Appendix 2

Commercial Investment Strategy
Resources - Estates

BUSINESS PLAN
(Q3 2015/16 TO Q4 2018/19))

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Client: HDC

Revision History:-

Version	Date	Status	Summary of Changes	Author
1	23/11/2015	Current	CIS Business Plan reviewed by Corporate Management Team	Clive Mason
1	08/12/2015	Current	CIS Business Plan reviewed by Overview & Scrutiny (Economic Well-Being) Panel	Clive Mason
1	10/12/2015	Current	CIS Business Plan reviewed/approved by Cabinet	Clive Mason

Distribution:-

This document has been distributed to:

Name	Role	S/R/I*
Cllr Jonathan Gray	Executive Portfolio Holder for Resources	S & R
CMT	Corporate	S & R

** S = SIGN-OFF, R = REVIEW, I = Information*

1. Business Rationale

1.1. **Description and Objectives**

The Council faces considerable "revenue" financial challenges over the medium term; as shown in the Medium Term Financial Strategy (MTFS) the Council will have a budget gap of £2.4m by 2019/20 and between the end of 2016 and 2020 there will be a general reduction in general fund balances of £6.3m; such use of reserves does not represent financial sustainability.

To achieve financial sustainability, the Council is required to bridge a funding gap of £8.2m, as shown on the "Plan on a Page" and a key business activity to meet this gap is "income generation", with the generation of revenue income via investment in Commercial Assets being a key component. The Council approved the Commercial Investment Strategy (CIS) in September 2015 and the CIS covers a 9 year period. This Business Plan is the vehicle through which the Council will aim to achieve additional revenue income between now and the end of 2019.

This approach will be a key thread in securing a sustainable financial future for the Council, as endorsed by Cllr Jonathan Gray, Executive Portfolio Holder for Resources:

> *"The Council faces an unprecedented decline in government funding and consequently, the Council needs to deliver services and generate income in new and innovative ways. The Commercial Investment Strategy will be a key driver to ensuring that the Council will have a sustainable financial future in the medium to long term. By investing in commercial assets, the Council aims to generate a revenue stream that will, over the medium term, support the delivery of cost effective services to the local community and over the next 10 years, to develop a healthy growth in invested capital resources".*

1.2 **Strategic Objectives**

The overall objective of the CIS is to undertake commercial activity to support the Council's General Fund in the cost effective delivery of services.

Consequently, the strategic objectives of the CIS are as follows, to:

i. generate sustainable revenue returns from investments in commercial assets that will support the general fund over the medium term.
ii. develop a long-term commercial asset portfolio that will generate capital returns for immediate reinvestment.

1.3 Business Background

1.3.1 **CIS**

The CIS portfolio model covers a 9 year period, broken down into 3 distinct, but not equal phases:

Phase 1 – this will focus on the development of revenue returns.
Phase 2 – this will consolidate Phase 1 and commence pool funding to invest in capital assets that will generate future capital growth.
Phase 3 – this will be an extension of Phase 2 so there is further investment in capital generating assets with a concentration on ensuring that the developed capital assets continue to develop revenue returns.

This approach to the commercial investment portfolio will aim to appropriately balance risk and reward with flexibility and the over-riding objective of revenue generation.

This first business plan will cover Phase 1, from now until 31st March 2019. The delivery options that the business plan will concentrate on include:

- Existing assets,
- Property Shares and Investment Funds
- Direct Assets (local and national)

1.3.2 **Existing Asset**

The Councils existing asset portfolio, as reported in the Councils Annual Financial Report 2014/15 is shown in **Table 1** below:

Current Investment Assets (31st March 2015)		**Table 1**
		£m
Revenue	Rental Income Direct Costs **Net revenue**	(1.9) 0.4 **1.5**
Capital	**Valuation**	**20.9**

The current portfolio generates a net return of 7.2%.

1.3.3 **CIS Investments**

It is intended that by the end 2017/18 the Council will seek to invest a further £50.1m, with the Councils existing asset portfolio this gives a total commercial estate of £71.0m.

The capital investment will permit the purchase of new assets totalling £47.8m with associated completion costs of £2.3m (see **Table 2** below). When the existing portfolio is included, this would give a total commercial investment portfolio of £68.7m. The completion costs of £2.3m are allowable capital expenditure and as such capital resources can be used to finance these costs.

CIS Investment Portfolio			**Table 2**
Funding	**Asset £m**	**Completion Costs £m**	**Total £m**
Existing Assets	20.9	0.0	20.9
Revenue Proposition			
• Investment Fund	4.7	0.3	5.0
Capital Proposition:			
• Property Shares	10.0	0.1	10.1
• Direct Assets (Local Area)	18.9	1.0	20.0
• Direct Assets (Regional Cities)	14.2	0.8	15.0
Total	**68.7**	**2.2**	**71.0**

1.3.4 **Funding of CIS**

The business plan proposes that the £71.0m CIS portfolio is to be funded as shown in **Table 3** below:

Funding of CIS Portfolio			**Table 3**
Funding	**Asset £m**	**Completion Costs £m**	**Total £m**
Existing Assets	20.9	0.0	20.9
Revenue Funding (2015/16)	12.1	0.4	12.5
Revenue Funding (2016/17)	2.4	0.1	2.5
Borrowing	33.3	1.8	35.1
Total	**68.7**	**2.3**	**71.0**

1.3.5 **Revenue Funding**

The CIS is not a “capital only” investment strategy; to spread risk and maximise investment opportunities it is beneficial for the investment portfolio to be as broad as possible. Therefore, by investing in revenue only investments (1.3.3) as well as using revenue funds to finance capital investment, the Council is able to maximise its portfolio but in the most cost effective way possible.

As at the 31st March 2015, the Council’s General Fund Balance stood at £9.3m and had earmarked £4.7m in a Capital Investment Earmarked Reserve (CIER).

The September 2015 Budget Monitoring information, as reported to Cabinet in November 2015, forecast that by the end of 2015/16 a further contribution to the:

- General Fund balance of £0.5m would be made, giving a balance of £9.8m.
- CIER of £1.0m would be made, giving a balance of £5.7m.

Considering that the Council has approved a minimum level of General Fund reserves of £3.0m, it is proposed that the Council will transfer £6.8m from the General Fund balance to the CIER, thereby giving the Council £12.5m to invest in its Commercial portfolio. The benefits of utilising the General Fund balance in this way will be to:

i. Minimise the need to borrow, and therefore reduce statutory costs relating to the Minimum Revenue Provision, and
ii. Maximise returns from amounts invested.

1.3.6 **Treasury Management Strategy - borrowing**

The current Treasury Management Strategy (TMS), approved by Council in February 2015, permits the Council to long-term borrowing of up to £60.0m for “capital investments delivering a commercial yield”. With the investment portfolio proposed within the BP (Phase 1 of the CIS) a total of £35.1m is estimated to be borrowed by 2018/19, the profile of borrowing is shown in **Table 3** below:

Estimated Borrowing Profile for CIS	Table 3 £m
Now until 31st March 2016	0.0
2016/17	20.0
2017/18	15.1
2018/19	0.0
Total	**35.1**

However, this leaves the Council with a further £24.9m available to borrow and invest in commercial activity. If an opportunity presents itself, the Council will be free to invest further within the CIS governance arrangements and the thresholds allowed within the TMS.

1.3.7 **Use of Debt**

Debt will be used to both increase the size of the CIS portfolio and to enhance returns. It is imperative that the use of debt as a form of financing is carefully monitored to ensure that the Council is not overly leveraged and the credit liability inherent in debt financing, and the cost of financing, is managed within the permitted limits of the Councils Treasury Management Strategy.

The overall amount of debt used in the CIS will be monitored in two ways:

i. Interest Cover Ratio (ICR)
This ratio determines the amount of total net income from property investments (after operating costs and any applicable taxes) compared with the interest expense of the debt. This is important so the amount of interest payable compared to income generated is proportionate.

Because debt commences later in the Phase 1 cycle, the profile of the ICR is shown in **Table 4** below. It is suggested that these are initial indices reflecting the maximum debt interest to revenue at the commencement of the BP. If investments profiles change, the ICR ratio will change.

Initial Interest Cover Ratio (at start of CIS Business Plan)			Table 4
Year	Estimated		ICR
	Revenue cash flow £000	Cost of Interest £000	
2015/16	183	11	16.6
2016/17	292	55	5.3
2017/18	403	87	4.6
2018/19	463	95	4.9

ii. Loan to Value Ratio (LTV)
This ratio determines the amount of total debt (compared to the total value of the underlying property assets as valued from time to time. Debt in this respect is both internal and external debt, i.e. revenue financing and borrowing from the market that is used to finance the capital propositions. Although it is recognised that the primary form of finance for the CIS portfolio is debt, it is important to ensure that the proportion of debt to asset value is actively managed to ensure that the debt burden is within acceptable limits

In a similar way to the ICR, the LTV rations, as shown in **Table 5** below reflect that debt commences later in the BP cycle. It is suggested that these are initial indices reflecting the maximum debt asset value at the commencement of the BP. If investments profiles change, the ICR ratio will change.

Loan to Value Ratio (at start of CIS Business Plan)			**Table 5**
Year	**Estimated**		**ICR**
	Loan Value £000	**Asset Value £000**	
2015/16	10.0	32.9	30
2016/17	29.5	52.3	56
2017/18	43.5	69.5	63
2018/19	42.3	70.1	60

It is recognised that while the LTV is an important indices when having regard to debt repayment obligations, the ICR is the more important indices when monitoring the CIS on an on-going basis because it provides performance information that will enable the Council to determine its ability to:

- Make revenue contributions that will support the delivery of Council services.
- Meet its interest payments commitments on the debt within the CIS.

1.4. Portfolio Approach

The CIS will be viewed on a portfolio basis, in that the CIS's performance will be monitored "as a whole". This reflects the fact that the portfolio is made up of different investment propositions that themselves have different risks and rewards.

The current Estates team will be restructured so it will be able to proactively monitor and report to management on individual assets, relevant subsets or sectors of assets also the total portfolio; this shall include the Council's current commercial portfolio. In addition, the CIS will be actively reported to the Treasury & Capital Management Group.

In this way the Council will be able to:

- Make decisions about and review the CIS on an integrated and holistic basis
- Target and achieve diversification of investments and risk styles
- Benchmark performance
- Better manage risk

1.5. Delivery Options

There are a variety of ways in which the Council can invest in property; these are detailed in **Annex 1** and summarised below:

1. Type 1: Existing Assets
2. Type 2: Investment Funds
3. Type 3: Listed Property Shares
4. Type 4.1: Direct Asset (Local Area)
5. Type 4.2: Direct Asset (Regional Cities)
6. Type 5.1: Risk Share Development – Forward Purchase/Funding
7. Type 5.2: Risk Share Development – Joint Venture
8. Type 6: Self Develop

The approach to all these options at the start of the investment programme should be to start the CIS investment approach with a lower risk activity that can evolve over time as more experience is gained. Whilst the CIS would permit the delivery of all six delivery options, only Types 1 to 4 will be considered over the Phase 1 period of the BP.

With regard to a definition for “Direct Asset (Local Area)”, this is seen as anywhere within Cambridgeshire and the Local Enterprise Partnership area that the Council resides.

The capital value options (Types 5 & 6) are recognised as having higher risk and will be developed over Phase 2 and 3 (2019/20 onwards). It is recognised that risk may in fact be lower for Types 5-6 where they are within the Councils boundary given the specific knowledge that the Council may have in relation to those projects, the planning context, tenant requirements and general market knowledge. However, these investments are more complicated by their nature and consequently at this time will be left to a later period of the CIS.

1.6. Progressive Approach

It is understood that the desired portfolio mix, income profile and risk profile of the CIS is unlikely to be achieved in the first year of the business plan, and should be viewed as an evolutionary process that will take time to mature. Indeed, actual investments may not follow that indicated as such investments will be dependent on a host of variables, including but not limited to when the actual opportunity arises.

An indicative approach to the build-up of the portfolio, the appropriate delivery options over time and the reinvestment of capital is set out in the chart in **Annex 2**.

1.7. Approach to Risk

The strategic objectives of the CIS are designed to mitigate risk by:

- Having the fundamental aim of an income rather than capital return (although the latter is part of the strategy)
- Adopting a portfolio approach so as to avoid concentration of risk in any one property, tenant or risk type

In addition, CIS risk will be managed having regard to the following factors:

1. A robust acquisition due diligence process and subsequent approvals.
2. Asset management plans and on-going reviews.
3. Liability management (reviews of debt levels and terms).
4. Tenants (financial exposures, potential defaults, changing business plans).
5. Portfolio factors including occupancy levels, operating costs, etc.
6. Delivery partners (suitability, performance levels and financial stability).
7. Market factors (with periodic advice from appropriate professionals).
8. State Aid considerations.
9. Professional advisors.

1.8. Role of the Business Plan

The role of the Business Plan is to review on a periodic basis:

1. The strategic objectives of the CIS
2. The target income returns of the CIS
3. The target amount of capital invested in the CIS
4. The debt levels to be utilised in the CIS
5. The target portfolio composition of the CIS
6. The delivery models for achieving the CIS
7. The appropriate risk profile for the CIS

1.9 Key Assumptions

The key investment assumptions included with the BP are:

- Maximum Debt: £60.0m
  - The limit on Commercial Investments as approved in Treasury Management Strategy.

- PWLB Loan Rate: 2.75%, loans with a life of 20 years
  - The prevailing loan rate.

- Cost of funding capital propositions: a margin of 2% per annum and a management fee of 0.75% per annum.
  - The inherent cost of financing capital investments on an ongoing basis.

- CPI/General Inflation: 2.5%
  - Inflation on costs and income.

- Completion fees ranging from 0.50% to 5.75%
  - Each investment will incur costs to acquire. Such costs can be charged to capital.

- Revenue indexation/growth ranging from 2% and 3%
  - Estimates for revenue growth from the portfolio and capital value.

2. Financial Objectives

2.1. Target Income Returns

The primary indices for measuring returns on investment is the “return on equity” (ROE) indices. This is effectively the:

*Net Revenue Contribution (*1) / Equity (*2)*

**1* Revenue contributions shall be calculated as net i.e. income returns after taking into account all operating and management costs, interest expense, minimum revenue provision and relevant taxes.

**2* Equity being the difference between the value of assets and borrowing.

Following extensive modelling of the proposed investment opportunities, the expected revenue contribution to the Council will be £2.5m by the end of 2018/19; this gives a ROE of **9%**.

However, reflecting the income expected to be generated from the CIS will grow over time, it is best to have an ROE range for the period of the BP, this will be set between **6%** and **9%** per annum.

It is accepted that individual investments will contribute different levels of income return and that the target revenue contribution is an average across the CIS portfolio (1.4).

2.2. **Allocations to Delivery Options** (see 1.5 for definitions)

Immediate

At inception the CIS will consist of the Councils current Commercial Portfolio (Type 1: Existing Assets).

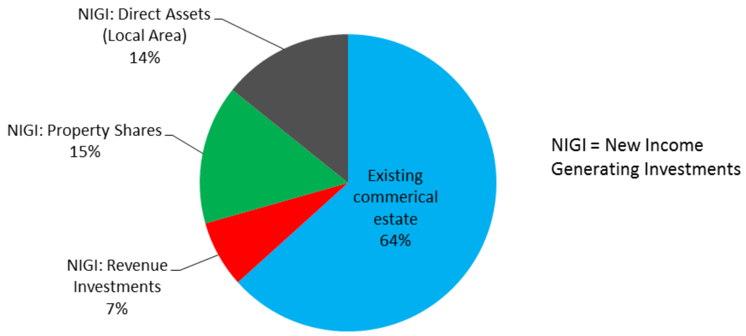
Year 1: Now until 31st March 2016

As well as the existing commercial estate, the Council will contribute £12.5m from in house resources to finance new commercial acquisitions, there will be no additional debt financing to the CIS. However, the £12.5m will used to meet estimated £12.1 in asset purchase costs and £0.4m in completion costs.

This additional investment will be allocated to immediate income generating investments:

i. Investment Funds (Type 2)
ii. Property Shares (Type 3)
iii. Direct Assets (Local Assets) (Type 4)

As a result it is intended that at the end of year 1 the capital invested (purchase price) in the CIS will be split as follows:



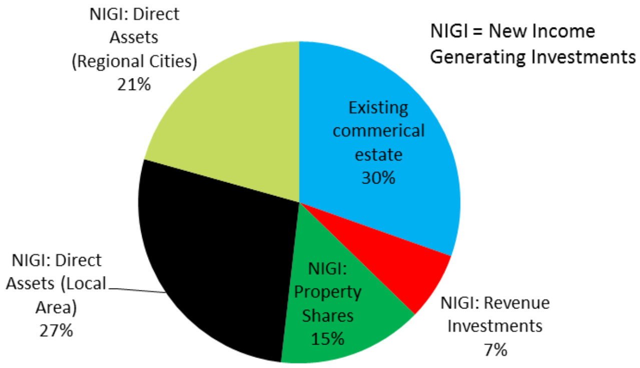
The net value of the Portfolio:	£32.9m
Debt within the Portfolio:	£10.1m

The net estimated revenue return by the 31st March 2016 is £1.4m, this is made-up of: £1.5m from the existing commercial estate, a marginal contribution from new investments of £27,000 and portfolio management costs of £100,000.

In this way the CIS can accommodate a blend of investments in year one between those that are immediately income producing and those that create capital returns and/or future income. As shown in the aforementioned paragraph, it should be noted that net returns are reduced in the initial period of investment as a consequence of initial purchase/sales fees – but as these fees are met, future year's returns start to increase.

Target Year 3: By 31st March 2019

By the end of the BP period, the value of the CIS portfolio will be £68.7m and split as follows



Some of the assets within the portfolio, such as revenue investments and property shares could be part of a wider asset product, similar to unit trusts. Consequently their liquidity is limited as the Council will not be able, on its own, to realise an investment quickly. However, such investments are not made for short-term capital gain and in reality the Council will be expected to invest in such assets for a minimum of 4 to 5 years. Because of the poor-liquidity of these investments, it is proposed that such assets will not exceed 25% of the CIS portfolio at any one time (the Illiquid Asset Ratio).

It is envisaged that investments made in future income producing investments (i.e. Direct Assets, either Local Area or Regional Cities i.e. delivery types 5 & 6) will either be sold and reinvested, or held as income producing assets. As such there will be a natural shift in the portfolio balance over time.

2.3. Borrowings

Borrowings will be the primary source of funding for the expansion of the CIS. As referred to in paragraph 1.3.7, there are two metrics that shall be used to monitor the debt position in the CIS, the Loan to Value ratio (LTV) and the Interest Coverage Ratio (ICR). As previously shown in **Tables 4** and **5**, there will be a range of indices as the BP matures up to the 31st March 2019, and the proposed range is shown below:

- LTV range shall be between of 5 and 17.
- ICR range shall be a between 30 and 65.

2.4 Future Capital Receipts

As the CIS develops, there may be occasions when assets are sold. All capital receipts will be ring-fenced to the CIS. Capital receipts will only be used for non-CIS investment when there has been separate agreement by Cabinet.

2.5. Section 151

As a consequence of the government's austerity programme, as well as the Council having to review both its direct and indirect service provision, it is also required to review the ways in which it manages and generates its corporate income. The current MTFS is forecasting savings required of in excess of £2.4m by 2019/20; however, with the continued pressure of ongoing austerity the Council is seeking to reduce its reliance on New Homes Bonus thereby becoming non-reliant on central government support. At this time this equates to savings of around 37.6% (£8.2m) by 2019/20.

Investing in commercial assets to generate an income stream is a relatively new and innovative way in which some Councils are seeking to bridge the gap in their budgets. This Councils Commercial Investment Strategy (and this Business Plan) is an ambitious plan to develop such a revenue stream. Expert advice has been sought from EC Harris, including the development of a financial business case which has allowed the Council to appropriately scenario plan different investment opportunities.

As mentioned, this Business Plan is ambitious but it is considered achievable. Obviously, returns are dependent on the market and the market remains "uncertain" even 7 years after the crash of 2008. However, the Council has not lost sight of the statutory requirement in respect of Treasury Management activity in that the primary driver must be to maintain the capital sum; consequently this plan represents a mix of investments and therefore a mix of risk to ensure the capital sum is fairly protected but allows for the generation of revenue income.

Firstly, the plan aims to invest in long-established property related investment funds (£15.0m), both of which are acceptable to the Councils Treasury Management advisors. Secondly, the plan then proposes to invest £35.0m in property assets; £20.0m in its local area (thereby clearly demonstrating the Councils commitment to its local area) and £15.0m on a wider geographical basis. It is therefore fair to say that the Plan takes a balanced view on risk, seeking to safeguard the capital invested but also to maximise the opportunity to generate fair revenue income returns.

2.6. Portfolio & Risk Metrics

A series of metrics will be used to examine the current performance and assist in planning the future profile of the CIS. The primary performances indices highlighted earlier in the BP include:

- Interest Cover Ratio (1.3.7i)
- Loan to Value Ratio (1.3.7ii)
- Return on Equity (2.1)
- Illiquid Asset Ratio (2.2)

Over-and-above these indices, there are other indicators that would be useful to monitor the CIS, however most of these will come into play as the CIS matures. These include:

- Historic and forecast income and total returns
  As the CIS matures, different assets will be purchased within the same asset type. It will be useful to monitor the performance of the assets to assist in informing future assets acquisitions.

- Benchmarking of returns (IPD)
  It would be useful to benchmark returns against the market and against other Councils.

- Gross & net income
  Gross and Net income of the CIS itself will be useful to determine the overall cost envelope and the efficiency of the portfolio.

- Operating costs
  This indices will be useful to determine the cost efficiency of the overheads within the Portfolio.

- Vacancy levels and Tenant exposures
  These two indices will be useful to determine how effectively tenancies within the property investments are being managed. Would also be useful to review the types of tenant and their relevant industry to see if certain industries are better tenants.

3. Reporting

3.1 Reporting to Council

The CIS will be an intrinsic part of the Councils Treasury Management Strategy (TMS) and as such will be reported to Council in line with the TMS and the other TMS related reports.

The performance reporting specifically related to the CIS will include the basket of indicators noted within the business plan.

3.2 In-year Performance Reporting

The Cabinet has established a "Treasury and Capital Management Group" (TCMG), its purpose to meet on a quarterly basis to review the Councils Treasury Management activity and the performance and approval of the Councils capital programme. As the CIS will become a key element of the Councils TMS, the TCMG will take a member lead in supporting and guiding the operation of the CIS.

4. Risk Management

Risk will be managed as envisaged in section 1.7 above and having regard to the portfolio and risk metrics referred to in section 2.5 above.

Appropriate reporting formats will be developed and reviewed in line with 5.

5. Other Matters for Consideration

5.1 Governance

The CIS is intended to be managed within the Councils current governance structures. Day-to-day management will be within the Resources Team with quarterly review by the Treasury and Capital Management Group, including relevant performance reporting as noted in 3.2 above. In addition, as the CIS will be a key element of the Councils TMS, it will be included within the TMS statutory reporting requirements.

5.2 Resourcing Plan

The current Estates Team will be reviewed following approval of the CIS Business Plan to ensure that the Council will have in place appropriate resources to ensure the effective and successful operation of the business plan.

5.3 Audit Requirements

The CIS and the Business Plane will be subject to both Internal and External Audit as agreed by the Corporate Governance Panel and the External Auditors Code of Audit Practice respectively.

5.4 **Timescales for the Commencement of the Business Plan**

Target Start Date	Cabinet – December 2015
Target End Date	31/03/2019
Business Plan review due	Annually, or more frequently if required.