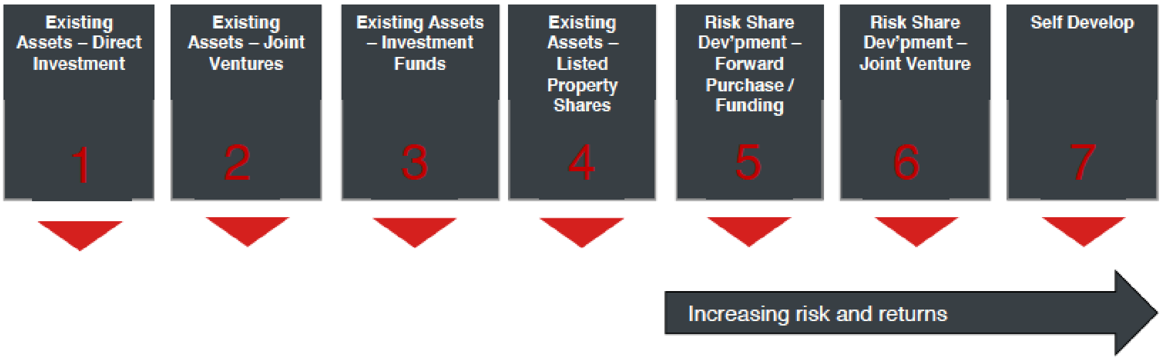
Southampton City Council – Property Investment Fund

Options Appraisal

The Options Appraisal considers the relative benefits and limitations of seven investment options as follows:-



These are assessed against eight criteria

- Financial Objective
- Revenue Delivery
- Risk
- Control
- Liquidity
- Management Oversight
- Performance
- Diversification

Existing Assets – Direct Investment

What is it?
▪ The Council acquires and manages freehold or leasehold properties.

How does it work?
▪ The Council uses property professionals to identify market opportunities.
▪ After deciding on price and clearing appropriate internal approvals, bid for assets.
▪ Using appropriate advisors (legal, surveying, valuation) undertake due diligence and complete legal acquisition documentation.
▪ Establish on going management arrangements (internal or outsourced).
▪ Regular asset reviews to determine business plan and exit strategy.
▪ Process required on an asset by asset basis.

Benefits

Financial Objective	Depending on property type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the property acquisitions
Risk	Low risk option
Control	High level of control
Liquidity	Reasonable liquidity, subject to usual property market timings
Management Oversight	Relatively light requirement – high involvement at key decision points (buying and selling)

Limitations

Performance	Low return option and no competitive market position
Diversification	Desired diversification unlikely to be achieved given current potential capital allocation

Existing Assets – Joint Ventures

What is it?
▪ The Council acquires and manages freehold or leasehold properties together with a partner.

How does it work?
▪ The options are to approach this on a case by case basis or create a strategic relationship with a trusted partner.
▪ The Council will wish to select a partner or partners on the basis of their demonstrated expertise and ability to co-invest with the Council (assume 50/50). The Partner will carry out much of the management role.
▪ The Partner will identify market opportunities.
▪ The JV will include governance allowing Council input on key decisions, including acquisitions and sales.
▪ The Partner is responsible for on going management arrangements.
▪ Council rights to review business plan and exit strategy.

Benefits

Financial Objective	Depending on property type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the property acquisitions
Risk	Lower risk option – JV partner risk added
Control	Medium level of control
Liquidity	Reasonable liquidity, subject to usual property market timings and governance of JV
Management Oversight	Light requirement – JV partner undertakes most of the direct acquisition, management and sales work

Limitations

Performance	Low return option. Partner selected to bring track record and potentially competitive market position
Diversification	Diversification improved given additional Partner capital contribution but still unlikely to be at desired level

Existing Assets – Investment Funds

What is it?

- The Council invests in an unlisted property fund which owns a range of diversified property investments.

How does it work?

- The Council will undertake a process of reviewing available fund options and the track record of the fund managers.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The fund documentation will set out the rights of the Council to redeem its investment and/or to sell it on the secondary market. The nature of these rights will vary depending on the type of fund.

Benefits

Financial Objective	Depending on fund type, is capable of delivering 6% annual return
Revenue Delivery	Generates revenue from the time of the fund investment – generally a shorter time than investing in direct property
Risk	Risk is determined by the nature of the fund. Additional risks relate to the fund structure, principally the performance of the fund manager
Performance	Returns are related to the specific investment strategy of the fund and manager performance.
Diversification	Fund investment can spread risk over a large number of underlying assets.
Control	High level of control of fund interest
Management Oversight	Very light requirement

Limitations

Liquidity	Unlisted investment funds generally have a low level of liquidity, particularly in market downturns.

Existing Assets – Listed Property Shares

What is it?

- The Council invests in listed property shares in a fund or a separate account mandate managed by a specialist fund manager.

How does it work?

- The Council will undertake a process of reviewing managers and available fund options and selecting an appropriate investment strategy.
- Once capital is invested the entire responsibility for acquiring and managing the investments is delegated to and the responsibility of the fund manager.
- The fund manager will report and pay distributions to the Council on a regular basis, usually quarterly.
- The mandate with the fund manager can be structured to allow an immediate liquidation of the investment portfolio if required.

Benefits

Revenue Delivery	Generates revenue from the day the property shares are acquired – share transactions can be effected in a short time period
Liquidity	The highest level of liquidity
Risk	The risk and return level is flexible and can be altered over time by reference to the agreed investment strategy
Diversification	Risk can be spread over a large number of underlying property companies/assets.
Control	High level of control
Management Oversight	Very light requirement

Limitations

Performance	Higher volatility than direct property. Longer term performance correlates to property but short term can correlate to general equity markets
Financial Objective	Dividend yields generally lower that direct property yields – to be investigated further.

Risk Share Development – Forward Purchase Funding

What is it?

- The Council enters into an agreement with a developer to fund part of the development cost and/or acquire a development on completion.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The Council will be able to determine the risk profile it wishes to take on in entering the arrangement with the developer (e.g. after planning permission has been secured and construction packages have been tendered).
- During the construction stage the Council will likely require monitoring rights.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment activity, so at least a 6% income return dependent on property type
Performance	A higher level of performance than investment activity
Risk	The risk of development is highly mitigated by the forward purchase/funding arrangements
Control	High level of control
Management Oversight	Moderate level once the transaction is agreed

Limitations

Revenue Generation	Revenue can accrue to the investment when funded, but this will only occur during or at the end of the development period
Diversification	Desired diversification unlikely to be achieved given currently contemplated level of investment
Liquidity	Low liquidity during the development period, thereafter as per the general property market

Risk Share Development – Joint Venture

What is it?

- The Council enters into a JV agreement with a developer to carry out a specific development.

How does it work?

- The Developer will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be shared 50/50 between the Council and the Developer.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type
Performance	A higher level of performance than investment and forward purchase/fund development activity
Risk	The risk of development is mitigated by careful partner selection and development stage oversight
Control	Strong level of control through JV documentation
Management Oversight	Meaningful level of oversight required

Limitations

Revenue Generation	Revenue will only accrue once the development is completed and leased (or sold).
Diversification	Diversification improved given Developer 50% capital contribution, but still unlikely to be at desired level
Liquidity	Low liquidity during the development period, thereafter as per the general property market

Self Development

What is it?

- The Council undertakes a development itself, appointing a development manager.

How does it work?

- The Development Manager will identify a market opportunity (although it may come from the Council) and carry out the development functions.
- The risk of the development will be taken 100% by the Council.
- The Council will be involved in key decisions during the development period.
- Post development completion (as per direct investment):
  - Establish on going management arrangements (internal or outsourced).
  - Regular asset reviews to determine business plan and exit strategy.

Benefits

Financial Objective	Should deliver a premium to pure investment and forward purchase/funding, so at least a 6% income return dependent on property type
Performance	The highest level of performance – the Council retains all development profit
Risk	The risk of development is mitigated by appointment of expert development manager and adoption of thorough risk management strategy
Control	Complete control with the Council

Limitations

Management Oversight	High level of oversight required
Revenue Generation	Revenue will only accrue once the development is completed and leased (or sold).
Diversification	Desired diversification unlikely to be achieved given the currently contemplated level of investment
Liquidity	Low liquidity during the development period, thereafter as per the general property market