South Somerset District Council

Investment Asset Update Report

Executive Portfolio Holder:	John Clark, Economic Development incl Commercial Strategy
Strategic Director:	Clare Pestell, Commercial Services and Income Generation
Service Manager:	Robert Orrett, Commercial Property, Land & Development Manager
Contact Details:	Robert.orrett@southsomerset.gov.uk or 01935 462075

Purpose of the Report

1. To provide a quarterly update to members on progress with implementing the commercial investment component of the Commercial Strategy agreed by Council.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of September 2021. This report provides a quarterly update between the half-yearly reports, the frequency being increased in response to the 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. 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 June 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.

South Somerset District Council

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. The District Executive recommends that the Chief 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 in line with 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.
   f) Approve the proposal for the reduction of requirement for reporting to the pre-Covid-19 frequency of every six months, rather than every three months, in light of the more settled economic landscape, with a quarterly dashboard type progress document.

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).

11. This report is a succinct update of high level figures for new investments since May 2021 up to 31 July 2021.

12. It is proposed to revert to the six-month frequency of reporting originally requested by District Executive now the UK economic impacts of Covid-19 are steadying. The intention would be to provide quarterly updates in a brief performance dashboard format alongside SSDC Performance Reports. The half-

yearly reports would be provided in December and June with quarterly updates in March and September.

Covid-19

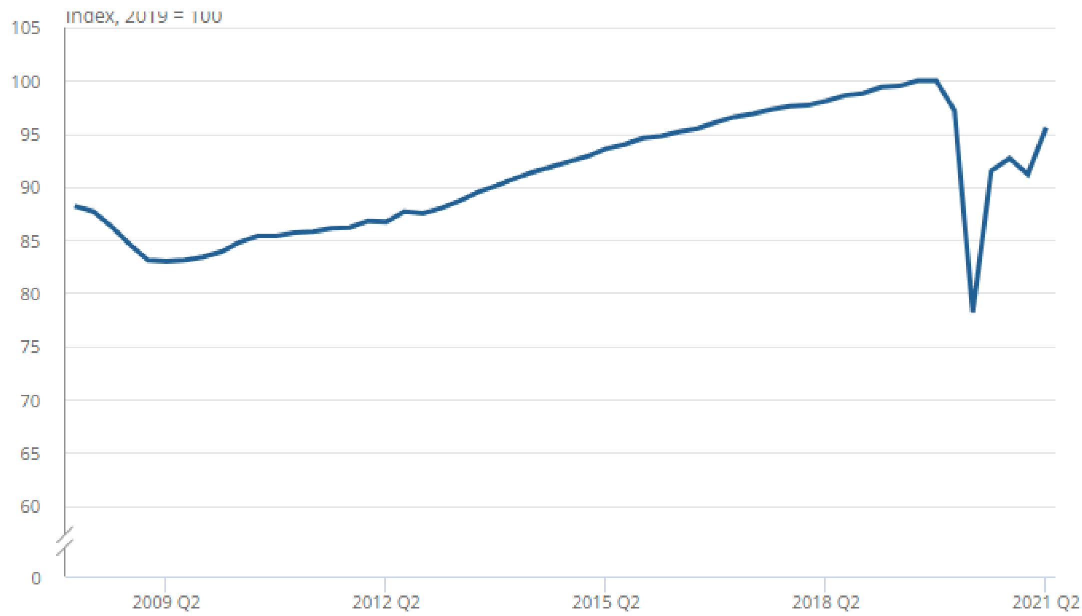
13. The pandemic has impacted on all aspects of society and is affecting economies across the world. The Office for National Statistics reported UK gross domestic product (GDP) is estimated to have grown by 4.8% in Quarter 2 (Apr to June) 2021 following the easing of coronavirus (COVID-19) restrictions.

14. Over the year as a whole, GDP contracted by 9.8% in 2020, marking the largest annual fall in UK GDP on record. On 30th June 2021 the ONS reported that UK gross domestic product (GDP) is estimated to have decreased by 1.6% in Quarter 1 (Jan to Mar) 2021.

15. With 75% of the adult population in the UK now double vaccinated, and all areas of the economy now open for business, a steady growth in the economy is now predicted by most forecasters.

Figure 1: Real GDP increased by 4.8% in Quarter 2 (Apr to June) 2021 as restrictions were eased, and is now 4.4% below its pre-pandemic level

UK, Quarter 1 (Jan to Mar) 2008 to Quarter 2 (Apr to June) 2021, index 2019 Q4 = 100



16. We have noted, as a result of the crisis, a negative impact on the office, and particularly High Street retail, property markets.

17. Most commercial property leases provide for rent to be paid quarterly in advance in March, June, September and December. We have therefore had six rent days since the initial outbreak. We had expected the June 2020 quarter day to be the hardest hit, with tenants having had three months of hardship in which to strategize, however we were able to report rent collection of 95% of contracted sums.

18. 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.

19. 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.

20. 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 (lower) industrial yields, while retail and, to some extent, offices suffer.

21. 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.

22. The volume of market activity for property investment transactions 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.

23. 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. With a lack of supply of industrial property, retail warehouses are increasingly sought after and we have noted yield compression in this sector over the first half of 2021.

24. 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.

25. We will look to augment the value of the portfolio by actively managing leases to seek longer terms, however the Council should note that in the office and retail markets tenants are taking advantage of market uncertainty to seek more attractive terms.

Commercial Investments

26. 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.

27. 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%.

28. 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.

29. £42m has been invested in battery energy storage systems (BESS) - Taunton (Fideoak) and FERL 1&2 through a joint venture company: SSDC Opium Power Ltd. The returns from these to SSDC come by way of interest on capital lent to the joint venture company, repayment of capital, and dividends from the profits of the company. As these projects must first be constructed, there is an initial period of investment without immediate return. A further £5m has been invested in the Marlborough residential development. Any return from this would be in the form of a single lump sum profit. We have excluded these investments from the charts below as their returns operate on a different basis from investment property – namely interest on loans and profit on capital. Detail on capital invested and earnings from these is included in the confidential appendix, as the detail impacts on our commercial relationships with tenants or other parties, and future reports will include more performance commentary on these.

30. Our total investment is therefore £134.5m, leaving a further investment budget of £15.5m to maximise the remit.

31. 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 some Local Authorities, who tend only to pay the interest. However, for the

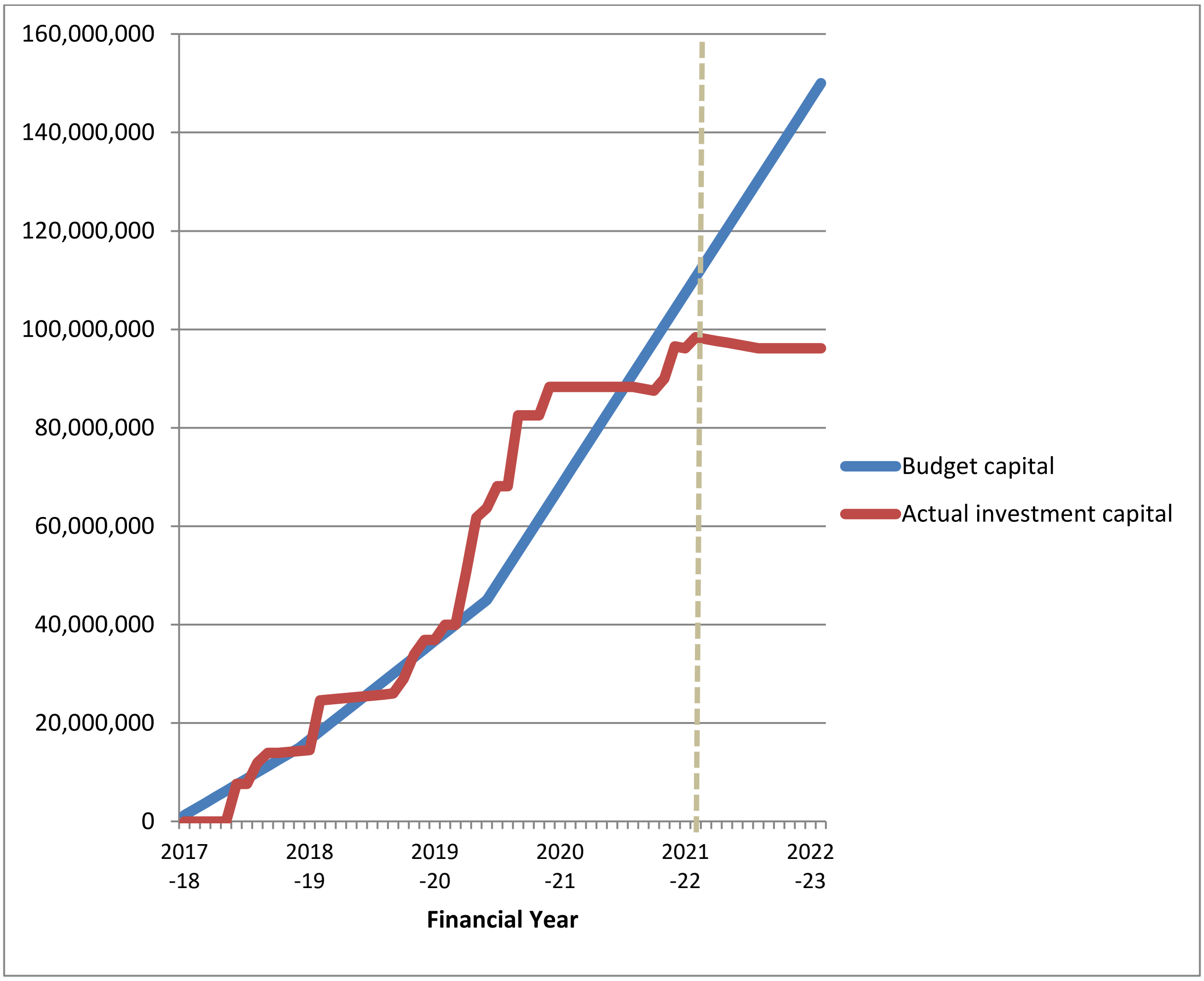
Council this means a decreasing level of debt and an increasing net value of the Asset Portfolio as the debt to value ratio reduces in the Council's favour.

32. 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.

33. This reserve currently stands at in excess of £6.6m 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.

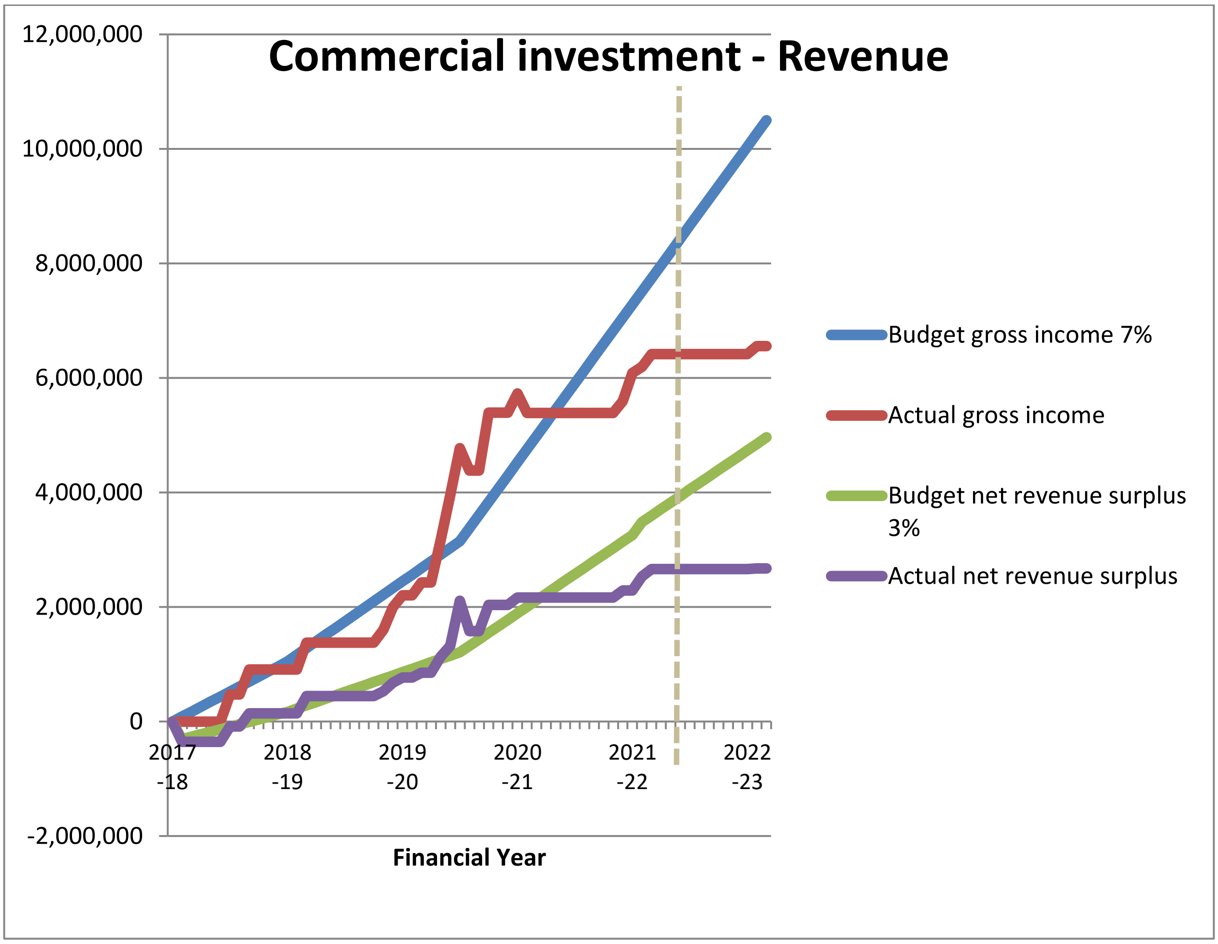
34. Progress is shown on the graph below for the actual capital invested to date in new commercial property investment assets. This is compared with the initial budget objective to invest £150m by March 2022. The fund was allocated across five financial years and to assist review is shown as a straight 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

35. 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.

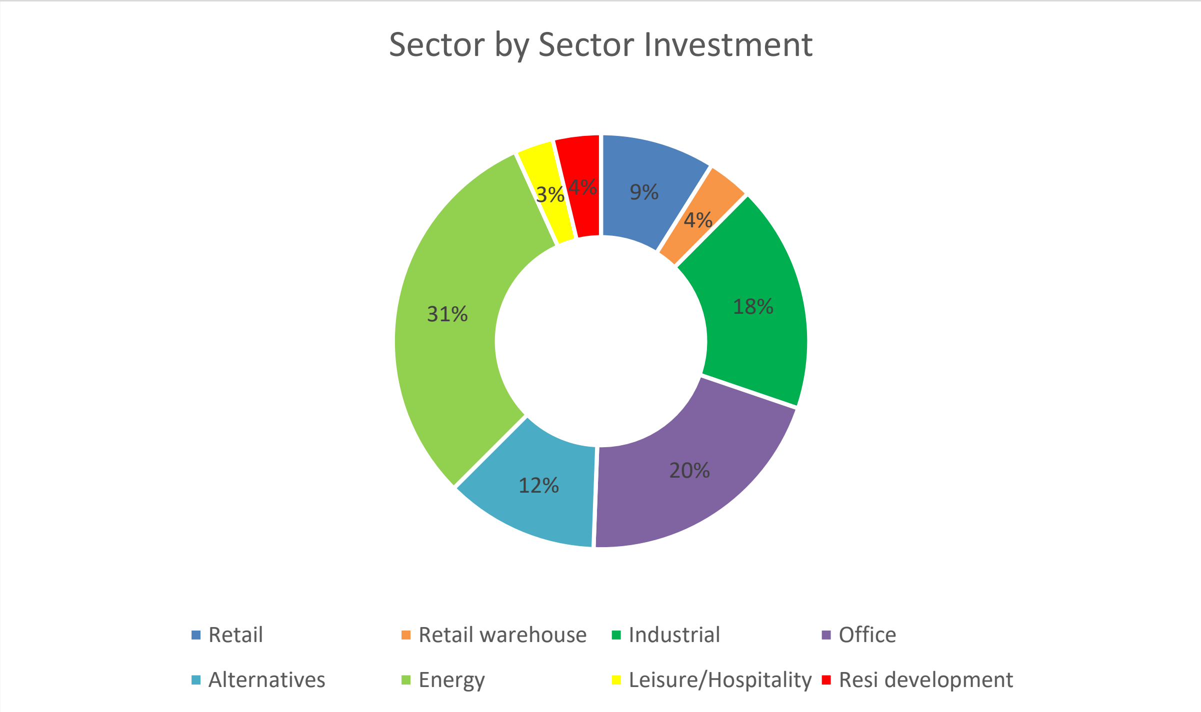
36. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed.

37. 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.

38. The Council currently has twenty-three investment property 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.

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

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



41. Since our last report in June 2021, the Council has not added further to the portfolio.

42. 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.

43. 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.

Portfolio Commentary

44. We have previously commented upon media coverage of Local Authority property investment. 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.

45. 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.

Asset acquisitions

46. Lyndon Place, Birmingham was acquired in May 2021 for £2.475m reflecting a net initial yield of 8.96%. We reported on this in June 2021. 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.

47. 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 21/22 financial year.

Residential Development, Marlborough

48. 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. Two house sales have now completed. We have the third house and two flats under offer. There is a good level of interest in the flats generally so we are hoping to see good progress with the sales in the next few months.

BESS Fideoak and Fareham

49. The Fideoak BESS continues to be fully operational and revenue producing. In April the system operated by SSDC OPL was successfully qualified and entered into the most lucrative Stability Services market - the Dynamic Containment (DC)

market. This is the highest earning market for Grid Scale Batteries, and as such has the most challenging technical requirements that must be met in respect of power delivery reaction time, accuracy of metering, stability of power delivery, and consistency of service availability.

50. From April through to June the whole site was gradually qualified and bid into the DC market, so that from July onwards the whole site was successfully operating in the most technically stringent of all the National Grid's ancillary service provision markets. The figures below include July's income calculated from services actually provided, confirmed and logged.

April Actual = £209,773.23
May Actual = £252,656.35
June Actual = £288,995.95
July Projection = £316,515.55
Year to date = £1,067,941.08

The projection for the August 21 to March 22 period is £2,008,000 - which would result in total income of £3,075,000 for the 2021/22 financial year. This is above the original projection for annual gross income. All these sums are the gross income received by the joint venture company and do not represent net income to SSDC, which will be reported at a later date. .

51. As a reminder to members, the National Grid has a 45-day payment policy, so we do not receive revenue for May until the end of July, June until the end of August and so on. So from a cashflow perspective we are always at least two months behind the actual generation. All figures exclude VAT.

52. The Fareham 40mw Phase 1 BESS is on schedule for practical completion within budget by our EPC contractors in September, and for energisation to the Grid in late October / November, with revenue earning operation initiating in January 2022 following final commissioning and qualification. All equipment is delivered to site as of August 11th, and final installation is in progress as per development programme. The Suez Canal blockage did cause some delay to the Inverters delivery date, but this was absorbed within programme and will not cause a delay to final delivery.

53. The Fareham 20mw Phase 2 BESS is also on schedule. Following project rights acquisition in Q1 this year, the land lease option has been exercised, equipment procurement/ordering initiated, site boundary security fence erected, and ground levels prepared. EPC contractors are scheduled to move straight on from completion of Phase 1 delivery in September to initiation of Phase 2 foundation works in late September / early October. Phase 2 is on budget and scheduled for completion in September next year.

Commercial Investment Acquisitions

54. 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. We are currently considering circa twenty opportunities a month.

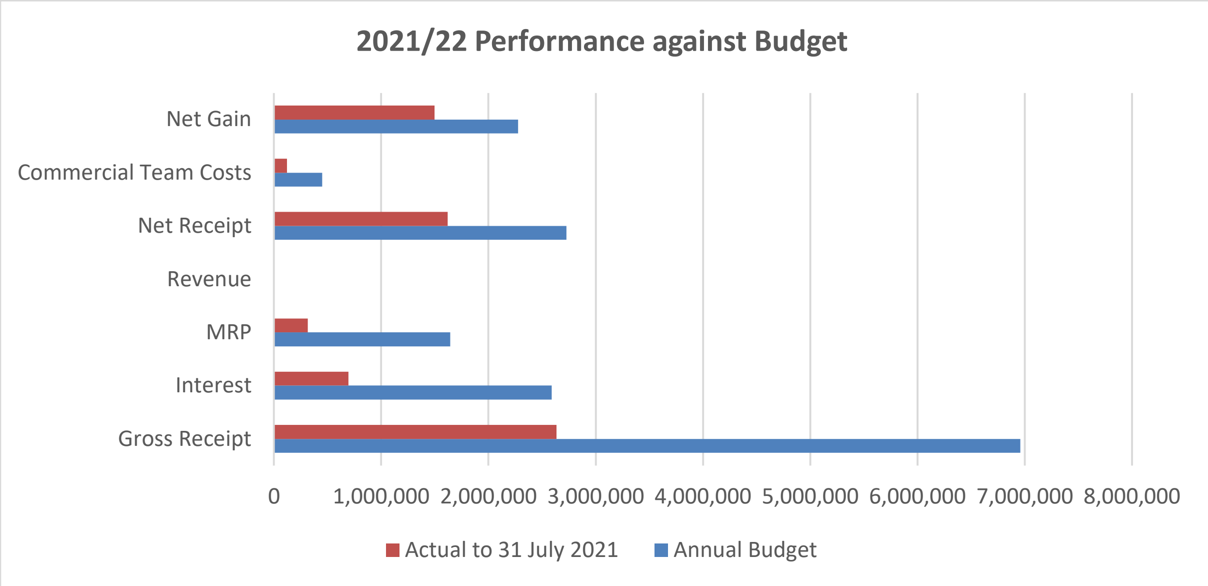
55. The Commercial Property Team has developed a reputation in the property investment market for acting quickly and professionally. This ensures that SSDC is offered the most attractive opportunities and does not overpay for property.

56. SSDC's Property Investment 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

57. 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 where the detail impacts on our commercial relationships with tenants or other parties.

58. The bar chart below shows the income and expenditure vs budget for the April to July period. The budget is the approved amount included in the 2021/22 budget setting report agreed by Full Council in February 2021.



59. SSDC have approved a large sum for commercial investment. The commercial strategy has been operating for 48 months, and good progress has been made, in line with target timeframes. Nevertheless the economic effect of Covid-19 have slowed progress as the market has struggled and less opportunities are available.

60. 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.

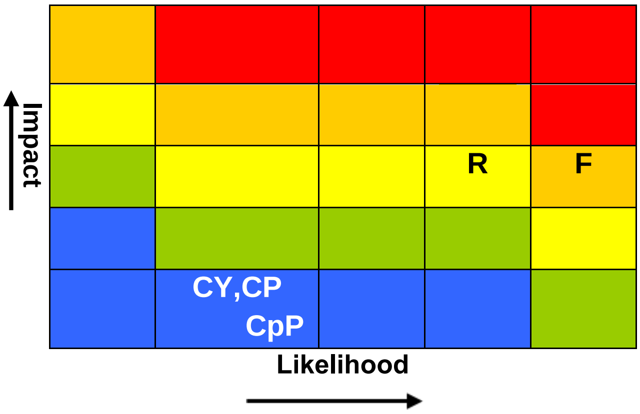
61. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

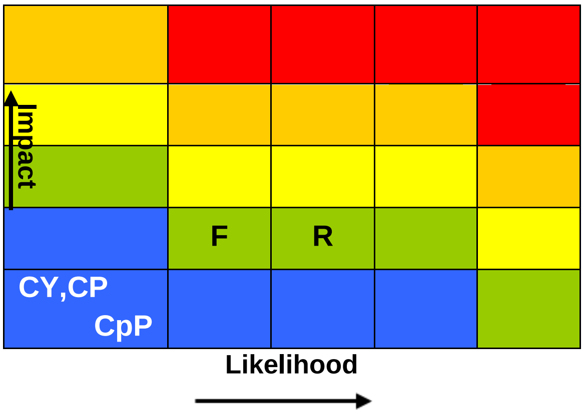
Legal implications (if any) and details of Statutory Powers

62. 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

63. 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

64. None.

Equality and Diversity Implications

65. None.

Privacy Impact Assessment

66. There is no personal information included in this report

Background Papers

67. SSDC Commercial Strategy 2017 and 2019