

**TO:** Council

**FROM:** Manager Governance

**MEETING DATE:** January 2013

**SUBJECT:** **PROPERTY GOVERNANCE OPTIONS**

## SUMMARY

This report outlines the two preferred options for the future governance of the Property Investment Portfolio – a management Council Controlled Organisation or an independent Property Subcommittee. Depending on which option is preferred, the matter may need to be included for consultation in the draft Annual Plan.

## IMPLICATIONS FOR:

- |  |   |
|--|---|
| (i) <b>Policy:</b>                     | No  |
| (ii) <b>Approved Annual Budget:</b>    | Yes – either option will require an allocation of fees for board members. |
| (iii) <b>LTP/Funding Policy:</b>       | No  |
| (iv) <b>Activity Management Plans:</b> | Yes – possibly for the Property AMP.                                      |
| (v) <b>Community Boards:</b>           | No  |
| (vi) <b>Sustainability:</b>            | No  |

## RECOMMENDATIONS

That Council consider which option it prefers for governance of the Property Investment Portfolio – a management Council Controlled Organisation or an independent Property Subcommittee.

## INTRODUCTION

Following the recommendations in the Larsen Report, Council and Dunedin City Holdings Ltd (DCHL) have been considering options for the future governance of the Investment Property portfolio. Mark Petersen of DHL Flinders was engaged to prepare a report on the options for governance of the portfolio and his report "The Investment Property Review" (the Petersen Report) is attached (Attachment 1). The report details governance options and Council has requested that the two preferred options be presented for consideration as part of the Annual Plan.

## **DISCUSSION**

Currently the Property Investment portfolio is governed by a Council Subcommittee comprising of four elected members. The Subcommittee has delegations up to \$5m with respect to sales, purchases and development of property and limitations around its ability to borrow. The full delegation is attached (Attachment 2).

While the current structure has operated well, there is general agreement that the structure needs to ensure a guaranteed degree of specialist, independent property expertise is available for the staff managing the investment portfolio. To this end, the Petersen Report was commissioned and it outlines two options for providing that expertise and independence.

The Petersen Report also discusses the performance of the portfolio and recommends various matters that need consideration when looking at the future profile and return of the portfolio. Clear investment guidelines will be required on Council's expectations for the portfolio whichever governance option is selected.

## **OPTIONS**

The Petersen Report proposed two preferred options for providing this independent advice. The two options are outlined below.

### **Management Council Controlled Organisation (CCO)**

This option proposes the creation of a CCO to manage the investment portfolio. The CCO would report through the current DCHL structure. It would have an independent board of directors, appointed using the existing "appointment of directors" process, who would be remunerated in line with remuneration levels of other CCO directors. The property assets would not be owned by the CCO (for tax reasons) and property staff would still be employed by the Dunedin City Council. The other property portfolios (Operational, Miscellaneous and Housing) would continue to be managed by City Property. Delegations for the CCO would be broadly similar to those of the existing Subcommittee and certain matters would still require the approval of the Council. The official information requirements of LGOIMA would apply to the CCO.

#### **Advantages**

- Independent board members would provide the commercial and property expertise
- There is an established process (DCHL Appointment of Directors) for appointing board members
- The opportunities for political influence are minimised
- DCHL can provide a broad oversight on all Group property investment opportunities.

#### **Disadvantages**

- Some political involvement is still necessary for borrowing decisions and decisions outside the delegated authority
- There is a separation between governance and ownership which may complicate various reporting lines
- The notification of meetings provisions of LGOIMA (section 7) do not apply to CCOs and may result in a loss of transparency.

Should Councillors wish to progress this option, then consultation on the proposal to create a CCO would be required via the Annual Plan (as this would be an amendment to the LTP) or by way of a separate special consultative procedure.

### **Independent Property Subcommittee**

This option would establish a subcommittee with independent membership as provided for by Schedule 7, clause 31(3) of the Local Government Act 2002. The property assets in the investment portfolio would continue to be owned by the Council (maintaining the tax advantages) and there would be no changes to the existing property staff reporting

arrangements. A process for selecting suitable members would need to be developed and fees would need to be set for the independent members. Payment of fees would be met from existing property budgets – likely by a reduction in the use of consultants. Delegations would be broadly similar to those of the existing subcommittee and certain matters would still require the approval of the Council.

### **Advantages**

- Independent board members would provide the required commercial and property expertise
- The opportunities for political influence are minimised
- There will be clear reporting lines for City Property staff
- The processes are very transparent as all the provisions of LGOIMA apply (including the requirements around meeting notification).

### **Disadvantages**

- Some political involvement is still necessary for borrowing decisions and decisions outside the delegated authority.

If the independent Subcommittee is the preferred model, then consultation by way of the Annual Plan is not required. Rather, staff would prepare a further report to progress a number of procedural matters. The current Property Subcommittee delegation would be redrafted to reflect the independent membership, the requirement for a mechanism for the assessment of group debt position and to meet the requirements of s30 of the LGA 2002 which enables the Subcommittee to continue past the end of a triennium. A process for selecting the independent members would be drafted (likely to be substantially similar to that used for the CCOs) and appropriate remuneration levels would be investigated. Standing Order A5.4 may also require modification. These matters would all be progressed and brought back to Council for consideration.

### **CONCLUSION**

The two preferred options both provide for independent property governance advice. Council needs to determine which of the options it prefers – a management Council Controlled Organisation or an independent Property Subcommittee.

Prepared by:

Sandy Graham  
**MANAGER GOVERNANCE**

Approved by: Paul Orders  
**CHIEF EXECUTIVE**

Date report prepared: 23 January 2013

### **Attachments**

- 1 The Investment Property Review (the Petersen Report)
- 2 Current Property Subcommittee delegation

January 2013

## Dunedin City Council

Investment Property Review

Mark Petersen, D H Flinders NZ Limited



CAPITAL MARKETS | REAL ESTATE ADVISORY | FUNDS MANAGEMENT ADVISORY | CORPORATE SERVICES

## Disclaimer

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## 1. Background

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The Larsen report submitted to Council in February 2012 contained the following observation in respect of the property investment portfolio.

*“DCC contains a property investment portfolio with a current value of approximately \$85 million. Internal proposals have been noted to increase the portfolio holding to \$105 million with growth in both the size and complexity of the portfolio. This investment is actively pursued as a source of non-rates income for DCC. Currently the portfolio includes plans for Auckland City industrial property investment and for property in other New Zealand provincial centres.*

*It is the authors understanding that almost all of the funds invested in this property portfolio are classified as endowment investments and as such attract favourable tax treatment. This precludes any governance advantages of placing these assets in a subsidiary company and then including the company within the DCHL structure. Notwithstanding this structural limitation and despite the property investment experience within the property subcommittee of DCC (the current governance body) the governance surrounding the property investment should be reviewed. An internal document sighted by the author contains a proposal to that effect. As already stated property investment is a high risk activity if not conducted within a carefully prepared and agreed strategy within appropriate delegated approvals, risk assessment and monitoring procedures. In short a board structure with appropriate governance procedures and additional property expertise is required.*

*It is recommended that the current property Investment Subcommittee of DCC be transformed into a Board type structure and the appropriate commercial disciplines in place. Property expertise on this board should be increased”*

As a result of this recommendation we have been asked to review the property investment governance structure, the property investment portfolio and the current requirements and expectations that Council has for the portfolio.

## 2. Brief

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To review the governance arrangements for the Dunedin City Council Property Investment portfolio and make such recommendations to Council necessary to enable management and Council ensure that the property delivers on the strategic objectives that it has for the portfolio.

Review, at a high level, the portfolio and how it fits with the council objectives.

### 3. Acknowledgements

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In preparing this report we have spent time with the Manager of the Property Business Unit, City Property, the Financial Controller, Chief Executive, Governance Manager and other council staff. I have also imposed upon staff to provide background data and information all of which is time consuming.

The author thanks all of those people who have contributed and accommodated me during the preparation of this report.

#### 4. Recommendation

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In evaluating the options available for the governance of the investment property portfolio 2 options emerged as providing a robust independent governance model that will address the primary issues raised in the Larsen report whilst also retaining the tax benefits associated with the endowment portfolio so long as it remains in the direct ownership of the City.

Both of these options have advantages and disadvantages for Council which are discussed in more detail in Section 5 of this report.

It is recommended that the following changes be made to the governance of the Property Investment Portfolio of Council:

- 4.1 That DCC retains a property subcommittee structure subject to the composition changes and recommended changes to the appointment processes set out below.
- 4.2 That the subcommittee comprises only independent appointed committee members and not elected Councillors. The appointed members must have appropriate commercial property, business and governance skills to oversee the management of the investment property portfolio owned by Council
- 4.3 That the Property subcommittee appointments process and governance oversight is substantially similar to the "Appointment of Directors" process used for the Council Controlled Companies.
- 4.4 The ownership of the Property Investment Portfolio remains directly with the Council to preserve the current tax advantages of Council ownership.
- 4.5 The Independent Property Subcommittee retains the same delegated authorities currently in place for the existing Property Subcommittee subject to confirmation from the Council's legal advisors. The delegated authorities held by the CEO in respect of property activities remain in place.
- 4.6 In addition the delegated authorities referred to in 4.5 above the delegation is extended to include the approval of commercial leases with a total contract value of up to \$10 million in respect of the Property Investment Portfolio. Note that any proposed changes to delegations will need to be considered in the overall context of the current CEO/Staff delegations and reviewed to ensure consistency.
- 4.7 The Independent Property subcommittee agrees performance targets with Council annually and reports to Council through the Finance, Strategy and Development Committee in respect of its performance targets. It may be that the Property Investment Policy is modified to include these targets.

We have also noted that the property investment portfolio performance targets can provide more specific objectives in terms of returns and risk management

As a result we recommend that:

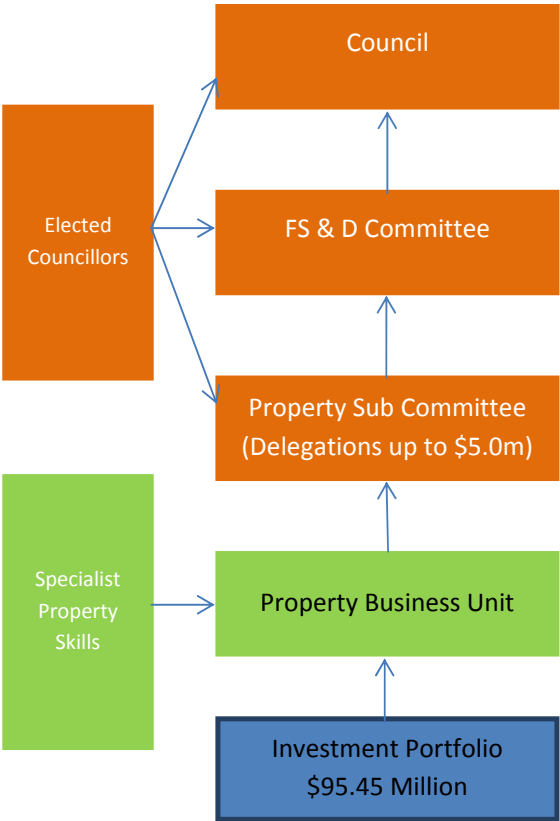
- 4.10 That providing returns above the opportunity cost of owning the portfolio is included in the strategic objectives for the portfolio.
- 4.11 That the new governance body be asked to undertake a strategic review of the portfolio and encapsulate changes in the long term strategic plan for the portfolio.
- 4.12 That as part of the strategic review the new subcommittee is asked to review the risk profile of the investment portfolio both in terms of asset allocation by property type and asset allocation by location.

**5. Investment Portfolio Governance Options**

City Property is the Property Business Unit (PBU) of Council charged with managing the Investment Property Portfolio. The PBU reports to the property subcommittee, a subcommittee of the Finance, Strategy and Development Committee of Council.

The current property subcommittee is comprised of elected Council representatives and while in recent times has had members with commercial property experience, Council cannot rely on elected members with property management/development experience being available in the future.

The current reporting structure is as follows:



In an absence of specific property expertise on the subcommittee there would be a significantly increased reliance on the PBU manager's expertise and advice in a complex operating environment. The subcommittee's role is to oversee the investment strategy, appetite for risk and ensure there is proper oversight of management's performance in managing the portfolio. It is required to question, test and understand the impact on the portfolio of the recommendations being made to it. Without an adequate level of property investment and management skills on the governing body we consider that the risk for the portfolio is increased. There is also a need to remove, as much as possible, conflicts between political interests and commercial realities.

Having appropriate skill sets on the governing body is also an important source of feedback, support and advice for the PBU manager and team. The PBU manager should have an adequate opportunity to test ideas and strategies with the governance body and in the absence of specific property expertise; unless he or she seeks independent advice outside of the governance group the current structure cannot be assured of providing this. This is an avenue of advice and oversight that we consider essential to the good governance of the portfolio.

When considering the options for the governance of the investment portfolio we have taken account of the tax benefits of direct Council ownership. Endowment portfolio, income in any form is not subject to tax which is a significant benefit to Council. To change the ownership model and by way of example have the properties owned by a CCO or CCTO would compromise this tax advantage and is not recommended. For this reason the CCTO option has not been considered.

In respect of the investment portfolio we have considered a number of governance models. In considering the models we have also taken into account the wider responsibilities of the PBU, and ownership of the portfolios which we have set out below. The advantages and disadvantages of each of the models are as follows:

**a. Retention of the Status Quo**

The current model has a Property Subcommittee with four elected members. It has delegations to consider matters related to the investment portfolio and the miscellaneous portfolio. The subcommittee is covered by Council Standing Orders and the requirements of LGOIMA. All Councillors get copies of the agenda and any may attend the publically advertised meetings. Councillors are not paid meeting fees for their participation in the current subcommittee.

**Advantages**

- The subcommittee is a transparent way of conducting Council business.
- It has operated successfully to date.
- It provides clear reporting lines for property staff.
- It provides the scope for a wider oversight mandate for the property portfolio should council require that.
- There are no additional costs for remunerating members of the committee

#### Disadvantages

- Relies on their being the requisite property experience on the Council for suitable membership which cannot be guaranteed
- Possible conflicts between political interests and commercial realities as outlined in the Larsen report in respect of councillor appointments to the Boards of the CCO's and CCTO's.
- In the absence of specific commercial property skills the establishment and oversight of the strategic objectives and performance of the portfolio is overly reliant on the PBU manager.

#### **b. Appointment of an Independent Property Sub Committee**

The appointment of property expertise to support the elected members appointed to the property subcommittee would provide a partial solution to the lack of specific property expertise to the governance model. However we see the potential for conflict between the commercial objectives of the portfolio and the potential for political influence over the decision making in respect of fund investments remains unresolved. The risks associated with this are made clear in the Larsen report and it is not a model we could support.

These concerns can be addressed with a fully independent subcommittee

The LGA provides that members of a subcommittee need not be elected members (sch 7 cl 31(3)). This means that the subcommittee can be fully comprised of independent non-elected members who have the property expertise required to provide effective governance for a portfolio of this nature. Members of the subcommittee would need to be remunerated and Council would need to consider the level of remuneration appropriate for the role.

The independent subcommittee should have delegations that clearly articulate its responsibilities with decision making powers up to \$5m which is the same level as the current delegations.

The tax advantages of Council ownership are maintained with this model.

#### Advantages

- The independent subcommittee is a transparent way of conducting Council business as the requirements of LGOIMA still apply.
- Independent members provide the expertise required to meet the objectives of independent advice.
- Clear and simplified reporting lines for property staff.
- Minimises political influence.
- Provides Council with the opportunity to have all of the property activities of Council overseen by the Property Subcommittee rather than having different reporting lines for Investment Portfolio and the other property activities of Council. This is an important consideration given its substantial property holdings in the Operating, Miscellaneous, Investment and Housing portfolios.

#### Disadvantages

- Possible conflicts between political interests and commercial realities still remain for those decisions that still require approval of full Council. This would be limited however, depending on the level of delegation that the subcommittee has.
- Commercially sensitive information around investment decisions and leasing arrangements may eventually public.
- Fees will be required to be paid to the independent members of the subcommittee - currently members are not specifically remunerated.

#### c. **Establish a Management CCO to manage the Investment Property Portfolio**

The establishment of a Management CCO to manage the Investment Property provides a clear focus and accountability through the already established CCO reporting, board appointment and governance oversight structures and is the model supported by DCHL.

The management CCO would require an independent Board of Directors with the appropriate property and commercial skills required to oversee a portfolio of this nature. Director's fees would have to be set in accordance with the process currently used for remunerating Directors of Council Controlled Companies.

#### Advantages

- Independent board members provide the commercial and property expertise to meet the objectives for the portfolio.
- Governance oversight and Board appointments process fits within an already established model overseen by DCHL.
- Minimises the political influence.

#### Disadvantages

- There is a separation between the ownership and the governance of the portfolio as the CCO would only be a management agency only due to the requirement to preserve the current tax status.
- Possible conflicts between political interests and commercial realities still remain for those decisions that still require approval of full Council. This would be limited however, depending on the level of delegation that the CCO has.
- Given the wider property activities of Council with the Operational, Miscellaneous, Investment and Housing portfolio's a CCO to oversee the investment portfolio would provide less clarity in respect of the reporting lines for the PBU.
- Potential loss of some transparency.
- Director's fees would have to be paid

## Recommendation

There are robust arguments that support both the independent Property Subcommittee and the Management CCO options for the governance of the portfolio. Both options provide an independent governance body that would serve the interests of Council well and address the concerns raised in the Larsen report.

Whichever model is decided upon the limit of the delegations will mean that from time to time decisions on capital expenditure, acquisitions and disposals still come to council because they are outside the delegated authority granted to either the CCO or subcommittee model so the potential for political influence over decision making remains to that extent. Given the recommended delegated authority levels are the same for both options this position is the same for both options.

The governance body will be dealing with sensitive commercial issues in respect of the property investment portfolio. The CCO option does provide a more discrete governance option in respect of the information that will be made publically available and who can attend meetings. The standing orders will need to provide for property subcommittee meetings to be held in private and the information that is publically available from the committee is only that information that is not commercially sensitive.

The PBU manages a diverse set of portfolios being the Operational, Miscellaneous, Investment and Housing portfolios. We consider that on balance the property subcommittee option provides Council with an opportunity to both strengthen and simplify the reporting lines for the PBU whilst addressing the need for property expertise and potential political conflicts of interest through independent appointees.

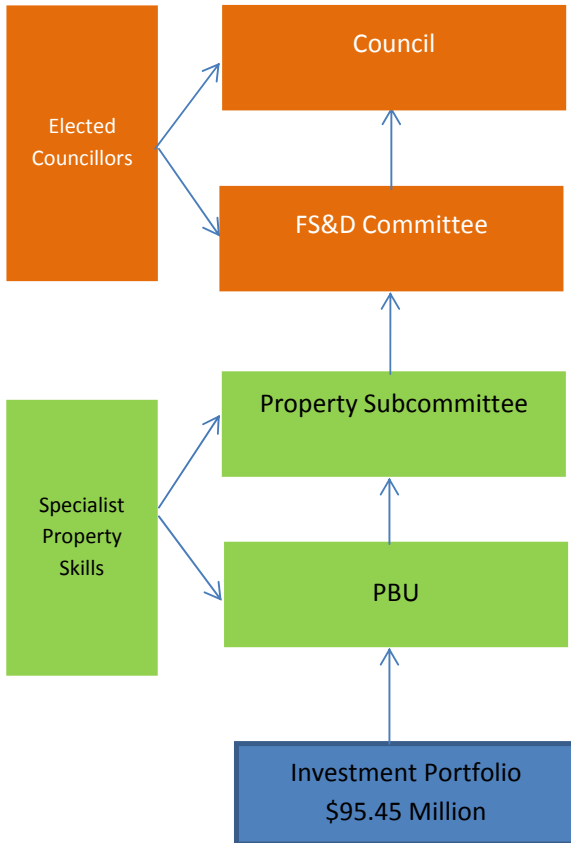
We consider that so long as there are protections in place to ensure that the appointment process for the independent subcommittee is substantially the same as that used by DCHL for the appointment of Directors to the CCO's and the political independence can be maintained the independent property subcommittee option provides the opportunity for greater clarity in reporting lines for the PBU whilst meeting the objective of having the appropriate levels of property expertise and business experience.

It is our recommendation to council that:

- The Property Subcommittee is retained;
- That the members of the subcommittee are independent, with the appropriate property and commercial skills required to oversee a portfolio of this nature; that the appointment of subcommittee members is made utilising a process substantially similar to that used for the appointment of directors of the CCO's.
- The current delegated authorities held by the property subcommittee are retained.

- That the current delegated authorities in respect of the property portfolios held by the CEO are retained.

Under Such a scenario the revised reporting structure will be as follows:



## 6. Role of The PBU

The PBU manages the Property Investment Portfolio, the Miscellaneous Portfolio, the Operational Portfolio and the Housing Portfolio. Currently the PBU reports to the property subcommittee on all significant property matters including the investment and other Portfolios. It reports to the Finance Strategy and Development Committee in respect of the operational portfolio. Under the new structure we recommend that the current management function of the PBU remains unchanged.

## 7. The Investment Portfolio

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### 7.1 Why Does the Investment Portfolio Exist?

The Property Investment portfolio is endowment property held under the Dunedin City Council Endowment for Lands Act 1988. At the time of its enactment it freed land held in trusts and reservations and declared that the land be held as an endowment for the general purposes of the city of Dunedin.

In 2006 the City obtained a legal opinion on the status of the endowment property from Anderson Lloyd Caudwell which was confirmed in June 2012. This opinion concluded that:

*“Given the common law position that Endowment Land is to be perpetually held in order to provide a source of income for future generations, and given that the Dunedin City Council Endowment Lands Act 1988 specifically records that the land recorded in its schedule is to be held by Council as an Endowment for the general purposes of the City of Dunedin, it seems clear that the proceeds of the sale of that Endowment Land, if it were to be sold under section 141 of the Local Government Act 2002, would have to be used in such a way to ensure that capital was retained to continue providing the source of income for the City of Dunedin. In other words, the land could not be sold and the proceeds used for the general rates. The proceeds would have to be reinvested in an endowment that would provide income for future generations in the City of Dunedin”.*

The opinion also notes:

*“In relation to the land in Dunedin which is set out in the schedule to the Dunedin City Council Endowment Lands Act 1988, there is no way that Section 140 and 141 of the Local Government Act 2002 could be used to help sell that land and free it from its Endowment status. It has already been freed from being held as Endowment for specific purposes to being held for “general purposes”. To free it from its status as Endowment altogether would require new legislation”.*

From this we ascertained that without a change to the legislation the Endowment property cannot be sold unless the proceeds are reinvested in other property. We also consider that based on the opinion that it is the proceeds from any property sales will not be available to pay down general Council debt. Anderson Lloyd Caudwell confirmed this in the June 2012 opinion.

### 7.2 Strategic Objectives of the Investment Portfolio

The investment portfolio is an Endowment investment and is managed by the PBU to meet the following strategic objectives:

- a. To provide a long term source of non-rates income for the benefit of current and future ratepayers.

- b. The preserve the capital investment in the property through value growth in the property.

In managing the portfolio PBU has set out its plan for achieving the Council's objectives through:

- Effective management and control of the property portfolio;
- Bringing a strong commercial focus to the ownership and governance of the portfolio;
- Targeting market yields and mid to longer term capital growth;
- Ensuring that the Governance of the Investments is appropriate and reflects best practice whilst recognising the Council's wider economic, social and environmental objectives; and
- Ensuring that financial reporting and administrative processes are in place to cater to growth in the portfolio and monitoring portfolio performance.

Up until the late 1980's the portfolio was predominantly passive with investments in long term and perpetually renewable ground lessor's interests. This model changed primarily since the legislative change in 1988 to a more actively managed portfolio with the further step of investing in real estate outside of Dunedin from the early 2000's in a move aimed at diversifying the geographical risk profile of the portfolio.

#### **Inclusion of Financial Return Objectives**

When considering the above objectives and whether ownership of the portfolio provides a financial benefit to Council the net income return plus the capital gain must be greater than the council's cost of servicing the Debt that could be repaid if the portfolio was sold today. Currently the council average cost of debt is 6.3% which in our view establishes the current opportunity cost of owning this portfolio.

This is not included in the current objectives for the investment portfolio, and putting aside for the moment the legal issues around a sale, it is a critical factor that justifies continued ownership of the portfolio. It establishes an objective measurement against which performance of the portfolio can be compared.

#### **Weighted Average Cost of Capital**

An alternative test that Council could apply to the objectives in respect of required investment returns is the Weighted Average Cost of Capital (WACC). There are some inherent flaws in applying a WACC to a portfolio that does not have traded securities, sufficient scale or liquidity.

However we can for comparative purposes look at the WACC's of the listed property securities traded on the NZX.

Property Investment carries varying levels of risk and this is reflected in the Weighted Average Cost of Capital for property investment companies. The average

WACC outlined below provides a guideline for the real cost of capital invested in a portfolio such as this.

The table below provides the WACC for the NZ Listed property Sector:

Property Company	Debt/TTA	WACC
AMP NZ Office	24%	6.3%
Argosy Property	44%	7.2%
Augusta Capital	40%	8.7%
CDL	0%	8.5%
Goodman Property	38%	6.9%
Kiwi Income Property	47%	6.3%
National Property Trust	40%	7.3%
Property for Industry	30%	6.1%
Average WACC		7.2%

The DCC portfolio is not subject to tax which has a lowering impact on the WACC however the portfolio the size and nature of the portfolio would place it within the upper quartile of the above companies. Adjusting for tax the likely WACC for the DCC portfolio is within the range of 6.0% – 6.25% reaffirming the appropriate base line financial performance measure at 6.3%

The portfolio currently has a net value of \$79.9 which establishes a current opportunity cost of ownership at \$5.03 million per annum.

### 7.3 The Portfolio

The portfolio comprises 19 investment properties with a total value as at 30 June 2012 of \$95.450 million. The portfolio comprises a mixture of retail, commercial office, car parking and industrial property. The portfolio still contains some residual ground lessors' interests that have been identified by management as properties that will be sold in the short to medium term. The individual properties range in value from \$198,000 to \$32.5 million.

The portfolio remains concentrated in Dunedin with 78% of its assets located there. In 2003 an internal strategic review resolved to invest in property outside of Dunedin to diversify the geographic risk. This process has occurred slowly with three properties\* having been acquired outside of Dunedin since that decision was taken. (\* The Christchurch investment is three separate adjacent properties however are considered to be one investment holding). The portfolio is also heavily weighted to retail real estate with 46% of the portfolio allocated to retail real estate. From a risk management perspective the asset allocation model is still in its early stages and the internal business planning undertaken by the PBU has identified a need to increase the level of investment outside of Dunedin.

Given the strategic objectives of this portfolio we consider that the asset allocation both geographically and by property sector needs to be reviewed as a risk management priority by the governance group. Because of the illiquid nature of property it will take time to achieve a change to the asset allocation across the portfolio however the diversification parameters should be identified in a long term strategic plan that the investment managers can work towards within a defined timeframe.

Such an investment approach should include the definition of a strategic asset allocation within each real estate asset class and geographic allocation which will provide a framework for long-term portfolio diversification and investment decision making.

#### 7.4 Current Asset Allocation

The current portfolio asset allocation can be considered in a number of ways, such as geographic location, property type, property size and tenancy expiry profile. In considering the diversification elements we have focused on those that do not change over time, specifically location and property type.

The current portfolio spread by location is set out in Fig 1. Below.

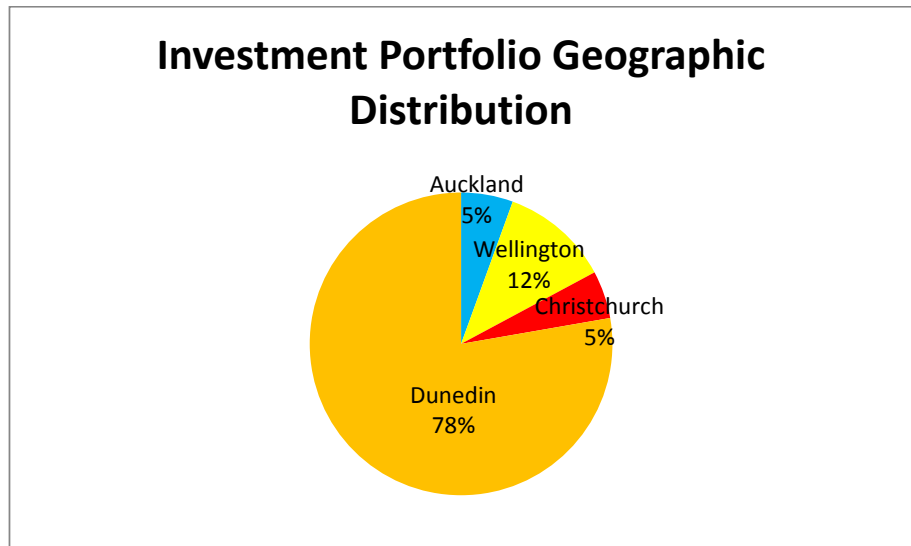


Fig 1

The high concentration in Dunedin is principally a result of history however it is important that consideration is given within the investment objectives to the level of commitment to Dunedin and the purpose of the portfolio.

Making a recommendation on geographic distribution is not a task for this report however will be an important consideration for the new governance group.

### 7.5 Sector Diversification

The portfolio has a high weighting to retail, largely because of the investments in the Bunning's Store in Porirua, Wellington and because of the investment in the Wall Street property. The incoming Governance Group should review the sector diversification in its assessment of the effective risk management of this portfolio. A review of the weightings is desirable to ensure that it enables the portfolio to best meet the strategic objectives of this portfolio.

Again this is a consideration for the new subcommittee as part of its strategic review and planning.

Further considerations for risk management relate to limitations on single investment exposures with targets limiting allocation to an individual building to <20% and 10% -15% to an individual tenant. Clearly there are exceptions where investments are available with long term blue chip tenants the parameters may be exceeded but always with the long term objective of returning to within the established parameters. At 20% the largest investment should be in the order of \$18 - \$20 million. This investment size will more logically suit a portfolio with a slightly higher industrial property allocation and with the target weightings in the following ranges being recommended:

It is recognised these are broad ranges and from time to time the portfolio may gravitate above or below the targets. It is then anticipated that a plan will be developed to bring the portfolio back within the ranges over time.

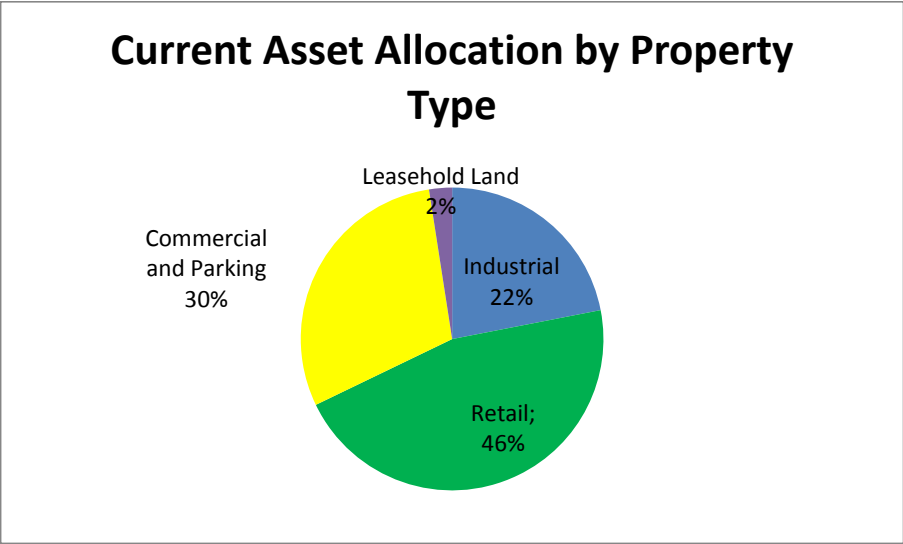


Fig 2

**7.6 Debt Levels**

The Fund debt level is just over \$15 million which is 16% of the fund. Management has planned the sale of \$3.2 million of peripheral leasehold and vacant property in the next 12 months which will reduce the level of debt to under \$12 million or around 11%.

Gearing for a portfolio of this nature can be increased and comfortably sit in the 30% to 35% range without any significant increase in risk and in the current interest rate environment provides the opportunity to enhance the dividend yields by targeting yield investments that provide an income return in excess of debt servicing costs.

Further debt funded investment of investment of \$24 million at a 1.7% - 2.0% positive income return over debt costs could generate an additional \$0.4 – \$0.75 million of cash flow for the fund. The interest rate environment is currently positive for property investment with low interest rates and yields still providing a significant positive cash flow. As the economy improves there is risk around interest rate increases however the improved economic activity also has a positive impact on rental growth expectations.

Increasing the Investment portfolio debt does however have to be considered in light of the City’s overall debt position and debt rating.

**7.7 Is the Fund Likely to provide returns greater than opportunity costs?**

We have completed high level modelling of the Property Investment Portfolio based upon the following base line assumptions:

- That the properties generate a gross rental return of 8% on average across the portfolio.
- That interest cost is at an average of 6.3% reflecting the average cost of council debt.

- Dividend is at 6.3% of Shareholders Funds covering the opportunity cost of ownership.
- The balance of free cash flow is applied to debt reduction
- That there are unrealised increases in value for the portfolio in Models A & B of 1% pa average across the portfolio.
- That there is no growth in value in models C and D
- That Models B and D provide for \$24 million of new debt funded investment lifting debt to gross assets to 30% in 2014

We consider that in the absence of a significant market change the modelling provides a conservative overview of the prospective returns from the portfolio over the next 5 years. This analysis reflects that the likely returns will be greater than the opportunity cost selling the portfolio and repaying debt however the margin is reliant on positive real estate value movements which are unrealised.

The modelling assumes no increase in debt costs for Council in that period.

	Cash Return %	Value Gain %	Total Return %	Opportunity Cost
Model A	7.1%	1.1%	8.2%	6.3%
Model B	7.3%	1.4%	8.7%	6.3%
Model C	7.1%	0.0%	7.1%	6.3%
Model D	7.1%	0.0%	7.1%	6.3%

Slight changes in sensitivity have significant impact upon the portfolio performance.

Increasing the average gross cash yield for the portfolio from 8% to 8.5% and projected portfolio value growth from 1% to the midpoint of the Government CPI Target at 2% improves the returns from Model's A & B as follows:

	Cash Return %	Value Gain %	Total Return %	Opportunity Cost
Model A	7.7%	2.2%	9.9%	6.3%
Model B	7.9%	2.7%	10.6%	6.3%

Conversely a reduction in the cash yield to 7.5% and growth to zero reduces the returns for Models C & D as follows:

	Cash Return %	Value Gain %	Total Return %	Opportunity Cost
Model C	6.5%	0.0%	6.5%	6.3%
Model D	6.6%	0.0%	6.6%	6.3%

These are minor shifts in portfolio performance and have significant impacts upon the return to Council. It demonstrates the risks and provides base line performance parameters that Council should establish for the performance of the portfolio.

Our view is that the portfolio outlook is positive and that it can with effective management provide positive returns for Council.

## 8. Conclusion

It is our view that the governance of the Investment Property portfolio needs to be enhanced with the current committee membership replaced with individuals with appropriate property and commercial skill sets. There are several mechanisms for achieving this. We believe the best format for is an independent Property Subcommittee with experienced commercial property and business professionals and the property remaining in the ownership of Council to maintain its endowment status.

The Investment Portfolio currently is just meeting its objectives of providing a positive financial contribution to council. We consider that it can continue to do this so long as it is well managed and that there is clear strategic direction and oversight.

We consider that it is important for the incoming governance group to consider the portfolio risk profile, asset allocation by property sector and location these risk factors need to be addressed in the medium term planning for the portfolio.

We consider that as a portfolio on its own the investment portfolio can accommodate higher debt levels without any significant increase in risk however this must be considered in light of the overall city debt position and the impact any increase may have on the city's financial rating.

Overall we would like to note that that the property management provided by the PBU is of a high standard and this can be seen in the presentation of the properties and the occupancy levels however we are concerned that there is undue reliance on the manager of the property business unit. It is an area that will be addressed through the recommended change in the governance structure.

Mark Petersen

## APPENDIX ONE

### Property Portfolio

## Appendix 1

### Dunedin City Council Investment Portfolio

Value 2012

101 Milners Rd, North Taieri

Lease Land(Dn Metro)

Lease Land(Pt Chlms)

Hightide Restaurant

20 Parry Street (lessees interest)

59-61 Ward Street (lessees interest)

57 Ward St (lessees interest)

211 George Street (Wall Street)

Gt King St Carpark/Retail

46 Timaru St

33 Treffers Road

5 Midland St

414 Moray Place

9 Heriot Drive, Porirua

YMCA Accom / Gym

14 Parry St

56 Parry St (lessee interest)

610 Rosebank Road

658 Princes St

**Total**

**\$ 95,545,000**

APPENDIX TWO

Portfolio High Level Financial Forecasts

<b>DCC Property Investment Portfolio</b>		<b>1% Growth Model No Additional Investment or Borrowing</b>			
<b>Projected 5 Year Performance</b>		<b>MODEL A</b>			
<b>Assumptions</b>					
Unrealised Capital growth	1%	2014 Property Sales per Budget 3.2 million			
Net Income Return Value	8.0%	Dividend at Cost of Capital			
Additional Investment	0				
Year End	2013	2014	2015	2016	2017
	\$m	\$m	\$m	\$m	\$m
Fund Value	95.45	93.2	94.1	95.0	96.0
Debt	15.55	11.7	11.0	10.4	9.7
Net Assets	79.90	81.5	83.1	84.7	86.3
Net Income Yield	7.64	7.45	7.53	7.60	7.68
Interest	0.98	0.74	0.69	0.65	0.61
Management and O/Head	0.95	0.93	0.94	0.95	0.96
Free Cash Flow	5.70	5.79	5.89	6.00	6.11
Dividend	5.03	5.13	5.23	5.33	5.44
Debt Prepayment	0.67	0.65	0.66	0.67	0.67
Unrealised Value Gain	0.92	0.93	0.94	0.95	0.96
Overall Return	6.62	6.72	6.83	6.95	7.07
Overall Return %age	8.3%	8.2%	8.2%	8.2%	8.2%

<b>DCC Property Investment Portfolio</b>		<b>1% Growth Model \$24 Million additional Investment and Borrowing</b>			
<b>Projected 5 Year Performance</b>		<b>MODEL B</b>			
<b>Assumptions</b>					
Unrealised Capital growth	1%	2014 Property Sales per Budget 3.2 million			
Net Income Return Value	8.0%	Dividend at Cost of Capital			
Additional Investment \$m	\$24.00	Debt to 30% in 2014			
Year End	2013	2014	2015	2016	2017
	\$m	\$m	\$m	\$m	\$m
Fund Value	95.45	117.2	118.3	119.5	120.7
Debt	15.55	35.7	34.9	34.0	33.2
Net Assets	79.90	81.5	83.5	85.5	87.5
Net Income Yield	7.64	9.37	9.47	9.56	9.66
Interest	0.98	2.25	2.20	2.14	2.09
Management and O/Head	0.95	1.17	1.18	1.20	1.21
Free Cash Flow	5.70	5.95	6.09	6.22	6.36
Dividend	5.03	5.13	5.26	5.39	5.51
Debt Prepayment	0.67	0.82	0.83	0.84	0.85
Unrealised Value Gain	0.92	1.17	1.18	1.20	1.21
Overall Return	6.62	7.13	7.27	7.42	7.57
Overall Return %age	8.3%	8.7%	8.7%	8.7%	8.6%

<b>DCC Property Investment Portfolio</b>		<b>0% Growth Model no additional investment or Borrowing</b>			
<b>Projected 5 Year Performance</b>		<b>MODEL C</b>			
<b>Assumptions</b>					
Unrealised Capital growth	0%	2014 Property Sales per Budget 3.2 million			
Net Income Return Value	8.0%	Dividend at Opportunity Cost			
Additional Investment \$m	0				
Year End	2013	2014	2015	2016	2017
	\$m	\$m	\$m	\$m	\$m
Fund Value	95.45	92.3	92.3	92.3	92.3
Debt	15.55	11.7	11.0	10.4	9.7
Net Assets	79.90	80.6	81.2	81.9	82.5
Net Income Yield	7.64	7.38	7.38	7.38	7.38
Interest	0.98	0.74	0.70	0.65	0.61
Management and O/Head	0.95	0.92	0.92	0.92	0.92
Free Cash Flow	5.70	5.72	5.76	5.80	5.84
Dividend	5.03	5.08	5.12	5.16	5.20
Debt Prepayment	0.67	0.65	0.65	0.65	0.65
Unrealised Value Gain	0.00	0.00	0.00	0.00	0.00
Overall Return	5.70	5.72	5.76	5.80	5.84
Overall Return %age	7.1%	7.1%	7.1%	7.1%	7.1%

<b>DCC Property Investment Portfolio</b>		<b>0% Growth Model \$24 Million additional Investment and Borrowing</b>			
<b>Projected 5 Year Performance</b>		<b>MODEL D</b>			
<b>Assumptions</b>					
Unrealised Capital growth	0%	2014 Property Sales per Budget 3.2 million			
Net Income Return Value	8.0%	Dividend at Cost of Capital			
Additional Investment	24	Debt to 30% in 2014			
Year End	2013	2014	2015	2016	2017
	\$m	\$m	\$m	\$m	\$m
Fund Value	95.45	116.3	116.3	116.3	116.3
Debt	15.55	24.0	23.2	22.4	21.6
Net Assets	79.90	92.3	93.1	93.9	94.7
Net Income Yield	7.64	9.30	9.30	9.30	9.30
Interest	0.98	1.51	1.46	1.41	1.36
Management and O/Head	0.95	1.16	1.16	1.16	1.16
Free Cash Flow	5.70	6.63	6.68	6.73	6.78
Dividend	5.03	5.81	5.86	5.91	5.97
Debt Prepayment	0.67	0.81	0.81	0.81	0.81
Unrealised Value Gain	0.00	0.00	0.00	0.00	0.00
Overall Return	5.70	6.63	6.68	6.73	6.78
Overall Return %age	7.1%	7.2%	7.2%	7.2%	7.2%

**PROPERTY SUBCOMMITTEE**

- REPORTING TO:** Finance, Strategy and Development Committee
- CHAIRPERSON:** Chair of Finance, Strategy and Development Committee
- CONSTITUTION AND MEMBERS:**  
Mayor Cull, Crs Bezett and Staynes  
(Quorum – three members)
- ALTERNATE:** In the event of a quorum being unavailable, the Chairperson of another Standing Committee is to be the alternate.
- MEETING FREQUENCY:** Six Weekly or as required

**AREA OF RESPONSIBILITY:**

- Property sales, purchases and developments in relation to the property investment and miscellaneous portfolios.

**POWER TO DECIDE: PART A MATTERS**

- 1 The authority to approve property sales and purchases from \$500,000 up to \$5,000,000 and matters incidental thereto, subject to Council's approval of related borrowing if required for purchases.
- 2 The authority to approve property developments from \$1,000,000 up to \$5,000,000., subject to Council's approval of related borrowing if required for development.
- 3 Infrastructure Services and Community Development Committees also have the authority to approve property sales and purchases from \$500,000 up to \$5,000,000:
  - a) In the case of Infrastructure Services Committee for road and access ways or properties held or required for designated works or other purposes within the Infrastructure Services Committee's area of responsibility; and
  - b) In the case of Community Development Committee for any park or reserve.
  - c) The acquisition and negotiation process is to be handled by the Manager, City Property.

**Note**

- ④ For all property sales and purchases up to \$500,000 and property developments up to \$1,000,000 refer to the Chief Executive's Delegations.
- ⑤ The purchases or developments that require borrowings are subject to Council's approval.

**POWER TO RECOMMEND**

- 1 Property sales, purchases or developments in excess of \$5,000,000.