APPENDIX 12

2023/24 Non-Treasury Management Investment Strategy

1. Background

1.1. The 2023/24 Non-Treasury Management Investment Strategy for the new Somerset Council is required to be considered by Somerset County Council as part of the 2023/24 budget setting process. This is a complex and highly regulated area of activity, and this strategy has been written to meet the relevant regulatory framework as set out in Annex 12C of this report.

1.2. Councils invest money for three broad purposes:

1) Because it has surplus cash arising from its day-to-day activities or cash that it holds pending its spending plans (known as treasury management investments).

2) To support local public services by lending to other organisations (known as service-based investments).

3) To earn investment income (known as investments made primarily for yield or commercial investments).

1.3. This investment strategy focuses on the second and third of these investment categories and together they are termed non-treasury management investments. The first category is considered in the 2023/24 Treasury Management Strategy. Whilst service investments and investments primarily for yield are entered into and managed outside of normal treasury management activities, the Treasury Management Strategy comes into play in their financing.

1.4. The objectives of this Non-Treasury Management Investment Strategy are to provide:

1) The proposed Strategic Objectives for 2023/24.

2) A high-level overview of the different types of non-treasury investments that will be held by Somerset Council on 1st April 2023.

3) The governance and reporting arrangements for these investments.

4) Management of the investments and the capacity, skills, and knowledge available to the Council.

5) The Annual Review of financial performance, as required under the revised Prudential Code, for 2023/24 of the net cost/return to the General Fund revenue budget of holding the investments for yield.:

6) An explanation of the relevant regulatory framework that needs to be considered when holding, managing, and divesting these investments.

7) An analysis of the associated risks and management's proposed mitigations including indicators which allow Elected Members and the public to assess the level of risk involved.

1.5. Proposed 2023/24 Strategic Objectives

Strategic Objective 1: Ensure the Council has flexibility and choice in obtaining loan finance.

Policy commitments and detailed objectives:

- Ensure the Council meets the criteria for accessing the Public Works Loan Board (PWLB) by not acquiring any new investments that fall within the definition "investments primarily for yield".

Strategic Objective 2: Ensure the investments for yield continue to contribute to the Council's overall financial health.

Policy commitments and detailed objectives:

- Retain the current investments made primarily for yield that will be vested to Somerset Council from the predecessor councils on 1st April 2023 for the immediate future.

- Ensure effective arrangements are maintained to collect all income due in a timely manner, and actively manage tenancy and lease arrangements to minimise losses through voids and/or non-collection of rents and service charges.

- Undertake regular modelling of the net return being achieved and forecast from holding these investments for the portfolio as a whole and for individual properties and from both the shorter and the longer-term viewpoint.

- Establish objectives, aims and expectations around the contribution being targeted from investments for yield.

- Maintain a proactive knowledge of the state of the UK commercial property market.

- Undertake regular reviews of relevant risks and mitigation options.

- Review opportunities for new permitted investment in existing investments to maximise the net return and/or improve the asset value (within acceptable risks).

- Review opportunities for selling the investments to maximise the overall net return, or to minimise future risks (such as reducing the Council's exposure in a particular market sector or geographic location), or to generate capital receipts.

- Review options available to the Council to finance the remaining indebtedness that has arisen from purchasing these investments to maximise the net return or to minimise future risks.

- Obtain relevant expert advice, when needed, to achieve these objectives.

Strategic Objective 3: Ensure commercial property investments are attractive in the market

Policy commitments and detailed objectives:

- Develop a Property Investment Strategy to ensure:
    - Properties remain attractive to tenants for letting and, at least, maintain their investment value.
    - Properties are fit for purpose, safe, and compliant with relevant legislative requirements.

- Review the costs of achieving a) and b) above with the potential return obtainable and the impact on other capital financing needs.

2. Investments Primarily for Yield

Background

2.1. The four predecessor district councils in Somerset all established programmes of investing for the primary purpose of making a yield. Most of the activity focused on acquiring commercial property. Many other councils across the country have also pursued this strategy with levels of local authority investment increasing more sharply in recent years across the sector.

2.2. The net returns make a significant contribution to the funding of the four councils' General Fund revenue budgets because the additional income generated exceeded the returns the councils were able to get with their cash investments and more than covered the costs of any short-term and longer-term borrowing undertaken to fund the capital acquisition costs.

2.3. The primary objective for all four councils was to generate new income to enable them to continue providing essential council services to their communities at a time of declining financial support from central government, and where risk and uncertainty of funding remains high (notably, Government grants and business rates). This was achieved.

2.4. The four councils viewed these acquisitions as long-term investments that would be proactively managed by having the flexibility to respond fluidly to opportunities and changes in the economy, the market, and differing performance across asset classes. The ability to sell properties to reinvest is a common portfolio investment tool in the private sector which helps achieve higher net returns whilst also mitigating risk.

2.5. However, since the strategies were implemented, there have been several changes to the regulatory and economic background that have significantly impacted on this investment activity (see Annex 12C for the detail):

a) Changes were made to the PWLB (Public Works Loan Board) terms of lending effectively making it inaccessible for councils who continue acquiring investments made primarily for yield.

b) Changes made to the Prudential Code also prohibited acquiring investments primarily for yield with councils needing to pay "due regard to" the guidance as required by legislation.

c) Other changes made to the regulatory framework now prohibit councils using the sales proceeds from selling these assets to fund new investments for yield. This means that the approach private property fund managers undertake in selling and repurposing the proceeds to acquire better performing and/or less risky assets cannot now be undertaken by councils.

d) Unfavourable and very rapid changes to the economic situation, particularly the rise in interest rates during the 2022/23 financial year and the risk of a recession, are putting pressure on the investments achieving a net rate of return in the short and medium term and potentially increase the risks involved in holding these investments.

2.6. Given that PWLB loan finance represents a relatively cheap and easy-to-access source of long-term borrowing, as compared to other often more complex sources of loan finance, it is being recommended in this strategy that Somerset Council ensures it has access to the PWLB if needed and therefore does not undertake any new acquisitions that fall within the definition of "investments primarily for yield".

2.7. The Director of Finance and Governance can confirm that the proposed Capital Budget for Somerset Council for the period 2023/24 to 2027/28 does not contain any budget for acquiring investments primarily for yield.

2.8. The portfolio of investments made primarily for yield is therefore now complete. The focus for Somerset Council will be on proactive management of the investments and associated risks within the regulatory framework as set in the proposed Strategic Objectives shown in paragraph 1.5 of this report.

Commercial Property Acquisitions and their financing

2.9. The period over which these investments were acquired is shown below. No further investments meeting the definition "investments primarily for yield" were acquired after December 2021 when the revised Prudential Code came into effect:

- Mendip District Council: October 2017 to November 2019
- Sedgemoor District Council: December 2018 to December 2020
- Somerset West & Taunton District Council: August 2020 to December 2021
- South Somerset District Council: November 2017 to December 2021.

Table one: Acquisition costs and financing (£000s)

Figures are in £000s	Mendip	Sedgemoor	Somerset West & Taunton	South Somerset	Total
Investment made	50,401	46,500	98,965	93,224	289,091
Funded by:					
Capital Receipts				4,000	4,000
Revenue resources			3,520		3,520
Long term borrowing	50,401				50,401
Short/internal borrowing		46,500	95,445	89,224	231,170

2.10. The councils financed their investment acquisitions through a variety of ways. Most of the funding however was by means of borrowing. Mendip District Council financed their investments through taking out several long-term loans whilst the other three predecessor district councils financed their investments through a mixture of revenue funds, capital receipts, internal borrowing, and shorter-term external loans.

Overview of the commercial property portfolio

2.11. The new Somerset Council inherits a diversified property portfolio, with a balanced spread between asset classes and geographical locations which will help mitigate the potential risk of holding assets all in one sector and/or location.

2.12. The following paragraphs and charts aim to illustrate key aspects of the investments held.

Chart One: Commercial property investments key metrics

Capital investment made £289m

Individual investment value from £0.7m to £22m

48 properties

36 out of Somerset

17 multi let

31 single let

96 tenants

Currently 6 voids

Average income per tenant £209k

Gross average yield 7.5%

Average WAULT 6.45 years

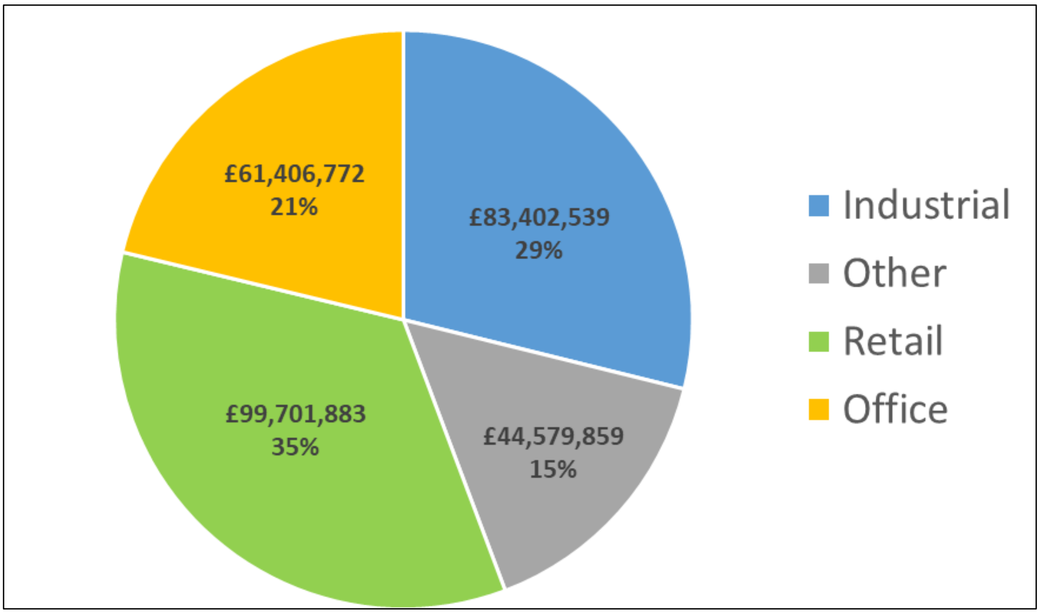
Gross rental income (2023/24) £20m

Direct holding costs (excluding officer time & financing charges) £0.8m

WAULT = weighted average unexpired lease term
Gross Yield = Contracted income return percentage on purchase price

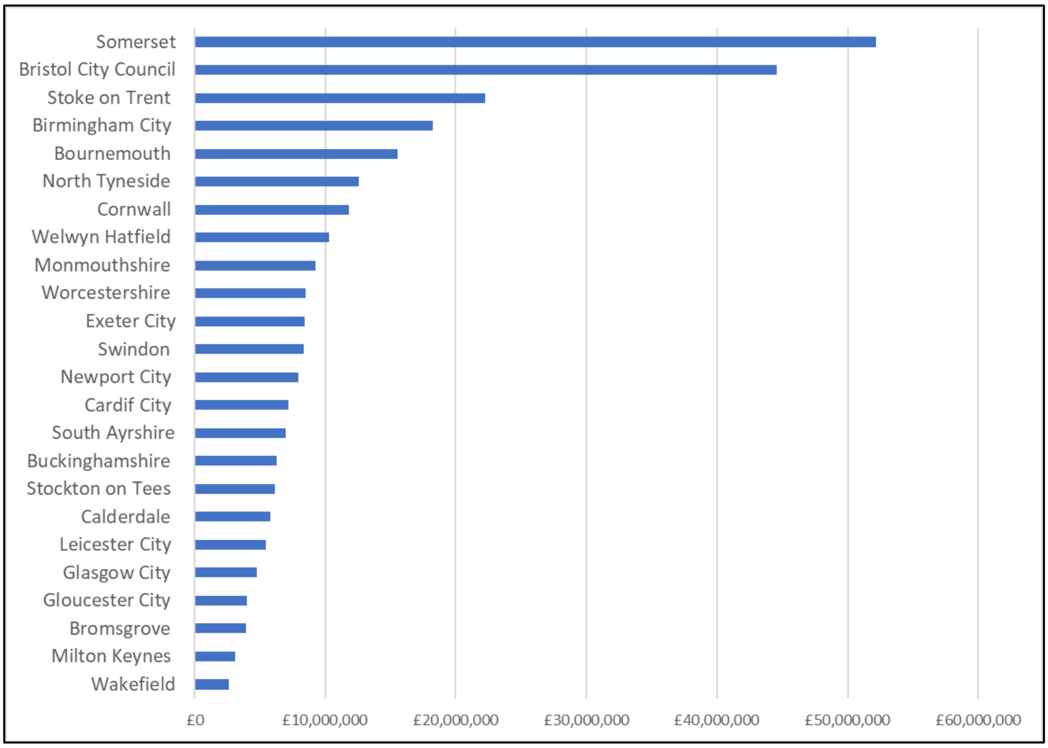
2.13. Property sectors: The portfolio is weighted towards retail and industrial asset classes. 35% of the investment has been made in the retail property sector followed by industrial (29%), office (21%), and the other property sector (21%). investments made in the latter include: a healthcare centre, a gym, and an NCP car park. Of the retail property, 25% can be regarded as high street / town centre retail.

Chart Two: Investments made per property sector (asset classes)



2.14. Location of the investments: 75% of the properties held are located out of Somerset Council's area. By value, £237m (or 82%) of the total investment that has been made is outside of the new council boundary. Chart Three shows the value of investment made across the United Kingdom.

Chart Three: Property investment made per local authority area



2.15. Average size of investments: The average acquisition price was £6.023m with 48% of the £289m invested being on properties acquired within the £5m to £10m range. The largest acquisition of £22m was made for an industrial property in Stoke-on-Trent.

Chart Four: showing size of investments made (numbers = no of properties)

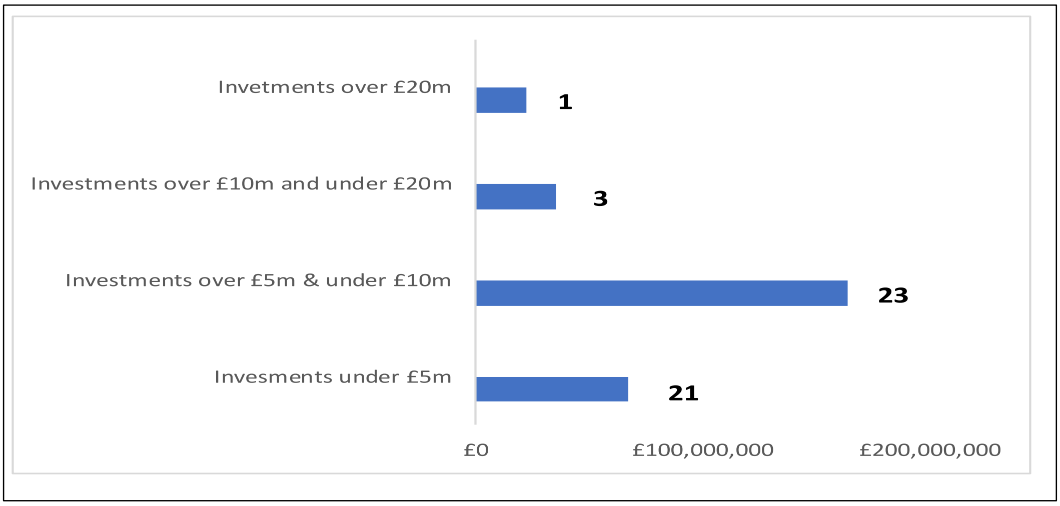
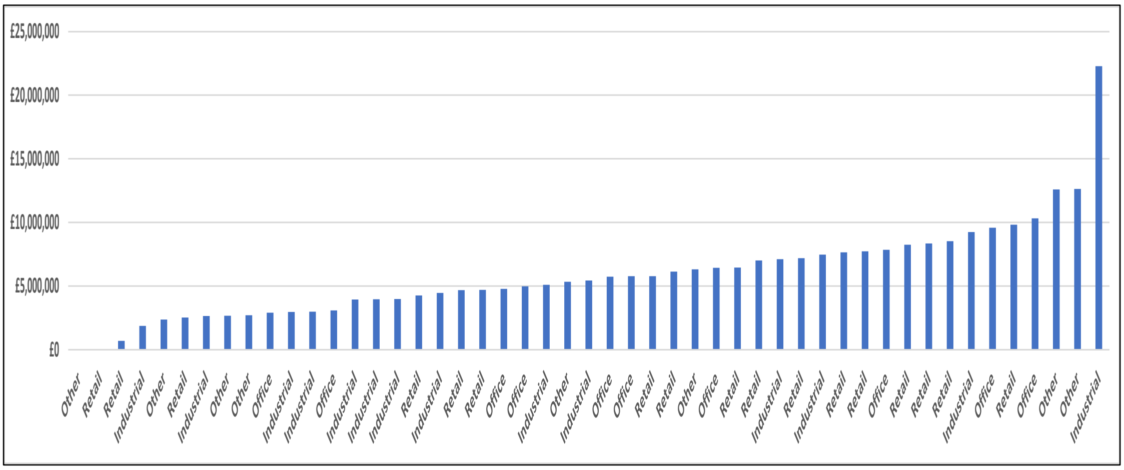
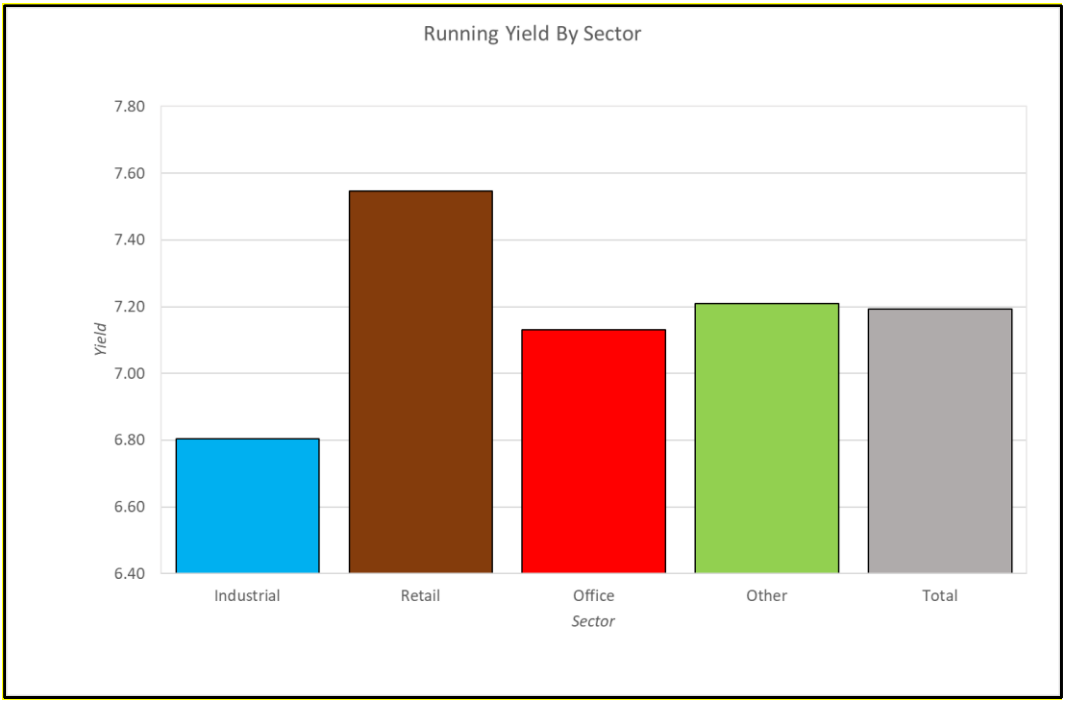


Chart Five: Acquisition cost per property



2.16. Gross yield: (which is the gross current income divided by the investment purchase price) by property sector shows the initial return the contracted rents provide split by district council and by investment sector.

Chart Six: Gross Yield % per property sector



2.17. Investment value: The unaudited value of the commercial property investments as at the end of March 2022 is £264m. As compared to the total investment made (£289m) this is a decrease in value of £25m (9%) but one-off costs of purchase (fees and SDLT) account for most of this difference. A new valuation will be undertaken to produce the 2022/23 Statement of Accounts. It should be noted that £15m of the indebtedness arising from purchasing these assets has already been paid by the predecessor councils through Minimum Revenue Provision (MRP) payments from their revenue budgets.

2.18. Security, liquidity, and yield: The principles of security, liquidity, and yield must be considered when making any investment. When considering treasury management investments, security is the highest priority, followed by liquidity, and yield is a low priority. However, the objectives for investing primarily for yield (i.e. to make a return to support the funding of core council services) has meant that such investments have not always prioritised security and liquidity as highly as treasury investments do.

2.19. Commercial property is not a liquid investment, such as a bank account where one can withdraw needed cash immediately. They can take significant time, and cost, to sell and are only divisible by the individual ownership components. A reasonable rule of thumb is to allow up to 6 months to dispose of an investment property.

2.20. **SSDC Opium Power Ltd (SSDC OPL):** As part of its commercial strategy, the predecessor South Somerset District Council, invested £42m through a joint venture company, SSDC OPL, in a design, build, finance and operation of battery energy storage systems (BESS) at Taunton, Somerset (SSDC OPL) and at Fareham, Hampshire (FERL 1 and 2).

2.21. The current structure of the JV comprises a parent company, SSDC Opium Power Ltd (SSDC OPL) and two subsidiary companies, Fareham Energy Reserve Ltd (FERL 1) and Fareham Energy Reserve 2 Ltd (FERL 2). There are 100 shares in SSDC OPL: the Council holds 50 and OPL holds 50. All the shares in FERL 1 and FERL 2 are held by SSDC OPL.

2.22. The returns from these investments come by way of interest on the capital lent by SSDC to the joint venture company, and dividends from the profits of the company. In addition, the loan repayments are used to fund the capital budget thus reducing the Council' s overall borrowing needs.

Table Two: loans made to SSDC Opium Power Ltd and subsidiaries

Amount Lent	Loan Date	Interest rate	Loan Period	Maturity date
9,840,000	17/05/2018	5.00%	8.25 yrs	31/07/2026
1,284,000	29/03/2019	5.00%	7.35 yrs	31/07/2026
2,033,055	15/08/2019	7.50%	7 yrs	31/07/2026
13,157,055	Total Loan to SSDC Opium Power Ltd			
18,690,560	20/10/2020	4.00%	25 yrs	01/01/2047
18,690,000	Total loan to FERL 1			
10,318,980	26/05/2021	4.00%	25 yrs	01/04/2048
10,630,877	Total loan to FERL 2			
42,477,932	**Total loan to SSDC OPL and subsidiaries**			

2.23. The loan balance at the end of March 2023 is forecast to be £39m. £3m of the £3.7m scheduled loan repayment for 2022/23 has already been paid (as at the time of writing this report).

2.24. As these projects needed to be constructed prior to any trading, there was an initial period of investment without immediate return. Taunton was completed in 2020, FERL 1 was completed in February 2022, and FERL 2 reached completion in June 2022. The project on this last facility is completing all its technical tests and will shortly start trading.

2.25. SSDC Opium Power Ltd started to generate a profitable trading position during 2020/21. Under the provisions of the Shareholders' Agreement for SSDC OPL any dividend payment requires express consent from the Council. For Taunton, there can be no dividend until the loans are repaid in full. Profits made to date have been used to accelerate the repayment of the loans provided by the Council. The dividend share is 50:50 between the Council and the other shareholder (OPL).

2.26. FERL 1 began to trade during 2022. Loan repayments are being made in accordance with the minimum amounts set out in the loan agreement, leaving a surplus in the company. Any profits are shared 65:35 in favour of the Council. As at the time of writing this report, the predecessor council is considering its position on whether to take a dividend or require the profit to service the earlier repayment of the loan debt outstanding.

2.27. FERL 2 has similar arrangements to FERL 1 other than the profit shares being 70:30 in favour of the Council.

2.28. **Security, Liquidity, and Yield**: The arrangements involve substantially more complexity than the property investments with the company structure, separate accounting and governance, and the need for the Council to appoint Directors to the Board. This investment sector is very specialised requiring niche advisory providers and is focussed on an emerging market which should be viewed as riskier.

2.29. However, the loan principal and interest are being paid in line with the agreed loan schedule. The current income returns to the company are well above the forecasts made when the lending was approved, but this trading information cannot be disclosed in a public report. The investment, like the commercial property portfolio, is not particularly liquid.

3. Investments made for service purposes

3.1. The predecessor councils have lent money to businesses, charities, housing associations, and other public bodies to support their service objectives. The table below shows the service investments (which are in the form of loans) the new Council will inherit on 1 April 2023 (unless any are redeemed early).

Table Three: Service Investments held by Somerset Council

Sector	Total Loan amount £	Financial Year(s) given	Total Balance as at 1/04/23 £	Length of loan period(s) remaining	Interest rate(s)
Registered Housing Association	117,810	1971/72	44,500	10 years	2.84%
Registered Society	1,684,900	2014/15 2015/16 2021/22	1,020,124	7 years	Various 3.49% - 4.89%
Charities	3,566,646	2017/18 2019/20	3,341,363	2- 26 years	Various 2.57% - 4.5%
Local Business	500,000	2018/19	400,223	14 years	3.75%
Council subsidiary	1,480,000	2015/16 2018/19 2019/20 2020/21	1,320,661	22 -27 years	Various 1.11% - 5.04%
College	4,500,000	2019/20	4,176,577	17 years	4.50%
Local Business	190,000	2015/16	88,890	13 years	2.76%
Schools	271,424	various	TBC	various	0%
	12,310,780		**10,392,338**		

3.2. Members may also wish to note that the Councils currently hold inter-authority service loans, for example in respect of loans provided by the district councils to SCC towards funding capital investment in the Somerset Waste Partnership. When the councils merge to form the new unitary authority on 1 April these loans will be cancelled, leaving the ongoing capital financing requirement to be financed through future treasury management.

3.3. **Security**: The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. However, the total risk exposure to service investments is currently £10.4m, which is not considered to be disproportionate to the overall size of Somerset Council.

3.4. Accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figure for any loans in the statement of accounts at the end of 2023-24 will be shown net of this loss allowance. However, up to this point in time no loss or impairment of these loans has had to be made.

3.5. **Liquidity**: These investments are not liquid as the repayments are made in line with agreed loan agreements. Table Three shows that most of the outstanding current debt will not be fully repaid before fifteen years.

3.6. **Yield**: In view of the public service objective, the yield obtained from the service investment has not always been the primary consideration.

Policy for granting service loans

3.7. Whilst given the public service objective, the Council is willing to take more risk than with conventional treasury investments; any decisions on granting such loans will be made on the basis that repayment to the Council remains a firm, secure, and realistic commitment from the applicant.

3.8. The yield obtained will not always be a primary consideration, but the Council will normally seek to at least cover its own financing costs in funding the loan and will pay due regard to market rates.

3.9. The Council may also from time to time make Soft Loans (loans charged at interest rates at less than market value). Before such loans are undertaken, the implied subsidy will be clearly identified and quantified as part of the decision-making process.

3.10. All loan requests must be set out in a Business Case from the sponsoring service demonstrating how the loan will deliver service outcomes.

3.11. Due diligence will be undertaken by carrying out a proportionate review of the credit risk of the applicant, a review of its published financial statements, and the Business Case detailing how the loan will be used.

3.12. Where deemed necessary (for example where a large loan request has been made) the Council will seek a legal charge on the underlying assets of the applicant to mitigate against the risk of the applicant defaulting on the loan.

3.13. All service investment requests will be considered in the context of the impact on the cumulative total of all such loans made by the Council and any implications for the its shorter and longer-term cash flow requirements.

3.14. Total exposure for service loans will be contained within the prudent limit set within the Treasury Management Strategy.

4. Governance and reporting arrangements

4.1. In line with legislative requirements this Investment Strategy will be prepared annually and will be approved by full Council as part of the wider budget setting process.

4.2. The Audit Committee is responsible for reviewing this Investment Strategy, recommending the strategy to Council for approval. It will receive a Mid-year Review Report and an Outturn report which are also reported to Council.

4.3. Monitoring of the budgets associated with these investments (for example, the rental income received compared to budget) will be included in the quarterly corporate budget monitoring report to Executive.

4.4. A review of the financial performance in terms of the net return being achived will be undertaken and reported quarterly in a separate report to Executive.

4.5. Significant information about the investments is required to be disclosed annually in the Statement of Accounts. This is subject to external audit.

4.6. Further appropriate governance arrangements will be put in place as part of the work on the constitution and democratic arrangements.

Officer delegation:

4.7. The Executive Director of Resources & Corporate Services (s151 Officer) has the overall responsibility for delivering the agreed Non-Treasury Management Investment Strategy and the 2023/24 Strategic Objectives.

4.8. Appropriate delegations will be made to the Service Director - Strategic Asset Management and the Service Director – Finance & Procurement to support delivery.

5. Management of the investments, capacity, and skills

5.1. **Property Portfolio Management:** In terms of day-to-day resource requirements and officer focus, the commercial property portfolio and SSDC OPL will need more proactive management than the other non-treasury management investments.

5.2. The four predecessor districts approached portfolio management in a broadly similar way and managed single-let properties in-house with multi-lets managed via external agents with service charge administration costs recovered from tenants. Managing multi-tenanted property is more complex and time consuming that managing single let property.

5.3. Investment property asset management is an area of experience not held by some local authority property specialists. Currently, there are only two investment specialists employed within the predecessor councils.

5.4. At the time of publication of this report, Somerset Council is very much in a transitional phase, with appointments to the tier 3 structure unlikely to be in place in January 2023 and with a clear position from the Chief Executive that the development of detailed structures beneath tier 3 will not be taken forward until service directors are in position.

5.5. It is not possible therefore to give details of the arrangements that will be available to manage the commercial property portfolio apart from the fact that it will fall within the service area for the Service Director - Strategic Asset Management. Sufficient budget for the staffing establishment, advisers and the range of consultancy costs must be retained so that good practice management delivery can be achieved as that is critical to income performance and protecting value.

5.6. The objectives for the management of the commercial property investments will be to:

a) Ensure that the Council has a fully resourced, proactive, and professional management in the handling of its commercial property to optimise the value of the investments and rental income over time. The evaluation of the mix of in house and external resources is in hand but not yet completed.

b) Modernise asset records and systems to ensure the efficient management and recording of property/tenant data and lease renewal dates to aid the timely collection of rents and service charges.

c) Ensure Property Finance management is a focussed activity with sufficient resources to deliver ongoing financial due diligence, monitoring and reporting, and to support decision making. This is a critical resource requirement due to volume and value of financial transactions involved with the portfolio, and the specialised requirements.

d) Develop a unified policy on the approval and giving of discounts and incentives, deposit management, debt collection, and write-offs.

e) Ensure effective budgetary control of the Council's financial position through completion of realistic prudent budget estimates and ongoing review of income, debt levels and void rates.

f) Undertake yearly valuation of investment assets.

g) Undertake effective rent reviews, re-gearing of leases where appropriate, or remarketing of lease opportunities in a timely and market-focused manner.

h) Undertake tenant vetting prior to a new lease being granted to minimise credit and default risk.

i) Ensure tenants fulfil their repair and maintenance obligations of their lease including dilapidation on termination.

5.7. **Skills and knowledge available:** The Executive Directorate of Resources & Corporate Services will include officers who are qualified chartered accountants and chartered surveyors.

5.8. Ongoing treasury management advice and taxation advice will be provided by specialist advisers to the Council.

5.9. The Council will use valuation experts to value Property, Plant and Equipment and Investment Properties. Expert advice will also be procured to value SSDC Opium Power Ltd battery storage assets which require very specialised advisers.

5.10. The portfolio management approach is being reviewed. Options will be presented with recommendations. Any internal appointments and external advisers can then be appointed and transition from existing arrangements and contracts completed.

5.11. Other specific advice will be procured as and when needed. There will be significant property legal resource requirements. The resourcing approach will need to be agreed and put in place.

5.12. The Council will ensure that appropriate training and learning is given to all officers involved in this area of work.

5.13. It is important that elected members understand the decisions they will be asked to make relating to these investments and indeed this is a regulatory requirement in CIPFA Prudential and Treasury Management Codes.

5.14. To ensure that members have the knowledge and skills required to support them in their decision-making role, a series of training events will be developed during 2023/24 which will cover the relevant knowledge areas.

6. Financial Performance of the investments made primarily for yield

6.1. Financial modelling has been undertaken to determine the net impact on the Council's General Fund revenue budget of holding these investments after considering the financing costs that can be reasonably associated with the borrowing undertaken to fund their acquisition.

6.2. Borrowing is of three types:

- Internal borrowing – using available cash to purchase the investment instead of putting the cash into the bank or other savings accounts. The use of this cash is temporary as it needs ultimately to be used for its intended budgeted purpose.
- Short term borrowing, generally a year or less, from external institutions.
- Longer term borrowing from external institutions, for example the Public Works Loan Board (PWLB) with lending available for up to 50 years.

6.3. Other longer term financing options may be available such as leases.

6.4. Local government does not borrow specifically for a particular capital purchase of an investment unlike, say, a homeowner who obtains a mortgage to fund a particular property.

6.5. This makes it difficult to be precise about what sort of borrowing has been undertaken in respect of financing these investments as compared to the rest of the capital programme. Mendip District Council obtained longer-term loan finance whilst the other three councils used internal borrowing and short-term loans in different proportions which changed over time.

6.6. A pragmatic view has been taken by calculating the proportion of the Capital Financing Requirement (CFR) (the amount of indebtedness held by the predecessor councils) arising from these investments as a percentage of the overall indebtedness incurred by funding their capital budgets. This amount has then been reduced to take into account the MRP (Minimum Revenue Provision) payments made by the councils since the investments were acquired (by £15m) which has reduced the indebtedness held.

6.7. This CFR position is used as the starting point to analyse whether the gross rental income is sufficient to cover the 2023/24 and future years' financing charges arising from this inherited indebtedness position. Current and forecast interest rates are used as well as the new Council's proposed MRP Policy.

Other key assumptions made:

6.8. The worst-case position for borrowing: that is the Council takes out loan finance from the PWLB rather than uses its own cash or short-term borrowing - both of which would have lower interest rate implications than PWLB borrowing. In practice the Council may not be able to use PWLB for a significant proportion of refinancing and will instead prioritise other options such as loans from other local authorities which tend to be cheaper than PWLB.

6.9. An average interest rate of 4.5% is currently being used for budget estimates, derived from assuming PWLB borrowing over a 50-year period. Further work is required to quantify a blended notional interest rate that reflects the Council's overall approach to treasury management.

6.10. The interest rate forecasts for 2024/25 use advice received from Arlingclose, the Council's Treasury Management advisers, and is based on their assumption of declining interest rates from 2024/25 and onwards. More detailed advice from the advisers on interest rates is given in the 2023/24 Treasury Management Strategy.

6.11. MRP costs of 2% on an Equal Instalments Basis. Further work is needed to finalise the MRP Policy and select a calculation method that reflects a prudent approach for this type of activity and is acceptable both to the S151 Officer and the Council' s external auditor.

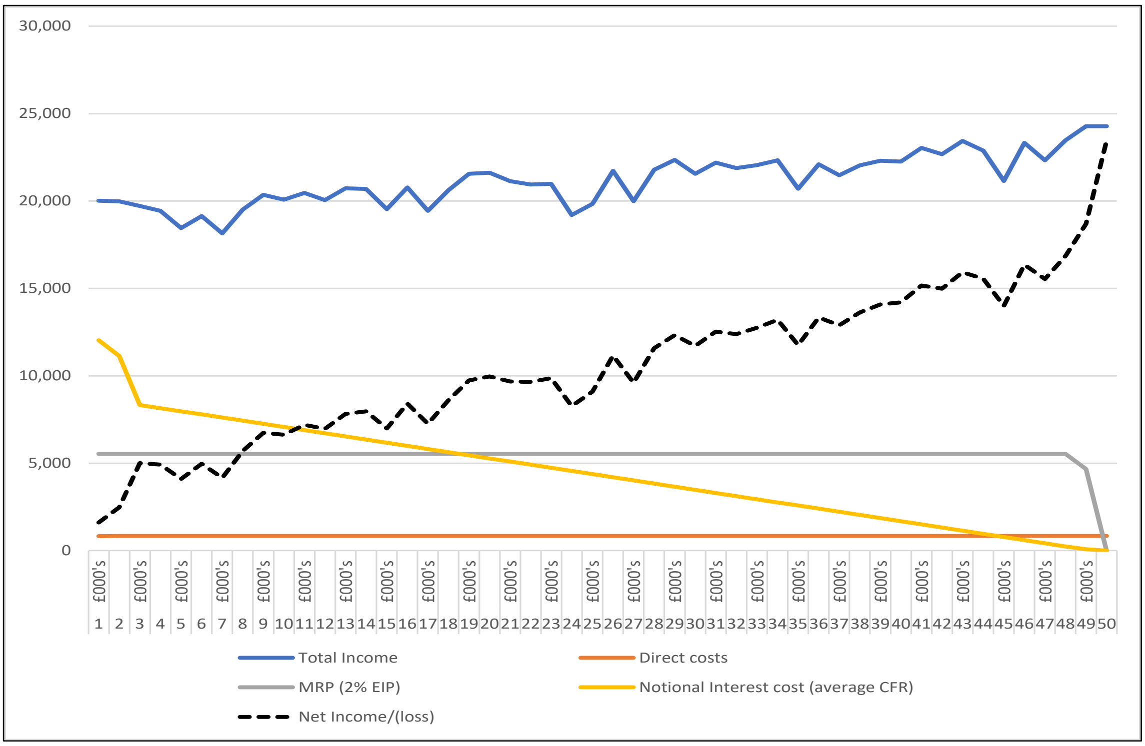
6.12. Financing costs are expected to reduce as the overall balance of CFR reduces each year. Costs will vary depending on the CFR balance and the interest rates than can be obtained each year.

6.13. Rental income is assumed to increase by 2% in a five yearly cycle. This is considered a prudent estimate for forecasting the average direction in the property market erring on the side of caution.

6.14. A cautious allowance has also been included in the model for void periods and the potential need for incentives such as a rent-free period for new tenants.

6.15. An assumption that the six properties that are currently void remain so over the modelling period, although all appropriate steps are being taken to improve on this assumption.

Chart Seven: Base mode in £000s (using Arlingclose interest rate forecasts)



6.16. Chart Seven above shows a fifty-year net income forecast (the dotted line) given the assumptions listed in the paragraphs above. (Year 1 is 2023/24). Rising interest rates are currently putting pressure on the investments achieving the net returns originally experienced when they were acquired.

6.17. The analysis shows that an estimated net return of 0.8% is forecast to be made in 2023/24 from the commercial property investments. This is at the overall portfolio level and is the estimated surplus after covering direct management costs, interest costs, and debt repayment. The net return however is very sensitive to interest rate changes and forecast rates going forwards. A 0.5% increase in interest rate assumption decreases the net return to 0.3%.

6.18. Net returns have also been calculated for each individual investment (not shown in this report), although the nature of the spread of investments means the return will vary from asset to asset based on many factors. The range is a negative 0.8% to a positive 4.5%, with 12 out of the 48 investments currently showing a negative return.

6.19. Chart Seven shows that the longer these investments are held, and as the outstanding debt is repaid off, the net return should increase. However, this analysis does not factor in potential risks relating to the individual investments (apart from potential void and rent-free periods) such as landlord capital costs and property obsolescence, nor the risks at portfolio level such as further legislative changes limiting local government holding these investments. A discussion of the potential risks associated with these investments is given in Annex 12B of this report.

6.20. Whilst the overall conclusion from this financial analysis is that Somerset Council retains these investments immediately post vesting day: both the financial and property officers involved in this work could propose individual investments that would be more obvious candidates for selling should the Council wish to consider this post vesting day. A key further element of work that would be needed however to take this forward would be to obtain a more recent valuation of the individual investments before taking a final decision. The latest valuations date from the end of March 2022.

6.21. Regular review of the net return position for the portfolio as well as the individual investments will be needed post vesting day as proposed in strategic objective 2 (paragraph 1.5).

ANNEX 12A: INVESTMENT PRUDENTIAL INDICATORS

Investment cover ratio:

This ratio shows how many times the total net income from non-treasury management investments relating to the Investment Properties can cover the interest costs associated with the outstanding indebtedness that has arisen from funding these investments. This demonstrates the Council's ability to service this indebtedness.

Table: Four Investment Cover ratio: times interest cost covered by income					
Year ended	Gross Income	Direct costs	Net Income	Interest cost	Cover ratio
	£000's	£000's	£000's	£000's	Times
31/03/2024	20,015	840	19,175	12,033	1.6
31/03/2025	19,977	840	19,136	11,129	1.7
31/03/2026	19,712	840	18,872	8,331	2.3

Loan to value ratio:

This is the amount of indebtedness currently held compared to the total asset value. In this instance, the asset value is the total value of the Council’ s property investments made primarily for yield. This illustrates whether the Council has assets of sufficient value to repay debt if required.

It should be noted that the Asset Valuation is the latest one undertaken, as at 31 March 2022. The next valuation will be undertaken for the 2022/23 Statement of Account (as at 31 March 2023) and is not yet available.

Table Five: Loan to Value ratio: % Closing CFR to Asset Valuation			
Year ended	Closing CFR	Asset Valuation	Cover ratio
	£000's	£000's	%
31/03/2024	264,628	264,167	100%
31/03/2025	259,097	264,167	98%
31/03/2026	253,566	264,167	96%

Total investments made primarily for yield as a proportion of total capital financing requirement (CFR):

This shows how much of the Council’ s overall CFR (indebtedness) (excluding Housing Revenue Account CFR) pertains to property investments made primarily for yield.

Table Six: % Property Investments CFR to Total CFR			
Year ended	Closing CFR	Total CFR	Cover ratio
	£000's	£000's	%
31/03/2024	264,628	1,022,100	25.9%
31/03/2025	259,097	1,031,000	25.1%
31/03/2026	253,566	1,015,700	25.0%

Income returns:

Net revenue income from commercial properties compared to the value of the property investment portfolio. This represents the yield of the portfolio as a whole – generally, the higher the percentage the better the performance of the portfolio. However, the better the quality of the asset and the tenant, the lower the yield is likely to be. Therefore, a balance needs to be struck between high yield and good quality assets.

Table Seven: Income return: % net compared to Asset Valuation			
Year ended	Net income	Asset Valuation	Cover ratio
	£000's	£000's	%
31/03/2024	1,611	264,167	0.61%
31/03/2025	2,476	264,167	0.94%
31/03/2026	5,010	264,167	1.90%

It should be noted that the Asset Valuation is the latest one undertaken, as at 31 March 2022. The next valuation will be undertaken for the 2022/23 Statement of Account (as at 31 March 2023) and is not yet available.

Gross and net income:

The income received from the Council' s investment portfolio at a gross level and a net level (after the deduction of operating costs, interest & MRP). These figures have been incorporated into the 2023/24 and MTFP revenue budget estimates.

Table Eight: Gross & Net income			
Year ended	Gross income	Net income	Cover ratio
	£000's	£000's	%
31/03/2024	20,015	1,611	8.1%
31/03/2025	19,977	2,476	12.4%
31/03/2026	19,712	5,010	25.4%

Net Commercial Income to Net Service Expenditure:

This indicator measures the Council' s dependence on the income investments made primarily for yield to deliver core services. It indicates proportionality and whether the authority is taking too much risk in aggregate.

Table Nine: Net Income to Council's Total Net Service cost			
Year ended	Net income	Net Service cost	Cover ratio
	£000's	£000's	%
31/03/2024	1,611	494,820	0.33%
31/03/2025	2,476	542,070	0.46%
31/03/2026	5,010	588,000	0.85%

ANNEX 12B: RISK ANALYSIS AND MITIGATION MEASURES

Risk appetite: can be defined as "the amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time". Risk always exists in some measure and can never be totally removed.

The new Somerset Council will need to develop its risk appetite regarding these investments. This will be facilitated by the establishment of an Investment for Yield Performance Review Board as proposed in a previous section of this report. This section on risks applies to all the non-treasury management investments.

At the time of writing this report, it has been assumed that Somerset Council will accept these potential risks at vesting day. The rest of this section describes the key risks involved, giving a monetary value for the total risk exposure, where possible, the likelihood of the risk happening (High, Medium, Low), and proposed mitigation measures.

The potential risks involved can be broadly categorised into two major areas:
- Potential risks at the individual investment and overall portfolio level.
- Potential risks arising from economic and legislative changes

Each predecessor district council built up earmarked reserves to help finance the cost of the potential risks should they arise. It is estimated that the four districts will transfer around £10m in reserves for this purpose on 1 April 2023. This represents some 50% of the 2023/24 gross annual rental income budget from the commercial property investments. A full review of the reserves position will be undertaken during 2023/24.

Potential risks at the individual investment and overall portfolio level:

Risk that loans made to 3rd party organisations are not repaid

Likelihood: This is considered low risk for service investments given the nature of the organisations the predecessor councils have lent to. In terms of SSDC Opium Power Ltd (SSDC OPL) it is considered to be low to medium as the loan is secured against the assets, principal repayments are being made in line with the loan agreement, and two out of the three companies are now trading at a profit.

Total risk exposure: For service investments - £6.6m.
For loans made to SSDC Opium Power Ltd and subsidiaries - £39m.

Risk Mitigation: For new service lending this will include undertaking proportionate:
- Credit rating checks
- Analysis of the financial health of the organisation
- Review of the Business Case on how the loan is to be used
- A consideration of a legal charge on the borrower's assets
- Risk Mitigation for SSDC Opium Power Ltd and subsidiaries:
- Lending secured against the assets of the companies.
- Active involvement and monitoring of the JV company is a fundamental mitigation to protect the lending and value of the shareholding.
- Suitable governance for selection of Council appointed directors.
- Monitoring that joint venture companies are correctly resourced in terms of management, advisers, and contractors.
- Appointment of appropriate expert advice when required.
- Full records and documentation for use of Council and compliance with Council accounting, standards, and procedures.

Risk that there are void rental periods

Description: Voids arise from having the property vacant (end of lease and inability to attract a new tenant, or tenant bankruptcy) or from negotiated rent free periods. The former the situation would mean not only the loss of rental income but the requirement to cover property costs such as Business Rates, void service charges, insurance, and security.

Voids frequently require some landlord capital spend to protect the long-term performance of the asset and achieve the best outcome on re-letting. There are fees to be met for letting agents and lawyers. Most new leases include a rent-free period as part of the letting package. Attempts to depart the normal mix of rent levels, lease terms and incentives are likely to frustrate the ability to re-let.

Likelihood: Low/medium: Currently there are six void properties. Most of the properties acquired are below £10m which means less risk of a single large tenant failing.

Total risk exposure: The current gross rental income is £20m.

The table below shows when leases end over the next few years and the rental income that would be at risk if a new lease is not obtained.

Table Ten: Lease end dates over the next few financial years

Financial Year	No of Properties	Rental income at risk £000's	% of overall income at risk
2022/23	9	£966	5%
2023/24	8	£1,388	7%
2024/25	8	£1,012	5%
2025/26	11	£2,533	13%
2026/27	14	£3,072	15%
2027/28	8	£1,622	8%
2028/29	7	£1,358	7%
2029/30	7	£2,004	10%

A small proportion of the properties are judged to involve greater short-term risk:

- M&S retail property at Yeovil (lease ends 31/03/27 – rental £505k pa; market rental value below 60% of passing rent and difficult to re-let)
- Wilko retail property at Yeovil (lease ends 28/04/25 – rental income £435k pa; market rental value below 50% of passing rent and difficult to re-let)
- Lyndon Place office in Birmingham (lease ends 31/10/2026; costly and difficult capital works required; high risk of void – rental income £196k pa)
- NCP (car park) in Bournemouth (tenant defaulted on lease; 12 month rolling agreement, ongoing risk, £200k pa income)

Risk mitigation:
For new tenancies undertake:

- Credit rating checks on tenant
- Analysis of a tenant' s financial health, business operations, and future performance
- Consider asking for a deposit from the tenant

For overall portfolio tenancies:

- Establish and maintain robust lease events calendar system and regular monitoring with structured arrangements for action triggers.

- Undertake prudent and realistic annual budgeting for income and costs.
- Proactively manage tenant relationships and intended tenant activity with the objective to secure the highest proportion of lease renewals rather than lease ends and re-letting.
- Proactively market new lease opportunities in a timely manner to minimise letting void periods.
- Retain earmarked risk mitigation reserve for these investments.

Risk that the building condition requires Council expenditure

Risk explanation: Properties may need expenditure to remain attractive to the market or to comply with current or future legislative standards, such as meeting the new Energy Performance Certificate (EPC) standards.

Review of the investment for yield portfolio has not yet identified any unit with an EPC rating worse than E although the review has a small proportion of properties yet to confirm. There will be future management needed for this as the EPC requirements will be increased to the point where a required rating of 'B' or above has been proposed to be needed by 2030.

Total risk exposure: short term risk is already addressed in capital budgets. Modelling should be undertaken to assess this component of risk reserve levels for the medium/long term.

Risk mitigation:

- Dilapidations at lease end are mostly at the expense of the tenant.
- Formal review of all existing let units should identify limitations on tenant repair obligations such as schedule of condition.
- Develop and maintain a robust capital budget for landlord expenditure at every potential lease expiry having regard to potential shortfalls in tenant dilapidations and reinstatement, key risks around building services, and aspects of building upgrades considered optimum for medium term income performance and lettability.
- Ensure management of the dilapidations processes are delivered in line with best practice to minimise cost impact to Council.

Risk that the portfolio is overexposed to certain property sectors and/or geographical locations

Risk explanation: There is more risk in owning a property portfolio where there is limited diversification in terms of geographic location and / or tenancy/property sector invested in.

Likelihood: The commercial property portfolio is diversified in terms of property sector and geographic location. This diversification reduces the risks of exposure to a single asset, tenant, or sector failure.

The portfolio at first glance may appear overweight in retail, but this is mitigated by the mix of high street, out of town, and retail warehouse properties. These are distinct sub-sectors performing quite differently.

Most substantial commercial property investors aim to achieve some portfolio churn in the medium term, selling properties when they offer the peak opportunity to realise capital growth or evolve the balance of the portfolio to respond to future or past changes in sector performance.

However the potential to pro-actively manage the portfolio appears severely limited by the terms of Prudential Code. The meaning of clauses in the Code referring to rebalancing and improvements may be clarified when the policy has been in use for some years.

Risk mitigation:
Whenever the highest-level strategy for commercial investments is set or revised, assessment should be made as to whether to seek recommendations for any properties for disposal due to issues of portfolio balance.

Risk that the Council may not receive the value invested if it sells

Risk explanation: property values can go up and down and there is the risk that the council can make a loss on the sale. Values are prone to fluctuation, for a range of reasons. These include economic shifts, changes in strategic investor requirements, financial market shifts, sector relative pricing, changes in the locality, or asset specific risks, such as tenant failure.

Likelihood: There is an immediate post-acquisition loss of the costs of purchase – assumed to be typically 6.8% of purchase price for Stamp Duty Land Tax and advisory fees. Shorter lease properties, or those where the contracted rent is well above the market rent, tend to progressively reduce in capital value as the lease term reduces. The capital value should return to the best level following successful reletting. In the case of over-rented properties, the eventual value is expected to be below purchase price.

Total exposure: The unaudited value of the investments as at the end of March 2022 are £264m. As compared to the total investment made (£289m) this is a decrease in value of £25m (9%), which is in part expected as initial costs include sunk costs such as taxes and fees above the purchase price. A new valuation will be undertaken to produce the 2022/23 Statement of Accounts, and as at 31 March each year thereafter. Any gains and losses in valuation do not impact on the budget or useable reserves, instead being written off to the Revaluation Reserve and Capital Adjustment Account. Any future actual disposal net proceeds are treated as capital receipts, and it is proposed these will be prioritised to reduce the Capital Financing Requirement (borrowing). If the proceeds fall short of the CFR balance at the time the residual amount will remain to be funded through the annual revenue charge for debt repayment (MRP) or other capital receipts set aside for debt repayment.

Risk mitigation: The council will undertake proportionate due diligence including:

Market Testing – The general presumption should be that any sale of an investment property asset should be subject to an open market sale where reasonable steps have been taken to identify all interests in acquiring the asset subject to expert advice on how best to optimise the value of the sale. There may be situations of a possible "special purchaser" – such as the tenant or owner of neighbouring property – where the price cannot be tested by general marketing. In any such cases, prior approval to engage would be confirmed with the Investment for Yield Performance Review Board. Confirmation that the negotiated price is appropriate and in excess of normal market value will be confirmed by external valuation.

Valuation – When an assessment is being made of whether to sell, advice should be obtained from appropriate specialists on expected selling price as well as best approach to marketing. An external investment agency firm is most likely to be used for sales and they should provide appropriate formal advisory recommendations.

Pre-sales due diligence – prior to any marketing, good practice due diligence should be completed to include legal work on perfecting title; resolution of management matters and assembly of good records and completion of any appropriate data room. The aim is to enable the sales process to progress in the easiest way and be able to close out any intended transaction with the risk that is involved with delays or unknowns coming to light.

Risk that the Council may not receive cash quickly if it wants to sell

Risk explanation: commercial investment property is relatively illiquid. Key reasons are that disposal must involve the whole property interest, and it involves a process of individual marketing, negotiation, due diligence, and then legal transaction. This is demanding and slow compared with assets such as equities, bonds, or investment units. Values are prone to fluctuation, particularly due to changes in the locality, the general economic outlook, or asset specific risks, such as tenant failure. The market is impacted by changes in confidence. Sharp economic downturn may lead to a period of severely restricted buyer demand.

Likelihood: The market fundamentals for this asset class are a fixture which cannot be avoided, and part of the context for direct investment in property. Extreme market cycles are occasional but difficult to predict.

Total exposure: This depends on the high-level strategy. If the intention is a long term "hold" then this risk is in the background. The current Prudential Code means the council could not operate as a "trader" in investment property. If there is an intention to partly or fully divest from the property investment portfolio, this can be planned to be delivered when market conditions are helpful and in an orderly programme.

Risk mitigation:
- Long term cash management planning so that shorter term capital requirements do not need to be linked to property investment sales.
- Any divestment options for investment property should be considered with strategic advice as to the expected market conditions and values, and if implemented then the approach should allow a reasonable time-period for sales to be concluded.
- A high-level strategy for the property investment objectives needs to be formulated and periodically reviewed. This will set and re-set the intentions as to the extent of divestment, if any.
- The property investment team should review the legal package for each asset, manage the physical assets, and tenant relationships and records so that there is a general situation of readiness should there be a decision to sell. Presale packs prepared before any property is put on the market.

Potential risks arising from economic and legislative changes:

Unfavourable economic outlook

Risk explanation: Property financial performance is closely related to factors in the general economy. Including prevailing interest rates.

Likelihood: A significant proportion of the capital financing requirement is currently financed through internal borrowing (which reduces treasury investment risk) and through short term loans. The Council will need to replace short term loans and may need to externalise internal borrowing and is therefore exposed to the interest rates available when refinancing decisions are made. If the cost of borrowing increases this adversely impacts on net income available to fund services.

It is considered highly likely that interest rates will continue to rise for the next 1-2 years but then begin to fall. It is considered unlikely the rates will return to the historic lows seen on the past decade.

Total Exposure: The estimated CFR on 1 April 2023 is £264m. 1% volatility in interest costs for a full year would be £2.64m.

Risk Mitigation:

- Prudent estimates of anticipated interest costs used for the budget.
- Taking advice from Arlingclose on a prudent treasury management approach to support the Council's overall approach to investment and borrowing.
- Holding adequate reserves to withstand adverse budget variances.
- Applying MRP to reduce debt and therefore the amounts required to be refinanced.

Risk of further changes to legislation

Risk explanation: Government and CIPFA have undertaken significant changes to legislation and guidance over recent years regarding investments made for yield with the impact of restricting activity by councils in this area. There could be further legislation in the future.

Likelihood: Government has already consulted in changes that would require councils to provide Minimum Revenue Provision (MRP) on lending to third party organisations (see Annex 12C).

There is also a possibility that enforcement will result in investment for yield investments having to be held via a company structure rather than directly by councils.

Risk mitigation: to keep aware of possible legislative changes and respond to any further consultations.

ANNEX 12C: RELEVANT REGULATORY FRAMEWORK

Borrowing from the Public Works Loan Board (PWLB)

On 26th November 2020 HM Treasury introduced new lending terms for the PWLB. Guidance issued at that time was further clarified and updated on 21st August 2021.

The changes mean that local authorities will be unable to borrow from the PWLB to finance any expenditure in their capital budgets if they are planning to acquire new investment assets bought primarily for yield in any of the following three financial years.

Local authorities cannot use the receipts from selling investments made for yield to acquire new investment for yield assets. Local authorities can only use the receipts from selling these investments to finance other capital expenditure in service delivery, regeneration, housing, and preventative action, or to repay capital debt.

HM Treasury advise that investment assets bought primarily for yield would usually have one or more of the following characteristics:

- buying land or existing buildings to let out at market rate,
- buying land or buildings which were previously operated on a commercial basis which is then continued by the local authority without any additional investment or modification,
- buying land or existing buildings other than housing which generate income and are intended to be held indefinitely, rather than until the achievement of some meaningful trigger such as the completion of land assembly, and
- buying a speculative investment asset (including both financial and non-financial assets) that generates yield without a direct policy purpose.

This does not prevent local authorities from borrowing for projects that are primarily for other purposes, but which also happen to generate a financial yield.

Local authorities are also able to borrow from the PWLB to finance capital expenditure to maintain existing commercial investments or to fund capital investment needed to increase their value prior to disposal.

Any investment bought primarily for yield which was acquired after 26th November 2020 results in the local authority not being able to use the PWLB to refinance this transaction at any point in the future. Such investments acquired, or contractually committed, prior to 26 November 2020 will not affect the local authority's access to the PWLB.

As a condition of accessing the PWLB, Local Authorities must submit a high-level description of their capital spending and financing plans for the following three years, including their expected use of the PWLB. The S151 Officer needs to confirm that there is no intention to buy investment assets primarily for yield at any point in the next three years. This assessment is based on their professional interpretation of guidance issued.

CIPFA Prudential Code

The Local Government Act 2003 requires Local Authorities to "have regard to" the Chartered Institute of Public Finance and Accountancy (CIPFA) Codes of Practice and they must explain their rationale and get Council approval if they choose to disregard this guidance.

A revised Prudential Code was published in December 2021. Some of the requirements of the revised Code applied with immediate effect following publication; including the stipulation that an authority must no longer borrow to invest primarily for a financial return.

Other changes could be delayed until 2023/24 including the requirement to annually review investments held primarily for yield with a view to divesting where appropriate. Relevant extracts from the Code are given below.

Authorities with existing commercial investments (including property) are not required by this Code to sell these investments.

Such authorities may carry out prudent active management and rebalancing of their portfolios, including repair, renewal and updating of the properties.

However, authorities that have an expected need to borrow should review options for exiting their financial investments for commercial purposes and summarise the review in their annual treasury management or investment strategies.

The reviews should evaluate whether to meet expected borrowing needs by taking new borrowing or by repaying investments, based on a financial appraisal that takes account of financial implications and risk reduction benefits.

CIPFA revised Treasury Management Code (2021) and DLUHC Statutory Guidance on Local Authority Investment Activity (2018)

These essentially contain the same statutory guidance with respect to non- treasury management investments. They contain requirements for councils to:

- Prepare an annual Investment Strategy which must be approved before the start of the forthcoming financial year by full Council.
- Ensure the strategy is publicly available on a local authority's website.
- Disclose the contribution that all non-treasury management investments make towards the service delivery objectives and/or place making role of that local authority.
- Include quantitative indicators within the strategy, that allow Councillors and the public to assess a local authority's total risk exposure because of its investment decisions. This should include how investments are funded and the rate of return.

The guidance requires that councils should consider the long-standing treasury management principles of security, liquidity, and yield (in that exact order) when considering non-treasury investments. These principles are briefly explained below:

- Security - Safeguard the value of, and expected returns from, the council's investment.
- Liquidity - Ensure the investment can be quickly divested to meet the council's cash flow requirements.
- Yield (the net return achieved from the investment) - Investment return is the final objective and should be considered after the security and liquidity requirements have been satisfied.

Minimum Revenue Provision (MRP)

MRP is the minimum amount which a council must charge to its revenue budget each year, to set aside a provision for repaying external borrowing (loans) and/or internal borrowing. It is the statutory duty for each authority to determine each year an amount of MRP that it considers to be prudent in accordance with section 21(1A) of the Local Government Act 2003 (revised 2018).

Recent consultations by DLUHC (Department for Levelling Up, Housing and Communities) indicate they would like to reform the guidance around MRP and, specifically with reference to non-treasury management investments, legislate councils to provide MRP on a debt which relates to investment for yield assets or capital loans made for yield or for service purposes. The legislation has been delayed and has not yet been introduced. However, the Council’ s MRP policy will include the approach recommended by the S151 Officer as a prudent provision notwithstanding future guidance.

Legislation regarding the sale of property investments

Compliance with Section 123 of the Local Government Act 1972 will be required which states that "except with the consent of the Secretary of State, a council shall not dispose of land under this section, otherwise than by way of a short tenancy, for a consideration less than the best that can reasonably be obtained".

Energy Performance Certificates (EPC)

Energy Performance Certificates (EPCs) set out how energy-efficient a property is from A (most efficient) to G (least efficient). They also show the potential level of emissions and associated costs of improving the rating for that property. Owners must obtain an EPC whenever a property is built, sold, or rented.

From April 2023, it will be a legal requirement for all commercially rented properties to have an EPC (Energy Performance Certificate) rating of at least E. This is currently a legal requirement for commercial properties before they can receive a new or renewal lease, but from next year this requirement will be extended to both new and existing commercial leases too.

The responsibility for obtaining an EPC is with the landlord of a property except where a lease is in place with an original term more than 99 years.