

Sovereign Public Sector Property Fund: Building a Conceptual Framework

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ABSTRACT

The public sector is the largest UK landowner and space occupier with local authorities owning and managing the majority of the real estate assets to meet services to the community. As central funding of these services reduce and the knowledge economy is changing the way we live, local governments are looking at more efficient and effective ways of managing their real estate operations and creating investment value to bridge the gap between funding shortfalls and the demand for public services. Several local authorities are now investing in commercial properties as a way to generate long-term stable income streams although current practices are highlighting narrow portfolio diversification, management challenges, fee leakage and limited awareness of the knowledge economy on future real estate returns.

This research paper examines the issues and provides a conceptual framework for a Sovereign Public Sector Property Fund which can create local level opportunities alongside a stable long term income stream. This can be achieved through a pooling of prime local government real estate assets to offer portfolio diversification with quality management, good governance, local authority appointed steering committee members and exposure to opportunities to benefit from aspects of the knowledge economy. Supported by central government, individual real estate assets in a Sovereign Public Sector Property Fund can provide a local destination with placemaking potential in the post COVID-19 era. Strengthening the connection between people and place, the real estate in the fund can be the catalyst for local employment opportunities and support surrounding communities. This exploratory study covers an important part of the UK economy and offers a valuable insight into creating a new real estate investment vehicle which can elevate the often underutilised prime local authority real estate assets.

Keywords: *Public Sector Real Estate, Local Authorities, Portfolio Diversification Strategies, Sovereign Wealth Funds, Flexible Space Market, Property Asset Management, Unlisted Property Funds.*

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1. INTRODUCTION

In the past, public sector real estate was a simple, straightforward bricks and mortar asset which aimed to provide quality accommodation to meet central and local government requirements. Often the premise-by-premise tactical approach utilised prime real estate space which over time created serious inefficiencies across the sector. Since the early 1980s, a trail of government reports have highlighted the shortcomings of the public sector real estate market in reporting chronic problems of ‘abandoned’, under-used and surplus accommodation (White 2011).

In recognising the past issues with public sector real estate, prominent reports (arranged in chronological date order; Audit Commission 2000, Lyons 2004, Green 2010, National Audit Office 2012, Audit Commission 2014) have all highlighted systemic failures and suggested pathways to develop public sector real estate assets. More recently, the Cabinet Office (2019) linked improved public sector real estate performance metrics to selective facility and asset measurements with reference to recognised private sector standards. In highlighting comparable evidence, sections of the public sector traditionally operate on a different operational platform, particularly at a local level, where real estate premises can form part of important services to the community. In detailing this, managing public real estate as a business function can lower costs, build value and in an operational context, support commercial space occupiers which can be captured to generate revenue in a real estate context.

The different applications for public sector real estate space is shown in Table 1.

Table 1 **Local Authority Real Estate Universe**

Community Resources		Investment Assets
	←-----→	
Utilities	Land	Offices
Social Housing	Leisure	Industrial
Age care	Community Centres	Shopping Centres
Schools	High Street Premises	Hotels
Childcare	Medial Centres	Carparks
Ground Leases	Outdoor Advertising	
Crematoriums		

Table 1 highlights the real estate categories that can form part of the local authority property portfolio. Community property assets often have unique building and operational features which require corporate property management skills, and a social enterprise value that can form an important part of the community hub and be a possible investment catalyst. Knowledge about customers and their destinations, alongside occupier relationships, is increasingly becoming important real estate tool both now and even more in the future.

Local governments face intense funding pressures, with central governments cuts, to deliver social services to a population which is growing and ageing concurrently. With these challenges, local government’s emphasis is on supporting public services whilst maintaining and improving current revenue streams and exploring new income opportunities. This approach requires a significant makeover of local government operations as to the services they deliver alongside a better understanding of their capital resources, both community and investment assets that include real estate.

On top of understanding current real estate challenges to the public sector, the real estate landscape is changing rapidly with the emergence of the knowledge (gig) economy. Increasingly, real estate and the knowledge economy are interconnected and will shape future markets. These elements need to be understood and managed to develop real estate assets offering ongoing stable returns.

Table 2 details emerging drivers impacting real estate markets.

Table 2 Emerging Drivers of Real Estate Markets

Title	Details
Technology Advances	- Known as the fourth industrial revolution, new innovations and rapid applications provide opportunities driven by digital connectivity, internet of things (IoT), artificial intelligence (AI), augmented reality, robots and machine learning across all sectors of the economy.
Globalisation	- Increased economic interdependence of national economies created by cross-border movement of people, capital and products offering inter-connected global networks with access to world markets.
Environmental Concerns	- Greenhouse gas emissions has led to changes in global and regional climate patterns (climate change). Need to protect species diversity and ecosystems and avoid excess pollution leading to a shift to renewable resources.
Urban Form	- Smart cities providing social sustainability: the role of density and housing type to offer coherent neighbourhood morphology (open spaces, buildings) with functions (human activity). Evidence shown with new local co-working environments.
Strategic Resources	- Management of people, products and processes providing improved supply chains offerings with controls on product quality, inventory levels, timing, and expenses - just in time strategies.
Emergency Preparedness	- Extreme risk events: Increasingly irregular large scale natural and manmade global shocks (superstorms, tsunamis, pandemics (covid19) and acts of terrorism etc), creating a need for sophisticated disaster planning and management strategies.

Table 2 identifies megatrends impacting society and the economy which flows into real estate decisions. Combined they offer a complicated relationship, primarily customer focused, which requires real estate owners to adapt to meet new occupier demands ideally within a placemaking environment. To manage these major changes, centralised strategies can provide the best solutions to deliver real estate that meets occupier requirements and improve investment returns.

The challenge in the public sector is to create a sustainable real estate model that provides synergies at a local level which can benefit the public sector’s increased focus on real estate as an investment asset. This can be achieved through pooling of local government prime real estate assets and offering quality management, portfolio diversification, good governance and

exposure to opportunities to benefit from aspects of the knowledge economy. A Sovereign Public Sector Property Fund can provide the answers; a combination of pooled (unlisted) property fund features in a sovereign investor framework.

In exploring the concept of a ‘Sovereign Public Sector Property Fund’, this study provides sections on i) local authorities and the management of the real estate assets, ii) concept of Sovereign Wealth Funds, iii) unlisted property fund features and iv) how a sovereign public sector property fund would work. The last section provided concluding comments.

2. LOCAL AUTHORITY PROPERTY MANAGEMENT

Real estate is a significant part of the UK economy, with the government being the largest landowner and tenant with real estate assets (including land) of approximately of £406 billion. On past evidence, just below two-thirds is held by local government, whilst the remainder is held by central government and public corporations (HM Treasury 2009, Lansley *et al* 2018).

The structure of local government is complex, with the distribution of functions varying according to legislative and historical arrangements. In England, outside of London, there is commonly a two-tier structure in local government functions, divided in most cases between county and district councils (local governments). It is these local government entities that primarily collect council rates and provide many community services.

The challenge for local government is that since 2010-11 funding has fallen whilst they need to maintain acceptable levels of community services. Increasingly, they have sought to offset funding reductions by more efficient and effective ways of managing their operations and assets. For many local authorities, a key consideration is the management of the real estate assets alongside the opportunity to enhance income with a rapid expansion in the acquisition of prime commercial properties, often funded by central government borrowing. (National Audit Office 2020, RICS 2019).

Naturally, the composition and size of local authorities’ property portfolios can vary depending on population and location. Historically, the level of individual property knowledge and performance data in local authorities is limited and often unreliable. Whilst major local authorities, like Birmingham City Council, have reported a portfolio which covers 5,500 property interests and generates £32 million per year (Avison Young 2020). For many local authorities, the extent of performance information on their property portfolio is sketchy at best. This can lead to underutilised, poorly managed real estate with limited opportunities for local authorities to make sound commercial decisions.

For a snapshot of a typical local authority property portfolio, the following is an overview of a recently reviewed undisclosed local authority, see Table 3.

Table 3

Typical Local Authority Real Estate Portfolio

Asset Groups	n/a	< £0.5m	£0.5-£1m	£1-£5m	£5-£10m	£10-20m	£20m+
Core Property							
Offices (inc.libraries)	5	7	3	9	1	0	2
Non Core Property							
Community centres and Nurseries	6	11	5	3	0	0	1
Education	68	88	5	28	20	1	0
Specialist residential	6	15	5	5	1	0	0
Land							
Green space	19	13	6	2	0	0	0
Smallholdings	14	80	0	0	0	0	0
Redevelopment and void	3	8	9	3	0	0	0
Alternatives							
Infrastructure, waste, depots	43	23	2	1	1	0	0

Notes

- Specialist residential - covering nursing homes, children's homes etc
- Most schools are academies on long leases (valued at £1).
- Community Centre above £20m is a new Urban Learning Centre

Table 3 shows a regional local authority real estate portfolio, comprising 522 property assets with an approximate value of £478 million. Managing the property portfolio must be a challenge, with opaque information on 30% of the properties and those which are valued, over 65% of the properties are below £5m with non-core representing close to 70% of the portfolio. In the current cost conscious operating environment, the complexity of scale and the different classes of commercial real estate would test many local authorities, as they opt to provide cost savings with low level management service to overview social amenities on a day to day basis. Interestingly, whilst the diverse portfolio is overweighted towards providing space for community services, the value of the two core prime located properties are above £20m and represent more than 10% of the property portfolio value. This rises to 23% when excluding the Education property portfolio as many are managed by the Department of Education and School Boards.

The challenge for the local authority is to support the provision of community services within a fit for purpose real estate framework which provides value add to those income generating properties which form current and future investment grade assets. In part, this can be achieved by a proactive approach to provide a destination, blending traditional operations with features of the emerging knowledge economy. This would require active specialist property management covering asset and business operational expertise which can be provided by property consultants at a significant cost.

Looking beyond the RICS (2012) and CIPFA Property (2018) guidelines for public sector property asset management, the changes in managing UK corporate real estate is described in-depth by Haynes et al (2017) and within the public sector by Ngwira and Manase (2016). Both highlighted the requirement for improved property planning with a well-documented focus on connecting strategic asset management decision making within a performance framework. For local authorities, measuring efficiency and effectiveness of their real estate is hampered by limited base data. This can lead to poor internal procurement procedures, bad data management and inadequate real estate management. As many local authorities are focused on costs, the property management team may not have the time, knowledge, and tools to effectively manage and improve the performance of their prime properties; especially the investment assets that could benefit from hands-on customer focused space managers.

In separating the community and investment assets, a separate internally managed entity can deliver on actively improving the value of prime local authority real estate assets with highly experienced motivated property professionals. This "in-house" management model can

improve corporate governance, avoid conflicts of interest with outsourcing tasks and reduce the considerable current fee leakage.

At another level, as central government funding decreases, local authorities have started to invest in commercial properties as a way to generate a long-term income stream. The attractiveness of the strategy was enhanced by subsidised central government loans available from the Public Works Loan Board with a low interest rate of around 2.5 to 3%. In part, the past four years of this scheme has led to over £6.6 billion being invested in investment grade commercial property by a group of local authorities for local regeneration and investment purposes (National Audit Office 2020).

As an investment option, a well-constructed commercial property portfolio can provide a stable income stream. However with all investments there are risks, more so with commercial property with the large concentration of value, high transaction costs, requirement for quality active management and exposure to changing landscape driven by the knowledge economy. Recent local authority property purchases (for example; shopping centres and single tenanted properties) have highlighted the challenges to achieving long term benefits of the current real estate strategy. As RICS (2019) noted “... *councils are buying into future business models and market dynamics of the occupier as much as – if not more than – into the bricks and mortar*”.

For an investment property portfolio, locational spread, mix of tenants and property types are essential. This is a challenge for individual local authorities to achieve portfolio density and so limit the impact of unsystematic (specific) risks, whilst focusing on the needs of active management on the operation of their own extensive property assets. A Sovereign Public Sector Property Fund can address this, as to offer a central government-backed collective portfolio strategy providing performance diversification with a business operational platform that enhances the performance of the occupied space, property and the surrounding community. A Sovereign Public Sector Property Fund real estate asset in a local authority location can be attractive as a destination for the community, offer employment opportunities and contribute both to direct and indirect council taxes.

3. SOVEREIGN WEALTH FUNDS

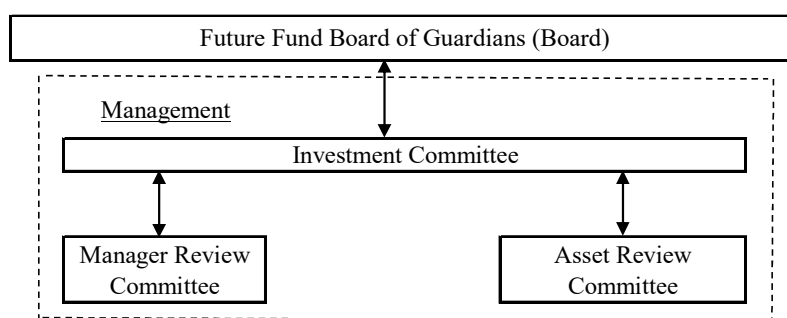
To explore the Sovereign Public Sector Property Fund concept, an understanding of the origin, and structure of Sovereign Wealth Funds is required. In various forms, Sovereign Wealth Funds have existed for decades. More recently, their popularity has increased significantly, currently there are more than 89 Sovereign Wealth Funds with accumulated assets amounting to nearly US\$8.5 trillion. Noticeably, the top 10 Sovereign Wealth Funds control 80% of the total asset under management, with Norway ‘Government Pension Fund – Global’, the largest (US\$1.2 trillion), and Chinese and Singapore entities controlling six of the ten largest Sovereign Wealth Funds (SWFI 2020).

The traditional Sovereign Wealth Fund model provides central governments with the opportunity to capture excess public revenues (for example: resource royalties, budgetary surpluses, sale of state-owned properties or business etc) and deliver steady future cash flows based around long term investments. The success of a sovereign wealth fund is associated with government policies and operational considerations. This interaction between a sovereign wealth fund and the government is important, with legislation to establish an independent board. There is evidence that where governance and public disclosure is limited, it can lead to financial pressures and misguided investments (Bernstein *et al* 2012).

As sovereign wealth funds emerge as global investors, there is increased interest with investment strategies assisted by gradual policy improvement covering aspects of transparency. Similar to pension funds, sovereign wealth funds look to invest across a range of asset classes with in-house and external managers. To improve returns, they are coming more proactive and sophisticated with joint ventures and co-investment vehicles alongside focusing on direct investments rather than delegate the management of their assets to fund managers. This trend is similar in real estate, with internal asset management strategies offering active risk adjusted investment returns from dedicated in-house real estate teams. This can lead to a more operational and customer orientated approach to open up opportunities within the evolving technology driven real estate landscape (Alsweilem et al 2015, PWC 2020).

In addition to establishing a sound investment approach, Sovereign Wealth Fund success depends on issues of implementation; notably the government engagement with the fund. A good insight to detailing the organisational structure and lines of responsibilities is provided by the Australian Future Fund - see Figure 1.

Figure 1 **Australian Future Fund Investment Decision-making Structure**



Source: Future Fund 2018

Figure 1 details the Australian Future Fund reporting structure, which is supported by an investment mandate with defined performance criteria. There is a detailed narrative on debt funding, and environment, social and governance (ESG) considerations, alongside managing liquidity, operational, counterparty and reputational risk. Analytical investment decision making includes key return benchmarks; CPI + 4% to 5% per annum over the long term (rolling 10 years) and a primary short-term risk measure of a conditional value-at-risk return over 3 years representing an average return measure for a 1 in 20 downside event (Future Fund 2018).

The Australian Future Fund provides a good example of a successful sovereign wealth fund, with current funds under management of AU\$162 billion, providing an impressive 10-year return of 9.2% per annum; exceeding the benchmark target for that period of 6.4% per annum. In providing an overview of their organisational structure and investment mandate, the outlined performance criteria can provide a model with unlisted property fund operational features for a Sovereign Public Sector Property Fund.

4. UNLISTED PROPERTY FUNDS

Unlisted property funds are an established UK property investment product with a £65 billion property portfolio value (MSCI/AREF 2020). It is attractive to institutional investors as a long term investment with access to the private property equity market without requiring extensive time input and property management experience. Unlisted property funds offer the following benefits:

- i. Access to experienced property fund managers
- ii. Diversification across diversified and sector specific property funds
- iii. Performance aligned with the underlying property assets
- iv. Investor representation on management steering committees
- v. Debt funding opportunities
- vi. Access to quality properties which are seldom available on the open market
- vii. Alignment with the appointed fund manager for development opportunities etc

Source: Higgins 2010

Unlisted property funds benefit from many features associated with owning real estate and offers relatively high returns; 7.7% per annum over the past 10 year period (MSCI/AREF 2020). To manage the pool capital, unlisted property funds often incorporate a management steering committee with appointed investor representatives. This can assist in enhancing the alignment of investors and managers' interests.

Debt funding can also form part of an unlisted property fund investment strategy as by combining equity and debt there is an opportunity for investors to increase the value of their property investment exposure and possible returns. In detailing the benefits of debt, the performance of a leveraged property investment can distort the risk and return profile of the underlying property portfolio. To avoid this, institutional unlisted property funds with a passive investment profile, generally kept the leverage below 20% gearing long term.

Unlike public equity, with shares traded on the stock market, unlisted entities depend on a secondary market. Many managers offer redemption schemes, with the prices of these unlisted investment vehicles calculated using the appraisal valuation method with a buy and sell premium structure around the property fund net asset value. The exit mechanism can be based on the size of redemption with property disposals as part of the process.

5. SOVEREIGN PUBLIC SECTOR PROPERTY FUND

The design of a Sovereign Public Sector Property Fund is centred on structure and operations as this can provide an insight into the benefits that can be achieved in pooling prime public sector real estate assets.

Structure

Management of a Sovereign Public Sector Property Fund is critical. Like Sovereign Wealth Funds, good governance can be achieved by detailed policies and an independent board with a clear set of aims and objectives to cover social, economic and financial considerations. In covering the financial aspects, specific real estate objectives can add value to the local community, offering quality places that meet the placemaking concept to improve the local environment. Establishing a blueprint of best practice can detail the role of management with investment and ethical (including ESG) guidelines alongside accountability and transparency.

Those local authorities providing real estate assets that meet Sovereign Public Sector Property Fund criteria, can receive units based on market value. Like a trust structure, net income revenue generated across the diversified property portfolio will be regularly distributed to the local authorities. As part of the management structure, an independently chaired, investment steering committee will offer local authority representatives opportunities to be part of the

Sovereign Public Sector Property Fund decision making process. In addition, like an unlisted property fund, units can be traded between local authorities plus the Sovereign Public Sector Property Fund can offer a redemption scheme based on appraisal values with defined buy and sell premiums.

With guidelines, central government can offer attractive debt facilities to meet the requirements of the Sovereign Public Sector Property Fund alongside private debt providers. This can assist performance by increasing property portfolio diversification and provide capital for refurbishment and development opportunities that meet the fund's objectives.

Figure 2 details the proposed structure of a Sovereign Public Sector Property Fund.

Figure 2

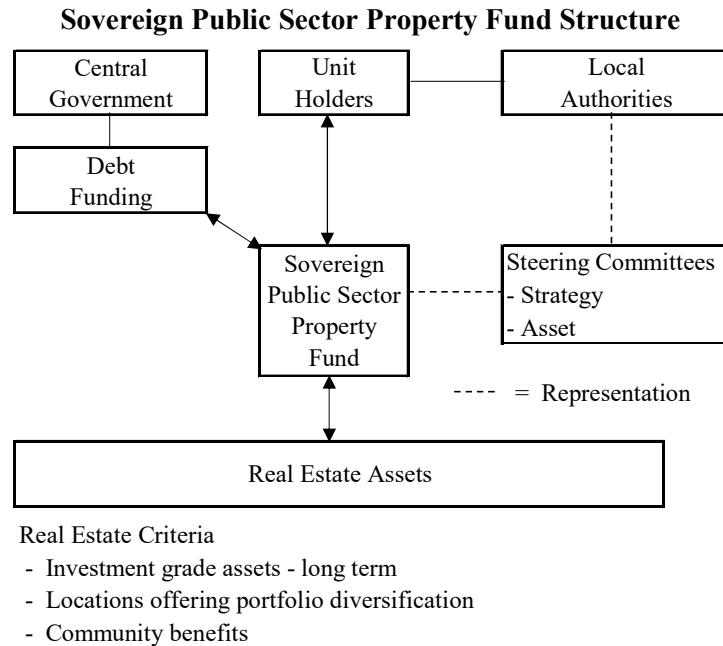


Figure 2 shows the outline constituents that can form a Sovereign Public Sector Property Fund. Aligning the interests of the Sovereign Public Sector Property Fund stakeholders can provide local authorities with the opportunity to invest in diversified long-term, sustainable income streams with local community benefits. In a competitive investment environment, the flat internal management structure offers synergies alongside value adding opportunities. The profits are distributed to the local authority unitholders and avoids revenue leakage to external entities.

Operation

The operation of a Sovereign Public Sector Property Fund can be separated with real estate assets and the business entity. This can highlight the value of the operational platform to embrace the knowledge economy within a real estate perspective – see Figure 3.

Figure 3

Sovereign Public Sector Property Fund Operational Structure

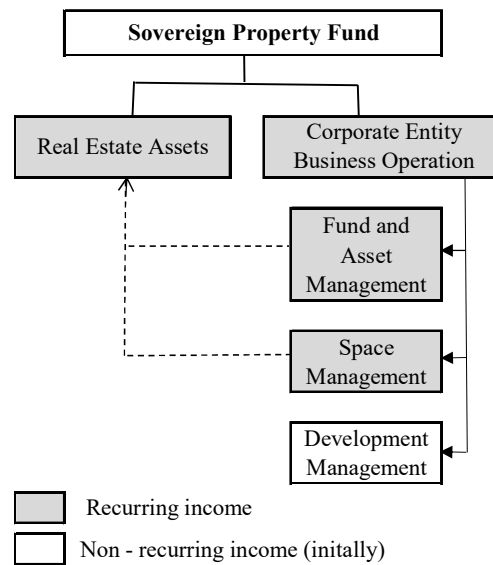


Figure 3 illustrates the management operations with defined business units for a sovereign public sector property fund. Whilst the fund management and asset management roles are well documented – fund strategy, portfolio development and property management (see Baum 2015), space management is an emerging area where proactive ‘hands on’ skills can create value for the fund. This is most evident in the co-working space, where a reported uplift in net rent premiums of 48% was achieved by a major property owner (Evans 2019).

In addition, a Sovereign Public Sector Property Fund could consider refurbishment and development schemes as many local authorities have limited available capital funds for this type of building work. On completion, viable property refurbishment and development opportunities can provide valuable additions to the stable income streams offered by a diversified sovereign public sector property portfolio. The building costs can form part of the government and private debt funding arrangements, to maintain short term property income streams for the Sovereign Public Sector Property Fund until the projects are completed and operational.

For local authorities, apart from the investment income stream, the value of the Sovereign Public Sector Property Fund is how the physical real estate in their location can benefit the community. This is the business operation, where space, for example, can provide an attractive local co-working environment and is linked to community amenities. The interaction provides knowledge sharing and opportunities, especially across the small to medium enterprises (SME) which comprise and increasing 54% of the UK workforce (European Commission 2018).

Furthermore, as the knowledge economy changes the work environment, central government recognise SMEs are the backbone of the economy and require space and seed funding to boost productivity, business expansion and increase impact. Substantial central and regional government funding arrangements are available to support local businesses. Access to these opportunities and flexible space arrangements can be initiated by a division of the Sovereign Public Sector Property Fund space management team.

Space management is becoming a critical consideration in real estate operations, with property owners providing a great degree of service provisions in a coworking environment. The flexible space market is attracted to prime locations with premium occupancy costs as they can offer high occupancy densities and intangible benefits covered in service fees. The

emergence of the flexible space market is a permanent change in owner-occupier relations as businesses embrace the opportunities created by the knowledge economy (Harris 2020).

As previously discussed, local authorities provide services across the community with an extensive managed property portfolio. In many instances past location decisions were made independently and may not reflect synergies across provided services. Increasingly, prime urban locality of defined community services can offer value with the emergence of the knowledge economy as creating leverage to the performance of a real estate investment asset – see Figure 4.

Figure 4 **Community and Investment Properties Performance Channels**

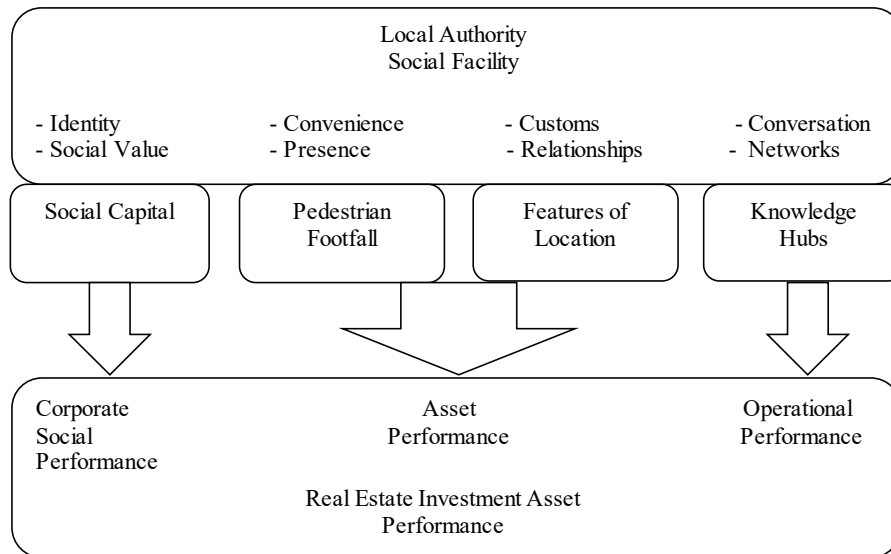


Figure 4 illustrates the engagement opportunities that community service location can offer to the surrounding businesses, as reaching out and interacting with the audience can provide new customers and overtime destination loyalty. The relationship with society can be identified and channelled to create value outside the traditional social context. Importantly, the interaction looks beyond the physical connection to new dimensions driven in part by changing generations and new work patterns supported by advancements in digital technology. Providing the platform, real estate hubs can capture the space value and provide an investment opportunity. This requires new business operational skills for many in the real estate sector, which a Sovereign Public Sector Property Fund could offer.

5. CONCLUSION

The public sector has a long complicated relationship with real estate. In highlighting past challenges, the real estate landscape is rapidly changing, principally driven by the emerging knowledge economy which offers space occupiers new operating practices. This places considerable pressure on the public sector to adapt and meet this demand led environment. This is particularly evident at a local government level, with large public sector real estate portfolios based around a community services policy agenda.

Increasingly, local government is looking at their real estate assets as a funding stream to bridge the gap between the demand for public services and central government funding cuts. This is now supported by some local government actively buying prime commercial properties with low cost central government loans. The combination of past poor procurement

and asset management procedures, alongside limited diversification value, have raised questions as to this strategy. The challenge is to create a sustainable public sector real estate model that provides synergies at a local level which can benefit the public sector increased focus on real estate as an investment asset. A Sovereign Public Sector Property Fund, a combination of unlisted property fund features in a sovereign investor framework, can provide the answer.

Operating with an independent board, a Sovereign Public Sector Property Fund can offer good governance and investment mandates for management implementation, with local authority representation on a steering committee to further align interests. In providing defined business units, the Sovereign Public Sector Property Fund has the opportunity to generate income within a space management team which compliments the traditional fund and asset management operation. Furthermore, refurbishments and new development projects can offer valuable opportunities for capital growth in part supported initially by central government and private debt funding arrangements.

Sovereign Public Sector Property Fund benefits and risks are detailed in Table 4.

Table 4 Sovereign Public Sector Property Fund: Benefits and Risks

Opportunities and Benefits	Threats and Risks
- Diversified property portfolio	- New property operating model
- Management scale and interests	- Local government engagement
- Creating knowledge based destinations	- Political alignment of interests
- Enhance income from service provisions	- Vagaries of local governments
- Broad appeal to local community	
- Respond to evolving occupier agenda	

As Table 4 details the challenges and opportunities, knowledge provided in this research paper can provide the groundwork for a Sovereign Public Sector Property Fund that can offer participating local authorities superior long-term stable investment returns. Alongside providing destinations and opportunities to bring forward investment in underutilised prime local authority real estate assets, leading to employment openings and support to the surrounding communities. In providing a conceptual framework there is a requirement for further research; combining placemaking and the knowledge economy, stakeholder consultation and analytical modelling. This can lead to a more in-depth understanding of this proposed real estate ownership vehicle. The challenge is to capture this real estate investment opportunity in an undervalued fragmented local authority sector which services an important part of the UK economy.

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