South Somerset District Council

Investment Asset 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 December 2020.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of June 2021. This report follows the format of the regular six monthly reports, albeit it follows a quarterly report in March 2021 reflecting the increased frequency of reporting linked to COVID-19 pandemic.

Public Interest

3. The Council's commercial strategy forms an important part of the Council's Corporate Plan ("Council Plan") and its Financial Strategy. Delivery of the Commercial Strategy enables the council to protect services to residents in the light of reduction in funding and to deliver its ambitions for South Somerset, for example the regeneration of town centres and high streets. This report is to update members on progress made to date on the investment component of the Commercial Strategy. The Council originally agreed to receive update on progress every six months. District Executive decided to receive quarterly summary update reports on Investment Assets until further notice in light of the economic effects of the COVID-19 pandemic. The last report was in March 2021.

4. The report includes updates on the purchase of new commercial property investments, 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, and updated with the review by District Executive and Full Council of the Financial Strategy and Commercial Strategy in September 2019.

5. The aim of this report is to give Members and the public an update on the performance and impact of the property investment to date including its contribution to mitigating the impact of reductions in Government funding and protecting services.

6. 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

7. That the District Executive:
   a) Note the resilience of the property investment portfolio throughout the COVID-19 pandemic.
   b) Note progress made to date in acquiring new commercial property investments and the asset management following acquisition.
   c) Note the return being achieved across the portfolio which is slightly below the Council's target of 7%.
   d) Note progress being made in securing income from our existing assets and the contribution to the revenue budget towards the revised £3.35m target.
   e) Note progress being made in disposals and transfers of existing assets, resulting in a reduction of future liabilities associated with these assets.

Background

8. Council approved a commercial approach to Land and Property management in August 2017 as part of the Commercial Strategy which was supporting the objective of becoming financially self-sufficient.

9. The commercial approach to Land and Property management is the major financial component of the Commercial Strategy. The objectives are to invest in additional commercial property assets and to manage existing land and property assets more commercially

10. 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.

11. This report is a succinct update of high level figures for new investments since February 2021 up to 30 April 2021. It also updates members on work being carried out to increase income from existing assets and reduce liabilities.

Covid-19

12. The pandemic has impacted on all aspects of society and is affecting economies across the world. The Office for National Statistics reported a contraction in UK GDP by 9.8% in 2020. Although GDP increased by 1.3% in Q4 2020, it is likely

to have fallen again in Q1 2021 as a result of the latest lockdown. We have noted, as a result of the crisis, a negative impact on the office, and particularly High Street retail property markets.

13. Most commercial property leases provide for rent to be paid quarterly in advance in March, June, September and December. We have therefore had five rent days since the initial outbreak.

14. The March 2020 quarter day (25th March) was only two days after the initial lockdown began. A number of retail and leisure based funds and landowners were substantially affected. Our rent collection across the investment property portfolio was broadly unaffected, with collection figures of 98%.

15. Our team has focussed attention on the connection with our tenants. We have sought to show appropriate flexibility as part of a supportive attitude, but also to protect the Council's investments.

16. We had expected the June quarter day to be a substantially harder test, with tenants having had three months of hardship in which to strategise, however we are pleased to report rent collection of 95%. Collection over the past year is well above the industry average, assisted by a diverse portfolio, with a low proportion of High Street retail investments.

17. Our investment acquisition programme paused from March 2020 until February 2021, as we took stock of the market and turbulence caused by Covid-19. Broadly, an increasingly polarised commercial investment market has emerged over the past year, with last-mile logistics units and warehousing in higher occupational demand resulting in harder industrial yields, while retail and, to some extent, offices suffer.

18. This has presented a problem, in that we have not wanted to acquire property in sectors with decreasing demand, but have not considered it appropriate to be paying higher prices for assets in more sought after sectors. Accordingly, our last three acquisitions, a gym, a food production facility and a datacentre, have all been 'alternatives' as opposed to the traditional industrial, retail and office sectors.

19. The market remains suppressed when compared with pre-Covid levels of activity. Owners of office and retail assets that do not need to sell are holding on in the hope that a swift bounce back in the economy will reverse some of the damage caused by the pandemic. Owners are holding industrial assets because of their strong performance and continued rental growth. An increased number of deals are now taking place 'off-market' as vendors attempt to offload assets quietly to free up capital. Industrial and retail warehouse properties that are being widely marketed are achieving figures well in advance of asking price.

20. We have noted polarisation in Market Rents, with decreases in quoting high street retail rents and increasing incentivisation in the office sector, opposite increasing

rents in the industrial sector. This is an important consideration for the revenue returns the investments are providing. The council's position, like other investors, is significantly protected by the fact that most leases contain upwards only rent review provisions. We will look to augment the value of the portfolio by actively managing leases to seek longer terms.

Commercial Investments

21. 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.

22. To date, a total of £87.5m has been invested in commercial property, producing a running yield of 7.03% allowing for the rent free incentive on the renewal of the lease with the tenant of our property The Ralph, Marlow (6.77% otherwise). In a reasonable worst case scenario this will decrease to 6.37% in 2022/23. We will however continue to work to renew leases and review rents to achieve improved results. The target running yield is 7%.

23. This is a gross target, which does not take into account costs of borrowing, acquisition, risk reserve and staffing. We will continue to manage the assets to improve this figure.

24. £41m has been invested in BESS - Taunton and FERL 1&2. A further £5m in the Marlborough residential development. We have excluded these investments as their returns operate on a different basis – namely interest on loans and profit on capital.

25. Our total investment is therefore £133.5m, providing for a future investment budget of £16.5m to maximise the remit.

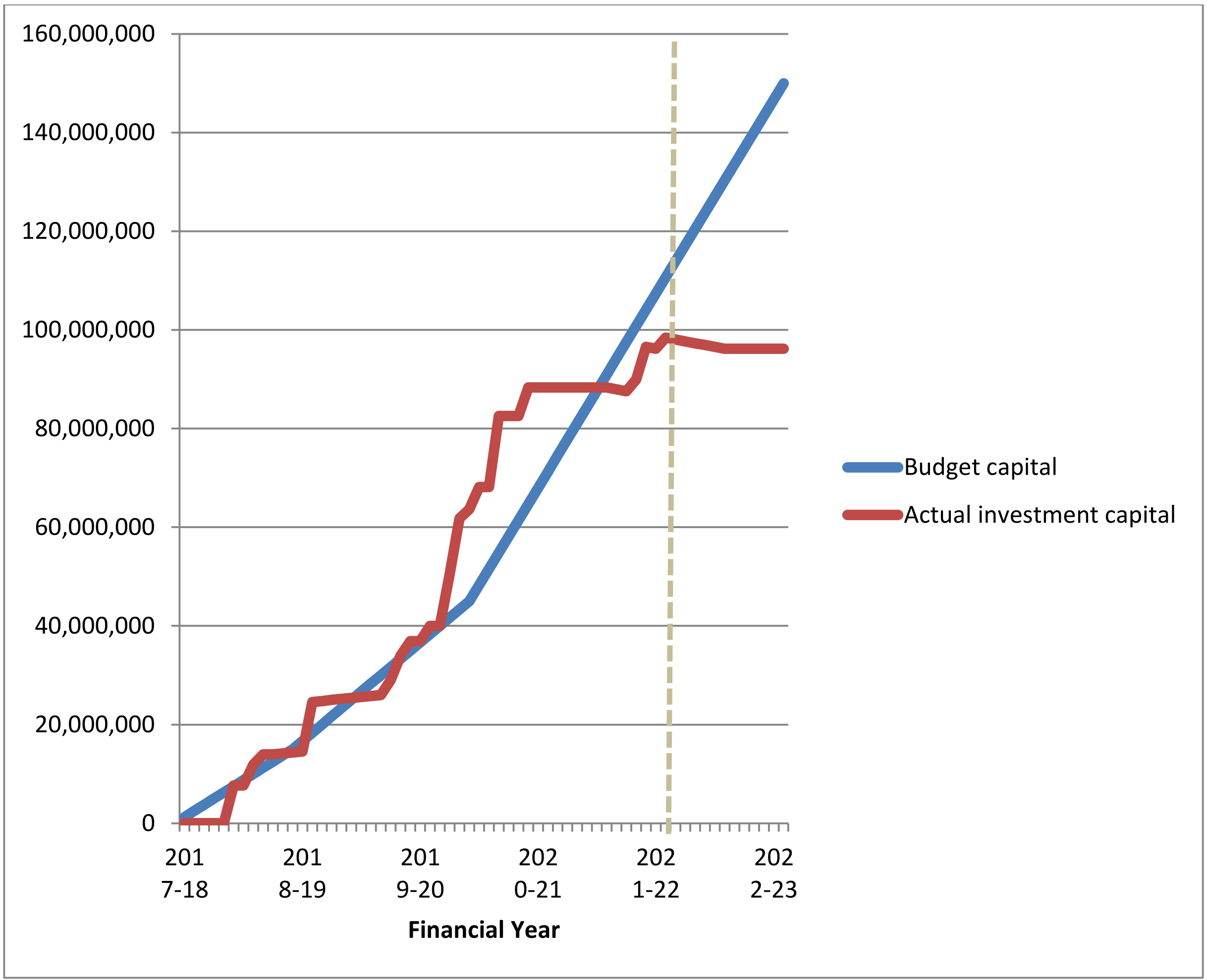
26. In assembling this investment portfolio, the Council is not applying all of the revenue generated to support the Council's revenue budget. The Council is fully meeting the requirement to set aside money annually to repay the principal. This is distinct from the approach taken by many commercial property companies and Local Authorities, 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 ratio reduces in the Council's favour.

27. In addition, the Council has recognised the risks attached to holding a property investment 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, income voids or repair costs.

28. This reserve currently stands at in excess of £6.5m as previously reported to District Executive. As a result of the Council's prudent approach, whilst the portfolio is generating a return of circa 7%, the Council is able to utilise the true net return to support the revenue budget.

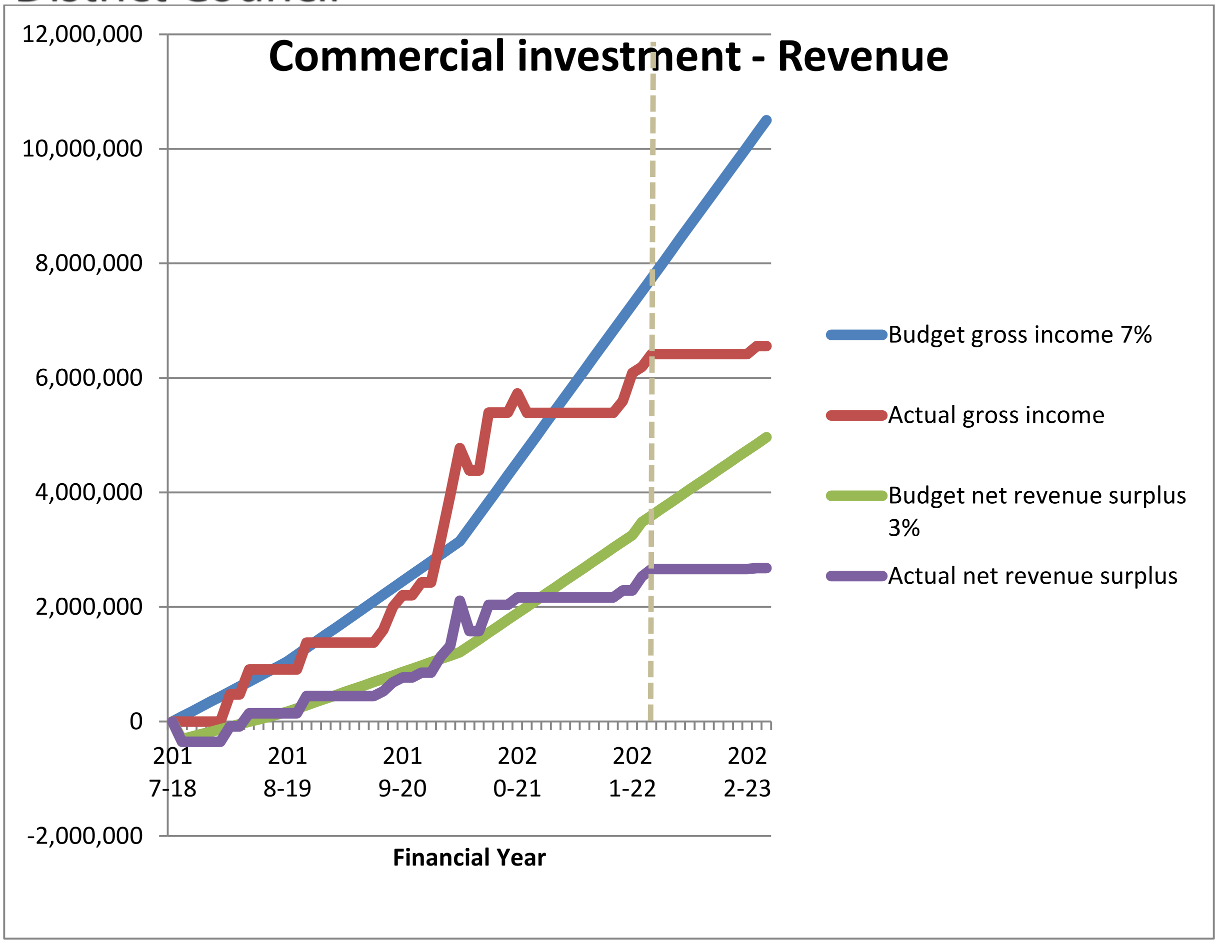
29. Progress is shown on the graph below for the actual capital invested to date in new commercial assets. This is compared with the initial budget objective to invest £150m by March 2022. The fund was allocated across four financial years and to assist review is shown as a straight line budget progression enabling progress over the time period to be seen as either below or ahead of the objective.

Figure 1 shows commercial investment capital – Budget v Actual



Note: Figure excludes investment in FERL 1 & 2

30. Progress in terms of generating additional gross revenue as a return from the capital invested shown in Figure 2 overleaf.



Note: excludes any income from FERL 1&2.

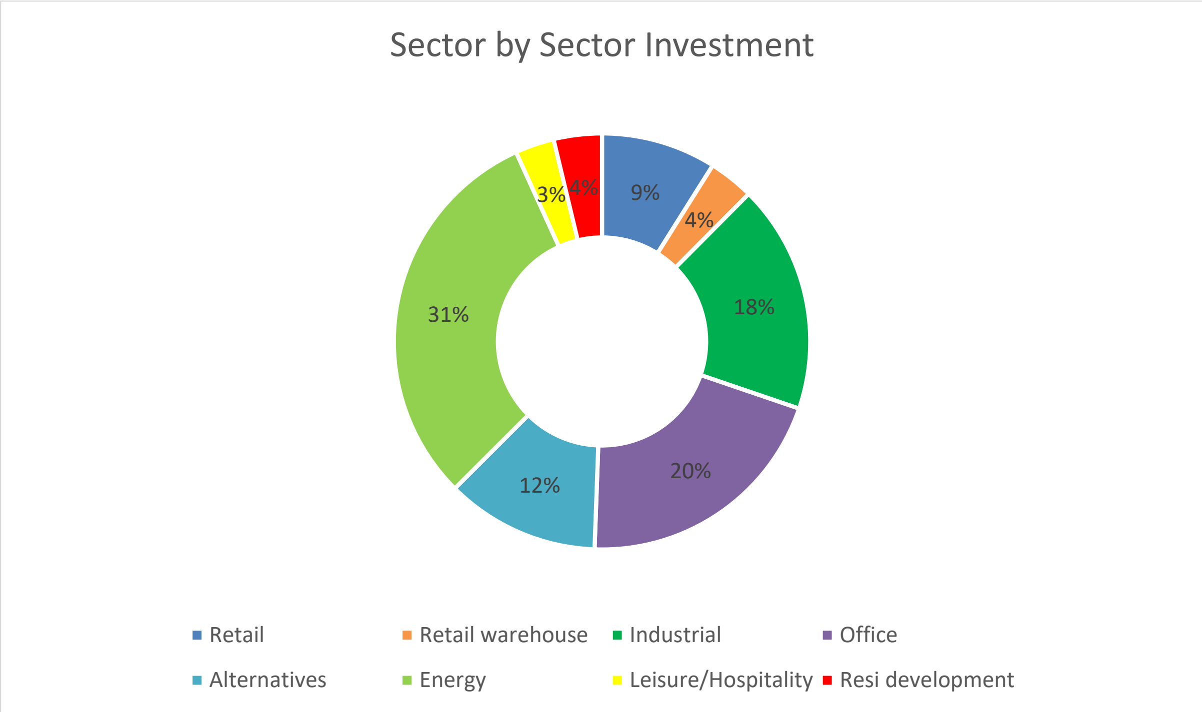
31. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed.

32. 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 Council's revenue budget to protect and support services to the community.

33. The Council currently has twenty-three assets in its 'new' portfolio, providing a gross income (before cost of borrowing) of £5.93m per annum using the whole year income for 2021/22 from assets in SSDC ownership as at 17th May 2021. This excludes the expected returns from BESS Taunton, FERL 1&2 and the Marlborough development project, which are not in the form of annually recurring income.

34. The battery storage facility in Taunton is now fully energised and income producing. This income is paid in arrears by National Grid.

35. The current sector split of capital invested in all of these assets, including Marlborough, BESS Taunton and FERL 1&2 is as follows:

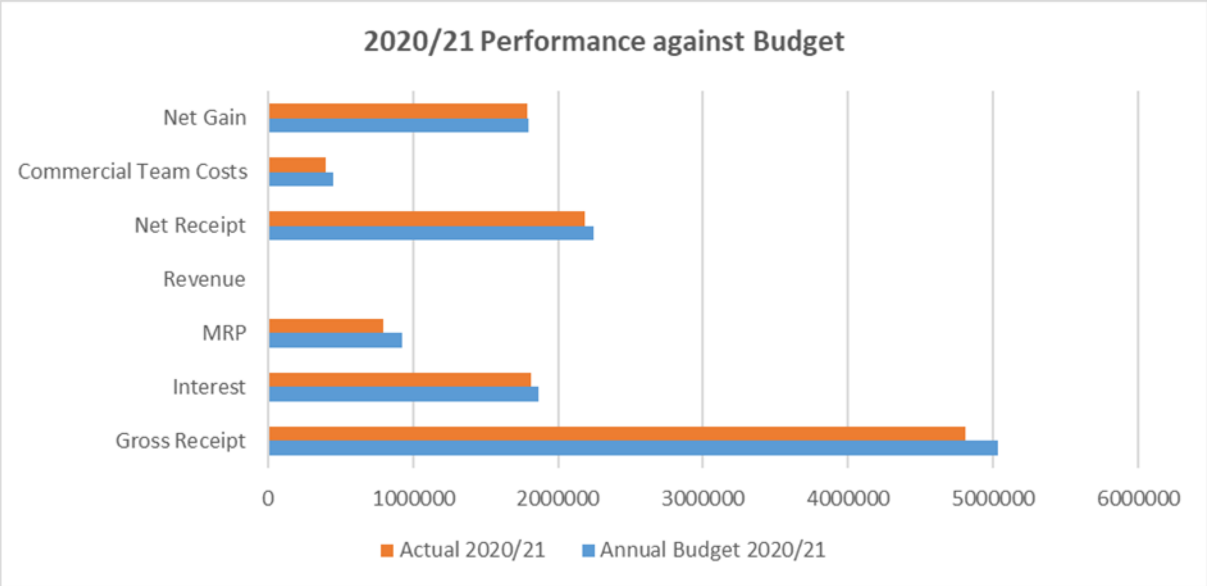


36. Since our last report in December 2020, the Council has acquired three commercial properties for a total of £11.725m. These add £919,187 to the gross annual income and £494,675 to the net annual income.

37. Acquisitions 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). 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.

38. 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 portfolio is set out in Confidential Appendix, table 1.

39. The bar chart below shows the income and costs to 31st March 2021 for 2020/21 against the budget that was included in the Budget Setting 2020/21 report agreed by Full Council in February 2020. It shows that despite Covid-19 the budgets set in February 2020 were accurate predictions.



Portfolio Commentary

40. The world is very infrequently dominated by one issue in the same way that COVID-19 has influenced global consciousness and the world economy. Earlier in this report we reported the impact that Covid-19 has had on GDP and rent collection.

41. Since January we have obtained planning permission for the development of a "drive-thru" coffee unit at B&Q, Glastonbury. We have agreed terms with a national covenant for occupation on a fifteen year term. Upon completion, this will add circa £1.1m to the value of the asset.

42. The lease renewal of The Ralph, on which we reported previously, is assessed to have added £1.2m to the value of the asset.

43. We have previously commented upon media coverage of Local Authority property investment. We reiterate that this matter should remain foremost in Members' minds. Press commentary has portrayed risk as if it is a black and white matter where there could be activity areas which do not have risk. This is a serious distortion of the actuality. The Commercial Strategy acknowledged from the outset that there are risks involved in commercial activity. In the property investment area, we have adopted implementation, acquisition and management strategies that assess and mitigate risks. This has to be adapted for the situation we now face, but our analysis does enable us to identify levels of price adjustment needed to reflect the potential impacts from economic slowdown and its effect on businesses and property markets.

44. Property investors are protected during lease terms from falls in market rental values as most commercial leases provide for upwards only rent revisions.

Analysis from past serious recessions shows how funds can perform effectively with purchasing during economic downturn.

New Assets

45. There have been two investment purchases in the period from February 2021 to April 2021.

46. 54 Willis Way, Poole was acquired was acquired in February 2021 for £2.55m reflecting a net initial yield of 7.47%. The property comprises an 18,174 square foot high quality gym occupied by Fitness First for an eighteen year unexpired term, with a break in eight years. Whilst the leisure sector has been hit by Covid-19 the highly accessible nature and large parking area mean that the value is underpinned by trade counter and retail warehouse uses.

47. The Cornwall Food Production Unit, Redruth was acquired in April 2021 for £6.7m reflecting a net initial yield of 6.71%, increasing annually by any uplift in the retail price index. The property comprises a 24,144 square foot, high specification food production facility which produces the food for Cornwall's acute hospitals. There is a further 12.3 year unexpired term to the highly secure Government backed covenant of the NHS.

48. Just beyond the cut-off, Lyndon Place, Birmingham was acquired in May 2021 for £2.475m reflecting a net initial yield of 8.96%. The property comprises a mixed use freehold property, with 90% of the income secured against global IT services provider SCC, who operate the ground floor as a data-centre. The upper floors are arranged as residential flats from which the Council derives a ground rent, and two roof mounted telephone masts. There is an average weighted unexpired lease term of 5.75 years to break.

49. In the calendar year 2019, SSDC acquired 12 properties totalling £56.3m. Subject to market conditions, this provides an indication of the ability to deliver the remainder of the acquisition programme required to meet the overall investment objective within the period stated in the Financial Strategy. Covid-19 paused our acquisition programme and we acquired just £5.4m property in the 2020 calendar year. We remain confident in completing our acquisition programme by the end of the 2021 calendar year.

Residential Development, Marlborough

50. The Marlborough residential development has been considerably delayed against original programme as reported previously, COVID-19 disrupting both completion of outstanding work and marketing activity. We have appointed new

selling agents. One house sale completed during the period being reported and we are expecting a second completion. We are hopeful that the end of lockdown will see the market pick up, and Marlborough as a location is expected to perform well.

BESS Fideoak and Fareham

51. The Fideoak BESS (battery energy storage scheme) continues to be fully operational and revenue producing. In March the system operated by SSDCOPL was put in the Dynamic Low High (DLH) market so we could qualify to Dynamic Containment (DC) market. In April, the first part of the month was in DLH and then trading went into DC. In addition, the figures below include a projection for April's income.

52. For May, this is a projected figure for 22MW of energy trading. The remainder of the 30 MW is still unqualified in DC, but it is the intention to get this qualified into DC before the end on April, once BYD, the battery suppliers, have finished software upgrades; so this figure should increase.

    March Actual = £134,229.6
    April Figure DLH = £67,067.62 & DC = £163,608 Total = £230,675.62
    May Projection = £287,256.00

53. As a reminder to members, we do not receive revenue for March until the end of May, April until the end of June and May until the end of July. So from a cashflow perspective we are always at least two months behind the actual generation. All figures exclude VAT.

54. On the Fareham BESS phase 1, all is on track and in budget to date with the only extras coming in relating to a hard dig for the service cable from a more cost effective soft dig. This was due to utilities being incorrectly mapped by their owners and the soft dig route not being available as it has already been used for utilities. These additional costs are being paid from within the contingency fund, contractors are confident some of this can be clawed back elsewhere before the end of development.

55. The only other update since our last report was linked to the Suez Canal blockage issue, with battery containers being on shipping delayed by the blockage. That has been resolved as a risk now, with no further adverse impact on the development programme.

Commercial Investment Acquisitions

56. Consideration of appropriate acquisitions has been sustained to continue progress towards meeting the Council's objectives for commercial investment. Before the pandemic, we typically considered some forty 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. The property investment market sharply reduced activity once the lockdown was announced although transactions have continued to complete.

57. The RICS announced a period of material valuation uncertainty, which although rescinded across all sectors by mid-September 2020, has restricted investment. We are currently considering circa twenty opportunities a month.

58. 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.

59. 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.

Financial Implications

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

61. SSDC have approved a large sum for commercial investment. The commercial strategy has been operating for 45 months, and excellent progress has been made, ahead of target timeframes. Nevertheless the economic effect of Covid-19 have slowed progress as the market has struggled and less opportunities are available.

62. 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 deferrals, refusals and 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.

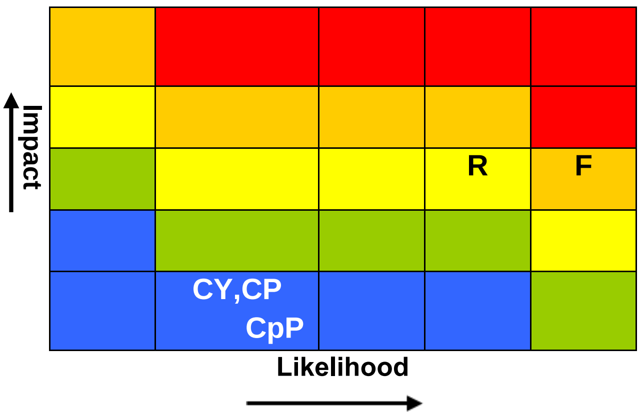
63. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

Legal implications (if any) and details of Statutory Powers

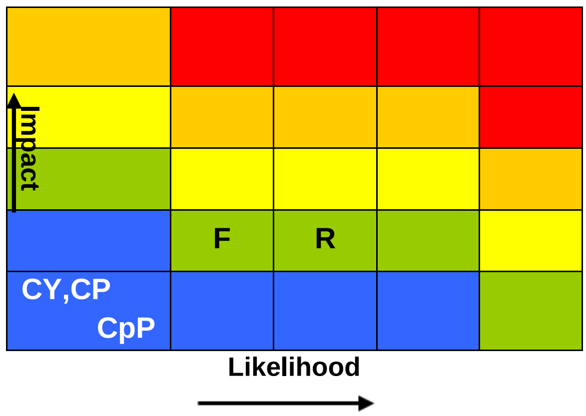
64. None.

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	High impact and high probability
CpP - Corporate Plan Priorities	Major impact and major probability
CP - Community Priorities	Moderate impact and moderate probability
CY - Capacity	Minor impact and minor probability
F - Financial	Insignificant impact and insignificant probability

Council Plan Implications

65. 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

66. None.

Equality and Diversity Implications

67. None.

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Privacy Impact Assessment

68. There is no personal information included in this report

Background Papers

69. SSDC Commercial Strategy 2017 and 2019

South Somerset District Council

Non-Confidential Appendix

Completions relating to SSDC Assets

- Service easement with Conrad Energy for a gas pipe under SSDC land in Yeovil for the sum of £2,000

- Disposal of 17 Woodland Grove, Yeovil for £140,500 to an individual who will continue to use the property as a HMO

- Lease of office space at Boden Centre, Chard to Ross Fanyaki (osteopath) for £3,000 per annum. The tenant will relocate to the regeneration site when new units are available

- Formalised an agreement between SSDC and Yeovil Crime Reduction Unit for office space at Petters House

- Letting of 1A Trafalgar House, Taunton to Soul Gourmet Limited for a ten year term at a rent of £18,000, increasing to £22,000 over the first three years of the term.

Asset Management Update

70. Since the last District Executive update in December 2020 the asset team have continued reviewing the portfolio and identifying opportunities to explore. The emergence of the phosphate issue in August 2020 has caused significant issues with obtaining residential planning consents. This has also led to certain disposals with outline planning consent being paused whilst a mitigation strategy is developed. As the mitigation may take the form of a financial contribution, secured through a s106 agreement or unilateral undertaking, this is causing some uncertainty to our buyers, as the scale of this contribution is not yet known.

71. Two significant disposals that were expected to have completed have been affected (2x homes at Eastfield, Martock and 2x homes at Piece Road, Milborne Port). These sites remain in the disposal pipeline and are expected to transact in the next 12 months, subject to the phosphate issue being resolved.

72. The team have concluded land sales to the value of £140,500, with additional small land parcels unaffected by phosphates due to compete later this year.

73. The post COVID-19 local market is proving to be relatively strong, however the ongoing phosphate issue is restricting the supply of residential sites to the market.

We anticipate strong demand for the future pipeline sites once they are in receipt of a planning consent.

74. We have also agreed leases and wayleaves totalling £42,260, of which £5,000 has already been received.

75. The work to develop a pipeline of small sites for disposal has continued, albeit at a slower pace due to Covid and the phosphate issue. The team have worked hard during lockdown to let any vacant small commercial units, and the portfolio currently has very few voids. We are in regular contact with the tenants at the Small Business Centre and have provided support and advice to help sustain their tenancies.