

Bath and North East Somerset Capital and Investment Strategy 2019/20

Introduction

This Capital and Investment Strategy is a new Government requirement for 2019/20 and is the overarching document which sets the policy framework for the development, management and monitoring of capital investment as well as lending to other organisations and commercial investments. The strategy focuses on core principles that underpin the council's capital programme, investment property, financing and the risks that will impact on the delivery of the programme and commercial estate; and the governance framework required for decision making and delivery.

The capital and investment strategy aligns with the priorities set out in the Council's Operational Plan of:-

- Protect and care for our most vulnerable
- Nurture residents' health, safety and wellbeing
- Provide ways for everyone in the community to reach their full potential

The strategy is integrated with the Medium Term Financial Strategy and Treasury Management Strategy.

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Capital Expenditure

Capital expenditure occurs when the Council spends money on assets, such as property or vehicles that have a life of more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. The Council has limited discretion on what counts as capital expenditure, and this is outlined through its Accounting Policies which are updated and published annually as part of the Statement of Accounts.

In 2019/20, the Council is planning capital expenditure of £173m as summarised in the budget report. Of this planned expenditure £20m is for New and Emerging Capital Schemes as outlined in Annex 5 of the budget report.

As part of the approval process Service Directors put forward Emerging Capital Bids annually by the end of August to include projects in the Council's capital programme for future years. Given the current constraints on local authority finances the following principles are used for the current programme as well as new schemes:-

- To continue to review all existing schemes and simplify, reduce, pause or stop as necessary;
- Minimise new schemes except those that meet corporate priorities;
- Agree an affordable limit for new schemes requiring corporate borrowing;
- Ensure adequate investment in assets supporting key service provision (including meeting health and safety requirements or replace obsolete or inefficient assets/equipment);and
- Deliver or work with partners to deliver high priority government funded programmes and WoE programmes where they meet corporate priorities.

Bids are collated by the Finance team who calculate the financing cost and whether the bid is funded through Service Supported Borrowing, Corporate Supported Borrowing, CIL, WECA, or external grant. Portfolio Holders review the overall bids to agree priorities and overall affordability. As part of the budget process each Scrutiny Committee reviews bids within their service areas followed by the Resources PDS reviewing all bids and comments before making recommendations to Cabinet. The final capital programme is then presented to Council in February each year. The Council's Capital Programme can be found at Annex 5.

Schemes can either be classified as **Fully Approved or Provisionally Approved**. Items gaining **Full Approval** are clear to proceed to full scheme implementation and delivery, subject to appropriate project management and governance.

Items for **Provisional Approval** will require either a further Officer decision and in some cases a formal Executive decision for Full Approval. The budget estimates for schemes shown for Provisional Approval are therefore included on an indicative basis, and as an aid to planning.

The Capital Programme will retain narrative only reference to pipeline projects and grant funding in early stage progression. These items will require further decision to incorporate into the programme at a later date.

Financing the Capital programme

Capital expenditure for the council is financed through a variety of sources, typically:-

- Receipts from the sale of capital assets

- Capital grants
- External contributions such as S106 or Community Infrastructure Levy
- The use of reserves or from revenue budget contributions

Any capital expenditure not financed by the above will need to be funded by borrowing. Existing council debt is therefore the consequence of historical capital expenditure. The council can temporarily utilise other resources in lieu of external borrowing to fund capital expenditure. This is referred to as internal borrowing.

In approving the inclusion of schemes and projects within the capital programme, the council ensures all of the capital and investment plans are affordable, prudent and sustainable. In doing so the council will take into account the arrangements for the repayment of debt, through a prudent MRP policy in line with MRP guidance produced by the Ministry of Housing, Communities and Local Government.

The capital financing charges and any additional running costs arising from capital investment decisions are incorporated within the annual budget and Medium Term Financial Strategy. This enables members to consider the consequences of capital investment alongside other competing priorities for revenue funding.

Borrowing costs are allocated as either Service Supported Borrowing where the service can demonstrate that it can fund the costs of borrowing from their individual budgets or Corporate Supported Borrowing where the costs are financed centrally.

Links to Treasury Management

One of the key aims of Treasury management is to retain sufficient but not excessive cash to meet the Council's spending needs, while managing the risks involved.

The Council currently has an agreed strategy of utilising its cash balances rather than incurring the higher cost of long-term borrowing at present. This can be demonstrated through the CFR at the end of 2017/18 which was set at £247.1m which outlines the Council's underlying need to borrow compared to the actual long-term borrowing of £192.5m.

Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and staff, who must act in line with the Treasury Management Strategy approved by Council. Quarterly reports on treasury management activity are presented to the Corporate Audit Committee and Cabinet. The Corporate Audit Committee is responsible for scrutinising treasury management decisions.

Loans

The council has discretion to make loans for a number of reasons, primarily for housing, economic development, and renewable energy. Current Loans include:-

Table 1: Loans for service purposes in £ millions

| Loan Detail | Amount Outstanding at 31st March 2018 |
|--|--|
| | £'m |
| Council's Housing Company | 4.287 |
| Council's Tourism Company (will be repaid in 2018/19) | 0.150 |
| Bath & West Community Energy - Renewable Energy Scheme | 0.121 |
| Total | 4.558 |

These loans are treated as capital expenditure. In making loans the council is exposing itself to the risk that the borrower defaults on repayments. The council, in making these loans, must therefore ensure they are prudent and has fully considered the risk implications, with regard to both the individual loan and that the cumulative exposure of the council is proportionate and prudent.

The council will continue to ensure that a full due diligence exercise is undertaken and adequate security is in place. The business case will balance the benefits and risks. All loans are either agreed by Cabinet or specific delegated authority. All loans will be subject to close, regular monitoring.

Shares

The Council holds nominal shares in its own wholly owned companies it does not hold any other shares.

Asset Management

The overriding objective of asset management within the council is to achieve a corporate portfolio of property assets that is appropriate, fit for purpose and affordable. The council's property portfolio consists of operational property, investment property and property held for specific community or regeneration purposes. The council has specific reasons for owning and retaining property:-

- Operational purposes e.g. assets that support core business and service delivery e.g. schools, office buildings.
- Investment properties held to provide a financial return to the council that support service provision.
- Parks, playgrounds and open spaces.
- Regeneration, enabling strategic place shaping and economic growth.

Asset management is an important part of the council's internal business management arrangements and is crucial to the delivery of efficient and effective services. The ongoing management and maintenance of capital assets will be considered as part of the Medium Term Financial Strategy. The 2019/20 budget includes an objective to optimise the council's office requirements through digital transformation and new ways of working. The Capital Programme also includes the following for capital works on Council owned properties:-

- Corporate Estate – planned capital maintenance £3.4m
- Commercial Estate – refurbishment programme £0.4m

Commercial Activities

The Chartered Institute of Public Finance and Accountancy (CIPFA) defines investment property as property held solely to earn rentals or for capital appreciation or both. Returns from property ownership can be both income driven (through the receipt of rent) and by way of appreciation of the underlying asset value (capital growth). The combination of these is a consideration in assessing the attractiveness of a property for acquisition.

In the context of the Capital and Investment Strategy, the council is using capital to invest in property to provide a positive surplus/financial return to finance Council services. The council can fund the purchase from either capital receipts or borrowing. The rental income paid by the tenant should exceed the cost of repaying the borrowed money each year. The annual surplus then supports the council's budget position, and enables the council to continue to provide services for local people.

The reasons for buying and owning property investments are primarily:-

- Financial returns to fund services to residents
- Market and economic opportunity.
- Economic development and regeneration within B&NES

Historically, property has provided strong investment returns in terms of capital growth and the generation of stable income. Property investment is not without risk as property values can fall as well as rise and changing economic conditions could cause tenants to leave with properties remaining vacant which not only reduces income but incurs additional costs such as maintenance and business rates.

The Council currently owns 322 properties held for investment purposes. The revenue income supports Council frontline services including Adult and Children's Social Care Services as follows:-

Table 2: Property held for investment purposes in £ millions

| Property Type | No of Properties | Value in Accounts as at 31/3/18 |
|----------------------|-------------------------|--|
| | | £'m |
| Retail | 195 | 243.932 |
| Offices | 18 | 24.274 |
| Licenced | 18 | 20.779 |
| Industrial | 22 | 15.963 |
| Other | 66 | 9.972 |
| Leisure | 3 | 7.352 |
| Total | 322 | 322.272 |

In accordance with government guidance, the Authority considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

A fair value assessment of the Authority's investment property portfolio has been made within the past twelve months, and the underlying assets provide security for capital investment. Should the 2018/19 year end accounts preparation and audit process value these properties below their purchase cost, then an updated investment strategy will be presented to full council detailing the impact of the loss on the security of investments and any revenue consequences arising therefrom.

The Authority assesses the risk of loss before entering into and whilst holding property investments by working closely with Hartnell Taylor Cook LLP (HTC) as its external commercial property adviser. In that capacity HTC advise the Council on all its commercial assets and potential acquisitions. Through HTC have access to a multi-disciplined team of property professionals to assist with all aspects of the management of the commercial portfolio, including detailed appraisal of potential acquisitions.

Advice has been sought on the appropriate level of gearing for the portfolio and how this should be benchmarked. Staying within the agreed gearing ratio will ensure the Council's portfolio is protected from the risk of fluctuations in the rates of borrowing.

New properties that are purchased will be supported by a Business Case detailing how they fit the Council's investment criteria, any associated risks and how these can be mitigated. The Council has taken legal advice from Trowers and Hamlins LLP regarding the legal powers available to the Council to acquire commercial properties outside of its geographical area.

With regards to acquisitions, where HTC introduce a property, that will be accompanied by a purchase report. Where a property is introduced by a third party, the Council would look to the introducing organisation to produce a Purchase Report but HTC will provide a commentary on that report. The report assesses the market and level of competition. The report will also consider the strength of the tenant covenant including its credit rating. In addition to the Purchase Report the Council commissions an external RICS Red Book valuation which includes a full risk assessment associated with the proposed investment

The Council will continue to invest prudently on a commercial basis within and the area surrounding B&NES to take advantage of opportunities as they present themselves, supported by a robust governance process. This will be done by:-

- focusing on secure assets let on long leases;
- Acquiring properties that create immediate income i.e. properties that are already let;
- Institutional quality assets to ensure liquidity;
- Diversifying the existing portfolio to address existing threats to the estate;
- Investment in alternative property sectors.

For each new asset the Council will review the structural and risk implications of adding the property to the portfolio. The risks associated with any new acquisition will be appraised prior to the acquisition and the Council will consider the following criteria for evaluating acquisitions:

- Location;
- Building quality;
- Quality of the income/financial strength of the tenant;
- Rental level compared to market level and potential rental growth;
- Tenant demand for property were it to fall vacant

In addition to the above considerations the Council will address the following in their appraisal of new assets. Each is a key consideration which needs to be carefully appraised when assessing the price the Council will pay to acquire the property and

the income yield that will be generated. Higher yields will be generated where there is greater tenant risk and shorter unexpired terms:

For each new property a Credit Safe check will be carried out on each tenant. Credit Safe provide a rating for the covenant strength of each tenant based on their last three years financial accounts. The higher the rating the more secure the tenant and the Council will target properties where there is minimal risk of tenant default. Tenants with a low Credit Safe rating will need be carefully appraised.

The Council is aiming to grow secure long term income from its' property acquisitions and will target longer leases for their investments. There will be opportunities to buy properties where tenants have a shorter term to their lease expiry, perhaps 2-3 years, and these will still be considered but alongside an asset management plan detailing how the lease could be extended. Through active asset management the Council may well be able to extend the unexpired term. These assets are likely to be acquired for a higher yield initially and if the term of the lease can be extended will represent good value for the Council.

At the point of acquiring the property the passing rent will be assessed in relation to the open market rent. In some cases the rent will be reversionary and the Council will benefit from a higher level of rent at the next rent review or lease renewal. The opportunity for rental growth will be closely linked with tenant demand in the particular location. The Council will consider whether there is currently an undersupply of a certain type of property which could drive rental growth going forward, for example the industrial market which is currently enjoying solid rental growth in the south west.

The Council will consider for each property acquired whether the tenant covenant can be improved, whether the lease term can be extended or break clauses be removed and whether at rent review there could be an improvement in the rental level. The Council will consider each property at the time of the purchase and the active asset management initiatives that could be undertaken to ensure the property will provide long term secure income in the future.

Compared with other investment types, property is a long term investment, relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. However, as part of the Council's management of assets, the portfolio is regularly reviewed to identify surplus or underperforming assets to be brought forward for disposal.

Proportionality

The Authority dependency on profit generating investment activity to deliver services is shown below:-

Table 3: Proportionality of Investments

| | 2017/18 Actual |
|---|---------------------------|
| | £'m |
| Gross Council Expenditure | 376.197 |
| Gross Income from Investment Properties | 18.184 |
| Gross Income from Treasury Investments | 0.102 |
| Proportion of Investment Income to Overall Expenditure | 4.86% |

The proportion is all investment income divided by the gross service expenditure

If budgeted income is lower or overall budgeted expenditure is higher than expected the Authority holds a Revenue Budget Contingency and Un-Earmarked Reserves to meet any in-year shortfalls. If a shortfall were to continue into the medium to longer term a pressure would be added to the Medium Term Financial Plan that would have to be found from other sources either additional income elsewhere or cuts to services.

Borrowing in Advance of Need

New Government guidance in 2018 outlined that local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. The Authority has previously borrowed for this purpose because the acquisitions have direct relevance in the following areas:

- A Strong economy & growth – The Council is able to exercise active management over its property holdings and seek to ensure a varied portfolio mix and diversification of risk.
- An efficient business – the acquisitions contribute significantly towards achieving the Council's strategic review targets as well as the Directorate Plan income generation aspirations.

In line with the Council's financial planning the income continues to be utilised to protect frontline services, including the provision of adult social care; children and environmental services pursuant to the Council's general power of competence under s.1 Localism Act 2011.

The acquisition of the properties are in pursuance of the benefits (and in particular those of an economic nature) that it will confer upon the Council and its area, in accordance with s120 of the Local Government Act 1972. The acquisitions align themselves with the Council's Investment Strategy for the Commercial Estate.

The economic benefits conferred to the Council and its area specifically include:-

- Diversification and mitigation of risk to the portfolio, in terms of location, sector and type;
- Council resourcing - the acquisitions will provide resources required to assist in the delivery of the Council frontline services, which benefits the Council and its area directly; and
- Opportunity – There are limitations in terms of demand and supply from being geographically constrained. By seeking opportunities within an appropriate drive time distance and within the LEP and other neighbouring areas, outside B&NES, provides exposure to a larger number of significant assets.

Business cases are assessed using the prevailing long-term PWLB borrowing rate. Changes in interest rates are carefully monitored and managed through Treasury Management. A Capital Financing Reserve is held to manage any in year additional borrowing costs. Income from the commercial estate is monitored monthly and the Council holds a Revenue Budget Contingency and Un-earmarked balances to meet with in-year shortfalls. Ongoing shortfalls would be reflected in the MTFS as well as a review of whether individual properties should be held or sold.

Provision for Risks Capital Bids

Each capital bid is risk assessed and a reasonable contingency sum is allocated within the project budget. In addition to this the Council sets aside a sum each year as a Capital Contingency as part of setting the budget to meet risks that require additional capital financing within the financial year. It also retains a revenue reserve to meet any unforeseen or additional revenue requirements such as additional interest or revenue reversion risks that require additional financing.

Knowledge and Skills

The council has professionally qualified staff across a range of disciplines including finance, legal and property that follow continuous professional development (CPD) and attend courses on an ongoing basis to keep abreast of new developments and skills.

The council establishes project teams from all the professional disciplines from across the council as and when required. External professional advice is taken where required and will always be sought in consideration of any major commercial property investment decision.

Investment Indicators

The Authority has set the following quantitative indicators to allow elected members and the public to assess the Authority's total risk exposure as a result of its investment decisions.

The following indicator shows the Authority's total exposure to potential investment losses. This includes amounts the Authority is contractually committed to lend but have yet to be drawn down and guarantees the Authority has issued over third party loans.

Table 4: Total investment exposure in £millions

| Total Investment Exposure | 31/3/18 Actual |
|--|---------------------------|
| | £'m |
| Treasury Management Investments | 37.700 |
| Service Investments Loans | 4.558 |
| Commercial Investments - property | 322.272 |
| Total Investments | 364.530 |
| Contractual Commitments to Lend | 0 |
| Guarantees Issued on Loans | 0 |
| Total Exposure | 364.530 |

Government guidance is that these indicators should include how investments are funded. Since the Authority does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, commercial investment properties shown in table 4 can be linked to the borrowing shown in the following table 5.. The remainder of the Authority's investments are funded by usable reserves and income received in advance of expenditure through Treasury Management:-

Table 5: Investments funded by borrowing in £millions

| Investments Funded by Borrowing | 2017/18 Actual |
|--|---------------------------|
| | £'m |
| Commercial Investments - Property | 47.946 |

The following indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting

framework, not all recorded gains and losses affect the revenue account in the year they are incurred:-

Table 6: Investment rate of return (net of all costs)

| | 2017/18 Actual or Average Value/ Investment | 2017/18 Actual Return | Rate of Return |
|--|--|--------------------------------------|-------------------------------|
| Investments net rate of return | £'m | £'m | % |
| Treasury Management Investments (weighted average balance) | 33.555 | 0.101 | 0.30 |
| Service Investments: Loans (weighted average balance) | 2.456 | 0.079 | 3.20 |
| Commercial Investments: Returns on Property Compared to Income | 322.272 | 17.305 | 5.37 |

Other investment indicators

- Debt payments to net service expenditure 5.04%
- Outstanding debt to net service expenditure 164.60%
- Commercial Investments debt compared to asset value 14.88%
- Net commercial income compared to net Council expenditure 14.80%