MoleValley District Council

Agenda Item 5

Executive Member	Councillor Charles Yarwood, Executive Member for Assets and Investments
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Ward (s) affected	None	**Key Decision**	Yes

Subject	Asset Investment Strategy

RECOMMENDATIONS

a) To increase the funds for investment through the Asset Investment Strategy by £51.5m, bringing the total to £100m, in order to generate total income of £1.35m pa by 2020.

b) To update the evaluation criteria for the potential purchase of property assets to enable a more diverse portfolio, specifically a reduction in the reference Internal Rate of Return, to 6%, (Section 7), and a revised Investment Evaluation Matrix, (Section 8).

c) To extend the scope of the Asset Investment Strategy to include possible investment in property funds, subject to identification of suitable funds by the Council's treasury management advisors.

CORPORATE PRIORITIES

PROSPERITY - A vibrant local economy with thriving towns and villages

- Successful implementation of the revised Asset Investment Strategy will ensure the Council has appropriate resources for meeting its prosperity outcomes, and is an innovative way to minimise the cost to taxpayers of Mole Valley District Council whilst protecting services.

The Council has the authority to determine the Recommendations

1. BACKGROUND

1.1 In October 2016, the Council approved the Asset Investment Strategy (**AIS**) which added £48.5m to the Capital Programme to fund the acquisition of property assets. A copy of that October 2016 report is shown at Annex A to this report.

1.2 The Asset Investment Strategy set out a strictly defined set of evaluation criteria for investment properties. These criteria reflected the Council's requirement to generate income through a satisfactory level of return, and took account of the Council's appetite for risk. These evaluation criteria are summarised below:

- A minimum Net Initial Yield (**NIY**) threshold of 5.0%;
- A minimum Internal Rate of Return (**IRR**) threshold of 7.0%; and
- An investment evaluation score of at least 100 out of a maximum potential score of 168.

1.3 The strategy also set out recommendations for a new ad hoc and cross-party working group, the Asset Investment Working Group (**AIWG**). This working group has enabled the preparation and submission of bids in consultation with Members, resulting in a greater degree of transparency, and has still enabled transactions to proceed to exchange and completion within the requisite timescales.

1.4 The AIS also authorised, subject to appropriate financial and tax advice, the establishment of the Council's wholly owned companies for the purposes of implementing the AIS. The corporate structure established is described in section 16.

1.5 The purpose of this report is to review the impact of the AIS in its first year of operation, and to consider possible revisions/extensions of the strategy, in order to increase its effectiveness and the management of risk.

1.6 This work has been commissioned by the Executive member for Assets and Investments, but the work has been scrutinised in detail by the Asset Investment Scrutiny Panel, who have made a significant number of helpful recommendations, suggestions and comments, which have been incorporated into this report. Thanks to them for their input.

2. IMPLEMENTATION OF THE AIS

2.1 In the first year of the strategy, officers worked hard to establish relationships with a variety of agents. To streamline the process, the team has created a dedicated Property Investment page on the molevalley.gov.uk website with a landing page for agents to better inform introducing agents as to the AIS criteria and the service that agents are required to provide.

2.2 Prior to presenting reports to the AIWG, in-house qualified and experienced surveyors (MRICS: Member of the Royal Institute of Chartered Surveyors) review and analyse proposed investment opportunities against the AIS criteria and lead negotiations via the introducing agent. 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') and the legal due diligence is outsourced to a panel firm on the Surrey Legal Services Framework.

2.3 Following consultation with the AIWG, the s.151 officer makes the final decision to fund Mova Property Limited for the purposes of acquiring the investment asset, and the directors of Mova Property Limited (which include the Monitoring Officer, the s.151 Officer, the Chief Executive and the Corporate Head with responsibility for Planning) make the decision to proceed to exchange and completion of the investment asset. The decisions are taken under urgency powers and, as key decisions, are published on the Council's website and reported to the next Council meeting.

2.4 Professional advice has been sought at various times over the last 12 months, primarily in relation to tax and technical accounting advice as part of the implementation of the AIS. The total cost of the external advice to date is £111,000 (tax, financial modelling and Minimum Revenue Provision (MRP) advice) and legal advice of £3,500. The figure for legal advice does not include legal fees for externalising completion of the individual transactions.

2.5 In excess of 100 investment opportunities have been introduced to the Investment and Regeneration team. From that pipeline of investment properties, three freehold properties have been purchased: an Asda superstore at Ystalyfera, Swansea (April 2017), two high quality offices known as Focal Point, Leatherhead (December 2017) and Unity House, Basingstoke, which is the headquarters and UK distribution centre for Game Retail Limited (January 2018).

2.6 The Council, through its company, Mova Property Limited (Mova), had its offer accepted on a further 3 properties, but these did not proceed to completion. Two did not progress through the due diligence process as further detailed information rendered them outside the criteria and one property was withdrawn by the vendor. These properties were a hotel, a cinema and an office. Where the vendor withdrew, the vendor reimbursed all abortive costs, including the time spent by the Legal Services team. Where the Council withdrew, the abortive costs for the hotel transaction were £17.6K in external legal and survey fees and disbursements, and minimal in relation to the cinema (travel expenses for a site inspection).

2.7 A further 12 properties were considered in detail, most of which were recommended to the AIWG for bidding. However, Mova did not reach the required purchase level to secure those properties and more detail on this is set out in section 7 of this report.

2.8 In addition to the 1.5 FTE surveyors within the Investment and Regeneration Team who are delivering the AIS in conjunction with the Council's Transform Leatherhead programme, implementation of the AIS has resulted in support being provided by other areas of the Council, in particular Finance but also Legal Services, amongst other service areas, as well as the senior management team. A service contract is in place between the Council and the Mova companies which enables appropriate Council officer time spent to be recharged to the Mova companies at a 10% mark-up. The amounts to be recharged will be finalised as part of the year end close of the Council and Mova's accounts.

2.9 The table below sets out the modelled target contribution in the Council report of 11 October 2016 against the forecast contribution based on the AIS activity as at the date of this report:

AIS modelled target contribution and forecast contribution

	AIS Model (Approved by Council on 11 October 2016) £000	Income and Expenditure as at February 2018 £000
Capital Expenditure	48,530	35,500
Gross Rent	(2,790)	2,176
Capital Financing Costs (Interest and Provision for Repayment)	2,039	1,709
Net Contribution	751	467

2.10 In terms of the timetable and phasing across the three years, from 2017/18 to 2019/20, progress in investing the capital sum is ahead of schedule. 80% has been invested in the first year whereas the original model projected expenditure of one third in each year, building to a total of £0.75m in Year 3.

2.11 On the figures to date, the contribution towards revenue is £117K lower than anticipated. The rent yield and the principal repayment provision (MRP) are in line with the model but interest on loans has been slightly higher, at an average of 2.36%. If the current pattern of spend and income is projected for the remaining capital investment (£10m), then the overall contribution will be £0.6m.

3. INVESTMENT MARKET

3.1. 2017 saw a strong start to the investment market and this was sustained through out the year. UK institutions accounted for £10 billion in volume for 2017, with overseas volume representing £28.1 billion (a factor being the fall in the value of sterling). Local authorities invested £1.8 billion into UK property in 2017, accounting for 3% of UK volume.

3.2. Prime Yields (the yield on fully rented property of the best physical quality, the best location and with the best tenant covenant) are generally sub the Council's NIY 5.0% threshold, which means that the Council is restricted as to investment assets which are generally in regional locations.

Sector	Prime Yield
Shops	4.00%
Shopping Centres	6.00% (Sub regional)
Retail Warehouses	4.50%
Central London Offices	3.50%

Rest of South East Offices	5.00%
Rest of UK Offices	4.75%
Office Parks	5.25%
South East Industrial	4.00%
Rest of UK Industrial	5.00%
Distribution Warehouses	4.00%
Hotels & Leisure	4.75%

(Source LSH UK Investment Transactions Bulletin – Q2017)

3.3. According to the LSH UK Investment Transactions Bulletin – Q42017, property compared to other investment classes is still good value, with the All Property total return forecast at around 6% for 2018 with income providing the main component of return with a slight improvement in capital values – although there will be fluctuating capital value movements at sector levels. Demand for core long-income assets is anticipated to continue.

4. IMPLICATIONS OF THE CRITERIA

4.1. As outlined in section 3.2, the NIY criterion of 5.0% has focused the search area on prime properties in regional locations, as the super-prime locations are achieving sub 5.0% NIY.

4.2. The IRR threshold of 7.0% has restricted the number of properties being considered, and has imposed an upper limit for bidding, which is highlighted by the number of unsuccessful bids outlined in section 7 of this report.

4.3. To achieve the IRR, properties typically need to have unexpired lease durations of 15-20 years, have fixed or RPI uplifts and be in non-prime locations. This has generally limited the choice of assets to supermarket/retail or hotel investments as occupiers of these properties have been prepared to agree rent uplifts linked to price indices.

4.4. For offices or industrial uses, the 7.0% IRR cannot generally be achieved with prime investments, as there is insufficient rental or capital growth over the hold period of the investment. To achieve 7.0% IRR, the NIY would often need to be in excess of 6.0%.

4.5. From a risk management perspective, the portfolio should be diversified over a variety of asset classes. However, the current criteria have not allowed a meaningful consideration of certain uses, such as industrial or office investments, which is a limiting factor on diversification of the portfolio.

5. PROPOSED UPDATE TO THE EVALUATION CRITERIA

5.1. Given the difficulties in meeting the criteria, alongside the concerns over the ability to achieve a diversified portfolio, it is recommended that there are limited changes to the criteria as set out below with the aim of being slightly more competitive in bidding for investments and achieving a diverse portfolio of assets. Any alterations will be kept under review and the results reported as part of subsequent annual reviews of the AIS.

6. NET INITIAL YIELD: NO CHANGE

6.1. The viability of asset investments (after taking into account the current costs of borrowing, including a Minimum Revenue Provision[1] to provide for repayment of the loan) is dependent upon achieving a minimum of a 5.0% Net Initial Yield (**NIY**). It is therefore not recommended that this is lowered.

6.2. Should the cost of borrowing available to the Council increase by more than around 0.5%, then a recommendation to adjust the NIY threshold will need to be considered by Council.

7. ADJUST INTERNAL RATE OF RETURN

7.1. It is proposed that for properties which satisfy the NIY and the other AIS criteria, the Internal Rate of Return (**IRR**) should be reduced from 7.0% to 6.0% and its role be that of a reference rate, rather than a hurdle rate.

7.2. Retaining IRR is still helpful as it is important to balance yield (income) and capital values (through not overbidding or acquiring over-rented assets). The proposed adjustment to the IRR of 6.0% is viewed as achieving an appropriate balance. However, IRR calculations involve a number of assumptions, in particular in relation to the optimum holding period for the investment under appraisal, appropriate exit strategies and corresponding forecast exit value. Examples of exit strategies may involve negotiating an extension to the lease term prior to remarketing or, for older properties, refurbishment and re-letting prior to disposal. The optimum holding period is generally set to counter significant depreciation eroding value, or before the need for redevelopment of the site is required. Although officers apply a rigorous approach to the assumptions underpinning the IRR calculations, and take a cautious and prudent view, it will always remain a forecast.

7.3. As outlined in section 4 above, the 7% IRR hurdle rate resulted in the Council being outbid on four excellent opportunities in 2017. Each delivered a NIY comfortably above 5%, scored extremely well on the AIS criteria (with 1 scoring 120, and the remaining three scoring in excess of 144), but the successful bid level in three of the four cases delivered a sub-7% IRR, but which was in excess of 6% IRR. A further 10 excellent opportunities were analysed where officers decided not to seek to bid as it would not have been possible to bid anywhere close to the asking level given the 7% IRR requirement. Again, in five of those opportunities, the successful bid level delivered an IRR in excess of 6%.

7.4. Without this alteration, it will continue to be extremely difficult to purchase classes of properties. A concentration of investments in retail assets could result in either (a) an

[1] The Minimum Revenue Provision is conceptually similar to depreciation, in that it creates a charge to the revenue account on the basis of the expected useful life of the asset (50 years for freehold land) so that the Council is in a position to repay the full amount borrowed to the PWLB at the end of the PWLB loan period of fifty years.

unbalanced portfolio with over-exposure to occupier and supplier demand in this sector or (b) extended timescales in investing the balance of the approved allocated funds. This would in turn increase the risk that the AIS objectives would not be achieved by 2020 with the consequential impact on the Council's Medium Term Financial Strategy.

8. INVESTMENT EVALUATION MATRIX

8.1. From the feedback at the AIWG it is apparent that greater emphasis is given by members of the AIWG to criteria such as covenant strength and lease length than location and the price of the investment than the current weighting factors and evaluation matrix suggests.

8.2. It is therefore recommended that evaluation matrix is revised as set out in the table on the following page as this better reflects the Council's appetite for risk, with the original evaluation matrix, contained at page 85 of the annexed Asset Investment Strategy report, following for ease of reference.

8.3. If any individual criterion scored 'Marginal' then officers would not recommend proceeding, even where the investment met the minimum score of 100.

8.4. Other qualitative factors are taken into account by officers and the AIWG, such as the activity/business of the tenant, the age and state of repair of the buildings, the availability of construction documentation, whether the original building contractor is still solvent, and environmental risks such as contamination/flood risks.

Proposed Revised AIS Evaluation Criteria

	Score	4	3	2	1	0
Investment Evaluation Criteria	**Weighting Factor**	**Excellent**	**Very Good**	**Good**	**Acceptable**	**Marginal**
Occupier Lease Length[2]	**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[3] - no landlord management	FRI - Landlord to manage estate	IRL[4] - 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

Max score: 168 Min score:100

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

[3] FRI – full repairing and insuring lease

[4] IRL – internal repairing lease

Current AIS Evaluation Criteria (page 85 of Annex A)

	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

9. PORTFOLIO RISK MANAGEMENT

9.1. Prior to bidding on a property, the optimum hold period is established together with the corresponding exit strategy. To assist in the risk management of the portfolio, the Council commissioned Ernst+Young LLP to create a financial model.

9.2. The financial model enables officers to model current and proposed 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 the Council 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.

9.3. 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.

9.4. Tenant covenant strength is monitored using Dun and Bradstreet reports supplemented by company reports and accounts. 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. Managing agents have been (or are in the process of being) appointed for all three assets purchased under the AIS to monitor and ensure tenant compliance with tenant repairing obligations and in the case of Focal Point, to manage rent and service charge collection as well. For Asda and Unity House, rent collection is currently managed by the Investment and Regeneration team.

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

9.6. 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 properties would be divested in the first three years post-acquisition, and the minimum optimum hold period is generally not less than five years.

9.7. 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.

10. INCREASING THE FUNDING OF THE ASSET INVESTMENT STRATEGY

10.1. The investment of local authorities in property investments outside their boundaries has received a lot of attention in local and national press and sparked debates on social media. The key concern is that the investment approach has been uninformed and high risk therefore putting the monies at risk rather than bolstering funds for the provision of local services. As evidenced in this report, the Council has not adopted an uninformed or high risk approach to property investment. Through the AIS criteria, the Council has only considered investments which are low risk and informed by expert property advice and thorough due diligence. Given the concerns raised it is not proposed to radically alter this approach and to retain a cautious approach to risk. Given the returns on direct property investment relative to this risk it is recommended that the Council increase the funds for investment from £48.5m to £100m with the aim of investing this sum by 2020, producing a total return of £1.35m per annum to be invested in services in Mole Valley.

10.2. There remains approximately £10 million of the original £48.5 million available for investment. The increase in funds for investment at this time is to enable the Council to be able to extend the AIS at a time when interest rates remain at a historic low. The first interest rate increase in November 2017 from 0.25% to 0.5% was coupled with signals from the Bank of England that interest rates may increase very gradually to 1.0% by 2020 as a result of forecast inflationary pressures.

10.3. On this basis, it is proposed to budget for a slightly more cautious estimate of the net benefit of the second tranche of investment. It is recommended that the net return for the second tranche of funding is budgeted at £0.60m, in line with the experience to date.

10.4. The increased borrowing that will be necessary to fund this increase will need to be approved by Council as part of a revision to the Council's Treasury Management Strategy (**TMS**). In particular, the prudential indicator that determines the "affordable limit" for borrowing will be revised. The necessary revisions to the TMS are to be presented to Audit Committee on 8 February 2018 and referred to Council for approval on 20 February 2018, subject to Council approving the recommendation to extend the AIS set out in this report.

11. INVESTMENT IN PROPERTY FUNDS

Background

11.1. On 19 February 2013, the Council agreed changes to the 2013/2014 Treasury Management Strategy to allow an investment of £5m in the CCLA (Churches, Charities and Local Authorities) property fund. The objective was to generate income at a higher rate than was being achieved through standard cash management investments in banks and building societies.

11.2. The change in approach was successful. The return on overall investments in the last 3 financial years has varied slightly between 1.58% and 1.61%. The return on the CCLA investment has been 5.87% in 2014/15, 5.57% in 2015/16 and 5.31% in 2016/17. Since the date of the original investment in June 2013 to 31 March 2017 the Council has received dividends of £982,276, net of management fees and the value of the investment has increased by £928,857 over the same period.

Proposed Investment in property funds

11.3. It is proposed that the scope of the AIS be extended to cover investment in property funds as an alternative to direct property investment. Investment in a property fund, rather than investing directly, has the advantage of effectively outsourcing the selection, management, maintenance and repair obligations to specialist investors as well as providing geographic and industry diversification that is not available to the Council through direct investment.

11.4. The previous investment in the CCLA Property Fund was funded from the Council's reserves. These are no longer sufficient to support a large scale investment of this type, so the funding mechanism will be mainly through borrowing. Potential property funds are currently being assessed. The Council has commissioned its existing treasury management advisor, Link Treasury Services Limited (formerly known as Capita), to undertake this work, and propose suitable funds.

11.5. Although the detailed criteria that apply to direct investment will not apply to investment in property funds, the Council will take a prudent and cautious approach to risk, balancing security, liquidity and yield, informed by external investment advisers and thorough due diligence.

11.6. The selection criteria and due diligence process will include analysis of the suitability of the individual fund investment strategies, current portfolio composition, past performance analysis in relation to peers and associated benchmarks (dividends paid and capital appreciation), the deduction and amount of entry fees, exit fees and ongoing management fees, and liquidity and credit risk. In addition to the due diligence on the investment company, its management and financial standing, the assets held by the funds will also need to be assessed, to verify that the funds hold prime properties which the Council would consider investing in. Many funds hold very secondary properties and there is little investor demand for these.

Investment Risks

11.7. There are a number of variables that should be acknowledged in pursuing this course of action. As with direct investment in property, there are risks as the state of the property market cannot be precisely predicted and it is affected by fluctuations in property values (capital and rental), interest rates, supply (which is affected by the planning process) and demand (overseas investors and domestic investors as well as occupiers), and accordingly, dividend payments cannot be guaranteed.

11.8. Property investments are relatively illiquid and the term of any investment should be measured in years (generally 5-7 years minimum). It is an alternative to direct investment, rather than a short-term investment with a view to switching into direct investment as and when an opportunity presents itself.

Accounting and Regulatory Issues

11.9. Advice has been provided by Ernst + Young on the accounting and regulatory issues of investment in property funds. As any additional investment in property funds will be funded by the Council'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.

11.10. The purchase of units in property funds such as the CCLA that are approved by the Treasury under the Trustee Investments Act do not count as capital expenditure, and this means that the Council 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.

12. LEGAL IMPLICATIONS

12.1. 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 the Council'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 the Council.

12.2. The articles of association of both companies recognise that as the directors are also officers of the Council, 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 the Council 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 the Legal Services framework) to the directors with the in-house Legal Services team advising the Council.

12.3. 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 and one of the directors has attended an Institute of Directors course on company direction which placed a significant emphasis on broader corporate governance.

12.4. As described in section 9, 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.

12.5. The Council has the power to invest in property funds 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 the Council's best value duty under the Local Government Act 1999. Where such an investment results directly or indirectly in an increase in the Council's borrowing requirements then, provided (i) the additional borrowing is prudent and complies with the Council's Affordable Borrowing Limit determined under section 3 of the Local Government Act 2003 and (ii) the Council follows proper accounting practices in accordance with section 21 of the Local Government Act 2003, it is considered to be lawful. The Council is required to have due regard to statutory guidance on Local Government Investments and on Minimum Revenue Provision.

12.6. Unless there is a specific reason to do so, (such as inability to buy a particular asset in the Council's name), it is not generally beneficial to undertake these investments through the Council's companies as there is no financial benefit to the Council or the companies to do so, given the companies' costs of capital and that any company profits are subject to tax.

13. REVISED STATUTORY GUIDANCE AND IMPACT ON THE AIS

13.1. Following consultation in November-December 2017, the Ministry of Housing, Communities and Local Government (**MHCLG**) published revised statutory guidance on (a) local authority investments and (b) on MRP on 2 February 2018. The local authority investments statutory guidance comes into force on **1 April 2018**; the MRP statutory guidance comes into force on **1 April 2019**.

13.2. The majority of the implications of the revised guidance take practical effect from 1 April 2019, (for example a revised approach to MRP, and enhanced transparency and reporting requirements), and will need to be considered through the regular updating of the Treasury Management Strategy.

13.3. However, some revisions, particularly to disclosure and reporting requirements are required immediately, and these are taken into account in the Treasury Management Strategy 2018/19, which is considered elsewhere on this agenda, following consideration by the Audit Committee on 8 February.

14. OPTIONS

14.1. Option 1: Approve all three recommendations above and this is the preferred option.

14.2. Option 2: Approve one or two of the recommendations.

14.3. Option 3: Not approve any of the recommendations and request further work is undertaken.

2.0 CORPORATE IMPLICATIONS

Monitoring Officer commentary

The Monitoring Officer confirms that all the relevant legal implications have been taken into account.

S151 Officer commentary

This report is essentially financial in nature, and the Section 151 Officer is content that all relevant financial issues are identified in the body of the report.

Risk Implications

There are three options to consider which relate to agreement of the three recommendations set out at the beginning of the report. The risk implications of each recommendation are set out below:

Recommendation a) - If funds for investment through the AIS are not increased, the £10 million unexpended balance of the £48.5 million will remain available for investment under the Asset Investment Strategy, however the Council will need to find alternative sources of income and/or savings, of approximately £0.6m pa, by 2020.

Recommendation b) - If the evaluation criteria for the potential purchase of property assets are not updated, the existing evaluation criteria will apply. As set out in the body of the report, the current market means that eligible investments will be restricted which could hamper the establishment of a diversified portfolio and delay execution of the AIS and corresponding income stream to the Council.

Recommendation c) - If the scope of the AIS is not extended to include investment in property funds, the Council will be restricted to direct investment in commercial property. This could increase the time and resources necessary to achieve a balanced property portfolio, which carries risks associated with changes in interest rates and/or government policy. Investment in property funds would support the Council in securing an additional source of income and enables the Council to access a broader range of property assets than would otherwise be the case and the property fund asset manages the underlying portfolio.

Equalities Implications

None.

Employment Issues

There are no direct HR implications in relation to Recommendations a), b) or c). There are however indirect implications in relation to the desired outcomes which are to enable continuation of improvement of the Council's services despite the challenging financial context. Many, if not all, of the Council's services are highly dependant on its ability to recruit and retain appropriately committed, dedicated and engaged members of staff. Pay austerity or services that are excessively lean can impact this resulting in unwanted turnover and/or difficulty recruiting.

Sustainability Issues

None.

Consultation

The Asset Investment Panel and the Scrutiny Committee were consulted

BACKGROUND PAPERS

MHCLG Statutory Guidance on Local Authority Investments and on Minimum Revenue Provision

Mole Valley District Council

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Strategic Management Team Lead Officer	Nick Gray
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Date	11th October 2016
Ward (s) affected	None
Subject	Asset Investment Strategy

Recommendations

a) To add a sum of £48.5m to the Capital Programme, for the acquisition of property assets, in order to generate additional income of £0.75m pa by 2020, (paragraphs 12 to 16).

b) To endorse the evaluation criteria for the potential purchase of property assets, (paragraphs 17 to 22).

c) To approve the amendment of the constitution to reflect the creation of an Asset Investment Working Group, to advise officers on the property acquisitions arising from this Asset Investment Strategy, (paragraphs 23 to 35) (Annexes B and C).

d) To approve the incorporation of a company or companies, wholly owned by MVDC, and to delegate the final corporate structure of these to the Chief Executive and Section 151 officer in consultation with the Leader and Executive Member for Finance and Investment, once the necessary specialist tax advice has been obtained. (Paragraphs 36 to 43).

Executive Summary

- The report considers the case for using the purchase of property assets, as investment vehicles, in order to meet the Council's budget pressures over the next three years. It ultimately concludes that there is a case for adding £48.5m to the Capital Programme, which would address the majority of the budget imbalance between now and 2019/20. This action is consistent with both the Council's Medium Term Financial Strategy and similar actions currently being taken by a significant number of other local authorities.

- It is important that the purchase of such assets is undertaken against a strictly defined set of criteria, and the report recommends such criteria.

- The report goes on to consider and propose the creation of an Asset Investment Working Group. The primary purpose of the Group is to advise officers on a) the application of the evaluation criteria to any proposed asset purchase, prior to a bid, and b) on the outcome of the 'due diligence' process, prior to exchange of contracts, following acceptance of a bid to purchase an asset. It is proposed that this mechanism will allow the Council to meet the often very short timescales that operate in relation to the commercial property market, while ensuring cross Group engagement in the purchase process.

- Finally the report identifies the fact that this activity, involving the purchase of assets purely for financial purposes, cannot be carried out by a local authority in its own name, and that a company, (or companies), wholly owned by MVDC would need to be set up, ('incorporated') in order to facilitate these transactions. It is proposed that the corporate structure of this company, (or companies), be delegated to the Chief Executive andSection 151 Officer, in consultation with the Leader and Executive Member for Finance and Investment, once specialist tax advice has been obtained.

Corporate Priority Outcomes

Prosperity

Successful implementation of the Asset Investment Strategy will result in the Council having appropriate resources for meeting its priority outcomes.

The Council has the authority to determine the Recommendations

1.0 Medium Term Financial Strategy

1. The Council's Medium Term Financial Strategy (MTFS), approved in 2013, set MVDC's approach to managing its financial position over the period 2014/15 to 2020/21. The themes of the Medium Term Financial Strategy adopted by the Council in 2013 included the following:

   - Make best use of assets: we will progress projects that use our land and property to improve services and generate income.
   - Improved returns on investment: without compromising unduly on the security and liquidity of our investments, we will seek to diversify in search of a better yield, with particular consideration of property and property related funds.
   - Capital spend to generate income: we will focus on opportunities to invest our capital in a way that generates benefits for our revenue budget.

2. The underlying conclusion in the MTFS was that the Council needed to do more than incrementally increase its income sources (Council Tax, Business Rates, Fees & Charges) in order to keep pace with the increasing demands for service and the expected reduction in Government support. In particular MVDC needed to make increased use of property assets, (both existing and to be acquired), in order to generate income to support service budgets.

3. The trend for reduced Government Grant identified in the MTFS has been confirmed in the grant settlements since 2013. The Revenue Support Grant (RSG) has fallen away more quickly than was envisaged. The settlement in December 2015 announced an end to RSG for MVDC from 2017/18, with possible further reduction in the amount of Business Rates retained by MVDC in 2019/20.

4. These issues are discussed further in the Financial Scene Setting report, (Council agenda 11th October 2016), which suggests that total further savings of around £1m might be necessary over the next 3-4 years. This makes it even more crucial that the Council continues to take the actions identified in relation to the use of property assets.

Investment in Assets

5. The Council, like many authorities, owns a variety of investment property. The Council acquired the assets over a number of years to facilitate the economic development of the district and generate rental income that helps support the wider financial position of the Council.

6. The latest valuation of the investment properties for 2015/16 is £27.5m. Income earned last year was £1.9M, representing a yield of just below 7%.

7. The properties are located mainly in Leatherhead and Dorking. Over half of the income is generated by properties in Leatherhead Town Centre, primarily Fairmount House. (This has been added to by the recent purchase of an interest in The Swan Centre). The other major sources of income are in Curtis Road and St Martin's Walk in Dorking. (A list of current investment assets is shown at Annexe A).

8. The tables 1 to 3 below show the capital valuation of those properties for the last six financial years, the income generated and the percentage yield achieved each year.

Table 1 – Capital valuation of investment property 2010/11 to 2015/16

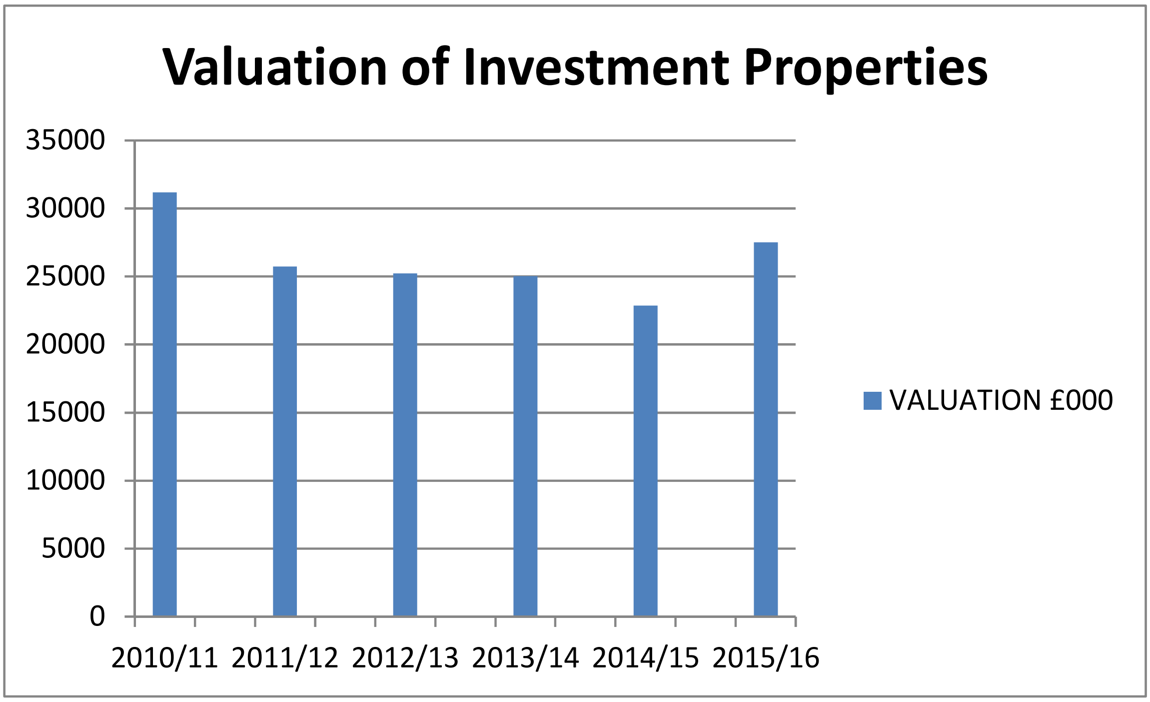


Table 2 – rental income from investment property 2010/11 to 2015/16

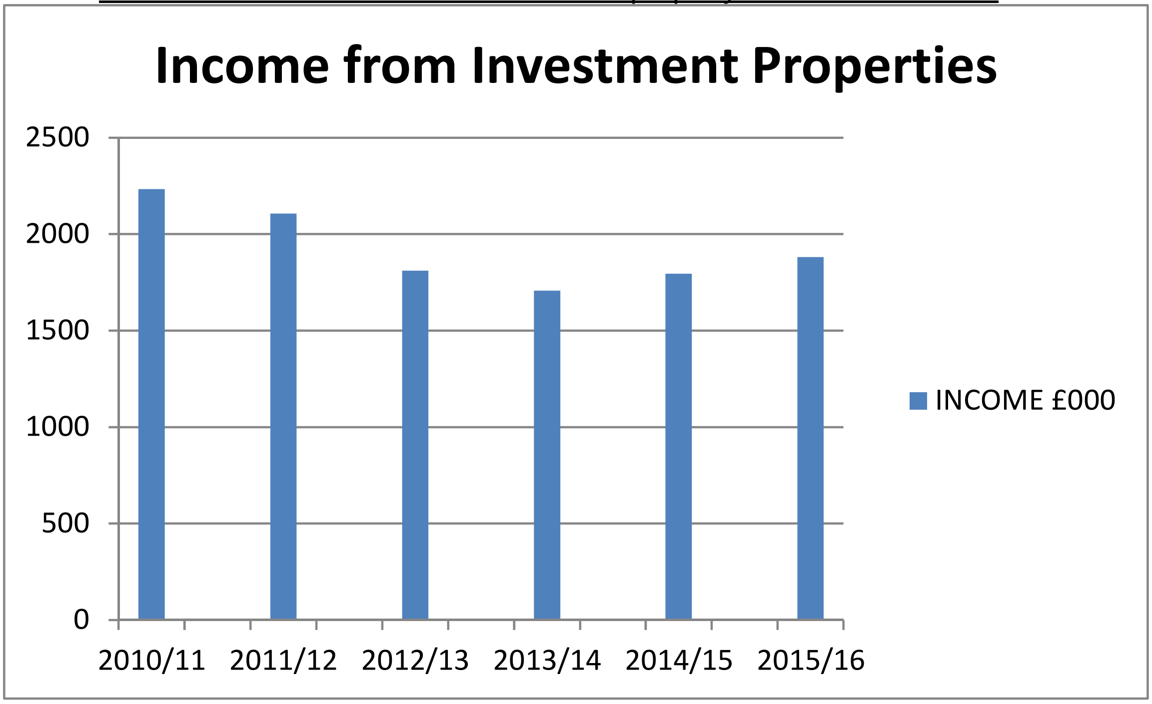
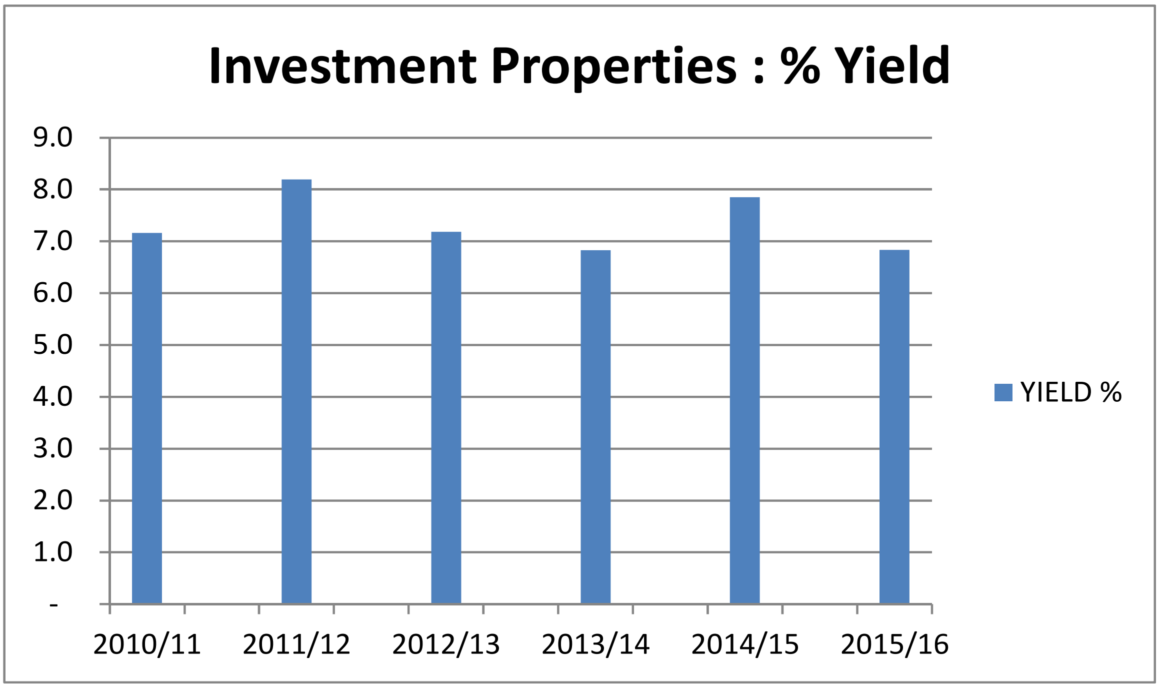


Table 3 – percentage yield from investment property 2010/11 to 2015/16



9. It is important to recognise that this 6% to 8% yield represents the average across a portfolio that has been accumulated over time. Although yields have held up well, throughout the ongoing period of depressed interest rates, it is unlikely that acquisitions can currently achieve a consistent 7% yield. Secondary location retail sites are currently selling for yields of 5.5% to 6.5%, but prime London retail sites are selling for yields of as low as 4.5%. A reasonable target for new acquisitions is perhaps an average of 5.75% yield across a balanced portfolio, which represents an extremely attractive investment proposition, compared with financial instruments.

10. These yields identify the immediate cash returns on the investment, (through initial rents). For most investments the intention would be to attempt to increase these returns over time. This would generally be achieved through improving the property so that higher rents can be charged. As a rule, the greater potential that an asset has to achieve this future ‘capital growth’, the lower the yield it will currently sell for.

11. Although it is recommended that MVDC’s property portfolio should seek some capital growth, (particularly in relation to assets where an element of economic regeneration is desired, such as Transform Leatherhead), the Council’s immediate requirement is to replace existing income streams. Therefore it is proposed that any portfolio held by MVDC would tend to prioritise initial yield, over the potential for capital growth.

Asset investment strategy

12. Based on the above framework, the following model proposes the purchase of property assets, to a level necessary to achieve a minimum of £0.75m, (per annum), rental contribution to the revenue budget by 2019/20. This would provide funding to address the majority of any likely reduction in government funding across the same period, without these impacting on service delivery. If funding reductions are not ultimately as severe as currently planned for, then the income generated from the Asset Investment Strategy would be available for other initiatives.

13. The model suggests that total purchases of £46m, (£48.5m including acquisition costs), would be the level necessary to generate an income stream of a minimum of £0.75m.

	£’000	£’000
Capital Cost		
Cost of assets		46,000
Plus acquisition costs (5.5% of asset cost)		2,530
Total capital cost		48,530
Annual Revenue Implications		
Gross rent, (5.75% yield)		2,790
Less: Capital financing costs, (c4%)	-1,942	
Administration, (c0.15%)	-97	-2,039
Net annual contribution to revenue budget		751

- Acquisition costs includes Stamp Duty, commercial advice and asset valuation, and legal costs.
- Capital financial costs include interest and an allowance for repayment of borrowing, (known as Minimum Revenue Provision).
- Administration includes day to day admin support, and regular expert portfolio management advice.

14. It is therefore recommended that the Council authorises the addition of £48.5m to the Capital Programme, for the acquisition of property assets, in order to generate additional income of a minimum of £0.75m pa by 2020. It is fully intended to look for a higher return, but this needs to be balanced with the investment criteria. The criteria and process for making these purchases are set out below.

15. Purchases will only be undertaken when appropriate assets are identified. As such it is likely that expenditure of the full £48.5m will take a number of years.

16. The borrowing necessary to support this expenditure will only be undertaken as and when necessary. As part of the Council's annual budget planning processes an estimate will be made of the possible level of acquisitions in the following year. This will in turn inform the Council's annual Treasury Management Strategy, (including the "Prudential Indicators" which define borrowing limits), approved by Audit Committee and Council.

Criteria for selecting investment assets

17. 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.

18. Any asset meeting these first two criteria will pass to the next stage for consideration. Subject to paragraph 18 below, an asset that does not meet these two main criteria would not be considered further.

19. 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.

20. 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.

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

Investment Evaluation Criteria	Score Weighting Factor	4 Excellent	3 Very Good	2 Good	1 Acceptable	0 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

22. 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.

Acquisition process and governance

23. Property investments are often marketed with very tight deadlines for submission of an offer. For example, in the cases of the recent purchases of the Swan Centre leases, and Claire House and James House, the deadlines for submission of firm offers were both less than a fortnight.

24. An accepted offer is inevitably followed by a significant period of "due diligence", during which a purchaser gains reassurance that what he is buying is what he thought he was buying when the purchase offer was made. Consequently, the purchase decision is not contractually binding until the due diligence process is completed and contracts exchanged.

25. That said, it is an accepted principle that all offers at this stage are 'firm', subject only to issues identified within the due diligence process. The failure to adhere to this principle, and to withdraw from purchases for any reason other than an issue arising from due diligence would quickly be recognised by 'the market', which is essentially a handful of major commercial property agents. A purchaser acting in this way would quickly develop a reputation which would make it difficult to make successful bids in the future.

26. Consequently it is vital that when MVDC makes an offer to purchase a property, it is a firm committed offer, subject only, to due diligence.

27. The short deadlines for making a firm offer can create difficulties, although MVDC's constitution includes provisions that have enabled the Council to deal with this timing issue in the recent property: in particular, the Corporate Head with responsibility for Property can, in consultation with the Executive Member for Assets, authorise property purchases, provided that they fall within the scope of the Council approved Capital Programme.

28. Further, although such property purchases inevitably constitute Key Decisions under MVDC's constitution, and therefore require inclusion on the Forward Plan 28 days prior to the decision being made, the constitution makes provision, (Rule 14, Special Urgency), for this requirement to be waived if the decision is urgent and cannot reasonably be deferred. (This requires the specific agreement of the Leader of the Council and the Chairman of Scrutiny Committee).

29. While these provisions have enabled MVDC to act within the deadlines necessary to make offers to purchase property, they have not always enabled the consideration of individual purchases by a cross section of Members from all political groups.

30. In order to address this issue, it is recommended that the constitution be amended to reflect the creation of a new ad hoc working group – the Asset Investment Working Group. This would ensure that Members are sighted and consulted on the implementation of the Asset Investment Strategy by officers and enable officers to consider the views of Members prior to reaching any decision that falls within their delegated powers. (Detail of the proposed constitutional changes are identified at Annexe B).

31. It is recommended that the Asset Investment Working Group would comprise the following:

<u>Members</u>

- The Leader of the Council
- The Executive Member for Finance and Investments
- The Executive Member for Property, Parking and Economic Development
- The Chairman of Scrutiny Committee
- The Group Leader of the Group not represented by the Chairman of Scrutiny Committee

<u>Officers</u>

- The Chief Executive
- The Director of Finance, (Chief Financial Officer)
- The Corporate Head with responsibility for property
- The Property Manager
- The Financial Services Manager
- The Legal Services Manager, (Monitoring Officer)
- The Democratic Services Manager

32. The primary purposes of the Working Group would be twofold:

    a) To consider recommendations from officers regarding the potential purchase of a property asset, prior to submission of a bid. This would include consideration of the yield, and the Investment Evaluation based on the criteria set out above, (paragraphs 14 to 18). This would be informed by analysis carried out by the commercial property agent acting on MVDC's behalf in a potential purchase. (These would be appointed on a case by case basis). The ultimate consideration would be whether to submit a bid or not, and at what value.

b) To consider the results of the due diligence process, (following acceptance of an offer from MVDC to purchase an asset), with the ultimate consideration of whether to endorse the purchase and proceed to exchange of contracts.

33. All decisions relating to both offers to purchase, and subsequently, to move to completion of a purchase, would be reported to the next available meeting of the Council.

34. Given the short notice that could often be inevitable in convening meetings of the Asset Investment Working Group, all members would be able to nominate substitutes if they are unable to attend, or meetings could be held on a 'virtual' basis. For similar reasons, a quorum is not recommended, (particularly as the Working Group would not be decision making), although a meeting should include:

- at least two of: the Chief Executive; The Director of Finance; and the Corporate Head with responsibility for property, (as these are the officers which, constitutionally, would be formally making decisions based on the advice of the Working Group), and;

- At least two of: the Leader; the Executive Member of Finance and Investments; and the Executive Member for Property, Parking and Economic Development.

35. The full suggested Terms of Reference are shown at Annexe C.

Mechanics of a property investment purchase

36. The Council may purchase and hold property assets in a variety of ways:

- in the name of MVDC;
- through a wholly-owned subsidiary;
- through a joint venture (which could be with a public sector or a private sector partner)
- through investing in a real estate investment trust (REIT) or other fund which includes property as an asset class.

37. To date, the Council has acquired or purchased and held property assets in the name of MVDC, as well as investing in a REIT, (the Churches, Charities and Local Authorities property fund).

38. MVDC's recent acquisitions have been funded from reserves and have been, at least in part, acquired to further economic regeneration objectives in relation to Transform Leatherhead. Such acquisitions have been permitted under the Council's normal powers to acquire land under s.120 Local Government Act 1972 as set out below:

For the purposes of—

(a) any of their functions under this or any other enactment, or

(b) the benefit, improvement or development of their area,

a principal council may acquire by agreement any land, whether situated inside or outside their area.

39. However, in order to expand its property investment programme, the Council will, in the absence of significant future capital receipts, likely to be funding most such acquisitions through borrowing.

40. Where MVDC is borrowing to fund a property investment and it is purely or primarily to generate revenue (as opposed for regeneration purposes or in relation to its functions), such investments can only be undertaken lawfully when purchasing such assets through a company.

41. It is therefore recommended that one or more companies limited by shares be incorporated and wholly owned by the Council. Specialist tax advice will be sought by officers to determine the appropriate corporate structure.

42. The ultimate corporate structure will need to achieve the most tax efficient structure for the Council in light of the type of assets (development property or pure investment property), the associated activities relating to those assets (capital appreciation and/or rental return) and the different risk profiles. There will also be the need to build in, as far as possible, future flexibility, not least in relation to the Transform Leatherhead initiative and future partnerships.

43. Further detail of the legal framework for the purchase of property assets, and the implications of the consequent recommendation to create one or more companies, wholly owned by MVDC, are set out in more detail at Annexe D.

Risk Management

44. There are the risks that capital values and rental values can fall as well as rise. There is the risk of tenants defaulting, and that financing costs could rise. All of these factors could have an impact on the net return to the Council.

45. It is vital that the Council maintains an adequate level of reserves and balances to ensure it can manage any down turn in the property market and limit the impact it will have on our revenue income.

46. We will seek to mitigate the risks through the choice of more secure property investments and maintaining an appropriate level of reserves; however we need to balance this with the requirement for a greater level of financial return.

47. Once finance costs start to rise, the net returns may become less attractive and there is a risk that we will be forgoing cash investment returns over the period of the lease if cash interest rates rise above the returns generated on our property investments. There will also be refinancing costs associated with external borrowing. Officers will prepare a detailed cash flow model for each prospective investment in order to appraise the cash flow risk and the internal rate of return of the investment.

Other Capital Expenditure

48. The above Strategy and associated evaluation criteria relate specifically to the purchase of property assets for financial return, (and no other reason), via the £48.5m Asset Investment Fund. As noted, (paragraph 21), the evaluation criteria are recommended as absolute – if an asset ‘passes’ the criteria, the Council would be prepared to make an offer, if it ‘fails’ the criteria the Council would not make an offer. No exceptions.

49. However, it is also worth considering the extent to which these principles and evaluation criteria could apply to other capital spending which is <u>outside the Asset Investment Fund</u>. This broadly falls into two categories:

<u>Asset Purchase with Community Benefits</u>

50. In some cases, a potential property purchase has demonstrable benefits other than financial, (for example in relation to Transform Leatherhead and economic regeneration). In such cases the Council might wish to have the discretion to accept a lower financial return on the basis of the community benefits that the purchase would deliver. However, it is important that the Council makes fully informed decisions which clearly identify the effective ‘price’ being paid for those benefits. In

considering such potential purchases a Business Case would need to be developed and endorsed by Council in order to allocate the necessary funding to the Capital Programme. In doing this it is recommended that:

a) The Business Case should identify the financial return and investment evaluation criteria, in exactly the same way as for a purchase from the Asset investment Fund.

b) Where the financial return falls short of the investment benchmarks of the Asset Investment Strategy, (e.g. 5% yield), the value of the shortfall should be calculated.

c) The Business Case should also clearly set out the non-quantifiable community benefits that would be delivered by the asset.

51. In this way, when making a decision, the Council would be able to compare the worth of those community benefits, with the loss of financial return relative to the Council's pure financial benchmarks.

Other Capital spending

52. The Council has a Capital Programme that incudes many projects that do not involve asset purchase. While some of these are intended to generate a financial return, (such as Meadowbank redevelopment, which alongside its community value also generates a significant income stream), many have been approved for a range of primarily non-financial purposes, (such as: support to affordable housing; refurbishment of playgrounds; and Disabled Facilities Grants). The 2014/15 MTFS clarified the criteria for approving future capital funding, such that projects now have to meet at least one of the following criteria for funding to allocated:

- Statutory duty;
- Health and Safety requirements;
- Maintenance of asset value;
- To achieve an income stream or future cost avoidance.

53. Projects recommended to Council for funding, and hence inclusion on the Capital Programme, have to be justified by a business case. This business case will, in many instances, include purely non-financial benefits. However, it is suggested that, in line with the principles set out above, all such business cases include explicit reference to the yield that would have been achieved if the capital requested were to be invested at 5%. In this way the Council will be able to make an informed decision, relative to the income that would be foregone in approving particular projects.

Financial Implications

These are set out in the body of the report above.

Legal Implications

These are set out in in Annexe D (and its Appendices 1 and 2). Should the recommendations in this report be approved, further specialist advice will be obtained to ensure that the corporate structure envisaged by this report is tax efficient and consistent with the realisation of the objectives of the Asset Investment Strategy and the extent to which any modifications to the Model Articles of Association prescribed by the Companies (Model Articles) Regulations 2008 are appropriate for a company formed for this purpose. Training for those officers who will be appointed as directors or otherwise discharging Companies Act 2006 duties (such as Finance and/or Democratic Services) will also be delivered to ensure that they have the skills and knowledge to comply with their statutory obligations. Any other registration and/or statutory notifications requirements will also be verified and applied for. Confirmation from the Council's insurance officer that the Council's officer indemnity policy is in place to cover the activities of those officers acting as directors will also be obtained.

2.0 CORPORATE IMPLICATIONS

Monitoring Officer commentary

The Monitoring Officer confirms that all relevant legal implications have been taken into account

S151 Officer commentary

The s151 Officer confirms that all relevant financial risks and implications have been taken into account.

Risk Implications

A section on risk is included in the main body of the report (paragraphs 44-47). In addition to maintaining an adequate level of reserves and balances to counteract the risks of a downturn in the property market or rising finance costs, further mitigation will come from the organisation continuing to seek to identify alternative areas of income generation, innovation and transformation. Moreover, the creation of a balanced portfolio will take some time to create and will depend on the availability of appropriate opportunities and so it is important that other financial solutions continue to be pursued.

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 Strategy. 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 from this report.

Consultation

None arising from this report.

Communications

An appropriate press release will be issued.

BACKGROUND PAPERS

ANNEX A

INVESTMENT PROPERTIES – VALUATION AT 31.3.16

Properties	Valuation (£)
Fairmount House, Leatherhead	9,428,800
Swan Centre, Leatherhead	5,449,500
Curtis Road, Dorking	5,125,400
Claire House & James House	3,446,200
Dorking Halls – ancillary buildings	846,900
Old Char Wharf	843,900
St Martin’s Walk, Dorking	566,700
Grove Corner shops	520,200
Pixham Lane	273,600
Foundry, Dorking	200,000
Rylands Court	172,800
Goodwyns Shop	145,000
Church Street	140,900
Other	356,900
TOTAL	27,516,800

ANNEX B

Proposed Constitutional Changes arising as a result of the Investment Strategy

The following parts of the Constitution will need to be updated, should the recommendations of this report be agreed.

Part 3 (Responsibility for Functions): (i) Appendix 1 Reservation of Powers to the Council

- Approval of the Asset Investment Strategy;
- In relation to MVDC as shareholder pursuant to the Asset Investment Strategy: approval of the allotment of further shares in a company (whether to third party shareholders or the Council),
  - exercise of any reserved powers in the Articles of a company,
  - determination of the distribution of any surplus or the issue of any dividends from a company;
  - consider any recommendation from company directors to cease trading.

Part 3 (Responsibility for Functions): (i) Terms of Reference of the Scrutiny Committee

Paragraph 9 shall be amended so as to make it clear that this includes the performance of companies owned in whole or in part by the Council pursuant to the Asset Investment Strategy.

Part 3 (Responsibility for Functions): (i) Terms of Reference of the Audit Committee

A new paragraph shall be inserted so as to empower the Audit Committee to receive reports on the business plans, corporate governance, risk management and financial performance of any companies set up pursuant to the Asset Investment Strategy, including six monthly financial statements.

Part 3 (Responsibility for Functions): (i) Terms of Reference - Terms of Reference of Working Groups and Fora

The terms of reference for the Asset Investment Working Group set out at Annexe C will need to be inserted into this section.

Part 3 (Responsibility for Functions): Scheme of Delegation to Officers

As the directors of the Company are taking decisions which are delegated to officers by the Executive in accordance with the Scheme of Delegation, it is proposed that officers are appointed as directors of any company set up under the Asset Investment Strategy.

Accordingly, the scheme of delegation to officers shall be amended so as to provide that the holders of the following posts shall at a minimum, having regard to quorum, be appointed as a director of any company set up in accordance with the provisions of the Asset Investment Strategy:

- the Chief Executive;

- the Deputy Chief Executive (section 151 officer);
- Corporate Head with responsibility for Property; and
- the Legal Services Manager (Monitoring Officer).

Under Finance, the scheme of delegation to officers shall be further amended so as:
- to delegate authority to the Deputy Chief Executive in consultation with the Asset Investment Working Group to take all actions and make all decisions not reserved to the Council or the Executive relating to the implementation of the Asset Investment Strategy, including the release of funds.
- to delegate responsibility for compliance with the provisions of the Companies Act 2006 to the Deputy Chief Executive (section 151 officer) in consultation with the Corporate Head with responsibility for Democratic Services;

.

Under Property, the scheme of delegation to officers shall be further amended so as to make it clear that:
- references to the Council's property portfolio are to references to property owned directly or indirectly by way of a company owned in whole or in part by the Council; and
- acquisitions/disposals of land/other property transactions pursuant to the Asset Investment Policy are reserved to the Deputy Chief Executive in consultation with the Asset Investment Working Group.

Under Miscellaneous, the Legal Services Manager shall be granted authority to appear on behalf of any company owned by MVDC in any court or tribunal.

ANNEX C

TERMS OF REFERENCE OF THE ASSET INVESTMENT WORKING GROUP

Purpose

The Asset Investment Working Group is established by the Council, the primary purposes of which would be:

(a) To consider recommendations from officers regarding the potential purchase of a property asset, prior to submission of a bid. This would include consideration of the yield, and the Investment Evaluation based on the criteria set out above (paragraphs 14 to 18). This would be informed by analysis carried out by the commercial property agent acting on MVDC's behalf in a potential purchase (appointed on a case by case basis). The ultimate consideration would be whether to submit a bid or not, and at what value.

(b) To consider the results of the due diligence process, (following acceptance of an offer from MVDC to purchase an asset), with the ultimate consideration of whether to endorse the purchase and proceed to exchange of contracts.

Membership

- The Leader of the Council
- The Executive Member for Finance and Investments
- The Executive Member for Property, Parking and Economic Development
- The Chairman of Scrutiny Committee
- The Leader of the Group not represented by the Chairman of Scrutiny Committee
- The Chief Executive
- The Deputy Chief Executive (Chief Financial Officer)
- The Corporate Head with responsibility for Property
- The Property Manager
- The Financial Services Manager
- The Legal Services Manager (Monitoring Officer)
- The Democratic Services Manager

Given the short notice that could often be inevitable in convening meetings of the Asset Investment Working Group, all members of the Working Group (both Members and Members) shall nominate substitutes if they are unable to attend, or meetings could be held on a 'virtual' basis (eg: by conference call or possibly by a service of exchanges of emails).

Quorum

A simple number based quorum is not recommended (particularly as the Working Group would not be decision making), although a meeting should include:

- at least two of: the Chief Executive; the Deputy Chief Executive; and the Corporate Head with responsibility for Property (as these are the officers who, constitutionally, would be formally making decisions based on the advice of the Working Group), and;

- At least two of: the Leader; the Executive Member of Finance and Investments; and the Executive Member for Property, Parking and Economic Development (or their nominees).

Frequency of meeting

The Working Group will be convened as required

Future Action

Following the meeting of the Working Group, the Notes will include:

- the views of the Group;
- the action proposed to be taken by the Officers and
- the concurrence of the Leader, Executive member for Property and Scrutiny Committee to comply with the requirements of the Constitution (eg covering the aspects of Key Decisions, Special Urgency and consultation with the Chairman of the Scrutiny Committee).

All decisions relating to both offers to purchase, and subsequently, to move to completion of a purchase, would be reported to the next available meeting of the Council.

Annex D

Legal Framework for Property Purchases

The powers available to a local authority to create an income stream through investment in commercial property need to be considered in three parts.

- the power to invest (s.12 Local Government Act 2003),
- the power to borrow (s.1 Local Government Act 2003) and
- the power to undertake an activity for a commercial purpose (s.1 Localism Act 2011)

Power to Invest

Pursuant to the powers set out in s.12 Local Government Act 2003, the Council may invest either for:

"any purpose relevant to the Council's functions under any enactment", (s. 12(a)),

or for

"the purposes of the prudent management of its financial affairs" (s.12(b))

The power to invest given in s.12 should in principle include the power to invest in commercial property. However, the power to invest in commercial property must be used either for a purpose relevant to a function of the Council, for example the regeneration of a town centre, or for the prudent management of the authority's financial affairs. Investing purely to create a return is not viewed as a function of an authority whereas investment of a surplus in such property may be prudent when used as a tool alongside other financial measures.

It is important that the primary policy objectives of any investment activity by a local authority are met and public funds are not exposed to unnecessary or unquantified risk. In exercising the power to invest under s.12(b) a local authority should have regard to the CLG Guidance on Local Government Investments. The Guidance advocates the preparation of an investment strategy which the Council will be expected to follow in its decision making process unless a sensible and cogent reason is articulated for departing from it.

Power to borrow

S.1 Local Government Act 2003 gives each local authority a power to borrow money -

- for any purpose relevant to its functions under any enactment
- for the purposes of prudent management of its financial affairs provided it does not exceed its affordable borrowing limit under s.3 Local Government Act 2003 (s.2(1) and 2(4))

These powers mirror those in s12 Local Government Act 2003 referenced at (i) above.

This particular power under the LGA 2003 is unlikely to be considered wide enough to permit local authorities to borrow to invest purely in order to benefit from a financial return. The point has not been fully tested in the courts but the prevailing view is that the power to undertake new investments financed as a result of borrowing is more than likely to be viewed as being outside the parameter which permits borrowing for the prudent management of the Council's financial affairs.

However, the Localism Act 2011 s.1 general power of competence grants a local authority the powers to do anything that a private individual of full legal capacity may do. Although the power does not operate so as to permit activities which were prohibited before the Localism Act 2011 came into effect, individuals do have the power to borrow and it may be relied upon as enabling the authority to borrow to invest.

Commercial activity

The s.1 power of general competence may allow an authority to invest in property for a return but this activity is likely to be characterised as an activity for a commercial purpose and cannot therefore be undertaken directly by the authority (s.4 Localism Act 2011). It may be pursued through a company formed for that purpose and being within the meaning of section 1(1) Companies Act 2006.

To date, the Council's property investments have been made for the purposes of enabling the Council to secure the objectives of Transform Leatherhead. Accordingly, these investments have not been made for a commercial purpose, nor they have been achieved through borrowing, and have not needed to be contained within a company structure.

As the Asset Investment Strategy's objectives are largely for revenue purposes, it is recommended, subject to further specialist tax advice, that all such future investments are made through a company. Profits made from investment assets are taxed after the deduction of normal business expenses such as fees paid to managing agents, and can be further reduced by capital allowances which will be applicable to eligible expenditure on plant and machinery such as the purchase of new boilers or air conditioning units for the property.

Where an asset held for the long-term is sold, the profit or gain can be reduced by an indexation allowance, which allows for the effects of inflation when calculating the gain made upon the sale of an asset. These tax allowances don't generally apply to property development. Separating out development activity from investment activity reduces the risk of a tax charge arising out of an asset being re-classified from development asset to an investment asset (or vice versa).

Setting up a company limited by shares

A company limited by shares is an incorporated company that has share capital. The members of the company are termed shareholders and generally invest in the company with a view to realising a profit. Shares can be transferred from one shareholder to another for value. As a company, it will be governed by a board of directors who will act in accordance with the company's articles of association. The general benefits of being an incorporated company apply, including the ease of setting up, the limitation of liability due to separate legal personality, and also the potential tax benefits from trading as a company. A company is relatively straightforward to establish and set up. As it has a separate legal personality, a company can own assets and execute contracts in its own right. Can also sue and be sued, which means that the shareholders of the company are distinct from the company.

Directors are appointed for the day to day management of the company and can be held liable for actions taken that are not in the best interests of the company. As it is a company, there will be ongoing obligations that must be complied with such as submitting its accounts and an annual return at Companies House. Further details of the ongoing obligations are set out in Appendix 1 to this Annexe. The directors will be liable to ensure that these obligations are satisfied.

The directors will also have numerous duties under the Companies Act 2006, including the duty to act in the best interests of the company, to act with independent judgement and a duty to avoid conflicts of interest. These are onerous obligations and, if not undertaken with sufficient care, can give rise to personal liability for the directors concerned. These liabilities can, however, be insured against in the absence of fraud.

The duties of a director are set out in more detail at Appendix 2 to this Annexe.

Summary of process to register a company

To register a company the following must be filed at Companies House:

- a completed application for registration (Form IN01) which includes details of the directors/secretary, statement of capital, initial share holdings, details of subscribers, a statement of compliance and a statement of persons with significant control;
- Memorandum of Association – the memorandum will state that the subscribers wish to form a company under the Companies Act 2006 and have agreed to become members and, in the case of a company that is to have a share capital, to take at least one share each. The memorandum must be signed by each subscriber;
- Articles of Association - All registered companies must have articles of association. The Companies (Model Articles) Regulations 2008 prescribe three different sets of model articles under the 2006 Act however the use of these is not mandatory;
- requisite fee -
    - £12 for online incorporation (registered in 24 hours)
    - £40 (company registered in 8-10 days)
    - £100 (same day registration); and

The company comes into being when the Registrar of Companies issues a certificate of incorporation. Each company has a unique company number and whilst the name or registered office of a company can be changed, its company number will remain unchanged at all times.

Appendix 1

Companies Act 2006 obligations

The constitution of a company consists of:

- its Articles of Association
- any special resolutions; and
- any agreement between the members of the company which otherwise would require a special resolution to implement.

Section 86 of the Companies Act 2006 provides that a company must at all times have a registered office, to which all notices and communications can be addressed.

Companies must keep records which include:

- Register of directors and secretary (although private companies need not have a company secretary, the company must keep a register of its secretaries if it appoints one). These registers must be kept at the registered office of the company or other place notified to the Registrar.
- Copies of all directors' service contracts or memoranda of the terms of such contracts must be kept at the company's registered office or other place notified to the Registrar.
- Register of members. This must be kept at the company's registered office or such other place notified to the Registrar.
- Register of charges. This must be kept at the registered office of the company or other place notified to the Registrar.
- Records of resolutions and shareholder meetings. These must be kept at the registered office or other place notified to the Registrar.

  Companies have on-going statutory accounting and reporting obligations, with accounts and annual returns needing to be filed at Companies House, as well as the preparation of corporation tax and VAT returns, and there is also the need to maintain insurance (as a minimum Employers and Public Liability Insurance).

Appendix 2

Duties of a Director

Who can be a director?
The company that is set up by the local authority must appoint directors. There are no restrictions on members or officers being appointed as directors of the company, however as directors they must comply with the duties owed by a director to a company. In summary the director, whoever appointed, must act in the best interests of the company and ensure that they do not use their position as a director merely to carry out actions for the benefit of the authority. They must ensure that in their capacity as a director of the company they act for the benefit of the company and declare any potential conflicts that may arise due to their position on the council.
Where a member or officer is appointed a director, they can be granted an indemnity by the council as provided for under the Local Authorities (Indemnities for Members and Officers) Order 2004.

As the directors of the Company are taking decisions which are delegated to officers by the Executive in accordance with the Scheme of Delegation, it is proposed that officers are appointed as directors of any company set up under the Asset Investment Strategy.

The duties owed by directors
Directors of a company are subject to duties. These duties initially developed through the common law, and there are some forms of incorporated bodies where the directors will be subject to these common law duties.
Statutory duties
Where there is a company formally incorporated at Companies House, the directors' duties as they apply are codified in the Companies Act 2006. A summary of these duties is as follows:

A. Act within powers

   Section 171 of the Act states that a director of a company must act within the confines of their powers as set out in the company's constitution (the "**Constitution**"). The directors cannot exercise any powers that they do not have as contained in the Constitution.

B. Promote the success of the company

   Next section 172 of the Act states that directors are under an obligation to conduct themselves and act in a way that they consider would be most likely to promote the success of the company. The consideration of what is most likely to promote the success of the company must be held in good faith. In addition, this particular section sets out considerations that the director should factor into decisions regarding what is in the best interests of the company. This includes consideration of:

   - the long term likely consequences of decisions made;
   - the interests of the employees of the company;
   - the importance of fostering company business relations;
   - the importance of the company maintaining a reputation of high standards for business conduct; and

- the need to act fairly as between members of the company.

This is not an absolute duty in the sense that there are some exceptions, for example as set out in subsection (3) which states that this duty is subject to any enactment or rule of law which requires the directors to act in the interests of creditors of the company.

C. Exercise independent judgment

Section 173 of the Act states that directors should exercise independent judgment. However a director will not be considered to be in breach if they exercise judgment in accordance with an agreement executed by the company which restricts the exercise of discretion or they act in a way authorised by the Constitution.

D. Exercise reasonable care, skill and diligence

Section 174 states that a director of a company must exercise reasonable care, skill and diligence in exercising their duties.

The section sets out the standards by which this will be determined. The general knowledge, skill and experience that is to be reasonably expected of a person carrying out the functions carried out by the director will be considered, in addition to the general knowledge, skill and experience which the specific director has.

E. Avoid a conflict of interest

Section 175 states that a director must avoid direct or indirect situations where there may possibly be a conflict of interest with the interests of the company. This refers to both potential conflicts of interests and a duty and also direct conflicts of duties.

This duty does not apply where there is a conflict of interest that arises in relation to a transaction or arrangement with the company. Further the duty will not be breached if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or if the matter has been authorised by the directors of the company.

F. Do not accept benefits from third parties

Section 176 states that directors must not accept a benefit from a third party that is given to them by virtue of them being a director or by any action/inaction as a director.

A definition of a third party is set out in the section and is stated to not include the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate.

Also it is stated that this particular duty is not infringed if the acceptance of the particular benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

G. Declare interests in proposed transactions or arrangements

The final of these statutory duties is set out in section 177, which states that where a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement of the company, he must declare the nature and extent of that interest to the other directors.

The section also provides guidance on the declaration. It must be made at a meeting of the directors or by notice to the directors either in compliance with section 184 of the Act providing for notice in writing, or section 185 of the Act providing for general notice. The declaration must be made prior to the company entering into the specific transaction or arrangement.

The director need not make a declaration where he is unaware of the interest or where the director is not aware of the transaction/arrangement. In addition the director does not need to declare an interest if it is determined that it is reasonably unlikely to give rise to a conflict of interest or if the other directors are already aware of the interest.

H. Other duties

The Companies Act 2006 also sets out other general responsibilities, including for example, ensuring that the company prepare and maintain accurate annual accounts and also prepare a report of the directors. In addition the directors may be liable if the company fails to carry out its statutory obligations.

<u>Duties that developed through the law</u>

The original directors' duties, from which the statutory duties were derived and which are still applicable to the directors of certain types of incorporated bodies are as follows:

A. Fiduciary duties:

- act in good faith and in the best interests of the company;
- act within the powers conferred by the company's memorandum and articles of association and to exercise powers for proper purposes;
- not to fetter own discretion and not exercise independent judgment on the company's behalf;
- avoiding conflicting interests and duties; and
- not make an unauthorised profit.

B. Common law duty of care to exercise a degree of skill reasonably expected from a person carrying out the same functions as that carried out by the director, and also considering the general knowledge and experience of the director.

C. There was also an equitable duty of confidence owed by the director to the company.

ANNEX B

Asset Investment Panel: Report of its review of the current and proposed future Asset Investment Strategy

The Asset Investment Panel was tasked with reviewing the implementation of the Asset Investment Strategy (AIS) and of considering officers' proposed adjustments to the AIS, which is the subject of a report to Council on 20 February 2018. The AIS was implemented in October 2016 with the objective of generating income for the Council to replace lost funding in order to support the delivery of Council services to its residents. After its first year of operation, officers have reviewed and proposed amendments to the AIS. The review undertaken by officers and then considered by the Asset Investment Panel had as its central focus the 4 core questions set out below. The work undertaken by the Asset Investment Panel included a review of the potential investments introduced to the Council, and a comparison of the existing and proposed AIS scoring criteria matrices.

1. **To what extent has the AIS achieved its objectives?**
    - o Panel satisfied with officers' work, they have demonstrated an awareness of risk and the following proposals demonstrate that learning has taken place
    - o Officers and panel recognised and recommend that it is important from a risk-management perspective to secure a diversified investment property portfolio.

2. **Should the criteria for the purchase of investment properties be amended in any way?**
    - o Delete the requirement to achieve a 7% IRR as a pass/fail criterion and replace with a target of 6% IRR: A minimum 6% IRR target, coupled with the existing 5% Net Income Yield (NIY) threshold and the AIS scoring criteria matrix, would, based on the market data, have allowed, and will enable, investment in a range of suitable properties.
    - o The panel agreed with the officer proposal to adjust the AIS scoring matrix.
    - o The panel recommended that the adjusted AIS matrix should be reviewed in 6 months by the Executive and 12 months by the Council

3. **Is it feasible and desirable to invest in ready-made property funds, as well as individual property assets?**
    - o Officers and panel agreed that, if feasible, this would be a desirable addition to the categories of investment available.
    - o However, it was noted that this is still subject to further legal advice and analysis of the Governments proposed revisions to Treasury Management regulations.
    - o If ultimately feasible, it was noted that investments would be selected with the benefit of professional advice from Capita, the Council's treasury advisers.
    - o Officers agreed to commission advice from Capita prior to the Council meeting on 20 February 2018 to enable Council to consider that advice in reaching a decision.

4. **Is there a case for extending the value of the AIS (currently £48.5m)?**
    - o Officers propose an increase in borrowing to £100m, with aim to invest the additional properties and/or property funds by 2020, in order to deliver a total return of £1.5m to be re-invested in service delivery.
    - o The panel recognises there is a case for the increase in the value of the AIS.

Further recommendation:

- The panel recommended that the "Proposal for Investment Purchase" report currently supplied to members of the Asset Investment Working Group, (to evaluate potential investments), be made available to all Members for information, once an acquisition has completed.