Report Number: SWT 92/22

Somerset West and Taunton Council

Full Council – 5 July 2022

Commercial Property Investment Update

This matter is the responsibility of Cllr Bennett Allen Executive Member for Corporate Resources

Report Author: Chris Hall, Director of Development and Place

1 Executive Summary / Purpose of the Report.

1.1 The Commercial Property Investment Strategy (CPIS) was approved in December 2019 and refreshed in December 2020 and 2021. A requirement of the strategy (Clause 11.5) is that a report is brought to full Council every six months to report on the commercial property investment activity and the performance of the portfolio. These will report the position as of 30 September and 31 March each year.

1.2 Since the last report was prepared, the revised strategy to take the Commercial Investment portfolio through to the April 2023 has been published, including a summary of the completion of the acquisition phase of the portfolio.

1.3 During this period borrowing costs have remained low and therefore the Council's treasury team have continued to apply a notional average borrowing cost of 0.75% to the investment portfolio. It is recognised that base rates have increased in recent months and may increase further this year. However, our overall need to borrow has reduced and our combined use of internal borrowing from cash reserves and already-arranged low cost loans significantly reduces the risk of volatility in 2022/23.

1.4 The Net Income for financial year 2021/22 is £3.719m, which gives a surplus of £220k and which reduces to £69k following a transfer of £151k to the Investment Risk Reserve at year end.

1.5 Despite the challenging economic conditions facing UK businesses and the economy the performance of the portfolio has been very strong. To date there have been no rental defaults.

1.6 Risk factors to property investment continue to be monitored, however with the portfolio complete including long leases / break dates alongside strong covenants and diverse sectors, the likelihood of market factors creating issues are somewhat reduced although risk remains as with any property investment. It is still too soon to know what the long term effects of the pandemic will be, but we have seen a large number of investors return to the UK property market with demand increasing for secure income investment which has in turn been forcing up capital values. Occupier performance and covenant strengths will continue to be monitored to identify any tenants that may be affected by the current market restrictions. In general, it is not considered that the level of risk has changed materially since our last report in December 2021.

2 Recommendations

2.1 That Full Council notes the Commercial Property Investment activity and performance for 2021/22 financial year.

3 Background and Full details of the Report

3.1 The Commercial Property Investment Strategy (CPIS) was approved by Full Council on the 17th December 2019 and an updated version approved in February 2022.

3.2 As part of the Financial Strategy agreed in 2019 the Executive set a net income target of £2m+ per year through commercial property investment. Due to a reduction in financing cost assumptions the updated financial strategy for 2020 increased this target to £2.9m.

3.3 The Commercial Property Investment Strategy sets out the governance framework and parameters for investment which ensures a balanced, diversified portfolio is established which will generate long term sustainable income contributing towards sustaining the Council's front line services for many years to come.

Summary of Acquisitions and Disposals

3.4 Set out below is a summary of the completed acquisitions since May 2020 and the annual rental due from properties in the portfolio.

Date	Sector	Location	Total Costs £000	Annual Rental Income £000
28/08/20	Office	Offices, 730 Waterside Drive, Aztec West, Almondsbury, BS32 4UE	9,573	759.2
11/09/20	Retail Warehouse	The Range, Pellon Lane, West Yorkshire, HX1 5QE	5,781	418.5
11/11/20	Retail Warehouse	B&Q Sanquhar Farm Rd,Ayr KA8 9TB	6,998	520.0
18/12/20	Retail Warehouse	Wickes Extra Aldridge Road Tameside Business Park, Perry Barr B42 2ET	9,816	733.3
05/03/21	Other	Jaguar Land Rover, Concord Way, Preston Farm Industrial Estate, Stockton On Tees	6,130	446.4
31/03/21	Office	One Quinton Business Park, Birmingham B32 1AF	5,765	372.5
09/04/21	Retail Warehouse	North Shields Retail Park, North Shields NE29 7UJ	12,585	970.7
11/05/21	Office	Fenick House, 1 Lister Way, Hamilton International Technology Park, G72 0FT	4,783	364.3
24/05/21	Other	Cardiff Audi, Cardiff Gate Bus Park, CF23 8RT	7,195	519.9
15/12/21	Industrial	Reflex Labels, 29 Moat Way, Barwell, LE9 8EY	5,433	327.0
15/12/21	Industrial	Reflex Labels, Smith Way, Ossett, Wakefield, West Yorkshire, WF5 9JZ	2,635	164.8
17/12/21	Industrial	Steelite International Limited, Newcastle Street, Stoke-on-Trent, ST6 3RB	22,272	1,342.8

Date	Sector	Location	Total Costs £000	Annual Rental Income £000
		Total as at 31 March 2022	**98,965**	**6,939.3**

3.5 There have been no disposals and there are no disposals pending.

Portfolio investment performance and performance against budget target

3.6 The Strategy originally included key milestones setting out the anticipated timetable for the delivery of the Investment Portfolio, which is now complete. Continuing targets will be based on maintaining forecast income levels, requiring proactive management of the portfolio parameters.

3.7 The tables below set out the delivery against the capital budget and the 2021/22 net investment income budget and actual performance for the year.

Investment Properties Capital Budget

	2020/21 £000	2021/22 £000	Total £000
Original Budget Profile	50,000	50,000	100,000
Completions During 2020/21	44,064		44,064
Completions During 2021/22		54,881	54,881
Total Invested	**44,063**	**54,881**	**98,945**

3.8 The Commercial Investment fund is fully invested at 31st March 2022, and no further budget request will be made. Total capital expenditure on property acquisitions during 2020/21 and 2021/22 financial years is £98.9m.

Net Investment Income 2021/22

	2021/22 Budget £000	2021/22 Actual £000	2021/22 Variance £000
Rent Income	6,035	5,577	-458
Direct management and abortive costs	-257	-259	-2
Sub-total – Gross Income Less Direct Costs	**5,778**	**5,318**	**-460**
Financing – Notional Interest	-525	-567	-42
Financing – Debt Repayment (MRP)*	-880	-881	-1
Optimism adjustment	-723	0	723
Transfer to investment risk reserve		-151	-151
Net Income to Revenue Account	**3,650**	**3,719**	**69**

*Note, this template reflects scheduled debt repayment in line with budget and approved Minimum Revenue Provision Policy. Accelerated debt repayment has also been undertaken above the amount shown in this table – see 5.09-5.11 below.

3.9 As reported through the Financial Strategy and budget setting reports, the Council has established an investment risk reserve to protect the annual budget from income volatility from the investment fund and an Investment Property Sinking Fund for asset management purposes. These reserves have 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 mitigates that risk. The current balances in reserves as at 31 March 2022 are:

- £3.2m in Investment Risk Reserve
- £0.5m in Sinking Fund reserve.

Risk assessments with updates on material changes to risks on individual assets

3.10 The follow schedule summarises the risks identified with individual assets in the portfolio:

Property	Risk	Mitigation	RAG Status
730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	Part of the first floor is vacant.	The vacant space rent and all costs are covered by a guarantee from the Vendor until 27th August 2022. Although we have had some interest, we have yet to secure a letting. The letting agent has reported a slow market across the location, and no firm interest.	Amber
730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	No identifiable risk	Date for tenant to trigger the break has passed, no mitigation currently required.	Green
The Range, Pellon Lane, West Yorkshire, HX1 5QE	No identifiable risks	None currently required.	Green
B&Q Sanquhar Farm Rd, Ayr KA8 9TB	No identifiable risks	None currently required	Green
Wickes Extra, Birmingham	At lease expiry 2027 it is likely the tenant will want to reduce their footprint by 50%	Consider regear of lease so the unit can be split – will involve capital expenditure, Aldi and Lidl have both expressed an interest in the other 50% of the space. Report to be presented to panel and board for consideration	Green
Jaguar Land Rover, Stockton-On-Tees	No identifiable risks	None currently required.	Green
1 Quinton Business Park, Birmingham	No identifiable risks	None currently required.	Green
North Shields Retail Park, North Shields NE29 7UJ	No identifiable risks	None currently required	Green
Fenick House, 1 Lister Way, Hamilton International Technology Park, G72 0FT	No identifiable risks	None currently required	Green
Cardiff Audi, Cardiff Gate Bus Park, CF23 8RT	Lease has 3 years 7 months remaining,	Instruct agent to commence negotiations to regear and increase the term.	Green

Property	Risk	Mitigation	RAG Status
Reflex Labels, 29 Moat Way, Barwell, LE9 8EY	No identifiable risks	None currently required	Green
Reflex Labels, Smith Way, Ossett, Wakefield, West Yorkshire, WF5 9JZ	No identifiable risks	None currently required	Green
Steelite International Limited, Newcastle Street, Stoke-on-Trent, ST6 3RB	There has been a 37% increase in the insurance premium following SWT's reinstatement revaluation, which has been challenged by the tenant	Continue to search the market for alternatives at renewal in August and communicate with the tenant	Green

3.11 The following table provides an update on general investment risks for the strategy and the portfolio as a whole.

Risk Identified	Mitigation	Commentary	RAG Status
COVID 19	The structure of the CPIS 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 safeguards which are in place of lot size and single tenant exposure.	We did not enter the market until 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 continue to seek the best in class advice around what the experts are predicting will be the long term effects of the pandemic on property. During 2020 we were able to take advantage of the limited number of purchasers in the market and secured a number of good properties. Since September however the number of buyers in the market has increased which has caused yield compression and made it more difficult to secure investments at a yield level suitable for our portfolio.	Green
General Economic Outlook for the UK and Tenants defaulting	We employ: proactive asset management and proactive tenant communication	Although the UK economy is facing challenging times ahead due to the continuing and prolonged pandemic and the increasing UK debt. However, to date there has been little effect on our portfolio mainly because the properties have been selected for their resilience to the risk factors identified, the secure income profile of the investments and the underlying property	Green

Risk Identified	Mitigation	Commentary	RAG Status
		metrics. No serious defaults have been experienced to date.	
Yield Compression in certain sectors of the UK property market	Careful selection of sectors and properties to ensure the income profile of the investment to be acquired is secure and the correct standard of property is maintained across the portfolio.	The scope of the investment strategy is sufficiently wide to enable adjustments to be made for various market factors. We are therefore able to adjust the properties being acquired as we build the portfolio in order not to increase the risk profile of the portfolio despite the yield compression. We have secured sufficient retail warehousing at a time where there appeared to be obvious value in the market and now the Council is benefiting from the yield compression in this sector. As we seek to acquire industrial property we will have to be mindful of the underlying metrics of the property to ensure any risk is limited to an appropriate level as this will be the hardest sector to align with our income profile target.	Green
Insurance premiums available to SWT are not equivalent to open market premiums	We are exploring specific commercial property insurance as part of the 2022 renewal to secure the best product for both landlord and tenants	Insurance is a pass-through cost; however, some tenants have challenged their premium renewals costs which have increased with the properties being purchased by SWT.	Amber

Any other relevant information

3.12 For the Council's Balance Sheet and Fixed Asset Register for the year ending 31/03/2022, all investment properties including those acquired during 2021/22 have been revalued. This is good practice following accounting standards and also responds to a recommendation from our external auditor to ensure our financial statements each year reflect up to date valuations. All assets in this portfolio have been independently revalued by Wilks Head & Eve as at 31/03/2022 and reflected in the 2021/22 Draft Accounts. This will be reviewed by the external auditor as part of the annual accounts audit with their findings to be reported to Audit and Governance Committee in September 2022.

3.13 The total balance sheet value of the portfolio (6 properties) at 31 March 2021 was £44.1m. At 31 March 2022 the gross value (12 properties including 2021/22 acquisitions) in the completed portfolio carried on the Balance Sheet is £96.8m. [WHE has also provided a net value after deducting costs and SDLT which is £90.4m.] As per table in para 5.10, the balance on the related borrowings at 31 March 2022 was £93.6m (96.7% of current value) and is projected to be £91.6m (94.6% of current value) by 31 March

2023 following further scheduled debt repayment in 2022/23.

4 Links to Corporate Strategy

4.1 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.

Objectives

1. 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
2. Meet the challenge of Government completely withdrawing the Council's grant funding.
3. Ensure our land and property assets support the achievement of the Council's objectives (including service delivery, regeneration projects and community initiatives).

5 Finance / Resource Implications

5.1 The investment in property continues to deliver a key element of the wider financial strategy and budget plan, as well as diversifying the Council's income streams, in the face of reductions and significant volatility/uncertainty in income through government funding and business rates.

5.2 The strategy has delivered significant additional income over and above expectations. Our budget estimates have proven to be prudent and reliable despite uncertainties and risk reserve balances have been maintained. The income generated from investment is imperative to contribute to the financial resources necessary to maintain and improve services as set out in the Council's Corporate Strategy and Budget.

5.3 Financial risks are mitigated through robust due diligence, effective portfolio management, use of reasonable estimates for budget purposes and prudent maintenance of reserves to mitigate investment asset costs and income volatility. During 2021/22 we have accelerated repayment of borrowing to reduce refinancing and interest risk as well as overall exposure to debt (see 5.9-5.11 below).

5.4 The investment completed during 2021/22 adds capital assets with a cost of £54.881m to the Council's balance sheet as at 31 March 2022 bringing the total Investments for Yield to £98.945m since May 2020. These assets are subject to annual valuation with positive revaluation values credited to the Revaluation Reserve. Valuation deficits will be written off to the Capital Adjustment Account within unusable reserves. Valuation changes are only crystallised and therefore only affect the Council's usable resources upon disposal of the asset.

5.5 Investment budget and performance information is included earlier in this report, with actual performance against budget providing a gross surplus of £220k, with £151k being transferred to the risk reserve (as agreed by Director of Development and Place and the S151 Officer) leaving a £69k surplus against budget to the revenue account benefitting the general reserves balance.

5.6 The commercial property net income budget estimates in future years related to the current £98.965m investment fund is summarised below. In practice the investments will transfer to the unitary Somerset Council on 1 April 2023 and be combined with investment properties of the other authorities forming the unitary.

	2023/24 £000	2024/25 £000
Revenue Estimates		
Rent Income	-6,930	-6,930
Management Costs	150	150
Net Income	**-6,780**	**-6,780**
Financing:		
Notional Interest Charge	1,500	1,500
MRP	2,000	2,000
Investment Income Net of Financing Costs	**-3,280**	**-3,280**
Contribution to Investment Reserves	**380**	**380**
Net Contribution to Revenue Budget	**-2,900**	**-2,900**

Note: This does not include legacy investment assets acquired prior to April 2020.

5.7 In the Annual Auditor's Report presented to the Audit and Governance Committee in December 2021, a key recommendation was made by our external auditor in respect of the risks related to the Council's investment in property for yield and the related borrowing requirements. A full update on the response to the auditor's recommendation will be reported to the Audit and Governance Committee on the 27th September 2022.

5.8 One of the measures to reduce risk includes reducing the level of borrowing needed to support the strategy. To this end we have an established policy of reducing debt through the annual Minimum Revenue Provision (MRP) and have, through the budget and year end processes, made further steps to accelerate debt repayment. This includes using additional business rates pooling funding surplus as highlighted in the Financial Outturn Report to be reported to the Corporate Scrutiny and Executive committees in July. The funding position for the investment fund can be summarised below.

	2020/21 £000	**2021/22 £000**	**2022/23 £000**	**Cumulative £000**
Capital Expenditure	**44,084**	**54,881**	**0**	**98,965**
Financing:				
Annual MRP per policy (proportion related to investment properties)	0	-882	-1,888	-2,770
Cumulative borrowing requirement balance before additional measures	**44,084**	**98,083**	**96,195**	**96,195**
Accelerated Financing Measures:				
MRP overpayments – Per Budget Report Feb 2022 for 2021/22	0	-1,000	-112	-1,112
Revenue Funding ("RCCO") – per Budget Report Feb 2022	0	-2,000	0	-2,000
Revenue Funding ("RCCO") – Investment Financing Reserve surplus	0	-173	0	-173

Revenue Funding ("RCCO") – 2021/22 outturn Pooling Gain surplus	0	-1,347	0	-1,347
Sub-total: Accelerated funding to reduce borrowing requirement	**0**	**-4,520**	**-112**	**-4,632**
Cumulative borrowing requirement balance after additional measures	0	**93,563**	**91,563**	**91,563**
Debt as % of Total Capital Expenditure	100%	94.5%	92.5%	92.5%

5.9 The table shows that the borrowing requirement will have been reduced by over £4.6m due to accelerated financing of the up-front spend since the auditor's recommendation. The total amount of debt repayment (MRP) plus revenue financing is planned to be £7.402m by 31 March 2023 leaving a borrowing requirement balance of £91.563m with 7.5% of the upfront investment having been fully financed. The acceleration of financing reduces debt costs and refinancing risks.

Unitary Council Financial Implications and S24 Direction Implications

5.10 There are no specific decisions related to entering contracts for expenditure or disposal of land within this report therefore no implications regarding S24 Direction. The report provides a retrospective summary of performance against the strategy therefore no direct implications for the new unitary council. All held investment assets will transfer to the unitary on 1 April 2023.

6 Legal Implications

6.1 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.

7 Climate and Sustainability Implications

7.1 There are no implications that follow from this update report.

8 Social Value Implications

8.1 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 front line services.

9 Asset Management Implications

9.1 The portfolio will be managed by a dedicated officer reporting into the Assets Manager, along with external managing agents where appropriate. The existing management structure remains with the process as outlined in the CI Strategy governing decision making routes and authority, including Director Development and Place & S151 Officer at Investment Panel, making recommendations into Commercial Investment Board. Board frequencies have been reduced following the completion of the portfolio.

Democratic Path:

- Full Council – Yes (5th July 2022)

Reporting Frequency: Six monthly

Appendices

A	**Approved Strategy 2022 (Confidential)**	Confidential Commercial Property Investment Strategy 22 23 .docx

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