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REAL ESTATE INVESTMENT STRATEGY

Prepared by CBRE Investment Advisory for
Trafford Council

September 2017

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BACKGROUND AND OBJECTIVES

1. BACKGROUND

Trafford Council (TC) is seeking to support the Local Authority's underlying service delivery by generating a supplementary longer term revenue stream by investing in commercial property investments. The strategy will assist the Council in creating a balanced portfolio that will aim to provide economic benefit, facilitate development/regeneration and support local authority functions.

TC has instructed an external strategic investment advisor (CBRE Investment Advisory) to develop an investment strategy, to create a diversified portfolio of investment assets.

On 3rd July 2017, we presented to a select group of TC's employees, including the Leader of the Council. We outlined and discussed the full investment process from setting objectives and benchmarks, determining a strategy, refining tactics, implementing the strategy and ongoing monitoring & management.

Since this presentation, we have created a bespoke investment strategy for TC. We have used a 'Top-Down' analytical approach to position TC to best achieve their objectives. This analytical approach involves reviewing the macro-economic outlook and property market trends before considering individual asset classes in greater detail.

We have made several recommendations throughout this report and we are looking forward to working with you to implement this strategy over the coming months. This type of commercial investment is a new journey for local authorities and we would be delighted to use our extensive investment experience to guide you through this process.

We recommend that the strategy is reviewed regularly, and at least on an annual basis, to ensure it continues to align with your objectives.

2. OBJECTIVES

Before setting an investment strategy it is imperative to have clear and concise objectives where performance can be benchmarked and success easily measured. Our July workshop included a discussion to determine the key objectives and benchmarks for the new investment portfolio. We identified the primary objective as:

"Generate a sustainable income to support the Local Authority's wider service delivery".

This objective needs to be achieved in a risk controlled manner and therefore the strategy should adhere to the following over-arching criteria.

- Create a diversified property investment portfolio which can spread the Council's risk over several sectors, properties, geographies and tenants.

BACKGROUND AND OBJECTIVES

- Investment properties must achieve an income return sufficient for the Council, to be considered an appropriate investment.
- TC is seeking to achieve a revenue stream without being over exposed to excessive financial and property risk. Balancing the risk and return profile is fundamental to achieving long term success.

Our proposed investment strategy focuses on achieving the primary objective through identifying the main market considerations and recommending an effective implementation strategy.

DETERMINING THE INVESTMENT STRATEGY

3. SECTION SUMMARY

Current market uncertainty is having an impact on investors' decision-making processes, with many choosing to adopt a defensive investment strategy which in turn has meant a relative reduction of product in the market. Given this period of increased uncertainty we recommend targeting investments in robust sectors with strong underlying fundamentals, which can still produce a sufficient income return for the Council.

4. INTRODUCTION

To determine an effective investment strategy, it is necessary to consider the economic and political background within which TC will be starting to invest. 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 UK economic background, the impact of the current political uncertainty on the property investment market, and the impact this could have on TC's investment Strategy.

5. UK ECONOMIC CONDITIONS

A key driver of economic growth in recent years has been consumer demand but several factors are now curtailing household spending power. Falling real earnings and lower savings may limit future activity: the household saving ratio is at a historic low of 1.7%. In recent years, retail sales volumes have been boosted by general discounting or targeted one offs. Offsetting this for now tourist numbers and spending will support retail and leisure activity and indicators of UK consumer confidence, though slipping, remain around their long-term average. The most recent figures show retail sales (excluding automotive fuel and internet sales) increasing by 0.3% over the three months to May but practically flat when compared with last summer.

GDP growth in Q2 2017 was driven by services, which grew by 0.5%. The production and construction sectors contracted slightly. Industrial production fell by 0.4% over the quarter with manufacturing output falling by 0.5% over the same period. But PMI manufacturing survey suggests weak sterling continues to boost export competitiveness although new export work has eased to a five-month low. Business investment rose slightly in Q1 2017 but not sufficiently to counterbalance weakness in consumption. The Bank of England's Q2 agents' survey found that investment intentions had strengthened a little but uncertainty was still holding back decisions.

Historically low unemployment, now at 4.5% (June 2017), would normally be consistent with strong wage growth but there have been only limited wage increases (below 2%) and in real terms wages are flat at best. Surveys show an increase in jobs but at a slower pace than over recent years. However, there is some evidence that there are selective pay awards (new hires, crucial staff) and that some people are moving jobs to improve their personal income. Surveys

DETERMINING THE INVESTMENT STRATEGY

suggest that London's existing skills shortages are being exacerbated by Brexit with companies competing for staff from a smaller pool which may create wage inflation in certain sectors.

We believe that the next base rate rise will be in early 2019, although three MPC members voted for an increase in June. In our view, soft growth and falling real wages will delay any rise. The Bank is concerned about the level of debt in the economy, private household debt increased by 10.3% over the year to April, and its serviceability when rates do rise will be a concern. The Bank may take direct action to control lending rather than raise interest rates.

6. ECONOMIC OUTLOOK

A year after the EU referendum the UK's economic prospects have softened while expectations for near-term global growth have strengthened. GDP growth softened to 0.3% in Q2 2017, a minor improvement on Q1 but still below the average of 0.5% over the previous 20 quarters. HM Treasury consensus GDP forecasts of 1.6% in July are up on the post referendum low of 0.7% (September 2016).

We believe that 2017 will see growth of 1.7% but the risks are to the downside from the weakness in consumption, with business investment and net trade unlikely to provide sufficient support.

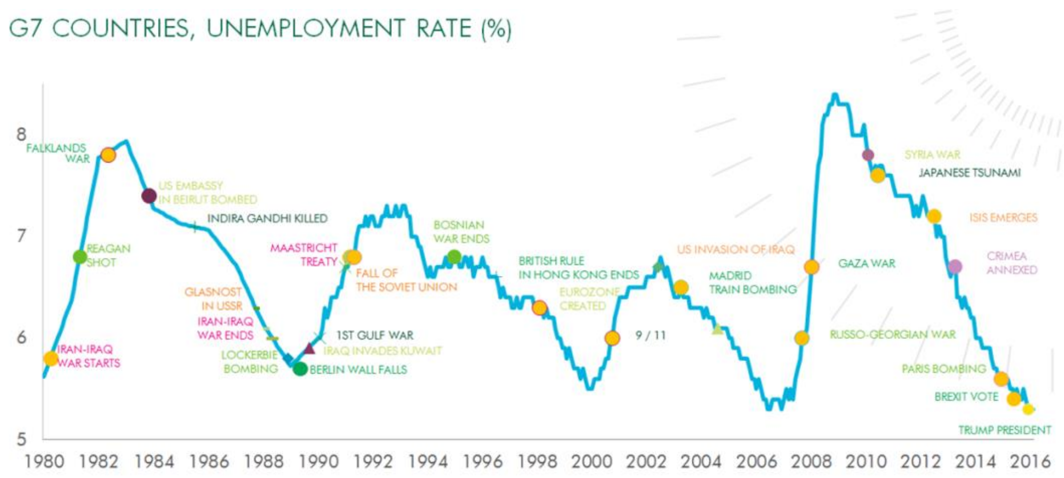
7. THE IMPACT OF POLITICAL UNCERTAINTY

The UK political situation is still creating uncertainty, especially due to the result of the recent snap general election and the continuing negotiations regarding the UK's withdrawal from the EU.

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 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.

DETERMINING THE INVESTMENT STRATEGY



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.

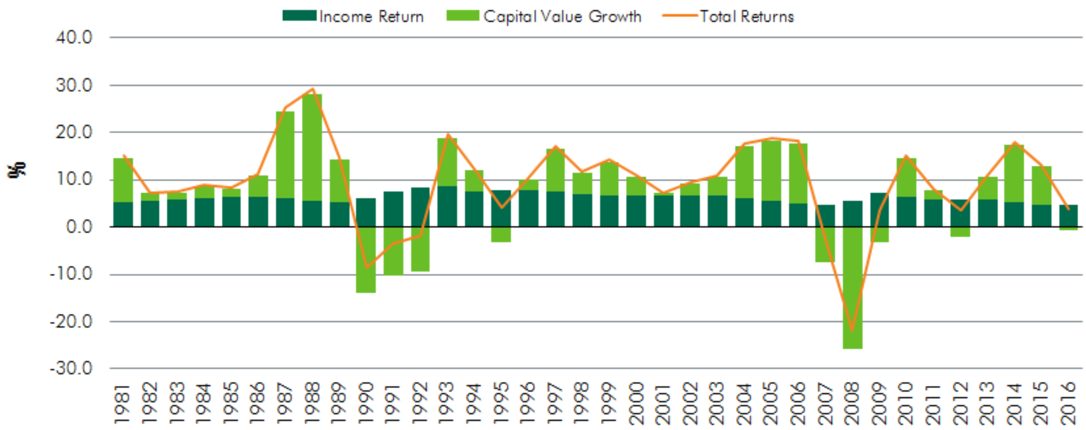
A further reason for resilient pricing is that investors who hold risk adverse or defensive properties have been very reluctant to sell and this has led to a shortage of stock in the market. Investors don't want to sell as it is difficult to re-invest any sale proceeds quickly back into the market. Thus, 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.

8. IMPLICATIONS FOR THE INVESTMENT STRATEGY

TC's primary concern is income security rather than capital appreciation (though this is not ignored). Despite many market cycles since 1980, income returns from property have been relatively resilient. This should provide TC with 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.

DETERMINING THE INVESTMENT STRATEGY



Source: IPD Annual Index

Identifying and underwriting properties which can produce sustainable income streams will be important to TC's strategy. Despite property providing a resilient income at a macro-level, the income security provided by individual assets varies considerably. Our strategy recommends identifying sectors which offer TC 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.

As a longer-term investor, TC will benefit from the ability to acquire and hold assets through any negative periods of the market cycle (whilst still collecting income) and to sell in positive periods of the market cycle (if desired). This could enable TC to maximise capital value returns whilst receiving consistent income over the medium to long-term horizon.

Whilst we appreciate that TC'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. The higher the purchase price the lower the relative income return compared to the capital invested, and therefore the greater the risk.

In addition, we understand TC will be funding the property from borrowing through Public Works Loan Board (PWLB). Thus, there will be an obligation to repay the capital investment in the future. Overpaying will increase the required minimum revenue payment (MRP) needed to be set aside on maturity loans or the amount of principal required to be repaid on repayment loans - reducing the net income return to TC. Moreover, if TC overpay the asset liquidity can be impacted as TC are unlikely to be able to sell the property quickly (if at all) for the same price. Understanding current market pricing is fundamental to achieving your objectives over the long term.

BUILDING THE PORTFOLIO

9. SECTION SUMMARY

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) and how they can contribute to regeneration of the local area.

Our key components of the strategy are as follows:

- The target income return should be between 5.0% and 6.5% to deliver sufficient margin over your borrowing costs and MRP requirements, whilst still providing you with the investment security required. The actual returns required will depend in part on the specific MRP approach adopted.
- To achieve sustainable returns, without being over-exposed to risk, we will need to target direct investment in prime and good secondary assets across a variety of sectors.
- Based on sector performance and the objectives, we recommend focusing on Industrial, Retail Warehousing (including Food Stores) and alternative sectors (i.e. budget hotels).
- Other asset classes should be considered on an opportunity basis to help meet the objectives, especially where they may help achieve longer term strategic goes (i.e. regeneration).
- Creating a diversified portfolio is important, whilst balancing the need to generate a return to support local authority functions. A target average lot size of between £20m and £30m sis recommended. Please note this is an average lot size across the fund, meaning that smaller or larger lot sizes can be considered on their merits.
- Multi-let properties will help reduce your asset and tenant specific risk. We therefore recommend that no more than 10% of your portfolio income should be from a single tenant to maintain the tenant specific risk at a manageable level.
- There will be a primary focus on opportunities within the North-West of England. However, opportunities that are outside of this region will be considered on case by case basis if they meet the objectives of the fund.
- You should consider lending to fund investment or development as part of the strategy, as this can have additional benefits especially when focused in the local area. We initially suggest that up to 30% of the portfolio could be allocated to debt, but are happy if this were to increase if required.

As always, commercial drivers may mean that it may not be possible to follow the strategy to the letter, particularly in terms of sector weightings and allocations to debt or regeneration. We have

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included a section on the 'Short Term Tactics' to address this and help you gain market penetration.

We recommend that the strategy is reviewed to reassess the portfolio balance, understand your remaining investment capacity and adapt the strategy as we move forward.

10. TARGET RETURN

The Target Return for an investment portfolio reflects its underlying risk profile. Given the requirement to provide a return that is sufficient to pay back the borrowings (interest and MRP included), as well as produce an income return to bridge the annual funding gap.

The impact of MRP on lower yielding investments, and the income risk on higher yielding investments, means that we recommend targeting an investment return of between 5.0% and 6.5% for the portfolio to achieve the Council's objectives. The actual level required will be dependent upon the specific MRP treatment adopted. The primary objective means that the focus will be on income return rather than total return.

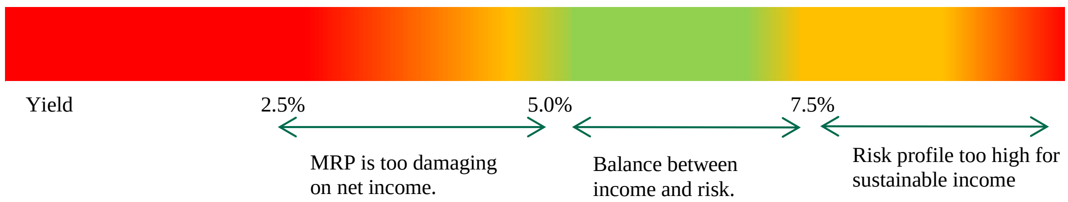

Figure 1: Suggested target return range

To achieve a balanced portfolio, investments should principally be balanced by property sector and investment type (debt and equity). However, other key considerations when considering investments are location, lease expiries, tenant exposure, unit sizes and the need for capital expenditure or further investment.

11. TARGET SECTORS

To achieve your objectives, we recommend that the focus is 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.

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SECTOR	TOTAL RETURN (ANNUALISED 2017-2021)	INCOME RETURN (ANNUALISED 2017-2021)	NOMINAL RENTAL GROWTH (ANNUALISED 2017-2021)
Industrial	6.2%	5.2%	2.4%
Retail Warehouse	6.1%	5.8%	0.6%
Super Market / Food Stores	4.0%	5.1%	-0.5%
High Street Retail	4.6%	4.9%	1.6%
Regional Offices	4.4%	5.3%	-0.6%
All Property	4.6%	4.8%	0.6%

Figure 2: Return Profile of Different Asset Classes

To target properties in these sectors and to ensure all acquisitions will be accretive to the portfolio, it is imperative that you understand the current market trends of these sectors. As the Council's objectives are long term (and income driven) sectors that have a positive capital growth at this moment should not be the primary concern (though this by no means a bad thing). Over the long-term income return remains much more consistent than capital growth (which is typically much more cyclical) – as the following graph identifies.

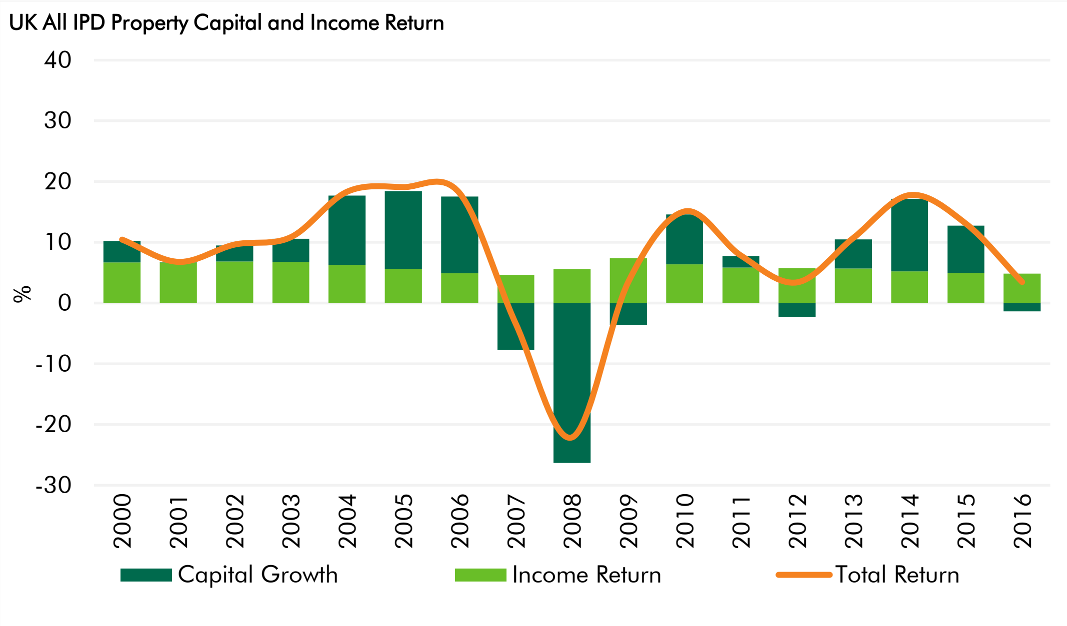

Figure 3: Property Capital and Income Return 2000-2016

Industrial

Occupational Commentary

The big box industrial occupational market is being driven by a lack of supply and the increase in online retailing. Retailers are requiring a greater number of distribution hubs, and satellite hubs, to service both the click & collect and home delivery markets, with the challenge of delivering goods the 'final mile' remaining a focus for the logistics sector, as it was in 2016.

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However, even without the contribution of online retail to the overall demand mix, take-up would still have been ahead of its longer-term average, by a margin of between one and two million sq. ft.

Investor Sentiment

For investors, the long leases, guaranteed income and often fixed uplifts associated with logistics investments have been attractive, given the wider economic uncertainties that have been present in the market. Furthermore, this sector has arguably the most compelling demand and supply imbalance, and the perceived structural change in the retail market is expected to only help this sector in the medium to longer term.

Yields on good quality properties are at historical lows which reflect the strength of the investment market for this type of product. Best in class properties experience several rounds of competitive bidding with UK institutional investors, overseas investors, local authorities and private investors battling for limited stock.

Strategy Recommendation

Pricing is becoming increasingly competitive and therefore stock selection is critical to ensuring the longevity of any investment. Core locations, new or overly specified buildings, and limited nearby development opportunities should all be priorities for TC when considering investing in this sector.

We would recommend being stringent on the property fundaments such as location and building quality when considering good secondary assets in this sector. The long-term value of the property will be linked more closely with location than the perceived covenant strength of a tenant on a ten-year lease. We recommend targeting assets with immediate access to the UK's major road network with the West Midlands and North West being key target geographies.

Given the above we would favour a strong weighting towards industrial properties compared to the other investment sectors, however the competitive nature of this sector may mean that suitable opportunities are fiercely contested.

Retail Warehouse/Food Stores

Occupational Commentary

<u>Retail Warehouse:</u> From an occupational perspective, the number of retail warehouses continued to increase every month throughout the year as they have done consistently since 2013. Core out of town occupational markets continue to strengthen and tenants are competing for space on the best parks. With vacancy rates at 6.2%, competition for space has seen rents beginning to increase again following a long period of stagnation. However, we would caveat

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this positive sentiment by stating that demand is focused on strong locations where there is often a dominant park and critical mass of retailers.

Supermarkets / Food stores: In 2017 UK shoppers have experienced higher food prices as a result of increased supplier costs being passed on to consumers. The grocery operators, whose margins are being squeezed from several factors which include a weakened exchange rate, will not be able to absorb further costs. The number of store openings will likely be lower than in 2016 and there will be a continuation of store closures where poorly performing Supermarkets are coming to the end of their lease.

Investor Sentiment

From an investment perspective, 2017 has brought softening of the yields due to increasing rents, stabilising capital values and uncertainty within the market. Although Prime Open Retail Parks saw yields move out by 40 bps over H2 to 4.75%, Prime Open Bulky Retail Parks remain below the long-term average after stabilising in September.

Secondary Retail Parks saw yields soften by 50 bps moving out from 6.75% to 7.25%. This caused the spread between prime and secondary assets to grow, with investors focusing on prime units. Secondary assets are now above the long-term average for the first time since Q1 2014.

Transactional activity witnessed a strong second half to the year closing at just over £2.4bn for 2016. The same observations apply to food stores which have seen a dramatic turnaround in investor sentiment since the Brexit Vote. Ensuring the property fundamentals are appropriate for the market is particularly important for investors, as the occupational market is still in flux as the big four food store providers re-align their portfolios to adjust to increased convenience shopping and the rise of discount retailers Aldi and Lidl. The desire for long term secure income has seen several supermarkets being marketed in 2017 and achieving strong prices.

Strategy Recommendation

Retail Warehouses are forecast to perform comparatively well as a sector with Total Returns anticipated to be 6.1% annualised over the next 5 years. The sector fundamentals of long leases, propensity for guaranteed rental increases, comparatively limited capital expenditure and reduced levels of obsolescence meet your criteria as a long-term income focused investor.

We recommend a strong weighting towards retail warehousing and food store sectors within the portfolio. However careful stock selection is critical as the best parks and locations will more than likely always experience demand from retailers despite wider economic uncertainty.

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High Street Retail

Occupational Commentary

The retail sector has been relatively resilient over the past 12 months. The 2016 Christmas period was surprisingly strong for several high-street retailers with Marks & Spencer, John Lewis, Primark, Debenhams, JD Sports and Ted Baker all reporting sales growth. However, 2017 is forecast to be a tougher year for the retail sector as it faces many headwinds. The devaluation of the pound and rising inflation is only starting to work its way through supply chains and thus prices are anticipated to rise in late 2017 and into 2018.

The rates revaluation will put pressure on retailers with extensive portfolios and this may make retailers reconsider the rationale for opening new stores. This is likely to have the biggest impact on the Central London market where the business rates liability has increased significantly.

Pressure on high street retail is expecting to continue from online retailing. Online sales represent circa 15% of total retail sales in the UK, anticipated to grow to 17% of all sales being made online by the end of the year. Overall levels of openings and closures of stores fell sharply in the middle of the year, before and after the Brexit vote. However, activity rose in the autumn.

Investor Sentiment

Regarding investment, 2016 saw the largest spread between prime and good secondary pricing for ten years. This has continued into 2017 and has been driven by occupiers increasingly focusing on their core estates, and seeking to reduce the underperforming parts of their portfolios. Thus, investors have been predominantly targeting best in class retail locations and then only the prime pitch within the town.

Strategy Recommendation

High Street Retail is traditionally difficult to forecast due to the asset's micro-location being key to rental growth, occupier demand and consequently performance. TC's income requirement means the target properties are likely to be in the good secondary category. As prime assets, will attract too low yields. Thus, you will likely have to target more inferior towns or off-pitch locations. Therefore, underwriting the long-term attractiveness of the location, and pitch, is fundamental to the underwriting process.

High Street Retail (including department stores) is traditionally difficult to forecast due to the asset's micro-location being key to rental growth, occupier demand and consequently performance. Furthermore, it can be difficult to acquire high street retail assets of an institutional lot size (£7 million plus). Therefore, although the sector is forecast to outperform, we would advise you to still consider investments on an opportunity-led basis hence why we have put a relatively lower weighting to this sector.

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Offices

Occupational Commentary

Occupier demand was, and still is, being impacted by the Brexit vote with many delaying their long-term decisions. Regional office occupier markets in 2016 proved relatively resilient, despite the timing of the Brexit vote and following uncertainty. Across the ten regional city markets monitored by CBRE there was only a small decrease of 7% from the 2015 total and just 3% lower than the five-year annual average.

Investor Sentiment

The Brexit effect has been undeniable and in the second half of 2016 office investment volumes were down by 38% from the first half of the year, though this was still 30% higher than the five-year average. South east offices and rest of UK offices are forecast to provide steady income returns, over the coming 5-year period, albeit with fluctuations in capital value. Therefore, this is attracting investors, especially for the good quality properties.

Strategy Recommendation

Offices tend to be a tactical purchase, rather a strategic decision, as timing is critical to maximising performance. Office buildings tend to suffer from more obsolescence than other asset classes, and as such require capital expenditure which can erode returns. This makes holding offices over a long period relatively more cost intensive.

Therefore, we recommend that you focus on the core property fundamentals when considering offices such as location, building quality, lease length, tenant covenant and rental profile. The focus should be on established cities (ideally within the core office districts) and locations with proven track records of attracting many high-profile tenants over a sustained period.

Alternative Investment Sectors (Budget Hotels, Leisure, etc.)

Occupational Commentary

Budget Hotels: Budget hotel brand Premier Inn is the largest hotel brand in the UK with 763 hotels comprising 68,256 bedrooms. Premier Inn opened nine new hotels, comprising 866 bedrooms in Q1 2017 alone and is projected to open a further 64 hotels, equivalent to 7,260 bedrooms over the next three years. Premier Inn and Travelodge dominate the UK budget market, comprising 68.5% of all supply.

Behind London, Manchester has the largest budget hotel supply of any city in the UK, offering 43 hotels, comprising 5,896 bedrooms. Budget hotel supply comprises approximately 35% of all hotel bedroom supply in Manchester.

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Behind Premier Inn, Hampton by Hilton has been the most active new entrant in the budget segment in Q1 2017, opening five hotels comprising 843 bedrooms, the largest being the 209-bedroom London Docklands property.

Leisure: Consumers' financial confidence is healthy and leisure venues are benefiting from increased attendance and participation. All of the main venues such as theme parks, music events, theatres, museums and attractions are greater than they were a year ago. This is positive news for the industry as it highlights that UK consumers are not cutting back their spending on leisure activities

Investor Sentiment

These assets tend to provide long income, with fixed uplifts from potentially strong covenants. Thus, high quality assets have remained resilient over the past 12 months.

The lack of yield movement for these assets since the referendum result would suggest that the alternative sub sectors could be considered less volatile than some of the traditional sectors. Therefore, you should consider targeting investments in these sectors to diversify the portfolio.

Like traditional High Street Retail, one of the principal drivers of these markets is the micro-location and therefore understanding the local market drivers and demographics is particularly important.

Leisure assets can be in bespoke buildings which can attract limited occupational demand if the tenant vacates. Therefore, investors pay attention to underwriting the alternative use value of the property to become comfortable with the investment.

Strategy Recommendation

Specialist Real Estate sectors have experienced little to no adverse effect from the wider market uncertainty and are predicted to remain resilient.

These assets often provide long income with fixed uplifts and strong covenants, and therefore could be considered less volatile than some of the traditional sectors. TC should consider targeting investments in these sectors although it should be noted that finding a sufficient quality and quantity of opportunities can be challenging.

These alternative sub-sectors can be affected by the assets micro-location and therefore underwriting the location's long term alternative use value is important to de-risking the investment. Lastly, alternative sectors such as budget hotels can offer diversification benefits due to their reduced correlation with the more traditional investment sectors.

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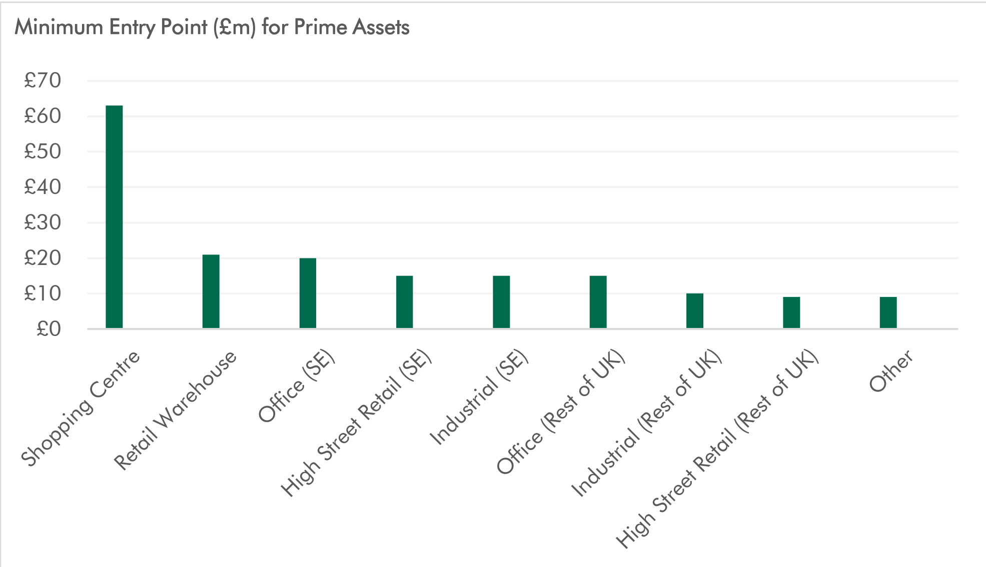
12. TARGET WEIGHTINGS

To create a balanced portfolio in line with your objectives, and considering the above, we recommend targeting the following investment portfolio weightings.

As you have not completed any investments at this stage, these weightings can be considered relatively arbitrary at the current time and as such we have provided indicative ranges. The initial emphasis therefore will be on sourcing opportunities in every sector.

ASSET CLASS/SECTOR	WEIGHTING (%)
Industrial	25%-35%
Retail Warehouse	20%-30%
Supermarkets	10%-20%
Offices	5%-15%
High Street Retail	0%-10%
Alternative Investment (Inc. Debt)	10%-30%

These weightings are driven by both the forecasted income return from each of the asset classes, as well as the typical capital requirements to enter each of the sectors – as follows:



The relative weightings of the sectors will be continuously reviewed, especially as the portfolio matures. However, this provides a suggested target mix that would help the Council create a diversified and balanced portfolio and provides us with a direction to move forward with – even if it is subsequently altered.

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13. INVESTMENT RESTRICTIONS/FOCUS

We recommend the following investment restrictions/focuses. These will need to be reviewed on a regular basis if they are adversely impacting our ability to source investments that meet your objectives.

- A focus on opportunities Trafford, Greater Manchester and the North-West of England where possible.
- Where possible sourcing regeneration and strategic opportunities within the metropolitan area, especially those that provide wider benefits other than solely an income return.
- Target average lot size of between £20m and £30m. Opportunities outside of the range will be considered when we believe there is justification of including them in the portfolio.

14. FORMS OF INVESTMENT

As well as direct investment, we understand that the Council is happy to invest through the provision of debt into either standing investments or development projects.

A key benefit of lending, rather than investing directly, is that there is no requirement for MRP. Therefore, the net returns are proportionally higher for this form of investment.

The Council can choose to lend for investment or development, dependent upon your requirements at the time and the specific opportunity. However, development funding has the benefit of allow allowing the Council to retain the business rates generated from the new development.

Regardless of the type of debt (although development clearly has benefit to a local authority), we feel that initially allocating up to 30% of the portfolio to lending could be a beneficial addition to the portfolio diversification strategy (as discussed, we are flexible if this were to form a larger proportion than indicated).

The returns from lending typically depends upon the type of debt and the security of the investment - as the following demonstrates.

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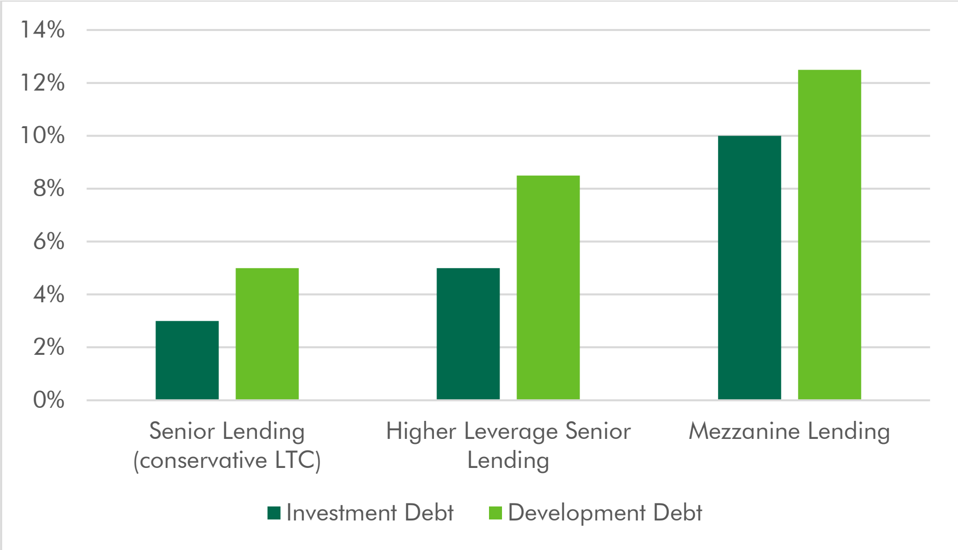

15. INVESTMENT TACTICS

The investment strategy is designed to help the Council create a balanced and diversified property portfolio to achieve its income objectives. Whilst we recommend that the principles should be followed where possible, there are several tactics that we recommend are considered in the shorter term that may assist in achieving your objectives sooner.

- **Initial Focus on Standing Investments** – as there is a requirement for income to support local authority functions in 2018/19, we recommend initially focusing on standing investments, with a reasonable unexpired term that require little or no management.
- **Portfolio Investment Opportunities** – an initial portfolio investment could be an efficient way to generate income, diversification and market exposure. However, opportunities are relatively rare so this should not be the only focus.
- **Target Lot Size** – a target average lot size of £20m to £30m should help you gain market traction, whilst not exposing you to overly excessive asset specific risk. Significantly smaller lot sizes in the shorter-term are unlikely to provide the market exposure that you require and could mean you end up with a very management intensive portfolio. Larger lot sizes will be considered on an individual basis if they meet the Council's investment or strategic objectives.
- **Strategic Assets** – assets that have medium to long-term strategic potential in all sectors should be considered, especially if they can also generate a return to contribute to supporting service provision in the short term.
- **Lending** – the Council could look at investment debt to generate an income in the shorter-term. We can also review the possibility to provide bridging (short-term finance) or to buy an existing loan facility (with a short expiry).

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DEVELOPMENT AND STRATEGIC SITES

16. SECTION SUMMARY

Investing into development and regeneration has many benefits (both financial and non-financial) to a local authority. However, development typically yields its returns over the medium to long term and therefore this may form a greater part of the strategy over the medium to long term, than in the shorter term.

17. INTRODUCTION

Whilst be recommend that the focus is on standing, sustainable investment properties there may be the opportunity to acquire assets that contribute to other objectives – especially within the borough boundary.

These opportunities should be considered carefully, especially if the investment fundamentals are not strong. However, we understand that there may be occasions where the Council wishes to acquire property for other means than just income return.

18. MEDIUM TO LONG TERM

Investing in regeneration and development opportunities (especially within Trafford and Manchester) could provide additional benefits to the Council – including:

- Opportunity to create value and additional income from assets over the longer term, meaning better returns.
- Ability to create social benefits including creation of jobs, redevelopment of brownfield land or creation of new homes.
- Prospect to benefit from creation of new business rates revenue that can be retained by the Council as additional income.

It is important to note that development and regeneration typically deliver their returns over the medium to long term and therefore this may not always align with your shorter-term return requirements.

19. SHORTER-TERM RECOMMENDATIONS

Whilst we believe most the benefit from development, refurbishment or regeneration will come in the medium to long term. The following suggestions could help generate a return in the shorter-term:

- Reviewing any current development or refurbishment proposals to see if any income can be extracted from them.
- Investing into development through debt rather than equity, so that a return can be generated in reduced timescales and MRP requirement is reduced.

MINIMUM REVENUE PROVISION

20. SECTION SUMMARY

As the Council will be borrowing the money from the PWLB to achieve its investment objectives it is important to consider the impact of MRP on net income. There are methods whereby the Council can demonstrate effective risk mitigation whilst increasing the net income receipt that we recommend should be pursued.

As Trafford Council will be making use of the Public Works Loan Board (PWLB) to finance property investments (repaid on a maturity basis), consideration of the Minimum Revenue Provision (MRP) is required to mitigate repayment risk.

There are a variety of approaches to MRP. This needs to be considered carefully by the Council as it has a material effect on the net income received. We have outlined the different approaches below and we are happy to discuss these with you to assist you with your chosen route for each acquisition.

It is important to note that the MRP approach taken may vary from investment to investment dependent upon the specific characteristics of each property. Therefore, consideration of these different approaches will be needed for each acquisition to choose the right offer.

21. LOAN TYPES

The loans are usually fixed rate and are repaid in one of three ways:

- Annuity: Half-yearly payments where each payment is of a constant amount, inclusive of principal and interest.
- EIP (equal instalments of principal): Half-yearly payments where each payment consists of a constant instalment of principal plus a diminishing amount of interest calculated on the balance of principal then outstanding.
- Maturity: Half-yearly payments where each payment is of interest only with a single repayment of principal at the maturity of the loan.

In our experience, local authorities are tending to favour Maturity Loans, as this does not require any ongoing principal repayments. However, to show they are borrowing prudently local authorities put aside an annual amount called the Minimum Revenue Provision (MRP) to repay the capital sum when the loan matures.

22. MRP APPROACHES

There is no strict guidance on how MRP should be approached and therefore there are several options available to local authorities, which this paper covers. These are:

1. Equal Repayment Approach
2. Property Company Approach

MINIMUM REVENUE PROVISION

3. Proportional Value Approach
4. Multiple Loans Approach – did not like it

Typically, local authorities have adopted option 1 or 2 above, but there are examples of all methods being used – each of which have their relative advantages and disadvantages.

Equal Repayment Approach

This approach applies MRP on a straight-line basis over the length of the loan. Therefore, on a typical 50-year maturity loan a 2% per annum MRP would be set aside to repay the full capital amount on maturity.

Whilst this approach ensures sufficient capital is available to repay the loan on maturity, but it requires a significant sum of money to be put aside each year thus reducing the net income received. It also pessimistically assumes that the asset and the land beneath it will have no value at the loan expiry.

It may be possible to place a lower proportion (than the 2%) to MRP and then place a balancing figure into a 'Risk Reserve Fund' to achieve the same effect. The benefit of this would be that the Council could use the Risk Reserve Fund for required capital expenditure on the property to maintain or improve its value during the lifecycle (i.e. non-recoverable expenses).

Property Company Approach

This is only applicable to local authorities who have set up subsidiary property companies. The property company's acquisitions are fully funded by the local authority in the form of a commercial loan (say 75%) and equity stake (say 25%). MRP is then only required on the equity portion of the financing arrangement, with the part in the form of a commercial loan to the property company does not have to MRP applied to it as with other forms of lending.

We understand that several local authorities have set up property companies, initially to allow investment outside of the borough. However, the advice regarding this has largely changed, thus allowing the local authorities to purchase directly onto the balance sheet. Furthermore, we understand that the introduction of BEPS (Base Erosion and Profit Shifting) may impact the viability of this type of model.

The formation of a property company means that company will incur a tax liability, but the MRP applied is significantly reduced due to only the equity portion of the financing arrangement being amortised.

MINIMUM REVENUE PROVISION

Proportional Value Approach

This approach is influenced by the proportional value of the constituent parts of an investment property. This approach could provide the Council with another option to consider in favour of the more 'traditional' approaches.

This approach is based on the value of all investment property being formed of 3 constituent parts: Land, Building and Lease. The quality of each one of these different aspects impacts the overall value of the property investment and their respective weighting.

Please see below a very high level example.

- Market Value: £10 million
- Land Value: £2 million
- Vacant Possession Value: £5 million

The value of the land is £2 million (20% of the overall value), value of the building is £3 million (VP value less Land Value) (30%) and value of the lease is £5 million (market value less VP value) (50%).

Each constituent part of the property depreciates at a different rate depending on the sector and location. Therefore, by varying the rate of MRP depending on the type of property being acquired the overall MRP payment could be reduced without increasing the repayment risk at the end of the loan. Adopting this type of approach could allow a local authority to target a greater quality of asset (with a lower yield) whilst maintaining a sufficient income return.

We have spoken with our research colleagues about obtaining a land value series which would show the average land value per sector / region dating back over a sustained period. Unfortunately, we understand there isn't currently a definitive UK land value series. The lack of information in this area has been identified by the Investment Property Forum Research Committee and consequently they have recently appointed academics from Reading University to create a land value series dating back 30 plus years and covering all the commercial sectors (office, retail, industrial, etc.). We understand that this research will be completed at the end of 2017, and will use 'base data' provided from CBRE. Once this is available we will be able to run scenarios to establish different approaches to risk.

This research will provide greater clarity and certainty within this approach. In the meantime, we have set out our thoughts on how the proportional value relationship may work on different types of geographies, sectors and assets.

For this high-level report, we have focused on just the retail, office and industrial sectors. However, we could review further alternative sectors (leisure, hotels, health care, etc.) using the same methodology.

MINIMUM REVENUE PROVISION

How to Calculate the Value Apportionment and What Does this Mean?

……..WHERE IS THE VALUE?

Land: The land value can be determined by either comparable land sales in the locality or by undertaking a residual valuation. The residual valuation would need to consider what could be realistically built and leased on the site (not necessarily what is already on the site), less the cost of developing the building and the required level of developer profit to undertake the project.

Therefore, the proportional land value is likely to be intrinsically in higher value locations where there is an active appetite for development but a shortage of available land, where the current use isn't the best use (e.g. office to residential conversion) or where the current site coverage is relatively low and additional massing could be added.

We would therefore anticipate a proportionally higher land value for geographies, sectors and assets which benefit from a supply shortage or are in very strong locations for the prevailing use (e.g. offices in London and retail on prime pitches of strong high streets).

In our experience land values, have generally risen over the longer term (this will need to be verified by the research and therefore should be treated on a case by case basis). Therefore, it is conceivable that no MRP, or relatively little, would need to be set aside for the proportional land value as land could be considered as an appreciating asset.

Building: The value of the current building can be calculated by two methods. Either using the re-instatement cost value (insurance valuation) or by using the difference between the vacant possession value of the current building less the value of the land.

A higher quality building in a strong location will likely have a higher vacant possession value as the re-letting prospects are higher and consequently a higher proportional value. Conversely a secondary building in a strong location will have a proportionally lower value as redevelopment may be a viable option and thus the land value is higher.

MINIMUM REVENUE PROVISION

All buildings suffer from deterioration and obsolescence, however the rates at which this happen vary considerably by sector. Offices have more physical deterioration especially the plant and machinery, as well as suffering from obsolescence. Offices require significant capital expenditure to maintain them at a high level, and a general rule would be that the M&E would need to be replaced every 20-25 years. Thus, it is likely a higher rate of MRP would need to be applied on offices to account for the likely depreciation in the value of an office building over the longer term.

Conversely, a high-street retail shop is likely to suffer from a far lower level of depreciation and obsolescence due in large part to the occupier fitting out the shop and paying for the M&E. Thus, the proportional value of the building is likely to be lower for this type of asset whereas a higher proportion of the value is in the underlying location. Therefore, the MRP applied to high street retail buildings could be lower than for office buildings. This logic could also apply to high quality industrial locations such as Park Royal in London.

Lease: The lease value can be calculated by taking the value of the property in its current form and deducting the value of the property with vacant possession. The vacant possession valuation would assume the property is in its current condition but is no longer occupied by a tenant.

The value of the lease is a function of the lease length, tenant's covenant, rental growth prospects and the strength of the underlying occupational market. For example, a long lease with fixed increases to a strong covenant is likely to have a higher proportional value in a weaker market than in a strong market. This is because there is increased value in income security during market uncertainty. Moreover, a weak market would likely mean limited development demand and thus a lower land value which increases the lease's proportional value further.

The length of the tenant's lease, and consequently the value, is a depreciating asset. However, the speed of depreciation isn't on a straight-line basis, as the fall in value between year 20 to year 15 is far less year 5 to expiry. Thus, MRP could be staggered over the length of the lease to reflect the varying level of depreciation. This would lend itself to properties with long leases which would meet the Council's objective of creating a secure long term income stream.

Multiple Loans Approach

The final approach, which we are aware of certain local authorities using, does away for the need of MRP at all and is fundamentally a change to the way the money is drawn down from the PWLB. Rather than taking out a single maturity based loan (as assumed in the previous options), the local authority takes out (up to) fifty individual loans to cover the full facility amount. In simple terms this would mean the first loan being for one year, the second for two years and so on, with the 50th loan being for 50 years. We understand the Council doesn't wish to pursue this route, but we would be happy to discuss with you should this be of interest in future.

GOVERNANCE AND MANAGEMENT

23. SECTION SUMMARY

Effective governance and efficient decision making processes will be critical to ensuring that you can be as competitive as possible when acquiring investments. Our proposed processes ensure that you retain full control over all decisions, but means that we can add significant value throughout the process without burdening you with the micro-detail.

24. GOVERNANCE AND DECISION MAKING

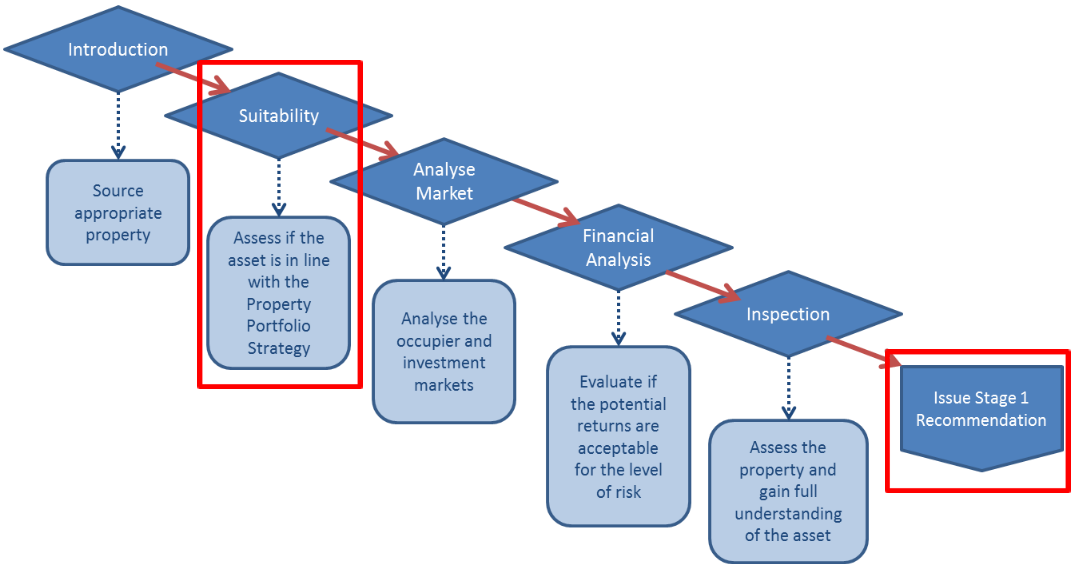
It is critical to have a clear governance and decision-making process to ensure you can act quickly and effectively; increasing the probability of successfully acquiring properties and creating a balanced portfolio in line with your objectives.

Experience has taught us that relying on monthly cabinet meetings to make investment decisions is often too slow to keep up with market demands and timescales, where quick decision making is looked upon favourably. It will therefore almost certainly put you at a disadvantage when looking to acquire under competitive circumstances if you must wait until cabinet to make investment decisions. We understand that you have established a small Investment Board, with delegated authority to make decisions on Investments, which will help you in this regard.

25. TRANSACTION PROCESS

When a potential acquisition opportunity presents itself, we propose a two-stage transaction process. This process maximises the speed to market, whilst still allowing the Council to retain control of the investment decision making. We have highlighted in red at what stage the Investment Board will need to make decisions (some more formal than others).

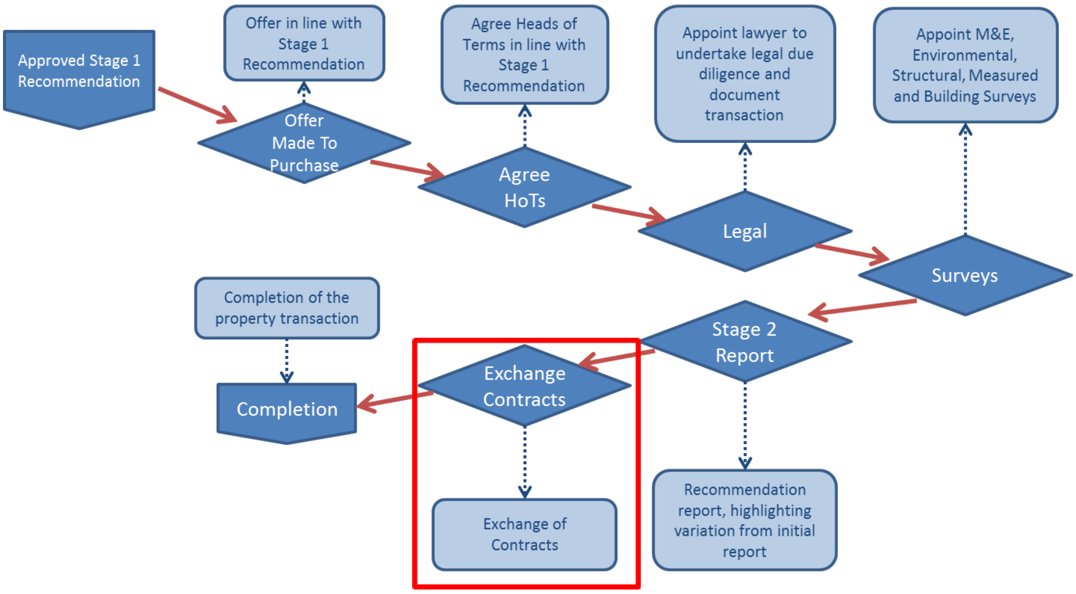
Stage 1 – Initial Recommendation



GOVERNANCE AND MANAGEMENT

In the first stage, we will conduct high-level due diligence based on the facts presented to us. This will allow us to make a recommendation (subject to full commercial, technical and legal due diligence) whether 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.

Stage 2 – Final Recommendation



During Stage 2 we will coordinate and oversee the due-diligence processes outlined in the diagram above - working closely with the investment agent and your in-house team, challenging assumptions and ensuring the asset is thoroughly underwritten. We will then provide our final recommendation after full consideration of the asset and after input from your other professional advisors.

26. INVESTMENT SOURCING PROCESS

Having a robust introductions process is imperative to ensuring the Council is not at risk of challenge from third party agents, as well as ensuring you have access to the widest possible range of opportunities across the market.

We find that the best solution is for the Council to adopt a blanket response and ask agents to introduce all opportunities directly to us as your investment advisor. This will minimise the impact on Council time and allow us to effectively manage the 'first-past-the-post' introductions process. As you are aware, we have now agreed this process and it is working well.

As a wider team, we receive many introductions from the majority of national and regional agencies in any one day (from our own agency teams and from outside CBRE). Therefore, you will receive access to a wider range of opportunities from across the market.

GOVERNANCE AND MANAGEMENT

27. ONGOING MONITORING AND MANAGEMENT

The portfolio will need ongoing monitoring and management both at portfolio and asset level. The strategy will need to be regularly reviewed (on a bi-annual basis) to ensure it remains relevant given the market conditions and the portfolio is well positioned to achieve the Council's objectives. At an asset level, properties will need to be pro-actively asset managed to maintain the income and identify opportunities for rental growth.

We would recommend reviewing four main considerations as part of the portfolio's ongoing management. These are asset management, property management, performance monitoring and investment timing.

Once acquisitions are made, we will produce an asset plan for each property and will discuss with you the best way to maximise the performance of each asset within your ownership. This will cover items such as tenant engagement strategies and key event dates as well as more value-add initiatives (among others). Certain elements included within the strategy can be performed by us (for example lease renewals with sitting tenants) and some will need to be conducted by third parties (i.e. rent reviews). If third parties need to be involved then we will make recommendation and will manage these third parties on your behalf, ensuring the demands on your time are minimised and you retain a consistently high standard of service.

Furthermore, once you have appointed Valuers we will engage with them on all new acquisitions and will work to challenge them on your behalf through the regular valuations process, to ensure the figures produced are as rigorous and accurate as possible.

CONCLUSIONS AND RECOMMENDATIONS

28. CONCLUSION AND RECOMMENDATIONS

Your primary objective is to acquire real estate investments to generate income to support the Local Authority's wider service delivery. the target income return on acquisition should be between 5.00% and 6.50% per annum to deliver sufficient margin over your current borrowing costs.

We have undertaken a "top down" analytical approach to target sectors which will meet your requirements and offer the best opportunities to maximise returns. We have considered the governance options that will enable you to efficiently create an investment strategy that can achieve your objectives as well as create a diversified portfolio.

Our key findings and recommendations are highlighted below:

- To achieve an acceptable income return, without being over-exposed to risk, TC will need to target assets in the prime and good secondary risk categories.
- Industrial, retail warehouses (including food stores), and alternative investment sectors like budget hotels are forecast to perform comparatively strongly over the medium term.
- We recommend predominantly seeking retail warehouse and industrial opportunities which are forecast to provide more balanced returns over the next five years. Acquisitions in the alternative investment sector, high street retail sector and office sector should be on an opportunity led basis.
- TC should seek to create a diversified portfolio. This could be done through targeting an average lot size of £20-£30 million or by purchasing multi-let properties where the letting risk is spread across several tenants. However, if you were to acquire large single let properties then we would advise ensuring the tenant has a strong covenant and undertaking detailed due diligence on the tenant's accounts. To minimise your letting risk, we advise no more than 10% of the portfolio income should be exposed to a single tenant once the portfolio reaches maturity.

In summary, whilst there are other economic and social objectives, income remains the most important component for TC. Therefore, investing in strong covenants remains a key part of the strategy. The sector recommendations should shape the over-arching sector however individual property fundamentals should remain a key focus (over a default sector bias) with attention given to the location, building quality, rental profile, tenant covenant, lease length, and long term alternative use.