

SURREY COUNTY COUNCIL**CABINET****DATE: 28 MARCH 2017****REPORT OF: MS DENISE LE GAL, CABINET MEMBER FOR BUSINESS SERVICES AND RESIDENT EXPERIENCE****LEAD OFFICER: JOHN STEBBINGS, CHIEF PROPERTY OFFICER****SUBJECT: INVESTMENT STRATEGY REVIEW****SUMMARY OF ISSUE:**

The Investment Strategy agreed by Cabinet in July 2013 was developed in response to the requirement for the Council to enhance its financial resilience in the longer term. In facilitation of this strategy, Cabinet approved the business case for the creation of a property company and associated subsidiaries in May 2014 in order to achieve a balanced property portfolio (across sectors and geographies) to generate an income for the Council. The property company, Halsey Garton Property Ltd, and its subsidiaries are referred to in this report as “the Halsey Garton Property Group” (HGP).

In order to reflect the increasing need to develop alternative and resilient revenue streams to support the Council’s services and with the objective of growing the income it is now realistic to reset the strategy and grow the portfolio to reach beyond the original annual income target of £5m and aim to deliver £10m by 2020/21. The Investment Advisory Board therefore recommends that the Council puts in place the necessary arrangements to deliver the target income. These arrangements include some revisions to the governance arrangements and an enhanced role for an external advisor to provide additional resources to both acquire and then provide ongoing asset management for the portfolio.

RECOMMENDATIONS:

It is recommended that:

1. Cabinet approves progressing the Investment Strategy, including arrangements to enable significant growth in the portfolio to reach an income target of £10m per annum by 2020/21;
2. Cabinet authorises a revision to the governance arrangements and recommends that the Leader delegates authority to the Investment Advisory Board to approve property investment acquisitions, property investment management expenditure, property investment disposals and the provision of finance to its wholly owned property company, Halsey Garton Property Ltd;
3. the name of the board will be amended to reflect this delegation and it will be known as the “Investment Board”; and
4. Surrey County Council procures a property investment advisor to provide the necessary skills and level of support required to expand the investment portfolio noting that any upfront expenditure will be drawn from the Revolving Investment & Infrastructure Fund and that the procurement will be undertaken

in two stages in line with the growth in the portfolio.

REASON FOR RECOMMENDATIONS:

The proposed arrangements will support the Council to continue to grow its portfolio and increase the level of income received from investments thereby enhancing its financial resilience over the longer term.

The provision of a substantial ongoing and resilient source of income to provide financial support to the Council's front line services is becoming increasingly important. Investments undertaken as a result of the strategy agreed in 2013 are successfully delivering a net income stream to the Council.

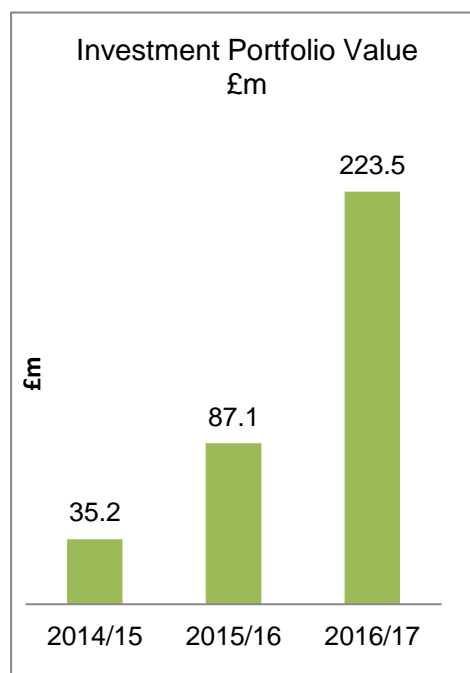
DETAILS:

Background

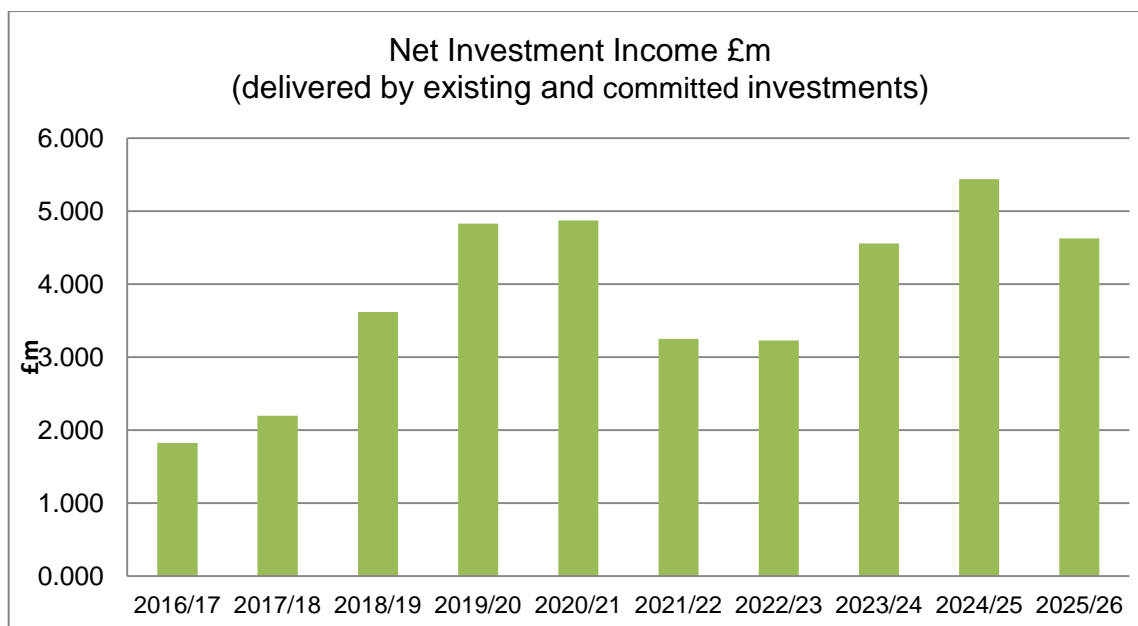
1. The Investment Strategy agreed by Cabinet in July 2013 was developed in response to the requirement for the Council to enhance its financial resilience in the longer term. The main principles of the Investment Strategy are as follows;
 - Creation of a diversified and balanced portfolio of investments to facilitate future service provision, manage risk and secure an ongoing annual overall return to the Council.
 - Use of the established Revolving Investment and Infrastructure Fund (the Investment Fund) to meet the initial revenue costs of funding initiatives that deliver savings and enhance income in the longer term.
 - The Investment Fund is to be used to support investments that generate additional income to support delivery of the Council's functions and services.
 - Investments that have the potential to support economic growth in the county of Surrey.
 - Retaining assets where appropriate and undertaking effective property and asset management, and if necessary associated investment, to enhance income generation.
2. The investment portfolio of the Council is therefore a combination of assets acquired or developed by the Council for future service needs, economic development and those acquired or developed by the property company. Cabinet approved the business case for the creation of the Property Company and associated subsidiaries in May 2014 in order to deliver the Investment Strategy and achieve a balanced property portfolio. The companies making up the Halsey Garton Property Group (HGP) were incorporated between June and July 2014.
3. The governance for the Investment Strategy is provided by the Investment Advisory Board (IAB), established following the Cabinet report in July 2013 and comprising members of the Cabinet and the Chief Executive, supported by officers. The IAB is responsible for providing appropriate evaluation of opportunities prior to Cabinet approval and for the strategic management of the

overall portfolio consistent with the aims of the Investment Strategy. The IAB monitors the portfolio to ensure that an appropriately balanced and diversified portfolio is created over time, across the combination of directly Council-owned assets and those owned by HGP. Officers, supported by independent specialist professional advisors, support the Investment Advisory Board. These specialist advisors periodically evaluate the recommended portfolio of property investment, taking into account market conditions and achievable returns.

4. In accordance with the conditions set by the Prudential Code, investment in assets of a commercial nature are required to demonstrate a return in excess of the opportunity cost of capital which is calculated with reference to the Council's interest payable on equivalent borrowing and the statutory minimum revenue provision (MRP) that sets aside funds for repayment of the borrowing.
5. The Council currently owns an investment portfolio of over £200m which is forecast to deliver a net revenue, after the deduction of funding and other costs including administration, of £1.8m in 2016/17¹. This income return includes a part year effect for investments made during the year. The forecast portfolio, taking into account agreed acquisitions, including Farnham Brightwells, and the development of the Crawley site, will deliver a net average income of £3.8m per annum by 2019/20. The Revolving Infrastructure & Investment Fund will continue to be required in order to smooth the impact of variations in the annual income due to potential lease expiries and to provide the ability to deliver further developments, including the full development of the Crawley site.



¹ Excludes acquisitions proposed to Cabinet in February 2017 which may not complete in 2016/17.



6. The current property portfolio has developed over a number of years with the rate of growth increasing more recently. The Council has created a good reputation in the market by demonstrating its ability to complete acquisitions to agreed timescales and therefore is increasingly being invited to consider various potential acquisitions, including some that are off-market. As transactions in the UK investment property market were over £50bn in 2015, for example, there is ample opportunity to deliver further growth.

Growing the Portfolio

7. In the context of the increasing financial challenges faced by the Council, the IAB have considered whether it is appropriate to significantly increase the scale and pace of investment in order to deliver more income in support of the Council's services. The Board consider that the Council can build upon the success to date and that it is now realistic to restate the original aims for the strategy and grow the portfolio to reach beyond its original target income of £5m.
8. The IAB are supportive of significant growth noting that expanding the portfolio further will contribute to the creation of a diversified portfolio which will mitigate against risk – however, noting also that growth will be dependent upon appropriate opportunities coming to market and property market conditions generally. Acquisitions will be progressed that contribute to the creation of an ongoing income stream in accordance with the strategy with the Council continuing to take a long-term view in regard to capital appreciation and depreciation. The IAB therefore recommends that the Cabinet puts in place the arrangements to deliver an ambition of a significant growth in the property portfolio, reaching up to an annual income target of £10m by 2020/21.
9. The assets required to deliver this scale of income will be determined by market conditions and the Council's risk appetite. The table below provides a simplistic illustration based upon current achievable returns in the market.

| Net Annual Return (after funding & other costs) | Estimated portfolio size required | | |
|---|-----------------------------------|----------------------|--------------------|
| | Low risk / low reward | Medium risk & reward | High risk & reward |
| £5m | £500m | £333m | £250m |
| £10m | £1,000m | £667m | £500m |
| £15m | £1,500m | £1,000m | £750m |
| £20m | £2,000m | £1,333m | £1,000m |

10. The purpose of the Investment strategy is to deliver an annual income stream in support of the Council's services and in doing so the Council is not assuming any gain from the value of the underlying assets. Instead a long-term view is being taken since the value of the assets may decrease as well as increase over time.
11. Asset values for investment properties are determined by a number of factors including market conditions, the length of lease left to run and the covenant of the tenant/s. Values are also sensitive to tax changes such as the changes to stamp duty last March. Assets held by both the Council and HGP are revalued each year as part of the year-end statutory accounts process. Any unrealised gain or loss is shown in the Council's comprehensive income and expenditure statement however this has no impact on the general fund of the Council – that is, no adverse implications for the tax-payer since adjustments of this nature are excluded according to statute. Similarly, any revaluation gain or loss related to properties held by HGP is shown in the company's profit and loss statement as an unrealised gain or loss but has no impact on the profit that can be distributed to the Council as its shareholder. The Council can choose to sell assets only when it is appropriate to do so since the rental income covers the associated funding costs.

Resource Implications

12. The Investment Strategy is delivered and supported by key officers in Property, Finance and Legal Services. There are a number of aspects to the resources required, split broadly between:
 - sourcing, evaluating and completing acquisitions (including the financing arrangements); and
 - managing the portfolio on an ongoing basis, for example tenant & agency management, financial monitoring and forecasting as well as all aspects of running a separate company.
13. The key constraint to delivering further growth is the specialist resource available and therefore a number of options to provide the required capacity have been evaluated and in doing so it is recognised that the capacity is required for both the portfolio held directly by the Council and that held by HGP. It continues to be the case that the strategy is to manage the overall portfolio as one, to deliver diversity, future flexibility and enhanced returns.
14. The delivery models considered for providing the additional property capacity were to recruit further capacity in-house, delegate fully to an external provider

or to seek a strategic advisor to provide the specialist capacity required. These options were evaluated against the following criteria –

- Extent of control & strategic oversight
 - Access to consistent expert advice
 - Access to investment opportunities
 - Cost / value for money
 - Scalability
 - Risk management & access to market intelligence.
15. Each option is affordable since the resources will deliver net income to the Council and all the options are capable of ensuring that the Council continues to have access to expert advice and investment opportunities. The in-house option does not, however, provide scalability since it takes time to attract suitable investment property professionals to work for the Council as demonstrated by recent recruitment activity. The IAB wished to maintain control over investment decisions as well as strategic oversight and therefore the fully delegated model is not appropriate for the Council and tends to be the more expensive model.
 16. The conclusion from the options analysis is that an advisor model delivers the advantages of the delegated model and the control / governance arrangements of the in-house model whilst being able to be flexible and deliver scalability to supplement and bolster the activities of the existing team. The advisor model ensures that there is continued access to expert advice and has the advantage of bringing strategic oversight and better access to market intelligence. The additional capacity will complement the Council's existing resources.
 17. The IAB therefore recommends that the Council progresses the advisor model and that this will be undertaken in two stages in line with the growth in the portfolio– interim arrangements to support initial growth with an OJEU procurement exercise to find a long term advisor as the second stage. It is expected that the advisor will be remunerated in two ways which broadly follows the two aspects of the resource requirements explained above:
 - Sourcing, evaluating and completing acquisitions: the advisor will provide property investment specialists to support acquisitions ensuring that each recommended purchase is in accordance with the Investment Strategy and contributes to the establishment of a diversified portfolio.
 - Managing the portfolio on an ongoing basis: the advisor will provide resources to assist in the day-to-day management of the property portfolio; for example tenant & agency management, tenant relationships, rent reviews, organising year-end valuations, analysing options for asset improvement and delivering any agreed programme of works.
 18. Growing the portfolio also requires additional finance and legal resources. Key activities will continue to be delivered in house in order to provide reassurance to the Council that there are appropriate “checks and balances” in place and therefore further resources will be recruited. As with the external property advisor, these resources will be affordable since they deliver additional income. Where appropriate, specialist external suppliers and advisors will continue to be utilised – for example for some legal transactions and the provision of

specialist tax advice. The cost of resources required, whether internal or external, will continue to be recognised in the actual and forecast performance of the portfolio as it is now and where work is undertaken for the property company the cost must be charged at commercial rates.

Investment Advisory Board

19. A further possible constraint to the growth in the portfolio is the speed of decision-making. The Council has been successful in progressing and agreeing terms with vendors to grow the portfolio however there are occasions when the decision-making timetable has meant that opportunities have not been able to be progressed. In order to substantially grow the portfolio further, respond and compete with competitors in the commercial investment market; which typically includes institutional investors such as insurance and pension funds as well as high net worth individuals and, increasingly, other local authorities, it is appropriate to consider making some changes to the governance arrangements.
20. The Cabinet is therefore requested to consider asking the Leader to delegate authority to the IAB to approve property acquisitions, property investment management expenditure, property investment disposals and the provision of finance to the Council's wholly owned property company, HGP, provided that these decisions are within the scope of the agreed Investment Strategy. The Investment Advisory Board will continue to be supported by key officers, including the Section 151 Officer and Monitoring Officer with expert advice and support provided by the property investment advisor, once appointed.
21. The revised Terms of Reference are attached as Annex 1. In accordance with the proposed changes, the Investment Advisory Board will become known as the Investment Board. There will be no delegation of decision-making in relation to non-property investments, these decisions will continue to be made in accordance with existing governance arrangements – by Cabinet or Cabinet Member depending upon value.
22. Investment decisions will be made by the Board in accordance with the framework established by the agreed Investment Strategy. A scoring matrix will be used as a guide to this decision-making which will help to ensure that opportunities are measured and assessed in a common manner. The matrix is attached as Annex 2 to this report however this will undoubtedly evolve over time in line with the growth in the portfolio and changing market conditions. It is possible that opportunities will arise that do not score highly on the criteria but deliver a positive economic outcome and these will be progressed in accordance with the strategy to deliver schemes that support economic growth in the county. Similarly schemes that provide the ability to deliver future service needs whilst delivering an income to the Council will continue to form part of the portfolio.

Scrutiny

23. The Investment Board will provide an update of decisions made to Cabinet each month (as a part two item assuming that the proposed investments have not legally completed) and a summary investment position will continue to be reported as part of the monthly monitoring report considered by Cabinet. The Board will also produce a comprehensive property portfolio annual report detailing the acquisitions purchased, the portfolio of investments and the net

income position for Cabinet to consider and for the purposes of scrutiny. The Council Overview Board will be able to call the Investment Board to account for progress in relation to achieving the stated aims of the Investment Strategy.

CONSULTATION:

24. The IAB has reviewed and considered the proposals over a number of meetings and supports the recommendations in this report.

RISK MANAGEMENT AND IMPLICATIONS:

25. The Investment Strategy results in the Council is managing different financial risks. Investments will be subject to inherent economic and market risks which requires a balanced portfolio of investments to be built over time. The performance of the portfolio is monitored by the IAB. The Strategy notes a preference toward assets within Surrey that are of good quality, in good or growth locations, however, in order to create a diversified portfolio a mix of geographical locations is envisaged.
26. The risk of tenant failure may become a more important consideration in building a larger portfolio if the general economic conditions in the UK over the longer term are negatively impacted by Brexit or other factors. Investments will continue to be evaluated carefully and with due regard to risk and exposure to potential tenant voids and will be managed to avoid over-reliance upon single tenants or types of tenants in terms of their impact as a percentage of the total portfolio.
27. Development opportunities by their nature will have a higher risk profile but will also provide the opportunity for a greater rate of return. The Strategy gives priority to development opportunities within Surrey where the wider benefits to the county will be taken into consideration such as the provision of housing, new business premises or town centre regeneration.
28. The governance process put in place is designed to mitigate these risks. All investment expenditure will be based upon a robust business case, developed using appropriate specialist advisors and which takes into account due and proper consideration of the balance between risk and reward and an assessment of the underlying security of the investment to comply with the fiduciary duty the Council holds. The procurement of an advisor to provide capacity and to provide further strategic oversight will also ensure that the Council has access to consistent expert advice and better access to market intelligence and insight which will contribute to the appropriate management of risks.
29. A number of local authorities have recently agreed similar investment strategies with some significant large scale investments featuring in the industry and public sector press. All of these strategies, including SCC's, are to a large extent predicated on a local authority's ability to borrow affordably from the PWLB (Public Works Loan Board). There is a potential risk therefore of enhanced scrutiny from Government and this may be exacerbated by the proposed changes in governance for the PWLB that transfers its powers and responsibilities to the Treasury. There are, however, other sources of finance available to the Council if this were to be the case, for example, by participating in a bond issue with the Municipal Bonds Agency.

Financial and Value for Money Implications

30. The objective of the Investment Strategy is to invest in income generating assets to partially offset the impact of reductions in Government grant and to protect service provision. The Council may fund investments through the use of its reserves, capital receipts and prudential borrowing. The proposed long-term objective to continue the existing strategy at a greater scale and pace will continue to be subject to the same safeguards in that all borrowing will be undertaken in accordance with the Prudential Code that requires the borrowing to be affordable, sustainable and value for money.
31. All investments will continue to require a robust business case before proceeding and all investments are required to demonstrate a return in excess of the opportunity cost of capital and other associated costs of delivery. The cost of an investment advisor and further internal resources will therefore be recovered against the additional income that is delivered by the growing portfolio and, as such, is an affordable expenditure. It is expected that the advisor will be remunerated in two ways, a fee charged as a percentage of acquisitions and disposals and a percentage fee determined by the rent receivable to pay for day to day property asset management activities and strategic oversight of the portfolio. The detailed methodology and associated costs and value for money considerations will be tested as part of the Council's normal procurement processes.

Section 151 Officer Commentary

32. A significant increase in the size of the investment portfolio will deliver additional net income to the Council in support of its essential front-line services. The increased portfolio will not necessarily increase risk since there are greater opportunities for diversification, however the governance arrangements will continue to ensure that each investment is supported by a robust business case. In approving a business case, the Investment Board will satisfy itself that the investment is within the Council's legal powers, it has properly considered the advice from its specialist advisors (both internal and external) and that its structure provides the best value for money taking into account all financial considerations. Full due and proper consideration will be given to the balance between risk and reward and the underlying security of the investments proposed to ensure compliance with the fiduciary duty to ensure that the financial standing of the Council is protected.

Legal Implications – Monitoring Officer

33. The Council's overarching property investment strategy is underpinned by its powers to acquire properties for current or future service use, to dispose of properties surplus to service requirement and by the "general power of competence" introduced by the Localism Act 2011. Decisions as to whether acquisitions are made by SCC or by HGP are determined by the purpose for which they are acquired. When property investments are intended for service delivery they are acquired by SCC, as has always been the case. If they are acquired for a commercial purpose they are purchased by HGP which is a company within the meaning of s.1(1) Companies Act 2006.
34. In deciding whether to adopt the revised strategy, Cabinet should take into account its fiduciary duty to Surrey taxpayers and satisfy itself that the

Strategy's objectives are deliverable, that the required investment is affordable and that it is a prudent and reasonable use of the Council's financial and other resources.

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| <u>Equalities and Diversity</u> |
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35. There are no equalities and diversity implications arising from the Council undertaking the proposed investments.

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| <u>WHAT HAPPENS NEXT:</u> |
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36. Following Cabinet approval, officers will progress the associated procurement required to secure a specialist property investment advisor and progress the recruitment of other resources as required.

Contact Officer:

Susan Smyth, Strategic Finance Manager, Tel 020 8541 7588

Peter Hall, Asset Investment & Disposal Manager. Tel: 020 8541 7670.

Consulted:

Investment Advisory Board

Annexes:

Annex 1: Investment Board Terms of Reference

Annex 2: Investment Decision Guide

Sources/background papers:

Cabinet Report July 2013 – Investment Strategy

Cabinet Report May 2014 – Establishment of a Property Company