Property Investment Strategy

2022

WINGECARRIBEE SHIRE COUNCIL

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1.0 - BACKGROUND

All councils have faced operating income and revenue pressures in recent years.

The key drivers have included the fluctuations in returns from approved Local Government investments, plus Government policies, capping or reducing council's traditional income sources. Examples include rates pegging and changes to Section 7-11 contributions.

With the need to improve and diversify its operating income, Council has endorsed a Policy to create a Property Investment Portfolio ("PIP").

The forecast returns from an effective PIP will sit well above those achievable from approved Local Government investments. These returns bring property ownership risk, and sometimes less liquidity than other investment forms, but these can be managed through appropriate property and risk management strategies and pro-active portfolio management.

The intent of this Investment Property Strategy is to focus on enhancing Council's investment returns and diversifying its income, through the strategic use of property, whilst employing risk diversification strategies, to ensure returns bring little to no additional risks.

This Investment Property Strategy:

- includes strategies and opportunities to secure capital and deliver PIP assets
- establishes the parameters for periodic reviews of the PIP Hurdle Rate
- Sets the risk and opportunity parameters pertaining to a PIP
- contains risk management and assessment criteria that enable PIP opportunities on a case by case basis
- provides guidelines for PIP construction, risk mitigation and ongoing management reporting
- provides guidance on how additional revenue will be allocated into Council's Long-Term Financial Plan

2.0 - CAPITAL ALLOCATION & ASSET DELIVERY

Council's strategic objective is to create a PIP to increase and diversify its revenue sources. This will require:

- the acquisition (or other delivery) of PIP assets
- capital to be secured for investment purposes
- reasonable portfolio scale, to make a significant contribution towards Council's objectives
- a defined category for PIP properties, so they are used solely for income generation.

Council's strategies to secure capital and assets will consider four potential sources, as follows:

1. income generation from existing assets
2. sale of identified surplus assets, of no specific use to Council
3. allocation of a portion of Council's unrestricted Balance Sheet Reserves for PIP investment (dependant on Council's liquidity)
4. using debt for PIP investment (unlikely, unless for very short-term purposes).

2.1 - Income generation – existing assets

Income generation from existing assets may also enhance overall portfolio efficiency and can often deliver a higher return on any capital cost, than the prescribed PIP hurdle rate.

Examples include leasing Council facilities such as saleyards, vacant land, significantly under-utilised halls or other facilities, asset conversion or development opportunities.

Council's strategy is to review all assets, to identify those with:

- no significant or currently foreseeable use; and/or
- inherent underlying commercial or development potential.

Assets which match these criteria will:

- be included in Council's Property Action Plan
- have strategies created to deliver (or progress) each initiative, including timeframes
- be categorised as PIP investments
- be targeted for Council endorsement for delivery, where necessary.

"Easy wins" will be targeted to assist the PIP establishment.

Council will undertake bi-annual portfolio reviews as its portfolio continues to evolve.

2.2 - Endorsed property asset sales

Council will review its portfolio to identify if any assets have no specific purpose, are duplicated, or cannot otherwise justify ongoing ownership through a process known as capital recycling.

Each property asset will be reviewed on a case by case basis to justify its ongoing use or ownership, in consideration with related strategies and plans in the form of an asset review.

Once an asset review is completed, an asset may be considered for divestment if it cannot meet **one or more** of the following criteria.

- Deliver essential operational and/or community services
- Provide current or expected income – which delivers an economic return on cost or value
- Required to deliver a future Council initiative (In the four-year delivery plan – or with reasonable certainty thereafter)

Divestments of operational land may be recommended to Council where:

- the review process and failure to meet the above criteria is demonstrated in the report;
- no alternative use, or re-purposing is economically viable;
- the proposed method of sale is included;
- the indicative sale price is supported by an independent valuation.

The proposed use of the sale proceeds will be identified and may be directed towards PIP investment.

2.3 - Allocation of unrestricted reserves

Council has significant unrestricted cash reserves on its balance sheet. These are generating returns below the PIP hurdle rate assessed in section 3.2.

Council should consider if some of its unrestricted reserves are earmarked for the PIP, having regard to:

- the annualised rate of return being greater than the annualise rate of return on cash investments;
- its likely use of these reserves in the future;

- whether it believes the risk adjusted returns justify some loss of capital liquidity;
- its overall appetite for risk and return.If a reallocation is appropriate, Council will consider whether a lump sum is initially transferred to a Property Reserve, or ongoing allocations occur as acquisitions arise, up to the approved limit.

2.4 - Use of debt

Councils typically have conservative balance sheets with debt used for key needs. In addition, any PIP income generated through using debt, will largely be offset by the debt servicing costs.

Council may strategically use debt for PIP transactions. Use may be limited to concluding transactions where required, when permanent funding is imminent from a preferable source.

2.5 – PIP asset categorisation

Council's strategy to protect and enhance the function of its future PIP properties is to:

- categorise current and intended PIP assets as "investment property";
- ensure investment properties are protected for their income generation purposes; and
- all community or other uses only occur under a market-based lease, and at a market rent.

2.6 - Short terms outcomes in establishing the PIP

The short-term outcomes for establishing and growing the PIP are:

- Identify "quick wins" in the portfolio - and associated delivery strategies
- Complete an interim Property Action Plan (PAP)
- Complete a Council report recommending:
  - A targeted capital allocation to create a PIP
  - The initial PIP size and scale to be targeted
  - Indicative funding sources
  - Targeted allocation of unrestricted Reserves (if any)
- Deliver a high-level site strategy for each Council owned property
- Completed a full portfolio review and finalises the PAP
- Identify any assets to be sold and complete Council reports – ongoing form

3.0 - PIP HURDLE RATE AND INVESTMENT RETURNS

Council's policy is to establish a PIP to diversify its operating income and access the attractive returns that passive income generating property can deliver, compared to other investment types.

Income returns that may be reasonably defined as "attractive" will vary over time, depending on:

- income returns available from other investment types; and
- property market conditions and expectations.

3.1 - Benchmarking the PIP hurdle rate

Returns from investment properties in the range of $8m to $30m, are considered the best benchmark to establish or review the PIP hurdle rate.

Smaller opportunities will be reviewed, but this will likely be the optimal price range for Council investment because:

- the lower end is generally above the "family trust investment market", where yields are lower, due to more available buyers; and
- above $30m, any investments will be large and may restrict overall PIP diversity – unless the
- PIP itself becomes very large over time.

To ensure its properties deliver satisfactory returns, Council will set a PIP hurdle rate for acquisitions and review it periodically. The hurdle rate is defined as:

"The required percentage return on an asset's purchase price, where the net annual rent is calculated as a percentage of the purchase price".

Council's strategy to set the hurdle rate is to periodically:

- confirm the returns available in the market, for passive income generating property;
- compare these with alternative investment returns for Council; and
- adopt the final hurdle rate based on the comparison between the two, but also overlay any economic trends it believes may be relevant.

This process should occur at least bi-annually, or if market conditions are considered to have changed.

3.2 Establishing the PIP Hurdle rate

Council investments are usually regulated by Ministerial Orders which restricts the range of investments where funds can be placed. In this regard Council regularly reports on its investment performance.

As of mid-2022, Council's average twelve-month investment return was circa 2.61%, comparable to numerous other councils which are currently in the range of 2% to 3% as at 30 September 2022.

This rate is currently increasing for councils, due to higher investment returns now emerging. These are accessed as existing exposures expire.

A comparison of core yields for passive investment property within the $8 to $30 million range in the NSW market and the larger Australian State capital cities, as at mid-2022, is shown below:

Property Type	**Prime Yield Range ****	**Indicative mid-point**
Industrial	3.5% to 5.0%	4.25%
Commercial Offices (Excludes Sydney & Melbourne CBDs as investment sizes are usually above Council's preferred price range).	4.5% to 6.75%	5.65%
Retail – Small centres and strip shops Retail – Bulky goods	4.0% to 6.0% 4.25% to 6.5%	5.00% 5.35%
Commercial Childcare	4.5% to 6.0%	5.25%
Average – Indicative only for guideline purposes	**4.1% to 6.0%**	**5.10%**

**JLL and CBRE Research - March to September 2022*

The conclusions for late 2022 are:

1. The gap between prime property yields and other council investment returns remains attractive. The former is within the range of 4% to 6% whilst the latter remains around 2%.

2. Increasing debt costs and other investment returns, suggest that yields for prime investment property may increase slightly, rather than tighten or stabilise, in the near-term.

3. Prime property yields are much less volatile than interest rates and most other investments.

4. Property ownership also brings yield growth, due to periodic rent increases in the leases.

Reflecting the above factors, the initial hurdle rate should be set at slightly below the mid-point of the property yield range, to allow for likely increases in other investment returns in the coming months.

On that basis the initial hurdle rate is adopted at **4.75%**. This hurdle rate will:

- allow potential acquisitions of any of the above property types; and
- preserve a reasonable margin between property and other investment types in the near term.

Future hurdle rate reviews will occur as noted above.

4.0 - ACQUISITON STRATEGIES AND PROCESSES

Council's policy is to create a PIP of quality investment properties and to offset property ownership risk.

Risks can occur during the acquisition phase and throughout the ownership period. They can be managed at both an "asset specific" and a portfolio level.

Council strategy is to review and assess opportunities internally, wherever possible. Where opportunities progress satisfactorily, the nominated personnel will recommend potential acquisition to the General Manager and if supported, then to Council, on such terms as the nominated personnel believe appropriate in accordance with the Property Investment Policy

Each PIP acquisition will represent a significant capital investment. Acquisitions require specialised valuation, due diligence, financial, and other input, some of which must be outsourced for probity purposes. Council endorsements may require specialist considerations, where additional, independent guidance is necessary, over and above that provided by Council officers.

The following sections comprise Council's strategies to review and acquire assets for the PIP:

- appropriate sources must exist, so PIP opportunities are brought to Council's attention
- processes exist so opportunities are reviewed consistently and efficiently, without interference
- internal recommendations to acquire assets are underpinned by independent external input.

4.1- Acquisition processes

Good quality investment properties are not always readily available and require proactive sourcing, identification of sound opportunities and specialist expertise to assess their suitability.

Council's interest in buying property must be known, so opportunities are brought to its attention. However, robust communication and assessment processes must exist, because:

- Council will be viewed as a purchaser with major financial capacity
- approaches may therefore be numerous, but very few assets considered, will prove suitable
- unsolicited approaches bring misrepresentation risks, legal or other claims by unhappy parties
- political input may occur or be perceived as evident, by the community or others
  allegations of inconsistent treatment, or inappropriate evaluation processes may occur.

To minimise risks of this type, Council will:

- create mechanisms to avoid direct approaches from the public
- require all approaches to be in writing and via an external, licensed real estate agency.

Council will create a preferred list of commercial agency firms ("agencies") but retain capacity to deal with others and will finalise a list of terms under which introductions may be made. Council will target written communications with external parties regarding acquisitions, wherever possible.

The written agreement with its preferred agencies, will include:

- Council's formal position on commissions payable and those responsible for payment
- restrictions on Council personnel with whom the agency may communicate
- a requirement for formal communications to be in writing
- provision to terminate or periodically review the terms and continuation of the agreement.

Consistent with these agreements, Council will refer any direct or public approaches from vendors, to one or more of its preferred agents. At these times Council will:

- advise the approaching party of the referred agency's agreement with Council
- confirm the approaching party must follow the agent's directions
- confirm that the proposed vendor (not Council) would pay agency commissions.

Council may retain capacity to pay an agency fee, where circumstances may dictate, in its sole opinion.

All external approaches (including from agencies) to Council regarding property acquisitions, or provision of information, is restricted to the following Council positions ("the nominated personnel"):

- Co-ordinator Property Services
- Manager – Business and Property
- Director, Corporate Strategy and Resourcing
- General Manager

All other Council employees and all Councillors must refer any approach to the nominated personnel and not discuss opportunities or receive information.

Opportunities reviewed outside this process, may be disqualified from consideration.

4.2 - Reviewing Potential PIP acquisitions

Council strategy is to review and assess opportunities internally, wherever possible.

The nominated personnel will:

- meet when reasonably appropriate, to consider current PIP opportunities;
- consider when external input may be commissioned and approve necessary costs; and
- reject any proposal at any time - as not meeting either Council criteria, or price expectations.

Where opportunities progress satisfactorily, the nominated personnel will recommend potential acquisition to the General Manager and if supported, then to Council, on such terms as the nominated personnel believe appropriate.

4.3 - Independent review of proposed acquisitions

Each PIP acquisition will represent a significant capital investment. Acquisitions require specialised valuation, due diligence, financial, and other input, some of which must be outsourced for probity purposes.

Council endorsements may require specialist considerations, where additional, independent guidance is necessary, over and above that provided by Council officers.

Council's strategy to deal with these challenges is to appoint an independent property advisor ("PA") to assist the acquisition process. The PA will:

1. become involved where an acquisition is to be recommended to Council;
2. independently review the final pre-acquisition due diligence and the Council report; and
3. provide an additional report, reviewing all matters that the PA believes appropriate.

Council will complete an agreement with the PA covering the basis of remuneration and its expectations and will periodically review both the terms and continuation of the agreement.

4.4 - Property acquisition reports

Council will include the following, as a minimum for any recommended PIP acquisition:

- a full legal and physical description of the property and the tenancies, including the lease expiry dates and the lease security provided
- details of the independent valuation secured
- a summary of all physical and legal due diligence
- the PC report and any area where the reports differ in opinion, or recommended outcomes
- the impact of the proposed acquisition on the full PIP, as per the requirements of Section 5
- an opportunity cost analysis, to compare the recommended acquisition with other uses for the capital sought. This will include alternatives for any existing property, should Council be considering an internal re-positioning, or development opportunity.

The acquisition and reporting processes will robustly review and minimise all "asset specific" risk, for any property coming into the PIP.

5.0 - PIP PORTFOLIO CONSTRUCTION

Council's policy is to create a PIP of quality investment properties, diversified across asset types, lease expiries and other variables, to reduce property ownership risk, whilst enhancing operating income.

Property ownership risk must also be managed at a portfolio level.

Council's strategies to deliver the deliver the policy outcomes at a portfolio level, include:

- targeting exposures to multiple properties and across different property types
- diversifying risk across acceptable property asset categories, where varying market and economic drivers often apply
- diversifying exposures to those companies or entities, that occupy PIP properties as tenants
- monitoring geographic allocations.

5.1 - Exposure to different property types

Whilst macro market factors, such as economic conditions, interest rates and supply and demand will always exist, the underlying drivers of each property type vary. These delivers diversity if harnessed.

Council's strategy is therefore to seek a balanced portfolio, targeting exposure to the following asset classes and their high-level underlying drivers.

Retail:

Relies heavily on retail spending, disposable income, wage growth and economic sentiment.

Well located retail typically has low vacancy risks, whilst strip shop retail is simple to manage and provides small, saleable investments. Volatility across the retail property asset cycles, is usually low.

The risk of new competition is best minimised through exposure to small, well-located investments, or very large regional shopping centres. Council would expect to invest in the former, not the latter. Overall, retail is a desirable property investment exposure for Council.

Bulky Goods Retail:

Demonstrates similar characteristics to traditional retail, but with more focus towards the housing market and associated goods. Well located investments have lower leasing risk, unless the location depends heavily on major (national) retailers, acting as anchor tenants. Market volatility across property cycles is slightly higher than the traditional retail category.

Bulky goods retail in areas with good critical mass, is a desirable investment exposure for Council.

Industrial:

Relies heavily on the economic drivers of manufacturing and goods distribution, plus blue-collar employment trends. Where it is non-specialised, industrial property typically comprises functional, smaller, and quite saleable investment opportunities, with limited overall volatility in its market cycles.

The impacts of Covid-19 saw the industrial sector become even more favourable with investors and the drivers of these outcomes seem likely to remain.

Industrial property is a desirable property investment exposure for Council.

Commercial Offices:

Are historically a more volatile asset class and subject to risks of new supply, and asset obsolescence.

Major drivers of office demand include White Collar Employment growth, worker space ratio trends, and changes in technology. These latter factors have impacted negatively on offices, given the main Covid 19 impacts. The risk of permanently changed tenant demand, remains at this stage.

Reflecting these risks and that office investments are often bigger than other property types, the required returns from offices are slightly higher for many investors.

Office property is an exposure Council will consider, but on a cautionary basis. Some PIP exposure is desirable, but this will be lower than for some other asset classes. Similarly, Council will require longer leases for office investment opportunities.

Commercial Childcare:

Is a newer asset class providing smaller investments with long leases.

For councils it can deliver both community outcomes and investment returns, and assets may also be able to be created from existing portfolio properties. Independent management is a requirement for PIP returns, rather than internal operations. Development risk is low, compared to other asset classes.

Commercial Childcare is a desirable property investment exposure for Council.

Other Property Types

Include internal generation from Council's property portfolio, or more diverse asset types such as motels, cinemas, or similar. These will each be considered on their own merits, but apart from internally generated opportunities, these asset types will likely have limited PIP presence.

5.2 - Asset exposure guidelines

Consistent with Council's strategy to risk manage, it will adopt PIP allocations to property types.

Early allocations (or weightings) will be volatile and have less meaning, until reasonable portfolio scale occurs.

Therefore, Council's strategy will be:

- to refer to the guidelines for information and reporting only, until a minimum of 5 properties or $50 million portfolio scale is achieved. ('the minimum scale")
- once the minimum scale is achieved, target ongoing weightings to the individual property categories as follows.

Property Asset Type	**Target Allocation**
Strip retail or shopping centre investments	0% - 35%
Bulky goods retail	0% - 35%
Industrial	0% - 35%
Commercial Offices	0% - 10%
Commercial Childcare	0% - 20%
Internally generated income – EG land leases, kiosks, etc.	0% - 25%
Other property types.	0% - 5%

Future reviews

Council will review the portfolio weightings biannually, or subject to any significant market changes.

A further review will occur once the portfolio achieves greater scale – at or beyond $100 million.

The weighting or allocation ranges will likely be narrowed for all asset classes, as most will likely be represented at that stage, by property owned.

5.3 – Individual tenancy exposures

Consistent with Council's policy to diversify risk, Council will adopt the following strategies to limit its exposure to the risk of tenancy failures:

- to refer to the guidelines for information and reporting only, until a minimum of five (5)
- properties or $50 million portfolio scale is achieved ('the minimum scale");
- once the minimum scale is achieved, target ongoing weightings to the individual property categories as follows.

Any individual entity – excluding ASX listed companies, Government and Local Government entities.	To a maximum 10%

Any individual ASX listed company	To a maximum 20%
Any individual Government or Local Government entity.	To a maximum 30%

A further review will occur once the portfolio achieves greater scale – at or beyond $100 million.

The weighting or allocation ranges may be tightened if considered appropriate at that time.

5.4 - Lease expiry risk

Lease expiries are inevitable for commercial property. Some risk is diversified through exposure to the different property asset classes, as reviewed above.

A further key aspect of diversity is creating and maintaining appropriately staggered lease expiry dates.

Council's strategy to deliver this outcome is to:

- limit the percentage of PIP lease expiries, in any particular year;
- review potential acquisitions for their impact on the full PIP expiry profile;
- where possible, adopt pro-active lease expiry and renewal strategies earlier, in years where a higher than preferred portion of lease expiries are due.

5.4.1 - Portfolio lease expiry risk

Exposure will be limited in all future years, where currently unforeseen property and economic factors may be severe. Council will achieve this by targeting maximum weightings to all future years.

Council's strategy will be:

- to refer to the guidelines for information and reporting only, until a minimum of five (5) properties or $50 million portfolio scale is achieved ('the minimum scale");
- once the minimum scale is achieved, target ongoing weightings to the individual property categories as follows:
    - limit lease expiries, in any one year to 25% of total portfolio income, beyond $50m PIP scale;
    - limit lease expiries, in any one year to 20% of total portfolio income, beyond $100m PIP scale.

5.4.2 - Property lease expiry risk

Another component of lease expiry risk is to require minimum levels of security when buying PIP assets.

Council's strategy to deliver this outcome is to specify a minimum weighted average lease expiry term ("WALE") for any property to be acquired.

Reflecting the high-level drivers for each property type (contained in section 5.1) and the property market at the mid 2022 review, Council will require a minimum WALE for each asset type as follows:

Asset Type	Minimum WALE
Industrial	6.0 years.
Commercial Offices	7.5 years.
Standard Retail Shops	3.0 years.
Retail – Bulky Goods	5.0 years.
Commercial Childcare	5.0 years.
Other – if recommended	Based on independent assessment.

- exceptions to WALE requirements may be recommended but justifying criteria must be strong;
- any Council property development projects must comply with the WALE requirements;

Other investments emanating from Council's portfolio, such as converted assets, land leases or similar may be assessed on their individual criteria, including the forecast return on any capital outlay, and the ability of the asset to be leased to the wider market.

In addition, the specific lease expiries of any acquisition, and the extent to which it changes the existing PIP expiry profile will be included in any pre-purchase due diligence.

If an asset otherwise meets all acquisition criteria but gives the PIP a very high expiry exposure in any future year, then further justification for its acquisition is necessary. Such factors may include:

- how far into the future the expiry risk will sit and any earlier opportunities to reduce it;
- the overall diversification of the expiry risk in that year.

6.0 - PIP REPORTING

Council will provide quarterly reports on the general PIP performance and a detailed annual report. The annual report will include the following:

At a portfolio level

1. the portfolio results and the income achieved for the financial year
2. a comparison of budgeted income verses income achieved and reasons for variances > 5%
3. the dividends available for distribution and use
4. the PIP composition and asset weightings, verses target exposures
5. single asset and individual tenant exposures, by percentage of total PIP value
6. combined lease expiries occurring – by percentage of total PIP income, in every future year
7. reasons for any variances in 4-6 above, from the targeted weightings
8. the Weighted Average Lease Expiry ("WALE") of the combined PIP
9. portfolio vacancy levels (if any) and imminent expiries
10. any capital needs or short-term PIP growth targets (where relevant)
11. if there is any debt used for any PIP assets, the amount, and the reasons
12. any other matters reasonably considered material for the PIP

At an asset level

- a comparison of budgeted income verses income achieved and reasons for variances >5%
- strategies in respect of each impending lease expiry
- confirm the Weighted Average Lease Expiry ("WALE") of each asset
- any other matters reasonably considered material for any individual properties.

As the portfolio begins to achieve reasonable scale, Council will likely update its Long-Term Financial Plan and other deliverables at least annually, for the impact of PIP distributions and related outcomes.

Key deliverable and indicators will be incorporated into Council's Operational Plan and captured as a part of the quarterly reporting cycle.

APPENDIX

IMPLEMENTTION PRIORITIES

Based on the details contained within this Strategy the following recommendations are made:

Identifies any "quick wins" in the property portfolio, where PIP assets may be created.	January 2023
Completes an interim Property Action Plan ("PAP") to deliver any opportunities, including delivery strategies and timeframes.	February 2023
Completes a Council report recommending: • A targeted capital allocation to create a PIP. • The initial PIP size and scale to be targeted. • Indicative funding sources. • Targeted allocation of unrestricted Reserves (if any).	April 2023
Completes a full portfolio review and finalises the PAP	June 2023
Delivers a high-level owndership strategy for each Council owned property	June 2023
Identifies any assets to be sold and seeks Council endorsements – ongoing from	June 2023
Adopts mechanisms for reviews of the PIP Hurdle Rate contained in Section 3.	July 2023
Adopts the initial PIP Hurdle rate.	July 2023
Adopts the PIP acquisition strategies and processes contained in Section 4	July 2023
Appoints an independent property advisor to advise on PIP property acquisitions	July 2023
Adopts the asset, tenancy exposure and lease expiry guidelines in Section 5	July 2023
Adopts the PIP Reporting Requirements contained in Section 6	July 2023