Housing, Finance and Corporate Services Policy and Scrutiny Committee

Date:	18th November 2015
Classification:	General Release (Appendices A & B, Not for Publication)
Title:	The Council's Corporate Property Strategy and current situation.
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Cabinet Member Portfolio	Finance & Corporate Services
Wards Involved:	All
Policy Context:	Investment & Corporate Property
Financial Summary:	The Council's Corporate Property portfolio amounts to 770 buildings combining investment and operational property, with an annual operating cost of £23m and annual income of £24m (excluding exceptional items and capital receipts), and a value of c. £800m
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RECOMMENDATION:

That Appendices A and B to the report be exempt from public disclosure by virtue of paragraph 3 of Part 1 of Schedule 12A of the Local Government Act 1972 because the information involves the likely disclosure of exempt information relating to the financial or business affairs of the Council or any other body.

1. Executive summary

1.1 This report describes the Council's Corporate Property Strategy and the current situation and aspirations for growth over the next 5 years.

2. Key matters for the Committee's consideration

2.1 Seek the Committee's view on whether the Council should use its General Fund land and property assets more effectively to grow income lines to support front line services.

2.2 Seek the Committee's view on how the Council balances the need to retain capital generated from real estate for growth of the portfolio, with the need to fund the Council's capital programme.

2.3 Seek the Committee's view on identification as surplus, and subsequent use of, property currently used by the Council for provision of services.

3. Background

The Council's Corporate Property portfolio

3.1 This paper aims to highlight the breadth of the Council's commercial property assets – the corporate portfolio, that is the real estate the Council occupies to provide its services, and the investment portfolio from which the Council generates revenue, and to highlight the strategic approach to its management.

3.2 The Council holds a property portfolio of approximately 770 buildings. About 370 buildings are properties held for investment purposes (c. 960 tenancies generating rental income to the Council) and 400 are operational properties (schools, depots, care homes, offices, libraries etc).

3.3 The investment portfolio generates approximately £24 million of rental income pa to the HRA and General Fund and has a value of c£390 million (April 2015). The cost of running the combined investment and operational portfolios is c£23 million pa., which feels disproportionately high.

3.4 While it is the revenue generated from assets held in the General Fund that supports the Council's funding of front line services, the Property team gives equal time to asset management of HRA held commercial property assets which generate revenue to support the Council's housing programme.

3.5 The internal Corporate Property team is small comprising c20 staff split between three core functions – asset management of the investment portfolio; asset management of the operational portfolio and project management of larger scale capital projects to the operational portfolio.

3.6 This paper will consider the investment portfolio and the potential to grow revenue by applying a more strategic active management approach to the portfolio. The paper will also identify early stage work to extract value from the property occupied for the provision of Council services by reducing the Council's operational property footprint, reducing the cost of occupancy and the potential to generate revenue from surplus property created as a consequence.

4. The Council’s Investment Portfolio

Introduction

4.1 The Council holds an investment portfolio of approximately 370 property assets, comprising 960 tenancies and generating c. £24m of rental revenue to the Council in support of the General Fund and the HRA. £18m flows to the General Fund. The investment portfolio was last valued at year end 2015 at £390m and generates a gross yield of c. 6.75% based on the 13/14 valuation which, for performance measurement, is treated as the year 1 valuation in the absence of historic valuation data.

4.2 In the last two years Corporate Property has recovered c. £5m of long term debt and grown revenue by £2m. A backlog of approximately 100 rent reviews and lease renewals is currently being addressed. Vacant premises account for no more than 4% of the portfolio though more usually this figure fluctuates around 2% which compares favourably with commercially run portfolios. Annual external management costs are c3.5% of revenue which is below the market standard of 5%.

4.3 The property management function of the investment portfolio is undertaken by external managing agents – Bilfinger GVA, who took over the role in March 2014

4.4 The investment portfolio can be identified via four distinctive groupings that are retail parades (primarily HRA); car parking; privately operated community based service provision; and disparate/general holdings.

4.5 Approximately 10% of the properties in the investment portfolio are let to voluntary sector organisations which provide services and resources to local residents and the local community on various discounted rental arrangements .The discounted rent arrangement may have been inherited or may have been entered into by the Council historically, based on the benefits that flow to the local community

4.6 The retail parades are secondary in nature from the perspective of both tenant covenant and location, but generate steady levels of revenue. Secondary retail (family run corner shops and hair dressing salons) tend to provide a lower risk from revenue void, but conversely do not provide the prospect of high levels of revenue or capital growth.

4.7 The investment portfolio includes 19 parades varying in size from 3 to 64 units. These generate approximately £5m of the portfolio’s revenue (20%), comprise some 200 assets (50%) and approximately £97.5m of capital value (22.5%).

Investment Objectives

4.8 As part of the Council's property strategy and in recognition of the need to drive up investment opportunities there are a number of key objectives that the team are delivering to. These include the need to -

4.9 Rationalise the existing investment holdings in order to reduce management costs and grow income.

4.10 Use the Council's land assets to maximise returns.

4.11 Reduce over time the number of properties and increase average lot size.

4.12 Create sustainable income streams in support of the Council's front line services and the HRA.

4.13 Reduce portfolio risk from held investments

4.14 Identify opportunities within the portfolio to create additional mixed tenure housing provision

4.15 Identify opportunities for capital receipt through development, joint venture or disposal;

4.16 Deliver a strategy to achieve the above and combine with broad intention as a local authority to bring about regeneration

Increasing income from the Council's Investment portfolio

4.17 As part of the changing fiscal climate facing Local Authorities, there are some key questions the Council will now need to consider as part of its future objectives for the portfolio.

4.18 In formulating a strategy the Council must consider the following-

- Understand the Council's investment objectives.
- Is income sufficient to cover requirements?
- Is income or capital the key driver?

4.19 Does the Council want to inject equity, to undertake asset management and to acquire properties which will enhance the performance and sustainability of the portfolio?

4.20 At the core of the Investment team's objective is driving revenue to support front-line Council services. The most appropriate method of driving returns is to grow income, or generate new income, from assets already owned by the Council.

4.21 Although revenue performance is possible through asset management alone this will be fairly limited and will not provide the revenue target required and aspired to. Furthermore, with the portfolio being relatively passively managed historically – aggressive efforts to drive rents to market levels across the portfolio is likely to cause political fallout from the sole traders and long-term occupiers of the portfolio.

4.22 Investment strategy to drive revenue has to be predicated on using capital generated from within the portfolio, or new capital, to implement a reinvestment programme designed to generate performance.

4.23 Since 2012 the Council has disposed of over £300m of real estate to fund the capital programme. Presently £140m of capital will be generated from the current disposal programme of which £50m will be allocated for reinvestment.

4.24 Assets once disposed of, have and are affecting the revenue position of the Corporate Property department (some of the assets disposed of result in the loss or revenue in the investment portfolio).

4.25 To support the Council, the department has identified the need to grow income from investing in revenue generating assets; this would require a decision to ring fence capital funds to replace and grow the investment portfolio.

4.26 It is agreed that the Council will desist from funding its capital programme from asset sales and that service areas projects must be self-funded from 2016

4.27 In order to optimise returns from capital investment the Property team has identified several Major Projects to enhance, or significantly increase revenue while also providing improvements to services, public realm and additional housing.

4.28 The programme of works optimises returns by developing land assets already owned by the Council, thus not having to contribute a land value to the scheme.

4.29 The programme will require a capital provision of c. £900m and could produce an additional £35m in revenue and £630m of capital receipt providing a gross income return in the region of 13%, while also delivering new sports and leisure facilities, office accommodation for Council staff, a health hub and new housing.

4.30 Accordingly, over the next 5 years the gross revenue generated by property assets held in the General Fund can increase to c. £60m pa providing significant surplus funds in support of front line services.

4.31 Moreover, the some of the additional revenue create can be reinvested in to the portfolio to continue to grow the portfolio and revenue generated from it.

Reflections on the investment portfolio are as follows:

- The need to balance the investment portfolio so the Council is not over-exposed in any single property sector. This might be through reducing holdings in tertiary retail and car parking and gaining greater exposure to office, industrial, leisure (particularly as a result of the nature of the borough) and private residential.

  - Much of this diversification programme will be dealt with as a result of the Council's Major Projects development programme, rather than by a defined disposal/acquisition based realignment.

- The need to look at the number of assets across the portfolio. The portfolio presently comprises approximately 370 assets with an average asset value of around £1m. This provides for a cumbersome and management intensive portfolio. While it might be argued that risk is reduced as a result of income diversification, it cannot be disputed that the cost of management, lease negotiations/renewals, rent reviews etc increases and the prospect of future income performance is reduced. A commercially operated investment fund of equivalent value would comprise perhaps 20 or 30 assets averaging c. £15m in value.

  - However it must be accepted that the portfolio was not acquired by design and the nature of the investor in this case prevents the evolution of an investment fund run on a truly commercial basis, but some concepts can be applied.

- The need to agree to the principle of reinvestment of capital that might be realised from investment disposals. In order to begin to restructure its investment holdings and optimise revenue, the Council can identify capital projects from within the portfolio to release capital for reinvestment and/or income enhancement. It can identify assets from which there is a limited prospect of future income growth and recycle capital revenue for the purpose of acquiring better quality investments. Most importantly this enables the Council to structure the investment portfolio with a view to building in future income growth to create a sustainable longer term income stream as well and improving capital growth potential.

5. The Fundamentals behind a Property Asset Management Strategy

5.1 A traditional property asset management strategy is predicated on a desire to look at how best to maximise return, measured in terms of both capital and income growth over time, from a portfolio of real estate assets. It will accept that the inward investment of capital is a necessity when considered against an overriding aim to create value, having understood the associated risks and the needs and aspirations of the underlying stakeholders.

5.2 Whilst there will be particular political, social and economic issues that will have a bearing on how aggressive the Council can be in the pursuit of additional value, relative to other property owners, the basic dynamics attributable to the application of a time lined property asset management strategy will remain relevant. The manager should remain focused on achieving an appropriate tenant mix by executing a strategy that aligns cash flow with portfolio and socio-economic needs, whilst managing both operational receipts and expenditure in a way that enhances overall portfolio return.

5.3 What we should not do is to confuse property management with property asset management. Property management is for all intent and purpose the daily application of the lease provisions, be that the collection of rent, service charge, management or repairing obligations. Whilst there is an argument that lease events such as requests for assignment, completion of rent reviews or lease renewals could also fall under the role of the property manager these events also provide the perfect platform for the property asset manager to take control, through negotiation with the existing tenant, creating the opportunity to add value through the repositioning of individual assets as part of a wider property asset management strategy. What is essential is the creation of a platform that allows clear lines of communication and the efficient dissemination of information.

5.4 There has been, for many years, a debate over the relative merits of active management against passive management particularly on property portfolios where there is a desire to maintain long term freehold ownership which removes, to a greater extent, the need for either short term relative benchmarking or the creation of value through a market led buy/sell strategy.

5.5 In a relatively static portfolio the ability to achieve above market performance will be heavily dependent upon the manager’s desire and ability to actively manage the assets they own. To employ a strategy that is predicated on the adage that “no asset is passive” requires a very clear understanding of the underlying dynamics of the portfolio, a precise handle on the implications of events within the life of the occupational leases and a clear commitment to invest capital throughout a pre-determined property asset management cycle to improve underlying performance.

5.6 If we start with the belief that real estate as an asset class can be improved through asset management to maintain and/or enhance value, then the following principles should be considered in building an appropriate property asset management strategy:-

- Real estate is defined inherently by its location and the micro socio-economics that impact on that location. It remains very much a local business with many of the drivers of performance being local in nature. There is not a “one size fits all” strategy that can be adopted across varying locations. For example each location will have its own particular characteristics which will need to be evaluated in order to arrive at a strategy that can achieve a mix of occupational tenants that matches the more established multiples with the niche/local start-ups assisted by a leasing policy that promotes flexibility and growth. Through such an approach values can be enhanced without destroying the very dynamics which have, over time, defined the location.

- The impact of major urban regeneration and/or infrastructure projects can't be underestimated when considering the property asset management of Greater London portfolios. Major changes to connectivity will open up new districts and reduce travel times, both of which will directly drive values, whilst urban regeneration should act as a catalyst for broader investment and development around the affected areas. These wider improvements will also unlock considerable underlying value in more local markets that have to date had few drivers of change and therefore performance potential.

- Individual assets can differ significantly in terms of physical layout which can materially affect the performance potential even within a relatively small geographic area. It is important therefore to evaluate how such physical layouts will impact on a letting strategy and how that strategy might change by reconfiguring individual assets or whole parades in order to justify the capital costs associated with such improvements relative to the additional value that can be created.

- Contrasting financial attributes such as covenant strength, lease provisions and lease term can materially affect both the existing value and the ability to add value through asset management. The duration of a cash flow generated by short leases will not surprisingly contrast with longer lease length and underlying covenant strength but it is a misconception to believe that long dated income streams will, by their very nature, carry greater value potential even if they carry less risk.

  Differing lease lengths will impact on lead in time in terms of implementing a property asset management programme leaving certain assets more easily managed in market led demand/supply cycles, particularly when considered alongside the wider economic conditions. The important underlying message is that the allocation of working capital to the right assets at right time will impact on the ability to add value over the life of a property asset management plan. Flexibility will be required in order to ensure when opportunities arise they are not missed and having agreed a plan allowing the managers the appropriate time to implement it.

5.7 The Westminster City Council Portfolio

5.8 As identified above, the portfolio currently totals some 370 properties, amongst which are 19 parades of predominantly retail assets that historically exist as an addition to large residential housing estates or apartment blocks, providing local convenience shopping for the residents of those estates. In London these are often called "villages" with defined physical and socio economic characteristics which have, in many of the locations, changed little since they were first constructed.

5.9 However, as retail trends have developed and consumer shopping habits have adapted to meet the requirements of modern day life so the need to review the overall strategy for these "villages" has risen towards the top of the agenda.

5.10 Many of the locations will never be seen as prime retail destinations which must be considered in drawing up a strategy that looks to create and then manage a more appropriate tenant mix that matches local demand with a desire to add value to the portfolio in order to provide additional revenues for re-investment across the numerous activities and services provided by the Council.

5.11 Members have previously requested more detailed information regarding the strategy for managing aspects of the portfolio, including the “village” retail parades which form such a significant element of the Council’s commercial property assets. These are presented in more detail elsewhere and highlight the commercial nature of this information.

5.12 Examples of such parades within the portfolio include the following and a high level strategy relating to these parades is appended to this report:

- **Tachbrook Street, Pimlico, London SW1**
- **Irving St, London WC2**
- **Crawford Street & Seymour Place, London W1**
- **Ebury Bridge Road, London SW1**
- **Lupus Street, London SW1**
- **Marshall Street, London W1**
- **Church Street, London NW8**

6. Identifying a Performance Target for the City Council’s Property Portfolio

Background:

6.1 The portfolio currently has a value of approaching £400 million and so comprises a meaningful proportion of the Council’s assets. It is best practice for the performance of such a portfolio to be monitored regularly and its performance compared against a benchmark. That benchmark should be the one that most closely replicates WCC’s strategic investment objectives for its portfolio.

Nature of the Portfolio:

6.2 The properties held are predominantly located within the city’s boundaries, a market with some of the highest capital values globally so could be viewed as prime. In reality the portfolio comprises predominantly secondary or tertiary assets away from the best locations. As a result, in 2014/15 it delivered a gross yield of 6.75% which is much higher than would be expected from a prime Central London portfolio. The secondary nature of the portfolio means that it provides frequent, profitable, asset management opportunities where strategic capital expenditure can increase value and income return by more than the cost. The capital required can be obtained from a development partner for major projects though a significant proportion of the upside is likely to be lost. However, it is often impractical to work with a partner on more minor projects so these need WCC capital to exploit.

Benchmarks:

6.3 There are a variety of benchmarks that could be used to assess the performance of WCC's property portfolio. Investment Property Databank (widely known as IPD and now owned by MSCI) produces the best known investment property indices which are based on the returns achieved by a wide range of institutions (insurance companies, pension funds, charities and property funds). Indices are produced for specific property types = office, retail, residential and industrial as well as 'all property' – and for a variety of geographies ranging from the entire UK to Central London. While IPD's indices are the best available for comparing the performance of an institutional quality property portfolio, they do not reflect all the costs in managing that portfolio, particularly the need to provide regular capital injections.

6.4 Other indices better reflect the full cost of running a portfolio. These include both for property funds (unlisted) and listed Real Estate Investment Trusts (REITs). These generally show a lower dividend yield as they reflect higher outgoings and provision for capital expenditure. Thus currently, the IPD quarterly UK All property Index (Q2 2015) is showing an income return of 5.2% compared with a dividend yield from the property funds of 2.8% and 2.7% from the largest REITs. These yields are a better reflection of the net income return that an investor can reasonably expect from a property portfolio, rather than the income return reported by IPD.

Benchmark challenges:

6.5 It is essential that the benchmark chosen best reflects the true aims of WCC for its property portfolio. As a result, the portfolio manager will receive the right signals for directing the portfolio. If the benchmark is mis-specified, the manager can be overly incentivised to pursue short term goals at the expense of the long term. While this may boost capital values in the short term, it is unlikely to promote long term income growth.

Designing a Performance Target for WCC's property portfolio:

6.6 Given the challenges above and taking in to account the unique nature of the Council's property assets, identifying a "Benchmark" against which to compare performance is therefore not appropriate.

6.7 The City Council expects its property portfolio to deliver a regular income that which needs to increase broadly in line inflation of the provision of Council services. The Council would also like assurance that the value of its portfolio is at least matching the broad London property market.

6.8 The Property team, with assistance from advisers, is developing a performance target to add robustness to the way in which the Council's assets are managed and to ensure revenue produced by the Council's property assets meets the Council's demands.

Governance

6.9 In developing an evolving strategy for the investment portfolio and to provide additional governance, the Director of Property has established the Property Investment Panel which includes two members external to the Council, Dr Robin Goodchild of LaSalle Investment Management; and Simon Latham of Brook Investment Partners.

6.10 Investment concepts are tested at PIP and at the Council's Commercial Opportunities Review Board

6.11 Major projects are subject to Green Book business planning and peer reviewed at the Major Projects Review Board with a quorum formed of representatives from Property, Finance, Procurement and Major Projects.

6.12 Business cases are reviewed at the Capital Review Group before forming the basis of a Cabinet Member Report.

7. Operational Portfolio Rationalisation

7.1 The cost savings and new revenue from rationalisation of the operational portfolio have been identified an important contribution to the Council's budget arrangements. A first stage review of the corporate property portfolio will provide clarity on how this will be taken forward.

7.2 Property as a resource should act as a facilitator and enabler to the Council's service provision. It therefore follows that an effective property strategy should reflect the Council's property needs translated from the scope and scale of services provided. It should also be noted that any strategy should be considerate of the cost of property in support of service provision.

7.3 The Council's full operational portfolio consists of over 300 individual sites. Approximately 150 properties comprise "bricks & mortar" real estate having excluded open spaces, gardens, playgrounds, parks and cemeteries. That is not to say that those areas of real estate do not themselves enjoy a latent value which could be leveraged.

7.4 The operational footprint of the Council is c. 1.43m sq ft.

Use	Sq m	Sq ft
Estate Offices	2,000	21,500
Libraries	10,900	117,325
Sports & Leisure	32,200	346,600
Depots	4,450	47900
Community Protection	750	8,070

Offices	26980	290,410
Children's Services	2,200	23,680
Nursery Schools	11,100	119,500
Adult Services	2,000	21,525
Adult Education	1,500	16,150
Schools	39,000	420,000
TOTAL	**133,000**	**1,430,000**

7.5 City Hall and Lisson Grove are subject to separate refurbishment projects aimed at savings/revenue generation. City Hall currently accounts for approximately £8m of the total running costs of the corporate portfolio and the City Hall Refurbishment Programme has identified c. £3m of potential savings.

7.6 A review and rationalisation of the operational portfolio will enable significant cost reduction. The Property, Investment & Estates department has begun a wholesale review of the operational property portfolio. This will focus initially on how intensely the property from which the Council provides its services is actually used before determining a strategy for future use, developing efficiencies to include hub strategies, workplace management, service co-locations and alternative delivery models. It remains necessary to consider the impact of the City Hall Refurbishment Programme and Lisson Grove which may create further strategic opportunities post refurbishment, as well as how the Council's operational portfolio overlaps with Tri-Borough.

7.7 Workspace Efficiencies and opportunities

- ***Desk Ratios & Decluttering*** – Decluttering has consolidated the work environment, provided break out areas and touch-down space and permitted a new ways of working. Offices at City Hall and Lisson Grove are moving to a 7:10 desk ratio as part of a smarter working policy. Adopting a 7:10 desk ratio across the operational estate will generate savings, but the City Hall and Lisson Grove refurbishments will provide and environment to enable a more challenging ratio of 6:10, or 5:10 as RBKC are targeting.

- ***Co-locations*** – Identify areas of commonality linked to their operational working practices where sharing of space and back office functions results in economies of scale.

- ***Hub Strategies/Interim Mini-Hubs*** – Identify clusters of services (eg Queen's Park, Stowe Centre, Porchester Leisure Centre, Churchill Gardens and Church Street) that would suit hub-working. Use existing space in estate offices to create mini-hubs for a phased delivery while we move towards creating the long term solution. The delivery of new hubs may be achieved through rebranding of existing facilities (libraries and Leisure Centre).

- ***Potential Development Opportunities*** – releasing surplus buildings and land as a result of rationalisation, for change of use, redevelopment and revenue generation. The Council does not have a measured survey of the portfolio yet (this is in production), but on a very high level assumption, releasing say 50,000 sq ft could lead to rental revenue of c. £2m pa

- ***Alternative Delivery Models***

  Two key functions for the Council are the provision of library facilities and sports and leisure facilities both of which form a considerable part of the operational footprint. Traditionally there has been the need for public intervention to address market failures in these areas. However, with technological and industry advances, is there an alternative method of delivery? This does not mean closing facilities, but modernising that way in which these services are provided.

8. Health and Wellbeing implications

There are no health and wellbeing implications.

9. Financial implications

Through the implementation and evolution of a property strategy which provides greater focus on the income generation and also efficient use of the Council's corporate property portfolio, we can make a substantial contribution to the Councils financial position.

10. Legal implications

- The Corporate Property Strategy will ensure the efficient use of the Council's property assets in line with its fiduciary duty to the Council's taxpayers.

- Westminster City Council is a large property owner and there are a number of powers relating to property acquisitions and disposals which will occur due to efficient use of the Council's resources.

- Therefore before deciding to dispose of property (freehold or leasehold above 7 years) at an undervalue (s.123 Local Government Act 1972) or acquire land (s.120 of the Local Government Act 1972) at above market value, the Council ought to consider whether this would be a prudent course of action bearing in mind the reasonableness test and best value.

- It is a key principle of administrative law that Local Authorities have to exercise their functions in a proper manner and make decisions based on the appropriate criteria and a reasoned consideration of the issues

(Associated Provincial Picture Houses Limited v Wednesbury Corporation (1948), 1 Kings Bench 223).

- Best value under the Local Government Act 1999 introduced the principle that Local Authorities are obliged to "make arrangements to secure continuous improvement in the way in which functions are exercised, having regard to a combination of economy, efficiency and effectiveness (Section 3 LGA 1999). This is a duty which underpins all Local Authorities' activities and functions and the Council must have regard to it in relation to the new Corporate Property Strategy and maximise the use of assets for the benefit of its area and Council taxpayers.

If you have any queries about this Report or wish to inspect any of the Background Papers please contact:
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APPENDICES

Appendix A (Westminster Asset Management Strategy Initial View)

Appendix B (City Hall Update)