

Somerset West and Taunton Council

Full Council – 7 February 2023

Commercial Property Investment Update

This matter is the responsibility of Cllr Bennet 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 Members are reminded that the purpose of the strategy is to deliver additional annual income to General Fund over a long period to provide funding for priority local services. The Council has acquired 12 properties between August 2020 and December 2021 providing an asset portfolio with prudent spread between property sector, location, occupation, and size. The total capital investment cost is £98.965m. No further acquisitions are planned, with the focus on ongoing effective management of the portfolio.
- 1.3 Most of the initial capital investment was funded through borrowing, which is reducing through Minimum Revenue Provision (MRP) payments. The current residual balance of borrowing after MRP this year is £91.563m representing 92.5% of the initial investment. During the investment period to date borrowing costs have remained low and therefore the Council's treasury team have continued to apply a notional average borrowing cost for 2022/23 of 0.75% to the investment portfolio. It is recognised that bank base rates have increased in recent months and may increase further this year as the Bank of England implements measures seeking to control high inflation. 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 forecast Net Income for 2022/23 is currently £4.049m, which is a surplus of £19k (0.5%) compared to the budget estimate.
- 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. A large number of investors continue to act in 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 June 2022.

- 1.7 The report contains commentary on the potential impact of interest rate rises in 2023-24.
- 1.8 This report also responds to a specific Scrutiny committee request for income information of other assets held outside of the commercial investment portfolio or strategy. It was agreed that this would be provided in table form in appendix B, this report does not make any further comment on these assets.

2 Recommendations

- 2.1 That Full Council notes the Commercial Property Investment activity and performance for the period 1 April 2022 to 30 September 2022.

3 Background and Full details of the Report

- 3.1 The Commercial Property Investment Strategy (CPIS) was approved by Full Council on the 17 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. Current low in year financing costs have enabled the Council to set a net income budget of £4.030m for 2022/23 thus exceeding the strategy target at this stage. Whilst we remain on track to meet budget for 2022/23 it is likely that borrowing costs will be higher in 2023/24 thus reducing net income to support the funding of services.
- 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 and the annual rental due from these properties in the portfolio.

Date	Sector	Location	Total Purchase Costs £000	Forecast Annual Rental Income £000
28/08/20	Office	Offices, 730 Waterside Drive, Aztec West, Almondsbury, BS32 4UE	9,573	690.5
11/09/20	Retail Warehouse	The Range, Pellon Lane, West Yorkshire, HX1 5QE	5,781	418.5

Date	Sector	Location	Total Purchase Costs £000	Forecast Annual Rental Income £000
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	458.7
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	980.6
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	1,342.7
		Total forecast full year 2022/23	98,965	6,892.8

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

Portfolio investment performance and performance against budget target

3.6 As summarised above the total capital expenditure on property acquisitions during 2020/21 and 2021/22 financial years is £98.9m. The projected performance against the 2022/23 budget estimates for net income is summarised as follows:

Net Investment Income 2022/23

	2022/23 Budget £000	2022/23 Forecast £000	2022/23 Variance £000
Rent Income	(6,930.0)	(6,892.8)	37.2
Direct management and abortive costs	150.0	150.0	0.0
Sub-total – Gross Income Less Direct Costs	(6,780.0)	(6,742.8)	37.2
Financing – Notional Interest	750.0	694.0	(56.0)
Financing – Debt Repayment (MRP)*	2000.0	2,000.0	0.0
Transfer to/from investment risk reserve	0	18.8	18.8
Net Income to Revenue Account	(4,030.0)	(4,030.0)	0.0

3.7 The Council holds funds in an Investment Risk Reserve to protect the annual budget from investment income volatility and an Investment Asset Management Reserve 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 financial risk 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 reserve balances are:

- £4.1m in Investment Risk Reserve
- £0.7m in Sinking Fund reserve.

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

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

Risk	Description	Mitigation	Status
Rising borrowing costs	Potential for increased costs of re-financing in 2023/24 and later years to reduce net income from property investment. With rising interest rates, the cost of PWLB lending has increased. The cost of inter-authority loans remains lower than PWLB but has also increased.	SWT borrowing needs for 2022/23 secured at beginning of year. Additional financing through revenue contributions and extra MRP has reduced overall refinancing requirement. Somerset S151s agreed interim treasury approach for 2022/23 and SCC has engaged Arlingclose to advise on consolidated treasury strategy for the unitary. LGR workstreams on investments and treasury management are working together to consider prudent approach to investment and borrowing in future years. Revised estimates for the unitary MTFP being prepared.	Red
Economic downturn	Potential to cause business failure and increased rental voids	Monthly financial due diligence on lower covenant tenants. Monthly rent payment where assistance is required to ease cashflow. Increase communication with tenants	Amber
Utility price increases	Potential to cause tenants financial difficulty	Liaise with Managing Agents to ensure optimum timing for contract renewal of utilities to hedge prices.	Amber
Insurance costs higher than anticipated by tenants		Re compete portfolio insurance April 2023 with view to reduce premiums for tenants.	Amber

Individual Property risk register

Property	Risk	Mitigation	RAG Status	Lease Expiry
730 Waterside Drive, Aztec West,	Vacant 5,504ft ² suite – does not let	Joint Agents appointed, refreshed marketing	Amber	2027 – 29 across the Units

Property	Risk	Mitigation	RAG Status	Lease Expiry
Almondsbury. BS32 4UE		brochures, placed new boards. Installation of EV Charging points to serve vacant accommodation.		
730 Waterside Drive, Aztec West, Almondsbury. BS32 4UE	1 x tenant break clause may be activated	Commence "soft marketing campaign "during remainder of term to find new tenant and minimise void.	Amber	
The Range, Pellon Lane, West Yorkshire, HX1 5QE	No identifiable risks	None currently required.	Green	2034
B&Q Sanquhar Farm Rd, Ayr KA8 9TB	No identifiable risks	None currently required	Green	2030
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, Discussions ongoing with Agent & Lidl / Aldi with a view to present scheme to Board post Unitary amalgamation. Viability report to be compiled 23/24 Regular communications with tenant.	Green	2027
Jaguar Land Rover, Stockton-On-Tees	No identifiable risks	None currently required.	Green	2031
1 Quinton Business Park, Birmingham	No identifiable risks	None currently required.	Green	2029
North Shields Retail Park, North Shields NE29 7UJ	No identifiable risks	None currently required	Green	2024 – 2029 across the units
Fenick House, 1 Lister Way, Hamilton International Technology	No identifiable risks	None currently required	Green	2031

Property	Risk	Mitigation	RAG Status	Lease Expiry
Park, G72 0FT				
Cardiff Audi, Cardiff Gate Bus Park, CF23 8RT	Lease has 3 years 7 months remaining,	2 options presented to Tenant for 10-year lease extension. Knight Frank instructed.	Green	2025
Reflex Labels, 29 Moat Way, Barwell, LE9 8EY	No identifiable risks	None currently required	Green	2041
Reflex Labels, Smith Way, Ossett, Wakefield, West Yorkshire, WF5 9JZ	No identifiable risks	None currently required	Green	2036
Steelite International Limited, Newcastle Street, Stoke-on-Trent, ST6 3RB	Utilities costs increases may affect operational viability. Insurance costs remain higher than anticipated and may strain relations with tenant	SWT Commercial Investment property specialist met Group Finance Director to start building working relationship with company Compete insurance renewal on open market renewal in April 2023 and communicate with the tenant	Amber	2036

3.9 The following table provides an update on general investment risks for the strategy and the portfolio.

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	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. During 2020 we were able to take advantage of the limited number of purchasers in the market and secured a number of good properties.	Green

Risk Identified	Mitigation	Commentary	RAG Status
	single tenant exposure.		
General Economic Outlook for the UK	We employ: proactive asset management and proactive tenant communication	The UK economy is facing challenging times ahead, post pandemic , the conflict in Ukraine and effects on utility costs and inflation. However, to date there has been little effect on our portfolio as the properties have been selected for their resilience to the risk factors identified, the secure income profile of the investments and the underlying property metrics. No defaults have been experienced to date.	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

- 3.10 The Council's investment properties are revalued annually on 31 March. All assets in this portfolio were independently revalued by Wilks Head & Eve as at 31/03/2022, reporting a gross value of £96.8m. WHE has also provided a net value after deducting costs and SDLT which is £90.4m. The current borrowing requirement in respect of these assets is £91.6m, which is expected to reduce each year as further annual MRP charges are made for debt repayment.

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 to support service provision.

Objectives

1. Pursue commercial investment opportunities that generate additional income that can be reinvested in service delivery 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 for SWT, 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 to date 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 and increased. 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, prudent debt repayment, and prudent maintenance of reserves to mitigate investment asset costs and income volatility.
- 5.4 Investment assets are subject to annual valuation with positive revaluation values credited to the Revaluation Reserve. Valuation deficits will be written off first against any credit balance in the Revaluation Reserve and then 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 an estimated surplus of £19k.
- 5.6 In the Annual Auditor's Report 2020/21 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 Council's response to the recommendation was reported to the Audit and Governance Committee on the 7 November 2022. The report highlights the range of measures already in place and working effectively, as well as a summary of additional steps that have been taken to further reduce risk including:
 - Using £3.5m of revenue funds towards financing of investment asset purchases, reducing the overall need to borrow.
 - Accelerating debt repayment through additional MRP charges of £1.1m, reducing the quantum of borrowing needed and reducing refinancing risk as well as reducing future MRP and interest cost exposures.
 - Increasing the balance of funds held in the Investment Risk Reserve by £1m and Investment Assets Sinking Fund by £0.2m, increasing resilience if actual results are adverse compared to budget.
 - Proactive treasury management to secure necessary borrowing early in the year, which has proven timely given the recent rise in interest rates.
- 5.7 The borrowing requirement has 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

- 5.8 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. SWT officers are involved in LGR workstreams in both Assets and Finance to help inform the approach to Commercial Property Investment in the new Authority.

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 is managed by a dedicated officer reporting into the Assets Manager, utilising external managing agents where appropriate. The current management structure remains, with the process as outlined in the CI Strategy governing decision-making routes and authority. The Director Development and Place & S151 Officer attend Investment Panel, making recommendations into Commercial Investment Board. Board frequencies have been reduced following the completion of the portfolio, but still meet regularly for quarterly reviews at a minimum.

10 Scrutiny Comments

- 10.1 The 6-monthly investment performance report was presented to Corporate Scrutiny on 4 January 2023. The committee noted the report and asked for clarification on the funding of the debt repayments made to date.
- 10.2 The S151 Officer clarified that £7.4m of the initial total investment of £99m has been fully financed, leaving a residual capital financing requirement (borrowing balance) of £91.56m. Members of the committee have been provided with the following additional information: The debt position can be summarised as follows:

	£000
Total capital investment	98,965

Less: Amount financed using revenue funds	-3,520
Equals: Amount financed using borrowing	95,445
Less: Borrowing repaid in 2021/22 and 2022/23 (known as MRP)	-3,882
Current balance of residual borrowing (92.5% of total initial investment)	91,563

The £7.4m repaid has been financed as follows:

£1.805m	From investment income
£2.597m	From Business Rates Risk reserve surplus and Pooling gains
£2.000m	From Budget Risk Reserve surplus
<u>£1.000m</u>	From General Reserves
£7.402m	

Democratic Path:

- Corporate Scrutiny Committee – Yes (4 January 2023)
- Executive – No
- Full Council – Yes (7 February 2023)

Reporting Frequency: Six monthly

Appendices

A	Approved Strategy 2022 (Confidential)
B	SWT Rental Income

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