in the first year of the AIS, of 2.36%, rather than 2%. The revised AIS model assumed that for the second tranche of investment, it would be at a Public Works Loan Board (**PWLB**) rate of 2.58% and assumed that of the total £100 million, £26.8 million would not be invested until 2019/2020 and the final tranche of £17.1 million would not be invested until 2020/2021.

IMPLEMENTATION OF THE AIS

3. SOURCING INVESTMENT OPPORTUNITIES

3.1 Officers established relationships with a variety of agents supplemented by a dedicated Property Investment page on the molevalley.gov.uk website. This contained a landing page for agents to better inform introducing agents as to the AIS criteria and the service that agents are required to provide.

3.2 In-house qualified[1] and experienced chartered surveyors in the Investment and Regeneration team who have between them 76 years professional post-qualification experience, review and analyse proposed investment opportunities against the AIS criteria. This enables MVDC to act as an intelligent client and to robustly review and interrogate the reports and opinions of its professional advisers. A property summary with the marketing brochure (if available) is submitted to the Asset Investment Working Group (**AIWG**) together with supporting commentary and an analysis setting out how the asset scores against each of the AIS criteria based on a recommended maximum purchase price. The AIWG comprises officers and members from each political group. The membership and terms of reference of the AIWG is set out in the MVDC constitution[2].

3.3 If, following consultation with the AIWG, the Deputy Chief Executive decides that a bid is to be submitted (up to the agreed maximum), the relevant chartered surveyor in consultation with the Deputy Chief Executive will lead negotiations via the introducing agent with the objective of obtaining best value. If a bid is accepted and heads of terms agreed, MVDC will instruct full due diligence. The technical due diligence is undertaken by external professional advisers in accordance with the relevant RICS professional standards, including a purchase report undertaken in accordance with the RICS Valuation – Professional Standards January 2014 (revised April 2015) (the ‘Red Book’) supported by building surveys and a Dun & Bradstreet (D&B) analysis of covenant strength (the ability of the tenant(s) to pay the rent).

3.4 The legal due diligence is outsourced to a panel firm on the Surrey Legal Services Framework who offers commercial property, planning, construction, environmental, corporate, commercial and tax law services. The in-house Legal Services team are

[1] MRICS: Member of the Royal Institute of Chartered Surveyors

[2] Part 3 – Responsibility for Functions: page 59 “Terms Of Reference Of The Asset Investment Working Group”

appraised of the transaction but do not have the capacity to undertake the due diligence in the very tight timescales required to secure the asset.

3.5 On completion of the due diligence, the chartered surveyor updates the initial analysis of the investment opportunity to take account of the due diligence and this is then provided to the AIWG together with confirmation of the final purchase price and gross investment level. Following consultation with the AIWG, the Deputy Chief Executive makes the final decision to:

3.5.1 acquire the investment asset in the name of Mole Valley District Council using its powers to acquire land under section 120(1) of the Local Government Act 1972;

3.5.2 in reliance on its section 1 Localism Act 2011 powers, to fund Mova Property Limited for the purposes of acquiring the investment asset, with the directors of Mova Property Limited (which include the Deputy Chief Executive, the Chief Executive and the Corporate Head with responsibility for Planning) making the decision to proceed to exchange and completion of the investment asset.

3.6 The decisions are taken by the Deputy Chief Executive under special urgency powers as set out in MVDC's constitution. The special urgency powers are used by the Deputy Chief Executive as transaction timescales mean it is not practicable to defer such decisions for meetings of Cabinet. Details of the decisions are published on MVDC's website as soon as practicable after the decision has been taken and these are subsequently reported to the next Council meeting.

4. PORTFOLIO

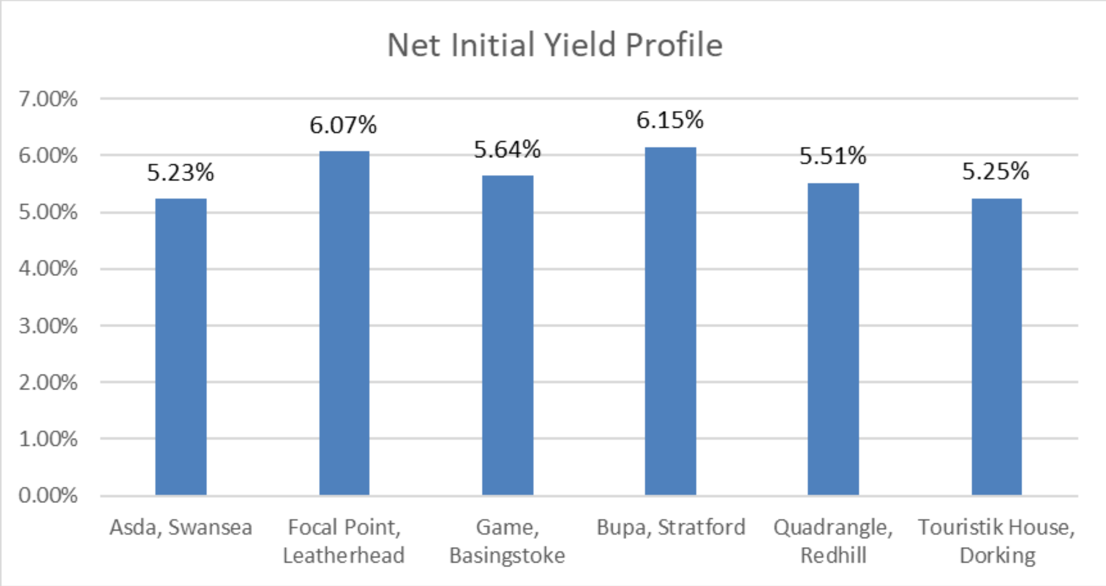
4.1 Since the commencement of the AIS in October 2016, six freehold properties have been acquired. Three freehold properties were acquired in the period April 2017 to January 2018, and a further three freehold properties were acquired in the period July 2018 to October 2018.

4.2 There have been no abortive bids in the period since the February 2018 report to Full Council. The combination of the following factors:

- clear criteria, reflecting MVDC's risk appetite, against which opportunities could be objectively assessed;
- a governance structure which enabled MVDC to work to exacting transaction timetables,
- an in-house qualified and experienced team of chartered surveyors,
- appropriate external legal advisors and other professional advisors such as building surveyors who were able to resource the due diligence to an exacting timetable, and
- access to finance,

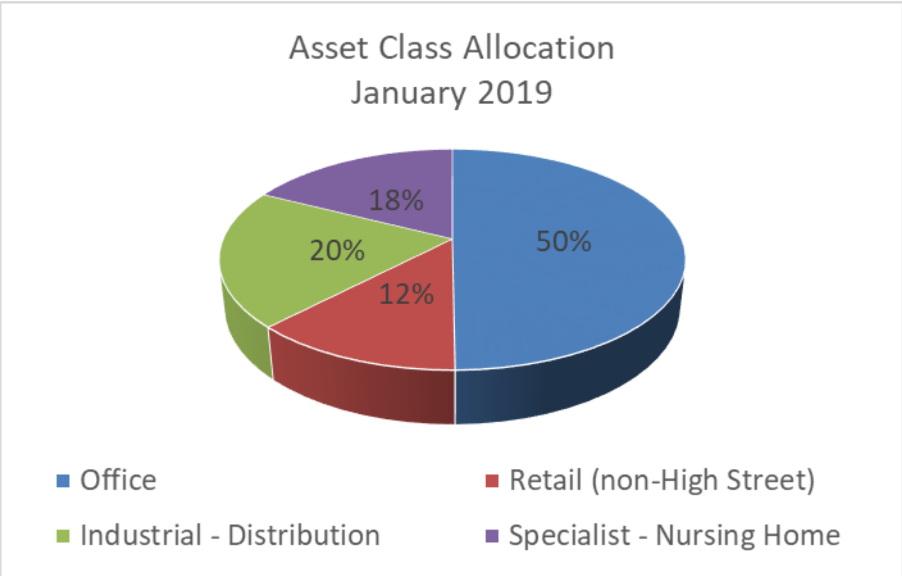
meant that MVDC was viewed as a credible buyer. This in turn meant that MVDC's bid, whilst it was often not the highest, was preferred, as the seller drew reassurance that MVDC would be in a position to proceed without delay, subject to the requirements of our due diligence process and external valuation report.

4.3 Further details of the assets are set out in Appendix B1, however, the table below demonstrates how each of the acquisitions to date exceed the 5% Net Initial Yield[3] requirement.



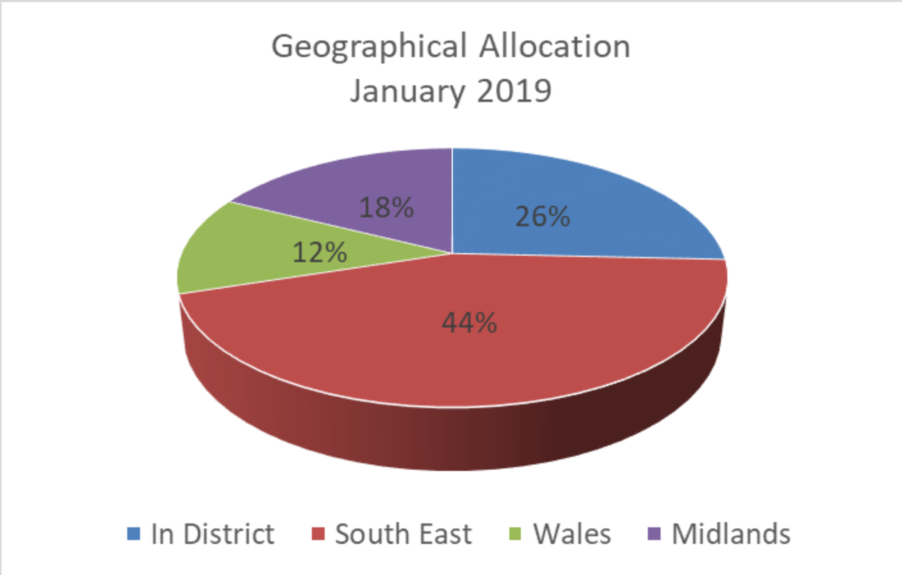
4.4 A diversified portfolio has been established. The diversification is geographical, asset class, tenant sector and tenant contribution.

4.5 The pie chart 'Asset Class Allocation' sets out the amount invested in each asset class as a percentage of the total amount invested. The Office asset class consists of Focal Point, Leatherhead (with two tenants), Quadrangle, Redhill and Touristik House, Dorking.

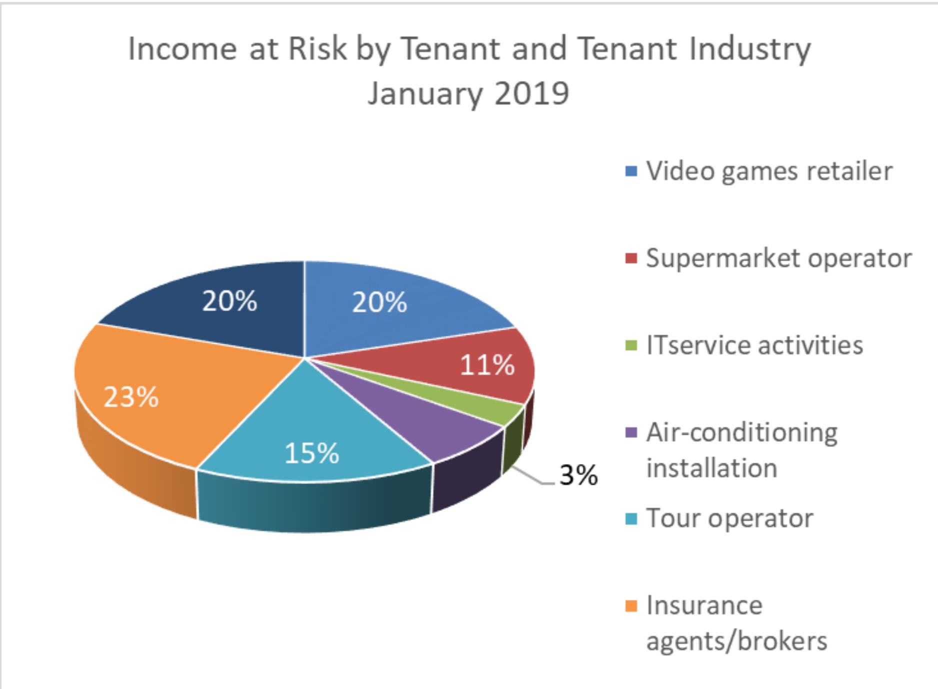


[3] Net Initial Yield is calculated by dividing the rent payable by the tenant by the total acquisition cost of the asset (being purchase price, stamp duty land tax, agent's fee, legal and technical due diligence fees).

4.6 The pie chart ‘Geographical Allocation’ sets out the amount invested by region as a percentage of the total amount invested. The properties classified as within the South East (but not in district) are Quadrangle, Redhill and Game, Basingstoke.

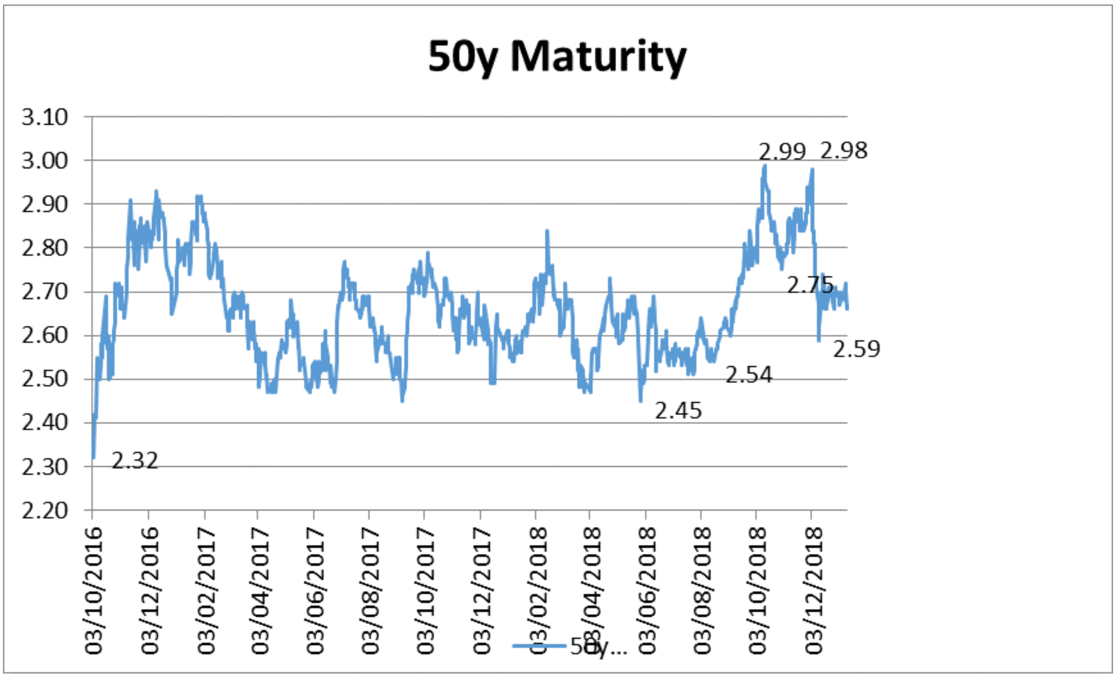


4.7 The pie chart ‘Income at Risk by Tenant and by Tenant Industry’ shows the industry in which tenant operates (and we have seven tenants across six properties, as Focal Point is occupied by two tenants), and the amount of rent receivable by MVDC as a percentage of the total rent receivable.



5. PORTFOLIO FINANCIAL PERFORMANCE

5.1 The Bank of England increased the base rate from 0.5% to 0.75% in August 2018; and the Public Works Loan Board (PWLB) lending rates, which are tied to Gilts rather than the base rate, also increased. Gilts yields reflect the relative attractiveness of investing in the UK, compared to other countries, and are sensitive to global political and economic factors. The graph below shows the volatility in PWLB rates for a fixed interest 50 year interest-only loan during the period October 2016 to January 2019.



5.2 No asset disposals are planned during the financial year 2019/2020. Political and economic uncertainty leading to volatility of cost of capital means that no further investments will be pursued under the AIS. MVDC may however continue to acquire property in accordance with its other priorities, such as Transform Leatherhead or to further its service delivery objectives.

5.3 The table at Appendix B2 of this report sets out the modelled target contribution in the Council report of 11 October 2016 against the projected contribution from the AIS assets as at the date of this report and assumes that no further investments will be acquired in 2019/2020.

5.4 The revenue generated to MVDC's general fund by the AIS portfolio is monitored as part of the monthly budget monitoring process and formally reported to meetings of the Cabinet as part of the business and budget reporting.

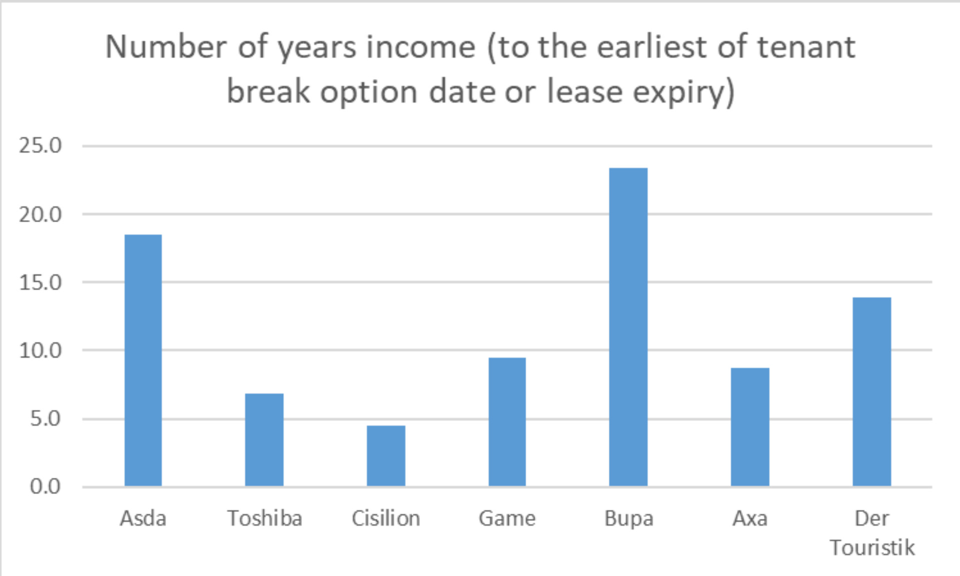
5.5 From a property and tenant risk management perspective, performance against the following basket of indicators illustrate the status of the AIS portfolio. All the AIS properties are tenanted; there are no vacant assets or unlet floor space.

Indicator	**Purpose**	**Target**	**Actual**
Fall in tenant D&B rating from date of acquisition	A fall in the D&B score indicates either a fall in tangible net worth or an increased risk of failure, or both.	No fall in rating assigned to tangible net worth AND risk of failure	One tenant's risk of failure has fallen from a 1 (minimum risk of failure) to a 2 (lower than average risk). There is no deterioration in tangible net worth.

			The position will be monitored.
Rent collection rates	Rent arrears indicate that the tenant may be in financial difficulty.	100% collection rate	100%
Late payments	Late payment indicate that the tenant may be experiencing cash flow difficulty.	0%	0%
Bad debts	Rent or other payments owed to MVDC that are classified as non-recoverable indicate that the tenant is in financial difficulty	£nil	£nil
Service charge reconciliation	No receipt of service charge from the tenant indicates that the tenant is in financial difficulty. A failure to reconcile the service charge account may reflect poor performance by the managing agent.	100%	100%
Outstanding rent reviews in excess of 12 months	Rent reviews which are calculated by reference to a pre-determined rate should be agreed and documented in a timely manner by landlord and tenant – subject to the publication date of the relevant information Where they are calculated by reference to Open Market Value (OMV), the process is more protracted. If the asset is over rented (the tenant's rent is more than the market rent) or the tenant had a poor covenant, this could protract agreement.	Nil	Nil. Two rent reviews agreed and documented since acquisition of the relevant asset. Next rent reviews fall in 2021/2022.
Health & Safety Incidents or Insurance Claims	Incidents or claims reported to the landlord may indicate a want of repair by the tenant with repairing obligations.	Nil	Nil

5.6 As can be seen from Appendix B1, there are no break options or lease expiries falling in 2019/2020, with the first tenant only break falling in 2023 and the first lease expiry not falling until 2026. As a result, there have been no dilapidation claims (which may arise on lease expiry if a tenant has not kept the asset in the required standard of repair under the lease) or capital expenditure incurred by MVDC (where necessary to secure a new occupier) across the AIS portfolio to date.

5.7 The number of years income by tenant is profiled in the chart below:



5.8 There are a number of risks arising from the AIS portfolio. These are set out at Appendix B3 together with the risk mitigation measures. For example, in relation to dilapidation claims, regular inspections of the asset and monitoring compliance with the tenant's repairing obligations should minimise the risk of an unplanned dilapidations claims or unplanned capital expenditure to put the asset back in lettable condition arising on lease expiry. Where the hold strategy for a specific asset anticipates that the asset will be held beyond expiry of the current lease, conservative assumptions relating to void periods and to capital expenditure have been factored into the IRR calculations. MVDC also operates revenue reserves.

5.9 Given that the income from the AIS portfolio is used to service the interest payments on the PWLB borrowing and funds service delivery, the greatest risks to MVDC from the AIS portfolio are from a reduction in the rental stream through the following events:

- a tenant seeking to reduce by negotiation the rent payable under the lease;
- a tenant seeking to negotiate a surrender of the lease due to a change in business circumstances;
- a tenant being unable to pay the rent in accordance with their lease obligations due to cash flow difficulties and/or entering into some form of insolvency proceedings.
- a tenant not complying with their repairing and insuring obligations;
- a tenant electing to exercise a break option and there being a delay in MVDC/Mova Property Limited finding a replacement occupier, and/or only being able to secure a replacement occupier through accepting a lower rent.

6. INVESTMENT MARKET

6.1. The table below sets out the Prime Yields (the yield on fully rented property of the best physical quality, the best location and with the best tenant covenant) for a range of different asset classes. As can be seen, they are generally below MVDC's NIY 5.0% threshold, which has meant that MVDC has focused on acquiring investment assets in regional locations.

Asset class	Prime Yield (Q2 2017)	Prime Yield (Q3 2018)
Shops	4.00%	4.25%
Shopping Centres	6.00%	6.25% (Sub regional)
Retail Warehouses	4.50%	4.75%
Central London Offices	3.50%	3.50%
Rest of South East Offices	5.00%	5.00%
Rest of UK Offices	4.75%	4.75%
Office Parks	5.25%	5.25%
South East Industrial	4.00%	3.75%
Rest of UK Industrial	5.00%	4.75%
Distribution Warehouses	4.00%	3.75%
Hotels & Leisure	4.75%	4.25%

(Source LSH UK Investment Transactions Bulletin – Q22017 and Q32018)

6.2. The table above illustrates that prime yields have increased (in other works, purchase prices have fallen) across the retail asset classes by on average 0.25% between Q2 2017 and Q3 2018. Prime yields on other asset classes have remained stable or fallen (in other words, purchase prices have stayed flat or increased). Full year data for 2018 is not available as at the date of this report.

6.3. According to the LSH UK Investment Transactions Bulletin – Q32018, UK commercial property remains attractive for overseas investors, and notwithstanding the risks around Brexit, the UK continues to offer relative value and a safe haven for international capital. Property compared to other investment classes has continued to provide good value, with the All Property total return forecast at around 6.5% for 2018 with income providing the main component of return.

6.4. Diversification of the portfolio across asset classes provides some protection from MVDC from fluctuations in the relative value of different asset classes. Through having secured long term funding from PWLB, MVDC is in a position of being a long-term investor which enables MVDC to withstand cyclical fluctuations in asset classes or across the commercial property market as a whole.

7. PORTFOLIO MANAGEMENT

7.1. At the time of purchase, officers worked with the acquiring agent to model a number of scenarios to identify when the asset should be sold (the optimum hold period). To assist in the risk management of the portfolio, MVDC commissioned Ernst & Young LLP (**E&Y**) to create a financial model.

7.2. The E&Y model enables officers to model purchases, to assess the impact of a property on both Mova companies from a profit and loss, balance sheet and cash flow basis, as well as the impact on MVDC General Fund (prior to MRP). It also enables officers to undertake sensitivity testing of the portfolio. There are currently ten different scenarios which can be evaluated, including inflation rates (CPI and RPI), void costs, staff costs, running costs, capex, hold period, exit proceeds, service charges, and interest rate changes. It enables officers to update the purchase assumptions and assess lease events to determine the implications on the asset management strategy of an individual asset and the optimum hold period. Monitoring in the initial post-acquisition period has focused on financial performance and tenant relations and monitoring; the resource allocated to this monitoring will extend and intensify over the term of the holding, as hold strategies and valuations are revisited and refreshed.

7.3. The Investment and Regeneration team receive regular market updates on investment trends, activity forecasts, investor sentiment and the state of occupational markets from the RICS as well as various member firms.

7.4. Tenant covenant strength is monitored quarterly, using the tenant risk indicators set out at section 5.5, including Dun and Bradstreet reports supplemented by company reports and accounts, and alerts. Tenant default is a significant risk to the success of the AIS, with the implications of void periods, and associated costs and corresponding loss of rent.

7.5. Lease event dates (such as break options, rent reviews lease expiries) are tracked and have been or will be managed by the Investment and Regeneration team at the appropriate time.

7.6. The actual decision to sell a property may be triggered by a variety of factors, including the state of the property market and the economic cycle, lease events, market forces, portfolio mix, tenant financial standing or changes in the AIS objectives. The portfolio is actively managed with a view to minimising risk and maximising returns. To take account of the costs of acquisition, it is not envisaged that any properties would be divested in the first three years post-acquisition, and the minimum optimum hold period modelled on acquisition is generally not less than five years.

7.7. The properties purchased under the AIS are subject to an annual revaluation using the fair value model in International Accounting Standard 40: Investment Property as adapted. The annual revaluation is undertaken by Wilks Head & Eve LLP, London based firm of RICS registered valuers who value all of MVDC's property portfolio. Any change in fair value valuations of the AIS assets will be recorded in the balance sheet of both MVDC and Mova Property Limited; however there will be no impact on MVDC's income and expenditure statement and so this would have no impact on council tax. In order to ensure that MVDC has sufficient funds to repay the loans from PWLB at the end of the term, MVDC will transfer funds each year to a ring-fenced reserve account; this is known The annual revaluation of the three assets held under the AIS as at 31 March 2018 all recorded an appreciation in capital value and provide security for capital loss.

7.8. Officers are seeking to appoint an investment advisor in 2019 to assist the Investment and Regeneration team in keeping the portfolio, and in particular the optimum hold periods, under regular review. This appointment will follow a competitive procurement process undertaken in accordance with MVDC's contract standing orders.

7.9. As no further capital is to be invested on AIS acquisitions, the current managing agent arrangements for the AIS assets are going to be aggregated and a competitive tender process undertaken in 2019. The role of the managing agent will be to support the Investment and Regeneration team in monitoring and ensuring tenant compliance with tenant repairing obligations and in the case of Focal Point, to manage rent and service charge collection as well. For the other assets, rent invoicing and rent collection is managed by the Investment and Regeneration team with support from the Finance team.

8. INVESTMENT IN PROPERTY FUNDS

8.1. As highlighted in the February 2018 report to Council, officers received advice from Ernst & Young on the accounting and regulatory issues of investment in property funds. As any additional investment in property funds will be funded by MVDC's capital programme, which in turn is supported by borrowing, such investments will need to be classified as capital expenditure in accordance with the requirements of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.

8.2. The purchase of units in property funds such as the CCLA (a UK charity fund manager who manage investments for churches, charities, and local authorities (CCLA)) that are approved by the Treasury under the Trustee Investments Act do not count as capital expenditure, and this means that MVDC will not be able to use the AIS funds, if extension is approved, to increase its holding in the CCLA or similar funds. The work currently being undertaken by Link Treasury Services Limited will determine the availability, suitability and desirability of Funds which meet this capital requirement.

8.3. Link Treasury Services advised officers that there were no suitable funds in which investment would classified as capital expenditure which could deliver an appropriate return to MVDC, after taking account of its cost of funds and the requirement for a minimum revenue provision (**MRP**).

9. LEGAL IMPLICATIONS

9.1. The October 2016 report to Council set out the legal implications of the Asset Investment Strategy. Since that report, MVDC has established its wholly owned company Mova Holdings Limited (company registration number 10510854) and a subsidiary, Mova Property Limited (company registration number 10510956), for the purposes of acquiring and holding properties purchased for the purposes of the Asset Investment Strategy using MVDC's general power of competence (section 1 Localism Act 2011). Mova Property Limited holds the property assets, funded through a mixture of equity and debt facilities from MVDC.

9.2. The articles of association of both companies recognise that as the directors are also officers of MVDC, there may be situations where the companies interests' are not aligned to those of either or both of the companies. An example of this is in relation to the rate at which MVDC is prepared to lend to Mova Property Limited. Advice has been obtained from PriceWaterhouseCoopers as to what constitutes an arms-length interest rate and the appropriate funding structure (debt: equity ratio), taking account of both tax and state aid compliance. Specific advice is provided on a transactional basis by external lawyers, Freeths LLP (appointed under a Legal Services framework) to the directors with the in-house Legal Services team advising MVDC.

9.3. Although the directors are required to manage the companies' activities in accordance with the Asset Investment Strategy approved by the Council, the directors must also ensure that any board decisions to purchase property also promote the success of the companies, taking into account the terms of the loan facilities offered to the company. All the directors have received training on directors' duties under the Companies Act 2006. Refresher training on directors' duties will be offered in 2019 and training on broader corporate governance is being explored for the directors. The Executive Head of Service with responsibility for Legal Services obtained the Institute of Directors' certificate in company direction in 2018 which places significant emphasis on corporate governance for small and large companies and this will be drawn on in order to design and deliver further training to the directors in 2018/2019.

9.4. As described earlier in the report, to support the directors' financial decision making and risk-management of the portfolio, a bespoke tool has been developed by Ernst & Young to enable the financial impact of actual and potential properties on both the company and on MVDC to be modelled. This tool also allows an ongoing review to ensure the company holds properties for the optimum period and disposes of properties at the right time in order to maximise returns. This supplements Sage, which has been purchased as the company's accounting software and which provides management accounts. An auditor has been appointed in respect of the Mova companies.

9.5. MVDC has the power to invest under its investment power contained in section 12 of the Local Government Act 2003. Any investment must be suitable and appropriate as part of a diversified investment strategy and be consistent with the Council's fiduciary duty to act in the best interests of its council tax payers and MVDC's best value duty under the Local Government Act 1999. Where such an investment results directly or indirectly in an increase in MVDC's borrowing requirements then, provided (i) the additional borrowing is prudent and complies with MVDC's Affordable Borrowing Limit determined under section 3 of the Local Government Act 2003 and (ii) MVDC follows proper accounting practices in accordance with section 21 of the Local Government Act 2003, it is considered to be lawful. MVDC is required to have due regard to statutory guidance on Local Government Investments and on Minimum Revenue Provision.

10. REVISED STATUTORY GUIDANCE : STATEMENTS AND DISCLOSURES

10.1. The AIS properties have been acquired by MVDC and by Mova Property Limited, a wholly owned company. In accordance with the statutory guidance issued by MHCLG in February 2018, a number of statements and disclosures are required to be contained in this document or to be clearly signposted, where they are contained in other report or document.

10.2. The revised statutory guidance relates to the implementation of the AIS in the following ways:

- AIS properties acquired directly by MVDC are classified as non-financial investments;
- Loans extended to Mova Property Limited and shares acquired in Mova Holdings Limited for the purposes of funding the acquisition of AIS properties by Mova Property Limited are classified as loans and non-specified investments respectively.

10.3. The AIS properties acquired by Mova Property Limited are financed by MVDC through loans equal to 70% of the purchase price, excluding acquisition costs, with the balance of the total acquisition cost being funded through the purchase of shares. MVDC has the benefit of a legal charge (mortgage) over the AIS asset owned by Mova Property Limited as well as a parent company guarantee from Mova Holdings Limited in favour of MVDC. External advice was sought on structuring the financing of the Mova companies to ensure that it was state aid compliant.

10.4. As well as a maximum Loan to Value (LTV) of 70% of the purchase price, the sustainability of the interest rate payments by Mova Property to MVDC is assessed by reference to an interest rate cover ratio over the life of the loan. The interest rate cover ratio is Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) divided by the annual rent. A ratio of 1.5 - 2.0 has been considered acceptable to both the directors of Mova Property Limited as borrower and to MVDC as lender.

10.5. The AIS properties acquired in the financial year 2017/2018 were valued by an external valuer, Wilks Head Eve LLP, in accordance with Internal Accounting Standard 40 for the purposes of producing the 2018 accounts and all three recorded an appreciation in capital value and provide security for capital loss. The three AIS properties acquired in the financial year 2018/2019 will be valued by an external valuer for the purposes of producing the 2019 accounts. If a loss is recognised in the fair value of any of the AIS properties as part of the 2019 year end accounts preparation and audit process, a report will be presented to Full Council detailing the impact of the fair value loss on the security of the investments and any revenue consequences arising as a result.

10.6. In relation to liquidity, this is recorded as a risk on the risk register together with the mitigations. For each asset, a business plan coupled with a discounted cashflow, typically modelled using valuation software such as Argus, was developed prior to acquisition, reflecting assumptions around rental growth and capital growth. This modelling established the hold period consistent with the target IRR, and it is this hold period and underlying assumptions that will be monitored.

10.7. In relation to proportionality, should MVDC not achieve the expected net income from the AIS assets (for example due to tenant default) in 2019/2020, MVDC has revenue reserves available for allocation as a sinking fund against void periods incurred.

10.8. Four of the quantitative indicators recommended in the statutory guidance are set out in the Treasury Management Strategy:

- Debt to net service expenditure (NSE) ratio (Gross debt as a percentage of net service expenditure is a proxy for the size and financial strength of a local authority)
- Commercial income to NSE ratio (Dependence on non-fees and charges income to deliver core services)
- Investment cover ratio (The total net income from property investments compared to the interest expense)
- Loan to value ratio (The amount of debt compared to the total asset value).

10.9. The remaining five quantitative indicators recommended in the statutory guidance are set out in the table below:

Quantitative Indicator	Description	
Target Income Returns	Net revenue income compared to equity. This is a measurement of achievement of the portfolio of properties.	The weighted average yield is 5.63% per annum across the AIS assets.
Benchmarking of returns	A measure against other investments and against other council's property portfolios	Other investments: CCLA: 4.5% per annum (on average) Other investments: 1.6% per annum (on average)
Gross and net income	The income received from the investment portfolio at a gross level and net level (less costs) over time	Total rent: £5.234 million Total contribution £1,050 million projected for 2019/2020
Operating costs	The trend in operating costs of the non-financial investment portfolio over time as the portfolio of non-financial investments expands.	Operating costs: these include the costs of administering the companies (statutory filings, accountancy, audit services and tax advisory), company secretarial, as well as managing agents and investment advisors. These are to be tendered in 2019/2020.
Vacancy levels and tenant exposures for non-financial investments	Monitoring vacancy levels (voids) ensure the property portfolio is being managed (including marketing and	None. Further indicators relating to tenant covenant monitoring are set out in this report at section 4 and

	tenant relations) to ensure the portfolio is as productive as possible,	in the risk register at Appendix B3.

Appendices

Appendix B1 Portfolio and AIS criteria

Appendix B2 Contribution

Appendix B3 Risk Register

APPENDIX B1

Asset and Tenant	Date of Acquisition	Purchase Price (excluding acquisition costs)	Gross Cost of Acquisition	Fair Value as at 31 March 2018 (IAS 40)	Net Initial Yield (%)	Current Rent per annum (£)	Unexpired lease term or term certain
Asda Superstore, Ystalyfera, Swansea Wales Tenant: Asda Stores Limited 	24.4.2017	£10,800,000	£11,461,033	£10,945,500	5.23%	£599,450	2037
Focal Point, Leatherhead Tenants: Cisilion Limited and Toshiba Carrier UK Limited 	06.12.2017	£8,030,000	£8,504,657	£8,189,000	6.07%	£519,964	2026 (Toshiba) 2027 (Cisilion with Tenant only break on 15 September 2023
Game Head Office and Distribution	31.01.2018	£17,600,000	£18,664,455	£17,921,500	5.64%	£1,060,000	2033 (Tenant option

Centre, Basingstoke Tenant: Game Retail Limited 							to break with effect on 7 October 2028
Alveston Leys Nursing Home, Stratford-upon-Avon Tenant: ANS Homes Limited Guaranteed by Bupa Care Homes (CFG) PLC 	31.07.2018	£15,300,000	£16,223,346	N/A as acquired during 18/19 Financial Year	6.15%	£1,029,308	2042
Quadrangle, Redhill Tenant: Axa Assistance UK Limited Guaranteed by Inter Partner Assistance SA	29.08.2018	£21,050,000	£22,267,980	N/A as acquired during 18/19 Financial Year	5.51%	£1,226,849	2032 (with Tenant only break clause in 2027)

							
Touristik House, Dorking Tenant: Der Touristik UK Limited (formerly Kuoni Travel Limited) Guaranteed by Rewe-Zentralfinanz E.G 	19.10.2018	£14,350,000	£15,288,624	N/A as acquired during 18/19 Financial Year	5.25%	£802,420 per annum including 01 January 2023	2033

AIS evaluation criteria

	Score	4	3	2	1	0
Investment Evaluation Criteria	**Weighting Factor**	**Excellent**	**Very Good**	**Good**	**Acceptable**	**Marginal**
Occupier Lease Length[4]	**12**	Greater than 20 years	13 -19 years	10-13 years	7-10 years	5-7 years
Tenancy Strength	**10**	Single tenant with strong financial covenant	Single tenant with good financial covenant	2 x tenants with strong financial covenants	Multiple tenants with strong financial covenant	Multiple tenants with good financial covenant / or risky single covenant
Repairing Terms	**8**	FRI[5] - no landlord management	FRI - Landlord to manage estate	IRL[6] - 100% recoverable	IRL partially recoverable	IRL landlord's obligation
Location	**6**	Prime towns, good location	Prime towns, non-prime location	Non-prime towns, good location	Non-prime towns, non-prime location	Tertiary
Tenure	**4**	Freehold / Virtual Freehold	Lease 150 years plus	Lease 135 - 149 years	Lease 110 - 134 years	75 - 109 years
Lot size	**2**	£10-15m	£8-10m or £15-£18m	£5-8m or £18-£20m	£3-5m or £20-£25m	£2-3m or over £25m

Maximum possible score: 168 Minimum score required: 100

NIY – Net Initial Yield – 5% hurdle rate
IRR – target 6%.

[4] Lease Length is the unexpired lease term or where there is a tenant break clause, up to the break date.

[5] FRI – full repairing and insuring lease

[6] IRL – internal repairing lease

APPENDIX B2 FINANCIAL MODEL AND CONTRIBUTION

	AIS Model (Approved by Council on 11 October 2016) £000	Income and Expenditure as at February 2018 £000	Adjusted AIS Model (Approved by Council on 20 February 2018) £000	Projected Income and Expenditure to for 2019/2020 £000
Capital Expenditure	48,530	35,500	100,000	92,410
Gross Rent	(2,790)	(2,176)	(5,749)	(5,234)
Capital Financing Costs (Interest and Provision for Repayment)	2,038	1,709	4,396	3,933
Net Contribution	752 (pre-tax) by 2019/2020;	467 (pre-tax)	1,353 (pre-tax) by 2020/2021	1,305 pre-tax and expenses 1,050 contribution **after tax and expenses** projection for 2019/2020.

Variance:

The Adjusted AIS Model profiled investment over the four financial years 2017/2018 to 2020/2021, and assumed that:

- by 2018/2019 approx. £56 million would have been invested;
- a weighted average rental yield of 5.75%;
- a weighted average cost of capital of 4.40%.
- MRP of 2% applying for the full year with no MRP payment holiday.
- No provision for sinking fund

Implementation of the AIS to date has resulted in:

- Approx. £92.4 million has been invested by 2018/2019;
- A weighted average rental yield of 5.63%
- A weighted average cost of capital of 4.40% (comprising weighted average interest rate from PWLB of 2.40% plus MRP at 2%);
- No Minimum Revenue Provision is required during the financial year in which the borrowing is drawn down.
- Weighted average yield of 1.23% (excluding assumed portfolio management costs and tax).
- The tax treatment of interest deductions changed with effect from 1 April 2017 which limited the tax deductibility of loan interest at £2 million.

The following PWLB borrowing was undertaken to support the AIS element of MVDC's capital programme:

Drawdown Date	Principal	Rate (% per annum)	Repayment date
28-Apr-17	£3,000,000	2.36	28/04/2067
26-May-17	£7,000,000	2.32	26/05/2067
08-Jan-18	£30,000,000	2.37	28/01/2068
30-May-18	£16,500,000	2.39	30/05/2068
20-Aug-18	£22,000,000	2.35	20/08/2068
16-Oct-18	£14,350,000	2.40	18/10/2028

APPENDIX B3 Risk Register

Risk	Risk Description	Likelihood (L)	Impact (I)	Total Score (LxI)	Risk Assessment and Controls	Adjusted Score
Downturn in property market	The capital value of existing assets falls. Open market rent reviews are negatively affected.	3	4	12	MVDC has borrowed £78.5 million over 50 years, and £14.35m over 10 years as a result of the AIS. The long term funding combined with the Minimum revenue provision requirements, means that MVDC is in a position to hold the assets over the long-term and to ride out cyclical downturns in the property market including Brexit-related volatility or depreciation. The market value of the AIS portfolio will be monitored through the appointed investment advisor. The IAS 40: investment accounting value of the AIS portfolio will be obtained annually and reflected in MVDC's/Mova Property Limited's balance sheet. A fall in value does not impact the income and expenditure statement for MVDC or the P&L for	6 Where Impact adjusted = 2

					Mova group companies. The rent review provisions are upwards only so contractually there will be no impact on revenue for MVDC or profit for Mova Property Limited. The portfolio is diversified.	
Tenant Default	Failure to pay rent or to otherwise comply with their lease obligations, resulting in loss of income and/or unplanned capital expenditure on lease expiry/termination, resulting in unplanned voids.	2	4	8	Tenant covenant strength was assessed as part of the initial acquisition process, and the existence of guarantors and/or rent deposits taken into consideration. As well as monitoring tenant covenant strength through credit reference reports, financial accounts and alerts, there is a set of indicators which also serve as indicators of a tenant's financial standing. Standard credit control practices apply. Diversification of tenant's industry/business type. MVDC operates revenue reserves from which a sinking fund against unplanned for void periods can be established. Managing agents are to be re-appointed and will undertake regular inspections to ensure that the tenant is complying with the repairing lease obligations; failure to keep in good repair is also another indication that a tenant is experiencing	6 Where Impact adjusted = 3

					cash flow difficulties. The MVDC in-house team has met at least once the relevant tenant representative.	
Liquidity	The process of buying and selling commercial property is complex and carries risk from market fluctuations, abortive transactional costs and delays in realising capital.	2	4	8	MVDC has borrowed £78.5 million over 50 years, and £14.35m over 10 years as a result of the AIS. The long term funding combined with the Minimum revenue provision requirements, means that MVDC is in a position to hold the assets over the long-term and to ride out cyclical downturns in the property market, including Brexit-related volatility or depreciation. The assets are investment grade, as a result of having acquired assets with on average greater than 10 years unexpired lease terms. Each asset was the subject of a detailed business plan as at acquisition; setting out a preferred hold strategy. Good portfolio management, keeping the market and wider economy under review and re-evaluating hold strategies. Good documentation management and access to agents and legal advisors helps streamline the sale process if disposal decision reached.	6 Where Impact adjusted = 3
Changes in Tenant	Certain types of	3	3	9	A diversified portfolio by asset class.	6

or Investor Demand	property may be less in demand from investors (affecting market valuation) or tenants (affecting rental and market valuations). This may be as a result of other investment opportunities becoming more attractive, an increase in supply or structural changes affecting occupier demand/interest for property.				The average term certain of the portfolio is 12.2 years and the average unexpired lease term is 14.2 years. Having locked in favourable cost of funding rates enables MVDC/Mova Property Limited to take a longer-term view as to when to dispose of the assets, informed by specialist advice.	Where Impact adjusted = 3