Birmingham City Council Investment Property Portfolio Strategy

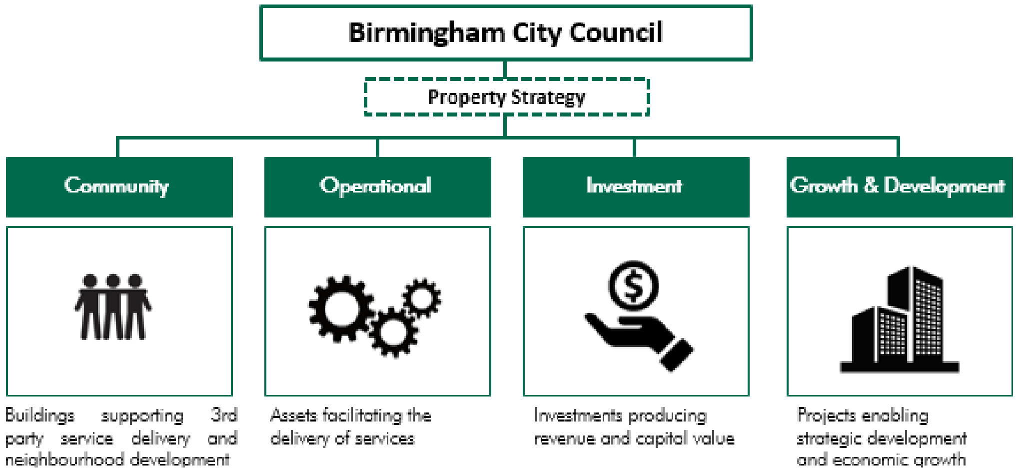
CONTENTS

SECTION 1: WHAT ARE INVESTMENT PROPERTIES AND WHY SHOULD WE HOLD THEM?

a) Context

In November 2018 Birmingham City Council (BCC or The Council) published its Property Strategy 2018/19 – 2023/24. The document took a long-term strategic approach to utilising The Council's asset base to ensure maximum commercial and social returns; by realigning its property to act as a catalyst for development and underpin the social fabric of communities across the city.

The property strategy is structured around four key themes: Investment; Growth and Development; Community; and Operational which set out an approach to guide how assets will be utilised efficiently and effectively to achieve the identified objectives and outputs.



The property strategy links to The Council's Financial Plan 2019 – 2023 and The Commercialisation Strategy which focusses on:

> *"Taking a business-like approach in every service, every day – making every £ count for Birmingham". This recognises that to maximise performance 'commercial thinking' needs to be embedded across the organisation.*

This document follows on from the above work with a direct focus on the investment portfolio.

b) What Are Investment Assets?

The City Council holds all properties which are let to third parties, within the Investment Property Portfolio. The assets within this portfolio is real estate owned or purchased by The Council with the primary intention of earning a return; through a combination of rental income and/or capital appreciation. Rental income is typically derived from commercial entities which lease space or assets at a market rate. The capital value is market based and driven by the quality of the land/location, lease/ tenant and the building. Note: Capital value is crystallised on the disposal of the asset but does have impairment implications during the period when the asset is held (see section 5d).

Within the global context, the UK commercial property investment market is transparent and established, attracting global investors ranging from pension funds to high net worth individuals. Within this market there is a wide spread in financial returns (known as yields), which relate to the quality of the asset in question. Yields reflect the risk / return and can be used to compare investments in the property market and wider investment universe.

Property investment yields within the institutional property market range from c.3.5% (low risk) for prime assets to 9% (high risk) for tertiary assets. Note: Prime assets are currently considered to be well specified, well located and rack rented to financially strong tenants on a lease with 10+ years unexpired with open market rent reviews. The market update section of this report provides more detail on these aspects.

c) Why Hold Investment Assets?

The City Council is taking a proactive approach to its overall performance and financial management. As a local authority it is seeking innovative and creative ways to respond to a challenging budget position and to support/deliver services for residents. One way this is supported is through the Investment Property Portfolio which holds and invests in property that provides a positive/surplus financial return. In 2017/18 the Investment Property Portfolio generated revenue representing almost 10% of all City Council income from external sources.

Whilst the portfolio represents a significant income stream, the current investment portfolio reflects the City Council's historic accumulation of assets. Accordingly, there is scope to review and reinvest into the investment portfolio based on commercially sound principles; to deliver enhanced returns to the residents of Birmingham.

An alternative would be for the Council to sell the portfolio and use the proceeds to enhance its capital programme or repay borrowing. However, this would result in the loss of a significant long-term income stream yielding around 5% net of costs, and growing each year due to rent reviews, whereas repaying debt would save interest and MRP of only 3.6% for a limited period. It will remain a key test for future investment property purchases that projected returns are greater than the cost of borrowing.

The Council therefore proposes to maintain the Investment Property Portfolio, and to deliver a growing income stream by continual review and reinvestment of the portfolio on risk adjusted commercial property investment principles to achieve good returns. It is important to highlight that the Council's Service and Commercial Investment Strategy (which covers the Investment Property Portfolio) states that its investment risk appetite is low, due to the substantial financial risks the Council is already exposed to. In relation to the Investment Portfolio, the Council wants a relatively low risk of volatility in the net income return.

The Council is not proposing to make additional investments funded by borrowing.

d) The Council's Objectives & Rationale

The underlying key aim for the portfolio is to deliver a stable net income stream which grows at least in line with inflation, whilst maintaining the capital value of the portfolio in real terms over the medium term.

The Council's objectives for the investment portfolio are therefore:

- To deliver a commercially driven, financially focused 'Investment Property Portfolio' which can respond promptly to property market cycles to deliver the highest returns - whilst still fulfilling the obligations of a Local Authority;
- To deliver medium growth in gross income, including inflation, by 2024- recognising there will be a reduction during the period of strategic rationalisation; and
- To deliver a total return annually in line with property market conditions.
- To invest predominantly in property in Birmingham or the surrounding economic area, providing good commercial returns are expected. The intention is that the investment of taxpayers' money in property should also benefit the economy of Birmingham, where this does not damage its financial interests. This does not rule out investment across the UK generally, subject to legal powers.

In order to achieve these objectives, the portfolio will reinvest capital receipts from disposals of assets which do not meet the investment criteria (detailed in Section:2B below), back into the Investment Portfolio through existing or more efficient new stock. An annual Property Investment Strategy report will be produced to review the objectives and strategy and map delivery.

It should also be noted that the Council is a long-term investor and is able to accept the peaks and troughs of property values across the economic cycle.

e) LA Guidance & Regulation

Local Authorities have substantially increased their commercial property investments in recent years, with a view to earning additional net income, and sometimes funded this from borrowing. The MHCLG (Ministry of Housing, Communities & Local Government) and CIPFA (Chartered Institute of Public Finance and Accountancy) have expressed concern at some of this activity, which may be unduly risky relative to the size and resources of the authority, especially where it is funded from borrowing.

MHCLG issued expanded investment guidance in 2017 which includes investment property. Authorities must by law have regard to this guidance. CIPFA has also issued guidance in its Treasury Management Code.

The Government and the CIPFA Guidance are statutory Guidance, which means that authorities must have regard to them and should only depart from them if they set out clear reasons why it is appropriate to do so. The Guidance has been addressed throughout this Strategy. Key issues include the following:

- The Council has approved an Investment Strategy which covers service and commercial investments including property, as recommended by the Guidance (see Appendix Q of the Financial Plan 2019-2023). This Property Strategy fits within that overall Investment Strategy.
- The Government Guidance says that authorities should not borrow to fund investment purely for the purpose of making a profit. Acquisitions will be made through capital receipts from disposals. This strategy does propose a borrowing facility of up to £50m, but as explained in 2c above, this is only borrowing for a short period to manage the risk of a timing gap between purchases and sales. The Council is not proposing to use borrowing to fund a permanent increase in the investment portfolio.
- If the portfolio makes investments outside of Birmingham, the purpose would be solely for profit with no local economic or social benefit. Such investments should be funded directly from asset sales without use of the borrowing facility, in order to comply with the Guidance.
- The Guidance warns against investment activity which is disproportionately large in relation to an authority's finances. The Council's Financial Plan now includes a prudential indicator which measures financial and property investment income as a percentage of the net revenue budget. This is forecast at 4.3% in 2019/20 rising to 5.2% in 2021/22. This represents a manageable risk in relation to the overall revenue budget.
- Risk management is addressed throughout this Strategy, including the management of security, liquidity and yield.

f) Legal powers

Section 120 of the Local Government Act 1972 is the primary power, which enables the Council to acquire land (whether within the Council's area or outside it) for the purposes of any of its functions, or for the benefit, improvement or development of its area, whether situated inside or outside their area. Counsel's opinion is that where acquisition of property for investment purposes is constrained by S120 of the Local Government Act 1972 or the Council's investment powers under Section 12 of the Local Government Act 2003 such investments are authorised under The Council's General Power of Competence under S1 of the Localism Act 2011 but only through a separate company vehicle .

Section 12 of the Local Government Act 2003 gives power to invest for the purpose of any of its functions or for the prudent management of its financial affairs. This covers situations where property may be acquired via a holding company or where property loans are taken. In using this power The Council must have regard to the Government Investment Guidance, to CIPFA's Treasury Management Code, and to its own Investment Strategy, all of which are referred to throughout this Strategy.

The General Power of Competence under Section 1 of the Localism Act 2011 enables the Council to do anything which individuals may do. This is subject to various limitations, and may not be available for out of area property loans which are solely for profit with no economic or other direct service benefit to the Council. The General Power of Competence under S1 of the Localism Act 2011 is not limited by the existence of any other power of the authority which (to any extent) overlaps the General Power of Competence. Counsel's opinion is that where The Council's borrowing and investment powers are constrained by the duty of prudent management of its financial affairs under the Local Government Act 2003 then borrowing and investment for the wider commercial purposes of The Council can be undertaken by The Council under its General Power of Competence but only through a separate company vehicle.

Section 111 of the Local Government Act 1972 also gives the power to do anything which is calculated to facilitate, or is conducive to or incidental to the discharge of any of its functions. The GPOC and S111 do not override any limitations or restrictions under other powers.

Section 1 of the Local Government Act 2003 gives local authorities power to borrow for the purpose of any of its functions or for the prudent management of its financial affairs.

SECTION 2: PROPOSED INVESTMENT POLICY - FRAMEWORK AND CRITERIA

The Investment Property Portfolio will be managed in accordance with the following policies (which will be refreshed annually with the Strategy report to Cabinet):

a. Property investment options

The portfolio may invest in:

- Direct property: ie. Property leased to commercial tenants at a market rate on institutional lease terms, with the primary intention of earning a financial return. This has historically, and will be the primary focus of the portfolio.
- Property debt: ie loans which are secured on a commercial property. These may be development loans for the duration of the construction or investment loans, post-completion which are typically five-year periods. This can provide useful diversification, and as an interim, short to medium term investment during the current period of transition whilst the portfolio is progressively consolidated into fewer larger holdings. It is currently proposed only to invest in property debt within the Birmingham / Midlands area (where there are economic benefits to Birmingham). This is expanded on in Section 5b.
- Indirect Property / pooled funds: investors purchase units or shares in these funds which invest in property across the UK. This is unlikely to be a significant holding due to the portfolio's priority for investment in Birmingham.

b. Property Investment Criteria

The following criteria will be considered on a portfolio and asset level on existing and future holdings.

Location
The portfolio will invest primarily within Birmingham and the surrounding west midlands economic area. The intention is that investment will be for financial return, but may have a positive impact on the Birmingham economy. Birmingham is also the part of the country which The Council understands best, and where good investment opportunities may come to The Council's attention.

It is recognised that prioritising investment in Birmingham will be a constraint to the financial objective and will increase the (geographic) risk of the investment portfolio. Nevertheless the Council believes that the investment of local taxpayers' money in property should benefit the infrastructure and economy of Birmingham, where this is consistent with a good financial return.

Building
The building quality and age will be assessed to ensure it is suitable for current/ future occupation with the potential for alternative uses considered to mitigate risk.

Lease
The portfolio will be assets with good income quality assessing aspects such as:

- Lease length
- Tenant covenant strength
- Rent review mechanism
- Reinstatement liability
- Alienation provision
- Any other onerous clauses

Tenure
The portfolio will invest primarily in freehold assets to ensure full control of the asset. Long leasehold assets will be considered in specific opportunities and assessed ensuring limited restrictions, obligations or value implications.

Asset Management Opportunities
Whilst The Council's investments will be relativity risk averse it will assess and pursue opportunities to add value to existing holdings or acquisitions with asset management potential.

Lease Renewal Risk
The Council values a stable investment income stream. The portfolio will therefore aim to spread lease expiries reasonably evenly over a long period of years in order to avoid a substantial reletting risk in any one year or period.

Property Management
Complexity and cost of managing will be assessed on existing and future assets. There will also be a preference for FRI (full repairing and insuring) leases to reduce the management requirement.

Diversification
The portfolio will invest in a range of property sectors such as industrial, retail and office assets, based on property market advice. A diverse spread of individual properties from different sectors should be maintained to reduce the impact of loss in any one property or sector.

Liquidity
The Council intends to invest in property for the long term, but it is recognised that unforeseen circumstances may require the sale of properties. Investment exit routes will be considered as part of acquisition decisions, and where possible, efficient exit routes will be designed into legal agreements and investment structures.

Security

Property loans will be secured on commercial terms on the underlying property asset.

Financial Considerations

The Council will invest in assets where the forecasted financial return is in line with the strategy and in accordance with the sector considering the risk profile of the property. This will take account of affordability and value for money considerations, as well as tax implications for the Council such as VAT partial exemption (further information is provided in Section 5e).

c. Borrowing

The portfolio will not borrow to fund additional investments, other than temporarily through an approved bridging loan facility of up to £50m. Borrowing creates a fixed liability and a fixed repayment obligation, whilst the investment's value and income are at risk. The scope for The Council to borrow to fund investments is also limited by the relatively high level of Council debt and low headroom for additional borrowing. In accordance with the Government Investment Guidance, The Council will not borrow to invest purely for financial gain. This policy is set out in the Service and Commercial Investment Strategy in the Council's Financial Plan 2019-2023, and does not prevent The Council from borrowing for the prudent management or protection of its existing financial and property investment portfolios in its financial best interests.

The £50m bridging loan facility will only be used for new purchases where there are firm plans to sell identified properties where the proceeds are expected within a year and are at least the same value of the borrowed capital. The proceeds will then be used to repay the bridging loan. The aim of the borrowing is to support the prudent management of the portfolio's financial risks by enabling the portfolio to plan concurrent sales and purchases, to avoid the income loss and risks arising from being out of the market for a significant period of time.

d. Advice and services

The Council will obtain appropriate expert property advice, including:

- On the overall portfolio strategy and implementation considering market conditions and outlook;
- On any proposed purchases and sales to ensure these are appropriate to the portfolio strategy and policy;
- To support the identification and implementation of investment opportunities; and
- To support the monitoring, evaluation and review of portfolio performance.

Potential property purchases are likely to be introduced by a range of property agents. The Investment Property Board will ensure that appropriate professional agents are used and kept under review, and that introduction fees are good value and in line with market practices.

The Council will also need legal advice on commercial property matters with the capacity to turn draft agreements around quickly. This will be sourced either internally through the Council's Legal Services team or externally.

e. Decision-making and Governance

As demonstrated in Section 2F, agile decision making is required in order to be able to respond at short notice to property investment opportunities, and to protect existing investments. This will not however be at the expense of good due diligence, negotiation and governance. Controls will be modelled in part on treasury management principles. It is proposed that:

- Investment purchases and sales up to £25m in a single transaction will be approved by the Leader and Cabinet Member for Finance & Resources (jointly with Director of Inclusive Growth, the Chief Finance Officer and the City Solicitor), or their delegates. Transactions over £25m require Cabinet approval. The decision reports will follow the Council's existing executive decision template and Full Business Case template, supported by external advice as set out in 2f below.
- An annual Investment Property Portfolio Strategy and Policy report will be taken to Cabinet for approval before the start of each financial year to set out the strategic and tactical investment approach for the year ahead and beyond. This will provide the framework within which delegations to the Investment Board and officers will be controlled.

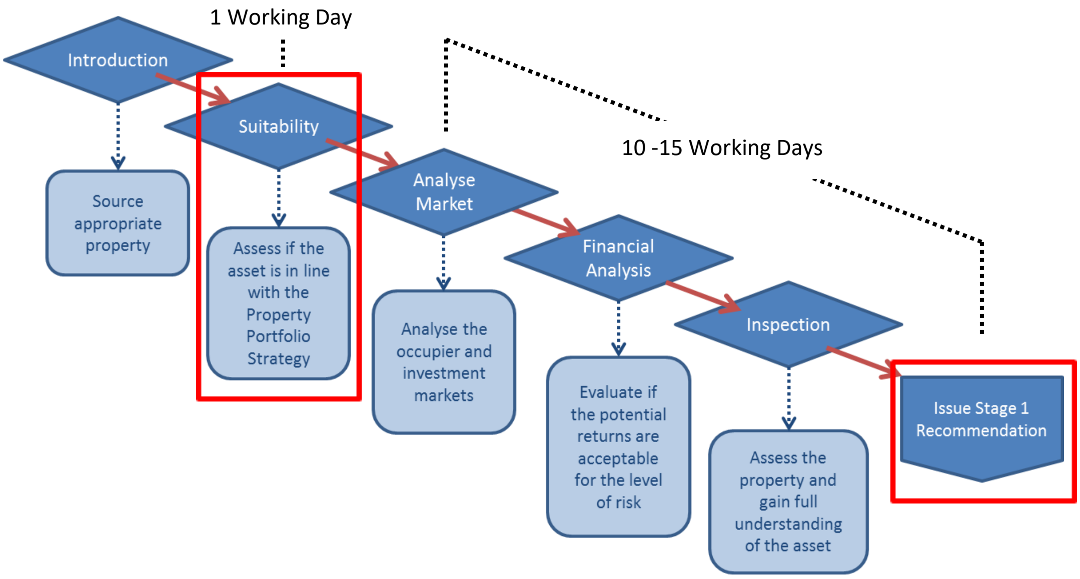
- An officer Property Investment Board, chaired by the Director, Inclusive Growth or the Assistant Director (Property) and including officers from Property Services, Treasury Management and the Finance Business Partner, will keep the portfolio and its budget under review and develop purchase and sale proposals for executive decision. The Board will take appropriate professional advice on an ongoing basis from investment and property professionals.
- Decisions made under delegations will be reported to Cabinet as part of quarterly financial monitoring reports.

f. Transaction process and sourcing

Having a robust introductions process is imperative to ensuring The Council has access to the widest possible range of opportunities across the market and use its inhouse resource efficiently whilst avoiding risk of challenge from third party agents in the 'first-past-the-post' introductions process. Accordingly, The Council will adopt a blanket response and ask agents to introduce all opportunities directly to its investment advisor.

When a potential acquisition opportunity presents itself, a two-stage transaction process will be utilised. This process maximises the speed to market, whilst still allowing The Council to retain control of the investment decision making. The stages where decisions will be made (some more formal than others) have been highlighted in red.

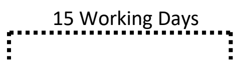
Stage 1 – Initial Recommendation

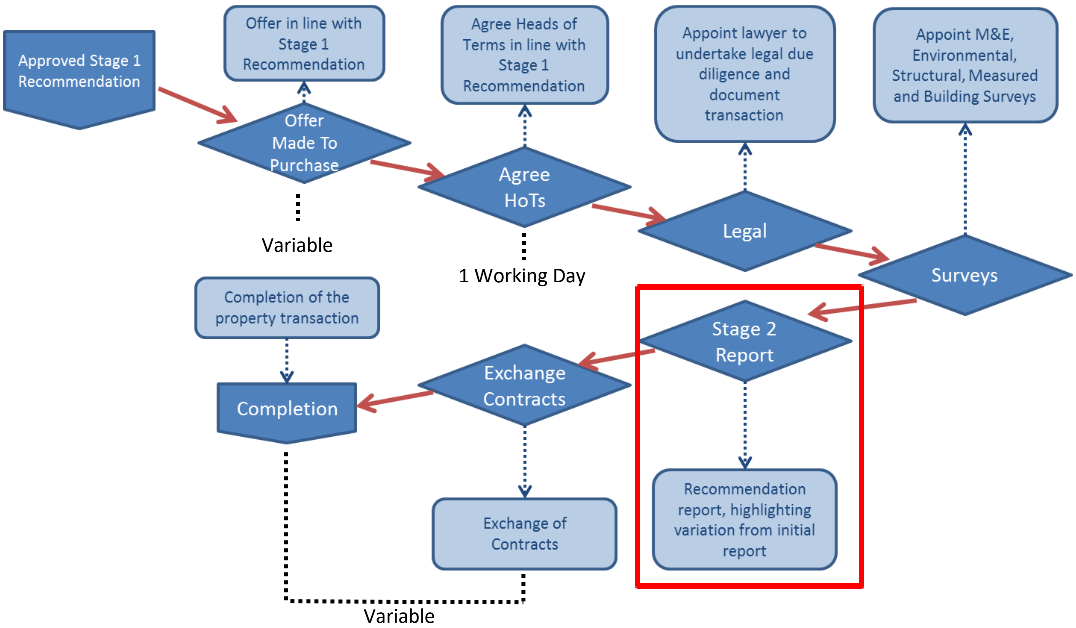


In the first stage, high-level due diligence will be conducted by The Council's Advisor. This will allow a recommendation (subject to full commercial, technical and legal due diligence) to be made, highlighting if it is an opportunity worth pursuing or not. At this stage, no investment decision is binding and its primary purpose is to allow an offer to be put in within competitive timescales.

Timing for the transaction process varies from case to case. In an indicative open market transaction with competitive tension a Stage 1 recommendation would be issued two to three weeks from receipt of the opportunity. Approval at this stage would be nonbinding.

Stage 2 – Final Recommendation





During Stage 2 the due-diligence processes outlined in the diagram above will be coordinated with the investment advisor working closely with the investment agent and The Council's in-house team, challenging assumptions and ensuring the asset is thoroughly underwritten. A final recommendation will then be made by the investment advisor after full consideration of the asset and after input from other professional advisors.

In terms of indicative timing, the heads of terms would then typically be agreed within one working day of the offer being accepted, followed by legals and surveys which take around 15 working days and incur associated cost. The Stage 2 recommendation would be issued shortly after receipt of the legals and surveys. Exchange and completion timing would vary, however for relativity, a typical transaction could take c.20-25 working days from bids being accepted to completion.

g. Capacity, skills and culture

Commercial property investment is a specialised professional activity. External advice will be retained (as set out above), and staff in Property Services and Treasury Management will maintain relevant professional skills and training. Training will also be periodically arranged for senior officers and members involved in decision making and scrutiny, through The Council's property and treasury management advisers.

h. Investment Management Practices

The portfolio will maintain Investment Management Practices as recommended by CIPFA. These will set out its operational arrangements for good risk management, governance, administration and training.

i. Monitoring and review

Portfolio monitoring and review will follow broadly the same principles as treasury management portfolio reporting:

- The Council's Annual Business / Financial Plan will approve the overall framework for service and commercial investments, including property;
- An annual Investment Property Strategy report will be taken to Cabinet at or before the start of the financial year. This will refresh any specific decision-making arrangements / delegations for the portfolio;
- Major property sale and purchase transactions (including decisions taken under delegations), a portfolio valuation summary and overall portfolio issues will be summarized in quarterly financial monitoring reports to Cabinet;
- Monitoring of the portfolio's revenue and capital budgets will be part of normal budget monitoring reports; and
- A year end annual report will be included in the Council's outturn report.

At operational level, the portfolio will be monitored and reviewed by the Investment Property Board, supported by external property and investment advice.

SECTION 3: MARKET CONTEXT

To determine an effective investment strategy, it is necessary to consider the political and economic background which will be invested into. This will shape the underlying investment approach and ensure risk is identified and managed in an effective manner.

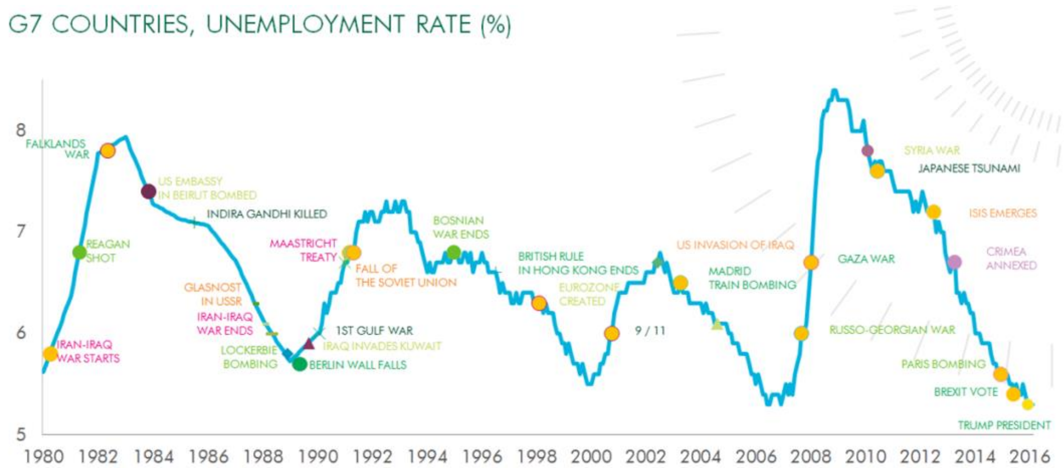
The following section will focus on summarising the impact of the current political uncertainty on the property investment market and the implications on the Council's Investment Strategy before providing context on the UK economic and property outlook.

a. Global Political Context: The Impact of Political Uncertainty (Q1 2019)

With daily political fluctuations both inside and outside of the House of Commons; the Brexit landscape alters rapidly causing sustained uncertainty.

Despite the political, and consequently economic uncertainty, it is worth noting that although geo-political decisions have short term impacts on the wider economy, history suggests that these events tend not to directly impact the cyclical nature of the global, or indeed national, economy.

Using the unemployment rate of the G7 countries as a proxy for the global economy, the graph below shows that the cyclical nature of the market is relatively unaffected by geo-political events. These events cause short term minor volatility but don't have direct impact on the economic cycles.



Source: CBRE Research, Macrobond, IMF, WEO

The longer-term impact on businesses of the UK's political uncertainty and, more importantly, Brexit is still unclear. This uncertainty is impacting investor sentiment, who are becoming increasingly concerned about the future of some occupiers / businesses and consequently sectors.

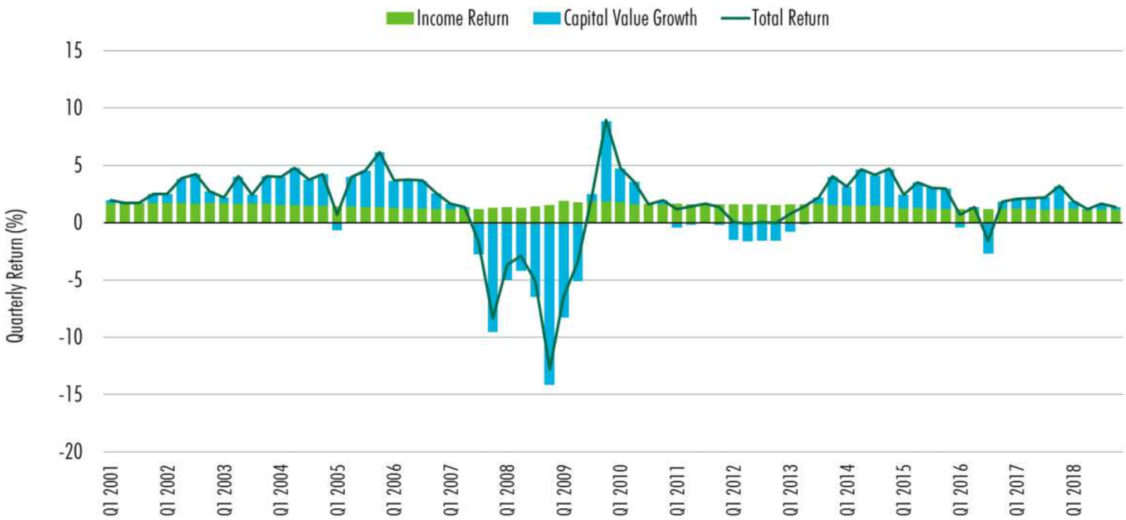
Pricing on prime assets across the market has remained largely resilient, with yields largely unchanged or even strengthening in some sectors. In an uncertain economic and political environment, investors have sought long term secure income streams and therefore demand for these types of assets has remained strong.

A further reason for resilient pricing is that investors who hold risk adverse or defensive properties have been very reluctant to sell and this has led to a shortage of stock in the market. Investors don't want to sell as it is difficult to re-invest any sale proceeds quickly back into the market. Thus, good quality properties which do come to the market face very strong competition for investors and prices are driven higher due to the competitive tension.

In the good secondary and secondary risk categories, investor demand has been inconsistent with varying degrees of investor appetite. These types of property have a greater inherent risk and therefore investors are becoming increasingly selective. In several sectors the yield margin between prime and good secondary is as large as it has been in over five years.

Implications for the Investment Strategy

The Council's primary focus is income security rather than capital appreciation (though this is not ignored). This is because, despite many market cycles since 1980, income returns from property have been relatively resilient. This should provide confidence in these uncertain economic and political times. Property's ability to produce long term and consistent income streams is demonstrated in the graph below showing total returns on



assets (Quarterly) in Birmingham.

Despite property providing a resilient income at a macro-level, the income security provided by individual assets varies considerably. The strategy recommends identifying assets which offer the most advantageous risk adjusted income return. Tenant selection and financial underwriting is fundamental to understanding tenant risk and thus ensuring a sustainable long-term income stream.

Whilst The Council's focus is on income security rather than capital appreciation, the capital value on entry must still be carefully considered as a fundamental investment consideration. Understanding current market pricing is fundamental to achieving your objectives over the long term. The higher the purchase price the lower the relative income return compared to the capital invested, and therefore the greater the risk. Moreover, if The Council overpay, the asset liquidity can be impacted as it will be harder to sell the property quickly (if at all) for the same price.

b. UK Economic Context (Q1 2019)

The UK economy is currently considered "late in the economic cycle", this is often characterised by rising real wages, lower unemployment levels and – on occasions – high and rising debt levels. The combination of which is often inflationary. The housing market has cooled and further rises in household borrowing may be hard to sustain. Over the past six months employment growth has slowed, with unemployment reaching 3.9% in Q1 2019. Interest rates are coming under increasing pressure following a rise to their highest point since March 2009, with further 'gradual' and 'limited' rises expected.

March 2019's PMI figures highlight an increase in manufacturing (55.1) off the back of stockpiling. However, at 48.9, the service industry has seen some contraction – underpinning dwindling business confidence in the sector that has propped up the UK economy. Business investment fell in every quarter of 2018, however, property investment remained relatively resilient, buoyed by foreign capital.

c. UK Property Market (Q1 2019)

The occupational market across most sectors remained cautious in the second half of 2018 and this trend looks set to continue. In the following section, the market trends which are impacting the occupational and investment markets in Birmingham will be reviewed.

Offices

UK GDP grew by 0.2% in Q4 in 2018. This was underpinned by a positive contribution from the services sector, but was offset by a negative contribution from construction. However, as denoted previously, since the release of these figures the services sector PMI as contracted over the past 3 months. Moreover, amid continued uncertainty, annual GDP growth was at its lowest level since 2012 at 1.4%, falling by 0.4% in December 2018.

Falling core inflation (omitting food and energy costs) and continued employment growth have benefited all regions, with real wage growth now returning. Despite challenges, inflation is still expected to fall allowing real incomes to expand over the medium-term, with unemployment remaining at low levels. Contrary to the national view the Regional PMIs have been showing strength of late – helping to prop up the figures mentioned previously in the 'Economic Outlook' section. The North West (53.9) and Yorkshire & Humber (52.8) were the two main contributors to UK output growth in

January 2019, as highlighted within the latest NatWest Regional PMI release. Any score over 50 is indicative of growth. Many other regions highlighted further positive growth, including Wales (52.7), East Midlands (52.5) and Northern Ireland (51.6).

Office Occupational Markets

Brexit concerns have not deterred tenants from taking space across the regional markets, with large occupiers including Starbucks and KPMG taking space in the south east. This has continued a trend from 2018 where, across the ten regional cities monitored by CBRE, overall take-up reached nearly 3.9m sq ft. This level was 24% above the five-year average and 37% higher than the 2.8m sq ft acquired in the same period of 2017.

Although there were variations across the UK, the majority of markets witnessed very strong growth throughout 2018. Six of the ten cities monitored by CBRE outperformed against their five-year average. These included: Belfast, Edinburgh, Glasgow, Leeds, Liverpool and Manchester. Others such as Birmingham and Bristol also saw healthy levels of occupier activity, albeit at slightly below their five-year average. The only potential brake on short-term activity in some markets is a severe supply shortage of good quality office space. These shortages will drive further pre-let and refurbishment activity.

The CBRE EMEA Occupier Survey 2018 has highlighted the growing importance of building technology for occupiers and how this can assist in the delivery of a flexible, efficient working environment. This will be a key theme moving forward.

Office Investment Markets

Appetite for regional office investments was buoyant in 2018. In total, c. £4.5bn was transacted across the regions in 2018, which was above the five year average. Estimated transaction figures across regional cities, excluding the south east, total £174m (18 assets) over 2019 to date, with £1bn available. This represents an 80% fall on Q1 2018, significantly driven by a lack of new Grade A stock coming to market across leading core locations such as Birmingham, Bristol, Edinburgh and Manchester.

There remains a competitive pool of investors. Prime assets in core regional office markets form an important part of strategy for a wide range of investors including UK funds and overseas buyers. Many are concerned over pricing in London. Despite political and economic headwinds, investors are very much focused on the strong fundamentals of UK real estate.

Retail

UK retail is undergoing a period of unprecedented change, with structural adjustments in the way we shop causing retailers to rewrite their physical space requirements, compounded by more short-term forces that are accentuating a challenging market.

Whilst employment levels and wage growth are still positive in the UK, concerns over future economic performance are impacting consumer sentiment. Key themes include:

- The impact of digital online retail is having a major effect on physical stores and retailer strategies, but profit warnings from online only companies, such as Asos, has highlighted that pure play (online only) retailers are not immune to the retail cyclical slowdown.

- Depreciation of sterling has translated into import inflation resulting in a trickle down impact on purchasing costs for retailers.
- The business rates revaluation had a considerable impact on higher rented locations, most notably in London and has added to the costs of running flagship stores.
- The National Living Wage, a statutory minimum which was introduced in April 2016, increased 4.9% in April 2019 to £8.21. The low paying nature of retail means the industry will be affected more than other sectors.

Retail Occupational Markets

The impact of elevated costs has caused several retailers to use Company Voluntary Arrangements ("CVA") as a means of averting administration. Many such retailers have

been the subject of speculation for some considerable time and there are still several on 'retail watch lists' that are being monitored today (see following page). The most recent, high profile, CVA has been Debenhams which was announced on 26th April 2019 – 22 stores have been earmarked for closure during 2020, with the potential for more to follow.

CBRE, March 2019

There are plenty of uncertainties ahead that may detract from business investment. For the time being, rents will remain under pressure, and brands will seek to maximise incentives to mitigate their risk position. This is often coupled with seeking greater flexibility on their occupation.

The major fashion houses – such as H&M and Zara – who are investing heavily in digital online platforms face the greatest competition from pure play retailers. Subsequently, these high street names are particularly sensitive to rental and rates liabilities, which has resulted in such occupiers seeking to include total occupancy cost caps on new leases.

Other mid-market fashion retailers are also negotiating heavily at lease events to try and secure reduced rents and more flexible lease terms. Large space unit rents are therefore under pressure and in the vast majority of cases are now over-rented.

There are some retailers who continue to seek new opportunities for store openings. However, leases are becoming shorter with the norm now five years' term certain for unit shops.

Brands are increasingly incorporating pop-up strategies for PR and brand awareness, trialling new concepts such as Fragrance Shop's Sniff Bar. Also a number of brands that typically do not have stores have run pop-up space for marketing reasons.

Retail Investment Markets

Retail properties have seen yields move out quite significantly over the past 6 months as the troubles in the occupational markets have impacted investor sentiment. Prime retail warehouses have moved out on average about 10% with more secondary schemes moving out considerably further. There are a number of secondary / tertiary properties across all the main retail sectors which have failed to attract any bids at any level.

The retail investment market is polarised with secondary and tertiary stock seeing virtually no investor demand. Prime / best-in-class assets will attract investor demand however prices being offered tend to be significantly below valuations and are only being sold by a forced seller.

Industrial

The industrial market remains buoyant. 2016 was driven by activity of retailers and wholesalers, particularly internet retailers, 2017 was more defined by an increase in take-up from manufacturers and budget food retailers. However, in 2018 the main driver of demand has once again been from the online retail sector which represented 31.7% of overall take-up.

The shift in consumer habits with increased multi-channel retail has created further requirements because of the nature of e-fulfilment. Retailers require larger primary pick faces plus packing areas which are space hungry. Moreover, very few have a satisfactory return logistics function set up which has the potential for further requirements to evolve in the short-term.

Requirements are now being centred on more affordable locations, where rents are relatively cheap with a good supply of labour, in comparison to prime M1 and South East locations.

Industrial Occupational Market

The driver for the high demand has been the online retail sector representing 31.7% of all 2018 take up. This reflected an increase from 18.3% in 2017. These large requirements from a wide range of online retailers were responsible for taking at total of 9.98m sq ft.

The second largest sector with 25% of take-up over the course of the past year was third party logistics, some of whose end user customers are also online retailers. The market remains solid in all regions, with good performance from the East Midlands region which accounted for almost 39.7% of the total take-up after achieving only 16.0% during 2017.

Occupational take up at 31.5m sq ft was significantly above the ten year average of 21.4m and 82.5% ahead of 2017. Design & Build space, at 14.1m sq ft, dwarfed speculative development which stood at 8.25m. Another clear trend during course of 2018 was the growing size of requirements, with extra-large big box ("XXL") warehouses (those exceeding 500,000 sq. ft.) accounting for almost half (c. 14m sq ft) of the total take-up, a proportion never seen before. Indeed, the average unit size for D&B space under construction is in excess of 500,000 sq ft. This trend has also encouraged developers to start building speculative XXL schemes again for the first time in almost a decade.

Supply improved substantially during 2018 and, at the end of the year, there were 133 units available which totalled 28.4m sq ft. Second-hand units tallied 12.7m sq ft whilst completed and ready to occupy speculative units amounted to 7.45m sq ft. The 31% general increase in supply is directly linked to the recent aforementioned rise in speculative development.

Industrial Investment Market

Investment volumes for single asset logistics were tracking behind the pace set in recent years. After the first six months of 2018, the total value of sales is £743.57m, compared to £1.19bn achieved after the first six months of 2017. Whilst, at first sight this may appear disappointing, the wider industrial investment market remains very active, with large amounts of capital attracted to distribution portfolios and the multi-let market. The larger single asset sales were all dominated by the specialist logistics property companies and institutional investors.

Three regions stand out as being the principal destinations of investment spending so far this year, which mirror the region with highest occupier take-up during the year to date. Two of these regions would be regarded as core destinations: 30% share of spend was in London and the South East and 22% of investment was in the East Midlands.

Alternatives

The alternative asset classes are starting to move more closely in line with associated mainstream sectors such as offices, retail and industrial – offering capital and income returns which can be enhanced through direct or indirect operational involvement.

Alternative asset classes are still targeted by investors as leases are often signed on such assets for periods of c.20 years, and those which fall short – such as student housing – benefit from such high re-letting rates that are unlikely to impact investor sentiment or valuation.

In light of the opportunities the alternative sector presents an overview of both the hotel and leisure markets has been provided – as these sub-sectors have the greatest potential to provide secure, long term income moving forward.

Hotels

Given the lag time for inflation to work through supply chains, operators are now experiencing a material impact and will need to be stringent with their purchasing to maintain both profitability and the guest experience.

Robust occupancy and increasing average daily room rates drove growth in revenue per available room (RevPAR) in 2018. Over the 12 months to March 2018, average UK hotel occupancy stood at 78.2%. When contrasted to the 20-year average of 73.4%, it is clear that the advent of disruptors such as Airbnb are yet to significantly impact the market – however, time will tell as to the true impact of these 'gig economy' companies.

Considering future pipeline, a significant amount of the development stock continues to fall within the 'Budget' category with operators such as Premier Inn and Travelodge remaining acquisitive for the right locations. At the start of the year there were 294 hotel projects with a 2019 opening date, with 7,371 rooms due to open in London and 16,165 in Region UK. A 4.8% and 4.3% supply increase, respectively.

Leisure

Leisure operations can be split into 3 sections; urban leisure, destination leisure and pay to play. Urban leisure spans leisure parks, cinemas, gaming, health and fitness and restaurants. Destination leisure schemes include holiday parks, marinas, golf courses, visitor attractions, stadia and arenas.

Supply tension is limited in the leisure market with operators and contemporary trends being significantly intertwined. The ability of an astute investor to spot both the trend and operator to follow is crucial to initial viability, long-term growth and wider asset performance.

Prime leisure yields have remained strong over the last couple of years and through 2018, driven primarily by institutional capital seeking out long indexed income and the move of traditional real estate investors away from secondary retail.

These positive trends look set to continue, although the spate of insolvencies and CVAs in the restaurant sector has dented confidence and curbed development activity, most areas of the leisure market remains strong.

Cinemas

The overriding narrative within the cinema sector is that all leading UK operators are investing back into their sites and focussing on developing a more premium offering which commands a stronger admission revenue and drives increased admission numbers.

Key operators have also been looking at re-gearing better performing sites and using this as a funding option for refurbs. Cineworld have '3DX' and Odeon have the 'Luxe' brand where the focus is about developing an experience. Where these investments have been made, return on investment has been very strong – in some cases leading to a 30%+ uplift in EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation).

This is all underpinned by a generally resilient leisure market and buoyant discretionary spending on particularly experienced based leisure activities, notably as real wage growth has returned.

SECTION 4: CURRENT INVESTMENT PORTFOLIO

Birmingham City Council is unique in the extent of its property ownership as the land estate is the largest held by any UK local authority. The City Council holds all properties which are let to third parties, within the Investment Property Portfolio. The purpose of the portfolio is to deliver a commercially driven, financially focused return. In 2017/18 the portfolio earned an annual income which represented almost 10% of all City Council income from external sources. Whilst the portfolio contributes a significant income, the assets held reflect the City Council's historic accumulation of assets, rather than a commercially driven investment rational. This section provides a high-level overview of the current portfolio as the starting point to base the investment strategy and ultimately help realise the full potential of the City Council's Investment assets.

Portfolio Overview

As of 2019, the investment portfolio is estimated to have c.5,500 legal interests (the majority within Birmingham), with over 3,000 tenants and gross rental income of c.£28m. Historically the portfolio was divided across an assortment of categories which are defined within the appendix. These titles do not align with commercial practice but are used for the initial portfolio overview. The table below provides a summary of the portfolio using the historic categories.

2019 Estimated Birmingham Investment Portfolio Statistics – Source: Birmingham City Council

CATEGORY	LEASES	LEASES (%)	WAULT (YRS)	AREA (SQFT)	AREA (%)	INCOME (£)	INCOME (%)	VACANT (LEASES)	VACANCY (% LEASES)	ESTIMATED VACANT INCOME (£)
Advertising	128	2%	2.4	-	0%	896,025	3%	5	2%	-
Agricultural	32	1%	10.5	3,294	0%	222,965	1%	6	2%	-
Birmingham Science Park	63	1%	1.8	138,127	3%	1,206,863	4%	10	4%	137,133
City Centre General	124	2%	99.4	325,061	6%	2,497,638	9%	7	3%	-
City Centre Multi-Let	131	2%	3.0	155,216	3%	2,237,869	8%	38	14%	326,217
Community Asset	195	4%	20.5	1,658,696	30%	1,463,014	5%	6	2%	-
General	201	4%	13.7	586,370	11%	2,566,476	9%	9	3%	-
Industrial General	414	8%	48.3	1,031,432	19%	4,145,330	15%	4	1%	-
Industrial Multi-Let	337	6%	1.8	433,349	8%	2,614,166	9%	13	5%	47,904
Jewellery Quarter	263	5%	6.5	78,960	2%	1,423,212	5%	27	10%	143,624
Markets	67	1%	12.4	130,193	2%	1,196,438	4%	7	3%	-
Minor Interest	674	12%	14.2	78,530	1%	83,211	0%	42	15%	-
NEC Area	23	0%	1.5	25,465	0%	1,537,410	5%	1	0%	-
Residential	356	7%	24.6	-	0%	444,314	2%	4	1%	-
Retail	60	1%	16.5	153,721	3%	849,144	3%	1	0%	1,897
Shop Parades	528	10%	10.1	587,739	11%	3,639,798	13%	27	10%	155,026
Utilities	1,854	34%	5.5	34,016	1%	1,033,234	4%	67	24%	-
	5450	**100%**	**22**	**5,420,169**	**100%**	**28,057,108**	**100%**	**274**	**100%**	**811,801**

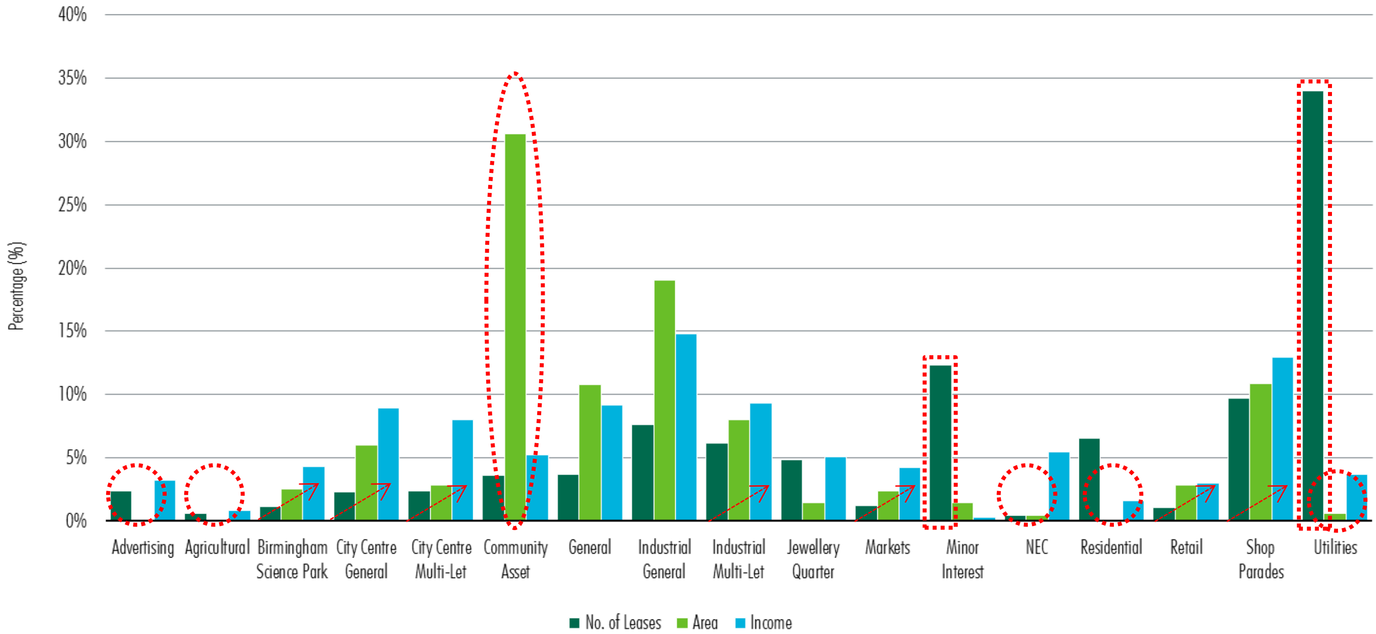
Note: 1. The difference between Commercial Portfolio rent budget of £25.776m is £2.203m of Housing Revenue Account – Shop Parades which is included for review but not part of the Portfolio Investment Strategy.

2. The data used for the analysis is being confirmed and subject to change.

3. There are ground rent interests within the various portfolio categories which have a different risk profile to direct property holdings.

The chart below shows the number of leases, area and income for the various categories within the portfolio.

Lease, Area and Income Summary (Birmingham City Council Headings)



Key Observations

7 of the 17 categories have a more traditional profile which shows a small number of leases controlling a relatively greater area which produces a proportionally larger income. These leases have a higher average rental income of £15k pa per lease and likely efficient in terms of property management and/or value for money.

46% of the leases in the portfolio are utilities and/or minor interest which only produce 4% of the portfolio's annual income. At an average lease rental income of £557 pa and £123 pa respectively they are the lowest income per lease in the portfolio.

A number of categories have little to no area. These are a mix of ground rents, land holdings and smaller holdings which produce a relatively small amount of income but may have some land value. The NEC Area (National Exhibition Centre) stands out as it produces 5% of the portfolio's income through 23 leases (.4% of the portfolios leases). These leases have an average rental income of £67k per lease.

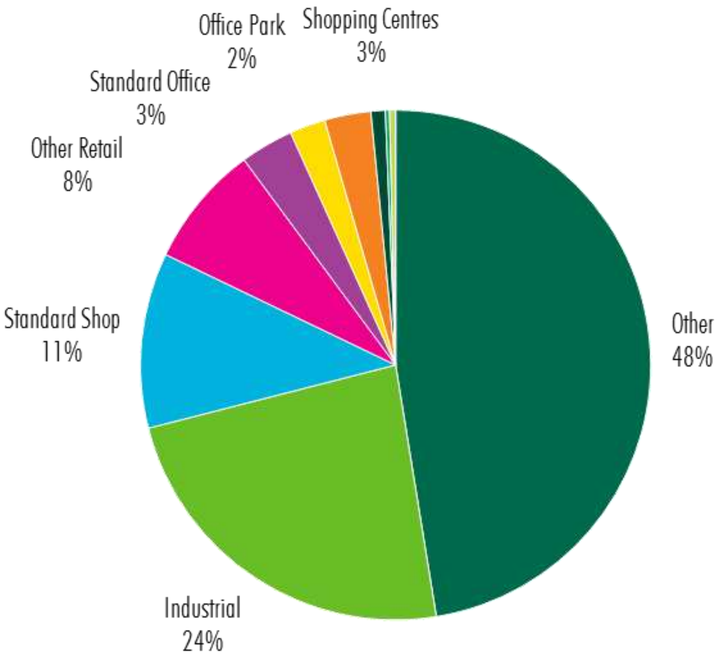
The community assets represent 30% of the portfolios area whilst only producing 5% of the portfolio's income. The income psf is one of the lowest in the portfolio at £0.88 psf pa.

Data Source: Birmingham City Council

Sector Analysis

The remining analysis of the portfolio is recategorized using MSCI index headings (Previously IPD – Investment Property Databank) as opposed to the Council's historic settings. The MSCI index is the standard benchmark for investors to analyse the performance of property in the UK market. This allows the portfolio to be compared on a commercial basis.

The following section looks at the portfolio by sector. This is important as each sector carries its own nuanced risk profile which needs to be considered individually, and as part of the whole.



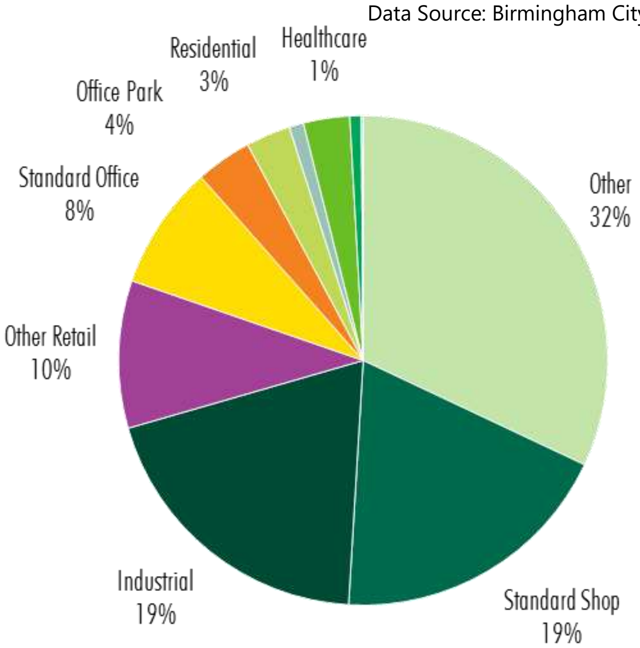
Sector Makeup by Area

OTHER	AREA
Community Asset	34%
Car Parking	7%
Land	3%
Utilities	2%
Agricultural	1%
Hotel	1%
Access	0%
Advert	0%

OTHER	INCOME

Sector Makeup by Income

Data Source: Birmingham City Council



Community Asset	9%
Car Parking	9%
Utilities	8%
Hotel	1%
Advert	3%
Agricultural	1%
Land	1%
Access	0%

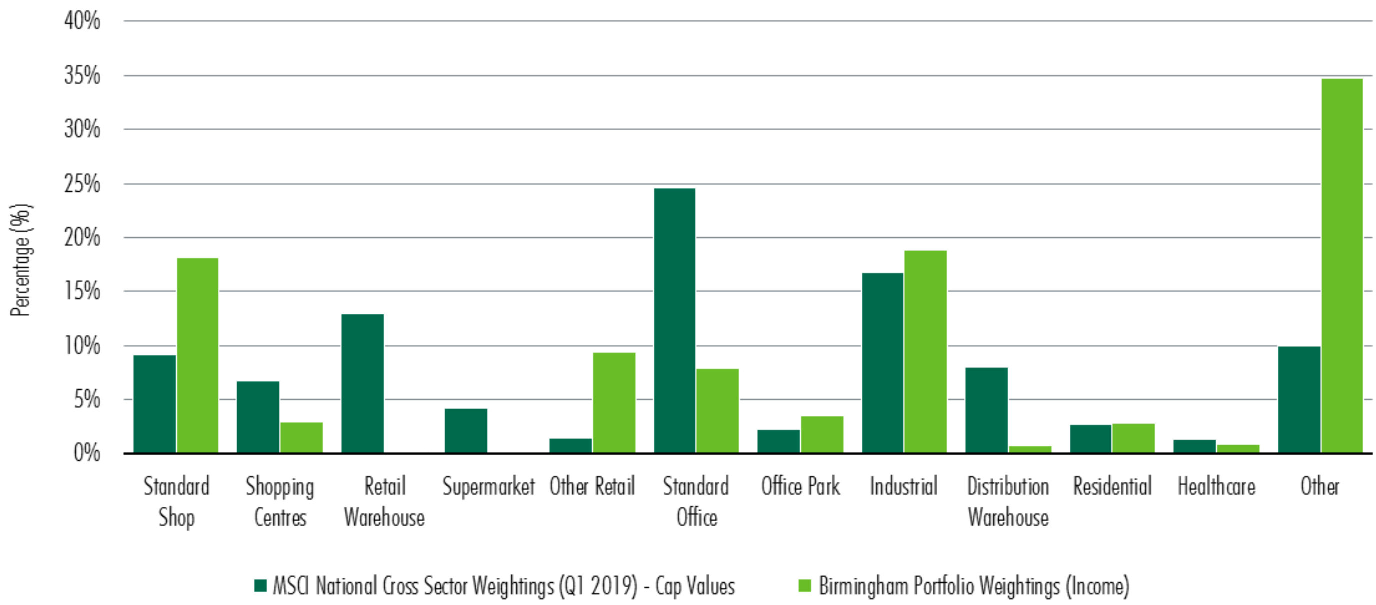
Data Source: Birmingham City Council

Key Observations

- The makeup of Birmingham's holdings are diverse and eclectic based on the portfolio's history. It is important to note that the constituent parts of the Other category are not a direct comparison (ie. MSCI does not have such a high percentage of community assets).
- A majority of the income and area is made up by the Other category. The tables provide a breakdown. From an area perspective this is dominated by community assets which has been discussed earlier. From an income perspective this presents an opportunity to help diversify the geographically constrained income profile.
- Retail, offices and industrial collectively make up a large proportion of the portfolio by income and area which is expected for a portfolio of this nature.

To provide risk and commercial context the chart below compares the Council's holdings to MSCI.

Portfolio Income Weighting Compared to MSCI



Note: It is not possible to undertake a comparison by value as a valuation of BCC's investment portfolio recent valuation is not readily available. Accordingly, BCC's income weight was used for the comparison.

Key Observations

- The portfolios makeup contrasts the MSCI benchmark. It is important to note the quality, lot size and covenant strength of the assets within the various sectors may vary between MSCI and the Council's Investment portfolio. In the short / medium term this means the returns will also likely differ for better or for worse.
- Relative to the index the Council is significantly overweight in standard shops. This presents a risk given the structural change / turbulence which is occurring in the retail market (ie. Vacancy, CVA's, declining investor sentiment, etc) and the associated negative impact on returns. This however is tempered by the portfolio's lack of retail warehousing and shopping centres meaning the total retail weighting (including other retail) is 30% compared to MSCI's 33%.
- The portfolio's weightings in "other retail" (food and beverage establishments, market stalls and car showrooms) and "other" (discussed above) needs to be considered in the context of a portfolio which is geographically constrained; in that it provides some element of diversification. Some caution / consideration is required as these assets typically require specialist advice to manage them effectively.
- The portfolio is significantly underweight in standard offices. The holdings it does have are a mix of short income and ground rents, whereas MSCI is primarily made up of Prime offices.

- The residential holdings are mainly ground rents which have a different risk profile to those in the MSCI benchmark.

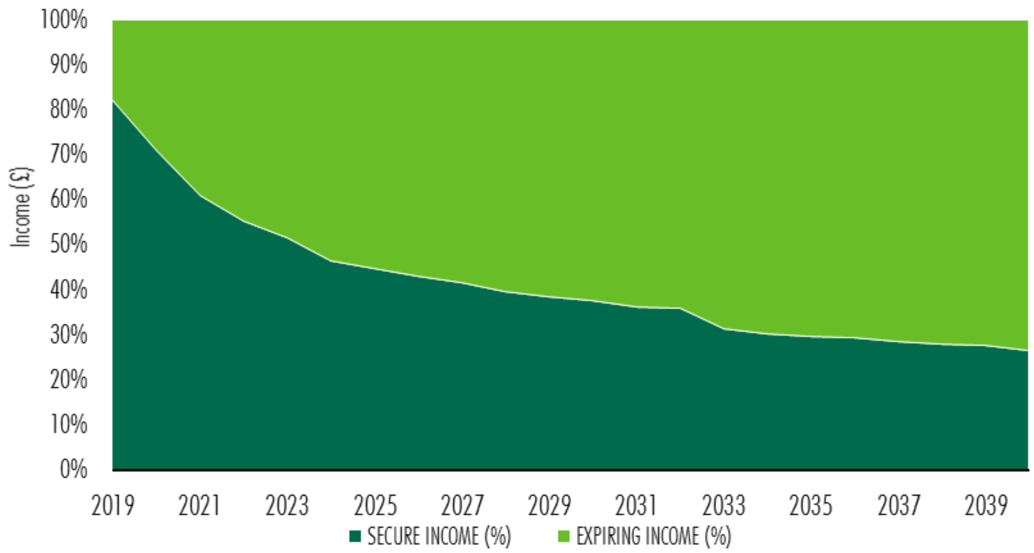
Income Security

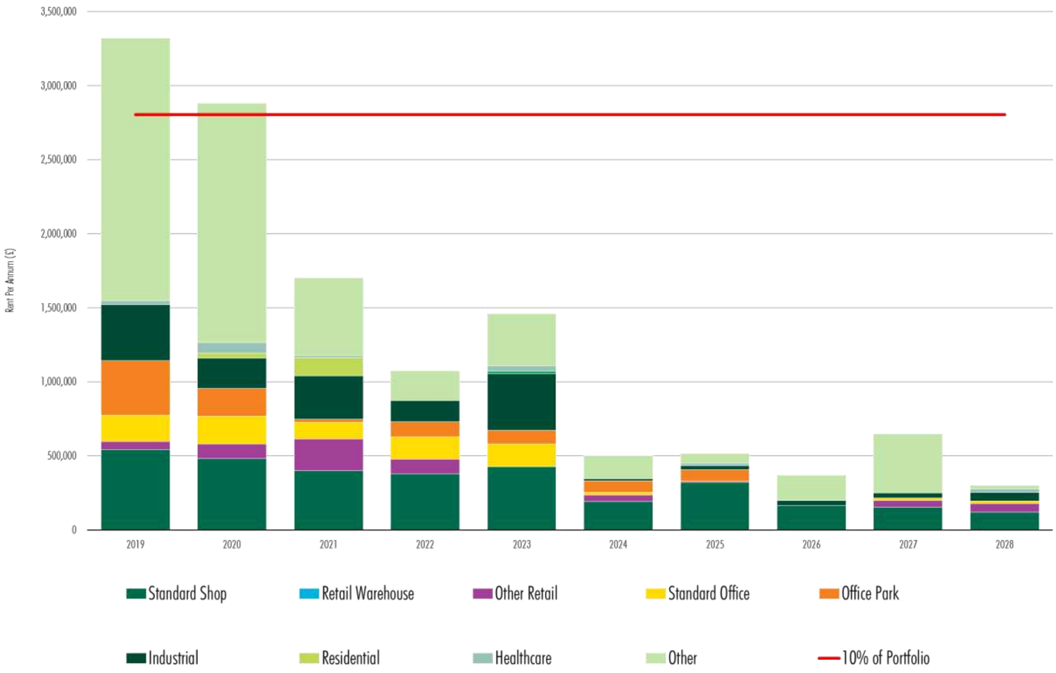
The following section looks at the quality of income within the portfolio. This is critical as the quality of income denotes the potential risk of receiving the income, its potential for growth and is a major consideration in its capital value.

One way of analysing the portfolio has a WAULT (weighted average unexpired lease term) of 22 years compared to MSCI's 12.9-year WAULT – Q1 2019 however this does mask some of the risk in the portfolio as a number of interests have terms over 50 years whilst nearly 50% are less than 5-year terms.

The chart below looks at the income secured by a lease (dark green) vs. the income which could expire in any given year (light green). The expiring income is income at risk as there is no longer a contractual agreement and the tenant can vacate at short notice. In a rising market this presents an opportunity to gain from higher rental values, however in the same sense in a falling market the expiries present the risk of void and/or lower rents.

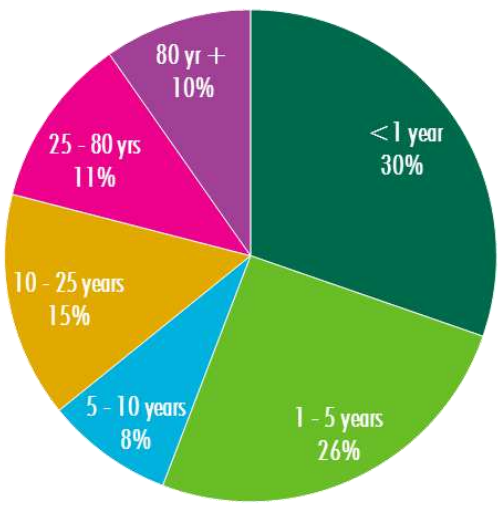
Income at Risk





Income Expiry Profile by Sector

Income Expiry Profile by Timespan



Key Observations

- In 2019, 30% of the portfolio's income will have expired (this includes leases that have already expired, where the tenant is still in occupation c.£3.3m of income).

This rises to 56% in five years. This presents a significant income security risk, albeit a lease expiry does not indicate a tenant will vacate.

- The majority of the expiries are in the "other" asset class followed by offices, industrial and retail. This is broadly in line with the sector weightings of the portfolio.
- More than 36% of the portfolio has a contractual term of 10 years or more with 21 % being 25 years or more. This helps to balance the other half of the portfolio which have shorter terms. It is crucial to understand the covenant strength of the tenants to ensure they will be able to pay the rent for the duration of the term.
- 21% of the income has a term of has a term between 25 – 80 years. If these are ground rents the term has reached a point where the capital value / saleability will be negatively impacted by the reduced term. Accordingly, there is potential for the regear of these leases to receive a capital receipt and/or negotiate with the leaseholder to redevelop the asset, where appropriate.

Analysis of the Council's top 20 tenants has been undertaken to understand the default risk within the portfolio. The analysis shows that 20% of the portfolio's income comes from 24 tenants, the majority of which is long dated and across a variety of sectors which helps reduce the risk. Many of the tenants have strong covenants / are government linked providing a strong covenant strength.

Disposals

To support the City's growth ambitions the Council has undertaken an initial strategic review of its property portfolio to identify opportunities to support inward investment, housing growth and job creation. A summary of the assets have been identified within the Birmingham Sites Prospectus documents. These interests have not been included in the earlier analysis.

As the portfolio is rationalised a number of hold options will be assessed (i.e. hold, asset manage and hold, asset manage and sell, sell). The assessment will be based on the investment criteria in section 2b. Assets which do not meet the investment criteria will be marked for disposal and a strategy will be produced to assess the most efficient approach to achieve best value.

SECTION 5: INVESTMENT RISK MANAGEMENT AND OTHER CONSIDERATIONS

This section reviews the key considerations which will impact the investment decisions.

a. Risk management

The prudent management of risks is at the core of this Strategy, given the responsibilities which attach to the management of public money. Investment risks will be managed using the framework set out in this report, ie in accordance with the Investment Policies in section 2 and the Strategy and tactics in sections 6 and 7, with regular performance reporting and review to Cabinet.

Investment risks cannot however be avoided. Property values will rise and fall under the influence of the economic and property cycle, and income is also likely to fluctuate. Some investments will be more successful than others. This has been the case for as long as the Council has held the investment property portfolio. This strategy proposes a more structured and active approach to the management of the property portfolio, in which under-performing or inappropriate properties are sold and more suitable replacement properties are bought, guided by professional property management advice. By adopting a more managed approach it should be possible to better balance risks whilst improving income over the medium term. It is not proposed to increase risk by investing more into the portfolio.

The professional skills required relate both to treasury management investment as well as property investment, and the governance framework draws on the Council's treasury management control framework under the CIPFA Treasury Management Code. Officers from Property and Treasury management teams will form the core of the Investment Property Board.

b. Geographical Diversification

There is a desire to invest locally where possible, but it is important to understand that solely doing so will be a constraint to the primary objective and will increase the risk of the investment portfolio. This is because the market opportunity and pipeline (across all investment classes) will be significantly reduced. By way of example Birmingham only accounted for 3% of the UK direct investment market in 2018 and there were only 26 deals over £10m over the full year, compared to a UK Wide total of 893 transactions (Source: CBRE Research 2019 Q1, Property Data).

One way of approaching this is classing investments into one of three geographical zones. The investment characteristics that an individual investment would need to exhibit would then be different dependent upon which zone the investment falls.

Zone 1 (Birmingham)	Zone 2 (Neighbouring Boroughs)	Zone 3 (UK Wide)

Commercial Return Regeneration / Development Supporting local investment Supporting local services	Commercial Return Regeneration / Development The regeneration link will be validated on a case by case basis.	Commercial Return

Whilst all investments must achieve the primary objective of sustainable income generation, it is acknowledged that those in Zone 1 and 2 will likely have secondary benefits as well.

c. Deployment Options

There are various ways to deploy capital into real estate. Each deployment option will have its own distinct risk return profile / considerations. The investment strategy will utilise various investment routes to build up a sustainable direct portfolio and ensure it is best placed to achieve its income objectives in the future.

The following table identifies the key considerations of each investment type:

	Direct Investment (Equity)	**Development (Debt)**	**Investment (Debt)**	**Indirect / Pooled Funds**
Definition	Assets owned or purchased with the primary intention of earning a return; through a combination of rental income and/or capital appreciation.	Loans issued to fund the development of real estate assets. The site is used as security and returns are made through interest payments and other fees. This is typically for the duration of the construction period.	Loans issued to finance standing real estate's assets. The asset is used as security and returns are made through interest payments and other fees. This is typically for three to five year periods.	The purchase of shares in a fund / publicly or privately company which holds real estate assets.
Advantages	Ownership of physical asset Sustainable and regular income Alternative uses for building/site Ability to add value to investment (capita growth/improvement) Supporting local occupiers (in Zone 1). Regeneration benefits (in Zone 1)	Typically, higher income return than direct investment. LTV/LTC provides risk cover Downstream benefits from funding new development Current market opportunity Costs borne by borrower	Similar returns to direct investment, but with lower risk Costs borne by borrower Regular income, with interest typically paid quarterly Longer investment periods of 5-10 years mean sustainable returns	Can invest smaller amounts Diversification benefits Opportunity to specialise by sector/location Benefit from property expertise No property management responsibilities Greater liquidity (depending on the vehicle used) Governance oversight

Disadvantages	Prime assets have low yields Lack of local opportunity at right risk profile. Susceptible to the full effect of negative market movement (capital falls)	Irregular returns (typically repaid at expiry of facility) Short investment period (1-3 years) Need to constantly recycle investments to generate a return Increasing competition in the sector has pressure on margins High concentration and market risk if all in Zone 1	Typically lower returns than development lending Highly competitive, means can be difficult to find opportunity Margins may be too low for secure assets. Likely to be limited opportunity in Zone 1.	Lack of control over investment decisions Vehicle management costs – impact on returns Depending on vehicle, returns, at least in the short term, may not mirror those of direct property Possible increased volatility in returns from gearing Possible lock-ins/restrictions on withdrawal (some unlisted vehicles) Relatively low/no secondary market liquidity (some unlisted vehicles)
Local Gov finance	Purchase cost is capital expenditure. Annual gains and losses in value will not hit revenue account	Loan advance is probably capital expenditure. Any impairment costs are unlikely to hit revenue account	Loan advance is not capital expenditure. Any impairment costs will hit revenue account	Purchase cost may or may not be capital expenditure, depending on the case . Any impairments or gains and losses in value may hit revenue account (including any initial loss on the bid/offer spread)

d. Impairment

Direct property purchases are likely to be accounted for as Investment Properties. They will need to be formally revalued in the balance sheet at each year end.

Any property loans in the portfolio will need to be impaired from the outset, and reviewed at each year end, using an estimate of the probability of default. The portfolio policies above expect that any property loans will be secured against the property asset on sound commercial terms, and this will reduce the impairment provision required. Nevertheless, where loans are not treated as capital expenditure, the portfolio will be very cautious in making property loans.

e. VAT

The VAT implications of all property acquisitions, developments and disposals needs to be considered prior to any acquisition, development or disposal. Some acquisitions will be liable to VAT where the seller has opted to tax. In which case, BCC needs to consider if it should also opt to tax to ensure that BCC can reclaim VAT on the acquisition and on any future expenditure. Other acquisitions may not be liable to VAT.

Where BCC acquires VAT opted properties with the benefit of tenants, BCC needs to opt to tax prior to the acquisition taking place to ensure that the transfer is that of a business as a going concern and not liable to VAT. This may be more beneficial from a Stamp Duty Land Tax ("SDLT") perspective rather than from a VAT perspective as SDLT is payable on the purchase price including any VAT that may be payable. So, if no VAT is payable on the purchase price, the value for SDLT should be lower than if VAT were payable.

The option to tax lies with each person that holds an interest in the property so, although an option to tax decision may be influenced by a seller's option to tax, opting to tax is an issue that BCC needs to consider based on its intended use of the property acquired. An option to tax decision should consider the extent of any intended expenditure on the property concerned on which VAT will be paid, e.g. acquisition, development, refurbishment etc., together with BCC's intended use of the property, e.g. for rent, disposal, own use etc.

Where BCC acquires VAT exempt properties, this should not have any adverse impact on BCC's VAT recovery position as long as no significant expenditure is incurred in connection with the acquisition. However, if BCC intends to develop or refurbish such properties for onward letting or disposal, BCC's VAT recovery position needs to be considered in respect of such use. Such considerations need to ensure that there is no adverse impact on BCC's VAT recovery position of any property developments etc.

Where BCC disposes of investment properties, those disposals may be exempt or liable to VAT by virtue of an option to tax. Where BCC has opted to tax the property concerned, VAT will be chargeable on the disposal unless the disposal is that of a transfer of a business as a going concern (subject to conditions) or BCC's option to tax is disapplied for any reason. It may be the case that BCC needs to opt to tax a property disposal particularly if BCC has any significant expenditure in connection with the disposal.

All property acquisitions, developments and disposals will be discussed with BCC's VAT Team to ensure that the VAT implications of those acquisitions, development and disposals are properly considered so that any adverse impact on BCC's VAT recovery position may be mitigated. BCC's VAT Team maintains BCC's option to tax list against which all property lettings and disposals will be checked to ensure that the correct VAT treatment is applied.

SECTION 6: INVESTMENT STRATEGY

Rather than being governed by arbitrary allocations to the different investment types, the best way to generate the sustainable income stream that the Council needs has been considered over the short, medium and longer term. This is based on prevailing market conditions, consideration of the geographical zones and the likely speed of capital deployment.

However, a balance of investment types will be maintained in the portfolio in order to diversify risks across different property sectors.

It is also acknowledged that the investment strategy will evolve over time as the investment portfolio becomes more mature.

Short Term

The strategy will initially focus on identifying appropriate disposals which will provide the seed capital for the portfolio's acquisitions. In general this will be medium term income (5-10 years) across various sectors to help balance the portfolio's risk profile. These acquisition opportunities will be assessed on a case by case basis. The £50m bridging facility may also be used to smooth the lag in disposal timings. This period will also be used to identify and pursue income generating/ optimisation opportunities within the portfolio this will include re-gearing ground rents and lease on longer terms and market rates.

Development lending (in Zone 1) will also be utilised where appropriate to supplement returns and make prudent use of the available capital. Income from development lending is irregular and will need to be recycled regularly; however it will allow the Council to strategically influence the portfolio's performance (including the existing portfolio) in the short term. It is important to understand that whilst development lending is a good short-term solution it is difficult to sustain a stable income profile over the longer term.

Medium Term

Over the medium term the portfolio will continue to be shaped by disposing of underperforming assets (relative to the selected benchmark ie. MSCI's IPD- Investment Property Database) whilst acquiring commercial assets (when sufficient capital has accumulated or disposal identified) which meet the Council's investment requirements. This will reduce the need to recycle any development loans and will help the Council develop a stable income base for the future.

The speed that this can achieve this will depend upon prevailing market conditions and the available capital/ disposals but it is necessary to ensure the income is long-term and sustainable.

Long Term

Over the longer term most of the income should come from suitable investments, this will be from assets held from the existing portfolio, new acquisitions, and/or through investment lending. This will ensure the Council can support its services through a regular and sustainable income steam.

This will then be supplemented with development lending, which may give enhanced returns but will not be as regular.

SECTION 7: INVESTMENT TACTICS

Sustainable and secure income remains a key objective. Sector recommendations should shape the over-arching strategy, but individual property fundamentals remain key (over a default sector bias) with attention given to the location, building quality, rental profile, covenant, lease length and alternative use. The Council should also consider diversification in investment method (direct or debt).

Direct Investment

To achieve the Council's objectives, the focus based on forecasted returns and holdings will be on the Industrial, Retail Warehouse (including food stores) and alternative investment sectors (such as budget hotels). Acquisitions in other sectors (high street retail and offices) should be on an opportunity led basis – particularly if there are strategic reasons for the acquisition.

Return Profile of Different Asset Classes (National)

SECTOR	TOTAL RETURN (ANNUALISED 2019-2023)	INCOME RETURN (ANNUALISED 2019-2023)	NOMINAL RENTAL GROWTH (ANNUALISED 2019-2023)
Industrial	3.7%	4.6%	1.3%
Retail Warehouse	4.0%	6.3%	0.2%
Super Market / Food Stores	3.3%	5.3%	-0.8%
High Street Retail	2.5%	4.8%	0.0%
Regional Offices	2.5%	5.1%	0.8%
All Property	**2.9%**	**4.6%**	**0.4%**

The key principles of the direct investment strategy are as follows:

- In line with the primary objective of a sustainable income stream, there will be a focus on running yield as opposed to IRR.
- Commercial opportunities with a yield of above 7.50% will be avoided due to the risk they present. Most prime yields are now significantly below this level across all sectors. It is important to understand that the risk will be higher when there is a focus on yield over quality.
- Given prevailing market conditions, if these 'hurdle rates' are set too high the Council risks not being able to buy assets that offer appropriate income security in line with its primary objective.
- Based on sector performance and the objectives, the Council will have an openminded approach to the different sectors (e.g. offices, retail and logistics). Instead focusing on good-quality buildings in good locations.

- A range of lot sizes will be considered, although a key objective is to rationalise the portfolio into far fewer holdings of commercially attractive size and which are efficient to manage, whilst maintaining sufficient holdings to achieve good diversification.
- Broader equity investments will be made on a case by case basis.

Development Lending

The key principles of the development lending strategy are as follows:

- Typical interest rates will be 5.5% per annum in line with current market rates for secure investments. This will be an 'all in' rate, rather than a margin above LIBOR.
- The Council will seek to enhance returns through a combination of other fees on the facility (including arrangement fees, exit fees, commitment and cancelation fees).
- All loans will be senior facilities, with a fixed first charge over the freehold interest. Other lenders may make up the capital stack, but only at a more junior position to the Council.
- Quality residential and commercial schemes will be targeted, primarily within Zone 1, and in Zone 2 where appropriate.
- The Council will look to lend into schemes where the developer has a good track record and where the property provides appropriate security for the loan.
- A minimum commitment (facility amount) of £10m will be set per facility, to ensure the they are additive to the Council's investment portfolio.
- A maximum LTV (loan to value) Ratio of 70% and a maximum LTC (loan to cost) Ratio of 80% will be set to ensure there is sufficient headroom above the Council's investment.

Investment Lending

The key principles of the investment lending strategy are as follows:

- Typical interest rate will be 4.0% per annum in line with current market rates for secure investments. This will provide the Council with a regular income, whist being competitive against incumbent lenders. These rates will typically be fixed for the term.
- The Council will seek longer term facility periods of 3-10 years to ensure sustainable income for the Council over the medium to long term.

- All loans will be senior facilities, with a fixed first charge over the freehold interest. Other lenders may make up the capital stack, but only at a more junior position to the Council.
- Quality commercial assets will be targeted, to ensure the Council's investment is secure.
- A minimum commitment of £8m will be set per facility, to ensure the they are additive to the Council's investment portfolio.

A maximum LTV Ratio of 70% will be set to ensure there is sufficient headroom above

APPENDIX

---

the Council's investment.

However the local authority finance system does not treat loans for such purposes as capital expenditure, because no new assets are created. The consequence of this is that any impairment of the investment would be a revenue cost to the portfolio (and an estimate of default probability needs to be charged to revenue at the start of the loan). Any use of investment loans will take account of this revenue account risk.

APPENDIX: Section 4 - Birmingham City Council Portfolio Definitions

BCC CATEGORY	DEFINITIONS
Advert hoardings	Sites let for advertising
Agricultural holdings	Sites let for agricultural purposes, primarily grazing and farmland
Birmingham Science Park	Offices forming part of the Birmingham Science Park in Aston
City Centre multi-let	Offices and shops located within multi-let managed buildings in the city centre
City Centre general	General sites located within the City Centre, primarily development ground leases
NEC Area	Sites at the NEC
Jewellery Quarter	Offices, workshops and retail units located within the Jewellery Quarter
Markets	Units at the Birmingham Wholesale Market (does not included Indoor or Rag Markets)
Industrial multi-let	Industrial units located within the multi-let manage sites
Industrial general	Industrial stand-alone sites, including industrial ground leases
Utilities	Cable and pipeline wayleaves, substations and telecoms equipment
Shop parades	Shops located outside of the City Centre forming the whole or part of a coherent parade
Other retail	Stand-alone shops and other types of retail unit
Residential	Ground leases on dwelling houses and larger housing developments
Community	Sites forming part of community service provision such as community centres
BCC occupied buildings	Sites occupied by BCC with small areas let out to external organisations, such as rooms in schools
Internal agreements	Sites let to internal BCC departments
Other	Sites not falling into any of the above categories

MSCI CATEGORY	DEFINITIONS
Standard Shop	Retail; Ground lease retail; Long lease retail; Shop in parade; Stand alone shop; Store
Shopping Centres	Shopping Centres
Retail Warehouse	Storage warehouse
Supermarket	
Other Retail	Café; Car showroom; Fast food street kiosk; Ice cream van; Kitchen showroom; Market stall; Petrol station; Pubilc house; Restaurant; Retail kiosk; Shop kiosk; Theatre
Standard Office	B1 office worshop; Ground lease offices; Long lease offices; Office above retail; Office above shop; Office in residential tower block; Office with car park; Stand alone office building
Office Park	Offices in Birmingham Science Park
Industrial	Ground lease industrial; Industrial general; Industrial bare land; Industrial site; Industrial stand alone
Distribution Warehouse	Storage warehouse
Residential	Care home; Ground lease residential; Long lease residential; Flats; Sheltered homes
Healthcare	Health centre; Hospital
Other	See MSCI Other Definitions

MSCI OTHER	DEFINITIONS
Access	Access and frontage land; Access and parking land; Access easement; Access land; Access Road; Accessway; Airspace; Easement; Easement for gas pipe; Emergency access; Frontage strip; Retail warehouse landscaping and access; Right of way
Advert	Advert
Agricultural	Agricultural; Farm; Garden centre; Grazing land
Car parking	Cable wayleave / car parking; Car parking; Garage
Community asset	Adventure centre; Allotment gardens; Arts centre; Athletics facilities; Bingo hall; Bus stop; Cash machine; Cemetery; Church; Clock tower; Community centre; Community educational facility; Community facility; Community play centre; Community training centre; Concert venue; Conference centre; Education facility; Environmental research facility; Fire station; Football pitches; Former bank; Golf course; Gymnastic club; Leisure; Leisure centre; Licence for CCTV; Museum; Neighbourhood office; Nursery; Park; Place of worship; Playing fields; Race track; Recreation facilities; Rifle range; Rowing club; Sailing club; School; Snooker hall; Social club; Sports club; Sports stadium; Stable grazing land; Stately home; Station building; Tennis club; Training centre; University
Hotel	Hotel; Hotel banqueting suite

Land	Allotment; Bus stop land; Fast food street kiosk land; Fire escape land; Frontage land; Garden land; Land; Land at front of office building; land for concrete supports; Land for ice cream van; Land for viaduct; Landscaping; Open space at rear of houses; Other; Other land; Petrol station forecourt; Retail building yard; Retail forecourt; Scrap yard; Seating area; Sports land; Unknown site; Vacant land; Wildlife conservation; Woodland management agreement
Utilities	Cable wayleave; Car scrap yard; Recycling centre; Satellite dish; Substation; Substation and wayleaves; Telephone exchange; Waste depot; Waste recycling centre