CABINET: 22nd July 2020

COUNCIL: 22nd July 2020

Report of: Corporate Director of Transformation and Resources

Relevant Portfolio Holders: Councillor I Moran & A Yates

Contact for further information: Chris Twomey (Extn 5262)
(E-mail: chris.twomey@westlancs.gov.uk)

SUBJECT: REVIEW OF THE COMMERCIAL PROPERTY PORTFOLIO

Wards affected: Borough Wide

1.0 PURPOSE OF THE REPORT

1.1 To provide Members with a review of the Council's existing Commercial Property Portfolio advising on current performance and indicating future trends, demand and investment needs. To set out the further action that will be required to successfully manage the portfolio in the medium to longer term.

1.2 To explain the current statutory framework and background context which councils seeking to grow their commercial property portfolios need to consider, and to propose an "Investing in West Lancashire - Commercial Property Strategy".

2.0 RECOMMENDATIONS TO CABINET

2.1 That the contents of this report, including the future actions required, be noted.

2.2 That the "Investing in West Lancashire - Commercial Property Strategy" set out in Appendix 3 be endorsed for approved by Council.

2.3 That delegated authority be given to the Head of Finance, Procurement and Commercial Property to make investments in accordance with the Commercial Property Strategy, subject to approval of scheme funding of up to £5m by the Strategic Assets Purchasing Committee and approval by Council of schemes for over £5m.

3.0 RECOMMENDATIONS TO COUNCIL

3.1 That the contents of this report, including the future actions required, be noted.

3.2 That the “Investing in West Lancashire - Commercial Property Strategy” set out in Appendix 3 be approved.

3.3 That the terms of reference for the Strategic Asset Purchasing Committee be updated to include the following function:

“To approve commercial property investments with a value of up to £5m in accordance with the Investing in West Lancashire - Commercial Property Strategy”.

4.0 BACKGROUND

4.1 The Council has a significant portfolio of commercial properties that generate a financial return, but which also contribute to other priorities, in particular supporting the local economy. These properties are occupied by third parties and provide rental income of circa £1.7 million to the General Revenue Account (GRA) per annum. The budgeted costs associated with these properties are on average £1.1 million per annum resulting in a £600,000 surplus, over the last three years (2016/17, 2017/18, 2018/19). These surpluses are used to supplement the funding of other GRA services. The Council also operates other commercial properties in ring fenced accounts, due to the terms and conditions under which they were obtained, where any surpluses generated must be used for specific purposes rather than being available for general use.

4.2 As with any investment, the ownership of commercial properties carries with it various risks and obligations. Any number of factors including the economy, market demand, business failure, and stock condition will play an important role in the level of return that the Council will receive from its property assets. The Covid 19 pandemic has placed some strain on the Council’s income from its portfolio, and this reflects the risks inherent in commercial property portfolios and the need to take a long term view on the returns that are generated, which will tend to fluctuate with general economic factors.

4.3 The purpose of this report is twofold:

a) To appraise Members of the current portfolio held by the Council, its performance over recent years, the anticipated future trends and an indication of where future investment will be needed.
b) Council agreed a Sustainable Organisation Review report at its meeting in July 2019, which included a proposal to develop an Investment Property Strategy, based on a commercial property investment pot of £30m over 3 years. This report gives Members the background context needed for them to consider growing the portfolio via the proposed Strategy. In particular, this part of the report gives an analysis of the changed legal and financial statutory framework since July 2019 which the Council will need to consider.

4.4 Appendix 1 to this report provides information relating to the individual property assets that make up the commercial property portfolio. A commentary is given in relation to demand, rental growth, and property condition together with any future issues that are being considered.

4.5 Appendix 2 provides financial information across the portfolio. Total GRA rental income is approximately £1.7 million per year which, considering the nature of the market for these properties i.e. demand is primarily from small independent companies and sole traders, represents a good level of return.

4.6 Appendix 3 provides the proposed “Investing in West Lancashire - Commercial Property Strategy”.

4.7 Appendix 4 contains an analysis of the risk involved in commercial property investment and the Council’s approach in mitigating these risks.

5.0 THE HISTORY AND BENEFITS OF PROPERTY INVESTMENT

5.1 The Council has, over a number of years, acquired an array of commercial premises that now forms its commercial property portfolio. The first of these holdings were the CRA portfolio – the Community Related Assets Balancing Package. These income generating assets transferred to the Council from the Commission for New Towns to balance the cost of maintaining the liabilities also transferred to the Council, as detailed further in Appendix 1. Primarily the properties are held as income generating assets and the surpluses generated are used to fund Council service areas. Local shopping centres such as those at Sandy Lane and Digmoor provide a focal point for the local community and provide a range of valuable services not only in the retail sector but voluntary agencies as well. Prudent estate management and development of services on offer have ensured that the Council has an effective mix within these well maintained centres, which contributes to the wellbeing of the local community.

5.2 In the case of the Langtree Portfolio and Investment Centre, external funding was secured to add these assets to the Council's Portfolio in 2003 and 2004 respectively. The surpluses are ring fenced, by the terms of the funding arrangements, so that these resources can only be used to fund specific areas of activity. However, aside from the income generation aspect of the portfolio the premises also contribute to the Council’s key priorities in terms of ambitions for our economy as we seek to retain and grow jobs, increase skill levels, and encourage business and wealth. For example, the small industrial premises are important in that they provide space for new business ventures. Flexible terms can enable business development, create new jobs, and boost the local economy.

5.3 In 2012 the Council commissioned an independent report by DTZ to examine how its assets were managed and their performance. This report commented on the performance and benefits of these Centres as follows: -

“At the time Council housing estates similar to those in Skelmersdale were built, local residents were far more dependent on shops within walking distance….. More recently such premises have had to adapt to serve as convenience stores and other local support services. Demand has fallen considerably in comparable centres and many are now obsolete or struggling to trade profitably.

This problem is been exacerbated in the current economic climate which has reduced consumer spending….. In this context, the vacancy rates within the

Digmoor and Sandy Lane centres are extremely low. The centres are clearly performing an important function in providing amenity to the respective local communities and the Council's continued intervention is seen as an important factor in sustaining a local retail offer in the absence of private sector interest. This is particularly relevant in areas where there are high levels of deprivation in terms of unemployment, health problems, income levels and low car ownership."

5.4 The economic and social benefits the portfolio of properties provide, run parallel to income generation, and officers ensure that all lettings reflect market terms and conditions and that rental income is maximised wherever possible. This does not preclude a flexible approach to lettings: rent free periods and break clauses can be agreed where premises are difficult to let or require expenditure by an incoming tenant to bring it into a lettable condition.

5.5 Maximising income not only increases revenue available to the Council, but also enhances the capital value of the asset. Aside from market conditions, rental and consequently capital growth will only be achieved by investing in the properties both in terms of planned maintenance and capital investment.

5.6 There has been a noticeable increase in the uptake of units below 2500 sq. ft which were not available in the market. The Council addressed the demand by construction of Greenwood Place which is a development of 11 units ranging from approximately 1300 to 2100 sq. ft, which was funded partly by borrowing and partly from reserves.

5.7 In 2016 the Council also acquired the Wheatsheaf Walks retail site in Ormskirk town centre at a cost of £3m, funded partly by borrowing and partly from reserves. This acquisition provided an opportunity to have a greater influence over development in the town centre, secure the Council's landholding position, and to generate a financial return.

5.8 Most recently building work has commenced on the new Skelmersdale Town Centre Redevelopment scheme. This is the largest single investment the Council has made in decades and will be financed partly from borrowing and partly from external funding from Homes England and the LEP. This scheme should provide significant regeneration and development benefits as well as providing a financial return for the Council.

6.0 ISSUES

6.1 A review of the portfolio has recently been undertaken and the outcomes are summarised in Appendices 1 and 2. A number of issues have been identified and these are summarised in the following paragraphs.

6.2 Overall, the Council's Commercial Property portfolio is currently performing steadily. DTZ reported that the portfolio was performing well compared to similar properties. Typically occupancy rates are relatively high, and a reliable income stream is generated. There will be a reduction in income levels as a result of the coronavirus and current recession, but the extent of this impact is not yet clear.

6.3 The review has, however shown that investment is needed to upgrade tired units in order to protect, and even enhance, rental returns and to maintain capital asset values.

6.4 Delf House has historically provided a significant proportion of the total income from the commercial portfolio, and a 14 year lease (to 2031) has been successfully negotiated. However this income is at risk if the current tenant (the Co-Op) do not renew their lease in the future as it is considered unlikely that another single large tenant could be found for the property.

6.5 The Langtree portfolio provides significant rental income of around £400k per annum which is ring fenced to spending on the redevelopment of business/employment sites. The surpluses generated have helped fund several major capital projects including the Greenshoots project and the enhanced rebuild of the fire damaged units in Gorsey Place. Use of the Langtree money in this way, to reinvest in the Council's current commercial portfolio, releases other revenue and capital streams that would otherwise be used to fund repairs and maintenance and it is recommended that this strategy should continue.

6.6 It is proposed that following the recent review of the portfolio a number of actions are now required as follows:

a) The investment needs of the existing commercial property portfolio should be quantified and prioritised through an Asset Management Plan. The funding of this plan will then be considered through the medium term capital budget setting process
b) The use of the surplus from the Langtree portfolio to reinvest in the overall existing commercial property portfolio should also be planned over the medium term as part of the capital budget setting process.
c) An exit strategy for Delf House should be drawn up over the medium term so that the Council can plan and build up resources to deal with the possible situation where the current tenant does not renew in 2031.
d) Potential candidates for asset disposal should be identified so that the capital receipts thus generated can be used for investment elsewhere in the commercial property portfolio and/or to reduce the overall borrowing requirements of the Council arising from its capital programme.
e) Consideration should be given to growing the commercial property portfolio by acquiring new assets in line with the recommendations agreed through the Sustainable Organisation Review. The rest of this report (and Appendix 3) considers this particular proposal.

7.0 LOCAL GOVERNMENT INVESTMENT IN COMMERCIAL PROPERTY

7.1 This part of the report gives Members key information about commercial property as an investment class, the associated investment risks, a summary review of local government activity in this area, and an explanation of the statutory framework governing these investments. The section concludes with an assessment of the critical success factors required to implement the investment activity. Members will need to consider the information in this section when deciding whether to approve the proposed "Investing in West Lancashire - Commercial Property Strategy" attached as Appendix C to this report.

Commercial property as an investment class

7.2 **Definition of commercial property:** The commercial property market is primarily made up of three sectors (retail, office, and industrial) and these have traditionally dominated investors' portfolios. Outside the mainstream asset classes is another fast emerging sector called the "alternatives" sector (e.g. student accommodation, GP surgeries, car parks – any land or property that makes a commercial return).

7.3 A commercial return can also be made by buying residential property for the private rental sector (PRS). However this area has not been included in the proposed draft strategy at this time, due to potential complexities with the Housing Revenue Account, although this position could be reconsidered at a future date.

7.4 **Other investments available:** Commercial Property is one of several asset classes in which the Council can invest. Other assets include cash, fixed interest securities (bonds) and shares. Cash (held in savings accounts) and bonds have the lowest risk profile, followed by property and share-holdings.

7.5 **Approaches to Investing in Property**: There are a range of approaches to investing in property assets, from, on the one hand, investing in a commercial property fund, (or real estate investment trust etc.) and, on the other, owning the physical assets – each with its own advantages and disadvantages.

Pros and Cons of Direct Ownership & Management of Investment Property

Pros	**Cons**
• Ownership of property assets • Opportunities to use assets to promote local economy, place shaping and regeneration • Receive income directly • Control over property decisions, both strategic and tactical • No fund management costs	• Reliance on own expertise • Active management required • Relative lack of liquidity • Need to invest capital over time to maintain and enhance • No sharing of risk

7.6 **Investment returns from commercial property**: Investment returns can arise from an increase in the asset value on sale (a capital receipt return) and the annual income generated from leasing the property to a tenant (rental income).

7.7 **Rental income**: The most reliable source of return is the rent paid by the tenant/s which they are legally obliged to pay under the terms of the lease until expiry. However it should be noted that landlords are usually unsecured creditors in the event of a tenant bankruptcy.

7.8 UK commercial property leases generally provide for rents to be reviewed every five years and set to the market level where this is above or equal to the rent being paid at the time of the review. If the market rent is below the current rent, the rent would remain unchanged for the next five years. There are other mainstream provisions including: fixed uplift rents, index linked rents (often linked to RPI (Retail Price Index)) and turnover-related rents.

7.9 Some leases include a “break clause” that gives the landlord and/or tenant the option to terminate the lease prior to its expiry date. This can impact on the value of a property because the income stream is no longer certain for the full term of the lease.

7.10 Market forces and the imbalance between supply of property and demand from potential occupiers will affect rental income returns and the time taken for landlords to find replacement tenants. For example, in a market where there is an oversupply of commercial property, landlords may need to offer rent-free periods at the start of the lease in the way of incentivising a potential tenant to take the lease.

7.11 **Active Management**: Unlike treasury management investments, commercial property is a tangible asset that requires active and effective management to maintain income flow and to ensure the building remains attractive to occupiers. Although it is common for leases of commercial properties in the UK to make the tenant responsible for some or most of the costs of repair, maintenance, and the insurance of the building, the landlord must still collect rent, settle dilapidations, serve notices, and undertake rent reviews and relets.

7.12 It should be noted that the costs of managing multi-let assets are often considerably more than for single let assets, since the landlord will often retain responsibility for common parts paid for via a service charge recovery. In the case of having a unit void in a multi-let property the landlord would pay the service charge for that unit until a new tenant is found.

7.13 Property can increase its value by proactive management. This can entail such actions as refurbishment or redevelopment, the renegotiation and extension of leases, the “right-sizing” of tenants (providing them with the optimum sized unit) or acquiring property with rental reversions (where the rents received for the space are less that the rental value of that space).

7.14 **Liquidity**: The process of buying and selling commercial property takes a lot longer than buying treasury management investments such as government bonds. Even in a buoyant market selling takes a long time and involves lengthy marketing periods that can easily take up to a year to conclude for limited market or complex assets. Investing directly in property therefore involves more liquidity/transactional risk that treasury management assets.

Potential risks involved in commercial property investment

7.15 **Risk and Return**: In summary and at its simplest, a property investment is an investment in land or buildings which has the potential to give the investor a return in the form of rental income and capital growth. Risk and return in property investment come both at a market level and from individual asset choice. In practice, property investment can be structured to create a range of different risk / reward profiles from stable bond-like annuity income performance to more volatile equity-like returns. A summary of the main risks and the West Lancashire Borough Council’s approach to mitigating these is given in Appendix 4.

7.16 Commercial property returns tend to be linked to national economic performance and to the relative prosperity of the economy. The short term outlook is therefore likely to be turbulent given the potential impacts of Covid 19 and Brexit. How the national economy will perform over the long term cannot be guaranteed.

7.17 The investment portfolio does however need to be seen over the longer term, as reactions to short term market changes can distort yields which are likely to be more stable if viewed over a greater timeframe. In this context it will be important to balance a one year budget cycle and any expenditure required for this with the longer term perspective that is required for investment management of either a commercial or residential portfolio.

7.18 The changing nature of the economy, globalisation the growth in home-working, automation and the use of artificial intelligent (AI) may yet have unforeseen impacts on the demand for different types of buildings. As businesses strive to become more agile, many are seeking shorter lease lengths than was historically the case or regular break options so they can react quickly to change. Increasing use of artificial intelligence and automation will change the demand for industrial and warehouse space, driven to some extent by a change in consumer shopping habits. The trend for internet shopping is also impacting on demand for more traditional retail space. The outcome of such trends and the speed at which they are developing is ever-changing, so a degree of forward thinking is required in terms of the portfolio strategy.

7.19 The conventional wisdom of retaining a balanced portfolio (between industrial, office and retail) to mitigate risk is therefore shifting and to optimise overall returns from investment a new portfolio balance may be required.

7.20 In the current climate with rates of return on cash reserves very low (the base rate is currently only 0.1%) property still presents an opportunity for better returns and also has a potential for significant capital growth over the long term.

A summary review of local government investment in commercial property

7.21 The National Audit Office (NAO) published a report entitled "*Local Authority Investment in Commercial Property*" in February 2020. As this is the most recent review of this activity the key findings from that report are given below.

Summary of key findings from NAO report for the period 2016/17 to 2018/19

28.7% real-terms reduction in councils' spending power (2010/11 to 2019/20)	**14.4 times** more spend on commercial property by councils compared with preceding 3 years	**105 councils** spent £10m plus on commercial property during the period - district councils are key players
£14.3bn increase in external borrowing undertaken by councils	**£6.6bn** spent by councils on commercial property	**£2.3bn** spent by councils on retail property
100 basis points added to PWLB rates in October 2019	**38%** of councils' commercial property acquisitions (by value) were outside their boundary	**17.5%** of all commercial property acquisitions in South East undertaken by councils

7.22 The acquisition of commercial property has become a significant area of activity for some councils in recent years. The National Audit Office found that the bulk of this activity is undertaken by a relatively small, albeit growing, group of councils. 80% of the expenditure in the time period examined was undertaken by only 49 councils, with councils in South East spending 53% of total by value.

7.23 Whilst councils buy for a variety of reasons, the NAO comment that yield is an important factor. 38% of purchases by value were outside of the council's administrative area and therefore were (probably) undertaken predominantly for yield. The NAO also state that obtaining data on net yields is difficult to come by but that they found reported net yields no higher than 2.6%.

7.24 External borrowing by local government, predominantly from the Public Works Loan Board (PWLB), has increased significantly over the period. Borrowing has played an important role in funding commercial property acquisitions. It is difficult to be precise about this as under accepted treasury management practices external debt is not "hypothecated" (allocated) to an individual capital project or asset acquisition. Rather borrowing is undertaken largely when the council's overall cash position requires the borrowing.

7.25 The NAO also reported on the weaknesses sometimes observed including insufficient transparency and reporting to elected members or the public, limited internal challenge to decision-making, reduced governance to enable faster decision-making, and limited capacity and skills at officer level.

The Statutory Framework governing commercial property investment

7.26 **Legal Powers**: The purpose of acquiring a commercial property asset is important in understanding what powers the Council is using and whether these are reasonable (under Wednesbury principles).

7.27 If the property will make an investment return alongside or as a secondary outcome of delivering other policy objectives then it is likely that the Council can use its general land and property acquisition powers, in particular:

- Local Government Act 1972, section 120, giving councils the powers to acquire land (inside or outside of their area) for the purpose of any of their functions or the benefit/improvement/development of their area.

- Localism Act 2011, section 1, giving councils the power to do anything that individuals generally may do, subject to constraints. Amongst the latter is that charges for services provided must be limited to recovery of the costs of providing the service (section 3) and that anything done for a **purely** commercial purpose must be done through a company (section 4).

7.28 If the Council is acquiring an investment that happens to be a property it's likely the Council can use its investment powers under section 12 of the Local Government Act 2003 which gives a council general powers to invest for any purpose relevant to its functions and for the purposes of the prudent management of its financial affairs.

7.29 However it is legally less straightforward that the Council can use its borrowing powers to finance the property acquisition if using investment powers (see below): it can however use capital receipts or revenue funding.

7.30 **Statutory Guidance on investment**: When purchasing commercial property, local authorities must "have regard to" statutory guidance contained in:

- CIPFA's (Chartered Institute of Public Finance & Accountancy): The Prudential Code for Capital Finance in Local Authorities,
- CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes, and
- MHCLG's (Ministry for Housing, Communities, and Local Government) Statutory Guidance on Local Authority Investment Activity.

7.31 CIPFA's Prudential Code states that "councils must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed." MHCLG revised their statutory guidance in 2017 to cover property investments held "primarily or partially to generate a profit". They termed these investments "non-financial investments" (and also included in that definition local government investment in 3rd party organisations, such as shares). MHCLG's revised statutory guidance supports CIPFA's statement in the Prudential Code that councils must not borrow more than or in advance of their needs purely for yield and profit purposes.

7.32 The statutory guidance from CIPFA and MHCLG is not compulsory, but councils do need to state robust reasons for not following it. The guidance is directed towards curbing local authority borrowing for the purposes of investing in commercial property solely to raise revenue. The guidance makes a distinction between councils who are taking on debt for regeneration and meeting local objectives, and those who borrow purely to get a return on investment. The MHCLG and CIPFA codes would suggest that purchasing commercial property outside of the council's area is likely to be viewed as an investment (purely for profit) as the investment would not relate directly to the council's wider objectives (such as regeneration or community development). The codes suggest that such investments should not be funded from borrowing.

7.33 CIPFA's Treasury Management Code and MHCLG's Investment Guidance also stress the importance and long-held good practice of placing security and liquidity above yield (in that priority order) when making any investment decision. One of the aspects of commercial property investment is that it is relatively illiquid. The

Council will therefore need to accept the higher risks associated with this approach when buying commercial property.

7.34 **Statutory guidance on reporting**: MHCLG's Investment guidance requires local authorities to prepare an annual investment strategy each year to include non-financial investments to show:

- How their non-financial investments relate to their core purpose.
- Quantitative indicators showing the council's total risk exposure from non-financial investments.
- An explanation of the council's approach to risk assessment including how it has assessed the market and what use has been made of external advisers
- An explicit statement of the degree to which commercial income supports the funding of service delivery and council agreement on the annual limits for:
    - The proportion of gross debt (used to finance non-financial investments) to net service expenditure.
    - The % of net service expenditure that is funded by commercial income.

7.35 This annual statement is presented at budget setting time as part of the Capital Finance and Treasury Management Framework report to February Council.

7.36 **Consultation on proposed changes to PWLB lending:** The Government has recently taken steps to limit the ability of local authorities to use borrowing to finance investment in commercial property primarily for yield. In October 2019, the interest rate payable on PWLB loans was artificially raised by 1% in order to slow all PWLB borrowing, and in particular borrowing for commercialism. Subsequently in March 2020, the government released proposals, currently in consultation, aimed at restricting PWLB funding to council policy objectives (i.e. housing, regeneration, and front-line services) and away from funding any commercialism aspect (borrowing in advance of need and/or borrowing for yield). The consultation will close on 31 July 2020. The initial proposals are:

- In order to access future PWLB funding, Section 151 Officers will need to provide assurance that the council does not plan to buy investment assets purely for yield. The Section 151 Officer will also need to provide a high level outline of the council's capital plans as part of the loan application process.
- They propose that they will restrict PWLB lending if a local authority has commercial activity as part of its capital plans.
- The government will publish guidance defining the activities that PWLB will no longer support with clear protections for service delivery, regeneration, housing, and the refinancing of debt.

7.37 Subject to the consultation being satisfactorily concluded, the government's intention is to lower the interest rate on new PWLB loans. The MHCLG is in addition planning a review of additional data gathering needed on borrowing and investment information being undertaken by local government.

7.38 **Public Accounts Committee inquiry**: It should be noted that the Commons Public Accounts Committee has also recently launched an inquiry into local authority investment in commercial property. This inquiry will focus on certain questions:

- Is commercial property a safe investment?

- Have local authorities fully considered the potential risks involved in such acquisitions?

- Are local authorities receiving value for money? Are local authorities meeting their Best Value Duty?

- Do local authorities have the commercial skills and abilities to properly manage these investments in a way that yields a decent return?

- In the light of COVID-19, will local authorities be able to meet their borrowing obligations, or will the Government need to bail them out? In addition, will the pandemic impact on the markets they have invested in?

7.39 **Conclusions on the legal and statutory context:** The changes CIPFA and MHCLG introduced to their statutory codes in 2017 made it unclear as to whether councils could fund commercial property acquisition, undertaken purely for obtaining a yield, by borrowing. Despite that uncertainty many councils have continued to undertake this activity. It is likely that case law is required in this area to clarify the issue.

7.40 The changes currently being consulted on regarding PWLB borrowing however were unknown at the time the Council approved the Sustainable Organisation Review in July 2019 (which included the proposal to obtain new income streams from buying commercial property). The government intends that councils who undertake commercial property acquisition for yield will not get access, or will get restricted access, to cheap, easy-to-acquire, PWLB loans. There are alternative institutions and methods for obtaining loans outside of PWLB, but these can take time, expertise, and money to acquire particularly for a smaller council such as West Lancashire.

7.41 In conclusion, it is recommended that the Council's focus for investing in commercial property needs to now change from that originally envisaged in the SORP i.e. one where yield (a financial return) is the primary purpose of the activity. Instead the focus is to invest in the district as a means of stimulating and enabling the growth of the local economy whilst also requiring that this investment makes a financial return to the Council.

Critical success factors

7.42 **An understanding of West Lancashire and the ability to identify/find opportunities:**

- Local intelligence and understanding of the district's economic, place-shaping and regeneration needs.
- An understanding of the local commercial property market and its outlook over the medium term.
- Use of both internal staff and external local agents to find opportunities (including agreeing to pay "finders fees" if required (this is normal in the commercial property market).
- Proactiveness in terms of finding opportunities such as writing to current owners of suitable properties to see if they are considering selling.

7.43 **A project team approach to implementation:**

- A matrix project team involving estates and property, regeneration/economic development, finance, and legal.
- Sponsorship at the corporate management level.
- Ensuring that the project team has capacity to deliver work that can be intensive at times but also sporadic and ad-hoc (depending on when opportunities are found or present themselves on the market).
- Ensuring that project team members have the right skill sets (or can learn them); commercial negotiation, knowledge of property law and conveyancing, financial investment appraisal and modelling, property appraisal (building management, surveying and valuation.
- Ensuring sufficient admin is available.

7.44 **The ability to act fast when required:**

- Quick decision making, for investments under specified values, when the desired property is on the market and there is either little time to make a bid or when there is a need for an officer to make a bid at auction.
- Agreed and clear decision making criteria and a pre-prepared financial model with which to assess the potential investment.
- Prior agreement to not produce a formal consolidated Business Case report for the proposal but to instead complete separate predetermined check-lists, reports, financial models, and a scoring matrix that include all the information needed to make a robust decision.

7.45 **A focus on transparency and governance:**

- The keeping of records and an audit trail is particularly important as external auditors are likely to review this activity as part of their annual VFM (value for money) study.
- Keeping members and the wider community informed will be important.
- Compliance with the requirement to report key decisions made is needed.

7.46 **A need for learning, development, and training:**

- The MHCLG’s Investment Code requires that all those involved in these investment decisions, both officers and Members, are to receive regular training in this area.

7.47 **Flexibility on spending the budget:**

- Spending the capital budget cannot be pre-planned, as is the case for other capital projects, as it is uncertain when opportunities will become available. Members should be aware therefore that the £30m funding pot will not be allocated to individual years, but will be available to be spent in any of the next 3 years.

8.0 ACTION

8.1 In order to continue to manage and grow the commercial property portfolio to the benefit of the Council the following actions are required:

- Action on the existing commercial property portfolio as discussed in paragraph 5.6, namely:

a) Prioritising and quantifying the investment needs of the existing commercial property portfolio in an Asset Management Plan.
b) Planning the use of the surplus from the Langtree portfolio to reinvest in the overall existing commercial property.
c) Producing an exit strategy for Delf House to deal with the possible situation where the current tenant does not renew in 2031.
d) Identifying potential candidates for asset disposal so that the capital receipts thus generated can be used for investment elsewhere in the commercial property portfolio.

- Action required to set up the project team (and procure the external advice needed) to implement the "Investing in West Lancashire strategy" as discussed in the strategy document. This will be undertaken by the Head of Finance, Procurement and Commercial Property

- Organising a training exercise for all Members that will be involved in taking commercial property investment decisions to be undertaken in the next couple of months.

8.2 Investment decisions can require action to be taken at short notice, for example when properties come up for auction. Given this context it is proposed that delegated authority is given to the Head of Finance, Procurement and Commercial Property to make investment decisions in accordance with the new strategy (which is similar to the existing arrangements on Treasury Management), but subject to the Strategic Asset Purchasing Committee approving funding for schemes of up to £5m, and with Council approval required for schemes over £5m. Details on all commercial property investments made will then be reported to the next available Council meeting.

9.0 SUSTAINABILITY IMPLICATIONS

9.1 Income received from the Council's commercial property portfolio supports a number of areas, assisting the long term sustainability of Council services.

9.2 Effective management and a programme of planned maintenance and capital investment will ensure the most effective and sustainable use of the Council's commercial property.

10.0 FINANCIAL AND RESOURCE IMPLICATIONS

10.1 The Council's commercial property investments have, historically, shown steady rental levels and provide a significant contribution to the Council's revenue streams which could not be matched in the present money markets.

10.2 Effective use of the Langtree reserves will continue to maintain and enhance the revenue generating potential of the portfolio. Use of these reserves will also enable Council budgets otherwise used to support the commercial property portfolio to be diverted elsewhere.

10.3 The SORP requires additional income and savings to be generated to enable the GRA to achieve a balanced budget position. The proposed new commercial property strategy should contribute to the Council's corporate objectives as well as deliver a financial return that can help to achieve the SORP requirements.

10.4 Through the SORP process, funding of up to £30m has been agreed for investment in commercial property over the next 3 years. The budget will be financed from borrowing, although opportunities to secure other external funding wherever possible will be pursued. Actively seeking external funding will help to minimise Council borrowing, increase the financial returns generated by new schemes, and in some cases may mean the difference between whether schemes are viable or not. There is a good track record of attracting external funding, particularly in areas where there are regeneration benefits, and the strategy will seek to build on this going forward.

10.5 A financial appraisal and assessment will be completed for each investment decision, that will take into account the cost of borrowing in terms of interest and debt repayment, as well as other relevant costs and the rental income generated. It will normally be expected that schemes must demonstrate at least a 2% net yield, on a prudent basis, to be considered financially viable. This requirement may however be reduced if the non-financial benefits of a scheme are so significant that it can justify this approach.

10.6 Funding of £100k was approved through the SORP process to fund the costs of implementing this strategy.

10.7 The strategy will be subject to review on an annual basis. Its initial focus will be on acquiring existing non-residential premises in West Lancashire and surrounding areas. Depending on the scale and scope of the opportunities identified, this focus may be widened in subsequent versions of the strategy.

10.8 The anticipated net new income arising from investing £30m in line with the strategy is some £600k annually (based on a 2% net yield). Given the dependency of finding suitable investments in the market, new rental income will not be anticipated in the GRA budget until it is actually achieved.

11.0 RISK ASSESSMENT

11.1 The Council’s commercial property portfolio is presently performing well considering the current economic climate. It is important to recognise though that there are significant risks inherent in acquiring and managing commercial property, and that while surpluses can be achieved it is also possible that significant losses can be made.

11.2 There has been a single incidence to date where a business operating from Council owned premises has failed this financial year, and this number is likely to increase given the economic downturn,

11.3 A full discussion of the potential risks in holding commercial property, and the measures the Council will use to mitigate those risks, is given in Appendix 4. This will include setting up an equalisation account under earmarked reserves, where budget surpluses will be transferred when performance is strong, and which will be used to support the GRA when financial conditions are more challenging.

12.0 CONCLUSIONS

12.1 The commercial property portfolio has an important role in delivering the Council's economic growth objectives by providing suitable commercial property for businesses already located or wanting to locate in the area.

12.2 The portfolio also continues to provide a significant source of income for the Council and offers the potential for releasing considerable capital resources should market conditions become favourable.

12.3 Continued effective estate management and implementation of the actions contained within this report should ensure the future effectiveness and performance of the Council's commercial property portfolio in terms of achieving corporate priorities for the area alongside those of income generation.

Background Documents

There are no background documents (as defined in Section 100D(5) of the Local Government Act 1972) to this Report.

Equality Impact Assessment

The decision does not have any direct impact on members of the public, employees, elected members and / or stakeholders. Therefore no Equality Impact Assessment is required.

Appendices

Appendix 1	Commercial Property Assets
Appendix 2	Commercial Property Portfolio Data
Appendix 3	"Investing in West Lancashire - Commercial Property Strategy"
Appendix 4	Summary of risks and measures to manage them

APPENDIX 1

COMMUNITY RELATED ASSETS (CRA)

The Community Related Assets properties comprise of a range of commercial premises in Skelmersdale which were transferred to the Borough Council from the former Commission for the New Towns in 1989.

The income received for the commercial portfolio is known as the balancing package and used to offset the costs incurred by the Council in maintaining the landscaping, community facilities and a myriad of other liabilities which were passed by Skelmersdale Development Corporation.

The CRA properties can be summarised as follows:

Sandy Lane Centre, Skelmersdale

A local shopping centre located in the Old Town area of Skelmersdale. Built in the early 1970's the partly enclosed centre provides 42 individual retail and office units over two floors. There are two adjacent surface car parks that serve the Centre.

The Centre saw a decline in the late 2010's with a high void rate leaving both ground and first floor units empty for long periods. However since earlier this year the Centre has been generally fully let and provides a good retail mix providing all the services that this size of neighbourhood would be expected to offer including a Co-op store, chemist, post office, newsagent and bookmakers. In addition there are a number of office/service occupiers. The Council's Housing Services also occupies office accommodation within the Centre which contributes greatly to the vibrancy of the area.

Rent reviews and new lettings have been steady from the Centre over the past few years, however whilst income and demand is expected to be maintained for the foreseeable future some investment is having to be made to preserve the fabric and integrity of the building and to maintain its appearance.

Digmoor Shopping Parade, Skelmersdale

Digmoor Parade is a local shopping centre located within the Digmoor area of Skelmersdale. The Centre houses 22 predominantly retail units including a post office, newsagent, chemist and general store.

Built in the late 1960's the centre is a single storey located around an open walkway /courtyard area. The premises were extensively refurbished in the early 1990's when residential premises at the first floor level were removed and a new roof provided.

Whilst demand and rental growth is anticipated to be lower than the Sandy Lane Centre, the Parade does provide valuable services for the local community. The buildings, whilst not particularly attractive, have been improved appearance wise with modest capital spend. However, it is the local environs adjacent to the parade that requires improvement and plans to enhance this area of Digmoor would undoubtedly improve the future performance of this asset.

Gorsey Place, Skelmersdale

Gorsey Place Estate was made up of 28 industrial units of 4700 sq ft located within the Gillibrands area of Skelmersdale which were developed in the late 1960's. In 2016 the Council took the decision to demolish a terrace of four units which were beyond their economic life and replace them with 11 smaller units. These units let well and have continued to be fully occupied ever since.

Officers visit the premises on a regular basis to support and liaise with the tenants to ensure that all possible support is given to assist viable companies to succeed and grow.

In October 2014 two units in a terrace of four were the subject of a fire, which completely destroyed one and severely damaged the other. The Council utilised the Langtee reserves to enhance the rebuild across all four units. Three of these four are currently let or under offer.

Apart from the rebuilt units, there is only a single unit presently vacant which is undergoing substantial refurbishment.

Delf House, Skelmersdale

Delf House is a multi storey office premises located in Skelmersdale Town Centre. The building, which offers 78,000sq ft of space, is let to Co-op bank on a 14 year lease, which expired in September 2031 at a rental level of £390,000.

The building is let on full repairing lease and inspections reveal that the Co-op have maintained the accommodation to a reasonable standard. The property alone provides a substantial proportion of the income that the Council receives from its commercial portfolio (18%).

Whilst the accommodation has been maintained and improved it does not necessarily meet the requirements of modern office occupiers in terms of energy efficiency and flexibility. There is unlikely to be demand for this accommodation from a single occupier and if the premises are left vacant for any length of time it will have a significant impact on the Council's revenue streams. However, the Co-op Bank has indicated that they retain a loyalty to the town and their employees and as part of the new lease the it was negotiated that the Co-op would carry out substantial renovation works to the property.

Whelmar Car Park, Skelmersdale

There is a surface level car park located adjacent to Whelmar House in Skelmersdale Town Centre.

As part of the Delf House lease negotiations the Co-op has agreed to take a lease of this car park at a rent of £57,337 p.a. which runs co-terminus with the lease for Delf House.

Silver Birch Public House, Skelmersdale

This site used to contain a public house, but this failed as a viable business and the lease was sold to a third party who planned to remodel the building. This failed to happen and the Council has forfeited the lease and demolished the derelict public house. Plans are being prepared for its future use.

FORMER LANGTREE INDUSTRIAL PORTFOLIO

In March 2003 the Council acquired 58 industrial premises from the Langtree Property Group with funding of £2.85m of Northwest Development Agency funding

The premises are situated at various locations within Skelmersdale and although hard-worn, produce a satisfactory level of rental income.

Under the terms of the funding agreement with the NWDA excess income generated by the Langtree portfolio, after deducting management and maintenance expenses, is ring fenced to the development and refurbishment of business /employment areas in West Lancashire.

Furthermore if the Council was to dispose of the portfolio either in part or in its entirety then it would have to pay back the relevant proportion of the grant funding.

The portfolio is made up as follows:

Grimrod Place, Skelmersdale

The Council owns four industrial units within this estate all of which are presently occupied.

Sandy Lane, Skelmersdale

This development of 11 small units is located in the Old Town area of Skelmersdale. By virtue of their size and location they attract quasi retail type uses and are fully let.

The Council has historically made significant improvements to the premises including replacement of asbestos roofing panels and environmental works and the rentals achieved reflect this.

Further works are being explored particularly on the doors to enhance the appearances and security of this estate.

Glebe Road, Skelmersdale

These two large units form 21,000 sq ft of high eaves industrial space. They were vacant for a number of years and limited yard and circulation space deterred potential occupiers. The present occupier is in the process of signing a new lease.

Pikelaw Place, Skelmersdale

The units occupy a small part of the land holding and are the only units owned by the Council in Pimbo. Generally well let, a work programme to re-roof part of the estate is being undertaken.

Greenhey Place, Skelmersdale

The largest estate within the Langtree Portfolio, Greenhey Place contains 22 units of varying sizes and produces an annual income in excess of £250,000.

This estate requires a significant amount of management time to achieve good occupancy rates, and although there is generally a relatively high turnover of tenants, voids are kept to a minimum.

Whilst these units are on full repairing leases there will be future capital investment required in the long term to replace roofing materials, cladding etc as these components reach the end of their useful life. Similar works have been undertaken on a smaller scale as described above but due to the size of Greenhey Place works can only be undertaken when the units are vacant and the timing of works needs to be considered alongside the rental income achieved and the demands such a programme would place upon the Langtree reserves.

Gladden Place, Skelmersdale

A small development of nine industrial units of 300 sq ft each. Turnover is low with just two vacancies at present. Whilst the Council has undertaken refurbishment works to these premises previously, more work is required to enhance demand and thus rental levels.

OTHER COMMERCIAL PROPERTY ASSETS

The Council holds a range of other commercial property assets in addition to the CRA and Langtree portfolios, which have been acquired over time as a result of a range of factors and where opportunities have been identified.

West Lancashire Investment Centre

The Council's flagship business premises was completed in December 2004 and provides accommodation for 33 small to medium sized businesses in a 47,000 sq ft two storey office building at Whitemoss Business Park, adjacent to junction 4 of the M58 in Skelmersdale.

The building was developed with £5m of Northwest Development Agency and European Regional Development Agency Funding and presently generates rental income of approximately (£320,000) per annum. Any surplus income generated by the Centre is ring fenced, as a condition of the funding arrangements, for social enterprise initiatives.

As with the ‘Langtree’ portfolio part of any capital released from the disposal of this asset would have to be repaid to Homes England (formerly the NWDA) as per the terms of the funding arrangements.

Demand for units within the Centre fell during the economic downturn with a number of tenants relocating to cheaper office accommodation. However a stable population has now been achieved with an occupation level of 93%.

<u>Greenhey Court</u>

Greenhey Court is a development of 5 modern industrial units within the Gillibrands area of Skelmersdale. The units were built by the Council in 2001 with the aid of £2.5 m of Single Regeneration Budget (SRB) funding. Presently generating an income in excess of £56,000 these units provide functional modern business space and have generally been fully let since completion.

<u>Wheatsheaf Walk</u>

The Council purchased, at auction, Wheatsheaf Walks in the summer of 2016 for £3 million. This portfolio consisted of 15 retail units, a Wetherspoons Public House and a large car park.

The retail units had not been managed intensively and there were a number of property management issues which have been addressed.

The car park was being managed by the Council on behalf of the owners and it was possible that if the Council had not secured this asset any new owner would have changed the arrangement.

The former Timpson premises is being operated as a pop up shop and welcomed its first occupier in November, anf further interested parties have approached the Council.

The two vacant units facing the Wetherspoons Public House are under offer but there is the possibility that this will not now take place.

<u>Greenwood Business Centre</u>

This was formerly a terrace of four units, each measuring 4700 sq ft which were in very poor condition. These were demolished and replaced with two terraces with a total of 11 units. Greenwood has exceeded all expectations, being let more quickly and achieving higher rents than anticipated and confirming the demand for quality units.

<u>**Appendix 2**</u>

Commercial Property Portfolio Data

		Type	No. of units	No. Vacant	Present Rent / Income (£)
CRA					
	Sandy Lane	Retail & Offices	42	0	275,700
	Digmoor	Retail & Offices	22	0	135,353
	Gorsey Place	Industrial	22	1	£210,290
	Delf House	Office	1	0	390,000
	Whelmar Car Park	Car Parking	115	0	57,337
	Silver Birch PH	Ground Lease	0	0	0
		Total			**1,081,120**
Langtree					
	Grimrod Place	Industrial	3	0	26,350
	Sandy Lane	Ind.& quasi retail	11	0	25,200
	Glebe Road	Industrial	2	0	31,000
	Pikelaw Place	Industrial	9	2	23,400
	Greenhey Place	Industrial	22	3	207,725
	Gorsey Place	Industrial	2	0	24,000
	Gladden Place	Industrial	9	2	14,050
		Total			**351,725**
Miscellaneous					
	Wheatsheaf Walk	Retail & Leisure	15	3	229,175
	Greenwood Business Centre	Industrial	11	0	113,070
	Greenhey Court	Industrial	5	0	56,050
	42 Westgate	Industrial	14	0	31,644
	Old Stables	Workshops	9	3	11,731
	Investment Centre	Offices	45	3	320,000
	Plot N Burscough	Ground lease	1	0	42,500
	10 Grimrod Place	Industrial	1	0	11,550
	3 Mill Lane Burscough	Offices	1	0	4,160
	Dalton Beacon	TV Mast	1	0	2,000
	Inskip Mtg Rooms	Meeting rooms	1	0	12,000
	Former Police Point	Offices	1	0	2,500
	Robert Hodge Centre	Vehicle Depot	1	0	23,355
	2 Saints Place	Retail	1	0	7,875
	Blaguegate	Leisure	1	0	20,000
		Total			**887,610**
		Totals			**2,320,455**

Appendix 4

Summary of Risks and WLBC's approach to mitigation

	Risk	WLBC Approach to Mitigation
Economic Outlook	Commercial property performance is closely correlated to national GDP (Gross Domestic Product)	To diversify the portfolio in terms of sector and tenancy type as not all sectors will necessarily be affected in an economic downturn. To take a longer term view and be prudent in how much income is taken to the Council's General Revenue Account budget.
Competition	Where the local market is very strong there will be increased competitive activity for limited supply of high quality investment property. This means that the Council is likely to be one of several bidders for available assets. In this situation there is a risk that the Council may not obtain the property and/or may have to pay over the asking price, which may not represent value-for-money.	WLBC will adopt procedures which will allow them to compete in the market but with appropriate governance procedures covering the necessary delegated authority and decision making. WLBC will actively seek "off-the-market" opportunities using its own internal economic development and property intelligence as well as employing external property agents. It will assign sufficient resources to the acquisition process so that it can get a good reputation in the market as an organisation with whom one can do business. In that way unsolicited opportunities may also be presented to the Council. It will commission a preliminary RICS Red Book valuation of the property before it makes a bid/offer for the asset.
Opportunity	The availability of property stock for investment in the Council's administrative area may be limited. As the Council seeks to grow the portfolio it may at times be frustrated by a lack of opportunity.	To counter this WLBC will seek out as many appropriate opportunities as possible, build relationships and communicate to the market the Council's requirement and ability to perform. It will adopt a matrix project based approach to implementing the strategy using the internal intelligence available from officers dealing in economic development, place shaping, and regeneration as well as property estates officers. It will also engage external property agents.
Void rental periods	The portfolio may have the risk of void periods or tenants may default on rent payment. Alternatively the Council may have to offer a rent free period as an inducement for a new tenant. Voids create holding and re-letting costs if they persist. For prolonged periods, these costs can be significant.	Active portfolio management will be undertaken by WLBC during the holding period to anticipate and reduce such risks where possible. It is proposed that an earmarked reserve is established to help finance and thus mitigate this impact. Income will be set aside when budget targets are exceeded and funding from the reserve will be used when trading conditions are more difficult.
Capital devaluation of asset	The value of the asset may decrease over time resulting in a loss.	Under local government accounting any decrease in value of the property is not a cost to the Council's General Revenue Account as net gains or losses are reversed out of the GRA through capital accounting impairment entries in various statements of the accounts.

		However if there is still an outstanding debt liability from the borrowing undertaken to finance the acquisition of the property, and the capital receipt obtained from the sale is not sufficient to pay off the loan debt, this would have an adverse impact on the GRA. In this scenario, the Council would still have interest and MRP costs to fund but without the benefit of the rental income to fund these costs. The Council's commercial property portfolio is subject to periodic valuations as part of the statement of accounts production.
Capacity and Expertise	Management of an investment portfolio requires specific skills, expertise and capacity. Direct ownership and direct management means this can be resource intensive. As the portfolio grows, there is a potential risk that the management burden will grow.	There is an experienced and well established Estates management team in place. The Council will consider as part of its evaluation of a potential investment-the amount of management time needed for a particular property.
Costs	Abortive costs, including legal costs, survey fees, officer time, may all be incurred for example in making a bid which is not accepted by the vendor or in undertaking initial feasibility investigations. Such costs cannot be capitalised and are there a cost to the General Fund Account.	WLBC will adopt a 'whole portfolio' view of costs and accept risk associated with occasional abortive costs whilst also undertaking due diligence to reduce the likelihood of these. These abortive costs can be met from the £100,000 funding pot that has been set up to fund the implementation of the strategy.
Reputation	How the Council acts to intervene in the market and deal with day to day management of its properties and tenants will have an impact on the Council's overall reputation.	WLBC will seek to adhere to 'best practice' in all its transactions and ensure effective regular liaison with tenants. Reviews of individual assets and the portfolio as a whole will identify any works required to protect or enhance the fabric of buildings which may be needed in order to re-let a void property.
Changes in legislation / regulation	There is a risk that government could change the statutory framework and/or lending terms for the PWLB, so as to restrict local government activity in this area. Changes in taxation law can impact on the value and property's relative attraction as an investment class – for example increases in stamp duty land tax or VAT. Changes to legislation to improve environmental sustainability can be costly to implement.	The Council will continue to review the statutory framework in which it undertakes its commercial property investments. It will also proactively seek alternative debt financing opportunities outside of the Public Works Loan Board (PWLB) if appropriate. The Council will procure specialist taxation advice where required. The evaluation of a particular property investment will assess the property's obsolescence and Energy Performance Certificate standards.