Investment Strategy Report 2019/20

Summary
The Council invests its money for two broad purposes:

- because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management** investments), and
- to earn investment income (known as **commercial investments** where this is the main purpose).

This investment strategy is a new report for 2019/20, meeting the requirements of statutory guidance issued by the government in January 2018, and focuses on the second of these categories.

Portfolio - Finance
Date Signed Off – 11 February 2019

Wards Affected
All

Recommendation

The Executive is advised to RECOMMEND to Full Council the approval of the Investment Strategy, as set out at Annex A to the report.

1. Resource Implications

1.1 Following 8 years of Government funding cuts the Council embarked on a strategy of income generation through property in order to maintain valuable services. In addition further property was acquired in order to advance the Council's key priority the regeneration of Camberley town centre.

1.2 Over the last year the Council has invested £25m in commercial investments which has all been funded through external borrowing. These investments are budgeted to contribute £550k a year towards Council services. This represents 4.6% of the Councils net budget and is thus a vital source of revenue if current services are to be maintained. In total the Council has been £164m invested in property generating a net income of £2.7m towards services. This is equivalent to 22.5% of the overall net cost of services.

2. Key Issues

2.1 New guidance in relation to investment was issued by the Government in January 2018 and further guidance was issued by CIPFA later in the year. This Guidance was issued in response to the growth in commercial investment by councils as a way of balancing their books

and maintaining services. The objective of the guidance is to provide greater transparency in respect of property acquisition and ownership and in particular for members to enable them to understand the risks inherent in this type of investment.

2.2 The guidance has statutory backing and hence all Councils must have regard to it and the completion of an investment strategy complies with these requirements.

2.3 Government guidance recommends that Councils should not borrow money to invest in property solely for financial gain. Investment in property should also support local objectives such as securing jobs and employment sites, growing the local economy etc. Generally speaking if an investment is in borough or close to it is assumed that this condition is fulfilled. Whilst other investments are not prohibited the Council has to state clearly its reasons for ignoring the guidance and how it is managing risks etc. Further guidance is expected from CIPFA which may be more prescriptive in its application

2.4 Property investment is not without risk and the value of investments can rise and fall over time. Given it is the Council's intention to hold property for the longer term the key consideration in the acquisition of any property is the certainty of the income stream to fund the borrowing since ultimately the borrowing costs will fall on the council's revenue budget.

2.5 Extensive due diligence is carried out with each acquisition to assess the security of this income stream and a margin is included to cover voids etc. However as with any investment there are no absolute guarantees but by having the portfolio spread over a number of different tenants in different properties goes some way to minimising this risk.

2.6 In respect of the town centre property this has been acquired with a view to regeneration and economic growth of an area rather than for investment return and as such therefore carry a higher risk than property purchased solely for financial gain.

2.7 In the short term income from these properties, particular during redevelopment, is likely to remain under pressure. However in the long run the investment the Council has made in its town centre through refurbishment of the SQ, public realm improvements and the potential redevelopment of LRB should ensure that over the life time of the borrowing to support these, namely 50 years, these should increase in value and generate a return for the Council.

3. Options

3.1 Members can accept, reject or amend the recommendations within this paper.

4. Proposals

4.1 It is proposed that the Executive:

(i) NOTE the contents of the Investment strategy;
(ii) RECOMMEND approval of the Investment Strategy by Full Council

5. Supporting Information

5.1 The Investment strategy is included as Annexe A within this paper.

5.2 Government guidance on local government investment is available on the MHCLG website.

6. Corporate Objectives And Key Priorities

6.1 Investment in property not only supports the Council objectives around place in that it supports the local economy but also prosperity in that it generates income to support services and maintains employment sites in the borough.

7. Legal Issues

7.1 The Council has to have regard to statutory guidance in respect of Local Government Investments.

8. Governance Issues

8.1 Only Full Council can approve capital investments and borrowing limits. In addition this strategy must be approved by Full Council.

9. Sustainability

9.1 Investment in property is one of the ways that the Council is not only sustaining its local economy but also sustaining Council services in the face of significant cuts in Government funding.

10. Risk Management

10.1 Investing in property is not without risk but it is an area in which local authorities have had a long involvement. Rents can fall, tenants can leave, and costs can rise. In addition the overall value of the asset can also fall sometimes to below the cost of acquisition. The Council takes steps to minimise these risks through a robust due diligence process and having independent valuation to ensure that it does not overpay for acquisitions. It also acquires property with a view to hold them for the long term.

10.2 The Council maintains reserves to enable it to deal with fluctuations in income, say between tenancies, for the short term. In addition as it is

the Council's intention to hold property for the longer term any reductions in value are likely to recover over time. That said there are no guarantees that the anticipated income and assets value will be achieved which in turn could put at risk services which are supported by investment income. However this needs to be weighed up against the fact that these services would need to significantly reduce had the Council not invested in property at all.

Annexes	**Investment Strategy 2019/20**
Background Papers	
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Annex 1

Investment Strategy Report 2019/20

Introduction

1. As explained in the summary the Council invests its money for two broad purposes:

    - because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments**), and
    - to earn investment income (known as **commercial investments** where this is the main purpose)
2. This investment strategy is a new report for 2019/20, meeting the requirements of statutory guidance issued by the government in January 2018, and focuses on the second of these categories.

Treasury Management Investments

3. The Council typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure and collects local taxes on behalf of other local authorities and central government in the form of Business Rates and Council Tax. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from the Chartered Institute of Public Finance and Accountancy. The balance of treasury management investments is expected to fluctuate between £10m and £20m during the 2019/20 financial year.

4. **Contribution**: The contribution that these investments make to the objectives of the Council is to support effective treasury management activities.

5. **Further details**: Full details of the Council's policies and its plan for 2019/20 for treasury management investments are covered in a separate document, the treasury management strategy, which is elsewhere on this agenda.

Commercial Investments: Property

6. Under guidance issued in January 2018 the Ministry for Housing, communities and Local Government (MHCLG) defines property to be an investment if it is held primarily or partially to generate a profit. This means that property purchased to further regeneration opportunities, such as the SQ shopping centre, are defined as commercial investments.

7. **Contribution:** The Council currently invests in local commercial property to support economic development and regeneration as well as with the intention of making a profit that will be spent on local public services.
8. The Council's current commercial property portfolio falls under either the place or prosperity objective within the corporate plan.

Place Objective

9. These properties are mainly based within Camberley Town centre and have been purchased to enable the Council to bring forward its regeneration plans as well as driving economic growth within Camberley.

10. The purchase of the SQ and its associated land holdings has enabled the Council bring forward a redevelopment of the London Road Block as it now has a controlling interest in the site. Similarly the Council has invested in the refurbishment of the shopping centre to attract new retailers and drive the economy of the town. The acquisition of the House of Fraser building has given the Council control of this key site at a time when its future is uncertain thereby ensuring that it can control what happens to this building and hence delivers a solution. The acquisition and subsequent conversion of Ashwood House in to housing has meant that a derelict building has been brought back in to use and will also provide much needed housing in the Town Centre.

Prosperity Objective

11. The Council has acquired a number of Industrial Estates (St Georges Industrial estate, Albany Park, Trade City and Sandhurst) in the borough or just over the boundary. These have been purchase primarily for investment return but also to ensure that these key employment sites remain as they are. i.e. they are not redeveloped for housing etc. This supports the local economy by maintaining employment within the borough. The Council has also considered buying property outside borough for investment return but has not done so far.

Property held for investment purposes in £ millions

Property	**Actual**	**31.3.2018 actual**	
	Purchase cost £m	**Gains or (losses) £m**	**Value in accounts £m**
The SQ and associated properties	105	4	109
Other Town centre properties	8	(2)	6
St Georges Industrial Estate	8	1	9
Albany park Industrial Estate	16	2	18
Trade City Industrial Estate	12	Acquired in year	Acquired in year
Sandhurst Industrial estate	15	Acquired in year	Acquired in year
TOTAL	**164**	**5**	

12. **Security:** In accordance with government guidance, the Authority considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

13. A fair value assessment of the Authority's investment property portfolio has been made within the past twelve months, and the underlying assets provide security for capital investment. However it is likely that the 31st March 2019 valuation will indicate that the fair value of the Authority's investment property portfolio is no longer sufficient to provide security against loss. This is mainly because of a downturn in retail sector rents coupled with values not increasing quickly enough on recently acquired assets to cover the costs of acquisition. The Council is taking mitigating action as follows to protect the capital invested:
    - Investing in the assets i.e. the refurbishment of the town centre properties, to in time drive rents upwards;
    - Looking to alternative uses for surplus retail property to deliver income.
    - Ensuring that commercial properties are fully let.
    - Intending to retain properties for the medium to longer term until values recover thereby not realising any loss. Indeed most properties will initially be worth less than their purchase prices due to the costs of acquisition hence it is important that properties are acquired with a view to holding for a longer time period rather than a quick turnaround.

14. **Risk assessment:** The Authority assesses the risk of loss before entering into and whilst holding property investments by :

    a. Having a knowledge of the local market by looking at rental and vacancy rates and the values of comparable properties. This is primarily why investment has been restricted to the local area where the Council has the greatest knowledge.
    b. The Council employs agents to advise it on the purchase of property who do an assessment of the rental market, assess the risks associated with the tenants and that type of property and also provide an independent valuation which the Council basis its offer on. The council also employs professionals such as surveyors etc. to advice on any maintenance and structural issues.
    c. Generally speaking local advisors are used as they have an understanding of the local Surrey Heath property market. Professional advice is tendered for to ensure that best value is obtained.

    d. Tenants and covenant strength are reviews by the use of credit ratings if appropriate, level of arrears etc. and the results of this are factored in to any offer made.

    e. The properties are all managed by professional external managers who advise on tenancy strategies to ensure that the assets remain fully occupied. These advisors are subject to review by the

investment and development team to ensure that they continue to deliver value and drive the Council's investment property forwards.

15. **Liquidity:** Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed, the Authority holds significant cash reserves which can be called upon if required. In addition the Council has not borrowed fully up to its capital funding requirements meaning there is adequate headroom for further funds to be borrowed should liquidity become an issue. That said the Council acquired the properties with the intention of holding them for the medium to long term and is making regular repayments to ensure that loans will be fully paid off within 50 years. This means that even if the value of the assets does not increase the debt outstanding will fall over time.

Loan Commitments and Financial Guarantees

16. Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Council. At the date of this report the Council has not made any loans nor entered in to any guarantee arrangements with third parties.

Proportionality

17. The Council has already lost £2.7m in Government funding over the last 8 years, which represents 25% of its net budget, with more reductions anticipated. In order to be able to continue to deliver discretionary services, such as meals on wheels and community transport, the Council has had to generate income to cover this shortfall. In common with many other Councils one of the ways it has done this is through investment in commercial property. Hence the Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the extent to which the expenditure planned to meet the service delivery objectives and/or place making role of the Authority is dependent on achieving the expected net profit from investments over the lifecycle of the Medium Term Financial Plan. Should it fail to achieve the expected net profit, the Authority's contingency plans for continuing to provide these services is to fund them from reserves in the short term until the profit improves, increasing income and savings from other services and as a last resort ceasing to provide some or all of the council's discretionary services.

Proportionality of Investments

	2017/18 Actual £m	**2018/19 Forecast £m**	**2019/20 Budget £m**	**2020/21 Budget £m**	**2021/22 Budget £m**
Gross service	43.543	44.435	45.471	45.800	46.600

expenditure					
Investment income	2.397	2.884	4.228	3.800	4.000
Proportion	6.3%	6.4%	9.2%	8.2%	8.6%

Borrowing in Advance of Need

Government guidance is that local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. The Authority has complied with this guidance and has only borrowed to fund capital acquisitions and programs that have been approved and are/have commenced.

Capacity, Skills and Culture

Elected members and statutory officers: The decision as to whether to make an offer for a particular property rests with the Chief Executive advised by the Leader, Deputy Leader, Sec 151 Officer, the Monitoring officer, Executive Head of Investment and Development and other professional advisors as appropriate.

For each potential acquisition detailed information is provided consisting of the expected rents, costs, financial return, borrowing costs, MRP provision, environmental risks, state of the property, tenant strength, state of the rental market etc. this also includes measuring of future cash flows and the impact of voids and investment at lease renewals. Some of this work is done internally by the Investment and development service and some is done with the assistance of external advisors. The Council's asset acquisition strategy stipulates a minimum return of 2% after borrowing costs to ensure that there is a margin for voids etc. and the council is keen to be not over exposed within one particular sector. An exception to this is property acquired in Camberley Town centre which forms part of the Council's regeneration plans.
The Council has a number of staff with experience of property acquisition over many years and with that a good knowledge of the inherent risks in property ownership.

Commercial deals: Most of the Council's property deals are either negotiated directly or through agents. The agents, who are commercial property companies and work with many Councils, are fully aware of the requirement that the Council is unable to pay more than a red book valuation and of the need to ensure that borrowing entered in to is affordable and prudent.

Corporate governance: Although the Chief Executive can recommend that the Council purchases a property she has no authority to complete the purchase, increase the capital program or increase borrowing. All acquisitions have to be approved by Full Council on the recommendation of the Executive. Such approval, if granted, is within agreed financial parameters (in respect of purchase price etc.) and subject to the Chief Executive being satisfied that the due diligence has been satisfactorily completed.

Investment Indicators

The Authority has set the following quantitative indicators to allow elected members and the public to assess the Council's total risk exposure as a result of its investment decisions.

Total risk exposure: The first indicator shows the Council's total exposure to potential investment losses. This includes amounts the Council is contractually committed to lend but have yet to be drawn down and guarantees the Authority has issued over third party loans.

Total investment exposure in £millions

Total investment exposure	**31.03.2018 Actual**	**31.03.2019 Forecast**	**31.03.2020 Forecast**
Treasury management investments	15	12	12
Commercial investments: Property	145	171	171
TOTAL EXPOSURE	160	183	183

How investments are funded: Government guidance is that these indicators should include how investments are funded. Since the Authority does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Authority's investments are funded by usable reserves and income received in advance of expenditure.

Investments funded by borrowing in £millions

Investments funded by borrowing	**31.03.2018 Actual**	**31.03.2019 Forecast**	**31.03.2020 Forecast**
Treasury management investments	0	0	0
Commercial investments: Property	120	147	147
TOTAL FUNDED BY BORROWING	120	147	147

Rate of return received: This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Investment rate of return (net of all costs)

Investments net rate of return	**2017/18 Actual**	**2018/19 Forecast**	**2019/20 Forecast**
Treasury management investments	1.94	1.22	1.00
Commercial investments: Property	2.28	2.27	2.03

A number of other investment indicators are included below in order to monitor the Council's commercial property activity

Other investment indicators

Indicator	**2017/18 Actual**	**2018/19 Forecast**	**2019/20 Forecast**
Debt to net service expenditure ratio	2.75	3.1	3.04
Commercial income to net service expenditure ratio	8:11	8:12	8:14