

Sevenoaks District Council

Property Investment Strategy

January 2015

EC HARRIS
BUILT ASSET
CONSULTANCY

AN  ARCADIS COMPANY

Contacts

	<p>Nick Kealey Partner</p>		<p>Mervyn Howard Property Investment Expert</p>
<p>T: 07810 850175 E: nick.kealey@echarris.com</p>	<p>EC Harris LLP 1 Whitehall Riverside Leeds LS1 4BN</p>	<p>T: 07884 068007 E: mervyn.howard@echarris.com</p>	<p>EC Harris LLP 34 York Way London N1 9AB</p>

Version control

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Introduction

EC Harris was appointed by Sevenoaks District Council (the Council) in October 2014 to prepare a Property Investment Strategy (PIS) to provide recommendations to the Council on its approach to generating an income stream from property to address identified and anticipated shortfalls in Central Government funding.

The aim of the commission is to:

1. Define the objectives for an Investment Fund in the context of the Council's financial and wider corporate objectives;
2. Set out the strategic approach for delivering these objectives;
3. Provide advice on the governance and delivery structure for the Investment Fund;
4. Advise on the next steps that the Council will need to take to set up the Investment Fund.

Methodology



Providing expert regeneration and development advice to enable project delivery



Background

The National Context: Public Sector Funding Gap

Prolonged austerity is driving an important shift in local government. The early years of austerity have been characterised by authorities taking action to reduce costs as Central Government funding has been cut by more than 40% by 2017-2018.

Most local authorities recognise that, regardless of whether there is a change of government following the 2015 election, there would not be a significant change to grant funding levels. To respond to this challenge many local authorities are considering alternative revenue streams to replace shortfalls in funding and deliver their statutory responsibilities in new and innovative ways, including:

- Increasing commercialisation of services.
- Generating higher income from business rates.
- Encouraging shared services and strategic partnering arrangements.
- Focusing on housing delivery by unlocking and accelerating the release of surplus public land for the creation of new homes and employment opportunities.
- Seeking to maximise returns from the council's asset portfolio and to drive community benefits over the long term.

Expectations from the PIS

The Council has set a 10 year balanced rolling budget in response to known and expected reductions in Central Government funding. This anticipates a revenue surplus in years 1 to 3, which will subsidise the remaining 7 years of the 10 year plan. This are no budget expectations within this plan for additional revenue generation by the PIS. That said, any additional revenue that can be generated will directly benefit service delivery and support the Council to deliver its Corporate Plan and become self-sufficient.

The Local Context: Sevenoaks DC Response

Since 2011, Sevenoaks DC has delivered savings in excess of £4 million in response to Central Government austerity.

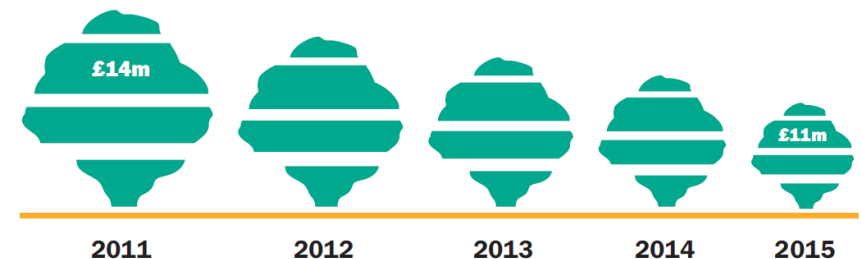
External auditors continue to praise their approach to value for money and highlighting their 10 year budget and 4 year savings plan.

The key vision is to become financially self sufficient – with less need for money from Central Government the more they can achieve with freedom from national constraints and increase the ability to deliver what local people and local businesses want.

Future Plans Include :

- Buy and build new assets that help improve the way [we] provide services.
- Share services with others.
- Raise income from letting out vacant space.
- Borrowing at low rates of interest to enable good levels of return.
- Invest in land and buildings to increase income.
- Continue to support tourism in the area.

Council Budgets 2011 to 2015



Sevenoaks budget reduction between 2011 and 2015

Background (2)

Property Investment Strategy: Work done to date

In July 2014, the Council agreed to the principle of an Investment Strategy based upon property assets, subject to the following criteria:

- Income yield of 6%+ (flexibility may be applied to those opportunities that show an acceptable social return on investment)
- Individual properties or portfolios
- Lot size of £1m - £5m
- Freehold/ Long leasehold
- Single or multi-tenanted
- Asset categories: Industrial, Office, Retail, Trade Counter and Private Rented Residential
- Initially, geographically located within the District
- Potential to increase rental income through pro-active Asset Management

In addition, the Council has also agreed to set aside up to £5m from a review of reserves for the purposes of the proposals outlined in the Investment Strategy. Following clarification with Senior Officers, we understand that the £5m will be sourced from capital receipts and therefore will not be subject to additional borrowing and the finance costs that this attracts. It is also understood that there is potential to increase the amount set aside for the PIS through additional reserves, further capital receipts, and if required borrowing, although all this would be subject to further Council approval.

Market Insight: Savills report Dec 2013

Sevenoaks DC commissioned Savills to undertake a review of the UK property market on a sectoral and geographical basis and advise on how this translates at a local (Sevenoaks area) level to inform the investment strategy.

The report concluded that there are a number of sector specific opportunities (referenced in the Council approval opposite) in the local area to acquire income producing assets, and if a longer term view was chosen, development opportunities.

Background (3)

What other Local Authorities are doing

Our research has shown that a number of local authorities are seeking alternatives methods of raising additional revenue. However, despite plenty of discussion there are limited examples of Local Authorities setting up Trading Companies for Property Investment, and where they have done this the amount of trade undertaken is relatively low.

Below is a case study from a local authority where a successful Property Investment Trading Companies has been set up, along with a number of other examples of different delivery vehicles and revenue generating activities.

The **Royal Borough of Windsor & Maidenhead** has set up a trading company (Two5Nine Ltd) to invest in the refurbishment of vacant Council property for the private residential market. The investment would generate a secure future income stream as well as benefit from enhanced capital assets. Following a £350k refurbishment, the scheme is generating rental levels of £850 - £950 per flat per calendar month.

(Source: Public Land, Public Good; Getting maximum value from public land and property, Localis)

Surrey County Council has set up a framework to establish one or a number of Trading Companies to pursue a strategy of commercial trading across a number of service areas. Each one will be a new legal entity, limited by shares and wholly owned by Surrey County Council. The Leader of the Council will Chair the Shareholder Board. Other members will include up to 3 appointed Cabinet Members, and the Chief Executive of the Council. The Section 151 Officer and Monitoring Officer will be advisers to the Board and membership will be reviewed annually.

All decisions regarding the day to day operation of each Trading Company, its business developments and commercial opportunities and the development and implementation of its internal procedures, would rest with the Directors of each Trading Company. Where Council services are commissioned from the Trading Company, Select Committees would scrutinise overall value for money and Trading Company performance of the contract.

(Source: Council Overview and Scrutiny Committee Report, Sept 2013, Surrey County Council)

Local authorities have also set up trading companies to deliver a range of services from depot services (e.g. Cormac Solutions Ltd – Cornwall Council); social services (e.g. Essex Cares); green waste collection (e.g. Rushcliffe Borough Council); professional services (e.g. Norse Group – Norfolk County Council)

Local Asset Backed Vehicles

A number of local authorities, including Slough Borough and Croydon have set up Local Asset Backed Vehicles (LABVs) to generate new revenue, capital receipts, and deliver regeneration outcomes. The LABV is a joint venture between the local authority and the private sector. The local authority invests the value of its assets, the private sector brings investment and development expertise. The development risk and financial returns are shared based upon the level of investment made.

Self Development

Local authorities are becoming increasingly more attracted to undertaking self-development in order to maximise returns both in terms of enhanced capital receipts and additional revenue. Access to finance, either reserves or borrowing are required, as well development capability and capacity. The most commonly found examples of the use of self-development is where the Council has developed assets with known end user requirements from other public sector organisations, where the covenant strength will be strong and they can 'trade' on their established relationships and the public sector partnering ethos e.g. medical centres.

PIS Strategic Objectives

Introduction

To understand the strategic objectives of the PIS, a workshop was held with Senior Officers and Members of Sevenoaks DC. We strongly recommend that the operation, structure of the delivery vehicle, and governance of the PIS is developed to respond to these strategic objectives and not the other way round i.e. **Form should follow function.**

Financial focus vs Delivering the Objectives within the Corporate Strategy

The Council's vision is 'to sustain and develop a fair, safe and thriving local economy' and to achieve this five promises are set out within the Corporate Plan. 'Invest in land and buildings that increase [our] income' is part of the future plan to deliver to the first promise 'To provide value for money'.

Following consultation, the consensus of opinion was that the primary focus of the PIS is to deliver a financial return and sustainable revenue stream for the Council. Whilst supporting the other promises is important and desirable, it is not seen as the primary driver. This is an important point as introducing potentially competing objectives can slow decision making, and impact upon the financial performance of the PIS.

The following high level criteria have been suggested to inform the investment decision process:

- Category 1 – Return on Investment, in any location with purely financial/return objectives
- Category 2 – As above, but within the District (and as result delivering some local benefits)
- Category 3 – As above, but also able to deliver wider regeneration and Corporate objectives

The aggregation of investments in all three categories should meeting the Council's anticipated income yield of 6%+ within appropriate risk parameters.

The above criteria provides a strategic framework and the more detailed PIS objectives captured over the page provides a further level of assessment which will determine how the PIS operates to meet stakeholders' expectations.

It is recommended that individual investment business cases, whilst focused on the financial issues, also consider the wider socio-economic impacts that may be delivered as a result of investment through the PIS.



Above: SDC's five promises within the Corporate Plan

PIS Strategic Objectives (2)

The following investment criteria have been identified:

PIS requirement	Reason for requirement	Potential approach taken to inform PIS and impact on performance
Low risk initially moving to higher risk over time	<ul style="list-style-type: none"> - Recognising that the Council has limited experience and evidence of benefits will need to be evidenced to demonstrate value to stakeholders and the wider community. 	<ul style="list-style-type: none"> - Identify potential lower risk sources of revenue initially, moving to a more balanced risk portfolio - Levels of return initially may be low
Focus on revenue (rather than capital)	<ul style="list-style-type: none"> - To meet revenue funding gap 	<ul style="list-style-type: none"> - Consideration for investing in existing property funds - Acquire to hold, rather than to dispose - Re-invest any capital receipts
Short term revenue generation	<ul style="list-style-type: none"> - To meet short term funding requirements 	<ul style="list-style-type: none"> - Seek to invest initially in current revenue generating assets or property funds in the short term. However ROI on investment may be low. - In the medium term, identify opportunities for greater ROI by taking a longer term approach e.g. acquisition of vacant properties, development to realise a revenue stream.
Ability to manage PIS with reference to current capacity and capability	<ul style="list-style-type: none"> - The Council has limited resources experience in property related investment and development 	<ul style="list-style-type: none"> - Consider simpler investment opportunities at the outset - Property and investment experience to be considered within any governance structure - Seek professional support to guide investment decisions and monitor performance
Ability to make quick decisions	<ul style="list-style-type: none"> - The Council's current governance structure does not allow the Council to react quickly to investment opportunities 	<ul style="list-style-type: none"> - Consideration for amendments to the levels of delegated decision making - Set up of a separate Trading Arm which will be empowered to be able to make quick decisions

PIS Strategic Objectives (3)

The following investment criteria has been identified:

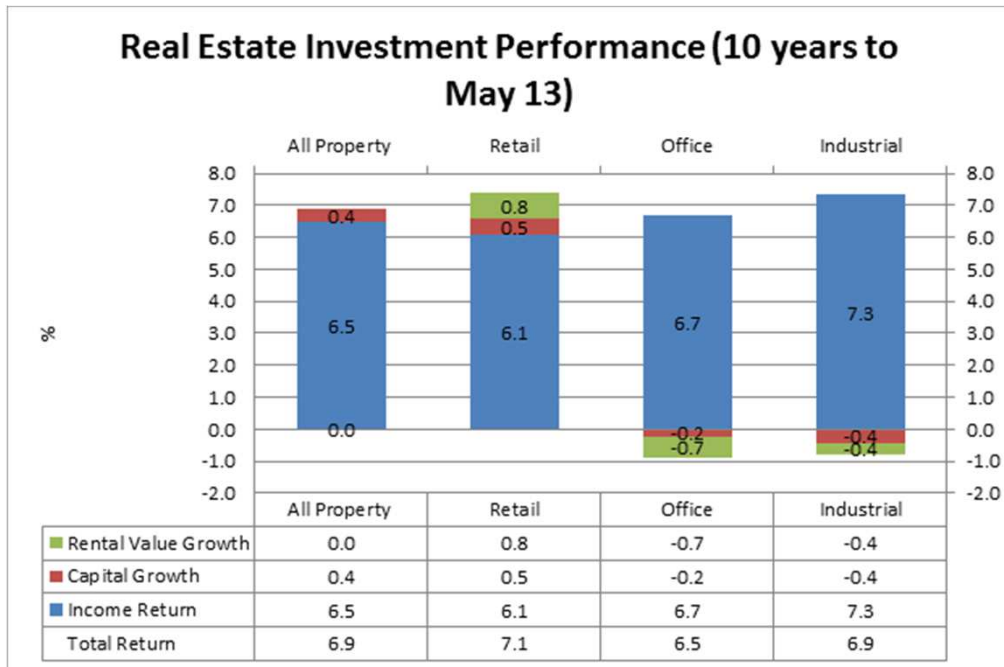
PIS requirement	Reason for requirement	Potential approach taken to inform PIS and impact on performance
Control over investment decisions	<ul style="list-style-type: none"> - It is important to the Council that they control the nature of the investments to allow the opportunity to mitigate potential risks 	<ul style="list-style-type: none"> - Indicates a preference towards direct investment (rather than investment into property funds) - If working with the private sector, preference is to have a controlling majority over decision making.
Stakeholder buy-in	<ul style="list-style-type: none"> - Recognising that the PIS needs long term stability and cross political support to be successful 	<ul style="list-style-type: none"> - Stakeholder consultation and engagement throughout the development of the PIS - Regular reports and reviews of PIS performance
Transparency	<ul style="list-style-type: none"> - Meets the Council's audit and scrutiny requirements - Demonstrates basis of investment decisions and value for money 	<ul style="list-style-type: none"> - Business cases required to support all investment decisions - Independent appraisal and evaluation - Regular reporting and review of PIS performance
Commercial and political sensitivity	<ul style="list-style-type: none"> - Recognising that the set up and operation of the PIS may create conflicts of interest - As a public body, there are reputational risks that may impact upon the nature and type of investments. 	<ul style="list-style-type: none"> - Consider setting up a Trading Arm which may allow some level of independence from the Council - Review governance structure for the PIS to mitigate any obvious conflicts of interest. - Consider the reputational risks for the Council within any investment opportunities (even if delivered through Trading Arm)

Achieving the Financial Objective

The financial objective of the PIS is to achieve a 6% income return. Different types of investment will provide different levels of return, income and capital.

The chart below shows the average income and total returns for the main property types over the last 10 years, based on data from the Investment Property Databank ("IPD"). *Please note these numbers relate to the returns from the property investments and do not include any costs of managing those investments.*

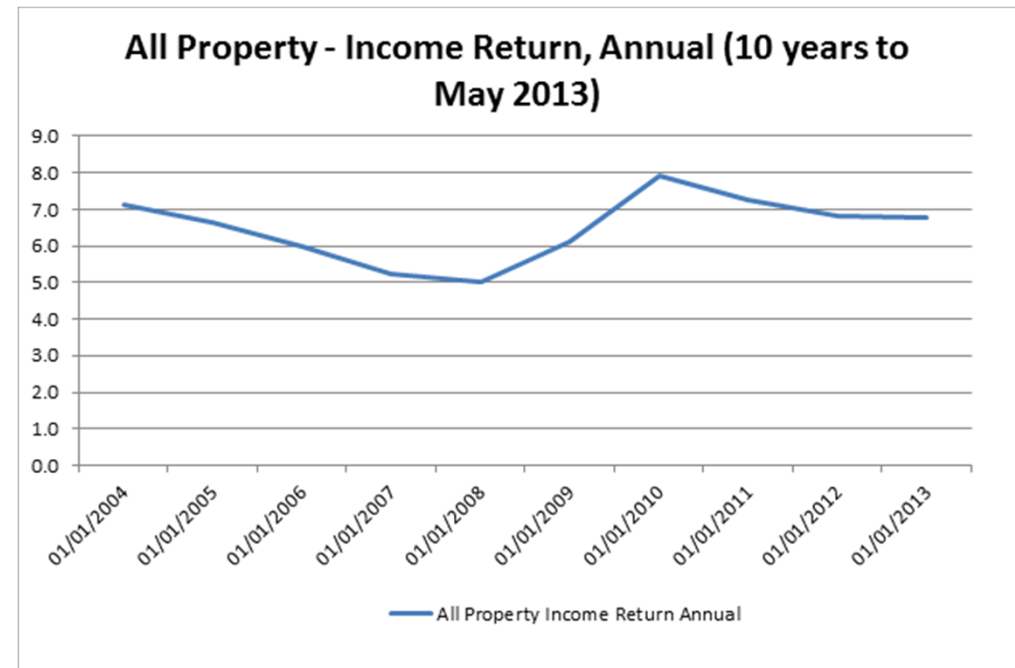
Historic data shows that a 6% income return from property is achievable over the longer term and through a full economic cycle



Various factors will affect the level of income return a property investment strategy will deliver over time including;

- the **general economic environment** (driving rent growth or reductions)
- **interest rates** (low rates drive prices up and property yields down)
- **investment demand** (high liquidity drives prices up and property yields down)

The chart below shows the income return from property annually for the last 10 years, based on data from IPD. Please note these numbers relate to the income returns from the property investments and do not include any costs of managing those investments.



Historic data shows that it is not always possible to achieve a 6% income return and that recent trends are for income returns to decrease.

High Level Property Market Insight

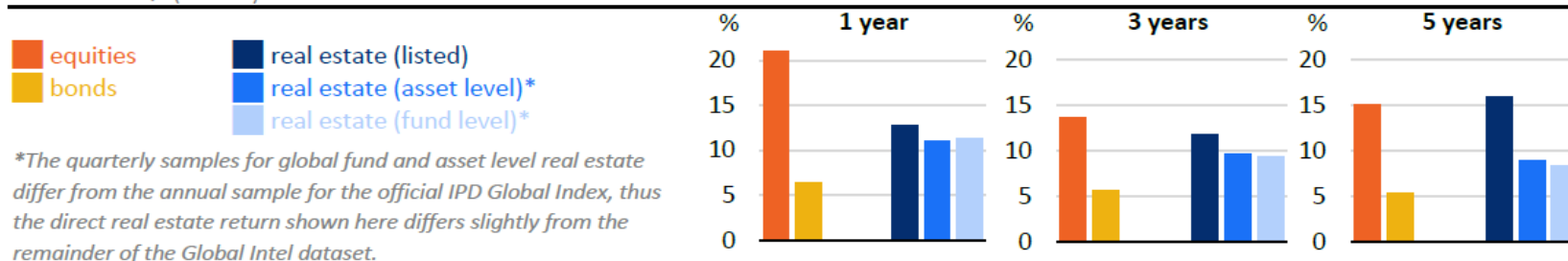
IPD has just released its first analysis of global property performance, reflecting different methods of investing in property (direct, unlisted funds and listed property company shares) and analysed the returns and risks associated with each over various time periods. In addition comparable return and risk analysis is provided for other types of investments – bonds and general equities.

This shows:

- investing in direct property has the second lowest risk (after bonds) as measured by volatility (standard deviation)
- for property investment options:
 - higher returns can be earned from investing in listed property shares and property funds
 - over a five year period listed real estate gave materially the highest absolute and risk adjusted returns
 - over a 10 year period listed real estate gave the highest absolute return (just) but as a result of high volatility direct property gave materially the highest risk adjusted returns

ASSET CLASS COMPARISONS

as of 2014-Q2 (Global)



RISK METRICS

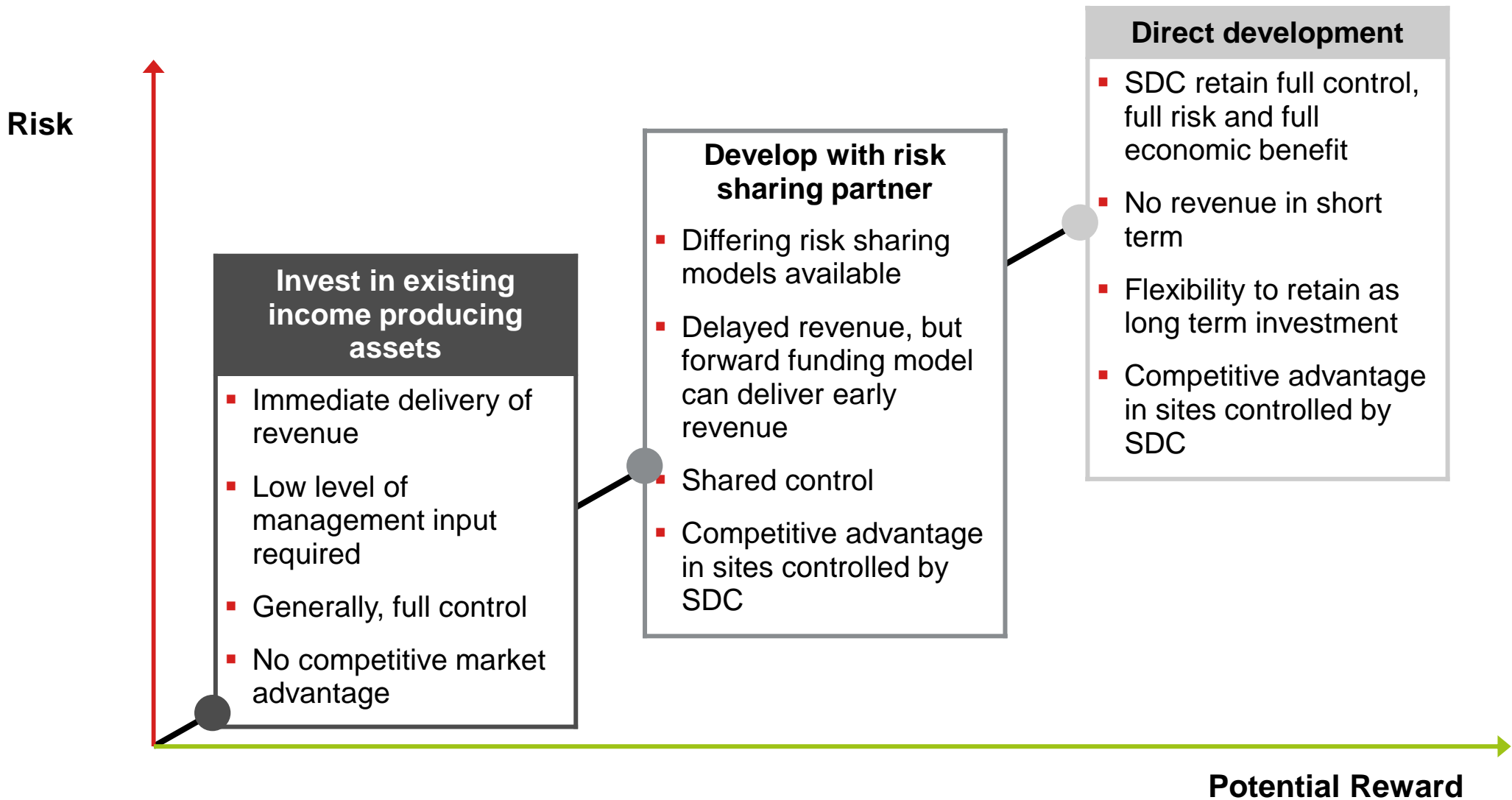
as of 2013

Global Indicators

	10-Year*			5-Year*		
	Total Return	Std Dev	Sharpe Ratio	Total Return	Std Dev	Sharpe Ratio
Real estate (direct)	7.0	7.3	0.57	5.2	6.9	0.36
Real estate (net fund)*				3.2	14.7	0.09
Real estate (listed)	8.0	26.0	0.32	14.8	15.6	0.85
Equities	7.0	19.3	0.30	14.9	13.8	0.96
Bonds	4.5	3.6	0.29	3.9	3.8	0.29

Delivery Options

There are a range of investment strategies with different financial, risk, and timing profiles



Each of these models could be used to deliver the Council's investment strategy

There are a number of delivery options for the investment strategy



Each model has benefits and limitations which can be assessed against SDC's key drivers

1. Existing Assets – Direct Investment

What is it?

- The Council acquires and manages freehold or leasehold properties.

How does it work?

- The Council uses property professionals to identify market opportunities.
- After deciding on price and clearing appropriate internal approvals, bid for assets.
- Using appropriate advisors (legal, surveying, valuation) undertake due diligence and complete legal acquisition documentation.
- Establish on going management arrangements (internal or outsourced).
- Regular asset reviews to determine business plan and exit strategy.
- Process required on an asset by asset basis.

Benefits

Financial Objective

Depending on property type, is capable of delivering 6% annual return

Revenue Delivery

Generates revenue from the time of the property acquisitions

Risk

Low risk option

Control

High level of control

Liquidity

Reasonable liquidity, subject to usual property market timings

Management Oversight

Relatively light requirement – high involvement at key decision points (buying and selling)

Limitations

Performance

Low return option and no competitive market position

Diversification

Desired diversification unlikely to be achieved given current potential capital allocation

2. Existing Assets – Joint Venture

What is it?

- The Council acquires and manages freehold or leasehold properties together with a partner.

How does it work?

- The options are to approach this on a case by case basis or create a strategic relationship with a trusted partner.
- The Council will wish to select a partner or partners on the basis of their demonstrated expertise and ability to co-invest with the Council (assume 50/50). The Partner will carry out much of the management role.
- The Partner will identify market opportunities.
- The JV will include governance allowing Council input on key decisions, including acquisitions and sales.
- The Partner is responsible for on going management arrangements.
- Council rights to review business plan and exit strategy.

Benefits

Financial Objective

Depending on property type, is capable of delivering 6% annual return

Revenue Delivery

Generates revenue from the time of the property acquisitions

Risk

Lower risk option – JV partner risk added

Control

Medium level of control

Liquidity

Reasonable liquidity, subject to usual property market timings and governance of JV

Management Oversight

Light requirement – JV partner undertakes most of the direct acquisition, management and sales work

Limitations

Performance

Low return option. Partner selected to bring track record and potentially competitive market position

Diversification

Diversification improved given additional Partner capital contribution but still unlikely to be at desired level

3. Existing Assets – Investment Funds

What is it?

- The Council invests in an unlisted property fund which owns a range of diversified property investments.

How does it work?

- The Council will undertake a process of reviewing available fund options and the track record of the fund managers.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The fund documentation will set out the rights of the Council to redeem its investment and/or to sell it on the secondary market. The nature of these rights will vary depending on the type of fund.

Benefits

Financial Objective

Depending on fund type, is capable of delivering 6% annual return

Revenue Delivery

Generates revenue from the time of the fund investment – generally a shorter time than investing in direct property

Risk

Risk is determined by the nature of the fund. Additional risks relate to the fund structure, principally the performance of the fund manager

Performance

Returns are related to the specific investment strategy of the fund and manager performance.

Diversification

Fund investment can spread risk over a large number of underlying assets.

Control

High level of control of fund interest

Management Oversight

Very light requirement

Limitations

Liquidity

Unlisted investment funds generally have a low level of liquidity, particularly in market downturns.

4. Existing Assets – Listed Property Shares

What is it?

- The Council invests in listed property shares in a fund or a separate account mandate managed by a specialist fund manager.

How does it work?

- The Council will undertake a process of reviewing managers and available fund options and selecting an appropriate investment strategy.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The mandate with the fund manager can be structured to allow an immediate liquidation of the investment portfolio if required.

Benefits

Revenue Delivery

Generates revenue from the day the property shares are acquired – share transactions can be effected in a short time period

Liquidity

The highest level of liquidity

Risk

The risk and return level is flexible and can be altered over time by reference to the agreed investment strategy

Diversification

Risk can be spread over a large number of underlying property companies/assets.

Control

High level of control

Management Oversight

Very light requirement

Limitations

Performance

Higher volatility than direct property. Longer term performance correlates to property but short term can correlate to general equity markets

Financial Objective

Dividend yields generally lower than direct property yields – to be investigated further.

5. Risk Share Development – Forward Purchase / Funding

What is it?

- The Council enters into an agreement with a developer to fund part of the development cost and/or acquire a development on completion.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The Council will be able to determine the risk profile it wishes to take on in entering the arrangement with the developer (e.g. after planning permission has been secured and construction packages have been tendered).
- During the construction stage the Council will likely require monitoring rights.
- Post development completion (as per direct investment):
 - Establish on going management arrangements (internal or outsourced).
 - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective

Should deliver a premium to pure investment activity, so at least a 6% income return dependent on property type

Performance

A higher level of performance than investment activity

Risk

The risk of development is highly mitigated by the forward purchase/funding arrangements

Control

High level of control

Management Oversight

Moderate level once the transaction is agreed

Limitations

Revenue Generation

Revenue can accrue to the investment when funded, but this will only occur during or at the end of the development period

Diversification

Desired diversification unlikely to be achieved given currently contemplated level of investment

Liquidity

Low liquidity during the development period, thereafter as per the general property market

6. Risk Share Development – Joint Venture

What is it?

- The Council enters into a JV agreement with a developer to carry out a specific development.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be shared 50/50 between the Council and the Developer.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
 - Establish on going management arrangements (internal or outsourced).
 - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective

Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type

Performance

A higher level of performance than investment and forward purchase/fund development activity

Risk

The risk of development is mitigated by careful partner selection and development stage oversight

Control

Strong level of control through JV documentation

Management Oversight

Meaningful level of oversight required

Limitations

Revenue Generation

Revenue will only accrue once the development is completed and leased (or sold).

Diversification

Diversification improved given Developer 50% capital contribution, but still unlikely to be at desired level

Liquidity

Low liquidity during the development period, thereafter as per the general property market

7. Self Development

What is it?

- The Council undertakes a development itself, appointing a development manager.

How does it work?

- The Development Manager will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be taken 100% by the Council.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
 - Establish on going management arrangements (internal or outsourced).
 - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective

Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type

Performance

The highest level of performance – the Council retains all development profit

Risk

The risk of development is mitigated by appointment of expert development manager and adoption of thorough risk management strategy

Control

Complete control with the Council

Limitations

Management Oversight

High level of oversight required

Revenue Generation

Revenue will only accrue once the development is completed and leased (or sold).

Diversification

Desired diversification unlikely to be achieved given the currently contemplated level of investment

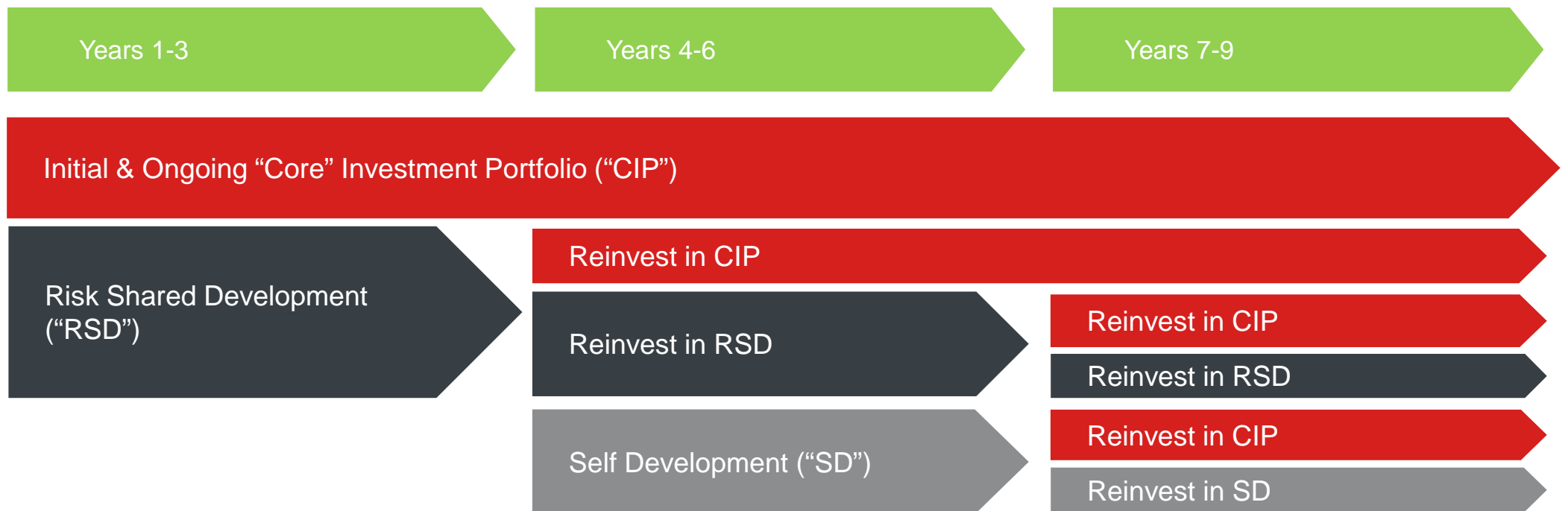
Liquidity

Low liquidity during the development period, thereafter as per the general property market

Achieving Greater Return

It is understood that SDC is intending to plan for a growing shortfall in Central Government funding which may result in a desire to achieve greater than a 6% income return on its initial PIS investment over time. This can potentially be achieved in two ways. Firstly by increasing the amount of PIS investment while still achieving a target 6% income return. And secondly by taking greater risk in the investment strategy.

A potential model for taking progressively, and measured, increased risk over time is shown below. The intention is that a blend of risk profiles are employed and that the proceeds of higher risk (and shorter term) activities are partly redeployed back into the lower risk, long term sustainable “core” investment strategy. It also envisages that additional funds can be made available after the first three year investment period.



Leveraging the Investment Pot

Whilst there are a number of potential constraints imposed upon the Council which will result in the PIS operating in a different way to a commercial property company, there are areas of competitive advantage over the private sector which we recommend should be leveraged to enhance the performance of the PIS or create/ identify opportunities that are not open to others.

- 1. Use of Prudential Borrowing** – whilst there is no initial requirement for prudential borrowing, if finance was required to grow the portfolio the Council can access funding at significant lower rates than the private sector. Comparatively, this results in better return on investment or improved development margin.
- 2. Tax Efficiencies** – there may be opportunities where investment can be made directly through the Council which is potentially more tax efficient than private sector delivery vehicles (further details about taxation is included in Annex A).
- 3. Access to Public Sector Grants** – whilst recognising potential State Aid issues, there is potential to use sources of public sector grant to support and benefit investment made through the PIS.
- 4. Use of existing assets** – there may be opportunities to optimise the value of existing assets through acquisition of neighbouring sites using the PIS. The ‘marriage value’ of existing and acquired sites is likely to be greater than individual sites.
- 5. Strategic acquisitions** – whilst mindful of potential conflicts of interest with the Local Planning Authority, the Council is in a unique position to make investments with the benefit of foresight of future development, demographic, and spatial trends, as well as planned infrastructure spend.

- 6. Offset Section 106 requirements** – there may be opportunities to meet Section 106 requirements across a property portfolio, which not only allows affordable housing to be provided where it is most needed (potentially on the less valuable sites) but also potentially minimises the requirement on more valuable sites.

Recommendations on Delivery Options

Given the PIS objectives and opportunities available to SDC within the District our recommendations are as follows:

1. The PIS be flexible enough to allow all seven potential delivery methods as described in this report.
2. To generate immediate income, initial investments be focussed on delivery methods 1 to 4 (direct property investment and property funds or shares).
3. Some initial investment be considered into the most liquid categories of delivery methods, namely 3 and 4 (property funds and shares). In this way, capital can be deployed quickly and flexibly. In the event further allocations do not become available for future projects, these investments can be readily realised and redeployed.
4. Higher value adding/risk activities (delivery methods 5 to 7) be focussed initially within the District. The SDC's knowledge of the District creates a competitive advantage and allows it to better manage risk and deliver wider SDC objectives. We understand a pipeline of opportunities is already under consideration.
5. In due course investments outside the District should be considered to ensure there is an appropriate balance of income, risk and returns through the accumulated portfolio of investments.

Governance Arrangements

Governance – Policy Context

Introduction

In order for the PIS to be successful a governance structure needs to be put in place that allows that allows the Council to trade on a commercial basis, whilst recognising the statutory and political boundaries that must be observed. Equally, given that the Council will likely be the main sources of resources, in the form of investment, assets, and skills, it needs to be a structure that Members and Officers are comfortable with.

Localism Act

The Local Government Act 2003 contained specific powers for Local Authorities to trade in its own right. In addition, the Localism Act (2011) allowed Local Authorities the ability to do any activity that a private individual is able to do, subject to certain statutory limitations. However, The Localism Act also made it a requirement for Local Authorities to undertake any activity for a commercial purpose within a company and not directly through the Local Authority. This has implications for the PIS. Previously, Local Authorities used the tax advantages afforded by a Limited Liability Partnership (LLP) to trade. This option is no longer available to Local Authorities and trading now should be undertaken through a limited company, which does attract tax and other costs.

The Council has in principle agreement to set up a Trading Company to facilitate opportunities for income generation.

Structural Options for the PIS

Setting up a Trading Company clearly has benefits from a delivery and operational perspective. However, operating in a such a way can attract additional cost and tax liability which will impact upon the performance of the PIS. As a result, it is recommended that the Council also uses its own corporate vehicle to undertake activity where it is able and beneficial for it do so. For example, some commercial investments could be made directly through the local authority, whereas residential investments may need to be made through a Trading Company due to the Council having transferred its Housing Revenue Account.

Governance – Structural Considerations

There are a number of issues that require further consideration in the context of the most appropriate governance structure and delivery vehicle for the PIS.

Issue	Context	Potential approach for PIS
Focus	Commercial activity within a local authority context can be challenging due to potential competing objectives and interests, and as a result make it difficult for the PIS to focus on ROI	<ul style="list-style-type: none"> - A Trading Arm makes it easier to focus on commercial return. Directors of the Company will be obliged to focus on the interests of the Company as opposed to wider Council objectives
Speed of decisions making	Local authority governance arrangements often make it difficult to quick and effective decisions which can lead to lost opportunities e.g. bidding for a site acquisition.	<ul style="list-style-type: none"> - A Trading Arm can be empowered to make quick decisions based upon its constitutional arrangements and agreed levels of devolved decision making
Partnering	If SDC was to partner with the private sector (or potentially other public sector bodies) in order to secure additional investment, resources, or expertise it is likely that this would be done through a arms length delivery vehicle.	<ul style="list-style-type: none"> - Setting up a Trading Arm for the PIS could make it easier to facilitate a partnering arrangement if it was required.
Local authority approval	Under Sections 95/96 of the Local Government Act 2003, the business case for the set up a trading company needs to be approved by the Local Authority.	<ul style="list-style-type: none"> - SDC has already given in-principle approval for the set up a Trading Company. A full business case would need to be developed and approved by the Council.
Cost efficiency	Setting up and operating a Trading Company can attract additional costs over and above what would be incurred in a local authority context.	<ul style="list-style-type: none"> - Subject to the company being a 'Teckal' entity, it can use the services of the Local Authority rather than having to employ its own resources - State Aid should be considered in relation to how the company accounts for the costs of services, as well as any other resources (accommodation etc) and finance.

Governance – Structural Considerations (2)

There are a number of issues that require further consideration in the context of the most appropriate governance structure and delivery vehicle for the PIS.

Issue	Context	Potential approach for PIS
Tax implications	Formal advice is required on this but generally investing through a corporate vehicle will result in taxes applying that would not otherwise be applicable for the Council. These include income/corporation tax and capital gains tax, depending on the characterisation of the activity undertaken (further details are included in Annex A)	<ul style="list-style-type: none"> - Efficient structuring can be used to appropriately mitigate these taxes to some extent.
Procurement	Both the Council and any Trading Arm it creates and controls will be subject to Public Procurement Rules with respect to delivering Works and Services (with the exception of services from the Council to the Trading Arm which can be subject to the Teckal exemption)	<ul style="list-style-type: none"> - Recognise that this potentially adds an additional cost and time delays to some types of investment activity e.g. development - Consider the set up or use of a framework for delivering Works and Services within the PIS
Transfer of assets	If assets are to be transferred into or from the Trading Arm it is likely that SDLT (see later section) will be incurred. It is also likely that Section 123 under the Local Government Act 1972 to achieve 'best value' will apply and as a result transfers will need to be at market rate.	<ul style="list-style-type: none"> - It is important to consider which entity is best placed to own the asset. We recommend the default position should be the Council, albeit in some instances where investment is made in residential assets, this may not be possible.
Conflicts of interest	The governance structure for the PIS should seek to avoid potential conflicts of interest which may either restrict its activity or create a reputational risk for the Council	<ul style="list-style-type: none"> - Consider membership of the Board for any Trading Arm or delivery structure. - Create 'Chinese Walls' between members of the Planning Committee and Planning Officers

Governance Arrangements

Introduction

Our report has highlighted that there may be opportunities where it is both beneficial and in some cases necessary to use a Trading Arm. However, we recommend that the delivery arrangements for each investment decision is made on its own merits. This section considers the potential governance arrangements that need to be put in place for a Trading Arm.

In considering the optimal governance arrangements for the Trading Arm the Council will need to decide not only who ought to be the Directors of the entity, but also what decisions are most appropriately made by the shareholder (the Council, through existing procedures) and by the Trading Arm itself (by the Directors).

Shareholder Decisions

At this stage it is envisaged that the Trading Company will be a Company limited by shares with the Council retaining a 100% shareholding. However, there is no reason why the private sector could not take a shareholding of the main company or subsidiary as long as Public Procurement Rules were observed. We have identified the following areas as likely key areas where decisions should be made by the shareholder(s):

- **Purpose** – defining the purpose and permitted activities of the Company
- **Capital structure** – how much finance to put into the company and on what terms?
- **Distribution policy** – is all trading profit to be returned to the shareholders or is any retained for future investment and/or running capital?
- **Board composition and appointments** – to agree the structure of the Board (see below) and approve specific appointment.
- **Appointment of auditors** – to provide transparency and as required under Company Law.

Company Decisions

Once the shareholder(s) have made the key decisions as suggested above more detailed operation decisions would be delegated to the company acting through its Board of Directors. Typical areas for the Directors to consider and approve include:

- **Annual and 5 year business plan** – agreeing the general investment targets for the period and an associated budget (although the shareholder(s) may wish to have separate approval rights).
- **Specific investment transactions** – acquisitions, sales, borrowing (if applicable) and other key transactions
- **Appointment of service providers** – lawyers, valuers, due diligence advisors, property managers, etc.
- **Reporting** – reporting arrangements to FRAC (Financial Resources Advisory Committee), Cabinet etc

Board Make-Up

There is no ideal make-up or size (although typically a minimum of 3 and a maximum of 6 members) for a Local Authority Trading Company, and therefore we have set out the options which the Council may want to consider. However, whatever board make-up is chosen, we recommend the following skills and experience are inherent within the Directors:

Skills and experience required –

- Financial
- Property
- Legal
- Investment
- Governance – other Board experience
- Private sector

Governance Arrangements (2)

Options for Board Make-Up -

Regardless of the make-up it is important that the rights and duties of Board Members under Company Law are understood and as a result irrespective of other Council interests, their primary responsibility as a member will be the interest of the Company.

Make-Up		Advantages	Disadvantages
1.	All Members	Public accountability	Potential conflicts of interests Potential capability issues
2.	All Officers	Effective and efficient link between Board and delivery team No conflicts	Potential capability issues
3.	Hybrid of 1 & 2	Combines the advantages of 1 & 2	Combines the disadvantages of 1 & 2
4.	1, 2, or 3 with non-exec directors	Additional skills Independence	Non Exec Directors will expect remuneration

We strongly recommend consideration for the inclusion of Non-Executive Directors as this should bring not only bring additional skills but also demonstrate independence. In many cases of best practice we have found that a Non Exec Director has been responsible for appointment of auditors etc to demonstrate greater transparency.

Industry Practice

- Private Sector** - Best practice in the private sector is to be found in the listed and fund management sectors. In the listed property company sector it is a standard requirement to have non-executive directors on company boards as well as senior management and sometimes representatives of significant investors. In the fund management industry there is usually a separation between the manager/promoter of a fund and the investors. The manager/promoter is often an investor as well. Governance practices were reviewed following the global financial crisis and it has become common practice to have non-executive (or independent) directors on Fund Boards or Advisory Committees along with manager and investor representatives.
- Public Sector** - Arms length trading companies and Special Purpose Vehicles (SPVs) vary significantly in form and function. Some public bodies have made the decision to retain a level of Member involvement in order to ensure a level of accountability is retained; others see Member involvement as creating a potential conflict of interest. Equally others have taken the decision to focus on Officer board membership which helps addresses some of the conflict issues; however arguably given their responsibilities to Members, may not allow them the ability to work independently and in the best interests of the Company. The presence of Non Exec Directors on the board is generally seen as a positive so long as they do not have a controlling majority and conflicts of interest can be managed.

Board Function

The role of the Board, the type and nature of activity it is able to undertake, and the decisions it is able to make will be set out in the Articles of Association. We recommend that an organisational business plan, that sets out the full proposed programme of activity, is developed to support the formal set up of the company and then reviewed and signed off by the shareholders (the Council) on a yearly basis. This should set out the parameters for the Board to make individual investment decisions.

Governance Arrangements (3)

The Role of Non-Executives

The role of the non-executive director is to bring both relevant experience and independence to the Board. This will involve:

- appropriate challenge to the executive members of the Board and/or to those presenting proposals for approval
- to be a separate voice of communication to the shareholder(s)
- to be a sounding board for the SDC officers involved in the PIS
- potentially to be the independent arbiter of any internal SDC conflicts of interest that may arise in relation to the implementation of the PIS.

As such it is important that there be no inherent conflicts of interest in those selected for the role of non-executive director.

Given our recommendations on the other Board members, we believe the key skills required for the non-executive directors are

- property and investment experience, ideally both from direct property investment and development and also from the property fund management industry
- experience of working on Boards or Advisory Committees representing multiple investors
- potentially with a legal background, given the various potential delivery methods contemplated by the PIS.

Recommendations on Governance

Given the objectives and structural requirements of the PIS we would recommend

1. The set up of a separate trading company to give the PIS independence from SDC and allow it to focus on its objectives.
2. Establish a Board with the appropriate mix of skills and experience to enable the company to perform successfully. We would recommend a Board membership initially comprising of five directors – three Council officers covering the following areas of expertise – economic development & property, finance, and legal; and two non-executives. This number and mix will allow the Council to retain control of the company whilst benefiting from the external viewpoint and expertise brought by the non-executives.
3. To facilitate decision making, we would recommend that quorum would be achieved through the voting of a minimum of three directors, of which one of these would be a non-executive.
4. We recommend that the non-executive directors be selected on the basis of relevant professional experience in property investment and corporate governance, and with careful consideration given to any potential conflicts of interest.
5. We have discounted the option of members becoming directors of the company given the potential for conflict of interest and influence over any Council officers involved. If there is concern about the lack of member presence, we would recommend that this is limited to one, and the appointed member to the Board has relevant recent experience and/or has responsibility for a relevant portfolio.
6. Consideration is given on a case by case basis as to the ownership of assets within the PIS in order to minimise SDLT liability.
7. That all costs, including those associated with Council resources, are properly accounted for within the trading company to ensure compliance with State Aid regulations and minimise tax liabilities.

Summary/ Next steps

Summary

Our review of the approach being taken by the Council to set up the PIS has confirmed that based on historic and forecast operational returns from investment in property can achieve a 6% income return on investment. We have captured the strategic objectives of the key stakeholders which will inform the type and nature of the work undertaken within the PIS. This rightly prioritises return on investment, whilst also recognising that as a public body there are wider considerations and sensitivities that the Council must consider. We have provided a range of investment options which attract varying amount of risk and return. We have set out a potential model to create a balanced portfolio which supports the Council's objectives.

We have shown that the set up of a PIS is organisationally possible and that a balanced, case by case, approach between making investments either directly through the Council, or a Trading Arm, should be taken depending on which route is most beneficial. We have outlined some of the governance arrangements that would need to be put in place for the set up of the Trading Arm.

Our specific recommendations are set out on pages 24 and 32 of this report.

Next Steps

1. There are a number of key decisions that now need to be made to progress the PIS.
 - Attitude to risk - reach consensus amongst the stakeholders about the level of risk that they are willing to take within the PIS, and as result manage expectations around the level of returns that can be anticipated.
 - Investment strategy – with reference to risk and return, decide which investment options should and should not be considered for the PIS
 - Governance – review the recommendations made on governance and membership of the Board of Directors for the Trading Arm.
2. Create a Business plan and Articles of Association in order to seek formal agreement from the Shareholders for the set up of the Trading Arm. The contents of the Business Plan would be expected to include:
 - The objectives of the business
 - The investment and other resources required to achieve those objectives
 - Any risks the business might face including how to mitigate against those risks
 - The expected financial results of the business, together with any relevant outcomes the business is expected to achieve.
3. Seek further advice in relation to taxation issues and legal input into the incorporation of the Trading Arm

Annex 1 – Potential Taxation Issues

Potential Tax Liability	Relevance to the Property Investment Strategy (PIS)	Impact if investments were made through a Local Authority (LA) operating model	Impact if investments were made through a Local Authority (LA) controlled, arms length, Trading Company	Points for further consideration (risks/opportunities)
Stamp Duty (SDLT)	A land transaction tax arising on the purchase or the granting of a lease of property. Calculated as a percentage of the transaction price including VAT (where applicable) The grant or assignment of options do not attract SDLT.	Applies to all relevant transactions.	Applies to all relevant transactions.	The purchase of shares in a company (1/2%) is often more SDLT efficient than the purchase of a property itself (4%), but brings with it the history of the company. Chattels are SDLT exempt.
VAT	Typically 20% liability on all transactions, but some exceptions can be at a rate of either 0% or 5%. Must register for VAT to be able to recover it on property purchases and construction works. A compulsory registration threshold applies where turnover exceeds £81,000.	Able to recover all VAT provided that not an exempt expenditure type (e.g. health centre and financial services).	Able to recover all VAT provided registered and the properties where necessary have opted to tax (i.e. elected to charge VAT on rents and service charges).	VAT registration must occur prior to commencement to ensure the fullest VAT recovery possible.
Corporation / Income Taxes	Tax on profits generated in the period of account. Specific expenditure such as depreciation is disallowed in assessing taxable profits.	Not applicable to a Local Authority as exempt under ICTA88 section 519.	Relevant to all trading / investment companies. Current rates are 21% for year to 31 March 2015 or up to 45% for individuals in the year to 5 April 2015.	Corporate structures ring fence liabilities within them if no external guarantees are provided. Money can be extracted through post tax dividends or through interest on LA's lending to the company on commercial terms.

Potential Tax Liability	Relevance to the Property Investment Strategy (PIS)	Impact if investments were made through a Local Authority operating model	Impact if investments were made through a Local Authority controlled, arms length, Trading Company	Points for further consideration (risks/opportunities)
Capital Allowances	Tax relief in lieu of depreciation on fixed assets within an investment vehicle. Can be claimed by corporates and individuals provided that identified in tax return.	As this is typically a non-taxable entity, it is unable to claim capital allowances on expenditure.	The use of a trading vehicle by a LA will allow for the claiming of capital allowances. Typically an office building will have a claim of 30%-45% of construction expenditure including fees. Likewise for a fitted out GP surgery, but residential and retail tend to only have claims in the region of 1%-10% depending on the specification.	Claims must be identified as part of the tax return and require specialist input to maximise the claim levels. NB, although investment property vehicles do not depreciate assets but reflect the moving value by adjusting for 'fair book value', they are still eligible to claim capital allowances.
Income Tax (for non-resident landlords)	If the investment vehicle is held offshore (e.g. Channel Islands, Luxembourg etc) then the company will remain liable to tax on any profits made within the UK on UK and overseas property.	Not applicable as the LA cannot be held 'offshore'.	Company will be liable to income tax at a current rate of 20% on profits. It can claim capital allowances (see above) and will be exempted from chargeable gains on subsequent disposal (see below).	Important to consider the political ramifications of placing the investment vehicle offshore. With regards to subsequent sales, investors are more inclined to acquire shares of a company holding the asset rather than the asset itself to save SDLT (see above).

Potential Tax Liability	Relevance to the Property Investment Strategy (PIS)	Impact if investments were made through a Local Authority operating model	Impact if investments were made through a Local Authority controlled, arms length, Trading Company	Points for further consideration (risks/opportunities)
Capital gains tax / chargeable gains (CGT)	Where an asset or investment (including shares) is sold for a profit, the asset will be chargeable to CGT. For companies this is usually at the rate that profits are charged to tax (e.g.20%), but for individuals this can be at 18% / 28% depending on the asset being sold.	LAs are exempt from CGT under TCGA92 section 271.	Vehicle is subject to chargeable gains on the disposal of assets and on the disposal of the shares, which can give rise to a double charge to tax. One way to avoid the double charge is to sell the shares or by the investment vehicle being held offshore (both approaches would be seen as positive by investors looking to purchase the asset) .	Careful planning required to mitigate the impact of this tax. By placing the assets in offshore vehicles, the subsequent disposal will be outside of CGT regime, provided the vehicle is managed and controlled offshore. If management function is undertaken in the UK it will lose the offshore status.
Group relief / Consortium Relief	Where losses are being made in a company, these can often be shared amongst other companies under common corporate ownership. As the rules can allow for even minor shareholdings to claim this relief it can be of value to joint venture partners.	LAs cannot claim group relief as not subject to tax.	Helps to reduce the total tax liability in the period by netting losses against profits. Any losses that are not used in the period that they arise, are usually carried forwards and can only be offset against the profits of the company within which the original loss arose.	If the LA enters into a JV, the JV partner may wish to extract the losses by way of group / consortium relief. This will reduce an 'asset' (i.e. the losses) in the business and the JV partner may be required to pay for those losses.

Summary and points for further consideration

The area of taxation is complicated and will require specialist input to ensure that the structure is set up correctly at the outset to reduce future liabilities and to create an attractive asset at the point of disposal, even if that is many years away.

The use of offshore vehicles is very common amongst the property development and investment community, but will have the political implication of being used to reduce tax liabilities. Choosing the offshore location will also need to be considered as to maintain its status, all decisions will need to be made in that location and not in the UK. The day to day running can be delegated to an external trust company to help preserve this status.