Property Investments for Treasury Management Since 2016

Portfolio:	Leader
Ward(s) Affected:	n/a

Purpose: To consider the motion referred by the Council at its meeting on 22 July 2020 and agree the next steps.

1. Background

1.1. As part of its Corporate Plan ('Great Place, Great Community, Great Future'), in financial year 2016/17 the Council committed to deliver an improved Camberley Town Centre for the benefit of all residents of the Borough. The Council was offered the opportunity to make a major investment in the town by acquiring all the holdings of Capital and Regional PLC in Camberley, which consisted of the Mall Shopping Centre and associated landholdings. The Council also acquired the House of Fraser Building. This meant that the Council became the largest landowner in Camberley and thus was in a better position to further its regeneration plans for the town and support the top priority of the corporate plan. All the assets acquired are held in a Jersey Property Unit Trust (JPUT).

1.2. In addition, in the same year the Council acquired an industrial and retail estate within the borough, Albany Park, for £16m to maintain employment and to generate a financial return to support services.

1.3. All in all, these purchases contributed £1.5m of revenue to the General Fund in financial year 2017/18. On the advice of treasury advisors (Arlingclose) these acquisitions were financed by short term borrowings from other local authorities to take advantage of low interest rates. This saved £600k in interest charges in 2016/17 alone.

1.4. A schedule of the Council's investment property acquisition since 2016 is attached as Annex B to this report.

2. Current Position

2.1. At its meeting on 22 July 2020, the Council considered a motion (moved by Councillor Sashi Mylvaganam and seconded by Councillor Kristian Wrenn) to note concerns about article in the national press regarding the Councils property investments in Camberley Town Centre; calling for a report to Council detailing purchase costs of property investments for treasury management since 2016 and suggesting further actions in the case of each acquisition in the event that there had been significant impairment of book value since the date of purchase.

2.2. The motion also called for the production of a Property Investment Strategy report in time for the 2021/22 Budget setting process, detailing options in

respect of the future management and deployment of the Council's property investments to ensure prudent financial management.

2.3. The full text of the motion is set out at Annex A to this report.

2.4. The Council was informed that the Performance & Finance Scrutiny Committee had agreed to dedicate its meeting on 9 September 2020 to the scrutiny of the Council's property investments and this might be a more appropriate forum for this matter, and this approach was agreed.

2.5. It was also noted that, although the Mall Shopping Centre, Camberley (now known as the SQ) had been acquired primarily for the purposes of regeneration (rather than purely investment purposes) this acquisition would be considered within the scope of the motion.

2.6. This report provides the Committee with an update of findings to date and suggests the next steps to be taken in this matter.

3. The Jersey Property Unit Trust

3.1. A Jersey Property Unit Trust (JPUT) is a specific type of Jersey trust which is commonly used to acquire and hold interests in UK property. Unlike a company, a JPUT is not a separate legal entity. The assets of the JPUT are held by its trustee on trust for the unitholders of the JPUT. The unitholders hold units in the JPUT, like shareholders holding shares in a company. As the JPUT is a trust, the trustee will be the legal owner of the assets of the JPUT whereas the unitholders (in this case Surrey Heath Borough Council) will be the beneficial owners of those assets. This is different from the position with a company, where shareholders have no direct ownership interest in the company's assets. JPUT activity is very common in the UK private sector, but less common in the public sector.

3.2. The benefits of the Council's use of a JPUT to hold and acquire its property investments include:

- No liability to Jersey taxes;
- Potential UK tax advantages (subject to changes to UK tax legislation);
- Relative liquidity compared to other arrangements in terms of ease of getting money or assets into or out of the JPUT;
- A commonly used structure familiar to advisors, sellers and buyers;
- Flexibility in relation to unitholder (the Council) rights.

3.3. The Trust holds various properties within the Camberley Shopping Centre. The principal activity of the Trust is to invest in real estate for capital appreciation and collection of rental income. The legal form of the Trust does not confer separation from the Council and therefore transactions and balances relating to the Trust are incorporated into the Council's financial statements.

3.4. The Trust prepares financial statements which are subject to independent audit by BDO Jersey. The Trust's year end for financial reporting purposes (December) differs from that of the Council (March). The Trust's financial statements are also prepared under FRS102 (the principal accounting standard in the UK financial reporting regime), whereas the Council's financial statements are based on International Financial Reporting Standards (IFRS).

3.5. BDO, the Council's external auditors, have examined the recommendations to the Council from Montagu Evans to acquire the Shopping Centre and noted in their 2018/19 Audit Completion Report that the blended yield rate of 6.32% reported by Montagu Evans when valuing the shopping centre at 31 March 2019 was towards the very top an acceptable range, but that this was not unreasonable based on the explanations provided by the valuer (the valuer's view was that local factors such as the quality and strength of the existing leases and tenants, the relative wealth of residents in the area, as well as recent capital expenditure on improvements would make the shopping centre more attractive to investors who would use lower yields when valuing the strength of the rental income).

3.6. At the time of acquisition in 2016, Montagu Evans suggested that the net yield on the investment would be no less than 5.38%. The annual rental income at the time of purchase was £5.545m and the price paid was £86.482m, suggesting a gross annual yield of 6.4%.

4. Property investment as part of the Council's overall financial strategy

4.1. Property investment is included a managed as a key corporate issue. The Council's property investment portfolio is primarily held to provide a revenue stream to support the delivery of services across the borough, and generated a rental income of approximately £5.100m in financial year 2019/20. Budgeted income for 2020/21 is ££8.400m (including £3.800m from SQ), and the latest forecast for actual income is £7.3million. A fuller report detailing the causes of the forecast variance in the current financial year (as well as its impact on the Council's Medium-Term Financial Strategy) will be included in the half-yearly financial review reported to the next meeting of this Committee.

4.2. Of total long-term assets on the Council's balance sheet at 31 March 2019 (£224.012m), investment properties comprised £82.724m or 37%.

4.3. Because some investment properties are held in support of wider council initiatives such as regeneration, job creation, provide additional amenity and other initiatives that have a social value, the Council's investment plans are not entirely focussed on profit maximisation. The Council's financial statements for 2018/19 point out that investments are held for **both** regeneration and for generating income As part of its audit of the Council's 2018/19 financial statements, the auditors noted the following regarding the Council's intentions for its property investments when evaluating the Camberley Town Centre assets:

> The Council considers this asset as supporting its long-term regeneration strategy and therefore has classified this as Property, Plant and Equipment (PPE) rather than investment properties… Such assets [can] be classified as PPE where assets are not held 'solely' for income generation or capital appreciation. Whilst it would appear that the net income generated from rents is being used to support the Council's budget, rather than delivery of services, we accept that it may be appropriate to classify this asset as PPE where this forms part of the Council's economic regeneration strategy.

4.4. This is an important distinction because comparisons of financial performance between public and private sector portfolios must make allowance for this additional social 'cost' which means that in general, public sector portfolio yields will tend to be lower than in the private sector.

4.5. With the gradual withdrawal of general government grant to support Council's day-to-day expenditure (Revenue Support Grant was ended entirely in 2018/19), Council's main sources of income are Council Tax, Business Rates, Fees & Charges (e.g., Planning Applications) and Property Rents. Of these sources, Property Rents carries the highest risk of volatility from year-to-year.

4.6. Consistent with other types of investments (cash, shares, bonds, etc.) the expected return on property increases with the level of inherent risk. Because Council's are investing public money, they will often sacrifice potentially higher yields for additional security or liquidity. Again, this will tend to mean that in comparison with private sector property portfolios, the public sector returns will tend to be lower.

4.7. Rental and capital values of property can also fluctuate upwards or downwards over time according to market and economic circumstances, as has been seen over the period 2016 to date. Due to these risks property is a long-term investment and suitable for strategic investment funds with a relatively long expected duration. For example, in the case of Camberley Town Centre, the goodwill generated on completion in 2016 is amortised over 50 years (to 2066). The UK economic cycle over the past 50 years has averaged 5.5 years per cycle, so between 2016 and 2066 nine economic cycles could be expected. The first of these has not yet completed, and a major restructuring of the portfolio assembled by the Council from 2016 to date seems premature.

5. Current Risk Exposure

5.1. The Council's approach to its risk exposure is robust. In the Annual Governance Statement (examined and approved unqualified by the auditors), apropos of the Camberley Town Centre acquisitions, the Council recognised that the acquisitions of the Town Centre to regenerate the SQ and the London Road development site carried a significant level of commercial and financial risk.

5.2. The Council's main source of risk mitigation is the appointment of professional agents to manage and advise on property acquisition and management.

5.3. The main risk exposures are:

- Failure to progress planned transactions (buying and selling);
- Fluctuations in property capital and rental values due to market or wider economic circumstances;
- Financial failure of tenants;
- Lack of suitable investments for acquisition;
- Property vacancies following lease expiry.

6. Additional auditor assurances regarding the Council's approach to managing its current and future investments

6.1. As part of the additional assurance that the Council has requested, in the Audit Plan for the coming year BDO have agreed the following:

In undertaking their audit of the Council, they plan to place reliance on BDO Jersey's work. In placing reliance on the work of BDO Jersey, they will undertake the following procedures:

- Assess the competence and independence of the BDO Jersey Team;
- Participate in planning meetings with the BDO Jersey Team, and communicate the work they require them to perform for the purposes of the audit of the Council. In doing so, they will communicate details of the financial reporting framework applicable to the Council, their timetable, the significant risks of material misstatement relevant to the audit of the Council, and the materiality levels applicable to the audit. They will also undertake a review of the BDO Jersey team's key audit working papers, and key outputs from their audit including reports to Those Charged with Governance.

6.2. In addition to the reliance the Council's auditors place on the work of the BDO Jersey team, as part of their audit of the Council they will:

- Review the inclusion of the Trust's financial statements into the Council's financial statements;
- Undertake testing of transactions and balances arising in the Trust between January and March 2020;
- Obtain direct confirmation of the cash balances held by the Trust at 31 March;
- Review updated valuations of the investment property held by the Trust; and
- Confirm that any adjustments required to convert transactions and balances from an FRS102 basis IFRS basis.

7. Resource Implications

7.1. At the meeting of Council on 22 July 2020, the Executive Head of Finance advised Members that the cost of the work proposed in the motion would be outside the existing budget and, if Members were minded to agree to this investigation, the Council would need to agree a budget for this work. At this meeting is was suggested that the budget required for all stages of work set out in the motion would be in the region of £110,000, which would cover both external costs and officer time.

8. Legal Matters

8.1. The Performance and Finance Scrutiny Committee may undertake investigations into matters relating to the functions of the Council and/or external organisations operating in Surrey Heath as may be referred by the Leader, Executive, Portfolio Holder or the Council. This is set out in Article 6.2 (iv) of the Council's Constitution. Accordingly if the Committee considers that an investigation is appropriate as per the motion as set out in Annex A, then it may only proceed to investigate following a referral.

8.2. The Committee does not have an allocated budget to commission external services or consultants to support any investigation. Council would need to set a budget to cover the estimated cost of these if it is minded to refer the motion to the Committee to undertake an investigation.

8.3. It appears the Council purchased the Mall primarily for the purposes of economic regeneration. It was also envisaged that the acquisition would have financial benefits in terms of generating income, however that does not alter that the purchase was primarily for economic regeneration.

9. Officer Comments

9.1. Corporate Management Team has discussed the issues within the Council motion, and given the current financial constraints, the findings contained in this report, and that the auditors over the years since 2016 have made no comment on the yield rates applied by the Council's valuers or on the Council's use of a JPUT to manage its property investments, it is felt that the cost of the investigation set out in the motion would be disproportionate in terms of the cost of undertaking the work and the expected outcomes achieved.

9.2. Alternative options to address the matters raised in the motion to Council have been considered and are set out in the proposals below.

10. Proposals

10.1. The following steps are proposed for consideration by the Committee:

10.2. <u>Increased focus on property and investment by officers</u>

To this end, a Town Centre Officer Group (looking at best practice nationally) has been established and the Property Group will widen its remit to include investment property decisions.

10.3. Further scrutiny of investment decisions 2016 to date

Set up a Member/Officer 'Task and Finish group' with a remit to examine the advice provided by professional agents to the Council regarding its property acquisitions and management to feed into the Council's future Property Investment Strategy. The work to comprise:

- Developing an agreed action plan on the key task at hand
- Action the work programme in a timely fashion i.e. doing the work
- Developing measures of evaluation
- Reporting on the impact, learning, and outcomes

The impact, learning, and outcomes from the Group to be reported to Performance & Finance Scrutiny Committee on 25 November 2020 and to Council on 9 December 2020.

The Interim Executive Head of Finance to be the lead officer within the Group.

11. Options

11.1. The Committee has the option to

(i) recommend to Council that the investigation proposed in the motion to Council on 22 July 2020 be agreed and a budget be approved to undertake this work;

(ii) agree that the proposals set out in paragraph 10 of this report be pursued; and/or

(iii) consider any other actions it considers appropriate.

12. Recommendation

12.1. The Committee is advised to RESOLVE that

(i) The proposals to establish a Town Centre Officer Group and widen the remit of the Property Group in order to provide increased focus on property and investment by officers be endorsed;

(ii) a 'Task and Finish Group' with a remit to examine the advice provided by professional agents to the Council regarding its property acquisitions and management to feed into the Council's future Property Investment Strategy be established; and

(iii) the membership of the Task & Finish Group be agreed as considered appropriate.

Annexes:	Annex A – Motion to Council Annex B - The Council's investment property acquisitions since 2016 Annex C – Information provided by Councillor Mylvaganam (exempt)
Background Papers:	None
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Annex A

Motion to Council
22 July 2020

At its meeting on 22 July 2020, the Council considered the following motion:

It was moved by Councillor Sashi Mylvaganam and seconded by Councillor Kristian Wrenn that

"this Council resolves that

(i) concern about articles which have appeared in the national press in respect of the Council's property investments which suggests possible multi-million pound valuation losses in the Council's property investments in Camberley Town Centre be noted;

(ii) in order to protect the current and future financial interests of Surrey Heath Borough Council Taxpayers Financial Officers, in conjunction with the Council's Auditors, and/or other independent organisation, be asked, subject to budget approval, to produce a report, to be presented to the next Full Council Meeting, detailing the purchase costs of property purchased by the Council as investments for treasury management since January 2016, together with independently ratified valuations of those property investments as at the time of purchase and at end of the last financial year and a current valuation, as at the date of this Council meeting;

(iii) in the event that the valuations as at the end of the last financial year show an erosion of more than 25% of the purchase costs, or 50% of the current valuation, a further independent report be commissioned, subject to budget approval, from the Council's Auditors or other qualified company or institution (in accordance with the Council's Contract Standing Orders) into:

a) the strategic rationales behind each property investment made since January 2016.
b) the procedures followed in respect of each investment to ensure that all Council Standing Orders and protocols were adhered to correctly;
c) the amount paid for each property investment made since January 2016 to assess if proper value for money at the time of purchase was obtained for Borough Council Taxpayers in respect of each investment;
d) the actual and forecasted rental income, and all other critical financial aspects, to assess whether the full financial costs, risks and benefits were properly evaluated;
e) whether the most appropriate financial methods and mechanisms, for both the short and
f) long term benefit of Council Taxpayers, were used to fund each property investment made since January 2016; and
g) Based upon a), b), c) and d). above, to produce recommendations in respect of procedures to be adopted in future property investments to ensure best practice is followed for the ongoing security and benefit of Council Taxpayers; and

(iv) Financial Officers, based upon the findings of the independent report(s), and taking further independent advice, as necessary, produce a Property Investment Strategy report in time for the 2021/22 Budget setting process, detailing options in respect of the future management and deployment of the Council's property investments to ensure prudent financial management."

It was noted that, although the Mall Shopping Centre, Camberley, now known as the SQ, had been acquired primarily for the purposes of regeneration rather than purely investment purposes, this acquisition would be considered within the scope of the motion.

The Executive Head of Finance advised Members that the cost of the work proposed in the motion would be outside the existing budget and, if Members were minded to agree to this investigation, the Council would need to agree a budget for this work.

The Council was informed that the Performance & Finance Scrutiny Committee had agreed to dedicate its meeting on 9 September 2020 to the scrutiny of the Council's property investments and this might be a more appropriate forum for this matter. In accordance with Council Procedure Rule 12 (e), it was moved by Councillor Rodney Bates and seconded by Councillor Alan McClafferty that the motion be referred to the Performance & Finance Scrutiny Committee to discuss in more detail. This procedural motion was put to the vote and carried.

IT WAS RESOLVED that the matters identified in the motion be referred to the Performance and Finance Scrutiny Committee for consideration.