APPENDIX 2:

Asset Criteria

Asset Criteria

Each property acquisition and development opportunity will be appraised by NHDC against the key qualitative and quantitative criteria detailed in Tables 1 – 9 below. Please note the criteria of Tables 2, 4, 5 and 6 do not apply to freehold acquisitions with vacant possession. Care is advised to ensure any decisions made based on the criteria are compatible with the Strategy's core goal and objectives.

Asset criterion	Category	Quality	Details
Location	Inside NHDC's district	Excellent	Underpins or enables any of NHDC's functions; **and** For benefit, improvement or development of NHDC's area. Acquisition or development secured **with** collaboration of NHDC and other local authorities.
	Outside NHDC's district	Very Good	Underpins or enables any of NHDC's functions; **or** For benefit, improvement or development of NHDC's area. Acquisition or development secured **with** collaboration of NHDC and other local authorities.
	Outside NHDC's district	Good	Underpins or enables any of NHDC's functions; **and** For benefit, improvement or development of NHDC's area. Acquisition or development secured **without** collaboration of NHDC and other local authorities.
	Outside NHDC's district	Acceptable	Underpins or enables any of NHDC's functions; **or** For benefit, improvement or development of NHDC's area. Acquisition or development secured **without** collaboration of NHDC and other local authorities.
	Outside NHDC's district	Marginal/Not Acceptable	Limited, deferred or no underpinning/enabling of any of NHDC's functions; **or** Limited, deferred or no benefit, improvement or development of NHDC's area. Acquisition or development secured **with or without** collaboration of NHDC and other local authorities.

Table 1: Location

Points to consider:

- Location and position will influence the strength and sustainability of underlying occupational demand for property.
- Highly accessible, highly prominent property well served by amenities and infrastructure and close to complementary properties will score higher against this asset criterion than property in more peripheral positions. The former should attract a stronger and more sustained occupier demand than the latter.

Asset criterion	Category	Quality	Details
Tenant Covenant	Single tenant with strong & resilient financial strength	Excellent	Tenant Covenant strength is appraised in terms of financial strength and resilience, and risk of business failure. Credit and Company Reports and, where appropriate, references will be utilised to assess Tenant Covenant.
	Single tenant with good & resilient financial strength	Very Good	
	Multiple tenants with strong & resilient financial strength	Good	
	Multiple tenants with good & resilient financial strength	Acceptable	
	Single/Multiple tenants with average or poor financial strength	Marginal/Not Acceptable	

Table 2: **Tenant Covenant**

Points to consider:

- Tenant Covenant will influence the security of rental income from property.

- A tenant with a strong and resilient financial strength should mean fewer rent defaults, fewer void periods and lower associated property holding costs. A strong covenant may also support the capital value of the asset and prospects for capital appreciation, for example an anchor tenant.

- To minimise management, single tenant assets will be prioritised over multiple tenanted ones.

- *Note:* Depending on the tenant mix and quality of tenant covenants, multiple tenanted assets may provide NHDC with a better hedge against tenant default and better protection of income streams, compared to single tenant assets. However, management of multiple tenanted assets is more intensive, costly and current resources prohibit the associated increased level of management. As NHDC's property portfolio expands, cost economies may permit investment in expanding manage resource so NHDC can enjoy the superior income security of multiple tenanted assets at no significant additional management cost to single tenant assets. At this point, it may be warranted for multiple tenanted assets to be prioritised above single tenant assets, and realign with the priority given by this Strategy to security of income of assets over management. NHDC should therefore keep Table 2's ordering of categories under review and be prepared to reprioritise.

- An element of tenant covenants operating in counter-cyclical markets should ideally be considered to maximise the robustness of the occupier base and resilience of rental income stream.

- In appraising tenant covenant, consideration of options available to call on tenant guarantors should be considered.

Asset criterion	Category	Quality	Details
Building Performance	Modern or recently refurbished with nominal capex required	Excellent	Building Performance is appraised on a building's exterior and interior quality, including structural fabric, services (such as mechanical & electrical) and energy performance (such as standard of insulation or efficiency of heating systems). All relevant surveys, including Energy Performance Certificates (EPCs), will be consulted to assess Building Performance.
	Good quality with capex not likely to be required until 20 years+	Very Good	
	Good quality with capex not likely to be required until 10 years+	Good	
	Good quality with capex not likely to be required until 5 years+	Acceptable	
	Low quality, older style or non-compliant, with capex likely to be required within the next 5 years	Marginal/Not Acceptable	

Table 3: Building Performance

Points to consider:

- Buildings requiring minimal capital expenditure will help limit service charges, and necessitate fewer occupier voids and occupier inconvenience whilst essential work is carried out.

- Buildings with modern specifications and flexibility and adaptability of construction and layout will be sought. Such buildings will facilitate future-proofing to allow them to respond to fluctuating market, economic and social trends, and to offset obsolescence.

- Sustainability and occupier wellbeing will also be considered under the umbrella of Building Performance as these factors are likely to increasingly influence an asset's performance over coming years.

- Ultimately better building performance helps sustain occupier demand by tapping into key changing social and economic factors, such as demographics and e-commerce growth. In turn, this helps secure long-term rental income and reduces capital expenditure.

- Buildings that perform better in terms of energy efficiency will also assist NHDC in pursuing green environmental and climate change policies.

Asset criterion	Category	Quality	Details
Lease: Repairing Obligation	FRI or effective FRI	Excellent	The nature of the lease repairing obligation will be ascertained by thoroughly reading the lease and any associated documents that may vary or supplement the lease, e.g. deeds of variation or licences.
	IRI – landlord costs 100% recoverable	Very Good	
	IRI – landlord costs partially recoverable	Good	
	IRI – landlord costs not recoverable	Acceptable	
	Landlord responsible	Marginal/Not Acceptable	

Table 4: Lease: Repairing Obligation

Points to consider:

- A Full Repairing & Insuring (FRI) lease places the responsibility for all external and internal maintenance, repairs, decorations and insurance of a property onto the tenant. Under an FRI lease, the landlord has no repairing or insuring liability. An effective FRI lease places the same responsibilities on the tenant but the landlord carries out the works (or commissions them) and is reimbursed for the costs via a service charge levied on the tenant.

- An Internal Repairing Insuring (IRI) lease is where the tenant is responsible only for internal maintenance, repairs, decorations and insurance confined to the internal parts of the property occupied by that tenant. Under an IRI lease, the landlord is responsible for maintenance, repairs, decorations and insurance for the exterior of a property, the structure and the common parts. The landlord's costs may be recoverable from the tenant through a service charge and the arrangements will be contained in the lease. IRI leases are normally granted where buildings are in multiple occupation.

- FRI leases or effective FRI leases will be prioritised over leases that narrow the tenant's repairing obligation.

Asset criterion	Category	Quality	Details
Lease: Rent Review Mechanism	Upwards only, open market, uncapped, short hypothetical term of 5 years or less	Excellent	The nature of the lease rent review mechanism and clause(s) will be ascertained by thoroughly reading the lease and any associated documents that may vary or supplement the lease, e.g. deeds of variation or licences.
	Upwards only, open market, uncapped, hypothetical term of 5 – 7 years	Very Good	
	Upwards only, Retail (or Consumer) Price Index (RPI/CPI) linked, uncapped	Good	
	Upwards only, open market, capped, short hypothetical term of 5 years or less or Upwards only, Retail (or Consumer) Price Index (RPI/CPI) linked, capped	Acceptable	
	Upwards and downwards, open market, uncapped but collared, hypothetical term of 7 years or less	Marginal/Not Acceptable	

Table 5: Lease: Rent Review Mechanism

Points to consider:

- Assets subject to leases allowing maximum rental growth potential in line with open market growth and inflation will be favoured over those which constrain rental income growth.

- All leases should be thoroughly read before acquiring an asset, with particular focus on:

    - The hypothetical term to be assumed by lease rent review clauses. Hypothetical terms should ideally mirror the lease length demanded by the current tenant market for each property.

    - The assumptions and disregards contained in the rent review clauses. For example, if a clause assumes the property can only be used for a narrow range of uses, or disregards the buildings on the site, this is likely to suppress the rental income growth achievable at rent reviews. Such detail may also suppress the capital value of the property realisable on disposal.

Asset criterion	Category	Quality	Details
Lease: Length of Occupational Lease	20 years+	Excellent	The length of occupational lease will determine the longevity of rental income stream. Generally, the longer the term, the more secure the asset.
	Between 15 and 20 years	Very Good	
	Between 10 and 15 years	Good	
	Between 5 and 10 years	Acceptable	
	Less than 5 years or vacant	Marginal/Not Acceptable	

Table 6: Lease: Length of Occupational Lease

Points to consider:

- Assets subject to long occupational leases will be favoured by NHDC as they provide stable income over a sustained period of time to help match the long-term ongoing costs of NHDC in fulfilling its functions and providing frontline services.

- Such assets are sought after by institutional investors to match their long-term obligations to provide pension and insurance funds. Demand for these assets will therefore be intense, particularly as the availability of long-term property investment opportunities in the current property market is reducing.

- Care will need to be taken to investigate whether occupational leases contain tenant break options and the conditions for exercising those options. It is now commonplace in the current market for tenants to require breaks after 3 years or fewer years.

- Security of tenure can increase the appeal of shorter leases to property buyers. This is because, depending on market conditions, such security can command higher rents from tenants.

- However, security of tenure can be less appealing for property buyers where they intend to redevelop, convert, asset manage or otherwise materially alter a property, for example to increase rental income and/or capital value. Sitting tenants may present obstacles to those intentions being implemented. The Landlord and Tenant Act 1954, Part II, and associated case law, requires landlords to meet certain conditions before being able to terminate leases of tenants with security of tenure. Meeting such conditions and lease termination cannot be guaranteed and will involve expense and delay before landlords can implement their intentions for the property.

Asset criterion	**Category**	**Quality**	**Details**
Tenure	Freehold	Excellent	Freehold promotes liquidity, safety of recouping money spent on the asset, and the strength of the asset as security for borrowing. Generally, leaseholds below 80 – 90 years offer less good security for borrowing funds and are less easily assignable/marketable (poorer liquidity) than a long leasehold or freehold interest.
	Long Leasehold of 125 years+	Very Good	
	Leasehold between 100 and 125 years	Good	
	Leasehold between 50 and 100 years	Acceptable	
	Leasehold less than 50 years	Marginal/Not Acceptable	

Table 7: Tenure

Points to consider:

- Property generally appreciates in capital value over the long-term. Acquisitions of freehold, virtual freeholds or long leaseholds will help NHDC benefit from the upturns in the property/economic cycle to compensate for the downturns, and thereby help sustain its functions.

- Purchase of freeholds of properties that are mission-critical to tenants, followed by leasing back to those tenants (sale & leaseback by the tenant), should be given greater consideration for NHDC's portfolio to support the defensive nature of the portfolio's balance.

- Acquisitions should be investigated for any ground rent or other outgoings for which NHDC may be responsible following acquisition.

- If NHDC is taking on an assignment of an existing leasehold interest, the ground rent review clause may have been devised several years ago and lack clarity or commercial business sense in the modern market. Such clauses can be a source of costly and time-consuming disputes. This point should be investigated by legal advisers prior to acquisition.

- The ability to assign and sub-let leasehold interests should be investigated by legal advisers prior to acquisition. Ideally, the ability should be unfettered, i.e. assignment and sub-letting should not be subject to NHDC first having to satisfy pre-conditions or penalties, which could be costly, onerous or incur delay for NHDC. Whilst Landlord and Tenant legislation legislates against unreasonable pre-conditions and penalties, the matter still requires investigating to reduce the chances of encountering disputes.

- Similar comments apply to investigating leasehold interests for the ability to implement change of use and to apply for planning permission.

- Consider the implications of the recently introduced leases standard under International Financial Reporting Standard 16 (IFRS 16). IFRS 16 requires lessees to bring most leases onto the balance sheet from 2019.

Asset criterion	Category	Quality	Details
Lot Size	Between £3 million and £5 million	Excellent	Single acquisitions in the range of £3 million to £5 million are prudent. They will promote a proportional and balanced diversity of capital outlay spread, security of capital, and help limit management costs.
	Between £2 million and £3 million or £5 million and £7 million	Very Good	
	Between £1 million and £2 million or £7 million and £10 million	Good	
	Between £0.5 million and £1 million or £10 million and £15 million	Acceptable	
	Less than £0.5 million or Greater than £15 million	Marginal/Not Acceptable	

Table 8: Lot Size

Points to consider:

- Spending significant funds in a single high value lot carries the potential opportunity cost of preventing the pursuance of a wider range of other assets.

- Conversely, spending smaller funds in numerous smaller value lots may give rise to onerous management issues and costs.

- A balanced risk acquisition and development strategy is likely to be achieved by acquiring several lots priced at between £3 million and £5 million. Spending on this lot size will help avoid the more crowded segments of the property market, with the lower segment targeted by private wealthy individuals, and the higher segment targeted by institutional investors.

- Conflict may arise between the priority Lot Size and the requirement for a proportional property portfolio, both outlined by this Strategy. For example, acquiring an office Lot in the ideal range of £3 million and £5 million may result in a disproportional share of the portfolio being represented by the offices sector. This may create an over-reliance on the offices sector, exposing NHDC to too much risk. Lot Size should therefore not be considered in isolation; it should be considered in the context of the effect on proportionality of portfolio.

Asset criterion	Category	Quality	Details
Net Minimum Return	6.00% to 12%	Excellent	A net minimum return of 1.50% per annum above financing costs (interest and Minimum Revenue Provision) is NHDC's target net minimum rate of return. Assets producing a net minimum return of below 1.50% per annum will need to demonstrate other benefits to NHDC if they are to be considered further, e.g. supporting regeneration of towns within NHDC's district. Assets producing a net minimum return of above 12% will need to demonstrate benefits to NHDC to be considered further.
	5.00% to 5.99%	Very Good	
	3.00% to 4.99%	Good	
	1.50% to 2.99%	Acceptable	
	Less than 1.50% or Above 12%	Marginal/Not Acceptable	

Table 9: Net Minimum Return

Points to consider:

- Net Minimum Return is based on the asset income received and projected less the associated costs. Income can factor in rent concessions, for example rent-free periods. Associated costs include acquisition costs such as Stamp Duty Land Tax and professional fees, the cost of borrowing (where appropriate) and the Minimum Revenue Provision (MRP) regulatory requirements. The net figure (income received minus costs) as a proportion of the capital sum initially spent indicates the return.

- The return reflects the quality of an asset as determined by its location, tenant covenant, building performance, lease terms (including repair responsibility, rent review mechanism and length), tenure and property type/market. Generally, the lower the return, the higher the quality of an asset. In turn, a lower return indicates greater security of capital, greater security of income/growth prospects, better liquidity and easier/lower cost management of that asset.

- NHDC should carefully consider and question the rationale of property opportunities that produce a net minimum return of below 1.5%.

- Assets yielding a net minimum return of above 12% indicate that the security or payback of NHDC's capital outlay on that asset may be at risk. Such acquisitions will only be accepted by NHDC if they stand up to rigorous appraisal.

- Not all properties produce a fixed rental income. Some are subject to turnover rent leases. These often (but not always) comprise a fixed base rent as a percentage of market rental value (commonly 80%) and an additional rent linked to the tenant's turnover (over a period). The turnover rent is rarely guaranteed because it depends on the tenant achieving certain thresholds of turnover. The turnover rent will be subject to change as it will be influenced by a wide range of factors, such as the performance of the market in which the tenant operates. Further, obtaining a full, accurate and verifiable record of a tenant's turnover may be difficult. Further still, disputes may arise between landlord and tenant, especially if the lease is not explicit or contains ambiguity as to how the turnover rent is defined or the triggers for its implementation.

- Turnover rent leases could therefore expose NHDC to uncertainty of income stream and be management intensive. Being a function of income level and security, yield can be significantly influenced by turnover rent leases. In appraising the net minimum return of a property opportunity that is subject to a turnover rent lease, NHDC must bear in mind that the return applicable at purchase may not give a reliable indication of the asset's long-term quality. Such properties are particularly vulnerable to returns changing in a short space of time. The income uncertainty and management cost need factoring in to the return assessment.

- In assessing return or the purchase price to pay for properties that are subject to turnover rent leases, NHDC could adopt several approaches. For example, erring on the side of caution, NHDC may disregard the turnover element and solely consider the base rent. Alternatively, NHDC may take a more risky approach by assuming or forecasting an average turnover rent achievable, perhaps based on past turnover trends achieved by the tenant. The assessment must be adapted on a case-by-case basis. It will depend on factors specific to each property, particularly tenant covenant.

- In assessing return or purchase price, consideration should also be made to other factors affecting income security and growth prospects. Examples are tenant break clauses and rent concessions, such as rent-free periods.