BUILDING OUR INVESTMENTS – HOW SOME LOCAL AUTHORITIES ARE EXPANDING THEIR PROPERTY INVESTMENT PORTFOLIO

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Chris and Susan kindly agreed to write this article after the Editor attended an AMP Network presentation on this topic, which seems to be of growing importance to many councils, as austerity measures bite ever deeper.

Many local authorities around the UK hold investment property within their portfolio. This part of the portfolio has received increased scrutiny since the CIPFA Code adopted the IFRS model in 2010, which created for the first time in the balance sheet the asset class of **Investment Property.**

Initially many local authorities classified as Investment Property any asset where a market rent was being received. Some even classified as an Investment Property anything where a rent was payable. Gradually over the past few years authorities have been reclassifying much of this property into a more appropriate classification that accords with the CIPFA Code of Practice on Local Authority Accounting (the Code).

The definition of an Investment Property in the Code is an asset that is "…**used solely to earn rentals or for capital appreciation or both…**"

Alongside this reclassification of assets, some authorities have started to consider what by nature a true Investment Property is and some authorities have challenged their earlier decision and determined that under the strict definition, they do not in fact have any such properties at all.

But while the general move has been to reclassify assets away from the Investment Property classification, there is a new body of authorities that are beginning to explore an expansion of their Investment Property portfolio.

We have undertaken some research into this area and while up to about

2-3 years ago there were only small numbers of authorities expanding their investment property portfolio, that number is certainly increasing. And when we delivered a presentation on this research at our most recent series of asset management network events around the UK, it became obvious that there are even more now taking this approach than we had at first realised.

So why are authorities expanding their portfolio of investment property?

Central government funding for local government has been falling for a number of years in response to the austerity measures. CIPFA/DCLG figures show a fall in spending of 29.1% between 2009/2010 and 2014/2015 (allowing for inflation), and 2014/2015 spending is at same level as 2005/2006 in cash terms.

This has impacted significantly on local government spending and budgets and has prompted some authorities to look for means to soften the impact by creating new income streams that will be free from austerity measures. Income from property is one of the areas that is often high up the list.

An increasing number of authorities have started to ask themselves questions like:

- Is there another means of plugging the funding gap?
- Is there another route to becoming more financially self-sufficient and sustainable?
- Was selling assets the right answer?
- Should we reverse that trend?

In parallel to the austerity measures and budget cuts, the levels of local authority cash reserves has increased significantly, occasionally prompting criticism from the Secretary of State and the Audit Commission. So where are these reserves held? Are they held in high earning long term accounts? Well sadly, in most cases they are not. According to Audit Commission data 62% of local authority investments are deposits with banks or building societies, where the rates of interest can be as low as 1% p.a.

In contrast, yields from property present an opportunity for much greater returns, even allowing for the inherent risk and illiquidity in direct property ownership. Property values are still relatively low in many parts of the UK, providing an opportunity to exploit capital growth, as well as the revenue return on investment.

It is this very simple comparison of returns that has prompted an increasing number of local authorities to look to property investment – directly or indirectly – as a means of helping to ensure greater financial stability.

Which authorities have embarked on this journey?

One authority that has expanded its investments in this way and which has received a degree of publicity is Ashford Borough Council. A report to its Cabinet in December 2013 set out the financial picture quite clearly, acknowledging that ever decreasing funding from central government has necessitated the council looking at innovative ways to generate revenue streams so the reliance on central government funding is reduced. At that time the council received £3.8m of formula grant and by 2015/16 it will fall to £1.9m and it is expected to fall even further by 2018/19. The report recommended making a strategic acquisition in order to strength its long term financial stability in line with the agreed Corporate Plan.

Having allocated £2m for property purchase, the council bought its first new property earlier this year using prudential borrowing to fund the purchase, at a fixed interest rate of 4%. The property is within the borough and is a mixed use retail and residential scheme.

The council has since considered further purchases and has also been exploring as an investment the construction of 3 new industrial units on land it already owns.

From the publicity that Ashford has received, one might be forgiven for concluding that it was the first to follow this course, but far from it. For example Elmbridge District Council started out on its journey in 2012 when it bought 2 investment properties - shops at Cobham for £6.8m and Consort House in Weybridge for £4m - generating net annual yields of 5.61% and 7.74% respectively (based on the rental stream for April to December). In December 2013 the council bought a further 2 investment properties, Albany House for £1.6m and The Old Post Office for £2m, both of which are in Esher, generating net annual yields of 6.45% and 4.78% respectively.

These net annual yields compare favourably with the 1.09% (1.45% annualised) it was receiving on cash investments at the time. The council acknowledges that there are always risks with rental properties and the Revenue Risk Reserve will serve as a safety net should there be periods of void or rent free periods.

But even before Elmbridge DC had started on its strategy, Eastleigh Borough Council, had developed its investment acquisition programme way back in 2008/09, reportedly in the tens of millions of pounds, including strategic investments connected with the county cricket ground. The difference with Eastleigh however, is that while the investment must generate an acceptable rate of return, there is a definite driver of local regeneration in its acquisition targets.

What do these examples have in common?

One clear common theme from the examples quoted is that they have all confined themselves to property acquisition within their own administrative areas. I am sure some readers of this article may question whether acquisition of property within a council's own area only can really be termed an investment. We might well have similar questions, as an asset that is to be treated as a true investment should surely be located where it will provide the highest possible rate of return, within the risk parameters that

have been adopted? This is unlikely to be only ever in the council's own geographic area.

Not only that, but so long as any acquired investment property is within the council's local area there is always the risk that there could be political 'interference' in the management of the investment, such as intervention by elected members in situations where a tenant finds itself in arrears or some other potential landlord and tenant conflict.

Some authorities have come to similar conclusions and made positive decisions NOT to acquire property within their geographic boundary. Examples of this are Wolverhampton MBC which is exploring options elsewhere and Mansfield DC which bought a hotel investment in Edinburgh.

What are the legal considerations in expanding the investment portfolio?

There are a number of areas to consider if your organisation is considering following the lead of those mentioned above, and one of the most important is the legal position. This is a complex area and we are not aware of any published guidance that local authorities can rely upon. They consequently have to weigh up the legal issues for themselves and be satisfied that what they intend to do is compliant with local government legislation.

We believe that Ashford BC relied upon the Local Government Act 1972 in its decision-making process, probably s120. As for the other examples given above, the situation is not quite so clear, but there is other legislation that councils might seek to rely upon such as s12 of the Local Government Act 2003 and the general power of competence contained in the Localism Act 2011 – and the latter we believe has been relied upon in some other cases not mentioned in this article.

Of course the legal landscape could well be different depending on whether the authority is intending to acquire property investments within or outside its geographic area.

What about the risks?

Despite the obvious gross financial benefits over interest on cash deposits, expanding or creating for the first time an investment property portfolio is not something to be entered into lightly, and will require a mature culture and, not least a full realisation of the inherent risks to the gross income.

We are not going to go into the detail in this article of all the risk issues. Suffice to say that issues such as portfolio mix and concentration limits (whether by sector or geography) – especially in the early years – do need to be thought through and evaluated.

Equally there will be a need to consider how the investment value will be maintained and how you will guard against deterioration in investment returns as the portfolio stock ages and as you move through economic cycles.

Is indirect property ownership an option?

Some authorities having considered the risk of direct property ownership, and especially the liquidity issue, have opted for indirect property acquisition instead – generally through one of the many property trusts available. Clearly the authority will incur fund charges but there is generally greater liquidity and the exposure to risks within particular market sectors or geographic locations is lessened.

Ultimately the decision on direct or indirect property acquisition is likely to turn on the organisational appetite for risk, and perhaps also on the economic regeneration aspects of property ownership.

Other challenges

Finally there are a range of other issues and challenges that authorities will need to consider and reflect upon, before developing any acquisition strategy, including:

- What will be the high level objectives/vision?
- Do you need a Statement of Investment Principles?
- Will 'responsible investment' be a factor to take into account?
- How will these objectives be balanced? (e.g. revenue & capital growth versus regeneration)
- What is the organisational attitude to risk?
- Is the culture right?
- Will there be adequate leadership – do you need a 'stewardship policy'?
- Will there be clear accountability?
- Which performance measures will you use to demonstrate achievement of your objectives?
- Will you make acquisition recommendations yourself or seek external expert advice?
- Who will make the ultimate decision on what is acquired? What will the checks and balances be and how will your schemes of delegation need to be amended?
- Will the investments be managed by the in-house team or will you use commercial agents?

Hopefully this article will provide a useful summary of some examples of who is doing what, and perhaps provide a stimulus to some to begin to consider whether these or other similar approaches might bring value to your organisation.

This goes to the heart of asset strategy, financial strategy and treasury management and needs to go much beyond just the estates manager acting alone. But the estates manager can at least start the dialogue.