ASSET INVESTMENT STRATEGY

Prepared by CBRE Investment Advisory for
Trafford Borough Council

October 2018

CONTENTS

This investment strategy has been prepared by CBRE Investment Advisory, part of CBRE Capital Advisors Ltd, an appointed representative of CBRE Indirect Investment Services Ltd, which is authorised and regulated by the Financial Conduct Authority.

EXECUTIVE SUMMARY

INTRODUCTION

CBRE Investment Advisory has updated Trafford Borough Council's Investment Strategy (originally drafted in September 2017) to take account of changes to Government Guidance in relation to local authority investment.

We understand that the Council needs to generate a sustainable income stream to help support its local services. It intends to do this by borrowing from the PWLB and investing into real estate. The Council is happy to invest via both equity and debt (lending to third parties) so long as it generates an appropriate risk adjusted return.

INVESTMENT OBJECTIVES

The Council's primary objective is to create a suitable income stream to support local services. However, there may be opportunity to generate secondary benefits from the investments. This should not be at the risk of not achieving the primary objective.

GEOGRAPHIC ZONES

The Council would prefer to invest locally, or at least within Greater Manchester. However, it is acknowledged that with this geographic restriction the Council may find it difficult to achieve its income targets at the right risk profile. We have therefore discussed the concept of geographical Zones, whereby investments in different geographic locations (Zones) must meet different criteria.

INVESTMENT STRATEGY

We will be flexible in the type of investments that are made and will consider both equity and debt investments. Currently development lending provides good risk adjusted returns, however the Council should be conscious that the returns are irregular and the capital will need to be continuously recycled which may not be sustainable in the long term. Furthermore, market conditions may change in the future.

The over-arching strategy is therefore to capitalise on the current development lending market, but ensure we build up a robust and sustainable income stream for the Council in the future. Therefore, whilst development lending will likely form a major part of the investment strategy, at least in the short to medium term, we will ensure due attention is given to building the Council's direct real estate and investment lending platforms for the long term.

EXECUTIVE SUMMARY

INVESTMENT TACTICS

Direct Investment

When targeting direct investments, we will focus on quality properties in strong locations, to ensure the Council invests its funds prudently. Due to this requirement, and the prevailing level of prime yields in the investment markets, we will target investments with minimum yields of 5.5% (5.25% if index linked) for direct acquisitions – with a minimum net income of £100k per annum to the Council after its borrowing costs.

Broader equity investments will be made on a case by case basis.

Development Lending

For development lending, we will target superior quality schemes and developers with a strong track record. We will focus on senior lending, set appropriate covenants on all loans to ensure the Council has sufficient headroom and target a minimum IRR of 7% (with a minimum interest rate of 5.5%). These facilities will typically be for a period of up to 3 years. It should be noted that the Council has yet to make any investments of this nature since developing this investment strategy.

Investment Lending

For investment lending, we will target superior quality well-let assets. We will focus on senior lending, at appropriate leverage to protect the Council's investment and target a minimum IRR of 5.0% (with a minimum interest rate of 3.5%). It should be noted that the Council has yet to make any investments of this nature.

Flexibility

The investment tactics will be reviewed and adjusted in line with market conditions.

CBRE

INTRODUCTION

BACKGROUND

Trafford Borough Council (Trafford or the Council) enlisted the services of CBRE Investment Advisory (CBRE IA) in July 2017 as its retained strategic real estate Investment Advisor. The Council's primary objective of investing into real estate was to deliver a sustainable commercial income return to support its underlying service delivery. It intended to do this through borrowing from the Public Works Loan Board (PWLB).

At that point in time the net income return sought by the Council was approximately £7 million per annum. This figure was to be 'net' of the costs of capital through the PWLB, including an allocation to the Minimum Revenue Provision (MRP) to repay the loan. The income will also be net of cost associated with holding the investments, however this will be relatively low due to the nature of the target investments.

Following a series of workshops with the Council, CBRE IA devised an investment strategy in September 2017, which was subsequently agreed at the Council's cabinet meeting.

CHANGES TO GOVERNMENT GUIDANCE

In December 2017, the government launched a consultation on local authority investment and subsequently published guidance on the topic. This had several implications for the investment strategy agreed in 2017; most notably as follows:

- Specific guidance around the treatment of the Minimum Revenue Provision (MRP);
- MRP will only apply to completed assets;
- Loans can be made to third parties locally to assist development and regeneration;
- More accountability and transparency, especially around commercial investments, and
- A greater focus on local investment and regeneration.

This has impacted the level of investment activity that local authorities have undertaken. Primarily because the effective cost of capital (interest on loan + MRP + admin costs) has increased.

NEW INVESTMENT STRATEGY

This has caused the Council to have to rethink its priorities and wider investment strategy. The Council has therefore asked CBRE IA, to update the strategy considering these changes with a view to generate a sustainable income stream through investment into real estate.

This strategy should be considered as an update to the original September 2017 strategy, which has been included at Appendix A.

INVESTMENT OBJECTIVES

SECTION SUMMARY

"The Councils primary objective is to generate an income stream to support the Council's wider service delivery. The income must be sustainable, secure and diversified with an appropriate risk adjusted return. We will consider investments with secondary economic benefits where it is appropriate to do so, but never at the risk of not fulfilling the primary objective."

PRIMARY OBJECTIVE

Before advising on any investment strategy it is imperative that objectives are clearly defined so that, where possible, performance can be benchmarked and success easily measured.

The September 2017 strategy report included the key investment objectives of the Council at the time. Whilst these remain broadly consistent we have identified them again below for completeness:

The Primary Objective remains to:

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

It is understood that the Council wishes to generate an income stream from this investment strategy to support its service delivery.

SECONDARY OBJECTIVES

Whilst the primary objective will always remain our priority, it is understood that if investments can also generate secondary economic or social benefits then this will be considered a desirable quality by the Council.

However, it is important to be clear that to achieve the Council's Primary Objective, most of the investments that we recommend will be commercial by nature. Importantly, if too much emphasis is placed on these secondary objectives the Council will not be able to achieve its primary objective.

CBRE

GEOGRAPHIC CONSIDERATIONS

SECTION SUMMARY

"The fewer investment restrictions that an investor requires, the more opportunity they will have to create a strong risk balanced investment portfolio. We therefore advise the Council to only restrict its investment activities where it is legally compelled to do so, as otherwise there is a significant risk that the primary objective will not be achieved and the risk profile would not be considered prudent or secure."

CONTEXT

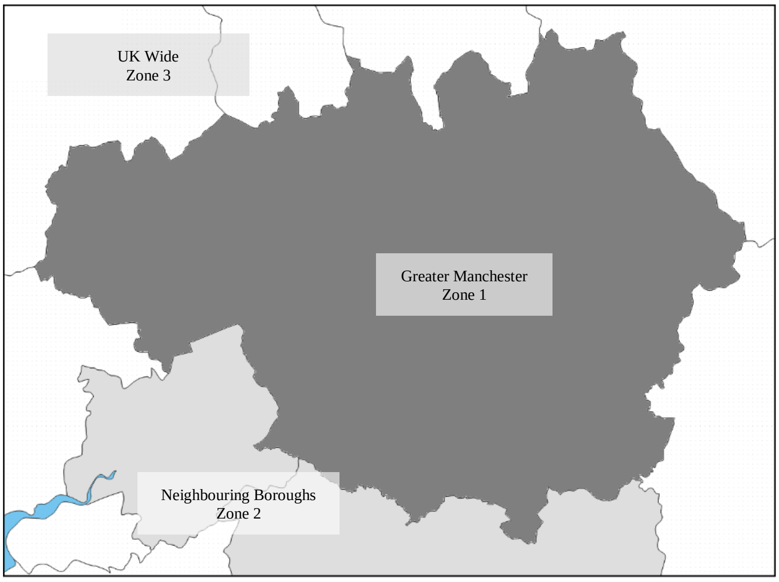
When the September 2017 strategy was produced the Council wanted to focus its investments in the north-west of the UK. Although it was acknowledged that this would result in far lower opportunity and pipeline.

To put this into context the UK investment market in 2017 had a total transaction volume of approximately £63Bn[1], with the north-west accounting for just £3Bn or 4% of the total market. This trend has continued when looking at YTD 2018 figures.

FUTURE STRATEGY

It is understood that there is still a desire to invest locally where possible, but it is important to understand that solely doing so will be at the detriment to the Council's primary objective and will increase the risk of the investment portfolio.

When we met to discuss the strategy we therefore agreed that investments should be classed 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.



[1] Property Data – Total Transactions UK 2017

GEOGRAPHIC CONSIDERATIONS

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. Therefore, a different view can be taken on risk/return over those investments that are purely for commercial purposes. To execute this strategy the Council may require a formal investment vehicle. It is important to define, and agree, the characteristics that investments should have in each of the 'Zones'. The investment priorities we would expect (in order of priority) for each of the zones is as follows:

Zone 1 (Greater Manchester)	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

It is however important to reiterate the point that if investment is restricted to Zone 1 (Greater Manchester) the market opportunity and pipeline (across all investment classes) will be significantly reduced. By way of example Greater Manchester only accounted for 2% of the UK direct investment market in 2017 and there were on 33 deals over £10m over the full year, compared to a UK Wide total of 1,014 transactions (Property Data).

INVESTMENT STRATEGY

SECTION SUMMARY

"The primary objective is one of income generation, but there are multiple ways to invest into real estate – all of which will have a place in a balanced investment strategy. However, it is important to understand that the relative weightings to each will evolve as we build a sustainable long-term portfolio and that whilst some types of investment are appealing today, the depth and changes in the market will likely mean more sustainable solutions will need to be found in future."

INVESTMENT CHARACTERISTICS

To date, we have invested both directly via equity and indirectly into developments via debt.

It is important to understand that whilst development lending is a good short-term solution, over the longer term the Council will need to build up a sustainable direct portfolio and investment lending platform to 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)
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. No MRP requirement LTV/LTC provides risk cover Downstream benefits from funding new development Current market opportunity Costs borne by borrower	No MRP requirement 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
Disadvantages	Impact of MRP on returns 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.

Whilst development and investment lending do not require MRP to be set aside, they do require annual assessments which could lead to impairments that may impact the revenue.

INVESTMENT STRATEGY

COST OF BORROWING

The following table demonstrates the average total cost of capital for each investment type that will ultimately impact the net income that the Council receives as follows:

	Direct Investment	Development Debt	Investment Debt
PWLB Rate*	2.55% pa. (50 year)	1.78% pa. (3 year)	1.96% pa. (5 year)
MRP	2.00% pa. (50 year)	0.00% pa.	0.00% pa.
Admin	0.20% pa.	0.20% pa.	0.20% pa.
Total	**4.75% pa.**	**1.98% pa.**	**2.16% pa.**

**PWLB Rates effective 16.08.2018 (Maturity)*

The total cost of capital for each investment type is made up of the PWLB interest rate (dependent on the loan period), any Minimum Revenue Provision ("MRP") required and a nominal administration fee. A risk reserve will also be included on direct investment on a case by case basis, based on the risk profile of the asset to form an appropriate portfolio level risk reserve. This reserve contribution could be in the region of 0.5% of the principal investment value per annum and would increase the total cost of borrowing to 5.25%.

The cost of capital for direct investment is higher than for both forms of lending, due to the requirement for an MRP to repay the facility after the 50-year period.

TYPICAL NET INCOME

Typical net returns will differ between the investment options based on the cost of capital and market rates. We expect the right sort of direct investments to provide the Council a yield of between 5.25% and 6.25%. Based on this, the margin the Council would receive would be between 50bps and 150bps above its borrowing costs. For example, this means to achieve an income of £10m per annum the Council would have to invest between £675m and £2Bn. At 5.25% cost of borrowing (inclusion of a risk reserve), then direct property investments with an average return of 6% would require an investment of £1.3bn to give a £10m return per annum.

The other end of the scale, development lending, which has the lowest cost of borrowing, will typically have a return of approximately 6.00% per annum. Because of the lower cost of borrowing (c.2.00%) the net income to the Council would be approximately 400bps. This means that to achieve £10m of income per annum using development lending the Council would need to have approximately £250m invested at any one time.

CBRE

INVESTMENT STRATEGY

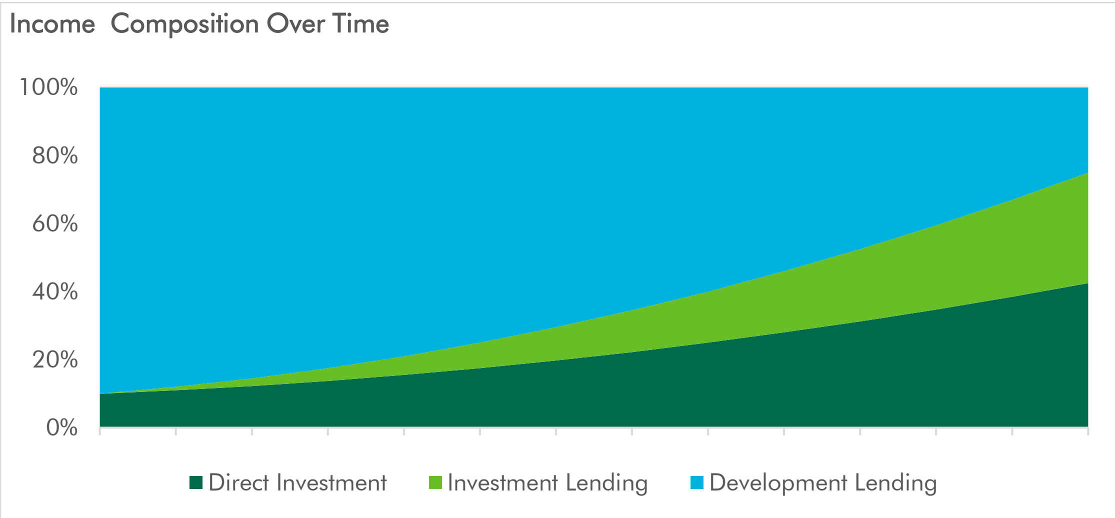
This demonstrates the typical net returns from each of the investment types. Based on this is would be easy to assume that development lending alone will be sufficient to create a sustainable income stream. However, the nature of the investment and the prevailing market conditions means that this is unlikely to achieve the Council's objectives over the medium to long term as it is unlikely to be sustainable.

The ultimate scale of investment will depend on the balance between direct and debt investments and will change over time.

DEFINING THE STRATEGY

Rather than setting arbitrary allocations to the different investment types, we have considered the best way to generate the sustainable income stream that the Council needs 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.

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 continue to focus on development lending (primarily in Zone 1), whilst there is opportunity to do so. This will provide the Council with the ability to invest meaningful amounts in the short term.

As income from development lending is a) irregular and b) will need to be recycled regularly, we will also focus on acquiring direct property and building an investment lending platform to build up the proportion of income that is genuinely sustainable.

INVESTMENT STRATEGY

Medium Term

Over the medium term we will continue to build the direct portfolio and investment lending platform. This will reduce the need to recycle the development loans and will help the Council develop a stable income base for the future.

The speed that we can achieve this will depend upon prevailing market conditions, 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, either directly investing 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.

INVESTMENT TACTICS

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)."

DIRECT INVESTMENT

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

- The target net initial yield should be a minimum of 5.25% for inflation-linked/fixed-uplift income and 5.50% for all other investments. This will provide the Council with between 50bps and 75bps as a minimum net return.
- In line with the primary objective of a sustainable income stream, there will be a focus on running yield as opposed to IRR.
- 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. Equally, we believe a secure 50bps of income is more aligned with your objectives than investments with a higher initial yield, but with a tangible risk of income falling away.
- We will typically advise against purely commercial opportunities with a yield of above 6.75% due to the risk they present. Most prime yields are now significantly below this level across all sectors. It is important that the Council understands that the risk will be higher when there is a focus on yield over quality.
- Based on sector performance and the objectives, we 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 target income of £100k per annum to the Council should be targeted.

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. This will provide the Council with sufficient margin above its borrowing costs.

CBRE

INVESTMENT TACTICS

- We will target a minimum overall IRR of 7.0% per annum, with a maximum facility period of three years.
- We will seek to enhance the Council's 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 (Greater Manchester), and in borough where appropriate.
- We will look to support schemes where the developer has a good track record and where the property provides appropriate security for the loan.
- A minimum commitment of £10m will be set per facility, to ensure the they are additive to the Council's investment portfolio.
- A maximum LTV Ratio of 70% and a maximum LTC 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 sufficient margin above its borrowing costs and a regular income, whist being competitive against incumbent lenders. These rates will typically be fixed for the term.
- We will target a minimum overall IRR of 4.0% per annum.
- We 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 the Council's investment.