

Somerset West and Taunton Council

Corporate Scrutiny Committee 5 January 2022

Commercial Property Investment Strategy, Six Monthly Performance Review and Asset Management Strategy

This matter is the responsibility of Executive Councillor Ross Henley

Report Author: Chris Hall, Director – Development and Place

1 Executive Summary / Purpose of the Report.

- 1.1 The Commercial Property Investment Strategy (CPIS) was approved in December 2019 as part of the Council's response to the financial challenge we face. This challenge remains and this report identifies the performance of the portfolio following recent acquisitions and its completion.
- 1.2 The portfolio is forecast to deliver a net income after management costs of approximately £5.1m this year, rising to £6.8m from next financial year. The investment performance is managed also taking into account provisions for financing costs, debt repayment and allocations to reserves to manage risk and future landlord costs. On average the estimated net contribution to the annual budget to fund services is £2.9m after covering these costs. This financial year the net contribution is projected to be £3.7m due to lower financing costs.
- 1.3 An updated strategy is appended, it reflects the completion of the Commercial Investment portfolio and focus on ongoing management, where the previous version was focused on acquisition.
- 1.4 The Asset Management Strategy is also appended, setting out how property will be managed during the transition phase to a Unitary Council.

2. Recommendations

- 2.1 Full Council is requested to support the following recommendations: -
 - a) Note the six-monthly update information.
 - b) Adoption of the revised Commercial Investment Strategy at Appendix 2.
 - c) Adopt the Asset Management Strategy as an interim document pending transition to a Unitary authority (Appendix 3).

3. Risks

- 3.1 **COVID 19** - The structure of the portfolio is designed to protect against market volatility and to gain exposure to the property market as a whole. This is achieved

through diversification across regions, sectors, and the safe guards which are in place of lot size and single tenant exposure.

The Council entered the market after the initial lockdown period had been implemented and therefore, we have always been aware of the risk that Covid poses. We are continuing to monitor the Covid situation and any impacts on our portfolio or the market more generally.

- 3.2 **UK exit from the EU** – Similar mitigations as identified above with the variety of property type and user spreading any risk protecting against market volatility. As with the pandemic risk we did not enter the market until after the announcement of Brexit and the first stage of the UK leaving Europe was complete. Therefore, the risk has always been known, we have always been conscious of the effects this may have on the UK economy.

Properties and tenant covenants are selected and considered in the light of how they may be affected by the UK exiting the EU and their resilience to an economic downturn.

- 3.3 **Risk of tenant default** – We undertake due diligence on all property purchases including the protection offered by the lease and the financial position of the tenants. Whilst it is an inherent risk that a tenant may be unable to meet their financial obligations our choice of property minimises this. We have also chosen property where we anticipate capital appreciation providing choice for us if a tenancy fails. No defaults have been experienced to date.
- 3.4 **Failure to adequately manage property assets** - The strategy identifies the mechanism for managing assets. The usual systems are in place for capital and revenue repairs and maintenance. All matters of compliance are managed within the leases for tenanted property in commercial investment portfolio or by the Asset Management team for property outside of this portfolio.
- 3.5 **Income Volatility** – Income may vary from budget estimates for a number of reasons such as tenant default, voids, rent reviews, and so on. This risk is managed through setting realistic and reasonable budget estimates, with significant reserves set aside as part of the financial strategy to underwrite significant volatility. This protects the General Fund budget and services from adverse impact of in-year investment performance.
- 3.6 **Financing** – The plan for this strategy is to finance upfront investment costs through borrowing. This will be through a combination of ‘internal borrowing’ from cash reserves and ‘external borrowing’ from loans and/or other facilities. Acquisition of borrowing is managed by the Finance team in line with the Council’s approved Capital, Investment and Treasury Management Strategies. There are risks in terms of borrowing costs through interest rates and access to different lenders. Risk is mitigated through effective treasury management. The plan also includes an annual Minimum Revenue Provision (MRP) charge to the revenue budget for the repayment of capital borrowing, reducing the capital financing requirement, and therefore refinancing risk, over time.

4. **Commercial Property List**

- 4.1 The Commercial Property Investment Strategy (CPIS) was approved by Full Council on 17 December 2019. The strategy identifies that update reports will be provided on a six-monthly basis.

- 4.2 Below is a full asset list of the commercial investment properties. No disposals have taken place.

Table 1: List of Investment Properties Acquired Since April 2020

Date	Property Type	Total Purchase Costs £000	Annual Rental Income £000	Net Initial Yield
28/08/2020	730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	9,573	759.2	7.93%
11/09/2020	The Range, Pellon Lane, West Yorkshire, HX1 5QE	5,781	418.4	7.24%
11/11/2020	B&Q, Sanquhar Farm Rd, Ayr, Scotland	6,998	520.0	7.43%
18/12/2020	Wickes Extra, Aldridge Road, Tameside Business Park, Birmingham	9,816	733.3	7.47%
05/11/2021	Jaguar Land Rover, Preston Farm Ind. Estate, Stockton On Tees	6,130	446.4	7.28%
31/03/2021	One Quinton Business Park, Birmingham	5,766	372.5	6.46%
09/04/2021	North Shields Business Park, North Shields	12,585	970.7	7.71%
11/05/2021	Fenick House, Hamilton, Glasgow	4,783	364.3	7.62%
24/05/2021	Cardiff Audi, Cardiff	7,195	519.9	7.23%
15/12/2021	Reflex Group, Barwell	5,433	327.0	6.03%
15/12/2021	Reflex Group, Ossett	2,635	164.8	6.28%
TBC	Industrial property due for completion December 2022	22,272	1,342.8	6.03%
	Total	98,965	6,939	7.01%

- 4.3 As the table above shows the total amount of investment to date is £98.965m, representing almost 99% of the authorised £100m Fund capital budget total, leaving a current balance of £1.053m not yet invested. The advice from officers is that this balance is too small to invest in the context of our portfolio balance, risk, and management costs. It is therefore recommended by the Investment Board that the initial build of the portfolio is considered complete with no further acquisitions planned.
- 4.4 It is therefore proposed to close the Capital Budget at the end of the current financial year. Future asset management and landlord costs will be covered by the sinking fund or a future business case to be approved as necessary.

5. Investment Performance

- 5.1 The implementation of the fund has successfully delivered a balanced property portfolio that meets the parameters set out in the Strategy. The blended Net Initial Yield for all the assets in the Fund is 7.01% which is a significant achievement considering the length of the secured income streams in the portfolio. The weighted average unexpired lease term as at the 25th of December 2021 is 10.91 years meaning the income from the portfolio should be much more stable than was anticipated by the original investment strategy.

- 5.2 The 2021/22 Original Budget approved by Council in February 2021 set a net income target (gross income less finance and management costs) for the portfolio of £2.9m (not including legacy investment assets). Due to the unpredictable nature of securing properties to establish the portfolio over the first few years an optimism bias of £0.8m was included within the budget estimates for this year.
- 5.3 Following a review of progress in the early part of the year and the S151 Officer's updated assessment of financing costs, reflecting our treasury management approach and performance, a Revised Budget was approved by Council in October. This increased the net budgeted contribution from the portfolio to £3.65m and enabled the Council to set aside the additional £750k into the Investment Finance Reserve to contribute to debt repayment costs in 2022/23.
- 5.4 The table below sets out the 2021/22 budget, the performance to date against the revised budget, the end of year forecast and the forecast variance against the revised budget.

Table: Investment Budget Performance 2021/22

	2021/22 Original Budget £000	2021/22 Revised Budget £000	2021/22 Q1+Q2 Actual £000	2021/22 Forecast Full Year Outturn £000	2021/22 Forecast Outturn Variance £000
Capital Investment					
2021/22 Budget	55,937	55,937	24,562	54,881	-1,056
Total Cumulative Investment including 2020/21 + 2021/22	100,000	100,000	68,625	98,965	-1,056
Revenue Budget					
Rent Income	-6,035	-6,035	-3,123	-5,412	623
Management Costs	257	257	153	257	0
Optimism Adjustment*	803	723	0	0	-723
Net Income	-4,975	-5,055	-2,970	-5,155	-100
<i>Financing:</i>					
Notional Interest Charge	1,275	525	243	556	31
MRP**	800	880	0	880	0
Investment Income Net of Financing Costs	-2,900	-3,650	-2,727	-3,719	-69

*An optimism adjustment is included during 2020/21 and 2021/22 to manage the risks associated with timing of buying properties and building out the portfolio. This to ensures the assumptions being made from this project are not overstated in the MTFP. The progress made in completing the portfolio in 2021/22 means the optimism adjustment is not required in 2022/23 budget.

**MRP will be posted as a single transaction for the year in Q3.

- 5.5 The forecast indicates a good performance against revised budget with a net contribution to the Revenue Budget of £3.719m which is surplus against revised budget of £69k. This is pleasing both in terms of reasonableness of budget estimates and the Council's performance in delivering the portfolio on target overall. At this stage it is assumed this surplus if realised will be transferred to the Risk Reserve pending consideration at the year end.
- 5.6 As reported through the Finance Strategy and budget setting reports, the Council has established a portfolio risk reserve to protect the annual budget from income volatility from the investment fund. This fund has been 'front-loaded' to provide immediate

resilience during the initial phase of growing the portfolio as well as for ongoing risk management. The biggest risk in the early years of the portfolio is from tenants defaulting and the costs and unanticipated capital expenditure which may be incurred as a result. This reserve helps to mitigate that risk. The Council agreed in October (Financial Strategy Report, Appendix A) to split the risk reserve and sinking fund amounts, and to create the Investment Financing Reserve. The projected balance in the reserves is as follows:

Table 2: Investment Risk Reserve

	Reserve Balance £000
Balance 1 April 2021	3,674
Transfers to other Investment Reserves	-674
Forecast surplus against budget for 2021/22	69
Projected Balance 31 March 2022	3,069

Table 3: Investment Sinking Fund Reserve

	Reserve Balance £000
Balance 1 April 2021	0
Transfer from Investment Risk Reserve	500
Projected allocations in 2021/22	0
Projected Balance 31 March 2022	500

Table 4: Investment Financing Reserve

	Reserve Balance £000
Balance 1 April 2021	0
Transfer from Investment Risk Reserve	174
Transfer Revised Budget Net Income increase to reserve	750
Transfer from Business Rates Volatility Reserve	1,250
Projected Balance 31 March 2022	2,174

- 5.7 The risk reserve provides significant financial resilience to income volatility. For example, this would mitigate, say, a fall of 43% in gross income in 1 year, or 14% annually over a 3 year period. The sinking fund provides a good up-front sum for landlord costs to effectively manage the assets and meet landlord obligations. The financing reserve provides for the planned financing of debt repayment in 2022/23 per the Financial Strategy.
- 5.8 The intention is to use at least £2m of the financing reserve to fund MRP in 2022/23. The demand on income volatility and sinking costs will vary over time therefore flexibility can potentially be applied between the reserves if required.

Asset Valuations

- 5.9 An external valuation of the portfolio has been required annually since March 2021 in accordance with CIPFA and the Council's valuation regulations and accounting

policies. Valuation changes only impact the Council at the point of disposal of an asset, and the carrying value of assets on the Balance Sheet. They do not impact on usable resources. Increases in value are credited to the Revaluation Reserve and decreases below historic cost are written off to the Capital Adjustment Account without affecting the General Fund balance.

- 5.10 The next valuation of the portfolio will be reported to members in the end of year investment report.

Medium Term Forecasts

- 5.11 Medium forecasts have been updated to reflect the performance in delivering the strategy and the current portfolio position. This maintains the positive income contribution of the portfolio in line with previous longer term projections, with a slight improvement in 2022/23. Although the Council's treasury approach takes advantage of lower cost debt in the short term the financing costs estimates allow for risk of increased costs through refinancing.

Table 5: Medium Term Forecasts

	2022/23 £000	2023/24 £000	2024/25 £000
Capital Investment (not including asset management costs)	0	0	0
Revenue Estimates			
Rent Income	-6,930	-6,930	-6,930
Management Costs	150	150	150
Optimism Adjustment	0	0	0
Net Income	-6,780	-6,780	-6,780
<i>Financing:</i>			
Notional Interest Charge	750	1,500	1,500
MRP	2,000	2,000	2,000
Investment Income Net of Financing Costs	-4,030	-3,280	-3,280
Contribution to Investment Reserves	0	380	380
Net Contribution to Revenue Budget	-4,030	-2,900	-2,900

Financing

- 5.12 The financing of the portfolio is planned to be financed through borrowing, the arrangements for which are implemented through the Council's treasury management team in line with the Treasury Management Strategy. Borrowing decisions take into account the Council's overall approach to managing cash flow, investment and borrowing risk in line with the Treasury Management Code and Prudential Code. Detailed information on borrowing is reported 6-monthly to Members through the Audit and Governance Committee – the last report being on 13 December 2021. Any borrowing is not attached to any specific or individual asset; it is based on the Council's overall capital financing requirement to meet the total General Fund and HRA capital programmes.
- 5.13 A notional interest charge is applied to the investment portfolio budget based on an annual estimate of the average interest costs related to investment and borrowing.

6. Links to Corporate Strategy

- 6.1 The Council's Corporate Strategy under the Enterprising Council Theme states that we will become a financially self-sufficient Council which has expanded its commercial activity and generated more income in order to support service provision. Whilst the Commercial Property Investment Portfolio alone cannot deliver this it is a significant provider of income to fund local services.

Objectives

- Pursue commercial investment opportunities that generate additional income that can be reinvested in service delivery in order to protect or enhance services on which our communities rely. Supported by a Commercial Property Investment Strategy
- Meet the challenge of Government completely withdrawing the Council's grant funding
- Ensure our land and property assets support the achievement of the council's objectives (including service delivery, regeneration projects and community initiatives).

7. Finance / Resource Implications

- 7.1 The investment in property continues to deliver a key element of the wider financial strategy and MTFP, as well as diversifying the Council's income streams in the face of significant reductions and uncertainty in government funding and through business rates retention.
- 7.2 Performance of the fund and against capital and revenue budgets is reported above, which shows positive performance outcomes.
- 7.3 Financial risks related to this investment activity are mitigated through robust due diligence, effective portfolio management, use of reasonable estimates for budget purposes, prudent reserves to mitigate investment asset costs and income volatility, and prudent plans to repay debt through the annual Minimum Revenue Provision charge to the revenue budget.
- 7.4 As stated above, the council has an increased borrowing requirement as a result of the capital expenditure on investment property acquisition. As previously reported, the PWLB on 26 November 2020 tightened its lending rules particular to authorities investing in assets primarily for yield. CIPFA are also expecting to publish updated Prudential and Treasury Management Codes in December 2021, with local authorities expected to fully comply with the new Prudential Code by April 2023 (recommended by April 2022). This is intended to prevent further acquisition of investment properties with authorities encouraged to reduce investment exposure in future to reduce risk. It is anticipated this will be a key consideration for the new Somerset unitary authority following local government restructuring.

8. Legal Implications

- 8.1 Section 12 of the Local Government Act 2003 specifically provides the Council with the power to invest for any purpose relevant to its functions, and for the purpose of prudent management of its financial affairs.
- 8.2 The Council is required to 'have regard to' the Prudential Code when considering capital investment decisions, as well as Capital Investment statutory guidance.

9. Climate and Sustainability Implications

- 9.1 Opportunities to make investments in the renewables sector were examined for suitability and 'fit' within the strategy but not deemed to meet the investment criteria to be brought forward to the Commercial Assessment Panel and Board.

10. Social Value Implications

- 10.1 Currently no opportunities which offer any direct additional social value benefits have come forward since the beginning of this reporting period. However, the income generated from the investment programme will in part be used to support the council's frontline services.

11. Asset Management Implications

- 11.1 The Asset Management Strategy is attached as Appendix 3, it is a light touch review that takes us to a Unitary authority.
- 11.2 The need for a 30 year costed maintenance plan was established and resourced during the early part of 2021. The work was scheduled and underway with our surfaced car parks taking much of the early focus. During this time the employee left for another role and despite multiple attempts to replace them we have been unable to do so. This has impacted on our ability to complete the work to support a more detailed review of the Asset Management Strategy.
- 11.3 The authority remains committed to maintaining the assets we have to a compliant standard, this is a continuous challenge not only in terms of changing legislation but also, in the financial constraints caused by the current supply issues for labour and materials.
- 11.4 A review of the legacy income generating assets was undertaken. Appendix 4 (confidential) identifies the early proposals for those assets. These will be considered in the context of Local Government Reorganisation and where a disposal is suggested they will follow the decision-making process as set out in the strategy. There is no proposed change to the disposal arrangements for asset that are not part of the commercial portfolio.

12. Scrutiny Comments / Recommendation(s)

- 12.1 Publication of the Full Council report will happen prior to the Corporate Scrutiny meeting occurring, and therefore a verbal update will be provided for Full Council.

Democratic Path:

- Corporate Scrutiny – 5 January 2022
- Executive – No
- Full Council – 18 January 2022

Reporting Frequency: Annually

Appendices:

- Appendix 1 Audit Report / Appendix 1.1 Audit appendix**
- Appendix 2 Commercial Property Investment Strategy - CONFIDENTIAL**
- Appendix 3 Asset Management Strategy - CONFIDENTIAL**
- Appendix 4 Legacy Commercial Investment Assets – CONFIDENTIAL**
- Appendix 5 Commercial Property Investment Strategy 20-21 CONFIDENTIAL**

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