**THE APPENDICES TO THIS REPORT ARE NOT FOR PUBLICATION**

**BY VIRTUE OF PARAGRAPH 3 OF PART 1 OF SCHEDULE 12A TO THE LOCAL GOVERNMENT ACT 1972**

**WEST OXFORDSHIRE DISTRICT COUNCIL**

**FINANCE AND MANAGEMENT OVERVIEW AND SCRUTINY COMMITTEE WEDNESDAY, 15 JULY 2015**

# ANNUAL INVESTMENT PROPERTY REVIEW

**REPORT OF FRANK WILSON, STRATEGIC DIRECTOR**

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(The report is for information)

## 1. PURPOSE

To advise members of current property investments and their performance since the last review in July 2014.

## 2. RECOMMENDATIONS

That performance of current property investments be noted.

## 3. BACKGROUND

3.1. Some years ago the Council's Medium Term Financial Strategy identified that the Council had an over reliance on cash based investments in its reserves and as a consequence suffered a major risk at times of falling interest rates. Additionally the approach of keeping just cash based investments means that the value of the capital deposited tends to diminish over time due to the effects of inflation given that the interest stream is not reinvested but is used to support the revenue budgets of the Council and keep Council Tax low.

3.2. As a consequence, the strategy was amended to allow the Council to take advantage of opportunistic investments in property that met the broad principles of improving the balance of the investment portfolio.

3.3. In September 2011 it was considered that ,due to the success of the investment strategy, and the continuing record low levels of interest rates the appropriate ratio of commercial property to cash would be targeted at 65% property and 35% cash.

3.4. In 2014/15 two strategic acquisitions were made in Station Lane, Witney at a cost of £1m.

3.5. The total investment property portfolio now stands at £40.0m (£37.8m 1 April 14) out of a combined cash (excluding cash flow) and property portfolio of £63m , around 63% therefore, in a spread of property assets. The reason for the property element falling slightly short of strategy target is principally that cash investments have remained slightly higher than anticipated due to an improved cashflow position, the inclusion of the remaining Icelandic balances, and, the use of latest asset valuations (1 April 2015) which omit the acquisition costs.

3.6. In addition to setting out the running yield on the properties (rent v total cost of acquisition), the report also tries to give a view on the overall return on property by taking account of any appreciation or diminution in asset values. This also has the effect of accounting for losses incurred as acquisition costs are deleted from valuations.

3.7. The table at Appendix A shows that the property values are in some cases lower than the purchase price The principal reasons for this are the acquisition costs associated with such investments and the natural diminishing length of lease term that has an impact on asset values for investment purposes. Typical acquisition costs are 5% to cover stamp duty, fees and survey costs. On the portfolio overall this has now been offset by capital appreciation.

3.8. It must be stressed that these gains remain unrealised and are based on estimated valuations. Appendix B identifies the overall return on property assets taking account of the issues set out in 3.7 above.

3.9. Of course the principal reason for the move into commercial property was to protect the Councils income stream from the volatility of interest rates rather than capital appreciation, although this remains a longer term possibility. The financial implications section gives a commentary on the success in respect of the income stream relative to cash.

3.10. The investment properties are subject to differing lengths of lease terms and these are set out in Appendix C. The industrial estates at Newman Court and Swain Court have been excluded as these are not capital assets of the Council (they are held under head leases). Also excluded is Greystones which is currently being reviewed and other buildings which are in part operational (depot) and garages which are viewed as de-minimus.

3.11. The balance of the investment portfolio in terms of its split between types of property is set out below:-

| | | |
|---|---|---|
| Industrial / Distribution | £ 9.4m | 23% |
| Office | £16.7m | 42% |
| Retail | £13.9m | 35% |

3.12. Given the high proportion of long term ground rents within the portfolio (Carterton, Woolgate, Marriots and Mill Walk) the average unexpired lease term is longer when compared to many portfolios, at around 26 years, and this provides further assurance to the Council of a relatively stable long term return. Of course this can mask a range of leases expiring in a short time period and the table below shows the rental income attributable to leases by reference to expiry dates and consequent risk to revenue streams.

| Lease Expiry | Rental Income |
|---|---|
| Within a year | £177,297 |
| 1 year – 2 years | £542,868 |
| 2 year – 5 years | £280,041 |
| 5 years – 10 years | £689,770 |
| 10+ years | £1,301,196 |

3.13. Clearly a major focus over the coming year is to continue to make progress on leases in the within 1 year category and 1-2 year category. Given the potential risk of voids in this scenario the Council has made provision within its reserves for such risk.

## 4. FINANCIAL IMPLICATIONS

4.1. This report is seeking to give the Committee additional information by detailing yield not just compared to purchase price (running yield), but also, to consider the overall return on property by taking into account unrealised capital gains and losses (overall yield).

4.2. The running yield on the commercial property portfolio (excluding Marriots, Woolgate and Mill Walk which were not purchased as part of the property strategy and are ground rents only) is currently around 7.5%.

4.3. The uplift in running yield being achieved on the commercial property is around 4.8% being the difference in the net yield in Appendix A (7.5%) and the return in long dated cash in pooled funds and housing associations (2.7%).(The retail ground rents have been excluded from this as they were not acquired as part of the investment strategy).

4.4. In financial terms this 4.8% uplift in performance from property is worth around £1.6m per annum (£33.6m @ 4.8%). To date the change in strategy has saved the Council in excess of £10.5m on a cumulative basis compared to cash and is likely to save £1.6m annually over the next one to two years given the outlook for cash rates (this is slightly lower than recent years due to the change in the cash strategy). This equates to some £40 per Band D property per year and therefore has potentially saved taxpayers a Council Tax increase of some 50% which would have been required to replenish reserves and balance the budget in the absence of such a strategy.

4.5. Calculation of the overall return is quite a complex exercise which is summarised at Appendix B. From this summary it can be noted that the overall return on property since acquisition taking account of losses due to transaction (acquisition) fees and notional unrealised valuation losses and gains is around 7.7% - some 0.2% over the running yield.

4.6. Some individual properties remain underperforming on an overall return basis (more particularly recent acquisitions) – this is in the main part because the acquisition costs have been amortised (written down) over a shorter period of time than the older properties.

4.7. The overall return on property can be summarised as:-

| | |
|---|---|
| (A) Overall Acquisition Price (incl costs) | £33.6m |
| (B) Latest Valuation | £33.8m |
| (C) Unrealised valuation gain (B-A) | £ 0.2m |
| (D) Overall Rental Stream (multi-year) | £ 13.3m |
| (E) Net Return (D+C) | £ 13.5m |
| | |
| (F) Rental Yield (D/A) | 39.6% |
| (G) Unrealised Capital Gain (C/A) | 0.6% |
| (H) Overall Yield (E/A) | 40.2% |
| (I) Annualised Time Weighted Yield* | 7.7% |

* This takes account of both the relative size of the property and the length of time held in addition to the yield on the property.

4.8. The above analysis shows that despite acquisition costs the portfolio has now achieved a small unrealised valuation gain and this together with the rental performance of the portfolio has led to, in overall terms, an extremely positive performance.

Frank Wilson
<u>Strategic Director</u>

Date: 30h June 2015