Leicester City Council

Overview Select Committee **Date: 7th February 2019**
Council **Date: 20th February 2019**

Investment Strategy

Report of the Director of Finance

1. Introduction

1.1 The purpose of this report is to seek Council's approval to the attached Investment Strategy.

2. Recommendations

2.1 OSC is asked to comment on the attached strategy.

2.2 Council is asked to approve the strategy.

3. Supporting Information including options considered

3.1 The Government now requires all authorities to prepare, and get full Council approval for, an Investment Strategy. This is separate from the investment strategy we submit with the treasury strategy every year (which is elsewhere on your agenda). The Investment Strategy covers property investments and loans to third parties for economic development reasons (amongst other things).

3.2 The new requirement results from the activity of some authorities who have been borrowing enormous sums to invest in commercial property, often outside their own areas.

3.3 The Government's aim is to increase the level of transparency over commercial investment decisions. The strategy is therefore important, because its sets parameters around what we can do in the future.

3.4 I will be presenting the document with slides at OSC.

4. Financial Implications

4.1 Finance is a key feature throughout the entire strategy.

4.2 The strategy does not seek approval to individual investment decisions which will each require separate reports (including financial implications).

5. Legal Implications (Emma Jackman)

5.1 This report proposes an investment strategy, and has regard to statutory guidance on local government investments issued by the Secretary of State under section 15(1)(a) of the Local Government Act, 2003.

6. Other Implications

None.

Report Author: **Mark Noble**

Date: **21st January 2019**

Appendix

Proposed Investment Strategy

1. Introduction

1.1 This strategy defines the Council's approach to making and holding investments, other than those made for normal treasury management purposes. The latter are described in the annual treasury management strategy.

1.2 New Government guidance requires the Council to approve an investment strategy. This requirement has arisen because of Government concerns about some authorities borrowing substantial sums of money to invest in commercial property (sometimes a multiple of their net revenue budget).

1.3 Because this strategy is an overarching approach to investment, it supersedes:-

(a) The Local Investment Fund, described in previous years' treasury management strategies;

(b) The Enterprising Leicester Investment Fund (approved by the City Mayor on 4th January 2016, and extended on 17th February 2017);

(c) The Investment Property Fund and "New Opportunities" Fund, approved by the City Mayor on 17th February 2017.

1.4 For the purposes of this strategy, an investment means any spending, or any interest bearing loan to a third party which is (at least in part) intended to achieve a return for the Council. It includes advances made to (or on behalf of) the Leicester and Leicestershire Enterprise Partnership (LLEP) for their purposes, if the Council or LLEP expects to make a return on the money: such advances may be made by the Council acting as accountable body or in its own right.

1.5 The Council also invests in pooled property funds. These are funds where large numbers of investors own a part share in a large number of properties, and are professionally managed. Our policy for investment in pooled funds is described in the treasury management strategy, rather than this strategy.

1.6 The strategy excludes investment in new Housing Revenue Account (HRA) dwellings, as this is not done to achieve a return.

2. Current Investments

2.1 The Council has approved the following investments which fall within the remit of this strategy:-

(a) The Corporate Estate, which consists of 338 properties available for commercial lease. The purpose of holding the portfolio is primarily for income generation purposes, but also with an eye to providing a range of accommodation for businesses and for ensuring a presence in city centre retail. The properties in the fund are held for their commercial value and not to provide accommodation or services to/for the Council. Accounting rules do not require us to treat the properties as investment properties for reporting purposes: however, they are held in part for return and thus fall within the ambit of this strategy. The portfolio includes industrial units, shops, and other business premises located in the city with some agricultural holdings outside. Much of the estate has been owned by the Council for decades. The total value of the portfolio is estimated to be £122m, and all purchases have been fully financed (i.e. there is no outstanding debt). Gross rental income is £6.1m per year from rents;

(b) A loan to Leicestershire Cricket Club of £1m, to enable the Club to improve its facilities at an interest rate of 5%. The loan is supported by guarantees from the English Cricket Board;

(c) A loan of £1.5m to Ethically Sourced Products Ltd, made under the (now former) “Enterprising Leicester Fund”. This loan carries a return equivalent to 4% per annum and is due to be repaid by 2025;

(d) A loan of £0.6m to the Haymarket Consortium Ltd to assist with the relaunch of Haymarket Theatre. This loan carries a return equivalent to 4% per annum and is due for repayment by March 2026.

2.2 Additionally, prudential borrowing of £8.4m has been approved to fund a hotel development at the Haymarket Shopping Centre, for which the Council will receive a revenue generating lease.

2.3 LLEP manages the “Growing Places Fund” which makes loans to businesses and other organisations for economic development. The total amount available is c.£12m. This fund does not come within the remit of this investment strategy, as the City Council has no financial exposure. (The original capital was provided by the Government, and there is now a revolving fund of new loans made as old loans are repaid. If there are defaults on the old loans, the fund simply stops revolving). The Council may seek LLEP’s agreement to use the fund jointly with City Council loan funding, which helps mitigate risk.

2.4 A loan of £4m made to support the relocation of Hastings Insurance to premises next to the railway station was fully repaid in 2018/19. Interest of £0.6m was paid on top of the outstanding capital sum (equivalent to 10% per year) and Hastings increased the number of jobs in Leicester to 1,000.

3. The Council's Overall Approach

3.1 The Council encourages investment which enables us to reduce reliance on returns from cash (the treasury management strategy) and at the same time put to use sums which would be earning little interest to benefit the people of Leicester. However, the Council acknowledges the risk associated with such investment, and will ensure it is not left hostage to changing market fortunes. The following limits are set and will not be exceeded:-

	Limit	Current Position
Gross external debt as a percentage of the Council's net service expenditure	100%	52% (£182m)
Outstanding prudential borrowing from activities covered by this strategy as a percentage of the Council's net service expenditure	30%	<1% (£3.1m)
Income from activities covered by this strategy as a percentage of net service expenditure	10%	1.8%(£6.2m)

(Net service expenditure is volatile due to accounting adjustments, and the 17/18 figure of £352m will be used until this strategy is revised. "Debt" excludes PFI).

3.2 In the case of the Corporate Estate, managers will be encouraged to dispose of under-performing assets, and reinvest in higher earning assets, taking into account the opportunity for a sustainable financial return, risks and liabilities. New acquisitions can be funded by:-

(a) Sale of existing, under-performing properties. These will be separately identified and approved by means of a decision of the City Mayor;

(b) Prudential borrowing, subject to limits given below and necessary approvals.

3.3 The Council is prepared to take greater risks in the furtherance of this strategy than it would be with the treasury management strategy: this is because investment will never take place <u>solely</u> for financial motives (the only exception being enhancement of the property portfolio within the Corporate Estate as described above).

3.4 Whilst recognising there are service reasons for investment, the Council's financial priorities are:-

(a) Security of capital – notwithstanding the above, this is the paramount consideration;

(b) Yield (the return on investments) - this is important, but secondary to ensuring our capital is protected;

(c) Liquidity (ability to get money back when we want it) – this is the lowest priority, and the Council accepts that such investments are less liquid than treasury management investments. We can live with this, because individual investments are small scale compared to the overall size of the Council. We have other (treasury) investments which are kept for liquidity: these exceed the value of our external debt.

3.5 Property acquired under this investment strategy will be located:-

(a) In the case of the Corporate Estate, within the boundary of LLEP (usually, within the city);

(b) If acquired for economic regeneration purposes, within the boundary of LLEP (or just outside the perimeter);

(c) If acquired for other reasons, normally within the city boundary, but may be elsewhere to better meet service objectives (for example, an investment in solar panels which provide energy to the city – the key consideration being best value from the site regardless of location; we may also join a consortium of other authorities to invest in facilities which serve all our purposes).

3.6 Individual investments can be funded by any of the following (or combination of the following):-

(a) Grants/contributions from third parties (including LLEP);

(b) Capital or revenue monies held by the Council;

(c) Prudential borrowing.

3.7 Items (b) and (c) together represent the Council's capital invested. Item (c) represents the risk of the Council requiring further capital or revenue resources if an investment fails; it may or may not represent any actual external debt. The amount of prudential borrowing outstanding may fall over the life of an investment. The totality of prudential borrowing outstanding at any one time is a key control over the Council's investment activity, and is termed "exposure".

3.8 The Council will not, at any one time, have exposure in excess of the following:-

	£m
On commercial or industrial property it owns	50

For loans to third parties (other than LLEP)	20
For sums advanced to, or on behalf of, LLEP	30
For other investments	40

3.9 The Council will not, at any one time, have exposure in excess of £100m for all activity arising from this strategy (it cannot, therefore, at any one time, maximise its exposure under each of the above categories).

3.10 Total exposure on these measures is currently £3.1m.

3.11 The Council can reduce its exposure, particularly if an investment is performing poorly, by writing down prudential borrowing using capital or revenue resources.

4. What we invest in and how we assess schemes

4.1 Decisions to invest will be taken in accordance with the usual requirements of the constitution. Executive decisions will be subject to normal requirements regarding notice and call-in. All decisions to use prudential borrowing require the approval of the City Mayor. The criteria below set normal expectations for investment decisions, but it is impossible to provide a framework for all potential opportunities: we do not know what might be available in the future. The City Mayor may approve investments which do not meet the criteria in this section 4 (the limits at section 3 will not be exceeded), but if he does so:-

(a) The reason will be reflected in the decision notice;
(b) The decision will be included in the next refresh of this strategy.

4.2 All proposals will be subject to a financial evaluation, signed by the Director of Finance. This will calculate expected return (see below), assess risk to the Council's capital invested, and ability to repay any prudential borrowing. The evaluation must therefore give evidence of a financially robust proposal, regardless of the other merits. The results of the evaluation will be reported in the decision report. For small purchases of property within the Corporate Estate, a more streamlined evaluation can be prepared.

4.3 Any investment for economic development purposes will accord with the Council's adopted strategies, except for early stage expenditure in contemplation of a new strategy.

4.4 The maximum prudential borrowing permitted for any given investment will be:-

£m

- For purchases intended solely to improve the financial performance of the Corporate Estate

- All other cases 10

4.5 Advances to third parties (including LLEP) will require additional security where the total capital invested by the Council exceeds £2m, e.g. the underwriting of risk by a third party (such as another local authority in the LLEP), a charge on property with a readily ascertainable value and a number of potential purchasers, or a commitment from the LEP to a percentage of anticipated rates growth.

4.6 The Council will look for a return on its capital invested, although this can be lower than a bank would seek (reflecting our cost of funds, and the expected service benefits). Except where a purchase is solely to improve the financial performance of the Corporate Estate, return will be measured by net present value and (disregarding external contributions):-

(a) The usual yardstick for investment is that, on a prudent estimate of costs and income, investments must make a positive return when discounted at 2.5% above bank base rate. A higher return may be sought where a project is riskier than normal;

(b) Where reasonably certain, growth in retained business rates can be included in the calculation of NPV until the date of the next national reset (although rates growth will continue to be accounted for as rates income, and not earmarked);

(c) Resultant savings in departmental budgets cannot be included in the calculation.

4.7 The City Mayor may take a conscious decision to accept lower returns for service reasons (an alternative way of looking at this is to say that the Council will sometimes choose to accept modest returns instead of providing something at its own expense for service reasons). Such a decision will be transparent and recorded in the decision notice.

4.8 The following are deemed to be suitable investments:-

(a) Acquisition or disposal of commercial or industrial property;
(b) Construction or development of commercial or industrial property;

(c) Construction or development of non-HRA housing, directly or via the wholly owned housing company;
(d) Acquisition of land for development;
(e) Infrastructure provision at key development sites;
(f) Loans to, or on behalf of, the LLEP to support its objectives;
(g) Loans to businesses to support economic development.

4.9 All investments and loans must be state aid compliant.

4.10 Acquisition of commercial or industrial property can be considered where:-

(a) There is a tenant of sufficient quality; or strong evidence of market demand for the property (e.g. identified end use, or small tenanted units with a ready supply of prospective tenants); or the property generates other reasonably assured income; and

(b) There is the prospect of capital appreciation and a ready market for the Council's interest (or there will be a ready market at the end of the investment period); and

(c) There are either economic development or service reasons why the city would benefit from the council's ownership, or the acquisition improves the performance of the Corporate Estate. An example of economic development reasons might be to facilitate a significant business relocation to the city or surrounding area.

4.11 Construction or development of commercial or industrial property can be considered where the asset constructed or developed would generate a continuing income stream, and have a readily realisable capital value. Whilst a pre-let is regarded as highly desirable, a benefit of Council involvement is that strategically important development can be secured which would not attract normal commercial finance. New grade A office space is a key example. It is, however, essential that the Council can be confident of a return on its capital invested, and an NPV shall be calculated using prudent assumptions of any void periods.

4.12 Construction or development of non-HRA housing can be used to develop sites, and provide housing for sale. It is an alternative to disposal of un-developed land for a capital receipt and may take place through a wholly owned housing company. Investment would be made into the company, either through equity or loan capital. Alternatively, we may want to invest in non-HRA housing to let, creating an institutional private landlord. This would take place through a wholly owned housing company as an alternative to disposal of undeveloped land.

4.13 Acquisition of land for development can be considered for strategic regenerative land assembly schemes, subject to the proviso that future development is planned and fundable:-

(a) The Council's return will usually arise from an appreciation in land values and this must be reasonably assured with a ready market;

(b) This type of investment is riskier than the acquisition of tenanted property, and a higher return would normally be sought.

4.14 The availability of other public funding to secure development will improve the acceptability of such proposals, as this will increase the return on the Council's capital invested.

4.15 Infrastructure provision at key development sites can be considered where development can be catalysed by provision of site infrastructure:-

(a) Investment can be considered where future disposals can be assumed with a reasonable degree of confidence; and

(b) Developments unlock strategic housing or commercial development on economic growth sites, or contribute towards bringing forward linked developments.

4.16 Advances of funding or loans to LLEP (or on behalf of LLEP) can take place to support economic development in the city or LLEP area. Such advances can be considered to support the LEP's strategic plan, subject to confidence that money will be returned through business rate growth or other LLEP finance.

4.17 Loans to businesses can be made at attractive rates (when compared to bank finance) for proposals which facilitate economic development, and where the Council can be confident that the money will be repaid. The following criteria will be applied:-

(a) Loans would normally be repayable within 10 years (or the Council has an asset which is readily realisable within that period, whether we choose to realise it or not);

(b) A minimum loan value of £100,000 will apply;

(d) Proposals must demonstrate that they are viable, i.e. there is a reasonable expectation that the capital and interest will be repaid;

(e) Security will usually be obtained (and always for higher value loans).

5. **Monitoring of Investments**

5.1 Except where the City Mayor decides (after consulting OSC) that an investment can be monitored in aggregate as part of the Corporate Estate, the following measures will be used to monitor performance of all investments. Performance will be reported as part of the annual budget outturn report:-

(a) Achieved return on capital invested;

(b) Capital appreciation;

(c) Timely receipt of returns;

(d) Write offs/write downs;

(e) Jobs or other outputs created.

5.2 The Corporate Estate measures its performance (in aggregate and by class of asset) with reference to the following indicators. Estimates for performance in 18/19 are also shown:-

	Target Performance	**18/19 Forecast**
Net Yield	5%	5%
Voids	3%	3%

5.3 Because the fund is assessed in its entirety, measures for individual acquisitions are not set.

5.4 Performance against the measures at paragraph 5.2 will be compared against other authorities with similar portfolios, and against industry benchmarks.

5.5 Buying/selling decisions for the Corporate Estate will reflect CDN's approved property investment strategy.

6. **Capacity, Skills and Culture**

6.1 The Council employs professional accountants who are skilled in carrying out investment appraisals, as well as regeneration, economic development and property specialists. Nonetheless, the more complex schemes will require external support to enable thorough due diligence to be undertaken and business cases to be developed and assessed. External specialists will work with Council clients to ensure they understand the public service dimension of the Council's business.

6.2 A presentation on the Council's investment strategy will be provided at OSC on 7th February.

6.3 The Council will use whatever presentation techniques are appropriate when decisions on individual investments are sought; these will in particular focus on the risk assessment.