Cabinet

10 February 2021

Update on Commercial Headleases

Ordinary Decision

Report of Corporate Management Team

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Electoral division(s) affected:

Countywide

Purpose of the Report

1 To provide an update on commercial headleases previously approved by Cabinet under the council's Property Investment Strategy, which is aimed at stimulating and facilitating inward investment, and creating more and better jobs.

Executive summary

2 The council's investment in property is part of a wider approach to attracting more and better jobs to the county and ensuring the local economy reaches its full potential, whilst also ensuring commercial objectives are fully considered as part of any assessment for investment.

3 Economic regeneration objectives have been at the forefront of all investment decisions taken to date. The investments that have been supported have been seen as strategically important in terms of retaining hundreds of jobs in the county, creating in excess of 1,000 new jobs and identifying new opportunities to bring businesses into the county whilst allowing current county based businesses to grow. At this

time, against the background of the pandemic, this strategy is seen as a vital tool for the council to be able to assist and boost the local economy - stimulating and facilitating inward investment and creating jobs. Without the councils intervention jobs would have been lost and developments would not have proceeded.

4 The council proactively targets a number of options to stimulate development in the county with the objective of delivering growth and jobs . This includes business support, skills programmes and successfully bidding for central government and regionally available grants. Through Business Durham, the council provides access to finance including loans to support new premises.

5 Over the last ten years, many local authorities have sought to offset the impact of austerity and associated funding reductions through additional income generation, including investment in property for revenue return. Some local authorities have actively pursued investment outside of their local authority boundary.

6 Austerity has also had an impact on the help and support that councils are able to utilise in attracting inward investment or retaining jobs in an area. Where local authorities are financially well managed and have a strong balance sheet, they can utilise their strong financial covenant to unlock sites and attract finance to ensure rents are competitive.

7 A number of local authorities have generated significant returns, but also taken significant risks as part of their commercial investment programmes. This is particularly the case where local authorities have invested outside of their geographical boundaries – where investments are made on purely commercial grounds.

8 On an annual basis as part of the budget setting process, Council approves the Property Investment Strategy. The strategy provides a framework for decision making when purchasing freehold interest in property or taking long term headleases over developments to stimulate and facilitate inward investment and create more and better jobs within County Durham.

9 The council’s approach set out in the Property Investment Strategy, is cautious and prudent and does not place a focus on investment purely for financial return, rather aligning the ambition for more and better jobs with proper commercial consideration and due diligence. All investments are required to meet a full and stringent due diligence process, be reported to Cabinet for approval (and transparency), include a robust risk assessment and must be within the county boundary (or at least on the edge and deemed to benefit the county).

They must also be seen to achieve broad economic regeneration objectives wherever possible – principally creating more and better jobs.

10 To date the council has not deemed any freehold purchase opportunities as representing value for money and has not invested in freehold at this stage, although a small number of council freehold properties do generate rental income e.g. Northumbria House and Priory House. Any freehold purchases would be very much for financial return whereas the council's clear focus to date has been upon economic regeneration and seeking a reasonable level of return.

11 Five headlease arrangements have been approved by Cabinet to date, that support both investment and economic objectives for County Durham. Headlease arrangements involve taking a long term lease with an institutional investor (normally a large pension fund) at an agreed rate per sq metre and then seeking to sub-let the space to other occupiers at a rate in excess of what it pays the developer. In these circumstances, the institutional investor has security of a long term commitment from the council and the council carries the risk and reward from sub-letting the space to third parties at a higher rate.

12 The business cases developed in each circumstance provide details of the overall and ft2 rental levels which the council forecasts will be received over the periods of the lease, together with assumptions around rent free periods and other incentives that may be offered and prudent provision for voids. This information is commercially sensitive and Cabinet reports are therefore exempt from publication and considered with the exclusion of the press and public. This is essential in ensuring the council is able to secure the most advantageous terms when the lease is entered into and when any renegotiations take place. All members of the council however have full access to these reports, though they are bound by the confidentiality of its contents and not permitted to disclose information contained within publicly.

13 Each one of the proposals seeks to provide new opportunities to either attract or retain businesses in the County providing buildings which are not available within the market presently or are in short supply. Intervening in the market to fill a gap is seen as essential in maximising opportunities for our residents in securing employment. In all cases without the councils intervention these projects and the benefits of the jobs and local wealth creation that they bring would not have been delivered.

14 It is forecast that the headlease arrangements entered into by the council will create 1,050 new jobs whilst also retaining 750 jobs in Durham City.

15 All of the developments agreed to date were forecast to make the council a financial return over the head lease term (normally 30 – 40 years) and are all still forecast to do so, though this is not the primary aim of these agreements. It is important to understand that these investment arrangements, by their very nature, represent long term commitments and judging any investment at a particular point in time will not provide an accurate picture of either the commercial outcome or the regeneration impact that will be achieved.

16 Naturally there are risks and opportunities across a long term lease period and these were assessed as part of the development of each of the business cases and included in the reports to Cabinet.

17 To date the council has generated a surplus across the properties for which head leases have been agreed, which has enabled a contribution to the MTFP of £0.250 million, as well as providing for additional business rates income and footfall into Durham city.

18 The Milburngate development is expected to create circa 1,000 new jobs, generate additional business rates and council tax revenue, reduce council tax benefit claimants and stimulate further development of the riverside of Durham city. Whilst the pandemic is likely to have a short term impact on the development, the longer term outcomes of the project are expected to provide a financial return for the council.

Recommendations

19 It is recommended that Cabinet:

(a) note the update on the council's commercial headlease investments;

(b) note that any variance from budgeted forecasts will continue to be reported as part of the council's quarterly forecast of outturn reports;

(c) note that the Statement of Accounts provides details on an annual basis of Investment Properties held; and

(d) note that any future property investments will continue to be reported to Cabinet for approval;

Background

20 Over the last ten years in response to unprecedented funding reductions, many local authorities have sought to generate income by investing in property.

21 Durham County Council has taken a considered approach to supporting investments that deliver strong economic outcomes for the community. In doing so the council has proactively worked with inward investors and developers to attract them to the county.

22 A number of local authorities have generated significant returns, but also taken significant commercial risks which has drawn media and government attention, particularly where these investments have been made for commercial gain outside of the local authorities boundary.

23 On an annual basis as part of the budget setting process, Council approves the Property Investment Strategy. The strategy provides a framework for decision making for the council purchasing freehold interest in property or taking long term headleases over developments to stimulate and facilitate inward investment and create more and better jobs within county Durham.

24 In accordance with the council's Property Investment Strategy investment opportunities go through a rigorous due diligence process as part of the development of individual business cases. The due diligence process identifies the risks inherent in the investment and seeks to balance these risks alongside the economic benefits generated and the forecast short term and long term financial impacts on any proposed investment. The councils approach seeks to maximise opportunities in respect of job creation and retention whilst being cautious and prudent from a financial perspective.

25 All investments are reported to Cabinet for approval. The reports include commercially sensitive information on the rental levels either being paid by tenants or forecasts of the levels of income the council will seek to achieve from a particular agreement. This includes assumptions on rent free periods and other incentives, plus prudent provision for void periods. It is not appropriate for this commercial information to be made available in the public domain as doing so would impact on the level of income that can be secured from tenants and would weaken the council's negotiating position. On that basis the reports are treated as exempt from publication and considered with the exclusion of the press and public. All members of the council however have full access to these reports, though they are bound by the confidentiality of its contents and not permitted to disclose information contained within publicly.

26 Cabinet agree that delegated powers are provided to officers in consultation with relevant portfolio holders to finalise commercial arrangements. Once legal arrangements are finalised, construction can begin with the council's headlease payments beginning from practical completion of the development.

27 The five headleases agreed to date are as follows:

(a) Freemans Reach, Durham City – Agreed by Cabinet April 2013;

(b) Freemans Reach, Durham City – Agreed by Cabinet October 2013;

(c) Drum Industrial Estate, Chester-le-Street – Agreed by Cabinet May 2018;

(d) Milburngate Riverside Development, Durham City – Agreed by Cabinet June 2018;

(e) Station Place, Newton Aycliffe – Agreed by Cabinet September 2019;

28 If expenditure levels or income levels vary significantly from budget this will be detailed in the quarterly forecast of outturn reports to Cabinet and in service forecast of outturn reports to Overview and Scrutiny Committees.

Property Investment Strategy

29 The council's current Property Investment Strategy was approved by Council in February 2020 and is attached at Appendix 2. The strategy is primarily aimed at stimulating and facilitating inward investment and creating more and better jobs forming part of a wider approach to support the economy.

30 Many authorities have sought to generate additional income wherever possible to protect front line services. Individual authorities have approached investment in property in many ways. A small number have taken significant financial risks in terms of freehold purchases, often outside of their authority boundaries. These types of investments have generated substantial interest from the media and from government due to the size of the commitments.

31 The council's approach has been much more measured and prudent. By initially focusing on property or sites which have the potential to create significant economic advantage or assist in the creation of new

businesses, the main priority for the council is not therefore on high return / high risk markets. The Property Investment Strategy is underpinned by a clear governance framework in which decisions are made. Two clear objectives within the strategy being that any investment must be within the county boundary or close enough to have a benefit to the county; and that there should be broader economic benefits wherever possible (inward investment and the creation of more and better jobs).

32 In assessing the viability of a development option and assessing the inherent risks and benefits, a broad range of issues are required to be considered, as detailed in the Property Investment Strategy. The following are examples of issues that must be considered in making any property investment:

(a) **Location** - the priority of the strategy is to invest in the geographical and administrative boundary of County Durham as this meets the councils key economic regeneration objectives and minimises risk to the Council, in addition to providing wider benefits to the County's economy. This could also include investment opportunities that sit on the periphery of the County boundary, where it is proven that they meet the key councils key objectives;

(b) **Economic Development** - Opportunities in relation to economic development require careful consideration for any investment, in order to understand the wider benefits to the County. This takes into account relevant factors, including but not limited to inward investment potential, job retention, new job creation and the quality of jobs created;

(c) **Tenure** - The acquisition of head leases will be considered and fully appraised, although freehold opportunities will also be considered, should appropriate opportunities arise. The strategy prioritises the opportunities for return on investment balancing commercial risk and regeneration benefits against commercial risk.

(d) **Occupier Lease Length** - The length of lease agreements is a key consideration for any investment decision and the Council will carefully consider the risks associated with potential void levels and the ability to attract good quality tenants at appropriate rental levels. Shorter lease lengths and break clauses further compound this, although this should be reflected in the rental level received.

(e) **Rental Income** - Rental income will be considered alongside lease length and covenant strength as part of the appraisal. This

will need to take into account cost of voids, rental levels, rent reviews and break clauses.

(f) **Yield/Return -** Yield will be considered as part of the initial appraisal and will be directly impacted by a number of the other appraisal criteria. This will inform the return anticipated on the investment, which would need to be considered acceptable in order to progress further

33 All of these issues are carefully considered and balanced as part of the due diligence process prior to any deal being taken forward. For transparency, the business case underpinning any investment is reported to Cabinet where the scheme is deemed to be viable and where it meets the objectives and criteria within the Property Investment Strategy. These business cases include long term financial forecasts which are based upon a range of prudent assumptions. At the same time risks are identified which can impact upon financial returns over the term of any lease arrangement.

Current Position

34 The four headlease arrangements detailed in this report expected to be in place within the next two years are forecast to have an initial annual cost to the council of circa £5.4 million. This cost will be offset by rental income from tenants with the council gaining from any surplus income and bearing the risk of any shortfall over the length of the relevant leases. At the end of the headlease periods, the council has the option to purchase the assets for a nominal sum of £1.

35 The scale of these commercial investments is prudent when considered alongside the gross expenditure budget of the council of circa £1.1 billion and bearing in mind the expectation that these investments are anticipated to generate new jobs and income for the council (rental income plus additional business rates and council tax income) over their lease terms.

36 If over time expenditure or income levels vary from estimates, then this will be reported into forecast of outturn reports to Cabinet and Overview and Scrutiny.

37 The council is required to publish in the Statement of Accounts the rental income generated from investment properties and any movement in the fair value of the council's investment properties. These disclosures are subject to external audit review on an annual basis, alongside their assessment of the Councils arrangements for securing value for money and its overall corporate and financial governance arrangements.

Development Updates

38 Freehold purchases tend not to provide new job opportunities but come with a ‘sitting tenant’. To date the council has not deemed any freehold purchase opportunities as providing strong regeneration benefits nor providing value for money and none have therefore been entered into. A small number of the Council’s freehold properties are rented out to generate rental income e.g. Northumbria House and Priory House. This has created new office accommodation in Durham city, of which there is a shortage, and enabled both Northumbrian Water and Watersons to base significant numbers of staff based in the County. Any freehold purchases would be primarily for financial return whereas the council’s clear focus has been upon economic regeneration in addition to a forecast reasonable level of return.

39 Five leasehold developments have been reported to and agreed by Cabinet for the council to take on long term headlease arrangements. An update is provided below on the current position on each of these developments.

Freemans Reach

40 Cabinet received reports in April 2013 and October 2013 in relation to the opportunity to take a 35 year headlease on two new office developments on the riverside in Durham City at Freemans Reach – located on the former ice rink site. Both National Savings and the Passport Office were seeking to relocate from their current outdated buildings which were then to be demolished and redeveloped.

41 The council has a 35 year lease on the development whilst the lease length for the National Savings (start date January 2015) and Passport Office (start date March 2016) is 15 years. The reports to Cabinet referenced the risks associated with the tenant rents being for 15 years, recognising that there was a risk that both organisations could choose at the end of the lease to end their tenancy and move elsewhere.

42 It was recognised at that point however that both organisations had a long history in the city with a secure workforce. It was considered that there was a strong likelihood of continuance of the tenancy beyond the initial 15 years. At the same time, it was recognised that if tenancies did end then new tenants would need to be sought.

43 In terms of financial performance of the tenancies since 2015 the council is forecasting a surplus has been achieved of over £1 million.

44 When the council entered into these headlease arrangements it was recognised that the tenants were ‘blue chip’ in terms of security of

payment. This security provided the confidence of including the forecast annual surplus income as a saving in the MTFP.

45 The initial 15 year lease with National Savings ends in 2030. By that point the council will have accumulated a healthy surplus which can offset risks faced over the remaining period of the lease. The main priority at that point will be to seek to retain the organisation in Durham whilst seeking to continue to generate a reasonable level of rental payment.

46 In addition to rental income the council has benefited from 49% of the business rates generated from the two developments. The business rates could have been lost to the city along with the 750 jobs if both organisations had chosen to move away from Durham. Since the developments were built the council has retained business rates of £1.6 million from these developments.

Drum Industrial Estate

47 Cabinet approved a report in May 2018 to take a 30 year headlease on an industrial unit development at Drum Industrial Estate, Chester-le-Street. A proportion of the unit was to be pre let on an expected ten year let with proportion developed speculatively. It was forecast that the development would create 50 new jobs.

48 This was the first time the council had sought to intervene into the market to stimulate and develop industrial space. It was identified that the county urgently required improvement in modern industrial space to attract and retain jobs in the area. Unfortunately, rental levels have been at levels that have not incentivised developers to invest to date as the returns are considered too low by the market.

49 The council becoming involved in the development however ensured that the strength of the council financial covenant could ensure that funding could be secured at lower interest rate levels than the private sector could secure.

50 This development at this stage has not progressed as the prospective tenant for the pre let wished to delay making a decision on expansion until there was clarity on the outcome of Brexit. There is still a possibility therefore than this scheme could progress once the terms of post EU exit Trade Deal are understood and assessed by the market.

Milburngate Riverside Development

51 Cabinet approved a recommendation in June 2018 for the council to take a 35 year headlease over the redevelopment of the former National Savings and Passport Office site in Durham City. The demolition costs

for the site were significant and it was looking highly unlikely that a viable development could be achieved on site due to the costs associated without the councils intervention. The strength of the council covenant however enabled development funding to be accessed at much lower interest levels than the private sector could otherwise have achieved, resulting in the development meeting viability thresholds.

52 This site is strategically important and fundamental to the continuing drive to attract more and jobs to the county and to the continued regeneration of Durham city. The riverside site is a pivotal site within the city and a derelict site in the centre of the city would have been a terrible outcome for the county and potentially impact of the longer-term ambitions of the Council in terms of the redevelopment of the Aykley Heads site.

53 The ambitious development of the site was to contain the following:

(a) Hotel – 92 beds;

(b) Cinema – 12,203 sq ft lettable;

(c) Leisure – 46,061 sq ft lettable (12 units);

(d) Private Residential Rental – 153 units;

(e) Office – 59,406 sq ft lettable; and

(f) Car Park – 323 Spaces.

54 It was forecast that the development would create over 600 short term jobs in terms of construction but most importantly an estimated 1,000 permanent new jobs once fully developed.

55 From a financial viewpoint a comprehensive long term financial plan was developed which detailed forecast income flows over 35 years building in prudent levels of starting rent, annual rent uplifts and expected void levels over all elements of the development.

56 The June 2018 Cabinet report forecast a surplus for the council over 35 years. In addition, the development was forecast to generate retained business rates and additional council tax for the council of circa £1 million per annum.

57 At that time, it was agreed that delegated authority be provided to the relevant Corporate Directors in consultation with relevant Portfolio Holders to finalise the commercial arrangements once a funder had been secured and the costs of construction were finalised.

58 The June 2018 Cabinet report fully detailed the risks associated with the development and the assumptions made in developing the financial business case. Also included in the report was a forecast of best and worst case scenarios.

59 The commercial scenario modelling did not take into account income estimated to be generated from business rates and council tax over the 35 years - which were expected to exceed £35 million.

60 In December 2018 a delegated decision was made to sign the legal agreements to take the headlease over this important development. The forecast financial return had been reduced due in the main to increases in the forecast construction cost. The net annual return to the council is forecast to be stronger in the earlier years of the lease period as it is forecast that the council lease payment will inflate at a higher reate than the council rental income is forecast to inflate across the life of the agreement.

61 Practical completion for the building is expected to be March 2022 Unsurprisingly, against the background of the pandemic, demand for tenancies has been slow to date but this is to be expected at this time. It is expected that demand for tenancies will increase over this year, especially as the vaccine is rolled out and the economy starts to recover.

62 It is recognised however that the prudent income levels forecast for the development may not be fully achievable - in the short term. It is expected that lower rental levels than originally forecast will need to be accepted in the short term to ensure that the development can thrive over the longer term. It is currently anticipated that short term tenancies are likely to be agreed initially although the final poisiton will not be known until negotiations conclude.

63 Updated modelling based on a more pessimistic scenario in terms of occupancy and rental levels achieved still forecast that the development will deliver a surplus in terms of rental yields.

64 Again, it is important to note that this forecast does not include annual forecast income of £1 million from retained business rates and from council tax and does not consider the significant regenerational benefits from the development, especially the creation of 1,000 additional jobs.

Station Place

65 Cabinet approved a report in September 2019 to take on a headlease on an industrial development which was expected to retain or secure 130 jobs.

66 The development is adjacent to the Hitachi factory in Newton Aycliffe and is another example of where rental levels for industrial units are too low for speculative private sector development, limiting the number of new developments coming to the market and resulting in an aging infrastructure for vital growing businesses. The strength of the council financial covenant and its intervention allows this impasse to be resolved.

67 Since approval was given, discussions have been ongoing with the developer of the site. At this stage construction tenders have been finalised and funding is secured. The terms of the funding were not as low as was originally forecast in the September 2019 Cabinet report resulting in an small increase increase in forecast annual council rental of £10k per annum. There is significant interest in the site and as such this has given confidence that this increase in rent can be accommodated.

68 Based upon the revised funding and income forecasts there is a reasonable level of surplus forecast over the headlease period. In addition, it is forecast that there will be circa £40k of retained business rates from the development and this is not included in the surplus forecasts.

69 It is expected that construction will begin development of the site in spring 2021, with practical completion expected in early 2022.

Summary

70 The council's exposure to headlease payments from investment properties is limited compared to many other authorities at circa £5.4 million from 2022/23. This exposure should be considered in the context of the council's gross expenditure budget of £1.1 billion per annum and the fact that there are additional business rates and council tax revenues forecast of over £1 million per annum from these developments. Updated modelling shows that all headleases entered into to date are forecast to return a surplus over the life of the agreements.

71 All investment decisions taken to date have been underpinned by a clear governance framework. Two clear objectives are set out with the council's Property Investment Strategy: any investment must be either within the county boundary or close enough to have a benefit to the county; and that there should be broader economic benefits wherever possible (inward investment and the creation of more and better jobs)

72 It is important that the council continues to robustly stress test all prospective developments. It is also vital that the council does not

overexpose itself to any particular sector whilst also seeking to maximise the financial return for the council against the targets set.

73 Once budgets are introduced for each project, monitoring of financial performance will be via Cabinet quarterly forecast of outturn reports and via service specific reports to Scrutiny. If income levels do not meet expected levels, this will need to be considered and reported as part of development of future MTFP's

74 In addition, the council is required to publish in the Statement of Accounts a list of all investment properties and the income generated.

75 The largest risk faced by the council at this time relates to the Milburngate Riverside development, which will not reach practical completion until March 2022. The securing of tenants for this development will be monitored closely.

76 The council's intervention has not only secured the retention of 750 jobs within Durham City and created a net surplus in terms of income and business rates, it has created an environment and market in which it is seen as a proactive council that supports businesses and has prepared the ground work for future regeneration and investment in the form of other developments now taking place including Milburngate phase 2 and the new office development at Sidegate. The alternative would be for the city and indeed in the council having to deal with a derelict 1960's office block in the heart of the world heritage city along with the stigma of losing public sector office jobs due to a lack of any suitable office market in the county. Future developments at Newton Aycliffe and Drum Industrial estate will see more opportunities created throughout the council as the strategy develops more job creation moving forward.

Other useful documents

- Cabinet – April/October 2013 – Freemans Reach Headlease
- Cabinet – May 2018 – Drum Industrial Estate headlease
- Cabinet – June 2018 – Milburngate Headlease
- Cabinet – September 2019 – Station Place Headlease

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Appendix 1: Implications

Legal Implications

The council has entered into a small number of long term headleases for a limited number of sites across the county. All headlease arrangements are carefully considered and subject to appropriate due diligence and risk analysis before being entered into.

Finance

The report provides an update on the financial performance of current headlease arrangements and an update upon headleases where developments are progressing. The report details a deterioration on the forecast return in the Milburngate development resulting from the impact of the pandemic upon demand for and income from rental, but confirms that based on a more pessimistic set of assumptions the development is still forecast to return a surplus over the life of the agreement.

The council's exposure to headlease payments from investment properties is limited compared to many other authorities at circa £5.4 million from 2022/23.

This exposure should be considered in the context of the council's gross expenditure budget of £1.1 billion per annum and the fact that there are additional business rates and council tax revenues forecast of over £1 million per annum from these developments.

Updated modelling shows that all headleases entered into to date are forecast to return a rental surplus over the life of the agreements.

Consultation

None.

Equality and Diversity / Public Sector Equality Duty

None.

Climate Change

None.

Human Rights

None.

Crime and Disorder

None.

Staffing

None.

Accommodation

None.

Risk

Each business case developed details the inherent risks and includes prudent assumptions on rental levels, void assumptions etc. The reports often also detail worst and best case scenarios.

Procurement

None.

Appendix 2: Property Investment Strategy

Purpose

1 The purpose of the Property Investment Strategy is to set out the Council's objectives relating to investing in property. It identifies the benefits, risks and approach to acquiring property in order to support the Council's priorities.

Definition of an Investment Property

2 This strategy defines an investment property as "an asset acquired by the Council for the purposes of income generation and profit creation", in line with the definition in the Statutory Guidance issued under Section 15(1)(a) of the Local Government Act 2003. Through the acquisition there may be secondary benefits achieved, such as new jobs created or existing jobs safeguarded. However, the primary purpose of the acquisition as an investment will be to provide a source of income to the Council.

Introduction

3 Over the past five years local authority investment within the commercial property market has grown, due to the return on investment opportunities presented by this market segment. As a result of the changing nature of budgets in local government, the Council is looking towards this market to support its overall priorities.

4 To ensure that investment decisions fit with the Council's requirements, this strategy has been prepared to set out the investment framework and policy to apply to the acquisition of commercial property investments. This will ensure that any opportunities considered are evaluated against agreed criteria and the risks and returns associated with these investments are fully appraised.

4 The overall aim of the strategy is to create a framework that ensures that all relevant issues are considered when the Council analyses a property investment opportunity. The Council will need to balance commercial risks against the opportunity to delivering term, sustainable revenue streams for the Council, together with potential for capital growth from investments. Investments could also help to generate economic growth and secure or protect jobs. The objectives of this strategy will ensure acquisition, management and returns relating to

investments made continue to deliver against the Council's priorities throughout their lifespan.

6 Set against key objectives the strategy will not only cover the income opportunities for the Council, but also the wider regeneration benefits that will be delivered, particularly in relation to acquisitions within the County boundary.

Objectives

7 The key objectives of the Property Investment Strategy are to acquire property that achieves the following:

(a) delivers a sustainable revenue stream;

(b) contributes towards a balanced investment portfolio;

(c) protects existing capital value or delivers capital growth opportunities, as the market dictates;

(d) maximises income within the agreed acceptable risk levels.

Investment Proposal

8 The Council have already taken opportunities to invest in property located within the County, where this decision has met the wider council objectives. This consists of surplus freehold Council properties, that have been converted to successful commercial lets and leasehold properties sublet for income generation and to support regeneration.

9 Examples include the surplus Priory House now leased to Northumbria Water and the Council taking the head lease at Freemans Reach to support the retention of civil service jobs in Durham. Investment properties are defined separately for accounting purposes and will be identified as such within the asset register. Annex 1 provides a list of current properties held by the Council for investment purposes, which provide a rental income of approximately £390,000 per annum. This level of income is comparably small when compared with council gross expenditure of almost £900 million.

10 This strategy forms the next stage in expanding investment opportunities into the wider commercial market. The Council proposes to acquire investment interests in property, including the acquisition of head leases benefitting from the security of tenure the Council covenant can provide to investment institutions and developers. However

freehold opportunities are not to be discounted at this stage, to provide the Council with flexibility should appropriate opportunities arise.

Investment Criteria

11 In order to assess whether an investment meets the objectives set out in the strategy, clear criteria have been established that forms the basis of an initial appraisal. These are set out in Table 1 below:

Table 1 - Investment Criteria

A. Location	The priority of the strategy is to invest in the geographical and administrative boundary of County Durham as this meets the key objectives and minimises risk to the Council, in addition to providing wider benefits to the County's economy. This could also include investment opportunities that sit on the periphery of the County boundary, where it is proven that they meet the key objectives.
B. Economic Development	Opportunities in relation to economic development require consideration for any investment, in order to understand the wider benefits to the County. This should take into account relevant factors, including but not limited to inward investment potential, job creation and the quality of jobs created.
C. Sector	The consideration of sectors will be specific to each investment opportunity and will need to be appraised as such. Market performance, growth, alignment with key partners and supply and demand within sectors will need to be considered in terms of location within County Durham. To ensure an appropriate risk profile is achieved investments should be cross sector to enable diversification of risk and a spread across sectors. This will prevent over exposure in specific sectors.
D. Tenure	The acquisition of head leases will be considered and fully appraised, although freehold opportunities will also be considered, should appropriate opportunities arise. The strategy will prioritise the opportunities for return on investment balancing commercial risk and regeneration benefits against commercial risk.

E. Tenant Performance	Head lease and freehold options would result in the Council subletting in order to raise income. The initial appraisal will need to review the quality of tenants and the ability to observe rental commitments. This tenant risk profiling exercise is essential as it directly affects the risk profile of the investment. Full legal and financial due diligence will be required as part of the appraisal process. In addition, the activities undertaken by the tenant will need to be reviewed by the Council to ensure they are considered appropriate for public investment.
F. Occupier's Lease Length	The length of lease agreements is a key consideration for any investment decision and the Council will need to consider the risks associated with potential void levels and the ability to attract good quality tenants at appropriate rental levels. Shorter lease lengths and break clauses further compound this, although this should be reflected in the rental level received. In terms of risk profile the principle of the longer the lease the more secure the investment applies. However, this should consider break options that may exist in the agreement, alongside the financial status of the tenant.
G. Rental Income	Rental income will be considered alongside lease length and covenant strength as part of the appraisal. This will need to take into account cost of voids, rental levels, rent reviews and break clauses.
H. Building Quality	Consideration of the building age and specification is a deciding factor in any investment as it can determine the lifespan, condition and capital expenditure levels required to ensure it remains available for let. An initial appraisal of this will be completed to consider the quality of the building against the proposed length of the Council's tenure. In addition, any acquisition of new build will need to consider the track record of the developer and main contractor, together with the security of warranties and contractual arrangements.

I. Repairing Obligations	Leases in the market can vary in terms of the repairing responsibilities that the landlord retains. In terms of initial appraisal, lease terms that transfer the repairing obligation to the tenant are more favourable, than those that require the landlord take more responsibility.
J. Yield / Return	Yield will be considered as part of the initial appraisal and will be directly impacted by a number of the other appraisal criteria. This will inform the return anticipated on the investment, which would need to be considered acceptable in order to progress further.

Governance Arrangements

12 All investment opportunities will need to be subject to an initial appraisal. The initial appraisal will be carried out at officer level and if considered appropriate will be then progress to a full business case. The business case will set out the detailed due diligence work, risk assessment and confirm that the investment meets the key objectives in order to establish the suitability of the investment. In some cases, the appointment of an external investment advisers may be required, where additional advice is necessary.

13 The completed full business case will need to be submitted to the Market Opportunities Board for approval. The current constitution requires that decisions on investment will then need to go to Cabinet for approval. However due to the fast paced nature of the investment process delegated powers may need to be utilised on occasion with full consultation with Portfolio Holders. All acquisitions will be subject to a building survey, valuation and completed business case.

Management Arrangements

14 All investment properties held by the Council will be subject to appropriate management, monitoring and review throughout the financial year. This will include an annual review of performance, of individual investments and the portfolio as a whole. Active management of the portfolio on a day to day basis will be undertaken by the council's Corporate Property and Land and Finance Teams, in line with the proposed Corporate Landlord model.

15. If an investment is considered to be underperforming, or no longer meets the key objectives then an exit strategy will be prepared.

Annex 1 – Existing Investment Properties

UPRN	Asset Name	Acquired by DCC	DCC Tenure
50621S01	Durham Wearside House (National Savings)	28/01/15	Leasehold
50658S01	Durham Freemans Reach (Passport Office)	18/03/16	Leasehold
50659S01	Durham Freemans Reach Kiosk	18/03/16	Leasehold
50660S01	Durham Freemans Reach Hydro-Turbine	28/01/15	Leasehold
3372S01	Northumbria House, Aykley Heads, Durham	Transferred to investment 01/11/14	Freehold
3230S01	Priory House, Pity Me, Durham	Transferred to investment 04/07/16	Freehold