South Somerset District Council

Investment Asset Update Report

Executive Portfolio Holder:	Cllr John Clark, Portfolio Holder for Economic Development including Commercial Strategy
SLT Lead:	Jill Byron, Solicitor and Monitoring Officer
Service Manager:	Robert Orrett, Commercial Property, Land and Development Manager
Contact Details:	Robert.orrett@southsomerset.gov.uk or 01935 462075

Purpose of the Report

1. To provide an update to members and the public on performance of the commercial investments owned by the Council since the last half yearly update reported in July 2022.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan under the title "Update of SSDC Commercial Strategy" with an anticipated Committee date of December 2022.

Public Interest

3. The Council approved substantial capital funding for the acquisition of commercial investments. Measured by financial scale, this was the major component of the Council's Commercial Strategy. The objective was to enable the Council to protect services to residents in the light of reduction in funding. The strategy has successfully achieved the intended outcome whereby the investments provide considerable funding for the delivery of council services.
4. The Council agreed to receive updates on progress every six months.

Recommendations

5. That District Executive:-

a. Note the continuing performance of the commercial investments of the Council

b. Note the gross return being achieved across the investment property portfolio which is in line with the Council's target of 7%.

c. Note that the net return from SSDC's investments is currently being reviewed for the new Somerset Council, along with the other three district councils' investments. This is to comply with the revised Prudential Code. This review will go to Somerset County Council's Executive meeting on 18th January 2023 in the Non-Treasury Investment Strategy.

Background

6. 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.
7. 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. The underlying objective continues to be to deliver a net return to the bottom line for frontline services of 3% from the capital invested.
8. Members requested regular updates to show progress made in meeting the Commercial Strategy.
9. The funding for commercial investment was increased by the Council in September 2019. New acquisition of additional commercial investments was ceased by a decision of Full Council in December 2021 in order to comply with the revised Prudential Code that also came into effect in that same month.
10. This report includes income data up to the end of October 2022.

Investment overview

11. A total sum of £142m has been invested by the Council via the acquisition of commercial asset investments with the aim of providing a net income return to the Council on a sustained long term basis. The investment assets split into three segments measured by the amounts invested:

Commercial investment property	93,440,498	66.0%
Renewable energy projects	43,487,058	30.7%
Residential development	4,727,375	3.3%
Total invested	**141,654,931**	**100.0%**

12. These investment segments are reported on separately in the sections that follow.

Commercial investment property

13. A total of 21 separate properties have been acquired. These are reasonably spread geographically and in terms of the uses of the properties. The rental income is derived from 43 separate tenancies. This further contributes to the portfolio spread. The lot sizes by property and tenant balance this resilience due to the spread of investments while limiting the intensity and cost of management. No further acquisition activity has been carried out, in line with the Full Council decision that the acquisition phase has been concluded.

14. The portfolio is summarised:

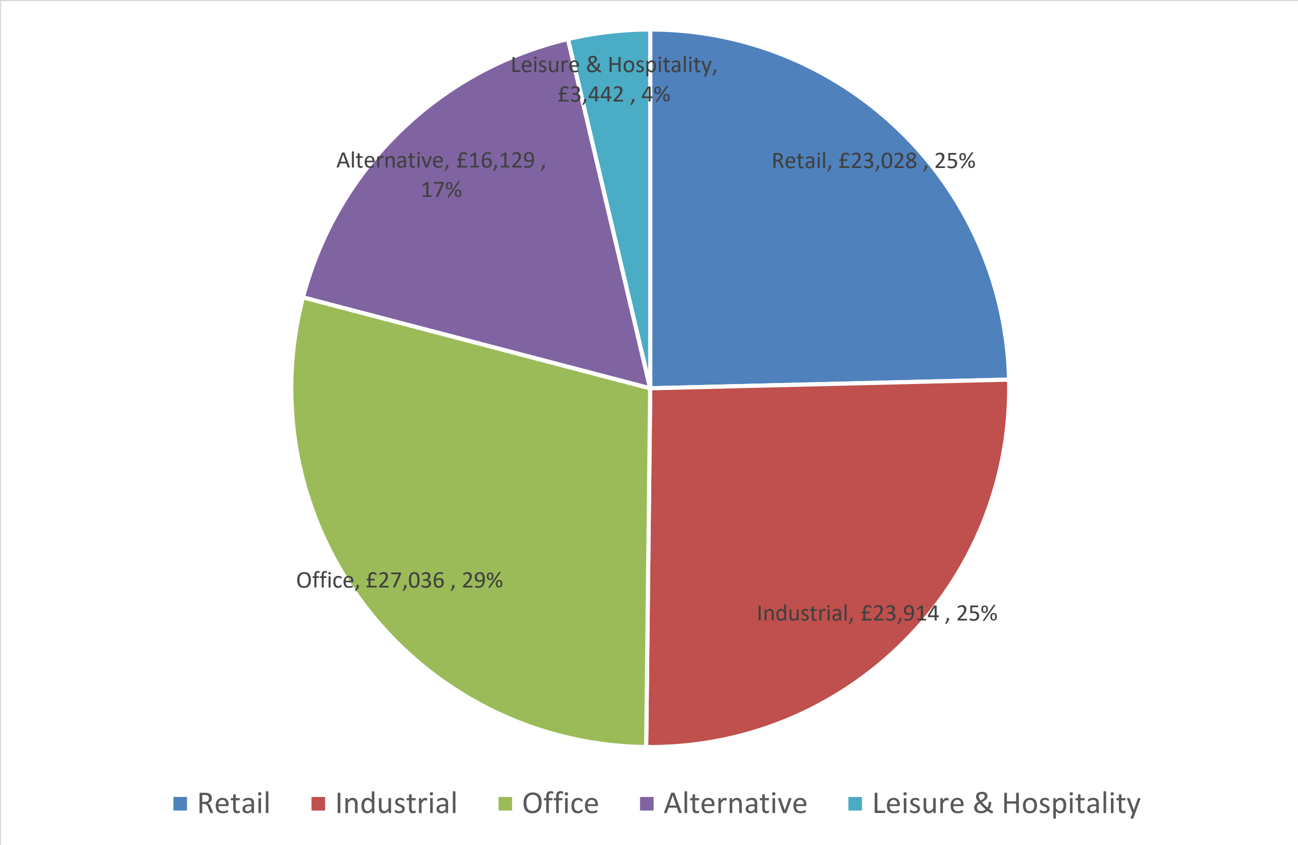
Table 1 – Property portfolio summary

		Portfolio	Retail	Industrial	Office	Alternative	Leisure & Hospitality
Capital Values	Asset Purchase (£'000)	£93,549	£23,028	£23,914	£27,036	£16,129	£3,442
	Portfolio Split (%)	100	25	26	29	17	4
Income	Total Income (£'000 pa)	£6,448.12	£1,815.61	£1,650.36	£1,762.96	£941.43	£277.76
	Portfolio Split (%)	100	28	26	27	15	4
Metrics	Assets	21	4	6	5	3	3
	Yield (%)	6.9%	7.9%	6.9%	6.5%	5.8%	8.1%
	Av Income per asset (£'000 pa)	£307	£454	£275	£353	£314	£93
	WAULT	7.11	4.97	4.04	4.58	24.02	15.42

Notes –

1. The Asset Purchase is the total amount of capital expenditure by SSDC in acquiring these investment properties.
2. WAULT stands for weighted average unexpired lease term and is the period in years for the average contractual lease commitments, weighted according to the amount of rent on each lease.
3. Alternative as a category for investment property sector, refers to uses that do not fall into the other categories. These may be in education, healthcare, land or specialised uses. For the SSDC portfolio the actual uses are – veterinary hospital, hospital food preparation, and data server facility. While these current uses are specialised, the buildings that accommodate them are standard – either offices or industrial.

15. Sector split chart:



16. The target set in the Commercial Strategy was for investments to achieve a gross property yield on average of 7.0%. The current overall portfolio yield is just above target at 7.01%. Gross yield is the gross rental income as a percentage of the purchase price, it does not take account of the financing costs of funding the investment acquisition.

17. The main aim is to deliver income from these investments. The current total income receivable is 98.4% of the income budget when the acquisitions were each approved. The reasons this is slightly down on budget are that there are vacant unlet units at two properties and in three other instances rent free incentives have been allowed as part of letting transactions. Conclusion of the rent free incentives will see total receivable rents above the budget aggregate level. Longer term income expectations can be monitored by reference to estimated market rental value (ERV). This is the opinion of the rent that should be achieved on re-letting of each lettable unit. The total ERV is 94.6% of the income budget when the acquisitions were each approved. Three properties were purchased on the basis this eventual ERV would be lower than the rent due under the lease in place. For the two retail properties we own in Yeovil, the ERV has fallen further since purchase. For all other properties, the ERV is either unchanged or increased since purchase.

18. The portfolio of properties acquired generally has either relatively short contractual lease terms, or longer terms with tenant breaks in the shorter term. These breaks or lease expiries create an expectation that there would be rental voids and other void costs as each property is re-let. This cost and risk was accepted within the acquisition

approach as an appropriate element of risk needing to be taken as a means to achieve the initial yield objective. Equivalent quality assets with longer certain terms would have required SSDC to accept lower investment yields below its return objective. The overall approach incorporated to the budgeting the "reasonable worst case" assumption. This means that for each break or expiry, whichever is earlier, the working approach was to assume the lease would end at that date. As landlord the council would then deal with seeking a new tenant and lease. The void costs were budgeted for in each case.

19. The asset management work has included encouraging exiting tenants to remain at the properties. Opportunities have been sought to agree removal of break options and/or to renew leases with tenants. There has been considerable success with this, but not total success. We have previously reported on void units within the portfolio. The current level of voids has been reduced with success in letting vacant spaces. We have been notified by two larger tenants of their intention to terminate their leases in early 2023. The rental voids that will arise have been budgeted for in the purchase assessment and we are managing the several workstreams that arise from these situations with the objective of achieving optimal re-letting in each case and generally managing the council's position effectively. Detail which impacts on our commercial relationships with tenants or other parties is reported in the Confidential Appendix.

20. The UK economy, along with many other major economies has experienced a sharp increase in the rate of inflation with CPI rising by 10.1% in the 12 months to September 2022, far above the inflation target of 2%. This rise has been sustained since March 2021 when the rate was below 1%, with continuing sharp rises since then. The November 2022 Monetary Policy Report from the Bank of England forecasts the inflation rate to remain high in the immediate term; that the current level is close to the peak; that inflation rates will be falling sharply by mid-2023 to around 5% by the end of 2023 and to 1.4% in two years' time.

21. On 3 November 2022, the Bank of England raised its base rate of interest to 3% as a step in its strategy to limit the UK inflation rate. In December 2021, the base rate was 0.1%. That 0.1% rate had been held since March 2020 and the base rate had been 0.5% or less since March 2009.

22. The base rate has a relationship with the rates of return investors require from their investments. It is not a directly connected impact but broadly the base rate, confidence levels and the expectation investors price in, determine the rates of return that investors require. These rates of return determine the price that would be paid for an investment. Lower rates of return equate to higher prices, and increases in rates equate to falling prices. 2022 has seen a series of base rate increases. Other major economic indicators have been adverse also. The spike in lending rates associated with the "mini-budget" of 28 September 2022 may have been a short term spike in rates, but the pattern in the UK and other major economies is one of higher interest rates than have prevailed for a long period before. These issues are very recent which means there is potentially less certainty in assessments of property investment yield (rate of return) implications.

However, leading consultancies with major exposure in transactional markets are indicating significant impact on yields and values. JLL November research indicates retail yields have moved out by 0.25-0.5% since August 2022, retail warehouses by 0.5-0.75%, offices by typically 0.5%, industrial/warehousing by 1.00-1.25%. This last sector had been arguably over-priced in the market for a period so the adjustment is greatest. Savills November research publication showed similar increase in yields. Looking over the last year, the pattern is more complex with retail being broadly at the same level as October 2021, office yields having increased by 0.5-0.75%, and industrial/warehousing by 1.75%. The changes may appear to be relatively small, but the impact depends on the proportionate change in yield. 0.5% increase in secondary retail yields equates to a 6% reduction in capital value. 1.75% increase in industrial yields equates to a 35% reduction in value.

23. The prices paid by this council for its investment purchases were not at the highest relative levels in the market so broadly the current re-pricing would not give rise to major reductions in value compared to our purchase prices, but nonetheless the capital values these assets will have reduced in the short term.

24. The investments are owned by the council for the income they generate. The rent is fixed by the terms of leases for each unit and does not reduce for short-term economic issues. A few of the rents we receive are index linked so will continue to rise.

25. Inflation on cost areas, and increased interest rates impacts on the cost of council services and on capital projects. There is no automatic relationship to the income returns from investment property. Over the last 50 years, there have been differences between the patterns of rental income growth and general inflation. However, over medium term periods (10-15 years) the general pattern has been for rental income growth to keep pace with general inflation. There is a higher risk of tenant bankruptcy however in adverse economic conditions.

Renewable energy projects

26. The Council has invested £43.5m in battery energy storage systems (BESS) - Taunton (Fideoak) and Fareham (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, 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. Taunton was completed in 2020, FERL 1 was completed in February 2022 and FERL 2 has reached completion in June 2022. This project on this last facility is completing all of its technical tests and will shortly start trading. As with FERL 1, the project is on budget for the construction and ahead of programme.

27. BESS contributes to renewable electricity supply by electricity storage - enabling power generated by renewable sources to be stored until needed. The commercial return on

the capital invested is achieved because the market for this sector offers a higher price to buy stored power than the cost it sells surplus at.

28. The Fideoak BESS continues to be fully operational and revenue producing. The system has continued to be operated by SSDC OPL in 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.

29. The figures in the table below include actual income received from April 2022 to September 2022, and the total income for the year 2021/22. All the sums are the gross income received by the joint venture company and do not represent net income (profit) to the company or SSDC's share of that profit. The operation of this overall market continues to evolve. The earnings are currently well above original expectations but expert advice is that they will move back in line with original expectations over the next two years.

Month	**£**
April	735,938.50
May	217,681.09
June	205,887.18
July	374,640.94
August	702,687.59
September	566,300.10
Total (6 months)	**2,803,135.40**
2021/22 Total	**2,846,021.74**

30. The National Grid has a 45-day payment policy, therefore revenue for October is not received until the end of December, November until the end of January and so on. From a cashflow perspective the company will be at least two months behind the actual generation.

Fareham Project update

31. The Fareham 40mw Phase 1 was energised in February 2022 and following live commissioning it qualified into National Grid's FFR (Frequency Stabilisation service provision marketplace) in March and then as planned rapidly qualified into the most lucrative National Grid Dynamic Containment service marketplace in April. The same two month lag on receipt timings as for Fideoak applies. The figures in the table below include actual income received from April 2022 to September 2022. There was no income in the year 2021/22 as the project was not complete. All the sums are the gross

income received by the joint venture company and do not represent net income (profit) to the company or SSDC's share of that profit.

Month	£
April	0.00
May	0.00
June	154,634.55
July	474,772.23
August	990,071.92
September	647,300.68
Total (6 months)	**2,266,779.38**
2021/22 Total	**0**

32. As can be seen from the figures, current trading performance is very strong and well ahead of the original projections.

Residential Development, Marlborough

33. The Marlborough residential development comprises 3 new build houses and 15 flats created by refurbishment of an existing building. The project was considerably delayed against original programme as reported previously, COVID-19 disrupting both completion of outstanding work and marketing activity. These delays and other detailed aspects of results compared with budgets means that this project is not expected to deliver any profit when all is finalised.

34. Good progress has been continued throughout 2022 with sales. Three houses and eleven flat sales have now completed returning to the Council 73% of the expected gross value. Flat sale completions have progressed at the average rate of one per month throughout 2022. A further two flats are under offer and in solicitors hands. This leaves three flats on the market. There is a good level of interest in the flats generally. We consider progress with securing buyer is now good and we are aiming to continue good progress and conclude all the sales in the coming months.

Investment Strategy

35. With the decision to stop the build up of the portfolio by new acquisition, the focus is now on portfolio and property management. We aim to maintain the lowest level of tenancy voids possible, and to protect and increase medium to long term growth in value of individual properties and the portfolio.

How investment acquisition decisions were made

36. Detailed and robust due diligence was undertaken on all potential investment acquisitions 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 underpinned recommendations and investment decisions. The acquisition decisions were taken following delegated agreed governance arrangements as approved by SSDC with the Investment Assessment Group (IAG) providing deferrals, refusals and unanimous recommendations to the Council Leader and Chief Executive for final decisions.

37. The external auditors have commentated in the 2020/21 Annual Audit Report that the governance arrangements for acquiring these investments were "sound".

Financial Implications

38. The financial implications in terms of revenue and capital expenditure and income are set out in the paragraphs that follow.

Capital Purchase Costs and Funding

39. The following table shows the up-front acquisition costs for investments and the approach to financing applied by the S151 Officer under approved delegations.

South Somerset District Council

Table 2

Category	Actual Spend 2017/18 £	Actual Spend 2018/19 £	Actual Spend 2019/20 £	Actual Spend 2020/21 £	Actual Spend 2021/22 £	Total Spend £
Retail	11,917,177	-	4,673,973	63,217	6,358,804	23,013,172
Industrial	-	2,989,106	20,696,459	228,410	6,530	23,920,505
Office	-	7,885,016	19,128,944	22,099	7,510	27,043,569
Alternative	-	-	6,309,885	7,164,720	2,665,357	16,139,962
Leisure & Hopsitality	-	-	-	2,726,352	596,939	3,323,291
Energy	-	9,840,000	3,317,055	20,011,023	10,318,980	43,487,059
Housing	2,358,573	1,326,395	787,333	255,074	-	4,727,376
Total	**14,275,750**	**22,040,517**	**54,913,650**	**30,470,896**	**19,954,120**	**141,654,932**
Funded by: -						
Useable Capital Receipts	4,000,000	-	-	-	-	4,000,000
Revenue Reserves	2,358,573	1,326,395	787,333	255,074	-	4,727,376
Borrowing	7,917,177	20,714,122	54,126,316	29,921,031	18,881,010	131,559,657
Loan Repayments from SSDC Opium Power Ltd	-	-	-	294,790	1,073,110	1,367,900
	14,275,750	**22,040,517**	**54,913,650**	**30,470,896**	**19,954,120**	**141,654,932**

40. Following Full Council decision in December 2021 to cease this expenditure there is no capital budget nor expenditure in 2022/23 for commercial investment acquisitions. The 2022/23 revised capital estimates contain a budget of £60k for known capital works on commercial property: this budget is to be financed by borrowing.

Net Direct income - Commercial Property portfolio

41. The table below shows the net direct income SSDC received in 2018/19, 2019/20, 2020/21 and 2021/22 as well as the budgeted income in the 2022/23 revised estimates. The table does not show the hypothecated costs of borrowing for the purchase of the investment.

Table 3

	Actual 2018/19 £	Actual 2019/20 £	Actual 2020/21 £	Actual 2021/22 £	Budget 2022/23 £
Retail	-925,715	-1,226,414	-1,164,978	-1,362,731	*-1,820,760*
Industrial	-49,117	-992,088	-1,607,514	-1,529,943	*-1,639,050*
Office	-55,360	-984,245	-1,811,778	-1,480,976	*-1,740,040*
Alternative		-253,778	-221,551	-1,127,855	-1,362,980
Leisure & Hospitality			-16,897	-593,589	-801,200

South Somerset District Council

Gross Receipt	**-1,030,192**	**-3,456,525**	**-4,822,718**	**-6,095,094**	**-7,364,031**
Less Interest	202,890	984,245	1,809,723	2,242,774	2,216,273
Less MRP	164,507	490,090	797,215	1,013,661	1,038,589
Less revenue costs	0	4,955	9,817	10,883	11,217
Less Commercial Team Costs	265,583	407,015	400,697	290,700	271,870
Net Receipt	**-397,213**	**-1,570,220**	**-1,805,267**	**-2,537,076**	**-3,826,083**
Transfer to Commercial Risk Reserve	132,393	1,078,511	105,530	0	0
Net Gain to Revenue	**-264,820**	**-491,709**	**-1,699,737**	**-2,537,076**	**-3,826,083**

Note 1: A Minus indicates income, and italics shows the forecast figures.

Note 2: Interest costs shown above are an estimate based on the PWLB borrowing rates that were current at the time each investment business case was agreed.

Note 3: MRP = Minimum Revenue Provision, which represents the repayment of the capital sum over the life of the asset.

42. As per the '2022/23 Treasury Management Mid-Year Performance Report and Strategy Update' as at the 30 September 2022 the Council was in receipt of £114m external debt funding. This external funding can be attributed to the assets purchased above, which is in line with our strategy that any such borrowing incurred by the Council will be asset backed and repaid (capital and interest) through the income received from the investment. The Council's external borrowing requirement is managed through our Treasury Management function in line with the Treasury Management Strategy which was approved by Council in December 2022. An assessment has been made that the income received from these investments will be in excess of the borrowing costs incurred, and will meet the Council's agreed Commercial Strategy and therefore be potentially considered a suitable investment for the Council.

SSDC Opium Power Ltd – Energy Investments

43. In respect of the commercial lending to SSDC Opium Power Ltd, the current repayment of the loan and interest relies on the generation of income through storage and selling of energy back to the Grid. As at 31 October 2022 the loan value advanced to SSDC Opium Power Ltd is £13,157,055 (Taunton Phase 1 and Phase 2) and the net accrued interest income due to date is £1,596,626.

44. Repayments of principal and interest totalling £4.868m have been made against the loan at 31 October 2022. It is anticipated that during the remaining part of 2022/23 further repayments totalling £0.716m will be made.

45. Total repayments on the loan are therefore expected to be £5.584m as at 31 March 2023. It should be noted that additional payments can be made by SSDC Opium Power Ltd if income to the company exceeds the anticipated level.

46. In addition, a separate commercial loan has been made to SSDC Opium Power Ltd in respect of the Fareham Battery Energy Storage Scheme Phase 1. The loan amount paid at 31 October 2022 for the scheme was £18,690,559.65.

47. The terms of the loan are that quarterly payments of interest and principal are due from the date when the site became income earning. Loan repayments commenced on 1 April 2022 and to date payments of principal and interest totalling £1.305m have been made.

48. The total repayments due in 2022/23, as per the loan repayment schedule, are £1.210m. The repayments to date have exceeded the amount due, this is due to an additional repayment of capital of £0.5m being made. It is therefore anticipated that the principal and interest repaid in 2022/23 will be £1.710m

49. Phase 2 of the Fareham scheme is completed now. The total project cost for this phase is £11,420,000, payments to date in respect of this project are £10.319m, no further payments are anticipated to be made. The loan repayments in respect of Fareham phase 2 are due to start on 1 April 2023.

50. The total loan repayments (principal and interest) received to date in 2022/23 for all sites is £5.105m with a further £1.121m due to the end of March 2023. This will mean total loan repayments of £6.226m is anticipated to be received in 2022/23.

51. The loan repayments due in 2022/23 as per the loan repayment schedules is £3.943m. The additional £2.283m received is in respect of the principal and interest due from previous financial years for the Taunton site and the additional repayment of capital made in respect of the Fareham site.

Revised Prudential Code

52. The revised Prudential Code published in December 2021 requires that from 2023/24 forwards, and where local authorities have an expected need to borrow, they must review options for existing their financial investments for commercial purposes and summarise the review in their annual non-treasury investment strategy.

53. The review required under the revised Code must be based on a financial appraisal that takes account of the financial implications and risk reduction benefits of:
- keeping the commercial investments and undertaking new borrowing, or
- selling the investments and reducing borrowing needs.

54. This requirement is voluntary for the 2022/23 financial year and SSDC has not undertaken this review both because it was not required under the Code nor was there a need to review key funding assumptions. At the time of budget setting, in February 2022, the interest rate was 0.5%, with Arlingclose forecasting it to rise to 0.75% in this financial year. Bank of England base Interest rate is now 3% (with economic forecasters predicting further future rises).

55. The review now required for 2023/24 is currently being undertaken for the new authority, Somerset Council, incorporating SSDC's investments along with the other three districts, and a report is due to go to Somerset County Council's Executive on 18th January 2023.

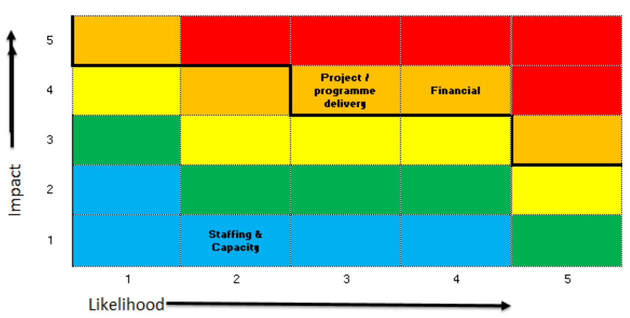
56. The current interest rate does put pressure on achieving a net return on commercial investments for the immediate future. However because councils do not hypothecate their borrowing to specific assets, as mentioned in previous paragraphs, the analysis required is complex. In addition, since acquiring the investments each Somerset District Council has, like SSDC, reduced the indebtedness arising from their purchase by making MRP (Minimum Revenue Provision) payments to reduce the indebtedness balance (effectively reducing the Capital Financing Requirement). This also will be taken into account in the financial modelling.

Legal implications (if any) and details of Statutory Powers

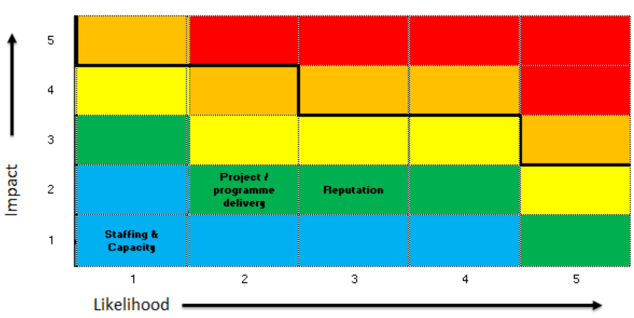
57. None.

Risk Matrix

INHERENT RISK RATING (Before application of Report Recommendations)



RESIDUAL RISK RATING (After application of Report Recommendations)



Risk Ref	Risk Category	Inherent Risk Rating	Residual Risk Rating	Risk Description	Mediation / Controls
1	**Project / programme delivery**	19	8	Requirement to meet delivery objectives in quantum and timing	Monitoring, resourcing and management
2	**Financial**	20	8	Income returns relative to target; change in capital or rental values	Due diligence on all transactions; expert team
3	**Staffing & Capacity**	3	1	Commercial property team and demands on other service teams (Finance and Legal)	Monitoring, management and priorisation of resources
4	**Reputation**	19	9	Damage to reputation linked to outcomes, business sectors of tenants or handling of management	Decision making criteria
5	**Governance & Legal**	3	1	Compliance with approved governance for decision making and implementing internal audit	Clear governance documentation, regular audit and reporting

Council Plan Implications

58. 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

59. None.

Equality and Diversity Implications

60. None.

Privacy Impact Assessment

61. There is no personal information included in this report

Background Papers

62. SSDC Commercial Strategy 2017 and 2019