Commercial Assets Update Report

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Purpose of the Report

1. To update members on progress with implementing the Commercial Strategy agreed by Council including the commercial investments and management of the existing asset portfolio since the last half yearly update in June 2019.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of January 2020. It had been previously shown for December 2019 but then deferred one month in response to need to release resource to work on the General Election.

Public Interest

3. This report is to update members on progress made to date on the Commercial Strategy. The Council agreed to receive update on progress every six months with the previous update being reported in June 2019. The report includes updates on the purchasing of new commercial investments and the financial performance of investments and their contribution to delivery of the objectives of SSDC's Financial Strategy originally agreed in September 2017 and the Commercial Strategy agreed in August 2017. There has been review by District Executive and Full Council of the Financial Strategy and Commercial Strategy in September 2019. The aim of this report is to give Members and the public an update on the performance and impact of the commercial strategy to date including its contribution to mitigating the impact of reductions in Government funding and protecting services.

4. Due to the sensitive commercial nature of investment acquisitions, and the need to manage risk and protect the value of the Council's investments over the long term, certain detailed information is included in a confidential appendix and not to be disclosed.

Recommendations

5. That the District Executive:

   a. Note progress made to date in acquiring new commercial investments
   b. Note the return being achieved across the portfolio which is slightly above the Council's target of 7%.
   c. Note progress being made in securing income from our existing assets and the contribution to the revenue budget in excess of the original £2.25m target.
   d. Note progress being made in disposals and transfers of existing assets, resulting in a reduction of future liabilities associated with these assets.

Background

6. While presenting the “Commercial Services Income Update” report to District Executive in February 2018, members requested regular updates to show progress made in meeting the Commercial Strategy (approved by Council in August 2017). These reports are normally provided at six monthly intervals. This particular report has been deferred by a month in response to need for resources to be released for work on the General Election. The cut-off date for information has not been changed so that this report and the next will each cover a six month period.

7. This report is a succinct update of high level figures for new investments since May 2019, updated to 1 November 2019. It also updates members on work being carried out to increase income from existing assets and reduce liabilities.

8. The Commercial Property Team has been stable in terms of staffing since the last report.

9. SSDC has a wide and varied range of assets that have been accumulated via various means over the years. The creation of South Somerset Homes (SSH) in 1998 meant that many assets were transferred via a Large Scale Voluntary Transfer (LSVT) to SSH, now Yarlington, albeit numerous tranches of land were retained for strategic purposes.

10. After the LSVT, SSDC retained a portfolio of assets that mainly comprised of operational offices, listed buildings, industrial units, car parks and an assortment of land, i.e. grass verges, open spaces and “ransom strips”. These assets do not generate a substantial annual income and are now in many cases costing SSDC money through increased maintenance and running costs. Some, however, provide opportunities to generate value through development, sale receipts and development to also provide Council Tax, business rates and New Homes Bonus grant funding.

11. As part of the Commercial Strategy, Council approved a commercial approach to Land and Property management in August 2017.

Commercial Investments

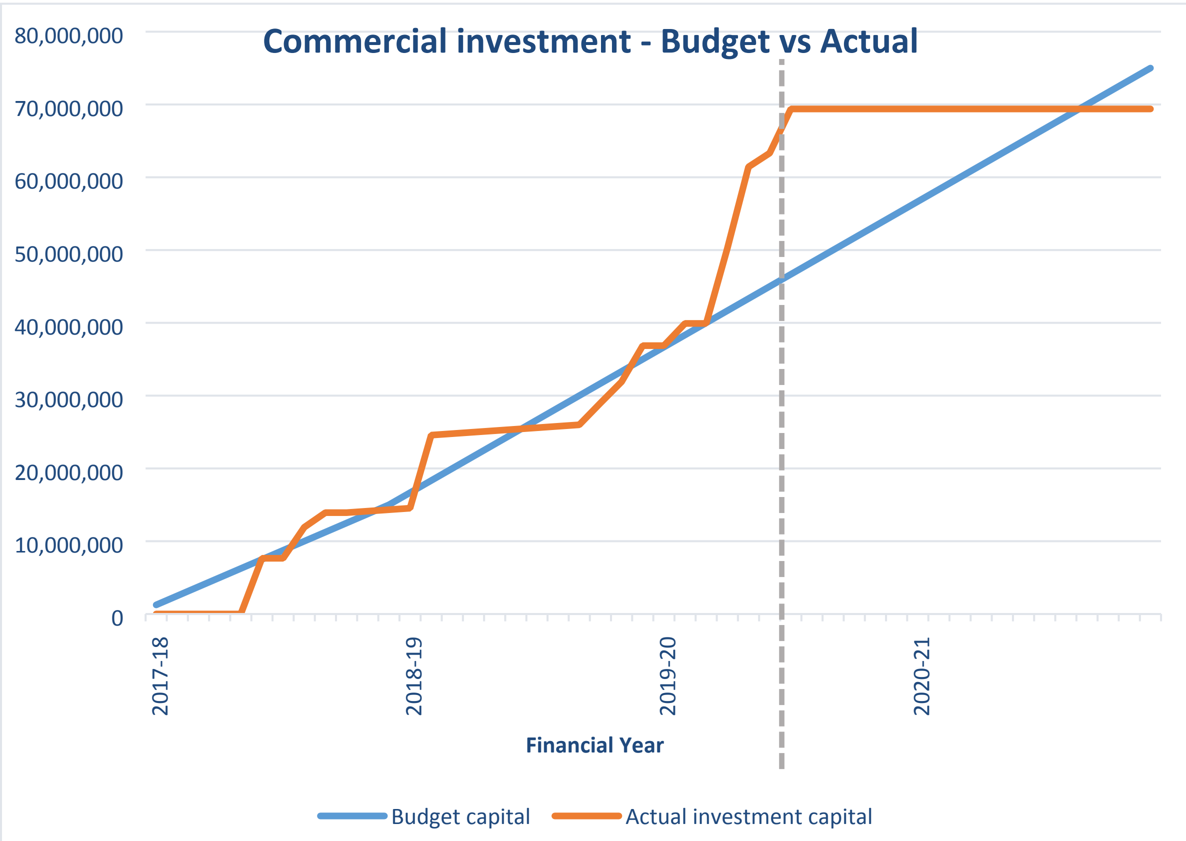
12. In 2017, the Council approved the objective of creating a commercial property investment portfolio with a fund total of £75m, and the goal of meeting a savings target of £2.25m. The period for implementation was to commence from August 2017 and achieve the full fund by March 2021. In September 2019 it was reported to Full Council that having committed £73.44m of the existing fund into a range of investments to date in 2019, a portfolio wide running yield on commercial property interests of 6.61% improving to 7.25% in 2020 has been achieved. This is to be compared against the target of 7% set in the initial Commercial Strategy 2017-2021. This target is net of all costs of borrowing, acquisition, risk reserve and staffing and equates to a 7% return from the investment.

13. In developing an investment portfolio, the Council has decided not to utilise all of the revenue generated to support the Council’s revenue budget. Instead, as well as paying interest, the Council decided to utilise a proportion of the income to pay down the capital borrowing. This

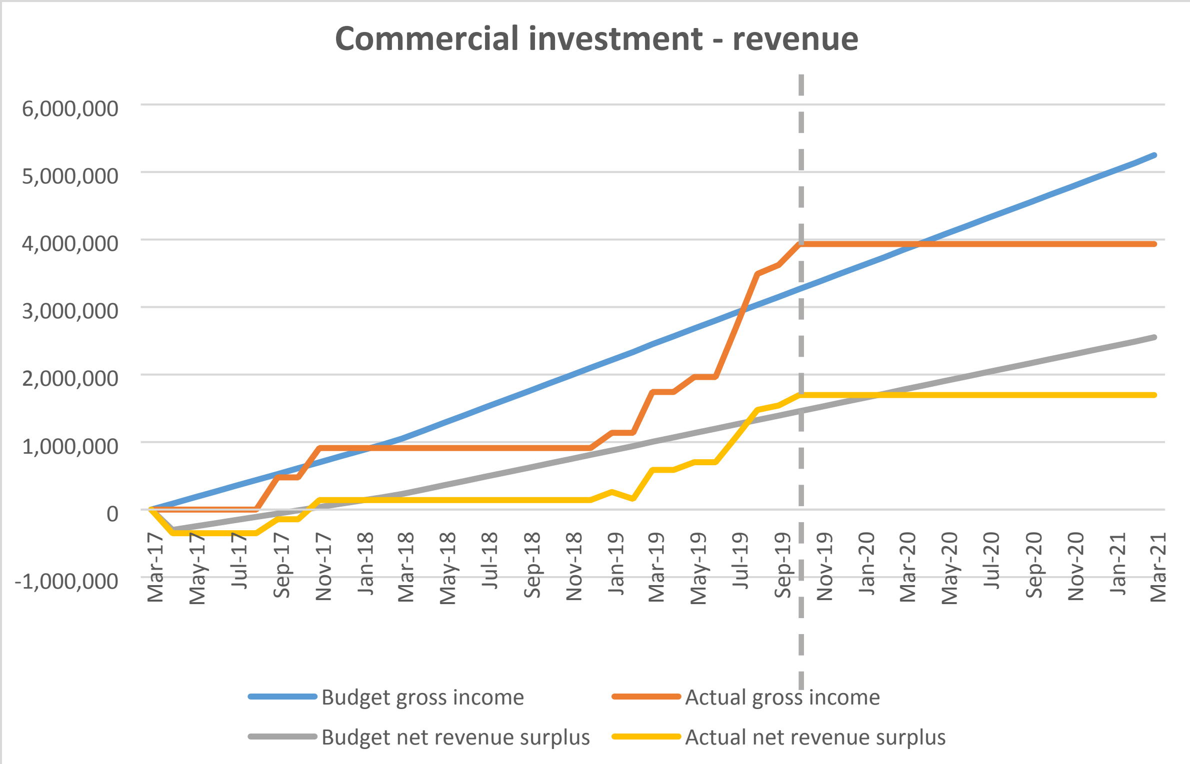
is distinct from the approach taken by many commercial property companies and increasingly some other councils who tend only to pay the interest. However, for the Council this means a decreasing level of debt and an increasing net value of the Asset Portfolio as the debt to value ration increases in the Council's favour.

14. In addition, the Council has recognised that there is risk attached to holding a Commercial Asset portfolio and using income for this to support the revenue budget and provision of services. Therefore the Council is also utilising a proportion of the commercial income to develop a Commercial Asset Risk reserve to protect the Council and the revenue budget from any potential future volatility or changes in the portfolio. This reserve currently stands at in excess of £6m as previously report to District Executive. As a result of the Councils prudent approach, whilst the Asset Portfolio is generating 7%+ return, the Council has chosen to utilise 3% return to support the revenue budget.

15. Progress is shown on the graph below for the actual capital invested to date in new commercial assets. This is compared with the approved budget objective to invest £75m by March 2021. The fund was allocated across four financial years and to assist review is shown as a straight line budget progression enabling progress over the time period to be seen as either below or ahead of the objective.



16. Progress in terms of generating additional revenue – gross and net – as a return from the capital invested is:

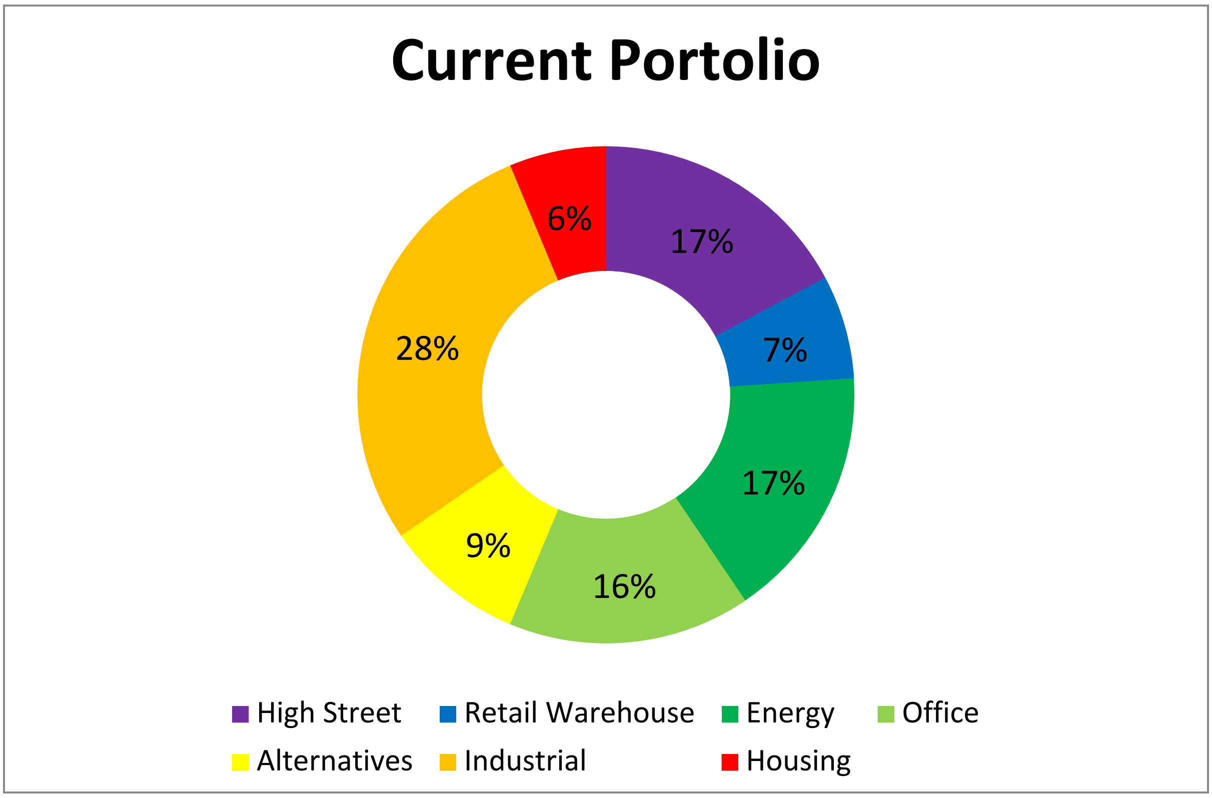


17. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed. It excludes the returns from the residential development at Marlborough and the Energy Storage Scheme as the basis of financial return on capital invested is not directly comparable.

18. In September 2019, the Council approved an increase in the fund from £75m to a new total of £150m to be achieved by March 2022. The revised savings / net income target (after interest, capital repayment and risk reserve) is £3.35m. Saving in this context is delivered by net revenue income.

19. Since the introduction of the Commercial Strategy, SSDC has purchased a number of investment properties. This report summarises the high level figures to demonstrate the annual income achieved via rent or sales. The investments made to date are aiding progress towards this target with commercial income in the 2019/20 revenue budget and beyond to protect and support services to the communities.

20. The Council currently has sixteen assets in its ‘new’ portfolio, providing a gross income (before cost of borrowing) of £4.99m per annum using the whole year income for 2020/21 from assets in SSDC ownership as at 1 November 2019. This excludes the expected returns from the Marlborough development project, which are not in the form of annually recurring income. The current sector split of these assets is:



Note: Alternatives – relates to a property used for "other" purposes – at this stage a single property used as a veterinary hospital.

21. Further acquisitions have been approved by Investment Assessment Group (IAG) followed by the Leader and Chief Executive in accordance with the purchase approval procedure. If these are completed they will be reported with any further acquisitions in the next half-yearly report.

22. These have been funded through a combination of capital receipts, cash resources and borrowing to date. In line with the Council's treasury management strategy we continue to utilise 'internal borrowing' to meet some of the financing requirement for the investments purchased. This approach reduces treasury risk. All borrowing will be asset backed (i.e. if the Council wished to pay off the borrowing it will have an asset to sell to achieve this) and the investment is required to produce a rate of return for the Council which meets the Commercial Strategy targets and therefore, covers interest, capital debt repayment and produces additional income to fund the delivery of services.

23. In making investments the Council seeks to meet its corporate ambitions as set out in the Council Plan to maximise the benefits to the communities of South Somerset. The costs and funding of the investment is set out in Confidential Appendix, table 1.

Market Commentary

24. After strong growth in 2017 and early 2018, economic growth slowed in the latter part of 2018 as a result of a range of phenomena affecting major industrialised nations. In July 2019 The International Monetary Fund predicted that global growth would slow from 3.6 percent to 3.2 percent in 2019, before improving to 3.5 percent in 2020. Both of these figures are 0.1 percent less than their April 2019 projections.

25. The Office for National Statistics reported that British productivity had dropped in Q2 2019 by 0.6 percent on the same quarter in the previous year. This was the fourth successive quarter in which productivity had dropped. The Office for Budgetary Responsibility projects GDP growth of 1.2 percent in 2019 and 1.4 percent in 2020.

26. The RICS' Q2 Commercial Property Survey predicted a fall in capital values in all retail markets and demand to continue to outstrip supply in the industrial sector and suggested that a slim majority of its members feel that the market is entering a downturn, with decreased demand from overseas investors. On the rental side it predicted growth of 3 percent for prime industrial stock, 2 percent for prime offices and 3.5 percent falls in prime retail stock.

27. Savills 'Market in Minutes' published in September 2019 points to a total of £27.9bn of commercial property investment in the year to date. Prime yields have softened to 4.9%, compared to 4.8% reported in April 2019, and the weakest since December 2016, on the back of ailing retail yields, with sentiment static in all sectors excluding high street retail and shopping centres.

28. Despite evidence pointing to the beginning of a period when values and activity decline, markets are still more competitive than when the Commercial Strategy was devised. This has meant that opportunities suitable for the Council have been harder to uncover. Nevertheless the Council has built a reputation as a dependable purchaser which means we are introduced to properties early in the marketing phase, which has enabled us to develop a diverse portfolio capable of meeting the objectives laid out in the revised Commercial Strategy.

New Assets

29. Progress has continued well to build up the assets within the portfolio with a total of eight investment purchases concluded in the half year period from 1 May to 1 November 2019. In this report there is a brief comment about each asset purchased since the last report. There is also continued individual comment on the two "development" properties SSDC is investing in as these are more complicated positions and have evolving situations. Investment properties already owned prior to this report are not commented on individually as there has not been material change in these fully let assets.

30. The investment by sector in the half year has been:

Sector	Investment
Energy	1,663,055
Office	3,049,947
Alternatives	6,310,328
Industrial	16,620,337
TOTAL	**27,643,667**

Bell House, Milton Keynes

31. Purchased for £2.92m in May 2019. A smart modern office building constructed in 2007 and let to four good tenants. The opportunity was targeted as having potential for above trend growth in rents due to office rents in the town being below other related regional centres and considerable infrastructure investment being made in the region. The tenants are all outside the 1954 Act, giving the Landlord a stronger negotiating position at renewal.

D1 Christchurch Business Park, Christchurch

32. At the time of the last report the property was under offer but the sale has now completed. A large, modern, single let property, built to institutional standards within the past decade and let to a strong tenant covenant. SSDC capitalised on the failure of a major property fund to complete, getting the property under offer at a figure below market value, £7.05m. The Solent market has very little supply leading to projections of rental growth. The property has a four year term certain.

Reevesland Industrial Estate, Newport

33. The UK distribution hub of worldwide toy and board game giant Hasbro was acquired in July for £2,780,000, reflecting a net initial yield of 7.0%. The property is a 77,200 square foot industrial unit, used as a distribution centre by the tenant. The particularly attractive feature of the property is the freehold ownership of the remainder of the estate by Hasbro, which SSDC consider makes it far less likely for the tenant to vacate at the end of the lease.

B&Q, Glastonbury

34. Acquired for £4,405,000, reflecting a net initial yield of 7.19%. The property is a 27,000 square foot retail warehouse, with 8,000 square foot external garden centre and 4,000 square foot secure delivery yard. It has been tenanted by B&Q since its construction with an unexpired lease term of seven years. The market for retail warehouses is soft, however there is a lack of supply in Glastonbury. The B&Q business is understood to trade well in this location, and there are requirements within the town from other occupiers. The Council has attracted an occupier for the proposed coffee pod in the car park which will increase the value of the asset and spread risk.

The Ralph, Marlow

35. Purchased for £5.95m in August 2019. The purchase price reflects a net initial yield of 7.09%. The only veterinary referral hospital between the M4 and the M40 was opened to the public

in February 2019 following an extensive development period. The Ralph's occupation provides an income stream of fourteen years term certain. The assessment is that with increasing levels of pet ownership and increasing levels of insurance for care of pets, The Ralph has been launched in good time to take full advantage. The South East location allows the Council to diversify geographically into a region that has historically benefitted from greater capital growth than the rest of the UK, whilst the use allows a diversification of sectoral investment within the portfolio.

Trafalgar House, Taunton

36. Bought in August 2019 for £1.75m reflecting a net initial yield of 7.80%. A small lot size purchased to allow SSDC to access a market sector where yields are currently hard. The purchase price reflects value for money. The property requires management but has good tenant mix, including three national tenants. We are currently engaged in letting the vacant unit.

Centurion Mill, Exeter

37. Purchased for £4.2m in October 2019, reflecting a net initial yield of 7%. Excellently located close to J30 of the M5 on the well-established Sowton Industrial Estate, with a strong local anchor tenant who also hold the adjacent premises. The property also contains one of the most profitable Greggs bakeries in the south-west, and an electrical wholesaler.

Residential Development, Marlborough

38. The construction period for this property has been extended due to design improvements involving additional work but also delays in connections of mains service utilities to the new homes and other construction work. Practical completion was achieved in October. Management arrangements for the property are in place.

39. The houses and flats are on the market and there has been considerable immediate interest from potential purchasers despite the dampening effect that Brexit and the General Election have had on the residential market generally.

40. Sales are expected to complete by summer 2020 although this will depend on the state of the market. Forecast selling prices are above expectations when SSDC agreed to invest in this project. This has been due in part to design improvements which have involved an increase in the construction cost and programme, and also due to growth in market values and the quality of the scheme delivered. The sales of completed homes should generate a healthy receipt for SSDC, which can be reinvested into our town centre regeneration schemes. The additional community benefit of this scheme is that whilst it is out of SSDC area we are using South Somerset contractors and suppliers wherever possible, aiding the local economy.

Energy Storage Scheme

41. The on-site 25MW project roll out was completed in this spring and over the summer Western Power (WPD), who are the local District Network Operator, have been working with British

Solar Renewables (BSR) to connect and test the SSDC OPL site linking into their equipment. From the WPD connection, this connection will then run into the National Grid (NG) Sub Station.

42. SSDC Opium Power Ltd had hoped that the site would be energised sooner, but legal easements for rights to run cables through third party land between WPD and NG have taken longer than anticipated. SSDC Opium Power have pressed for progress as hard as they judged was constructive but this was not within their control and therefore we have been dependent on the rate of progress by third parties. These legal easements are now agreed and work has commenced on the final cable run into the National Grid substation. It is on target to be completed before Christmas 2019.

43. In early January, National Grid will then undertake some 'real time testing' to ensure everything is safe and working correctly before we become energised. This facility is high voltage and the impact of energisation on the national grid needs to be tested, known and timing managed before being 'switched on' to ensure that there are no adverse impacts for the national grid. We hope to be energised and income producing by the end of January, but this is subject to National Grid proceeding when they are satisfied with their testing.

44. In terms of the financial impact of the delay, it should be noted that the first energy contract was due to commence in the latter part of October. Recognising their role in the delay, National Grid have agreed to hold the contract over until the site is energised.

45. Meanwhile, Phase 2 for an additional 5 MW has commenced, in line with both SSDC's Commercial Strategy and Environmental Strategy, to deliver more clean energy and invest in the green energy sector. This smaller but final Phase for the site maximises the licence before that opportunity was lost, and use of site area suitable for Battery Energy Storage at this location. It also makes use of the infrastructure and connections developed for Phase 1 (25 MW) and will deliver more income to SSDC for the future, as well as aiding the balancing of the National Grid with cleaner energy. This will assist with fossil fuel production of energy being phased out more swiftly.

46. The valuation of the site, as at 31 March 2019, for our accounts purposes confirmed that the facility and land was valued at more than the project costs expended. It also commented that by maximising the site with an additional 5 MW this would remain the case and increase appropriately. The investment Market Value, once energisation and trading are established may well mean that the value increases again and we are now close to that position. An updated valuation will be sought at the financial year end. In summary, national data confirms that this project demonstrates 'value for money' when the cost per MW is considered against the national averages for similar installations in the UK to date. In addition, energy storage is recognised as a growing market with an increasing number of commercial companies now looking to follow SSDC's lead, as well as significant interest from other councils.

47. Our investment return in SSDC Opium Ltd is initially in the form of loan financing secured against the assets of the business, which provides a commercial rate of return. Loan and interest repayments are scheduled to reflect the expected cash flows of the business. In the longer term, once the loan facilities are fully repaid, the Council expects to receive its investment income through dividend distribution of profits. As a result of the way the

investment has been structured the delay in energising the site delays interest being paid back to SSDC by a few months but actually means SSDC will generate increased income from the investment because SSDC Opium Power Ltd will be required to pay more interest.

Commercial Investment Acquisitions

48. Activity is being sustained to continue strong progress to meet the Council's objectives for commercial investment. We consider some 40 investment opportunities each month and have a regularly updated set of criteria for agents identifying target yield, lot size, sector, unexpired term, location and tenant.

49. The Commercial Property Team has developed a reputation in the property investment market for acting quickly and professionally. This ensures that SSDC is offered the most attractive opportunities and does not overpay for property.

50. SSDC's Commercial strategy also aims to create a risk-mitigated and balanced portfolio and therefore we will continue to be highly selective, in order to meet our strategic objectives.

Asset Management Update

51. Since the previous update to District Executive in June 2019, a number of enquiries have been received regarding the potential disposal of SSDC assets. These disposals can deliver estate management savings to SSDC, reducing our asset costs for the future and in turn improving the overall quality, values and returns of the wider portfolio.

52. Work has continued to identify and assess small development sites across the district. Of the two applications submitted earlier in the year, one was deferred at Area North committee and remains under review. The second application in Area East has now been recommended for approval and is going through the internal due diligence process. Whilst these have been progressing a joint application with Yarlington Housing Group has been approved for two new homes in Yeovil. A number of other opportunities are being progressed.

53. Specific asset management transactions are included in the Confidential Appendix.

Financial Implications

54. The financial implications for the progress with commercial investments and of asset management activity are set out above within the report and also in further detail in the Confidential Appendix.

55. SSDC has approved a large sum for commercial investment. The commercial strategy has been operating for 27 months, and excellent progress has been made, ahead of target timeframes.

56. This report demonstrates that a number of acquisitions have been progressed. Others have been considered and rejected for a variety of reasons. This demonstrates the strategy is working, with the overall outcome that SSDC is making good progress in acquiring a balanced

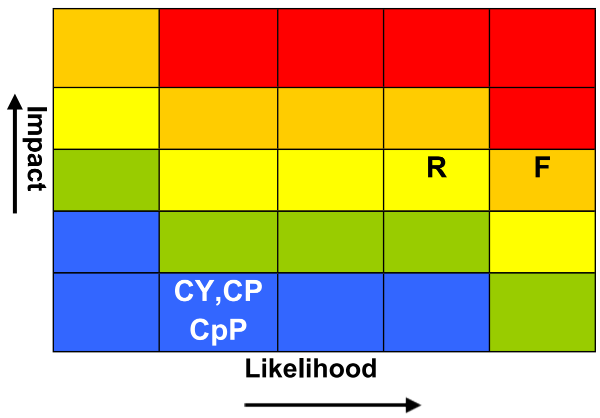
portfolio of investments that is on track to meet overall income generation targets within the financial strategy.

57. Detailed and robust due diligence has been completed with extensive involvement of SSDC's finance and legal specialists together with external advisors (e.g. valuers, tax specialists, legal advisers, sector specialists) to support the property team in completing robust business cases that underpin recommendations and investment decisions. The decisions made have been through the agreed governance arrangements as approved by SSDC with the Investment Assessment Group providing unanimous recommendations to the Council Leader and Chief Executive for final decisions. Arrangements have been reviewed by Internal Audit and the minor improvements recommended have been implemented

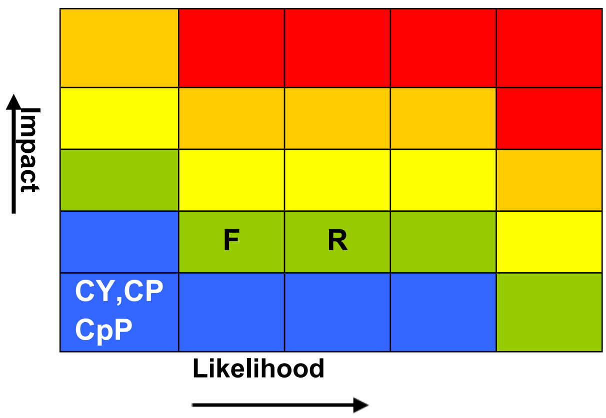
58. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

Risk Matrix

Risk Profile before officer recommendations



Risk Profile after officer recommendations



Key

Categories			**Colours** *(for further detail please refer to Risk management strategy)*		
R	=	Reputation	Red	=	High impact and high probability
CpP	=	Corporate Plan Priorities	Orange	=	Major impact and major probability
CP	=	Community Priorities	Yellow	=	Moderate impact and moderate probability
CY	=	Capacity	Green	=	Minor impact and minor probability
F	=	Financial	Blue	=	Insignificant impact and insignificant probability

Council Plan Implications

This report links to the following Council Plan objectives:

- Protecting Core Services

- Take a more commercial approach to become self-sufficient financially
- Supporting the Regeneration of Chard, Yeovil and Wincanton
- Supporting local businesses

Carbon Emissions and Climate Change Implications

None

Equality and Diversity Implications

This report does not involve any equality or diversity implications

Privacy Impact Assessment

There is no personal information included in this report

Background Papers

- SSDC Commercial Strategy 2017