EAST HERTS COUNCIL

EXECUTIVE - 7 OCTOBER 2014

REPORT BY THE EXECUTIVE MEMBER FOR FINANCE

SELECTING PROPERTY FUNDS TO INVEST IN

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

This report recommends two property funds to invest money into, in line with the Treasury Management Strategy agreed at Audit Committee on 16th July 2014.

RECOMMENDATIONS FOR EXECUTIVE: that:	
(A)	**investment of £10m in each of the two selected property funds now detailed be approved;**
(B)	**before final agreement to invest in actual funds, the Council will ensure that the most up to date legal advice about investment is considered; and**
(C)	**at the time of investment, the Director or Finance and Support Services, in consultation with the Executive Member for Finance, is delegated the powers to sign off the specific terms of the investment as long as these are not significantly different from those terms outlined in this report.**

1.0 Background to Developing an Investment Strategy and Investment in Specific Property Funds

1.1 With central government funding for local authorities on a clear downward trend in both the short and medium term there is a growing need for East Herts to identify new and/or additional sources of revenue income. While the organisation will continue to find new efficiencies and more joined up and innovative ways of working, greater self reliance in funding will be required if many key services are to be secured.

1.2 One means of contributing to that self-sufficiency is via the investment strategy that was agreed in November 2013, utilising some of the council's capital currently held in money market accounts yielding low levels of return, to instead invest in other assets to deliver an enhanced income.

1.3 Local Government Finance Rules impose their own set of constraints on what the Council can, and can't do and importantly the council's policy and priorities will also shape our approach. The Council must be satisfied that 3 main criteria are considered and balanced, whatever investments it undertakes. These are Security, Liquidity and Yield.

1.4 The Councils governance arrangements are such that the key document which prescribes the types of investment that the Council is willing to invest in, is the Treasury Management Strategy, which is usually presented annually to the Audit Committee for their consideration and agreement. For this year, there has been an additional refresh of the policy and strategy, to take account of the ability to make investments in Property Funds.

1.5 The actual selection of specific funds to invest in is an Executive decision, and follows a selection process supported by Capita Asset Services, who also act as our Treasury management advisors.

1.6 There are both financial risks and opportunities associated with investment in Property Funds, and Executive Members need to be satisfied that they have considered the risks described and the arrangements in place to monitor performance are sufficient for them to monitor the funds' performance in the short, medium and long term

1.7 The Treasury Management strategy allows the Authority to place up to £10m in two funds (so a total of £20m). The funds for these come from Capital receipts already held and are therefore appropriate sources of money that can be invested in these types of assets.

2.0 <u>Property Funds – What they are and associated Risks and Opportunities</u>

2.1 Property Funds are essentially a form of mutual fund that invest only in property. Any profits produced from the sale of investment units will be reinvested in the fund so that they can be available to buy or lease other properties.

2.2 The sales and rental fees on properties that are a part of these funds are paid out to participating investors, the yields are calculated at set periods of time, and will differ from fund to fund.

2.3 The Capital value of the fund is also revalued on a periodic basis (at least annually) and depending on the changes of those values, will need to be recognised in the Council's accounts accordingly. The way particular funds are structured will determine how any income is recognised, and also how the Capital value of funds is recognised in our accounts. Specific financial advice is being taken to ensure that we comply with Local Authority accounting regulations.

2.4 The Capital value of the funds can both increase and decrease depending on the properties held within the fund. When making a decision to invest, it must be recognised that there is a risk that the Capital Value originally invested could, over a period of time, go down but it is expected over a longer investment period, that this would at least hold its value or increase. It is a risk that prior to investment, Members should be satisfied that is considered fully.

2.5 Property Funds are investments that need to be considered over a longer period of time that some other asset classes, typically at least 5 years. This means that the money that is invested and the performance and financial impacts of those investments, should not just be looked at over a short period of time. Any decisions to disinvest money should carefully consider this factor. Fund values may temporarily reduce if, for example, a property is sold to allow the purchase of another property.

2.6 Property Funds are not therefore very liquid assets. For most funds the lead in time to take funds out require a minimum of 3 months' notice, which takes account of the fact that the fund needs enough time to allow the sale of any property to be able to pay back the investor. This can be both an advantage and a disadvantage when choosing to invest. If the Council was in a position where it needed to quickly release money, then it would have to wait some months to receive funds back. However, it does also mean the other investors are unable to quickly sell their investments too quickly and destabilise the fund.

2.7 To mitigate against the risks around liquidity, it is useful to understand if there is a strong secondary market available to be able to sell on any investments should the need arise. This was considered as part of the approach on selecting funds to recommend to Executive.

2.8 The Council also needs to recognise that when entering a property fund, there are some entry costs that need to be taken into account. These are required to cover costs such as stamp duty, legal fees and other costs normally associated with purchasing of property. In most cases, funds will charge these at the time of entry into the fund and effectively mean that on Day 1 of purchase, the capital value of the investment is automatically reduced by the equivalent sum of the fees. For example, if a fund charges fees of “Bid price plus 5%”, an investment of £10m will effectively mean that this is worth 5% less (£9.5m) to begin with, if you chose to take your money out the following day. However, the anticipated yields on the investment would then smooth out, and the capital value would be expected to return to full value over the term of the investment if the fund performs as expected.

2.9 The investment the Council is making would yield monies in two ways, actual yields on the investment as well as expected increase in Capital Value over the life of the investment in the longer term. This is why the investments need to be considered as longer term investments of several years and not short term investments.

2.10 By handing over money to the fund, the Council has no control over what property the fund buys, so can not dictate that this should be within the bounds of East Herts or the type or specifics of properties to be bought.

2.11 As investors, the Council would receive quarterly updates of fund performance and would need to ensure the financial implications of these are considered as part of the overall Councils financial monitoring.

3.0 <u>Selecting Specific Funds</u>

3.1 To select appropriate funds, officers engaged Capita Asset Services to assist in the selection process and to provide specific accounting advice on the funds.

3.2 Initially, outline criteria were established to determine appropriate funds that were available, and would be both legal for the Council to invest in, and were open to accept funds from Local Authorities. Additional criteria were also agreed to ensure that the funds were of sufficient size (over £100m in total) so that the Council would not become too dominant an investor and bear greater risks than necessary, by investing up to £10m into the funds. It was also agreed that the funds should be UK based.

3.3 The 11 funds that were long listed were considered on an objective basis, and were scored and ranked according to their performance yields over 3 months, 1 year, 3 years annualised and 5 years annualised as well as fund size. Although past performance cannot guarantee future performance, the fact that this was considered over a 5 year period gives an indication on the stability of funds, their ability to change to factors in the market and gives some reassurance of their ability to manage risks.

3.4 The top 6 funds were then invited to fill in a more detailed questionnaire that covered a number of areas that the Council wished to consider, including (but not limited to):

- The types of property held (geographically, sector, size)
- Net rental income
- Void rates and void policies
- Availability of secondary markets
- Typical lease lengths
- The size and experience of the team managing the fund
- How they manage risk
- Reporting arrangements
- Fund forecasts
- Transaction costs
- Fee structure

3.5 All of the factors above have an impact on the potential performance of the fund.

3.6 This short list was further shortened, so that 4 funds were then interviewed to probe in more detail the answers to the questions. To reduce the 6 potential funds to 4, an objective analysis was completed weighted 40% against “fund return criteria” and 60% to “quality criteria”. These criteria included:

- Outperformance against benchmark (so a fund with a net return on or above the benchmark score higher than those below)
- Total expense ratio (total fund costs as a proportion of total fund assets, excluding entry/exit fees)
- Investor diversification (those with a more diverse level of investors scored higher, due to the availability of a secondary market)
- Gearing (both gearing ratio and maximum gearing, where lower gearing created a higher score)
- Fund size (larger fund scored higher)
- Stock (Higher scores for lower void rates, a good spread of lease lengths and cash holdings)

3.7 The final 4 were then interviewed on one day by 2 officer representatives (Director Finance and Support Services and the Accountancy Manager) and 2 Councillors (Portfolio Holder for Finance and the Leader of the Council) as well as 2 representatives from Capita.

3.8 These interviews consisted of a presentation from the fund managers (or their representatives) and then each fund was asked the same set of questions to ensure fairness and transparency in the selection process (if they hadn't already covered the information in their presentations.)

3.9 The answers given were then independently scored by the 4 Council representatives and the 2 funds with the highest average scores are recommended in this report.

3.10 In **Essential Reference Paper B** the questions that were asked of each fund manager are included.

3.11 **Essential Reference Paper C (Private and Confidential)** shows the average scores for each fund. A summary of the answers of the two highest bidders is also included.

3.12 Executive are therefore recommended to agree that funds be placed with "Lothbury Property Trust" and "Hermes Property Unit Trust" as soon as possible. It should be noted, however, that the lead in time that was advised at the time of interview was that investment may not be possible for at least 9 months. The panel scores, however, reflect that despite this long lead in time, it is felt that given that these are longer term investments, that it would be better to wait to place money in these funds at the first available opportunity.

3.13 Given the length of lead in time, East Herts will need to be satisfied that no changes in legislation detrimentally affect the placing of these funds. Executive are therefore asked to delegate the decision to the Director of Finance and Support Services, in consultation with the Portfolio Holder for Finance that they are satisfied at the time of placement of investment, that the Council is satisfied that it has the powers to make these investments and is clear on the financial and accounting implications of doing so.

4.0 Implications/Consultations

4.1 Information on any corporate issues and consultation associated with this report can be found within **Essential Reference Paper 'A')**.

Background Papers
None

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