CBRE
CBRE Limited

Level 14, ANZ Centre
23-29 Albert Street
PO Box 2723
Auckland, New Zealand

T 64 9 355 3333
F 64 9 355 3330

Date: 12 April 2018

To: Manager Property – Napier City Council

From: Martin Boys

Subject: NCC Investment Property Portfolio Review – update of financial performance

Background and scope

Introduction

Napier City Council (NCC) owns a lessor's interest portfolio which comprises 74 leases and has a book value of approximately $34 million, known as the 'investment property portfolio'. As at 31 December 2017 the portfolio generates approximately $1.93 million of rental income per annum. The sites are predominantly commercial and industrial in nature and are principally located in Onekawa, Ahuriri and Pandora. Council owns the lessor's interest in these properties and a number of individuals and businesses own the lessee's interests.

The leases are perpetually renewable meaning that, subject to continuing to pay rental (which is reviewed at periodic intervals), the lessee's have a perpetual right to occupy the land. The improvements on the land are owned by the lessees, not Council.

The investment property portfolio includes some high density residential property as a result of changing land use over time and new apartment development occurring on former commercial/ industrial land.

For clarity, Council owns an additional circa 14 residential lessee's interests, all of which are subject to the Hawke's Bay Endowment Land Empowering Act 2002 which (in conjunction with Council's policy) allows the lessees to purchase the freehold from Council. These leases do not form part of the investment property portfolio and are excluded from this review.

Background to ownership

The investment property portfolio consists of:

- Properties transferred to Council from the Hawke's Bay Harbour Board as part of the local Government reorganisation in 1989. The reason for the transfer was to provide an income generating asset to offset the liability associated with the upkeep of the Inner Harbour and Foreshore Reserves, which was transferred at the same time.
- Properties already owned by Council as a result of land development in conjunction with the Harbour Board.
- Other sundry properties which have been owned by Council for many years.
- Endowment Properties – these nine properties are subject to the Napier Borough Endowment Act 1876. Council is currently seeking legal advice as to whether these properties could be sold and, if so, the process that would need to be followed.

Scope and purpose

In recent years, a number of lessees in the portfolio have requested that Council review its ownership of the investment property portfolio and specifically requested the right to freehold their site, which would essentially involve lessees purchasing Council's interest in the land. CBRE prepared a report in 2016 to assist Council with evaluating whether freeholding sites may be appropriate. That report also provided financial analysis of the portfolio's historic performance.

Much of the qualitative advice presented in the 2016 report is still considered valid (e.g. pros and cons of freeholding and how this process could be undertaken); however, the financial analysis is now out of date. NCC has therefore requested that CBRE updates the financial analysis of the portfolio including:

- Analysis of historic performance of the portfolio relative to relevant benchmarks; and
- Key descriptive statistics of the portfolio (e.g. value, analysis of net income etc.);

Assumptions and limitations

This memo is subject to the following critical assumptions and limitations:

- The analysis presented in this memo is intended to comprise an update of Section 2 of our 2016 report. This memo is intended to form an addendum to, and should be read in conjunction with, the 2016 report.
- We have relied upon current and historic data provided by NCC with respect to lease details, lessor's interest valuations and rental receipts. CBRE has not sought to verify this data.
- NCC has advised that, subsequent to our 2016 report, the leases for 1 Ridell St / 3 Lever St and 102 Taradale Road have been cancelled and these properties no longer form part of the investment portfolio[1]. The number of properties considered in this review is therefore two fewer than in the 2016 report.

Boffa Miskell review

In 2016, Council commissioned Boffa Miskell to undertake a review of the properties included in the investment property portfolio to consider the strategic value of each site in terms of urban landscape development potential. All properties were assessed and categorised into three approaches/categories as described below. The site assessment criteria are listed in the Boffa Miskell report (which we have not reviewed).

Approach/ Category	Description
A	Retain the land and undertake further design and planning investigations to look at securing better community outcomes and value from the area. This could include a specific project design, public space design, upzoning the land to enable better utilisation /development potential and combinations of these. An outcome following further investigations may be to dispose of the land but the key direction in this approach is to retain the land for now and do further design and planning investigation.

[1] For background, we note that the land at 1 Ridell St / 3 Lever St is a former Road (Collin Street) and Council took the opportunity to secure the site for a future parking precinct. The site remains in Council ownership. Council's interest in 102 Taradale Road was sold to the lessee after a legal opinion determined that an historic clause in that particular lease provided the lessee the option to purchase the freehold.

Approach/ Category	Description
B	Dispose of the land, but first look to establish some specific public benefit outcomes such as a connection easement, design controls through the District Plan or the like.
C	Dispose of the land as it has no particular urban or landscape design attributes or potential that would warrant keeping it.

Financial performance and use of income

Key descriptive statistics

FY17 (actual)

- The investment portfolio comprises 74 sites in Napier valued at approximately $34.1m plus GST as at 30 June 2017.
- Over the 2016/17 financial year (ending 30 June), the portfolio generated approximately $1.60 million of rental income.
- After management and operating expenses of circa $0.1M per annum, the net income derived equates approximately 1.7% of Council's total operating funding requirement for the 2017 financial year and was equivalent to approximately 4.1% of the general rates funding available to Council over the same period.

FY18 (forecast)

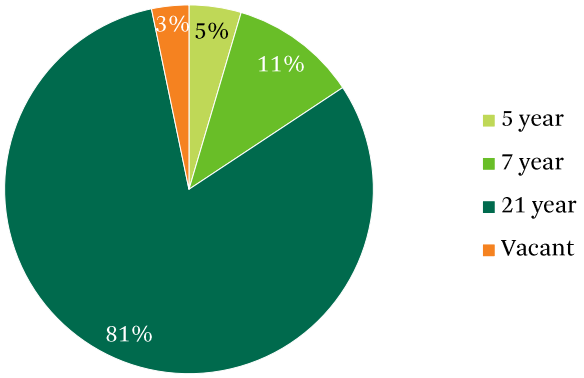
In addition to the above, based on information provided by NCC we note that:

- As at 31 December 2017, the portfolio generates approximately $1.93 million of rental income per annum.
- The portfolio is forecast to generate approximately $1.85 million in rental income over the 2017/18 financial year. This is lower than the figure noted above because of timing of rent reviews over the financial year.
- Assuming that annual management and operating expenses remain the same in FY18, the forecast net income in FY18 is will equate approximately 1.7% of Council's total forecast operational funding requirement for the 2018 financial year (i.e. consistent with FY17) and approximately 4.5% of the general rates funding available to Council over the same period (relative to 4.1% in FY17).

Frequency of rent reviews

The chart below stratifies the portfolio by rent review frequency and identifies that the majority of the portfolio experiences rental reviews every 21 years.

Chart 1: Portfolio value by review frequency – as at 30 June 2017



Vacancies

The following properties are currently vacant (i.e. not leased):

- **13 Husheer Place, Onekawa**: The property has been abandoned by the lessee and the lease has been cancelled from the title; improvements have reverted to Council ownership (i.e. no lessee's interest presently exists).
- **40-52 Thames Street, Pandora**: The lessee has elected not to renew the lease and, per the terms of the lease, the improvements will be auctioned in a two stage process. Council and legal advisors are currently agreeing the second auction process and should the improvements not sell at this auction, they will revert to Council.

We note that both of these properties were also vacant at the time of our last review in 2016.

Historic performance of the portfolio

Portfolio value and return

The following table illustrates the return that the portfolio delivered to Council (before management costs) for the 2017 financial year, summarised by location.

Table 1: Portfolio value by location – including Endowment land (FY17)

Location	No. of leases	Lessor's interest as at 30 June 2017 ($M)	Share	Rental income over 2016/17 financial year ($M)	Income yield
Seafront	11	$18.4	54%	$0.80	4.4%
Ahuriri Other	8	$1.7	5%	$0.11	6.4%
Pandora	16	$5.0	15%	$0.33	6.5%
Onekawa	35	$7.0	21%	$0.31	4.5%
Other	2	$0.8	2%	$0.05	6.7%
Vacant	2	$1.1	3%	-	-
Total	**74**	**$34.1**	**100%**	**$1.60**	**4.7%**

By way of comparison:

- Council's average return on treasury investments for the year ended 30 June 2017 was 3.27%.
- For the nine months ending 31 March 2018, Council's average return on treasury investments is forecast to return 3.45% per annum.

The following tables summarise the FY17 portfolio value and return relative to the Boffa Miskell site classifications as described on page 2 of this report.

Table 2: Portfolio value by Boffa Miskell classification – excluding Endowment land (FY17)

Boffa Miskell classification	No. of leases	Lessor's interest as at 30 June 2017 ($M)	Share of portfolio value incl. Endowment land	Rental income over 2016/17 financial year ($M)	Income yield
A	27	$13.4	39%	$0.78	5.8%
B	3	$8.7	26%	$0.31	3.5%
C	35	$9.7	28%	$0.36	3.7%
Total	**65**	**$31.8**	**93%**	**$1.44**	**4.5%**

Table 3: Summary of Endowment land value by Boffa Miskell classification (FY17)

Boffa Miskell classification	No. of leases	Lessor's interest as at 30 June 2017 ($M)	Share of portfolio value incl. Endowment land	Rental income over 2016/17 financial year ($M)	Income yield
A	-	-	-	-	-
B	6	$0.9	3%	$0.05	5.6%
C	3	$1.4	4%	$0.11	7.7%
Total	**9**	**$2.3**	**7%**	**$0.16**	**6.9%**

Historic returns

The table below presents historic total returns over a range of investment periods and compares these to a range of benchmarks. Note that all of the returns are presented as compound annual growth rates (CAGR).

Appendix 1 provides detail on how the total and income returns have been calculated, noting that total return of the investment property portfolio includes changes in capital value, measured using historic valuation estimates provided by NCC (prepared by Telfer Young).

Table 4: Historic returns (CAGR) incl. endowment land – as at 30 June 2017

Analysed period	No. of leases analysed	Total return NCC investment property portfolio [1]	CBRE Auckland Industrial	CBRE Auckland Overall [2]	NZX50 Index	NZ 10 Year Govt. Bonds[3]
5 years	74	4.9%	20.3%	17.9%	17.5%	4.2%
10 years	74	2.3%	12.6%	11.7%	6.0%	6.8%
15 years	74	14.4%	15.0%	14.2%	9.3%	6.0%
20 years	71	15.5%	14.1%	13.1%	N/A	6.8%

[1] *Total return reflects the lessor's interest only in 13 Husheer Place.*

[2] *CBRE Auckland Overall includes Industrial, Office and Shopping Centres.*

[3] *Return on bonds reflects the IRR for an investment in NZ govt. 10-year bonds over the analysed period. Where the analysed period is greater than 10 years, reinvestment is assumed at then-current rates. Where the end of the analysed period does not align with maturity of the bond, the exit price is estimated based on yield to maturity for a bond of the same term at the end of the analysed period.*

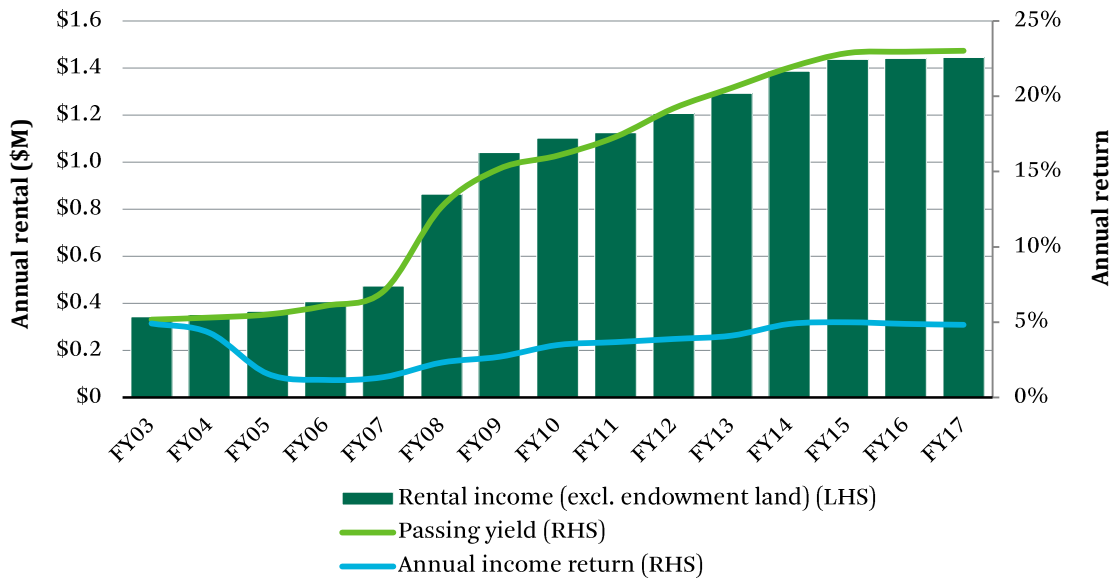
This illustrates that:

- Over the long term (15-20 years), the NCC investment property portfolio has provided a similar level of total return as the Auckland Industrial and Auckland composite indices and has outperformed the NZX50 over the last 15 years.

- Over the last 10 years (i.e. from 2007), however, the portfolio has underperformed relative to all of the benchmark indices including 10 year government bonds. This is, in part, due to the current capital value of the NCC portfolio being circa 16% below the level observed in 2007, despite some growth occurring over the last 12 months.
- The NCC portfolio has also generally underperformed relative to the benchmark indices over the last five years, providing considerably lower total return relative to the CBRE Auckland Industrial and Overall indices and the NZX50, although providing a marginally higher total return relative to an investment in 10 year government bonds.

The chart below illustrates the income return from the portfolio (excluding endowment land) over the last 15 years. The bars represent the actual dollar cash return achieved, the blue line represents the rental return as a percentage of the opening portfolio book value (revalued annually) and the green line represents the passing yield or return on the 2003 opening (initial investment) value.

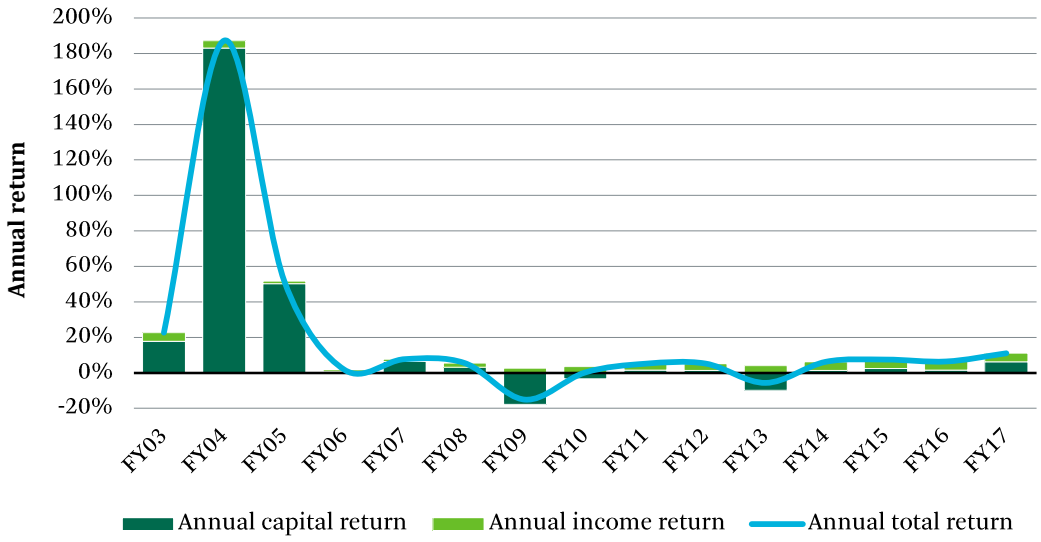
Chart 2: Annual income returns (excl. endowment land)



What this demonstrates is that the return on lessor's interest portfolios are typically heavily driven by capital (and therefore land) value growth with relatively low income returns. This is consistent with the original intention of Glasgow style leases in that the level of income tracks generally in alignment with land values, notwithstanding the lag effect associated with rent reviews.

Historically the portfolio has provided strong total returns with compound annual growth rates of circa 14.4% and 15.5% over the last 15 and 20 years respectively. However, this was heavily driven by a spike in land values in 2004, as illustrated in the following chart, which provides a breakdown of the return contribution.

Chart 3: Capital and income returns (excl. endowment land)



The cash return is typically relatively low, as a percentage of asset value, at any point in time because the majority of the portfolio has a 21 year review frequency. Over the last 15 years, the income return peaked at 5% in FY15 with a low of 1.2% in FY06 (excluding endowment land). It is important to note that this is measured relative to capital value (from the previous year), not the initial investment. When compared to the initial investment, the cash returns start to look very strong, over time, as illustrated by the green line in Chart 2.

Summary

Overall, while the portfolio has performed strongly historically, performance was poor for an extended period of time following the GFC (total return between 2008 and 2015 was essentially nil). However, with capital growth of 6.1% over the last 12 months, the portfolio provided total return of 11.1% in FY17 which is the highest annual rate observed since 2005 and the total return over the last three years equates 8.4% per annum (including endowment land).

Use of income

Expenses related to the ongoing management and operation of the investment property portfolio are summarised as follows.

Table 5: Average annual management and operating expenses

Management and operating expenses	$pa
Salary and overheads	$50,000
Legal fees	$15,000
Valuation fees	$15,000
Arbitration (annualised)	$15,000
Total	**$95,000**

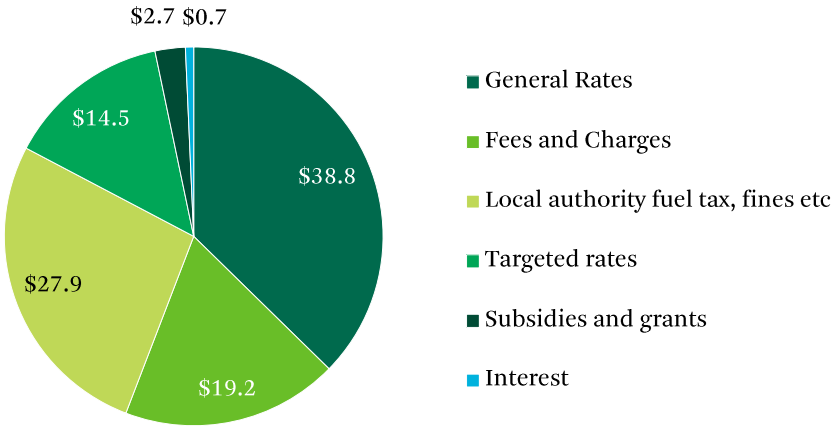
The net income derived from the investment property portfolio after allowing for average annual management and operating costs in FY17 was circa $1.51 million.

Council funding sources

The following chart illustrates the makeup of Council's operational funding for FY17. The net income derived from the commercial and leasehold property portfolio (i.e. post operating expenses) equates to 4.1% of Council's general rates funding over the same period. The

implication is that, to the extent the investment property portfolio was sold and the proceeds not re-invested in assets providing similar cash return, general rates would rise by up to 4.1%. Where capital can be invested to achieve similar returns, rates may not be affected.

Chart 4: Council sources of operational funding 2016/17 actual ($M)



We note:

- The total of all funding sources in FY17 is 88.8M; the forecast budget for FY18 is $103.9M.
- General rates funding is forecast to increase from $37.0M in FY17 to $38.8M in FY18.

Inner Harbour and Foreshore Reserve

At the same time the commercial lessor's interest portfolio was transferred from the Hawkes Bay Harbour Board, Council also took over responsibility for maintenance of the Inner Harbour (wharves, seawalls, dredging etc.) and some Foreshore Reserves. The income generated from the investment property portfolio has, historically, been applied to funding part of the cost associated with these activities.

Appendix 1– Total and income returns calculations

Total return is the sum of capital growth and net income in a single period expressed as a percentage of capital employed, with income reinvested. The following formula is used to calculate Total Return (TR_t) for a single year t:

$$TR_t = \frac{\left(CV_t - CV_{(t-1)} + I_t\right)}{CV_{(t-1)}}$$

Where:

- TR_t = Total Return in year t;
- CV_t = Capital Value (lessor's interest valuation) at the end of year t;
- I_t = Rental income during year t.

The following formula is used to calculate Income Return (IR_t):

$$IR_t = \frac{I_t}{CV_{(t-1)}}$$

Investment Property Portfolio Review

Prepared for Napier City Council

March 2016

CBRE
Structured Transactions and Advisory Services
Report prepared by:
John Holmes 0274 899 095
Martin Boys 022 1941 263

Contents

1. Executive summary

1.1. Portfolio overview and context

NCC currently owns a portfolio of 76 lessor's interests in Napier with a combined value of approximately $32.3m, generating a current passing rental of $1.63 per annum i.e. yielding circa 5.0% pa[1]. This income or cash return (before management costs) compares with NCC's treasury investments which yielded 4.58% over the 2014/15 financial year. In addition to an income or cash return, the portfolio has historically provided strong capital growth but more recently (over the last 5 – 10 years) this has been relatively subdued, resulting in a cumulative average total return over the last ten year period of 1.6% pa.

At present, the rental derived from the portfolio is used to offset the cost associated with maintenance and upkeep of the inner harbour and foreshore reserves and overall represents approximately 1.8% of NCC's total funding (or revenue) sources.

A number of lessees in the portfolio have requested that NCC review its ownership of the investment property portfolio and specifically requested the right to freehold their site, which would essentially involve lessees purchasing Council's interest in the land. In order to evaluate whether freeholding sites may be appropriate, NCC has requested that CBRE prepare a report that:

1. Summarises the portfolio's characteristics and its performance historically, and provides comment on performance expectations moving forward.
2. Considers whether leasehold tenure may be having an impact on reinvestment in Napier.
3. Considers the pros and cons of freeholding and how this process could be undertaken.
4. Briefly considers what Council could do with the proceeds, should it elect to freehold, and the work required in this respect.

1.2. Summary of findings

1. The portfolio provides a modest but low risk, stable cash flow that would be difficult to replicate. However, looking forward, there does appear to be greater risk of lessee default and capital growth is likely to be more subdued than has been observed historically, at least in the short term, in our view.
2. It is difficult to determine whether leasehold tenure has, to date, had an impact on re-investment decisions; analysis of improvements value to capital value and the age profile of assets across freehold and leasehold sites in Onekawa doesn't provide any definitive conclusions. However, discussions with lessees would suggest that it has/does make investment more challenging. We are certainly of the view that, at the individual site level, leasehold tenure makes development and reinvestment more difficult and illustrative feasibility analysis presented in this report highlights these challenges.
3. However, it is difficult to argue that the NCC leasehold portfolio is having a more prevalent impact investment in Napier across the board. While the scope of our work does not extend to evaluating the primary drivers of Napier's economy or investment into it, we expect that land tenure, and its impact on investment decisions, is some distance down that list of factors. Put another way, leasehold tenure is likely to be a material issue for individual lessees and their investment decisions but there is

[1] Before annualised management/operating costs of $95,000 per annum.

nothing that we observe which would suggest it is having a material impact at the city level.

4. It is evident from our discussions with both NCC and lessees that some animosity exists and this would ultimately appear to be unhealthy for the relationship between Council and business in Napier. Freeholding presents a viable option which, if managed correctly, provides NCC with an opportunity to achieve fair value for its investment, which is important to ensure fairness to all NCC ratepayers, while at the same time providing lessees with an opportunity to enhance their investment and improve their ability to make reinvestment decisions looking forward.

5. If Council does elect to freehold it has two options in our view. The first would be to make a freeholding offer to lessees and leave this option open for a fixed period (say 6-12 months). The second would be to incorporate a freeholding provision into the lease, making this a permanent possibility for lessees. Both options have pros and cons which we outline in the body of this report.

6. Undertaking a freeholding process does raise the question of how NCC would and could reinvestment the proceeds, noting that it would need to continue to derive a similar level of income (circa $1.6m pa); to do otherwise may have implications on rating levels. However, the decision to freehold the portfolio should be treated somewhat separately from the decision to re-invest in our opinion. Ultimately, alternative investments are likely to be available.

   The most significant concern we would have relates to the rate at which freeholding occurs and the implications this may have for re-investment. Where take-up is relatively slow, Council will be 'drip fed' capital and this makes re-investment more difficult and (likely) more costly. Where Council does intend to freehold the portfolio, it will need to revisit and consider its current investment policy to determine how this may accommodate reinvestment and whether it needs to be changed. We would recommend Council seeks investment advice in this regard.

2. Brief overview of the investment property portfolio

2.1. Introduction

The investment property portfolio is a portfolio of 76 properties owned by Council within Napier, largely in Onekawa, Ahuriri and Pandora, known as the 'investment property portfolio'. Council owns the lessors interest in these properties and a number of individuals and businesses own the lessees interests.

The leases granted by Council are perpetually renewable meaning that, subject to continuing to pay rental, which is reviewed at periodic intervals, the lessee's have a perpetual right to occupy the land. The improvements on the land are owned by the lessees, not Council.

The investment property portfolio includes some high density residential property as a result of changing land use over time and new apartment development occurring on former commercial/ industrial land.

For the sake of clarity, Council owns an additional circa 30 residential lessees interests, all of which are subject to the Hawke's Bay Endowment Land Empowering Act 2002 which allows the lessees to purchase the freehold from Council. These leases do not form part of the investment property portfolio and are excluded from this review.

2.2. Background to ownership

The investment property portfolio consists of:

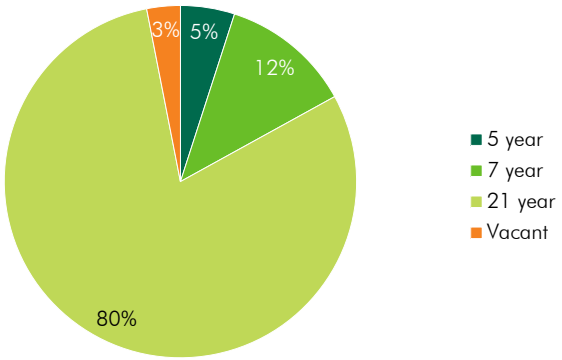
- Properties transferred to Council from the Hawke's Bay Harbour Board as part of the local Government reorganisation in 1989. The reason for the transfer was to provide an income generating asset to offset the liability associated with the upkeep of the Inner Harbour and Foreshore Reserves, which was transferred at the same time.
- Properties already owned by Council as a result of land development in conjunction with the Harbour Board.
- Other sundry properties which have been owned by Council for many years.
- Endowment Properties – these nine properties (identified in Appendix III) are subject to the Napier Borough Endowment Act 1876. Council is currently seeking legal advice as to whether these properties could be sold and, if so, the process that would need to be followed.

2.3. Key descriptive statistics

- 76 sites in Napier, as shown on the map attached as Appendix III.
- Valued at approximately $32.3m plus GST as at 30 June 2015.
- Two properties are currently vacant – 13 Husheer Place, Onekawa and 40-52 Thames Street, Pandora (five titles held under one lease). Market rental for these properties as at 30 June 2015 is $82,300 plus GST per annum.
- Generates approximately $1.6 million dollars of rental income per annum as at 30 June 2015. After management and operating expenses of circa $0.1m per annum, the net income equates to approximately 1.8% of Council's total operating funding requirement for the 2016 financial year (estimated at $86.3m) and is equivalent to approximately 4.3% of the general rates funding available to Council.

The chart below stratifies the portfolio by rent review frequency and identifies that the majority of the portfolio experiences rental reviews every 21 years.

Portfolio value by review frequency – as at 30 June 2015



2.3.1. Vacancies

The following properties are currently vacant (i.e. not leased):

- 13 Husheer Place, Onekawa: The property has been abandoned by the lessee and the lease has been cancelled from the title; improvements have reverted to Council ownership (i.e. no lessee's interest presently exists).
- 40-52 Thames Street, Pandora: The lessee has elected not to renew the lease and, per the terms of the lease, the improvements will be auctioned. If the property does not sell at auction, Council enters another renewal valuation process with the lessee and, if not successful, a second auction will take place. If not sold at the second auction, the improvements revert to Council.

2.4. Historic performance of the portfolio

The following table illustrates the return that the portfolio has historically delivered to Council (before management costs). Appendix 1 provides detail on how the total and income returns have been calculated, noting that total return includes changes in capital value, measured using market valuation estimates prepared by Telfer Young.

Portfolio value by location - as at 30 June 2015

Location	No. of leases	Lessor's interest ($m)	% of total	Rental ($m pa)	Income yield
Seafront	11	$17.4	54%	$0.80	4.6%
Ahuriri Other	9	$1.7	5%	$0.12	7.0%
Pandora	16	$4.6	14%	$0.33	7.1%
Onekawa	36	$6.8	21%	$0.32	4.7%
Other	2	$0.8	2%	$0.05	7.0%
Vacant	2	$1.0	3%	-	-
Total	**76**	**$32.3**	**100%**	**$1.63**	**5.0%**

By way of comparison, Council's average return on treasury investments for the year ended 30 June2015 was 4.58%.

The table below presents historic total returns over a range of investment periods and compares these to a range of benchmarks.

Historic returns - as at 30 June 2015

Analysed period	No. of leases analysed	Total return Council Portfolio *	CBRE Auckland Industrial	CBRE Auckland Overall	NZX50 Index	NZ 10 Year Govt. Bond Yield**
5 years	76	3.4%	17.4%	16.1%	14.0%	5.5%
10 years	76	1.6%	12.0%	12.1%	5.8%	5.7%
15 years	75	14.7%	14.0%	13.6%	N/A	6.9%
20 years	63	16.3%	13.4%	13.1%	N/A	7.5%

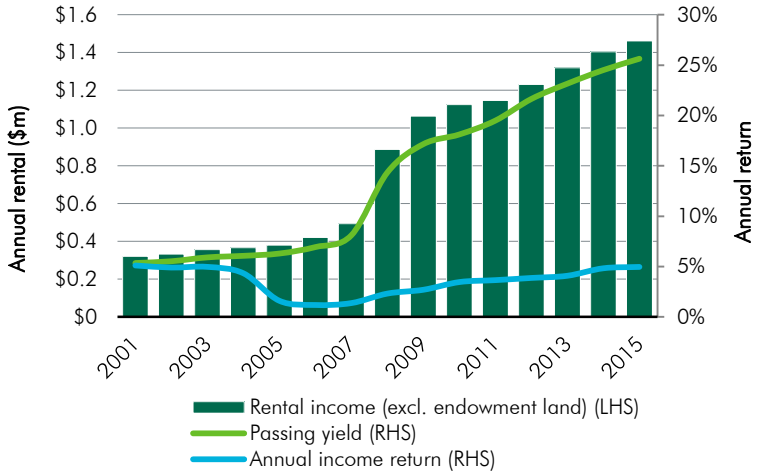
** Total return reflects the lessors interest only in 13 Husheer Place.*

*** Bond yield is the yield to maturity at the start of the analysed period*

As illustrated, the Council portfolio has provided a higher return than the selected investment alternatives over 15-year and 20-year investment periods, but has provided a lower return than all selected investment alternatives over the last five-year and ten-year periods[2]. Historically total returns from the Council portfolio were similar to the CBRE Auckland industrial index but significant divergence has occurred between the two over the past ten years with the leasehold portfolio underperforming.

The chart below illustrates the income return from the portfolio (excluding endowment) for the last 15 years. The bars represent the actual dollar cash return achieved, the blue line represents the rental return as a percentage of the opening portfolio book value (revalued annually) and the green line represents the passing yield or return on the 2001 opening (initial investment) value.

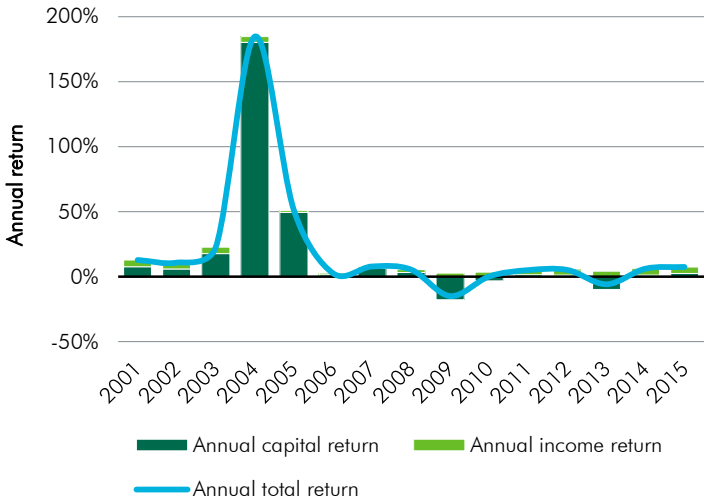
Annual income returns (excl. endowment land)



[2] This comparison does not consider 'risk adjusted' returns (which is beyond the scope of this report) it simply compares headline total returns by asset class.

Historically the portfolio has provided strong total returns at a cumulative average return of circa 14.7% and 16.3% pa over the last 15 and 20 years respectively. However, this was heavily driven by a spike in land values in 2004, as illustrated in the following chart which provides a breakdown of the return contribution.

Capital and income returns (excl. endowment land)



The cash return is typically relatively low, as a percentage of asset value, at any point in time because the majority of the portfolio has a 21 year review frequency. Over the last 15 years, the income return as a percentage of the capital value from the prior year, peaks at circa 5.1% and falls to a low of 1.2% of capital value. It is important to note that this is measured relative to capital value, not the initial investment. When compared to the initial investment the cash returns start to look very strong, over time, as illustrated by the green line in the annual income return chart.

2.4.1. Summary

Overall, while the portfolio has performed strongly historically, performance has been relatively subdued over the last ten years. Absent capital growth, the portfolio provides a modest but low risk cash flow.

2.5. Use of income

Expenses related to the ongoing management and operation of the investment property portfolio are summarised as follows.

Average annual management and operating expenses

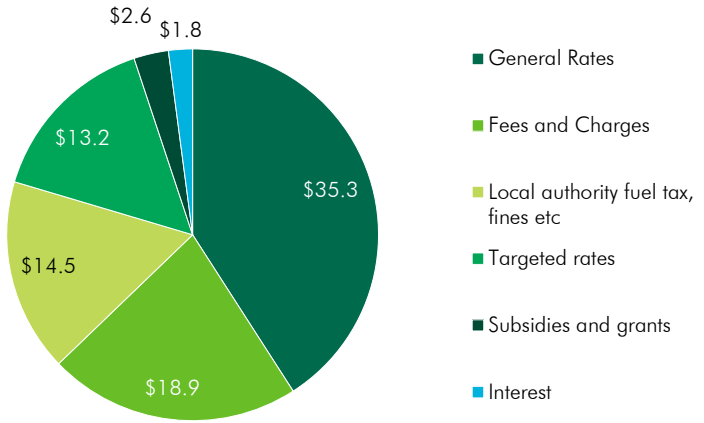
Item	Amount
Salary and overheads	$50,000
Legal fees	$15,000
Valuation fees	$15,000
Arbitration (annualised)	$15,000
Total	**$95,000**

The net income derived from the investment property portfolio after allowing for average annual management and operating costs is circa $1.53m per annum as at 30 June 2015.

2.5.1. Council funding sources

The following chart illustrates the makeup of Council's operational funding. The net income derived from the commercial and leasehold property portfolio (i.e. post operating expenses) equates to 4.3% of Council's general rates funding. The implication of this is that, to the extent the investment property portfolio was sold and the proceeds not re-invested in assets providing similar cash return, general rates would rise by up to 4.3%. Where capital can be invested to achieve similar returns, rates may not be affected.

Council Sources of Operational Funding 2012/13 Estimate ($m)



2.5.2. Inner Harbour and Foreshore Reserve

At the same time the commercial lessors interest portfolio was transferred from the Hawkes Bay Harbour Board, Council also took over responsibility for maintenance of the Inner Harbour (wharves, seawalls, dredging etc.) and some Foreshore Reserves. The income generated from the investment property portfolio has, historically, been applied to funding part of the cost associated with these activities.

3. Is leasehold tenure having an impact on reinvestment in Napier?

3.1. How can the impact (if any) be measured?

It is difficult to definitively determine whether leasehold tenure is having an impact on investment decisions in Napier. However, as a means of addressing this, we have considered:

1. General observations made during our physical inspection of the investment property portfolio and discussions with lessees.
2. The profile of the lessees (i.e. the proportion of owner occupiers versus investors) and whether this might impact on reinvestment, anecdotally or theoretically.
3. A worked example of a hypothetical development feasibility for a typical industrial property, in order to demonstrate how investment decisions are (or should be) considered.
4. The ratio of capital value to land value for all sites within the Onekawa area, as a broad measure of the level of investment in freehold versus leasehold sites.
5. The relative age of improvements for leasehold versus freehold sites in Onekawa as a broad determinant of the level of investment that has occurred in recent years and to understand the remaining useful life of improvements within the portfolio and how this might affect reinvestment going forward.
6. Other examples/case studies from Auckland where parallels can be drawn with the NCC portfolio.

3.2. General observations

During our visit we physically inspected (from the exterior only) a large number of the NCC properties in Onekawa, Pandora and Ahuriri.

At a high level, no noticeable difference in appearance/presentation of the exterior of the leasehold properties was observable relative to the surrounding freehold properties. That is, the tenure does not *appear* to be having an impact on the level of maintenance and upkeep undertaken by the lessees, at a portfolio level. There are of course site-specific exceptions.

In fact, many properties appear to have been redeveloped/ modernised in recent years (e.g. residential and mixed use development in Ahuriri). However, this investment generally occurred in the last 'wave', prior to the GFC, and we understand from discussions with lessee's that any investment over the seven years since the GFC is likely to have been minimal.

The lessees we met with all displayed very negative sentiment towards leasehold property in general and argue that ground rent obligations do affect their investment decisions. However, we note that we met with a small sample of lessees only, specifically selected by Council because of their strong views.

3.3. Profile of the lessees

The following table summarises the proportion of lessees that are owner-occupiers, sub-lessees (i.e. investors) and body corporate lessees.

Profile of the lessees

	Leases No.	Area (ha)	Value ($m)	Rent ($m pa)
Owner occupied	34	6.0	$13.2	$0.74
Sub-leased (i.e. investors)	37	7.3	$9.0	$0.50
Body corp. lessees	3	2.3	$9.1	$0.39
Vacant	2	0.8	$1.0	-
Total	**76**	**16.4**	**$32.3**	**$1.63**

We make the following observations:

- The proportion of owner occupiers and investors is broadly equal across the portfolio with 34 and 37 leases respectively. When weighted by land area, owner-occupiers account for a smaller proportion of the portfolio than investors; however, the reverse of this is true when weighted by value or rent.
- The average annual ground rent for the owner-occupied properties equates approximately $22,000 per annum per lease and $13,500 per annum per lease for the subleased properties. With regard to the body corporate lessees, the share of rental for each individual unit owner (circa 150 units over the three properties) equates circa $2,600 per annum.

On balance, this analysis is not particularly clear or conclusive as to whether the profile of the lessees might be impacting on reinvestment in Napier.

3.4. The impact of tenure on development economics – worked example

To illustrate how tenure might be having an impact on reinvestment in Napier, we have undertaken high level residual analysis for a hypothetical industrial development, which seeks the economic or 'feasible' price for a parcel of land when all development costs and margins are deducted from the site's 'highest and best use' value.

In this example we first seek the indicative economic rents that are required to support a land value that is in line with market (freehold) evidence and second, we analyse how the development economics are altered under a leasehold scenario. Finally we compare the economic rents to market rents to assess how this further affects the equation.

Our analysis is on the basis of a 2,000sqm site which is proximate to the average site within the Council portfolio, and we assume the following GFAs, rental rates and build costs.

Indicative revenue and cost assumptions

	GFA (sqm)	Net rental* ($/sqm)	Build cost ($/sqm)
Office	200	$180	$1,800
Warehouse	1,000	$90	$700
Yard	500	$0	$70

** Indicative economic rental.*

Indicative value parameters

	Freehold	Leasehold
Ground rent (% of freehold land value)	N/A	5.00%
Capitalisation rate	7.50%	9.00%

We note:

- Our adopted revenue and cost assumptions are high level only; this analysis is provided for illustrative purposes only and should not be treated as an accurate representation/assessment of market value.
- The adopted leasehold capitalisation rate reflects a margin of 150 basis points relative to freehold. In reality this margin could be larger; sales of lessee's interests have been in the order of 8.5% to 17%+ over the last 3-5 years, although for generally smaller scale, secondary quality properties.
- We have modelled ground rental of 5% of freehold land value under the leasehold scenario, which is consistent with the majority of Council's portfolio.

The residual values under each approach are presented below.

Indicative residual value

		Freehold ($m)		Leasehold ($m)
Indicative value		$1.72		$1.29
Less: Development margin	12%	$0.18	17%	$0.18
Less: Total development cost		$1.28		$1.27
Residual land value ($m)		**$0.25**		**-$0.16**
Residual land value ($/sqm)		**$127**		**-$81**

The freehold land value implied is $127psm which is broadly in line with land sales evidence in Onekawa (at net rents of $170psm and $90psm for the office and warehouse respectively). The negative value implied under the leasehold scenario demonstrates that development on land with leasehold tenure is challenging. Consequentially, leasehold tenure could be inhibiting development on land within the Council portfolio.

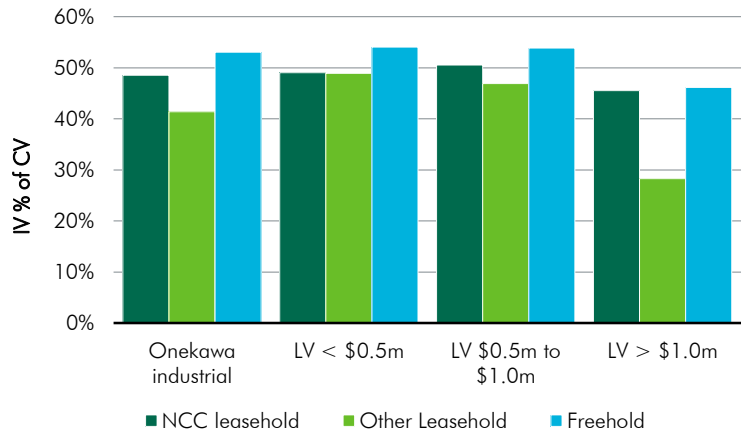
Market rents for new-build industrial premises are currently in the order of $750 to $85psm for warehouse and $130 to $150 for office (gross, with outgoings at 8% to 10%), which is well below the economic rents required to support an appropriate development margin. This suggests leasehold tenure is unlikely to be materially impacting the level of investment in Napier at present, because feasibility appears to be challenging on freehold land.

3.5. Analysis of capital value to land value in Onekawa

As another means of investigating the impact of leasehold tenure on investment decisions in Napier, we have analysed the ratio of capital value to land value for all sites within the Onekawa area.

We chose Onekawa because both NCC and Corunna Bay Holdings have reasonably significant leasehold portfolios within the Onekawa area and it is therefore possible to obtain a reasonable sample to analyse. The chart below presents improvement value as a percentage of capital value based on rating valuations.

Improvements value as a percentage of capital value in Onekawa



As illustrated, the level of investment in sites with freehold tenure is higher than both the Council leasehold portfolio and the remaining

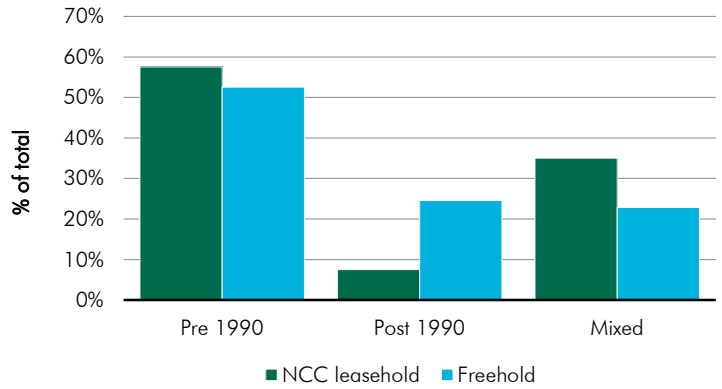
leasehold assets owned by the private sector. These trends are generally supportive of the view that leasehold tenure has restricted investment in improvements.

There are properties within the NCC portfolio where land is underdeveloped. In theory, the lessees should develop these sites to their highest and best use in order to maximise revenue from the improvements; however not all lessees are capable of the investment required.

3.6. Age of improvements in the NCC portfolio

The following chart provides analysis of the general age of properties in the NCC portfolio, relative to freehold, in Onekawa.

Building age: NCC vs freehold in Onekawa



This illustrates that the proportion of properties with improvements built in the 1980's and earlier (i.e. older than 25 years) is broadly similar for both the NCC and freehold samples, at circa 58% and 53% respectively.

Interestingly, however, the NCC portfolio has very few properties that have been developed in the last 25 years and a larger proportion of 'Mixed' age (i.e. partially redeveloped/upgraded) properties.

This possibly suggests that, for leasehold properties, owners are more likely to invest in smaller (i.e. less expensive) additions and alterations to existing properties when required, to prolong the life of the asset, rather than demolish old/obsolete improvements and build new.

3.7. Other examples

The Cornwall Park Trust Board in Auckland has, in recent years, faced similar challenges that NCC is now being presented with, typically as a consequence of 21-year rent reviews resulting in substantial increases in ground rent for lessees.

In one recent, well publicised case, a Cornwall Park lessee's rent was increased by nearly 800% following a 21-year review which ultimately led to the abandonment of the property. Earlier this year it was further reported that the Trust Board had eight to ten properties in the area that were abandoned/vacant as a result of large rental increases.

The Cornwall Park portfolio is entirely residential, and differs from the NCC investment property portfolio in that respect; however, around half of the NCC lessees are owner-occupiers and are therefore responsible for ground rent payments either personally or through their businesses and are therefore personally affected by large rental increases, not unlike like the Cornwall Park lessees.

At the opposite end of the spectrum, institutional property investors and developers do successfully develop on leasehold land. As one example, Goodman is currently developing the Fonterra HQ on leasehold land in Auckland. Goodman owns the lessee's interest and will sub-lease the improvements to Fonterra. Fonterra will not be

liable for ground rent (Goodman will meet this cost) and income that Goodman receives, once occupied, will therefore equate the net improvements rent, less the ground rent.

Private property investors that own the lessees' interests in the NCC portfolio are, or should be, more aligned with the Goodman example. Owner-occupiers with small business potentially exhibit characteristics similar to the Cornwall Park lessees.

Point of View

Commercial leasehold property has historically provided a more affordable way for small business owners to own their premises. However, with interest rates at historically low levels, with first tier banks offering mortgages at circa 5.0%, leasehold tenure no longer provides a more affordable option where the ground rental percentage is at similar levels (5.0%), which is the case in the NCC portfolio.

Conceptually, if managed correctly and well understood, leasehold tenure in a commercial setting can nevertheless be a viable alternative. However, leasehold tenure does, in most cases, tend to cause problems over the medium to long term, particularly where the frequency of rent reviews is low and/or land value growth is significant. In part this is because land value growth has exceeded expectations in many locations and interest rates have fallen to a point where they are similar to ground rental percentages. However, perhaps the most basic issue is that purchasers / lessees tend to view their asset as an investment in real estate. Under a traditional ground lease with market rent reviews the lessee does not own an investment in land (or real estate); the lessee rents the land and owns an investment in buildings or improvements. While investments in real estate typically appreciate, an investment in a building typically depreciates as it ages (like a photocopier or car but over a longer term). Unfortunately, this is not well understood and only crystallises when the ground rental increases every seven or 21 years.

4. Should Council offer the right to freehold?

It is evident from our discussions with Council staff and lessees that some animosity exists and this is ultimately unhealthy for the relationship between Council and businesses in Napier.

In addressing this question, we are also drawn to Council's investment policy which maintains that *"Council generally holds investments for strategic reasons where there is some community, social, physical or economic benefit accruing from the investment activity. Generating a commercial return on strategic investments is considered a secondary objective."* In this case, it would be difficult to argue any community, social, physical or economic benefits accruing as a result of the investment property portfolio.

On this basis, we believe Council should consider offering lessees the right to freehold and to assist with this decision we have considered:

1. Whether alternative investments are available;
2. Whether freeholding is likely to enhance investment in the region;
3. The downsides/risks associated with freeholding; and
4. How the portfolio would be expected to perform going forward.

We address these considerations as follows.

4.1. Are alternative investments available?

In our view, the decision to divest the investment property portfolio should not be based on any one or more specific alternative investments. The freehold decision is independent of what to do with the proceeds.

However, if Council does decide to freehold, then it will need to consider what alternative investments are available, having regard to its investment policy. Having reviewed the investment policy, it is likely that it would need to be reviewed in order to accommodate longer term investment alternatives and Council would require independent investment advice in this regard. Council currently has nil external debt and therefore the proceeds cannot be used for this purpose.

Noting Council's relatively low appetite for risk, its desire for stable income returns (to fund its operational activities) and its tax status, we have compared a selection of potential investment alternatives, at a conceptual level, with the existing investment property portfolio. This analysis is attached (Appendix II).

Generally, the strengths of the existing investment property portfolio include:

- Limited management requirement.
- An inflation hedge, where land price growth correlates with inflation, in that the capital value tends to grow over the long term with the property market.
- Relatively stable and low risk cash flow.

The table below summarises the benefits and disadvantages of continued investment in the leasehold portfolio, relative to alternative investments.

Pros and cons of continued ownership of the leasehold portfolio

Pros	Cons
• The cash flow return is relatively low risk and has historically proved relatively stable. • Historically (over the last 20 years) the portfolio has outperformed alternative investments, having generated total returns in excess of 16% pa (CAGR). • The investment is relatively passive and requires limited management relative to say freehold commercial investment property or direct investment in shares without a fund manager. • NCC can utilise its tax exemption	• The investment property portfolio is not particularly diversified either from a geographic or asset class perspective. • Total returns over the last 5-10 years have been suboptimal. • Council ownership has created animosity amongst ratepayers and is not healthy for the relationship between Council and businesses. • The portfolio is relatively more management intensive than say, government bonds or an investment in a diversified fund, managed by a fund manager.

4.2. Is freeholding likely to enhance investment in the region?

In our view, there are two quite distinct components to this question:

1. Is freeholding likely to enhance overall investment in the Hawke's Bay region and specifically Napier? i.e. is it likely to encourage new and productive capital investment? This is the 'macro' question.
2. Is freeholding likely to encourage investment in the specific assets which form part of the existing NCC leasehold portfolio? This is the 'micro' question.

4.2.1. Macro considerations

Numerous factors will drive investment in the Napier region. As an economy with significant exposure to rural production, agriculture commodity prices and exchange rates will play a significant part in economic performance and therefore the appetite to invest. Population growth will also drive growth in commercial and business services and access to labour supply will, in addition to proximity to markets and supply chain, drive investment in processing and manufacturing.

There will be many other factors and land tenure, in some cases, may be one. While it is beyond the scope of this report and the author's expertise to undertake a comprehensive assessment of the region's economic growth potential, we expect that at a macro level, land tenure is likely to be lower down the hierarchy of investment drivers than many other factors. Put another way, we find it difficult to believe that, at a macro level, freeholding the NCC portfolio would have a material impact on the region's ability to attract capital and / or grow GDP.

4.2.2. Micro considerations

By contrast, at a micro level we have little doubt that the existing tenure will restrict investment in those businesses located on NCC owned land. This suggests that freeholding will, in the long term, inevitably lead to greater investment in the subject sites. However, we understand that many lessees are capital constrained at present and, therefore, in the short to medium term, committing to purchase the freehold from Council is likely to absorb much of the financial capacity that exists i.e. acquisition of land would tie up additional

capital relative to the status quo (i.e. not freeholding). Any benefit in terms of additional investment that accrues from freeholding is likely to take some time to observe.

Case study – 84 Thames Street

84 Thames Street is a property in the NCC portfolio where the lessee is in arrears and we have selected this property as a case study to determine whether freeholding would be beneficial for the lessee.

The lessee's interest at 84 Thames Street was purchased by Thames Street Holdings Limited (TSHL) in 2002 for $130,000. The ground rental was reviewed to $31,500 per annum in 2009 (an increase of 379% over seven years) and is currently above market.

Based on a recent Bayleys appraisal, updated for the current ground rent, the lessee's interest is indicatively worth circa $7,000 at present. The lessor's interest is currently valued at $364,500, therefore the combined value of the lessee's and lessor's interest is $371,500. The freehold value of the property, assuming some value in the improvements, could likely be conservatively $400,000 which is circa $28,500 greater than the value of the combined lessee's and lessor's interest (marriage value).

If TSHL has more than $7,000 debt owing on the lessee's interest at present, it will have negative equity in the property. However, if the debt owing is relatively low (circa 27% or less in this example, i.e. less than $35,500), THSL would benefit from purchasing the freehold, because the marriage value would exceed the value of its existing (negative) equity.

Conversely, if TSHL has higher levels of debt at present, it would not make sense to purchase the freehold because the additional capital required would not exceed the marriage value (unless the property is part of a wider portfolio where the total equity gain is realised, i.e. where the starting equity position is positive).

4.3. Are there any downsides/risks associated with freeholding?

Potential downsides/risks of freeholding include:

- Valuation risk. For background, the average market freehold land value of the lessor's interest portfolio in Pandora and Onekawa was independently assessed at $165psm and $153psm respectively at June 2015. There is limited industrial land sales evidence to analyse, however, from 2012 to now, there has been six industrial land sales in these areas, all between $81 to $161psm and generally in the $115psm to $130psm range, for 2,000 to 6,000sqm sites.
- There is a high likelihood that few lessees elect to freehold. As we discuss in more detail in the following section, only five of the 33 Iron Pot and Corunna Bay lessees purchased the freehold during the recent sale process. The key issue with this is that sale proceeds are 'drip-fed' to Council over time, making reinvestment more difficult because of a lack of scale.
- A suitable alternative investment must be found; reinvestment risk therefore exists. If alternatives are lower yielding or provide more volatile returns, Council may be required to increase rates or decrease spending. Any rates increases would be in addition to the increases already proposed, as summarised below.

Proposed Napier City rates over the next five years

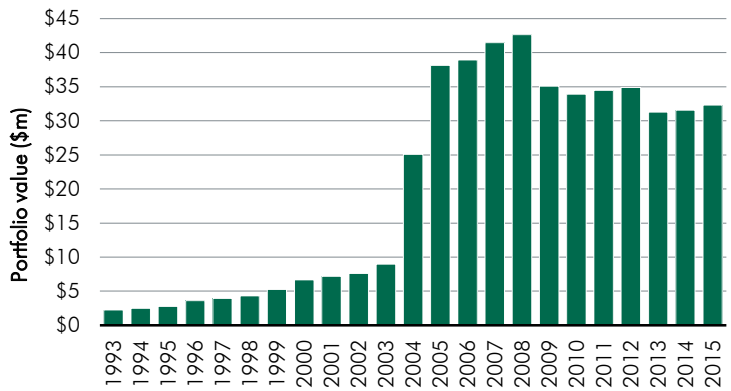
	2015/16	2016/17	2017/18	2018/19	2019/20
Amount ($000)	48,609	50,745	53,372	55,886	58,234
Annual increase	2.9%	4.4%	5.2%	4.7%	4.2%

Assuming Council could sell the entire portfolio at book value in one line (i.e. circa $32 million) and reinvest the proceeds at the average rate of return it received on treasury investments over the last 12 months (i.e. 4.58%), it would generate annual income of circa $1.48m, leaving a shortfall of just $150,000 per annum relative to the current net income derived.

4.4. How would the portfolio be expected to perform going forward?

As illustrated in the following chart, the portfolio experienced significant capital growth between 2003 and 2008, particularly in 2004 and 2005, although values have since come back nearly 30% from the peak and only modest growth has occurred over the last two years. Approximately 50% of the portfolio by value was reviewed during the four year period between 2005 and 2012 and, as a result, circa 30% of the portfolio (by value) is now considered to be rented above market levels. This component of the portfolio therefore offers limited growth potential.

Historic value of the investment property portfolio



Approximately 28% of the portfolio (by value) comprises leases with 21-year review cycles that are due for review in the next ten years. All of these properties were last reviewed prior to 2004 and this component of the portfolio is therefore likely to experience considerable rental growth. As at June 2015, the market rent for these properties is circa 356% above current rent.

More generally, economic indicators suggest that capital growth is unlikely to be material over the short to medium term:

- Napier City's population is projected to increase by just 3.6% in total over the ten years between 2015 and 2025, reflecting a compound average growth rate ('CAGR') of 0.4% per annum[3].
- The unemployment rate in Napier City has broadly been in the order of 7.5% to 8.5% for the last five years which is above the national average.
- GDP growth in the Hawke's Bay is forecast to be between 1.5% and 2.5% per annum over 2015 to 2025[2]. By comparison, national GDP growth is forecast between 2.8% and 3.3% per annum over 2015 to 2019.
- The residential property market in Napier City has been steadily improving over the last 12 months, with sales volumes now at the highest level since mid-2007. Prices also picked up noticeably in late 2014/early 2015 and are above pre-GFC levels.
- The commercial property market is more subdued, particularly for CBD retail and office in Napier. In contrast, the strength of the primary producer sector in Hawke's Bay is underpinning a strong construction market for large scale cool-store and food processing plants in the region (i.e. outside of Napier).

[3] Forecast is from the Napier City Council Long Term Plan 2015-2015.

On balance, we would expect capital growth returns to remain modest over the short term, supplemented by income returns which are currently circa 5.0% per annum.

5. If Council offers the right to freehold, how should it do it?

5.1. Iron Pot Investments and Corunna Bay Holdings

The Iron Pot and Corunna Bay portfolio was taken to market by CBRE in 2014, offering the lessees the right to purchase the lessor's interest (i.e. the freehold interest).

The portfolio was essentially broken down into two tranches, namely (a) the smaller properties which are generally leased by 'mum and dad' investors and smaller companies, and (b) larger sites over circa 1Ha with corporate and larger private lessees. In short:

- The vendor's expectation of value was not necessarily entirely rational, seeking yields in the order of 4% to 4.5% on the basis of interest rates available on bank deposits.
- There was strong interest to purchase from the smaller lessees; however, valuation advice was typically below the vendor's expectations and negotiations took place and generally fell through over relatively small amounts. We are also aware of instances where lessees made offers close to the vendor's desired pricing (e.g. within $20k) but were capital constrained and could not raise the additional funds or did not fully understand the concept of marriage value.
- Pricing was the key issue for the larger lessees, with yield expectations generally in the order of 6% to 6.5%.
- Many properties have been underinvested in and have limited improvements value, which was identified as a key risk by investors.
- Investors were also somewhat reserved about growth expectations in the Hawke's Bay.

To date, only a handful of properties have sold, all to one investor who owns a number of lessee's interest in Napier, and the process is now proceeding 'off market'. Price has typically been the key constraint, and the vendor is not necessarily a particularly 'willing' participant.

5.2. Process

At one end of the spectrum, Council could elect to undertake a fixed term offer process that would provide lessees the right to purchase the freehold within a predetermined timeframe. Alternatively, the right to freehold could be incorporated within the existing leases which would provide lessees with a perpetual option to purchase. We consider the alternatives below.

Fixed term offer to existing lessees

- Council serves a letter to lessees which provides a fixed-term (say 6-12 months) opportunity to freehold.
- The letter sets out the price (e.g. existing or updated book value) with the relativity to (percentage of) freehold value referenced.
- A vendor funding/ 'rent to own' package could be provided if desired (which we discuss in more detail later in this section).

Right to freehold is incorporated into the leases

- Council arranges to have the leases varied.
- The freeholding pricing mechanism would be defined in the lease (e.g. market value, to be established by a registered valuer).

- The valuer would be instructed to assess the market value of the lessees interest and present relativity to freehold value.
    - The terms could provide that the lessor (Council) instructs the valuer with the assessed value setting the price; or
    - The lessor and lessee could separately instruct their own valuers and attempt to negotiate/arbitrate on the price. There is a greater risk of an inferior outcome to Council under this approach and negotiations could stall and/or become expensive.

The following terms are not considered appropriate:

- Vendor funding / 'rent to own' package: Future councils would be left with a potentially undesirable and onerous financial commitment in perpetuity.
- Price set at a percentage of freehold value: This may lead to behaviours where, for example, lessees wait for the optimal time to transact, i.e. when the market value is greater than the predetermined percentage. This approach is taken with residential sites in some cases because it is easy for lessees to understand but it is not strictly rational.

Pros and cons of the options

Option	Pros	Cons
Fixed term offer to existing lessees.	• Capital realised quicker. • Doesn't bind future councils (but doesn't preclude future offers). • Ensures the 'call to action' is balanced with sufficient flexibility to arrange funding (debt and equity).	• Some lessees may not have the capacity to execute at this time. • Unlikely to work for residential/mixed use properties that require multiple owners to agree (i.e. bodies corporate).
Right to freehold is incorporated into the leases.	• Would improve the liquidity of lessee's interests. • Greater potential for uptake over time.	• Council could be 'drip-fed' capital in small amounts over time, making reinvestment difficult. • Exposed to market cycles (e.g. lessees may make offers when market is weak).

5.2.1. Residential / Mixed use versus balance

The process of freeholding the subdivided/strata-titled lessee's interests (i.e. multi-unit residential and mixed use properties) will likely be more challenging.

In these cases it is ultimately the body corporate that Council will be negotiating with, i.e. a single entity; however, the respective body corporates would first need to pass a special resolution requiring a minimum 75% vote in favour of freeholding.

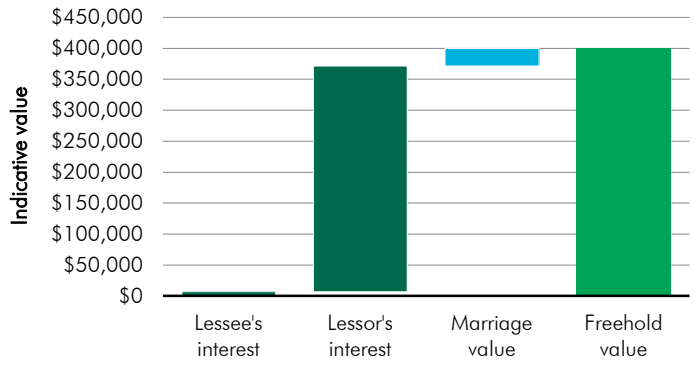
For this reason Council would need to be prepared to engage over potentially a number of years in order to (a) provide enough time for unit owners to arrange their finances (debt and equity) and (b) allow the body corporate to achieve the required level of lessee 'buy in' to pass the special resolution.

5.2.2. Market value

If Council offers the right to freehold it would need to continue to act commercially in the interest of ratepayers and any sale of the freehold should therefore be at market value (market value of the lessor's interest, as opposed to market land value).

That said, market value represents a good deal for lessees because freehold value typically exceeds the combined value of lessees' and lessors' interests, with the surplus referred to as 'marriage value'. The following chart illustrates how marriage value 'bridges' the gap, using 84 Thames Street as the basis of analysis.

Marriage value diagram – 84 Thames Street



Note that this analysis is high level and is undertaken for illustrative purposes only. It is not intended to provide an accurate representation of value.

5.2.3. Vendor funding package with fixed term offer

Ultimately, if Council elects to offer a funding package to lessees, the terms need to be at market, i.e. no more favourable to lessees than terms offered by the major banks. Where Council did offer a lower interest rate, for example, this is equivalent to discounting the sale price.

A 'market based' funding package may still assist with uptake because it removes one hurdle for lessees.

5.2.4. Engagement with banks

In order to ensure the support of local lenders it may be appropriate to engage directly with banks (relationship managers and credit) prior to making the freeholding offer, to demonstrate the merits of the proposal.

The 'marriage value' that exists when the lessees' and lessors' interests are combined presents considerable value for both the mortgagor and mortgagee. It is possible that many lessees that purchased prior to the GFC have negative equity and freeholding would likely enhance their position and significantly improve the lenders' security.

Council could also potentially establish general terms that banks would be willing to offer to lessees.

Having all stakeholders informed and 'on board' before formally commencing the process may help to mitigate some of the risks/uncertainties and ultimately improve uptake of the offer.

6. If Council elects to sell the freehold, what should it do with the proceeds?

Ultimately, if NCC elects to freehold all or part of the portfolio, it could then:

1. Reinvest the proceeds in alternative investments, having regard to investment policy, to continue to provide ongoing income and fund operations.
2. Invest the proceeds in other initiatives that may not generate a direct financial return, but may be deemed to provide economic return to the city/region, or to address social, cultural or environmental outcomes.

We firstly address NCC's current investment policy, and then address the benefits and advantages of continued ownership relative to each of these alternatives.

6.1. Current investment policy

Council's investment activities are guided by the Trustee Act of 1956 which highlights that, when acting as a trustee or investing money on behalf of others, trustees have a duty to invest prudently and that they shall exercise care, diligence and skill that a prudent person or business would exercise in managing the affairs of others.

6.1.1. Acquisition of new investments

With the exception of treasury investments, new investments are acquired if an opportunity arises and approval is given by the appropriate Council Committee, based on the advice and recommendation of relevant Council officers. Prior to making an investment Council gives due consideration to the contribution the investment will make in fulfilling Council's strategic objectives, and the financial risks of owning the investment.

6.1.2. Mix of Investments

Council maintains the following mix of investments.

Equity investments

Equity investments are held for various strategic, economic development and financial objectives, as outlined in the Long term Plan. Equity investments currently include interest in the Hawkes Bay Airport Authority and Omaranui Landfill Operation.

Property investments

Property investments are held only where it is necessary to achieve Council's strategic and commercial objectives, or where it is deemed to be a core Council function. At present, property investments include car parking, the leasehold portfolios and rental and retirement housing.

Treasury Investments

Council maintains treasury investments to manage loan redemption reserves, trusts, bequeaths and special funds as well as to invest surplus cash and working capital funds. Essentially, Council seeks to:

- Ensure investments are liquid.
- Maximise investment return.
- Manage potential capital losses due to interest rate movements.

The table below summarises the approved investments available to Council for the purposes of treasury management. Investment in corporate shares is expressly forbidden.

Counterparty limits

Issuers	Approved instruments	Minimum long-term & short-term credit rating (S&P)	Maximum per counterparty	Max % of total investment portfolio
NZ Government	Treasury bills, Government stock	N/A	Unlimited	100%
NZ Local Government Funding Agency	LGFA Fixed and Floating Rate Bonds, Promissory notes / Commercial paper, Borrower Notes	AA-/A-1	$40m	50%
NZD Registered Supranationals	Promissory Notes / Commercial Paper, Fixed and Floating Rate Bonds	AAA	$20m	30%
State Owned Enterprises	Promissory Notes / Commercial Paper, Fixed and Floating Rate Bonds	A+/A-1	$15m	20%
NZ Registered Banks *	Money market call deposits and term deposits, Registered Certificates of Deposit, Senior Bonds	A+/A-1	$30m or 40% of total portfolio (whichever is the lesser)	100%
Corporate Bonds *	Promissory Notes, Commercial Paper, Fixed and Floating Rate Senior Bonds	A+/A-1	$3m	20%
Local Authority	Fixed and Floating Rate Bonds and Stock, Commercial Paper	A+/A-1 (if rated) Unrated	$5m $3m	20%

* Note: An approved exception to the above is other treasury investments made with local registered banks that are regulated by the RBNZ having a credit rating of at least BBB. Such investments shall be limited to a term of 3 months or less and be for not more than $2 million in aggregate. At no time should the total exposure to this risk category be greater than 5% of the total investment portfolio.

6.2. Option 1: Reinvest the proceeds for financial return

If Council sells the freehold in all or part of the portfolio and elects to reinvest the proceeds for financial return, it is likely that the current investment policy would need to be reviewed in order to accommodate longer term investment alternatives.

If NCC wishes to consider redirecting or reallocating part, or all of, the existing investment portfolio, the key considerations are likely to be:

- Appetite for risk.
- Diversification.
- Management commitment/fees.
- Tax.
- Liquidity.

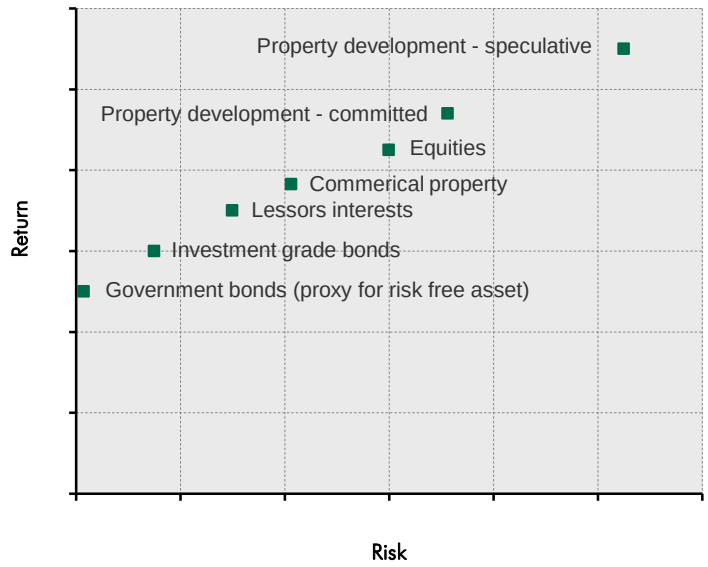
Ultimately, Council would require investment advice in this regard. However, to assist Council in its thinking, a conceptual comparison of alternative investment options is provided in Appendix II.

6.2.1. Risk and return expectations

The following chart provides a conceptual illustration of the relationship between return and risk for various investment classes. This illustrates that, as return expectations increase, expected risk (or volatility in return) also increases.

The chart also illustrates where a number of asset classes are typically considered to fit on the risk-return spectrum. For example, equity investments (shares) are typically regarded as being more risky than commercial property investment and investment grade bonds are typically regarded as being lower risk than commercial property. There will of course be exceptions; this is illustrative only.

Conceptual risk-return diagram



We have positioned an investment in lessors interests (similar to the portfolio held by NCC) between investment grade bonds and commercial property. There will be some bonds that exhibit more risk than NCCs portfolio (depending on their credit rating for example) and potentially some commercial property that could be regarded as lower risk, but in general, the chart provides some idea of where the current investment sits. The relative gap between each asset class (i.e. the scale of the axis) will also vary over time.

6.3. Option 2: Invest in other initiatives that may not provide a direct financial return

The second alternative available (relative to status quo) is to sell all or part of the investment portfolio and reinvest the proceeds in projects that do not generate a direct financial return for NCC, but have the potential to grow the rating base, for example.

The decision to allocate proceeds towards alternative initiatives to realise economic, social, cultural or environmental outcomes is ultimately a decision for Council, however we would note that:

- Once this decision is made, it is unlikely to be easily reversed, if at all, and when the funds are exhausted, clearly the options with that capital are at an end.
- The economic benefits associated with these projects would need to be critically evaluated on a case-by-case basis, relative to the costs, and projects should be subject to a separate business case.

6.3.1. Economic Development

Council is keen to improve economic activity in the region by supporting existing businesses, major regional events and regional business initiatives such as Business Hawke's Bay.

The Economic Development Manager is tasked with implementing a plan to attract businesses to Napier and would like to see greater funding of economic development initiatives.

Council produced a consultation for the Long Term Plan 2015-2025 that sought feedback on a proposal to fund $0.2 million per year for economic development initiatives and circa $0.1m funding for Business Hawke's Bay, in addition to existing budgets.

The Economic Development department's responsibilities include:

- Revising the Hawke's Bay Regional Economic Development Strategy.
- Developing a regional Business Attraction Strategy.
- Leading Napier and regional business promotion activities.
- Directing Council's financial assistance to key local and regional economic development organizations and initiatives such as Business Hawke's Bay, the Art Deco Trust and Napier City Business, Inc.
- Maintaining and enhancing the Council's sister city relationships.
- Facilitating business development, business start-ups and mentoring in collaboration through the various organisations in the Business Hub.

One option would be for any proceeds to be allocated to this department for reinvestment.

6.3.2. Development agency

Council has expressed an interest in understanding the merits of establishing a development agency for Napier, similar (albeit on a smaller scale) to Panuku Development Auckland.

Overview

Typically, development agencies are tasked with driving urban renewal in areas of a city that exhibit an underutilisation of land, have reached a point where comprehensive change in land use is required or where town centres require revitalisation, for example. In some cases development agencies start with a single focus e.g. Tamaki Redevelopment Company (TRC) or Auckland Waterfront Development Agency (AWDA), and then evolve into entities with wider regional mandates; this has been the experience in Australia and in effect describes the lifecycle of Panuku Development Auckland (which has evolved from AWDA and Auckland Council Property Limited).

Development agencies may also respond to particular market challenges. For example, among many factors driving the establishment of Panuku Development Auckland, the current housing supply shortage is one of the more high profile reasons.

Determining whether a development agency may have merit in Napier would require a full business case. However, before this occurs it would be necessary to identify reasons why one is required. The reason that public sector entities typically play a role in urban renewal via development agencies is because they can drive outcomes that the private sector may otherwise not deliver. This is because urban renewal projects are typically large, involve multiple stakeholders, exhibit complexity in a variety of ways and are long term in nature; all characteristics that make these projects more challenging for private sector capital.

Development agencies also typically seek financial, economic, social, and environmental outcomes. While it is beyond the scope of this report, we are not aware of any obvious candidate projects in Napier and as a first step, we would recommend that NCC seeks to identify potential projects and the outcomes sought in order to establish whether a development agency could have a meaningful impact. Relevant questions (by no means exhaustive) would include:

- Whether the project has scale.
- Whether the site or location is of regional importance.
- Whether the project has the potential to deliver meaningful social or economic benefits and is therefore more than a property development.

We also note that development agencies (or its council / government parent) will commonly own either large or strategically important blocks of land in the location and in some cases these assets derive an income that can be used to fund the entity's activities. Where a

development agency is required to acquire land for the purposes of urban renewal this gets much more challenging.

Finally, in order to be effective, a development agency will require investment in the form of operating funding and where there is limited scale (i.e. number and size of projects) the overhead cost associated with the entity would need to be carefully managed in order to ensure that the benefits outweigh the costs.

Challenges

Given the complexity of these projects, it is not uncommon for various stakeholders to have different agendas, which need to be managed carefully to ensure that conflicts result in better outcomes, not inaction. Ultimately, it is this complexity and these challenges that give rise to the need for development agencies.

In addition to navigating these complexities, a core component of a development agency's role is to engage with the private sector and, in our view, successful outcomes will rely heavily on the agency's ability to productively engage with this market.

Appendix I – Total and income returns calculations

Total return is the sum of capital growth and net income in a single period expressed as a percentage of capital employed, with income reinvested. The following formula is used to calculate Total Return (TRt) for a single year t:

$$TR_t = \frac{\left(CVt - \quad CV_{(t-1)} + I_t\right)}{CV_{(t-1)}}$$

Where:

- TRt = Total Return in year t;
- CVt = Capital Value (lessor's interest valuation) at the end of year t;
- It = Rental income during year t.

The following formula is used to calculate Income Return (IRt):

$$IR_t = \frac{I_t}{CV_{(t-1)}}$$

Appendix II – Alternative investment options

The table below provides a selection of potential investment alternatives and compares these, at a conceptual level, with the existing investment property portfolio.

Conceptual alternative investment options

Investment alternative	Complies with Council investment policy	Management Commitment/ Cost	Ability to benefit from Council tax exemption	Ability to diversify	Liquidity
Government bonds	✓	Nil	✓	n/a	↑
Commercial bonds	✓	Nil	✓	✓	↑
Term deposits	✓	Nil	✓	n/a	↑
Lessors interest portfolio located elsewhere in NZ	?	↑	✓	✓	↔
Commercial property in Napier	?	↑	✓	✓	↔
Commercial Property outside Napier (e.g. Auckland, Wellington)	?	↑	✓	✓	↔↑
Managed Fund	?	↑ (outsourced)	✗	✓	↑
Share portfolio	✗	↑ (outsourced)	✗	✓	↑

Legend

Symbol	Description
✓	Yes
✗	No
?	Not currently contemplated by Council Investment Policy
↑ or ↑	Higher than for Council's lessor's interest portfolio
↔	Same or similar to Council's lessor's interest portfolio
↓ or ↓	Lower than for Council's lessor's interest portfolio

CBRE

Risk and return considerations

The table below compares the risk and return associated with alternative investment options that may be available to Council. Again, the arrows compare the relevant alternative investment with the existing investment property portfolio, per the legend to the right.

Risk and return considerations

Investment alternative	Expected total return[4]	Expected income return[2]	Capital growth potential	Risk profile
Government bonds	↓	↑	Nil	↓
Commercial bonds	↑↓	↑	Nil	↑↓
Term deposits	↓	↔	Nil	↓
Lessors interest portfolio located elsewhere	↔	↔	↔	↔
Commercial property in Napier	↔↑	↑	↑	↑
Commercial Property outside Napier (e.g. Auckland, Wellington)	↑↓	↑	↔↑	↔↑
Managed Fund	↑	↑	↑↓	↑
Share portfolio	↑	↑↓	↑ (generally)	↑

Legend

Symbol	Description
✓	Yes
✗	No
↑ or ↑	Higher than for Council's lessor's interest portfolio
↔	Same or similar to Council's lessor's interest portfolio
↓ or ↓	Lower than for Council's lessor's interest portfolio

[4] Actual returns will inevitably vary from expected returns. Expected returns provide an indication of the return that would be expected, in the long run, from an investment of this nature, acknowledging the risk of the investment. As discussed, investments with higher expected returns typically exhibit higher expected risk and the probability that actual returns will vary from expected returns is therefore higher, as the expected return increases.

Appendix III – Map of NCC investment properties