

SUBJECT:	INVESTMENT COMMITTEE PERFORMANCE REVIEW
MEETING:	AUDIT COMMITTEE
DATE:	19TH MARCH 2020
DIVISION/WARDS AFFECTED:	ALL

1. PURPOSE:

- 1.1 To present the first performance review of the Investment Committee for consideration and in accordance with the requirements of the Asset Investment Policy.

2. RECOMMENDATIONS:

- 2.1 For the Audit Committee to consider and scrutinise the first performance review of the Investment Committee.
- 2.2 To consider the proposals for improvement outlined in the report and resulting from audit work undertaken and a review of the current Asset Investment policy and the governance arrangements and controls currently in place to oversee investment activity considered by the Investment Committee.
- 2.3 To receive a verbal update at the meeting following consideration of the Performance Review by the Investment Committee at its meeting on 18th March 2020.
- 2.4 For Audit Committee members to determine any further recommendations for improvement.

3. KEY ISSUES:

Background

- 3.1 In May 2018 Council approved a revised Asset Management Strategy. The strategy had been updated in order to provide strategic direction aligned to and reflecting priorities outlined in the Corporate Plan, and which included the need for a more commercial approach to the management, sale and development of assets.
- 3.2 The Strategy outlined a set of key themes which included a targeted approach to commercialisation. This included the adoption of an Asset Investment Policy, delivery of the County Farms strategy, optimizing returns from our existing investment properties, maximizing capital receipts and exploring other commercial opportunities.

- 3.3 The Strategy contained a new policy for the acquisition of investment assets (see appendix 3). This policy positioned the Council in a commercial context providing the framework for the acquisition of income generating assets.
- 3.4 The purpose of the policy was to help sustain Council Services and enhance the asset base by enabling a framework that allowed investment in commercial property assets in order to increase the net rental income stream for the Council and to secure potential further capital growth opportunities.
- 3.5 The Council's Corporate Plan identifies five priorities, of which one concerns the Council being "future focused". One of the key measures for this is income generation from commercial investments. This policy provides the framework for the evaluation of potential commercial property investments.
- 3.6 The intention of the Authority's investment approach is to actively seek out investment opportunities within the County of Monmouthshire, City Deal geographical boundary and neighbouring areas of economic influence which will support our economic and regeneration priorities. In order to manage and spread the risk we also look to identify investment options beyond our county boundaries that meet our criteria. The intention therefore is to work towards an investment portfolio that allows for a diversification of risk.
- 3.7 Investments are judged by SLY principles that look at security, liquidity and yield and a wider set of investment and financial criteria as outlined in the policy. Risks and appropriate mitigations are appropriately assessed against potential return and wider benefits identified.
- 3.8 Acquisitions are funded through prudential borrowing with a £50,000,000 fund originally put in place to fund acquisitions and investments over a three year period. The cost of the debt is funded from the rental streams derived from the property, with a requirement that it will provide a net surplus over and above borrowing costs.
- 3.9 An Investment Committee was established which is made up of the Council Leader, Deputy Leader, Cabinet Member for Resources and the Leaders of the two largest opposition parties (political balance 3:1:1). The Committee is advised by the Resources Chief Officer and Officers from Finance, Estates and Legal Services. The Investment Committee has delegated authority to make investment decisions utilising the £50,000,000 allocated borrowing.
- 3.10 When considering acquisitions and investments expert advisors are procured to assist with due diligence and for the development of business cases that are subsequently brought to Investment Committee for consideration. This supplements expertise and capacity within the Authority.
- 3.11 In July 2018 the Asset Investment Policy was supported and complemented by the Commercial Strategy being approved by Cabinet. The Commercial Strategy reinforced as one of its key pillars the development of an approach to commercialising assets.

3.12 In February 2019 the definition of a commercial investment was extended beyond land and building acquisitions to include:

- Commercial loan facilities
- To build or renovate investment portfolio holdings
- An equity or debenture interest

And in order to provide suitable flexibility that allowed the Investment Committee to consider opportunities that met their investment definitions.

The Asset Investment Policy

3.13 The Asset Investment Policy provides a framework for the acquisition of investment opportunities that derive a net return to the Council, provides the governance and delegated authority arrangements and establishes the necessary investment and financial criteria to be met. Investments can not only look to generate net returns to benefit the Council and its communities but also facilitate economic development or regeneration or wider policy objectives of the Council.

3.14 Individual acquisitions or investments must meet financial criteria laid out in the policy, otherwise the decision must be approved by Cabinet rather than the Investment Committee. The target income return is for returns to exceed borrowing costs by at least 2%, though a lower return can be adopted where investment brings economic growth to Monmouthshire. A target total return of at least 7% must also be achieved.

3.15 Investment criteria are also laid out to assess investments and the wider investment portfolio. These includes matters such as strength and security of income, income and capital growth, identifiable risks etc. All acquisitions are subject to a business case or an investment proposal alongside which due diligence is undertaken and that considers both the financial and investment criteria.

3.16 As with all investments there are associated risks. In terms of the income generated from them and their market value. Furthermore the ability to dispose of an asset or recover investments against security held. Commercial property investments require ongoing management to ensure that the capital value is protected and income streams are optimised. Business cases submitted to Investment Committee take into full consideration these risks and outline the extent and level of mitigation in place.

3.17 The Investment Committee takes the decisions on any acquisition or investment on the basis of business cases received and ensuring that they meet the requirements and criteria laid out in the Asset Investment Policy. The Committee is responsible for reviewing the performance of the Investment Portfolio and for reporting this to Audit Committee.

The need for an Annual Performance Review

3.18 One key aspect of the Asset Investment Policy and the review principles contained therein is the requirement for an annual performance review to be undertaken of the Investment

Committee and the investment activity undertaken during that period. The purpose of the review is to ascertain performance against the following criteria:

- Governance arrangements and adherence to policy
- Relevant Market indexes
- Property performance locally
- Capital, Income and Total returns

3.19 This performance review refers solely to property acquisitions and investments that have been considered and/or made during since the Investment Committee was constituted and first met in June 2018. The review covers the period up to and including the end of February 2020. The review does not consider any other investment properties and assets such as the solar farm, the cattle market in Raglan, industrial property holdings or Innovation House.

Investment activity to date

- 3.20 In practice the volume of suitable proposals considered by investment Committee has remained fairly restricted, because realistic opportunities are limited when compared against a test of suitability and risk appetite. Furthermore a number of Investment Committee meetings have had to be cancelled or postponed as a result of proposals not being sufficiently developed for consideration. Which is the nature of commercial activity and where third party negotiation and agreement is involved.
- 3.21 To date the Investment Committee has prudently only taken forward two investments being the acquisitions of Castlegate Business Park in June 2018 for £8m and Newport Leisure Park in February 2019 for £22m as they derived a sufficient return after repaying borrowing costs. In terms of the acquisition of Newport Leisure Park and as a result of the investment exceeding the financial criteria in that the investment represented more than 20% of the total £50m fund value, the decision was referred on to Cabinet who subsequently made the decision to acquire.
- 3.22 The investment in Castlegate Business Park, whilst deriving a sufficient return after repaying borrowing costs, also recognised the Council's intent to support economic development in Monmouthshire. The investment in Newport Leisure Park, an out of County investment again derived sufficient return but also afforded a level diversification of risk due to the differing industry sector focus.
- 3.23 Both of these investments are actively managed and monitored by the Council's Estates Development team in conjunction with support from Alder King as advisors and acting agents with necessary support from both finance and legal officers. Investment performance is reported as part of the Council's periodic budget monitoring arrangements.
- 3.24 No exit strategies have had to be considered or recommended to the Investment Committee. The carrying value of the investments, Land Transaction Tax and fees aside, remains in line with the original capital cost of acquisition. In terms of mitigation strategies Castlegate Business Park has seen occupancy drop from 95% since acquisition to 88%. Mitigation steps are being taken and vacant units are being actively marketed.

Furthermore, the cessation of a lease and relocation of a theatre group will provide an opportunity to remodel and re-let commercial space.

- 3.25 Both investments continue to generate positive returns to the Council. Further information is provided in the resource implications and against the financial and investment criteria in place.
- 3.26 Beyond the investment acquisitions the Investment Committee has also approved for due diligence to be undertaken on a number of other investment opportunities. These are currently in train and will be considered by the Investment Committee in due course and if the necessary investment and financial criteria are met and officers make subsequent recommendation to the Committee. A number of investments have also had due diligence undertaken and have not subsequently come forward to Investment Committee.
- 3.27 The Authority continues to actively source, pursue and consider potential investment opportunities. Future opportunities may potentially arise from the Authority's interest in housing or commercial development and that looks to support the delivery of Council's Local Development Plan, Economic Ambition Statement and Inward Investment Prospectus. As well as in meeting other policy objectives such as to aid delivery of the Digital Infrastructure Plan.

The Wider National Context

- 3.28 It is worth mentioning the wider national context at this stage and in providing an objective review of commercial investment activity across Local Government in the UK. Local Authorities investing in commercial property investment has attracted a lot of interest in the media over recent years and driven by a sharp rise in local authorities borrowing for commercial purposes and to supplement their revenue budgets with rental income. But particularly a small number of authorities who have invested significantly and relative to the assets and income of the Council. The most reported of these being Spelthorne Borough Council who bought BP's Head Office for a sum reported between £360-£380m.
- 3.29 The rise in commercial activity of Councils has also prompted CIPFA to issue property investment guidance to local authorities. The guidance reinforces the legal and regulatory framework that Councils operate within and the need to have regard to the Prudential and Treasury Management Codes. And where decisions are seen to be prudent, affordable and sustainable. Furthermore, the guidance highlights the need for the risks of investments to be understood and suitably mitigated or managed. The Council has had regard to this guidance and the principles therein in putting the necessary policy framework and governance arrangements in place with its commercial investment activity,
- 3.30 The Welsh Government (WG) published revised Investment Guidance in November 2019 which placed additional reporting requirements upon local authorities. The guidance also covers investments that are not part of treasury management, for example commercial investments including property and loans and other investments in local organisations. The Treasury Policy and Strategy approved by Council in March had regard to these additional requirements and the relevant extracts, including the prudential indicators are included in appendix D.

- 3.31 UK Government has also taken a direct interest. The Public Accounts Committee took an interest when assessing the financial sustainability of local authorities in 2016. And a briefing paper was produced for the House of Commons in September 2019 on local government commercial property investment.
- 3.32 A February 2020 report by the National Audit Office found councils spent £6.6bn on commercial property from 2016-17 to 2018-19 – 14.4 times more than in the preceding three years, and mostly financed by borrowing.
- 3.33 Most recently and resulting from the UK Government's budget announcement by the Chancellor consideration is being given to curb local authorities being able to use PWLB borrowing as a means to invest in commercial activity/property for purely commercial gain. So for investment assets that are solely for yield and with no direct policy purpose. This announcement came after PWLB introduced a surprise 1% hike in rates in October 2019. It is as yet unclear as to how UK Treasury will both consult and introduce measures and this will continue to be closely monitored and any potential implications will be assessed in the interim. It is seen that this potential action by UK Government is unfortunately driven by the commercial activities and behaviours of a few local authorities.

Audit Coverage

- 3.34 As part of the Internal Audit plan for 2019-20 a review of Investment Property Acquisitions was undertaken and in line with the risk based internal audit approach of the Council. This review was welcomed and looked to provide an independent assessment of the control environment within which acquisitions took place and are managed. The final audit report is provided in appendix 1.
- 3.35 The process for investment property acquisitions was assessed as providing 'Reasonable Assurance'. 18 strengths were identified during the course of the audit. There were however two significant weaknesses identified relating to: (i) the tender and award of the contracts to Alder King as advisors and managing agents; and (ii) a decision made at Investment Committee on 6th March 2019 being seen as inquorate. A further nine moderate risks and four minor risks were identified.
- 3.36 Management responses have been provided and management action is being promptly taken to address the recommendations made and to continue to strengthen the arrangements in place. A number of the recommendations made were not agreed or partly agreed and management responses and justifications are provided in appendix 1.
- 3.37 Further to the work of internal audit WAO have been undertaking two separate reviews:
- a) The first of these is a study into commercialisation in local government. This aims to ensure that new commercial activities are strategically led, risks considered and appropriately scrutinised and regardless of what form they take.

The study has been undertaken by looking at five local authorities in Wales who have or are developing approaches to growing commercial activity. It looks to determine

whether Councils have established effective systems to consider and approve whether they pursue new commercial activity. The study focuses on long-term approaches to financial sustainability and how commercial activity supports organisations to deliver wider wellbeing objectives and corporate priorities. This study does not focus on the commercial acquisitions made by the Council.

The study is a National Review and will lead to a national report that will outline good practice and self-evaluation tools and that draws on evidence and research. Findings from local evaluation will be shared with the Council in a form yet to be prescribed. Fieldwork was undertaken by WAO earlier in the year and the Authority has contributed in providing information and undertaking interviews to support the study. The national report and local feedback is yet to be received.

- b) The second WAO review is the financial sustainability assessment which represents a new programme of work that is proposed to be undertaken annually going forward for each local authority in Wales. The Council produced a self-assessment and relevant members and officers were subsequently interviewed. The Authority has just received the first draft of the local report and assessment for 2019-20 and will now comment on the findings and conclusions drawn. In terms of commercial activity, a single draft recommendation is made that in pursuing its commercial strategy that the Council should ensure that it manages the associated risks of any additional borrowing. A national report will also be produced and published.

Risk Management

3.38 Whilst each investment will have its own unique characteristics and associated risks, as is the case with any investment, the key risks associated with commercial and property investment and where the Council is drawing on borrowing to fund such commercial activity are:

- That all decisions to incur expenditure and to borrow are backed by effective legal powers and a resultant risk if decisions made subsequently become invalidated by changes in statutory provisions or developments in case law.
- The authority's returns are at risk, while, once incurred, borrowing costs are unavoidable. A reduction in returns could put pressure on the authority's revenue account
- Capital gains are at risk and in relation to the fair value of the property on the balance sheet, for example, where the commercial property fair value is less than the value of the debt liability.
- A risk of proportionality in terms of extent that the authority's revenue budget is reliant on income from commercial investments.
- A lack of expertise with council staff and those undertaking review and making decisions leading to poor acquisition decisions.

- A downturn in the property market or the market within which an investment is made.
- 3.39 Separate Legal counsel advice has been received and that confirmed that the Council can operate within existing legal powers and guidance and in making the commercial investments as intended. Legal advice is sought separately for each commercial investment being considered.
- 3.40 Business cases that are developed and considered by Investment Committee undertake a full and proper assessment of risk and associated risk management and mitigation strategies. Business cases are supported by detailed commercial, financial and legal due diligence with external advisors appointed as required to supplement the experienced staff in Estates, Finance and Legal.
- 3.41 Proposals presented to Investment Committee seek to describe the opportunity being considered from the perspective of the cashflows anticipated, and net returns quantified, any qualitative benefits evaluated, reasonableness of assumptions made, any risks/volatility anticipated against those assumptions, and provides the risk mitigation action proposed should those risks crystallise. There is a skewed emphasis towards the risk mitigation aspect of any proposal, not because highly speculative opportunities are being presented to Investment Committee, but instead recognising that any investment has a degree of speculation and despite commercial investment being an increasingly common aspect for local authorities to address declining central government resourcing, the stewardship of public funds and security of investment remains a key consideration to any local authority decision making.
- 3.42 Ongoing monitoring of the investments take place and risks are continually assessed. Business cases have exit strategies to mitigate any situation where a long-term erosion of capital value is anticipated.
- 3.43 Prudential indicators monitor and contain local authority borrowing levels and commercial investment activity is separately shown and further supported by the additional reporting requirements brought in by recent and revised WG Investment guidance. Further information and analysis is contained in appendix 3.

Proposals for Improvement

- 3.44 One of the key outcomes from the performance review being undertaken is to reflect on proposals for improvement resulting from audit work undertaken as well as separately reviewing the current Asset Investment policy and the governance arrangements and controls currently in place to oversee investment activity considered by the Investment Committee.
- 3.45 The following proposals for improvement are recommended for the forthcoming period:
- To review and update the Asset Investment Policy and Investment Committee terms of reference as required taking on board latest guidance, internal audit recommendations and the Council's policy objectives around economic growth

- To ensure that the performance review is undertaken on an annual basis going forward
- That an overarching risk assessment is produced, maintained and reported to the Investment Committee on at least an annual basis, with any emerging risks being brought to the attention of the Committee on a timely basis
- To update the constitution to include details of the Investment Committee
- Declarations of interest forms to be completed as required by those attending Investment Committee meetings
- A performance dashboard to be developed and reported to Investment Committee on at least twice a year such as to review performance of the investment portfolio
- To ensure that any investment proposals that are not taken forward are reported back to Investment Committee
- To implement the Estates restructure and to fill current vacancies and that look to address existing capacity issues and that are resulting in the need to draw additionally on external advisors at this time
- To assess training needs of staff and members involved in the decision making process for commercial investments
- To consider the merit of independent members being added on to the Investment Committee
- To consider the need to re-introduce a sinking fund in earmarked reserves to act as a buffer against any in-year deficits caused by investment performance
- To maintain a close ongoing review of further advice and guidance, and in light of the UK Government and Chancellor's announcement and the intention to constrain local authorities commercial activities through PWLB borrowing.
- To procure a new investment advisor for commercial property investments and to ensure all future appointments are made in line with Contract Procedure Rules.
- To ensure that adequate consideration is given to the Climate Emergency and environment considerations of any investments

4. OPTIONS APPRAISAL

4.1 This report is not a decision making report. It represents a performance review of the Investment Committee and therefore no option appraisal is required.

5. EVALUATION CRITERIA

5.1 Evaluation is undertaken and required at a number of stages being:

- a) When an investment opportunity is identified or an investment proposal received and Investment Committee agrees for due diligence to be undertaken;
- b) On the submission of a proposal or business case to the Investment Committee for consideration;
- c) On an ongoing basis as part of routine and regular monitoring of commercial investments – reporting and taking action as required;
- d) As part of the annual performance review that is a requirement of the Asset Investment Policy – acting on proposals for improvement; and

- e) As part of internal and external reviews undertaken – acting on recommendations and proposals for improvement

5.2 The results of the evaluation arising from this performance review are outline in 3.42 together with the resource implications shown below.

6. REASONS:

6.1 The Asset Investment Policy requires an annual performance review of the Investment Committee to be undertaken and in order to ensure that the governance arrangements, policy documentation and necessary guidance and legislation are being reviewed and adhered to.

7. RESOURCE IMPLICATIONS:

7.1 As stated above the two investment acquisitions to date relate to Castlegate Business Park and Newport Leisure Park.

7.2 Of the £50m prudential borrowing capability delegated to the Investment Committee £30.7m has been spent to date and on the two acquisitions. Any additional costs of due diligence and advice incurred in exploring other commercial investment opportunities have been met from existing revenue budgets, to the extent that they aren't subsequently able to be incorporated into future investment or acquisition costs.

7.3 As a result of the acquisitions made budgeted savings have been introduced and form part of the revenue budget savings. The budgeted level of savings for Castlegate Business Park and Newport Leisure Park are £209k and £400k respectively. Most recent forecasts for the current financial year report a £73k shortfall for Castlegate and a £82k outperformance for Newport Leisure Park. Whilst this represents a net forecast shortfall against budgeted savings of £9k the two investments are contributing £618k savings over and above borrowing costs.

7.4 The original budget case for Castlegate was based on a target occupancy of 95% and which resulted in an investment return over borrowing (ROI) of 3.01%. Occupation is currently running at 88% as a result of a number of vacant units. As a result the current ROI is 1.81% which whilst falling below the 2% benchmark is being addressed currently. New units are awaiting final rental agreements being agreed and other vacant units are being actively marketed.

7.5 In terms of Newport Leisure Park the business case was predicated on 100% occupation and this is being maintained with some rental concessions currently in place. The original budget case was based on a 2.11% ROI and the current ROI being achieved is 2.14%.

7.6 In terms of capital value, and Land Transaction Tax and Fees aside, both investments are maintaining their value and based on the latest valuations held.

7.7 In terms of arrears of rent and service charge with tenants there are no significant issues to report other than with one tenant at Newport Leisure Park where rent and service

charges remains outstanding for the January to March 2020 period and where a statutory notice will be considered. However, this continues to be actively monitoring by estates, finance and appointed agents.

8. EQUALITY AND FUTURE GENERATIONS EVALUATION (INCLUDES SOCIAL JUSTICE, SAFEGUARDING AND CORPORATE PARENTING):

8.1 There are no Equality, Future Generation or wider implications directly arising from this report. This report is looking to provide a review of performance. Any implications will be assessed as required by the Investment Committee when considering any investment. All proposals for improvement look to strengthen future governance arrangements and again have no resultant potential implications.

9. CONSULTEES:

Chief Executive
Head of Legal Services (Monitoring Officer)
Chief Officer for Resources (Acting S151 Officer)
Finance Manager – Central Accountancy
Head of Commercial, Property, Facilities & Fleet
Interim Estates Manager

10. BACKGROUND PAPERS:

Appendix 1 – Investment Property Acquisitions - Internal audit report
Appendix 2 – Welsh Government guidance on Local Authority investments
Appendix 3 – Treasury Policy & Strategy 2020-21 (Extract)
Appendix 4 – Asset Investment Policy 2018
Appendix 5 – Investment Committee Terms of Reference

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12. CONTACT DETAILS:

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