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REPORT SIGNED OFF BY	***Date:***
*1) Service Manager – **Dawn Adey***	*YES*
*2) Legal - **NA***	*NO*
*3) Finance/s151 – **Paul Fitzgerald***	*YES 22/04/2021*
4) Governance Team	*YES– dd/mm/yyyy*
5) SMT	*YES/NO/TBC – dd/mm/yyyy*
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*7) Governance Team - **Name***	*YES/NO/TBC – dd/mm/yyyy*

Somerset West and Taunton Council

Corporate Scrutiny 2 June 2021
Executive 16 June 2021
Full Council 6 July 2021

Commercial Property Investment Update

This matter is the responsibility of Executive Councillor Ross Henley

Report Author: Dawn Adey, Director of Development and Place

1 Executive Summary / Purpose of the Report.

1.1 The Commercial Property Investment Strategy (CPIS) was approved in December 2019 and refreshed in December 2020. A requirement of the strategy (Clause 10.4) is that a report is brought to full Council every six months to report on the commercial property investment activity and the performance of the portfolio. These will report the position as at 30 September and 31 March each year.

1.2 Since the last report was prepared, despite difficult market conditions resulting from Covid, four further properties have been purchased. These are a retail warehouse in Ayr occupied by B&Q, a retail warehouse in Birmingham occupied by Wickes, a car dealership in Stockton-On-Tees, trading as a Jaguar Land Rover franchised dealership, and an office in Birmingham occupied by the Highways Agency. Additional investment totals £28.70m taking the total amount invested in the portfolio to £44.06m by 31 March 2021 and increasing gross rental income of the portfolio to £3.25m per annum.

1.3 The portfolio build is on track with a further acquisition completed in April and two properties currently under offer and scheduled for completion by the end of April which if completed will take the total amount invested to £68.6m of the approved £100m fund.

1.4 During this period borrowing costs have remained low and therefore the Council's average borrowing costs are still predicted to be around 1.5% per annum.

1.5 The Net Income budget for 2020/21 is £0.440m, reflecting an estimate of the pace of investment during the first year and part year rents on completed assets. Actual net income reported for the year is £0.614M, providing a surplus of £0.174M (40%) against budget.

1.6 Despite the challenging economic conditions facing UK businesses and the economy the performance of the portfolio has been very strong. To date there have been no material rental defaults and during the period of September 2020 and March 2021 the market has seen a great deal of yield compression particularly in the retail warehousing and industrial markets. As a result the retail warehouse assets contained in the portfolio which were purchased earlier in 2020 will already have increased significantly in value potentially adding £1.75M of capital value to the value of the property.

1.7 Risk factors to property investment continues to be monitored. The immediate risks around Brexit continue to be assessed. The Covid pandemic remains and is continuing to cause difficulties to trading business and the UK economy as a whole. It is still too soon to know what the long term effects of the pandemic will be but we have seen a large number of investors return to the UK property market with demand increasing for secure income investment which has in turn been forcing up Capital values. Occupier performance and covenant strengths will be continued to be monitored to identify any tenants that may be affected by the current market restrictions. In general it is not considered that the level of risk has changed materially since our last report in December 2020.

2 Recommendations

a) Scrutiny Committee reviews performance against the Commercial Property Investment Strategy and supports the following recommendation to the Executive and Full Council:

2.1 The Executive recommends that Full Council notes the report which is the review of the Commercial Property Investment activity and performance for 2020/21 financial year.

3 Background and Full details of the Report

3.1 The Commercial Property Investment Strategy (CPIS) was approved by Full Council on the 17th December 2019 and an updated version approved on the 15th of December 2020.

3.2 As part of the Financial Strategy agreed in 2019 the Executive set a net income target of £2m+ per year through commercial property investment. Due to a reduction in financing cost assumptions the updated financial strategy for 2020 increased this target to £2.9m.

3.3 The latest Medium Term Financial Plan forecasts, as set out in the General Fund Budget Report to Council in February 2021, include a projected Budget Gap rising to £3.5m in 2022/23 and reaching £6m by 2025/26. This gap already takes into account the targeted £2.9m income from commercial property investment. The primary reasons for the scale of budget gap include a sharp reduction in core income to the Council from business rates and New Homes Bonus grant, which underlines overall funding volatility faced by the Council. Business rates and NHB combined to give £9.5m of annual funding in 2020/21 but this is projected to reduce to only £4.3m by 2023/24 – a fall of some £5.2m. Council tax increases alone are not adequate to offset funding reductions and service cost pressures, with a 1% increase in council tax income generating around £90k per annum in additional income.

3.4 The Commercial Property Investment Strategy sets out the governance framework and parameters for investment which ensures a balanced, diversified portfolio is established which will generate long term sustainable income contributing towards sustaining the Council's front line services for many years to come.

3.5 Since SWT first entered the investment market in May 2020 general market activity has greatly increased. The market has seen considerable yield compression (pricing increase) particularly in certain sectors. Two of the most affected sectors are retail warehousing and the industrial sectors. In part this has been driven by the large number of investors that have returned to the UK property investment market looking for a perceived safe haven for cash funds in anticipation of a global economic downturn as a result of the Covid pandemic. During 2020 many funds have concentrated their efforts on equity raising and this has created a significant weight of money to be gathered from global investors which is now chasing secure income profile, institutional grade property particularly in the non-retail sectors.

3.6 Although the higher numbers of investors active in the market has made the further acquisition of property more difficult, the trade-off is the yield compression this has created has increased the capital value of the retail warehousing assets that SWT purchase earlier in 2020, when the market was very subdued and there was obvious value to be achieved particularly in the retail warehousing sector. As a result the retail warehouse assets contained in the portfolio will already have increased significantly in value potentially adding around £1.75M of capital value to the value of the portfolio. In addition, it is also likely the other assets in the portfolio will also have increased in value due to the secure nature of the income stream and the high quality of the properties but maybe not by such noticeable amounts.

Summary of Acquisitions and Disposals

3.7 Set out below is a summary of the completed acquisitions since May 2020 and the annual rental due from properties in the portfolio.

Date	Sector	Location	Total Costs £000	Annual Rental Income £000
28/08/20	Office	Offices, 730 Waterside Drive, Aztec West, Almondsbury, BS32 4UE	9,573	759.2
11/09/20	Retail Warehouse	The Range, Pellon Lane, West Yorkshire, HX1 5QE	5,781	418.5
11/11/20	Retail Warehouse	B&Q Sanquhar Farm Rd,Ayr KA8 9TB	6,998	520.0
18/12/20	Retail Warehouse	Wickes Extra Aldridge Road Tameside Business Park, Perry Barr B42 2ET	9,816	733.3
05/03/21	Other	Jaguar Land Rover, Concord Way, Preston Farm Industrial Estate, Stockton On Tees	6,130	446.4
31/03/21	Office	One Quinton Business Park, Birmingham B32 1AF	5,765	372.5
		Total as at 31 March 2021	**44,063**	**3,249.9**

3.8 **Overview of activity including initial filtering of opportunities and number of successful and unsuccessful bids (specific detail will remain confidential)**

- As at the 31st March 2021 we have sourced 868 investment prospects. These have all been reviewed and classified in to the following groups:

- 9 are “Active” and are being actively investigated and discussions and negotiations with agents are ongoing.

- 16 are on a “watch” list. The reasons for this categorisation is mainly due to the three reasons:

  A. that they may be properties which have come to the market with strong pricing and at this time the Vendor is not willing to consider offers at the level we believe the property to be worth. We will continue to monitor these investments to see if the price and the Vendors expectations soften over time.
  B. it may be they are properties that we have tried to secure but which have gone under offer to other parties and we are monitoring them to see if the transactions complete.
  C. The properties cannot be purchased now but we have intel that they may be brought to the market shortly or the owner will sell later in the year.

- We have rejected 825 as the initial review has determined these properties are not suitable for the Council to invest in. The reasons for rejecting a property vary hugely with some of the more frequent reasons being set out below:

  - ➢ Lot size does not fit with the strategy
  - ➢ Pricing structure doesn’t offer value for money

- Property location unsuitable e.g. in a high flood-risk zone
- Covenant of tenant is not strong enough
- Lease hold is too short
- Defective title documents

- We have acquired 6 properties as detailed above
- We are under offer on 3 properties
- We have made bids on 9 properties which have been unsuccessful
- We have made no disposals since the strategy was approved.

Portfolio investment performance and performance against budget target

3.9 The Strategy included key milestones setting out the anticipated timetable for the delivery of the Investment Portfolio. Progress against these milestones is influenced by a wide range of factors however overall progress is on track as shown below.

Milestone status as at 31/03/20	Actual	RAG Status
September 2020 we aim to complete at least two transactions and have approx. £20m invested.	£15.350m invested with two transactions completed by 30 September 2020.	
December 2020 aim to complete two to three more transactions and have £40m-£50m invested.	By the end of December 2020 four properties had been acquired with a total investment of £32.2m.	
December we will prepare a progress report for Council on the CPIS	Reported to Council on 15th December 2020.	
March 2021 we aim to complete two more transactions and have £60m–£75m invested.	As at 31 March 2021 6 properties have been completed with a total of £44.063m invested. A further 3 properties were under offer and in an advanced stage of due diligence with the aim of completing in April, taking the total portfolio to 9 properties with £68.6m invested.	Amber
May 2021 Review of portfolio performance to Council	This is this report.	Green
June 2021 aim to have completed a further two - three transactions and have £80m- £100m invested.	This is still an achievable target	Green

September 2021 have the remaining part of the funds invested and have achieved a fully built out £100m+ property portfolio.	This is still an achievable target	Green
October 2021 Second report to Council on CPIS	This is still an achievable target	Green

3.10 The tables below sets out the delivery against the capital budget and the 2020/21 net investment income budget and actual performance for the year, together with a forecast for 2021/22.

Investment Properties Capital Budget

	2020/21 £000	2021/22 £000	Total £000
Budget Profile	50,000	50,000	100,000
Completions During 2020/21	44,063		44,063
Balance to be invested in 2021/22		55,937	55,937
Total Actual + Projection	44,063	55,937	100,000

3.11 As part of the end of year financial performance report the Executive will be recommended to approve the carry forward of the £5.937m balance of the 2020/21 capital budget, so that the capital budget in 2021/22 will be adjusted to £55.937m in order to complete the £100m investment over the two financial years.

Net Investment Income 2020/21

	2020/21 Budget £000	2020/21 Actual £000	2020/21 Variance £000
Rent Income	1,065	1,137	72
Direct management and abortive costs	-202	-301	-99
Sub-total – Gross Income Less Direct Costs	**863**	**836**	**-27**
Financing – Notional Interest	-225	-222	3
Financing – Debt Repayment (MRP)	0	0	0
Optimism adjustment	-198	0	198
Transfer to reserve		**0**	**0**
Net Income to Revenue Account	**440**	**614**	**174**

3.12 Rental income is accounted for on an accruals basis. Rent payments receivable or received in cash in 2020/21 totalling £1.034M, reflecting money due in advance of the period of rent this covers, has been deferred to subsequent years and is not included in the table above.

3.13 Net income has exceeded the budget ‘bottom line’ estimate by £174k or 40%, which is a very positive position to have achieved during the first year of implementing the Strategy. Options for allocating this surplus are considered in the Finance / Resources Implications section later in this report.

3.14 Reflecting previous questions from Members, the following table gives an indication of rental income forecast for 2021/22 and compares with the gross rent income budget. The overall position against 2021/22 net investment budget will be covered fully in reports during the financial year.

Gross Investment Income Forecast 2021/22

	2021/22 £000
Budgeted Rent Income (reflects assumptions around timing of completion of investment during 2021/22 and optimism adjustment for budget estimates)	5,232
Forecast Income – Assets completed in 2020/21	3,250
Balance needed in-year from future completions to meet budget estimate	1,982

3.15 As reported through the Finance Strategy and budget setting reports, the Council has established a portfolio risk reserve to protect the annual budget from income volatility from the investment fund and accrue 'sinking funds' for asset management purposes. This fund has been 'front-loaded' to provide immediate resilience during the initial phase of growing the portfolio as well as for ongoing risk management. The biggest risk in the early years of the portfolio is from tenants defaulting and the costs and unanticipated capital expenditure which may be incurred as a result. This reserve mitigates that risk. The current balance in the reserve as at 31 March 2021 is £3.5m.

Risk assessments with updates on material changes to risks on individual assets

3.16 The follow schedule summarises the risks identified with individual assets in the portfolio:

Property	**Risk**	**Mitigation**	**RAG Status**
730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	Part of the first floor is vacant.	The vacant space rent and all costs are covered by a guarantee from the Vendor until September 2022. Although we have had some interest we have yet to secure a letting.	Green
730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	Verex Insurance have a tenant's break clause in December 2022.	18 months prior to the break we will open dialogue with the tenants to understand their intentions.	Green
The Range, Pellon Lane, West Yorkshire, HX1 5QE	No identifiable risks	None currently required.	Green
Wickes Extra, Birmingham	No identifiable risks	None currently required.	Green
Jaguar Land Rover, Stockton-On-Tees	No identifiable risks	None currently required.	Green
1 Quinton Business Park, Birmingham	No identifiable risks	None currently required.	Green

3.17 The following table provides an update on general investment risks for the strategy and the portfolio as a whole.

Risk Identified	Mitigation	Commentary	RAG Status
COVID 19	The structure of the CPIS is designed to protect against market volatility and to gain exposure to the property market as a whole. This is achieved through diversification across regions, sectors, and the safe guards which are in place of lot size and single tenant exposure.	We did not enter the market until after the initial lockdown period had been implemented and therefore we have always been aware of the risk that Covid poses. We are continuing to monitor the Covid situation and continue to seek the best in class advice around what the experts are predicting will be the long term effects of the pandemic on property. During 2020 we were able to take advantage of the limited number of purchasers in the market and secured a number of good properties. Since September however the number of buyers in the market has increased which has caused yield compression and made it more difficult to secure investments at a yield level suitable for our portfolio.	Green
UK exit from the EU	The structure of the CPIS is designed to protect against market volatility and to gain exposure to the property market as a whole. This is achieved through diversification across regions, sectors, and the safe guards which are in place of lot size and single tenant exposure.	We did not enter the market until after the announcement of Brexit and the first stage of the UK leaving Europe was complete. Therefore, the risk has always been known and we have had always been conscious of the effects this may have on the UK economy. Properties and tenants covenants are selected and considered in the light of how they may be affected by the UK exiting the EU and their resilience to an economic downturn. Although UK parliament has agreed a trade deal with the EU we are still in a period of transition and therefore we continue to monitor the political situation to ensure any changes which may have an effect on the UK Economy or UK business are identified as soon as possible.	Green
General Economic Outlook for the UK and Tenants defaulting	We employ: proactive asset management and proactive tenant communication	Although the UK economy is facing challenging times ahead due to the continuing and prolonged pandemic and the increasing UK debt. However, to date there has been little effect on our portfolio mainly because the properties have been selected for their resilience to the risk factors identified, the secure income profile of the investments and the underlying property	Green

Risk Identified	Mitigation	Commentary	RAG Status
		metrics. No serious defaults have been experienced to date.	
Yield Compression in certain sectors of the UK property market	Careful selection of sectors and properties to ensure the income profile of the investment to be acquired is secure and the correct standard of property is maintained across the portfolio.	The scope of the investment strategy is sufficiently wide to enable adjustments to be made for various market factors. We are therefore able to adjust the properties being acquired as we build the portfolio in order not to increase the risk profile of the portfolio despite the yield compression. We have secured sufficient retail warehousing at a time where there appeared to be obvious value in the market and now the Council is benefiting from the yield compression in this sector. As we seek to acquire industrial property we will have to be mindful of the underlying metrics of the property to ensure any risk is limited to an appropriate level as this will be the hardest sector to align with our income profile target.	Green

Any other relevant information

3.18 An external valuation of the properties in the portfolio is not required within the first year of the properties being purchased and therefore the value of the assets will not change in the valuations used for the end of year accounts from the original purchase price. However in 2021/22 the properties which were purchased during 2020/21 will be independently valued, and from 2022/23 all the assets within the portfolio will be independently valued.

4 Links to Corporate Strategy

4.1 The Council's Corporate Strategy under the Enterprising Council Theme states that we will become a financially self-sufficient Council which has expanded its commercial activity and generated more income in order to support service provision.

Objectives

1. Pursue commercial investment opportunities that generate additional income that can be reinvested in service delivery in order to protect or enhance services on which our communities rely. Supported by a Commercial Property Investment Strategy
2. Meet the challenge of Government completely withdrawing the Council's grant funding.
3. Ensure our land and property assets support the achievement of the Council's objectives (including service delivery, regeneration projects and community initiatives).

5 Finance / Resource Implications

5.1 The investment in property continues to deliver a key element of the wider financial strategy and MTFP, as well as diversifying the Council's income streams in the face of reductions and significant volatility/uncertainty in income through government funding and business rates. Whilst it is clear the market continues to be exposed to risk (e.g. through leaving the EU; COVID-19) there is an active market which is presenting opportunities which continue to fit with the strategy.

5.2 Despite the risks, as reported separately in the Financial Strategy report to the Executive, the strategy has delivered significant additional income over and above expectations. The income generated from investment is imperative in order to provide the financial resources necessary to maintain and improve services as set out in the Council's Corporate Strategy and Budget. In terms of balancing the investment portfolio it is prudent to continue to fully invest the fund to provide suitable diversity and spread of risk. Whilst assets acquired to date provide some spread, further diversification during the completion of the fund across sectors in line with the approved strategy will strengthen the spread of risk and resilience in the portfolio. This also spreads the risk against alternative income streams which are reducing significantly as reported above, such as business rates and new homes bonus grant income.

5.3 Financial risks are mitigated through robust due diligence, effective portfolio management, use of reasonable estimates for budget purposes and prudent maintenance of reserves to mitigate investment asset costs and income volatility.

5.4 The investment completed during 2020/21 adds capital assets with a value of £44.063m to the Council's balance sheet as at 31 March 2021. These assets will be subject to annual valuation (apart from in the year of acquisition) with positive revaluation values credited to the Revaluation Reserve. Valuation deficits will be written off to the Capital Adjustment Account within unusable reserves. Valuation changes are only crystallised and therefore only affect the Council's usable resources upon disposal of the asset.

5.5 Investment budget and performance information is included earlier in this report and reports the additional income received over and above the budgeted figures in 2020/21. The actual performance against budget for the year shows a surplus of £174K. This represents some choices for the use of funds. These include:

- Transfer the surplus to the Investment Risk Reserve
- Use the funds to part fund capital costs of investment assets
- Transfer the balance to the general fund reserve

5.6 The Director of Development and Place, in consultation with the S151 Officer and the Corporate Resources Portfolio Holder, plans to transfer the excess income to the Investment Risk reserve fund. This payment into the reserve further protects the required income for future years.

5.7 The commercial property net income budget estimates, related to the current £100m investment fund, is summarised as follows:

	2021/2 £k	2022/3 £k	2023/4 £k	2024/5 £k	2025/26 £k
Gross Income	6,035	7,100	7,100	7,100	7,100
Optimism adjustment	-803	-420	0	0	0
Management and abortive costs	-257	-280	-280	-280	-280
Sub-total Investment Income	4,975	6,400	6,820	6,820	6,820
Financing costs (interest + MRP)	-2,075	-3,500	-3,500	-3,500	-3,500
Net income forecast in MTFP	2,900	2,900	3,320	3,320	3,320
Estimated reserve transfers			-420	-420	-420
Net income for budget	2,900	2,900	2,900	2,900	2,900

Note: This does not include legacy investment assets acquired prior to December 2019.

5.8 The current progress to date acquiring assets to the portfolio provides confidence the Council remains on track to achieve the net income estimates. The full picture on performance can be reported once the Fund is fully invested, at which point the budget estimates can be reviewed for future budget reports.

5.9 The table indicates the potential to transfer funds to the reserves in the medium term, which will help to replenish the reserve if rental income falls below estimate and to build funds for asset management and maintenance. As the investment reserve has been frontloaded it is not planned to add to the reserve in the early years, although this will be kept under review through the normal course of financial planning.

5.10 The MTFP continues to forecast a significant and increasing budget gap in future years. This gap would be much more significant without the inclusion of the above net income projections, increasing the challenge of delivering sustainable, affordable services.

6 Legal Implications

6.1 Section 12 of the Local Government Act 2003 specifically provides the Council with the power to invest for any purpose relevant to its functions, and for the purpose of prudent management of its financial affairs.

7 Climate and Sustainability Implications

7.1 Where there are opportunities to make investments in the renewables sector these will be examined for suitability and ‘fit’ within the strategy and if suitable be brought forward to the Commercial Assessment Panel and Board. However, current pricing of this sector means it is unlikely any opportunities will be identified which meet the target yield requirement of the CPIS.

8 Social Value Implications

8.1 Currently no opportunities which offer any direct additional social value benefits have come forward since the beginning of this reporting period. However, the income generated from the investment programme will in part be used to support the Council’s front line services.

9 Asset Management Implications

9.1 The Commercial Investment Team will continue to asset manage all the properties in the investment portfolio.

10 Scrutiny/Executive Comments / Recommendation(s) (if any)

10.1 To be added following Committee meetings.

Democratic Path:

- Scrutiny Committee – Yes)
- Executive – Yes
- Full Council – Yes

Reporting Frequency: **Six monthly**

Appendices

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