SURREY COUNTY COUNCIL

STRATEGIC INVESTMENT BOARD

DATE:	**18 DECEMBER 2019**
REPORT OF:	**MR MEL FEW, CABINET MEMBER FOR FINANCE**
LEAD OFFICER:	**LEIGH WHITEHOUSE, EXECUTIVE DIRECTOR OF RESOURCES** **PATRICIA BARRY, DIRECTOR OF LAND AND PROPERTY**
SUBJECT:	**PROPERTY INVESTMENT STRATEGY REFRESH**

SUMMARY OF ISSUE:

Having established a portfolio of investment properties since 2015, there is a continuing need to find new / increased sources of revenue to fund essential services for the people of Surrey.

Meanwhile, as a result of high investor demand, yields on the type of high quality, well located property assets attractive to the Council have fallen, and its funding environment has tightened. This is leaving investors - including the Council - with an unenviable choice between large capital investments for low returns, or accepting higher risk assets if meaningful increases in revenue are to be achieved.

However, the Asset and Place strategy has identified significant new opportunities within the Councils' (**non-investment**) property estate - but with a limited pool of property expertise within the Council, pursuing them at the same time as continuing to grow its investment portfolio is unlikely to be successful.

This paper makes recommendations about how a refreshed strategy for investing in property will allow the Council to deploy its scarce property capability to maximise its total property revenue (and capital) opportunities, whilst at the same time actively investing more in Surrey for the benefit of residents.

Scope: The scope of the work covered by this report was to develop a strategy for the future handling of the Council's property investment portfolios. Whilst there are passing comments on areas such as the size and structure of the Council's property team, governance, and operational processes these were all out of scope for detailed analysis / comment.

RECOMMENDATIONS:

It is recommended that the Board adopt a revised strategy for investment in property assets as follows:

1. The Council should retain but, for the time being, make no further investments in its portfolio outside Surrey - unless it is to protect or enhance the value of an existing investment. e.g. where a tenant fails, invest for conversion of the property to an alternative use.

2. In general, there should be greater focus placed on capital/revenue/tax planning at the evaluation stage of any future property investments.
3. The resources in the Council's property team and its financial resources should be reprioritised to focus on:
   - Identifying non-operational properties and surplus operational properties in Surrey which offer value opportunities (revenue, capital or both) through development or disposal (in line with the Asset and Place Strategy).
   - Unlocking the identified value opportunities in Surrey, by investing appropriately.
   - Managing robustly (via professional advisors) the performance of the existing institutional grade UK-wide investment portfolio of the Halsey Garton Properties Ltd group of companies (HGP).
   - Delivering the ambitions / plans for the small number of investment properties held directly by SCC for strategic purposes.
4. Until the review of the treatment of asset revaluations by HGP is concluded, legal entities outside HGP should be used for processing surplus assets arising from the Asset and Place strategy.
5. Bespoke Key Performance Indicators (KPIs) should be adopted for each of an emerging group of distinct sub – portfolios of property investments (e.g. SCC, versus HGP) to reflect the different underlying asset types and financial expectations of each.

REASON FOR RECOMMENDATIONS:

The revised investment strategy:

- Protects an important revenue stream of £5m per annum needed to support the provision of much needed services in the county of Surrey.
- Focuses the Council's people and financial resources on the highest value opportunity available whilst also recognising the primacy of the needs of the people of Surrey for housing and economic / town centre regeneration.
- Recognises a progressively less benign outlook for financing of non-Surrey based property (gearing constraints, treatment of asset revaluations)
- Recognises changes in the wider UK property market over the last 2-3 years which have driven down yields for high quality assets to a point where the balance between risk and reward is currently no longer attractive.
- Gives scope to develop and retain the best assets released under the Asset and Place strategy to provide additional income streams for the future, whilst further diversifying the overall mix of investments held.

DETAILS:

Original Strategy

1. Developed in 2014, the core aims for the Strategy were to:

   - Build a balanced portfolio of UK-wide property investments (sector/geography) to generate a long term stable revenue stream to fund essential services in the County.
   - Make investments within Surrey which had the potential to support economic growth, town centre regeneration, or the provision of new housing.

2. Wider UK investment assets were to be of good quality, in growth locations – with an emphasis from Day 1 on revenue generation rather than capital/development gains.

3. Assets were to be acquired by HGP (Annex 1, Appendix A) being wholly owned and ultimately funded by SCC on the basis of approximately 70% debt: 30% equity, and the plan was for a sectoral split as follows:

	% value (+/- 5%)
Retail	52.5
Industrial	22.5
Office	12.5
Other	12.5

4. Over time, the portfolio has evolved to be much more aligned with the IPD Index* profile (see Annex 1, Appendix B), although within the headline mix there are some “lumpy” exposures notably the Malvern Retail Park, and the Symphony factory, Barnsley.

5. All investments were required to show a return in excess of the cost capital, and together formed two distinct sub – portfolios:

    - “Strategic” Investment properties acquired/developed by the Council for future service needs or economic development (owned by SCC).
    - Assets acquired across the UK purely for investment purposes (owned by HGP).

[March 2019]

6. In assessing the **overall** performance of the investment portfolio, it is important to note that it is comprised of the net income from property assets (whether owned by SCC or HGP) **PLUS** the margin charged on loans from SCC to HGP (see Annex 1, Appendix C)

*Investment Property Databank Index = A benchmark index used by UK institutional and commercial investors covering £250bn of UK property assets.

<u>Current position</u>

7. Since June 2018, the updated investment priorities have been to:
    - Generate immediate revenue
    - Diversify further the income profile
    - Continue to focus on high quality assets, i.e. those with good (i.e. long) lease lengths – and ideally fixed/indexed rental uplifts
    - Focus additionally on the quality of the underlying asset – for when the lease eventually expires

8. The majority of assets are performing well – and in line with purchase expectations: notable exceptions are the Malvern Retail Park, and the Debenhams store in Winchester, both of which reflect the current state of the property market and the economy in general.

9. There is good spread of covenants – with the majority being high quality (Annex 1, Appendix D) and excluding units held specifically for redevelopment, void rates are low at 2% compared with an IPD index benchmark of 7.3% (See Annex 1, Appendix E)

10. There is evidence of active management of investments subject to approaching lease breaks/expiries – and whilst there are 'spikes' in 2027 and 2038 (Annex 1, Appendix F) which present revenue risks, there is not a strong case for substantial new investment simply to smooth the profile.

11. As noted above, the mix of assets by sector is now much closer to that of institutional funds following recent substantial investments. That said, the portfolio is slightly overweight in the office and retail sectors – and the Councils retail holdings are dominated by the Malvern Retail Park. In due course (and when market conditions are more favourable) consideration could be given to disposing of part of the site to Worcestershire County Council as a potential natural purchaser/JV partner. The Symphony site in Barnsley presents a similar (albeit smaller) issue in the industrial sector holdings. NB: Both of these assets were acquired at a time when further, near term expansion of the investment portfolio was envisaged, and the observations made regarding their relative size is not a criticism of the investment decisions made at the time.

12. The process supporting investment decisions appears to be sound – although it may be worth revisiting the assessment of sector and tenant risks, and in particular the reliance on Dun and Bradstreet credit ratings before making further investments: this was also suggested in the draft report prepared by Montagu Evans earlier this year.

13. In terms of value, a number of properties are being carried at a book value which is lower than the acquisition 'cost'. In some cases, this reflects a genuine downward adjustment in the value of the investment – but more frequently reflects the current policy of capitalising all costs associated with a purchase (e.g. stamp duty) at the time of acquisition – only for the asset to be revalued downwards at the year end to a level closer to the sum paid to the vendor.

14. To summarise: Overall the HGP portfolio is performing well, and generally in line with expectations. For the time being there is not a strong case for large scale disposals – especially as the combination of dealing costs and current market conditions (Annex 1, Appendix G) would see some assets crystallise a loss. Equally, the same market conditions discourage further investment – at least in the near term. Meanwhile, assets within the SCC portfolio are generally held for strategic purposes – which are gradually being progressed: on this basis, no changes to it are proposed.

Potential for increased returns – HGP Sub Portfolio

15. In basic terms, there are four levers available to the Council to driver higher returns from its HGP investment portfolio:
    - Higher income
    - Lower costs
    - More debt (and therefore more tax-deductible expense)
    - Improved tax management

16. Setting aside four small properties held specifically for redevelopment (usually residential development of upper floors of commercial buildings and having a rental value of c1% of the total) the vacancy rate within the portfolio is commendably low at 2%. And this level of occupancy is 'real' i.e. it has not been delivered through the extensive use of tenant incentives e.g. rent free periods. Apart from some future index linked rent increases, the scope for imminent income growth is close to zero.

17. In terms of unexploited development opportunities – which would in time deliver rental growth – the absolute focus on immediate revenue when building the portfolio means that almost all assets are already fully developed, and fully occupied. A couple of opportunities exists – but they are low value and for the medium term, so again the scope for revenue growth from this source is negligible.

18. Annex 1, Appendix Ha shows a summarised profit and loss account evidencing very low HGP costs – even after the full recharge of SCC admin costs. Scope for reduction is minimal.

19. The Council has funded assets purchases by HGP on the basis of approximately 30% equity: 70% debt. This is already stretching the outer limits of what would normally be regarded as acceptable and in fact, the Finance team makes a central adjustment to reflect a more usual 40% - 60% split for calculating tax deductible interest. In short, there is no scope for increased returns from a revised approach to funding structures.

20. To date, HGP has been in a growth phase so tax planning, beyond corporation tax, has not been a feature of its performance. But as surplus properties from the Asset and Place strategy start to flow, this is likely to become a more important issue for HGP management, and it is recommended that it is given higher priority when evaluating new projects. The same applies to the need for strengthened links between initial project proposals and revenue/ capital planning 2-3 years forward. Note: SCC and HGP benefit from group relief status for stamp duty purposes.

21. To summarise: there is little prospect of substantial, near term revenue growth from the existing HGP sub-portfolio.

22. At this point is it worth noting that returns from the HGP Portfolio were always going to be low. Annex 1 appendix I is taken from a 2014 paper explaining how the finances of the HGP/SCC would operate. From this it can be seen that because HGP assets were ultimately funded entirely from debt raised by SCC, the expected investment 'profit' was simply the difference between the rental yield and the SCC cost of capital – minus a few expenses and some tax. In normal market conditions, that is always going to be a small figure.

23. In contrast, institutional/commercial portfolios will usually carry a blend of development and investment assets – but more importantly a large element of *genuine* equity, the cost of which is met by dividends. The combination of these factors will usually generate higher 'headline' yields, but they are not meaningful benchmarks for HGP.

24. A summary of the invest more/divest options considered for the HGP portfolio and rejected is given in Annex 2.

<u>Potential for increased returns – SCC Sub Portfolio</u>

25. There are currently 10 investments in this group, and almost all are held for specific strategic or operational purposes: to that extent, they are owned for reasons beyond pure investment returns even thought a number generate revenue for the Council. Each asset is unique and has a specific plan which is being progressed.

26. In time, further development of the Nexus site in Crawley should generate additional revenue – but this will be more than offset by the loss of income related to planned disposals. In common with HGP, the costs of operating this portfolio are low, and offer limited scope for reduction: See Annex 1, Appendix J.

27. Future financial returns from this portfolio are likely to be only marginally positive – but this reflects the strategic / transitional status of many of the assets.

<u>Assets and Place Strategy – capturing the potential, and is there a role for HGP?</u>

28. Given the (very) limited opportunities available in the existing investment portfolio, it is recommended that a refreshed property investment strategy be adopted, which would see the SCC property team focus on:
    - Delivering the plan for each of the 10 properties in the SCC 'strategic' investment portfolio [No change]
    - Driving continuing high levels of performance in the HGP investment portfolio – but pausing further investment unless it is to protect/enhance the value of an existing asset [Revised]
    - Processing the surplus assets released under the Asset and Place strategy to generate capital receipts, and operating cost reductions. [New].

29. As surplus assets are released under Asset and Place strategy, consideration should be given to moving them to a new ring fenced portfolio – possibly in a separate legal entity, and Halsey Garton Development Limited (Part of the HGP group) may be a suitable vehicle.

30. Ring-fencing the assets will work to focus the attention of management on:
    - disposing of appropriate assets as they stand in a timely way
    - undertaking some form of development to enhance value - prior to disposal
    - undertaking some form of development to create an asset with an ongoing revenue stream which is to be retained for the future benefit of the Council and local residents.

31. After completion, residential assets for retention could be held in Halsey Garton Residential Limited, but it is suggested that the redeveloped office/retail/leisure assets for retention be held separately from the existing HGP Investment Limited (HGPI) portfolio. The underlying assets of the newly developed portfolio and the existing ones of

HGPI will be radically different – in terms of both quality and financial performance: keeping them separate will make these differences visible – and focus manage attention accordingly.

32. An illustration of how surplus assets might in due course move through the HGP ‘system’ is given in Annex 1, Appendix K.

33. NB: The ultimate decision to use which – if any – of the existing legal entities within the HGP group, or whether to opt for Limited Liability Partnerships/new companies outside the HGP group will depend on tax/funding considerations and legal constraints. That said, the accounting policy for the treatment of asset revaluations by the HGP group is currently under review and, until that work is completed, it is recommended that legal entities outside the HGP group be used for processing surplus assets arising from the Asset and Place strategy.

Performance metrics:

34. By adopting the recommended refreshed property investment strategy, the two existing sub – portfolios will grow to five:

Existing:

- SCC Strategic Investment
- HGP

New:

- ‘Development’: a transitional holding pen for surplus properties arising from the Asset and Place strategy which are being processed for development and/or disposal.
- ‘Surrey Commercial Investments’: completed retail, office, or leisure properties which flow out of the ‘Development’ portfolio when complete to be retained for future revenues.
- ‘Surrey Residential Investments’: completed residential units which flow out of the ‘Developments’ portfolio to be retained for future revenues.

35. These portfolios will have different characteristics – both financial and non-financial, and a recommended minimum set of KPI’s for each is shown in Annex 3. By using bespoke KPI’s, underlying performance of the various grouping will be transparent.

RISK MANAGEMENT AND IMPLICATIONS:

36. There are four primary risks associated with the refreshed strategy:

a. As assets flowing from the Asset and Place strategy are developed and retained, SCC/HGP will have and even higher investment exposure to holdings of Surrey based assets than is normal for institutional / general commercial investors – with the associated economic risk. This is off-set by the wider employment and regeneration opportunities, which are available from the strategy.

b. Whilst there has been some diversification in the portfolio over the recent years, at its current size it holds 2-3 disproportionately large assets. In due course, and as market conditions permit, consideration could be given to partial sales of the relevant assets.

c. Even with a narrower, sharper, focus the Council is likely to need extra resources to execute the refreshed strategy. A separate piece of work supported by external advisors is exploring ways to reshape/grow the team such that it is able to meet the challenge.

d. The Council has access to external contractors of sufficient scale to be able to handle the volume of capital and relocation work likely to be needed over the next 2-3 years. However, without forward notice of the impending uplift in SCC related work, they may be unable to deliver what is required in a timely way. Open communication, plus good forward planning and work pipeline management will mitigate this risk.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

37. Of the options evaluated, the proposed strategy option represents the highest value for money and will be a key enabler in releasing the benefits of the Asset and Place strategy. There is a place marker in the 2020 Capital Plan to support the work: this figure will be refined as feasibility studies for specific projects progress.

SECTION 151 OFFICER COMMENTARY

38. The Council's medium term financial outlook is uncertain as it is heavily dependent on decisions made by Central Government. With no clarity on these beyond 2020/21, our working assumption is that financial resources will continue to be constrained, as they have been for the majority of the past decade. This places an onus on the Council to continue to consider issues of financial sustainability as a priority in order to ensure stable provision of services in the medium term.

39. As such, the Section 151 Officer supports the Property Investment Strategy Refresh and the quantifiable implications have been built in the 2020-21 Budget Planning Assumptions.

LEGAL IMPLICATIONS – MONITORING OFFICER

40. The Council has a wide range of powers and legal requirements concerning property investment and development. These include the Local Authorities (Land) Act 1963, the Local Government Act 2003 and the Localism Act 2011. Broadly, these can be split between three categories:
    a) Where the Council already owns property;
    b) Where the Council acquires property for strategic need or regeneration ("a council function"); and
    c) Where the Council acquires property purely for the potential generation of income ("a commercial purpose").

41. In situations a) and b), the Council is not limited in the models it can utilise, including direct ownership, development in-house or through an LLP. For situation c), the Council is required to utilise a company structure such as HGP.

42. Legal Services will continue to provide advice on the Council's powers and potential vehicles for any future investment activities.

EQUALITIES AND DIVERSITY

43. There are no direct equalities and diversity implication in adopting the recommendations made in this report.

WHAT HAPPENS NEXT:

If the recommendations are agreed, then the next steps will be to:

- Share the refreshed strategy with the in-house team, and then with CBRE as the Council's currently appointed investment advisors. [immediate]
- Build the team numbers and strength in line with recommendations to follow from a separate piece of work. [immediate]
- Overhaul the process and content required for future business cases – including clear rigorous forward planning for tax and the required balance between capital and revenue receipts. [by 31 January 2020]
- As plans for delivering the Asset and Place strategy became clearer, the existing network of contractors should be briefed regarding the emerging pipeline of work. [by 31 March 2020]
- Undertake a short procurement exercise to appoint an advisor/manager to support the emerging 'Surrey Commercial' and 'Surrey Residential' portfolios: this role is likely be better suited to a local, rather than National agent. [by 31 March 2020]

Contact Officer:

Contact officer: Graham Brammer- Strategy Adviser – 07515158506

Consulted:

A number of SCC officers, have been consulted in the preparation of this paper, together with the portfolio holder and his deputy. CBRE was also consulted as the County's currently appointed property investment advisor.

Annexes:

Annex 1: Supporting data

Annex 2: HGP Portfolio: Options considered, and rejected

Annex 3: Recommended (minimum) key performance indicators

Sources/background papers:

Legal opinion: Ranjit Bhose, QC	31 May 2013
Property Company: Background, SCC	April 2014
Cabinet Paper: Establishment of a property company	27 May 2014
Cabinet Paper: Award of a contract for Property	18 July 2017

Investment Advisory Services – Part 2 report

Strategic Investment Report: Half Yearly Update, CBRE	January 2019
Investment Strategy Review: Montagu Evans (draft)	31 March 2019
Cabinet Report: Surrey Asset and Place Strategy	30 April 2019
Cabinet Paper: Governance Review of the Council's Assets, Shareholder and Investment boards	7 May 2019
Cabinet Paper: Investment Board Annual Report 2018-19	25 June 2019
Companies and Investment Governance Review: David Cogdell	2 August 2019
Surrey County Council: Property Investment Strategy (draft), CBRE	October 2019
