Investment Assets Update Report

Executive Portfolio Holder: *John Clark, Economic Development including Commercial Strategy*
Director: *Clare Pestell, Commercial Services and Income Generation*
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 update members on progress with implementing the Commercial Strategy agreed by Council including the commercial investments and management of the existing asset portfolio since the last half yearly update in January 2020.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of 4 June 2020. This returns to the regular six monthly update pattern after one month's deferral of the last report.

Public Interest

3. The Council's commercial strategy forms an important part of the Council's Corporate Plan ("Council Plan") and it Financial Strategy. Delivery of the Commercial Strategy enables the council to protect services to residents in the light of reduction in funding and to deliver its ambitions for South Somerset, for example the regeneration of town centres and high streets. This report is to update members on progress made to date on the Property Investment component of the Commercial Strategy. The Council agreed to receive update on progress every six months with the previous update being reported in January 2020, following deferral due to the General Election from the scheduled report in December 2019.
4. The report includes updates on the purchasing of new commercial property investments, the financial performance of investments and their contribution to delivery of the objectives of SSDC's Financial Strategy originally agreed in September 2017 and the Commercial Strategy agreed in August 2017, and updated with the review by District Executive and Full Council of the Financial Strategy and Commercial Strategy in September 2019.
5. The aim of this report is to give Members and the public an update on the performance and impact of the property investment to date including its contribution to mitigating the impact of reductions in Government funding and protecting services.
6. Due to the sensitive commercial nature of investment acquisitions, and the need to manage risk and protect the value of the Council's investments over the long term, certain detailed information is included in a confidential appendix and not to be disclosed.

Recommendations

7. That the District Executive:
   a. Note the resilience of the property investment portfolio thus far in the context of the COVID-19 pandemic.
   b. Note progress made to date in acquiring new commercial property investments and the asset management following acquisition.
   c. Note the return being achieved across the portfolio which is slightly above the Council's target of 7%.
   d. Note progress being made in securing income from our existing assets and the contribution to the revenue budget towards the revised £3.35m target.
   e. Note progress being made in disposals and transfers of existing assets, resulting in a reduction of future liabilities associated with these assets.

Background

8. While presenting the "Commercial Services Income Update" report to District Executive in February 2018, members requested regular updates to show progress made in meeting the Commercial Strategy (approved by Council in August 2017). These reports are normally provided at six monthly intervals.
9. This report is a succinct update of high level figures for new investments since November 2019, updated to 1 May 2020. It also updates members on work being carried out to increase income from existing assets and reduce liabilities.
10. The Commercial Property Team has been stable in terms of staffing since the last report.
11. SSDC has a wide and varied range of assets that have been accumulated via various means over the years. The creation of South Somerset Homes (SSH) in 1998 meant that many assets were transferred via a Large Scale Voluntary Transfer (LSVT) to SSH, now Yarlington, albeit numerous tranches of land were retained for strategic purposes.
12. After the LSVT, SSDC retained a portfolio of assets that mainly comprised of operational offices, listed buildings, industrial units, car parks and an assortment of land, i.e. grass verges, open spaces and "ransom strips". These assets do not generate a substantial annual income and are now in many cases costing SSDC money through increased maintenance and running costs. Some, however, provide opportunities to generate value through development, sale receipts and development to also provide Council Tax, business rates and New Homes Bonus grant funding.
13. As part of the Commercial Strategy, Council approved a commercial approach to Land and Property management in August 2017.

COVID-19

14. The pandemic has impacted on all aspects of society and is affecting economies across the world. The sharp falls in activity and GDP are being reported for the UK and other countries. The medium term effects for the UK economy and its property market are being forecast across a broad range of severity but there is currently more consensus that there will be some medium term impacts on the economy.

15. Most commercial property leases provide for rent to be paid quarterly in advance in March, June, September and December. The March quarter day is 25th March, only two days after the announcement of the lockdown albeit well into a period of awareness of there being some restrictions due. Across the broader market, a number of businesses did not make the payment of their March quarter rent, including a list of well-known retailers. Landlords which specialise in the retail sector have experienced a sharp reduction from the normal level of rent collection they make. Our team has focussed attention on the connection with our tenants. We have sought to show appropriated flexibility as part of a supportive attitude but also to protect the Council's investment.

16. We have collected 87% of rents for the March quarter (at the date of writing), with rental guarantees covering a further 8%, considerably better than much of the industry. We will continue to work closely with our tenants to avoid adding pressure to their business and will help with staged payments where appropriate. For the industry as a whole, we expect the June quarter to be more difficult than March.

17. In terms of property acquisitions, we will be keeping strategy under review as the economic picture becomes clearer. We expect to remain in the market as it resumes some activity. We will look to agree transactions if the pricing is reflective of the situation. We will also apply criteria to recognise that there are property sectors less and more likely to be impacted by recession, depending on the extent of that, and adapt the due diligence having regard to revised risks. We believe it likely there will be some reductions in market rental values, which is an important consideration for the revenue returns the investments are providing. The council's position, like other investors, is significantly protected by the fact that most leases contain upwards only rent review provisions.

Commercial Investments

18. In September 2019, the Council approved an increase in the fund from £75m to a new total of £150m to be achieved by March 2022. The revised savings / net income target (after interest, capital repayment and risk reserve) is £3.35m. Saving in this context is delivered by net revenue income.

19. To date, a total of £92.5m has been invested, producing in 2020/21 a gross yield on the investment properties of 7.16%, compared with the target to average 7%. This is a gross target, which does not take into account costs of borrowing, acquisition, risk reserve and staffing. (BESS Taunton and the Marlborough development are excluded from this as their returns operate on a different basis – namely interest on loans and profit on capital.)

20. In assembling this investment portfolio, the Council is not applying all of the revenue generated to support the Council's revenue budget. The Council is fully meeting the requirement to set aside money annually to repay the principal. This is distinct from the approach taken by many commercial property companies and who tend only to pay the interest. However, for the Council this means a decreasing level of debt and an increasing net value of the Asset Portfolio as the debt to value ratio reduces in the Council's favour.

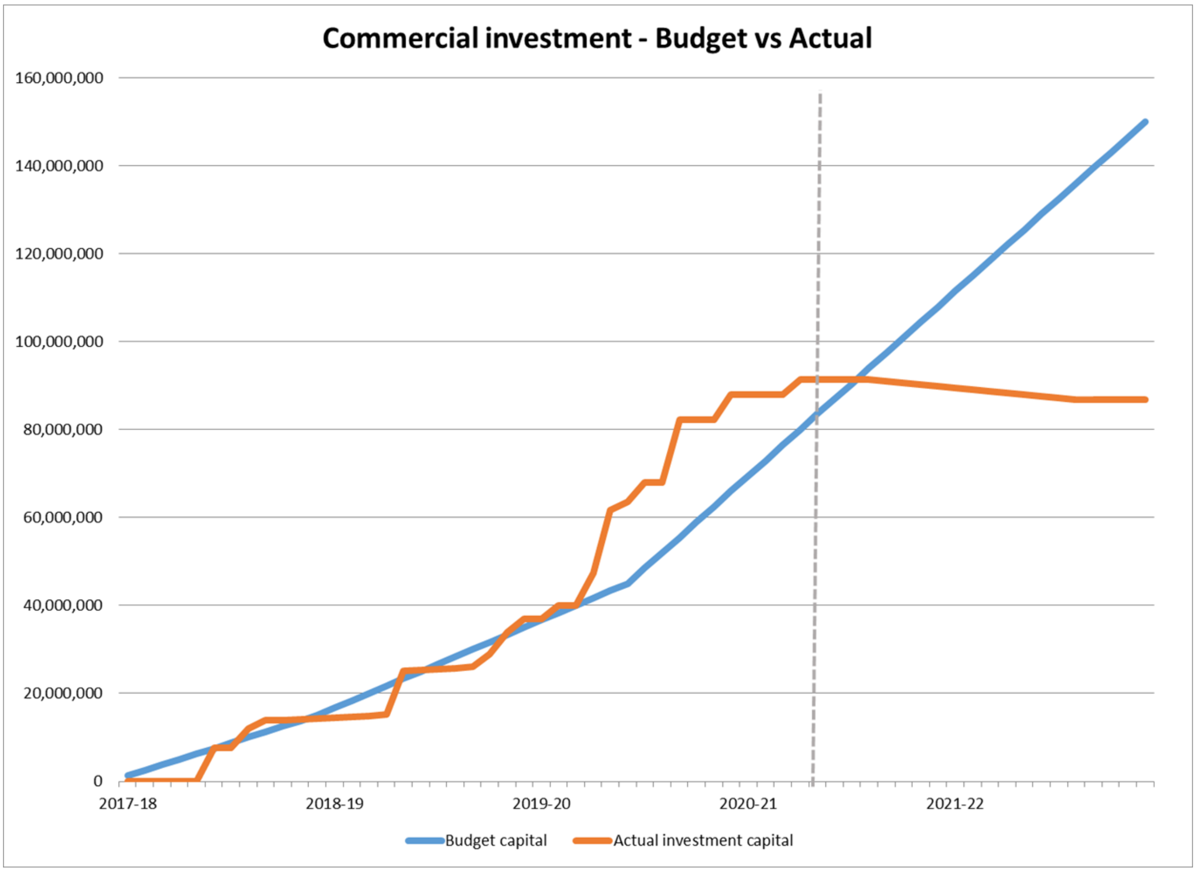
21. In addition, the Council has recognised the risks attached to holding a property investment portfolio and using income for this to support the revenue budget and provision of services. Therefore, the Council is also utilising a proportion of the commercial income to

develop a Commercial Asset Risk reserve to protect the Council and the revenue budget from any potential future volatility, income voids or repair costs.

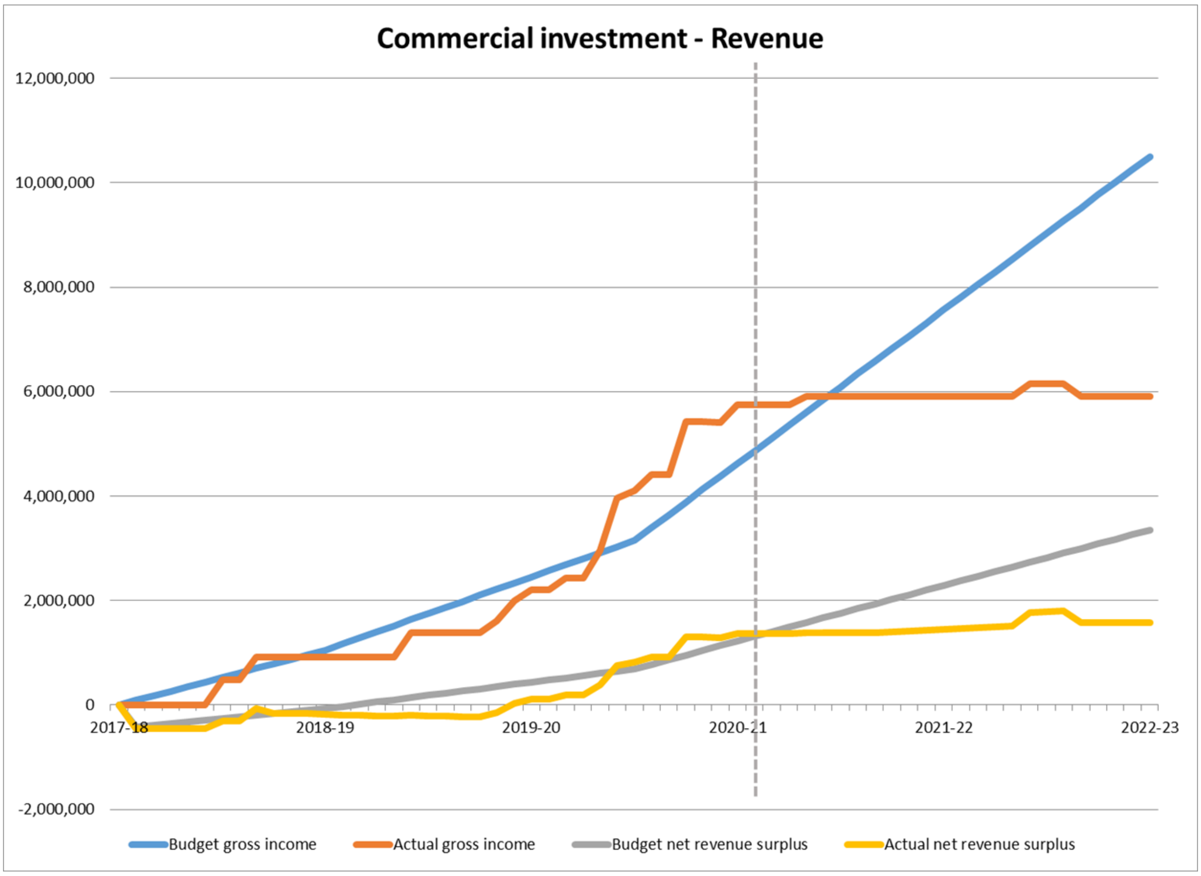
22. This reserve currently stands at in excess of £6m as previously reported to District Executive. As a result of the Council's prudent approach, whilst the portfolio is generating 7%+ return, the Council is able to utilise the true net return to support the revenue budget.

23. Progress is shown on the graph below for the actual capital invested to date in new commercial assets. This is compared with the initial budget objective to invest £75m by March 2021. The fund was allocated across four financial years and to assist review is shown as a straight line budget progression enabling progress over the time period to be seen as either below or ahead of the objective.

24. Figure 1 shows commercial investment capital – Budget v Actual



25. Progress in terms of generating additional revenue – gross and net – as a return from the capital invested shown in Figure 2

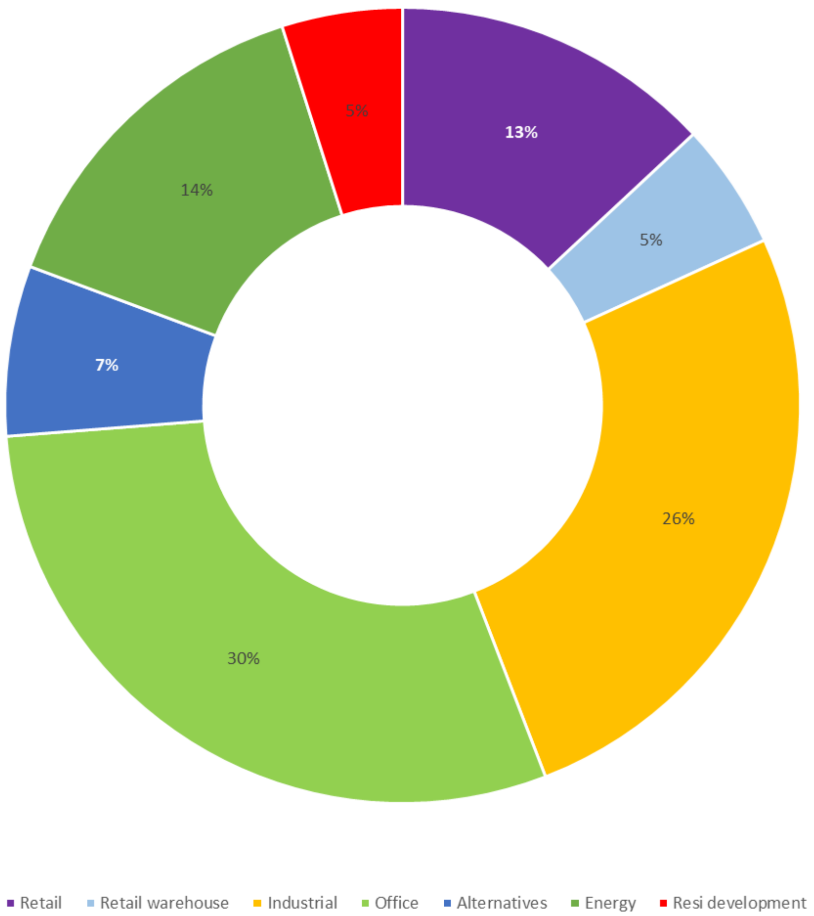


26. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed.

27. Since the introduction of the Commercial Strategy, SSDC has purchased a number of investment properties. This report summarises the high level figures to demonstrate the annual income achieved via rent or sales. The investments made to date are aiding progress towards this target with commercial income in the Council's revenue budget to protect and support services to the community.

28. The Council currently has eighteen assets in its 'new' portfolio, providing a gross income (before cost of borrowing) of £5.29m per annum using the whole year income for 2020/21 from assets in SSDC ownership as at 1 April 2020. This excludes the expected returns from the Marlborough development project, which are not in the form of annually recurring income, the income from Travelodge in Faringdon which is not due to commence this financial year, and the battery storage facility in Taunton which is now fully energised and income producing, but with income paid in arrears from National Grid. Therefore, our next 6 monthly report will be able to provide more detail on this matter.

29. The current sector split of capital invested in all of these assets, including Marlborough and BESS Taunton is:



Note: Alternatives – relates to a property used for “other” purposes – at this stage a single property used as a veterinary hospital.

30. Due to the outbreak of COVID-19 there are currently no further acquisitions that have been recommended for approval by the Investment Assessment Group (IAG) to the Chief Executive in consultation with the Leader. Any further acquisitions would be reported in the next or subsequent half-yearly reports.

31. Acquisitions have been funded through a combination of capital receipts, cash resources and borrowing to date. In line with the Council’s treasury management strategy we continue to utilise ‘internal borrowing’ to meet some of the financing requirement for the investments purchased. This approach reduces treasury risk. All borrowing will be asset backed (i.e. if the Council wished to pay off the borrowing it will have an asset to sell to achieve this). The investment is required to produce a rate of return for the Council which meets the Commercial Strategy targets and therefore, covers interest, capital debt repayment and produces additional income to fund the delivery of services.

32. In making investments the Council seeks to meet its corporate ambitions as set out in the Council Plan to maximise the benefits to the communities of South Somerset. The costs and funding of the investment is set out in Confidential Appendix, table 1.

Market Commentary

33. Market confidence during 2019 was relatively flat. There was some impact from the view that there were rising risks in the global economy. The delay with Brexit also had a dampening effect on the UK economy. Business sentiment in the UK declined in 2019 to a lower level than the early part of 2008, just prior to the Lehman Brothers collapse. Investment property transaction volumes were generally low, but the yields reflected by sales and purchases saw little change across the year. The General Election result and the progress to the point of finally leaving the EU did stimulate activity and short-term confidence. However, there was the view that this was more of a blip than signalling a shift in the market. Yield levels were generally flat compared to 12 months before. The exception to that was high street retail and shopping centres where yield rates moved out equating to falls in value in the rage 10-20%.

34. Those transactions that have completed since the lockdown commenced are at values that appear to be unchanged relative to immediate pre-lockdown prices. However, the initial optimism that the sharp reduction in economic activity would be quickly followed by an equivalent recovery has been reducing. There is more recognition of the possibility that the economy will be seriously damaged by the consequences of the pandemic. The Chancellor of the Exchequer commented on May 13 that “We are seeing one [quarter of GDP contraction] here with only a few days of impact from the virus, so it is now … very likely that the UK economy will face a significant recession this year and we are in the middle of that as we speak”.

35. Sectors of the economy are very differently affected, with the hospitality and hotel sector being the worst and construction and manufacturing the least. All would acknowledge how unpredictable the near-term future is, but it has been possible for researchers to model the impacts on different sectors and consider potential market impacts.

36. There has been press commentary about council property investment which has portrayed risk as if it is a black and white matter where there could be activity areas which do not have risk. This is a serious distortion of the actuality. The Commercial Strategy acknowledged from the outset that there are risks involved in commercial activity. In the property investment area, we have adopted implementation, acquisition and management strategies that assess and mitigate risks. This has to be adapted for the situation we now face, but our analysis does enable us to identify levels of price adjustment needed to reflect the potential impacts from economic slowdown and its effect on businesses and property markets.

37. Property investors are protected during lease terms from falls in market rental values as most commercial leases provide for upwards only rent revisions. Analysis from past serious recessions shows how funds can perform effectively with purchasing during economic downturn.

New Assets

38. Progress has continued to build up the assets within the portfolio with three investment purchases concluded in the half year period from 1 November 2019 to 1 May 2020. Progress in the latter part of the period has paused due to the early impact of the lockdown. In this report there is a brief comment about each asset purchased since the last report. There is also continued individual comment on the two “development”

properties SSDC is investing in as these are more complicated positions and have evolving situations. Investment properties already owned prior to this report are not commented on individually as there has not been material change in these fully let assets.

39. In the calendar year 2019, SSDC has acquired 12 properties totalling £56.3m. Subject to market conditions, this provides an indication of the ability to deliver the remainder of the acquisition programme required to meet the overall investment objective within the period stated in the Financial Strategy.

The investment by sector in the half year has been:

Sector	Investment
Energy	2,480,110
Office	16,078,997
Alternatives	- 443
Industrial	4,076,122
TOTAL	**22,755,800**

Alchemy, Welwyn Garden City

40. Purchased in December 2019 for £9.72m, a net initial yield of 7.0%. A 40,000 sq ft multi-let grade A office space, tenanted by T-Mobile, Pinnacle Engineering, The Environment Agency and Affinity for Business (who have subsequently been acquired by Castle Water). The property is the prime building in Welwyn Garden City, and is underlet with rents £5 per square foot less than space 4 miles away. We consider the equivalent yield to be 7.48%. The strong tenant line up with a utilities firm, a telecommunications multi-national and a Government department to be very strong, even in a recession.

Sherwood Road, Bromsgrove

41. Purchased in December 2019 for £3.7m, a net initial yield of 6.58%. A 36,882 sq ft, four unit trade counter scheme tenanted by Screwfix, Howdens and Toolstation (all considered to be the strongest possible tenant by credit rating agency Dun & Bradstreet). The site is situated in the centre of the principle industrial estate in the town. The yield will revert to circa to 7.17% following the outstanding rent review. The estate has recently been refurbished, with the vendor undertaking a further £200,000 works to the vacant unit to make it lettable. SSDC were not the highest bidder, but our bid won due to our track record of successful acquisition.

King William House, Bristol

42. The most recent acquisition was completed in March 2020 for £5.4m, reflecting a net initial yield of 7.5%. A long leasehold, 28,000 square foot multi-let office building in a prime location in central Bristol. Other property on Queen Square being marketed at 5-5.75%, so this was a good opportunity to get into the very strong Bristol market. We consider that this building is underlet with potential to uplift and improve tenants. There is also potential to undertake light refurbishment to reposition the building.

Residential Development, Marlborough

43. Practical completion for this development of 15 flats and 3 houses was achieved in October 2019. There was a delay with construction progress which the Council had little effective power under the construction contract to resolve. The stage of practical completion needs to be awarded in accordance with proper procedure. It is usual that there are some remaining items (snagging) to be fully completed or resolved.

44. The residential flats and house were put on the market. Continuing significant contractor presence did not enable the scheme to be seen at its best, and until the General Election there was no doubt that the local residential market was subdued. The expectation was that the public reaction to announcing that the Government had "Got Brexit Done" at the end of January 2020 would give a significant boost to the residential market across the first six to nine months of the year.

45. Unfortunately, there was a serious failure in the new hot water installation in one of the upper level flats in January, which caused damage to a number of flats and we decided to temporarily suspend all marketing until repairs were made. The contractors have accepted responsibility for the repairs, and proceeded with an insurance claim. Works had just commenced when the lockdown started. Our contractor furloughed all of its workforce. Therefore, works remain to be done once the contractor has remobilised.

46. At the time of preparing this report, we are in the first week since the Prime Minister announced that Government expects the constructions sector to resume working. Like many other companies, our contractor actually needs to prepare and plan what it can do safely and effectively. We are engaged with them aiming for the earliest progress we can achieve.

47. Management arrangements for the property are in place, keeping landscape and external areas in order and we are regularly checking the property.

48. We will work to resume marketing once the works are complete. Government guidance has also now confirmed that people can move house, which is helpful to the residential market recovering. The residential market only "opened" in the week this report was being finalised. There is no post-lockdown transaction evidence to determine whether there has been a change in market values. At the point shortly before lockdown, our forecast was that there remained the expectation of sufficient profit to fully meet the base level profit return the Council investment had forecast. Development profit is the balance between gross development value and gross development cost. If market values fall following the lockdown and the economic shock, then our profit element will start to be eroded. At present this is unknown.

49. It is likely that sales will take around 12 months to conclude once we can fully market the residential units, due to the impact on the market of COVID-19.

Energy Storage Scheme

50. The Fideoak, Taunton battery storage scheme is owned via a joint venture company, SSDC Opium Power Ltd (SSDC OPL), a joint venture between SSDC and Opium Power

Ltd, which purchased the site in 2018. The site comprises a compound bounded by a security fencing with infrared security cameras. The first phase of the project comprises 25MW battery storage facility for short-term supply of electricity to the local distribution network. Project roll out has been completed followed by work to connect and test the SSDC OPL site linking into electricity utility company equipment into the National Grid (NG) Sub Station.

51. Acceptance testing for the system following this connection was completed in March 2020 and the scheme was energised to the grid. There was some delay to the residual warranty and final commissioning work that could only be completed following this, due to the COVID-19 lockdown and the decisions taken by companies to be able to work on site together based on Government directions. However, the project managers and contractors have established safe methods of working that are enabling the final commissioning phase to complete, albeit slower than usual in order to mitigate risk to workers.

52. The expectation at the time of writing this report is that the very last testing requirement will take place before the end of May 2020 following which the system will be fully operational and earning revenue.

53. Phase 2 for an additional 5 MW is progressing well, in line with both SSDC's Commercial Strategy and Environmental Strategy, to deliver more clean energy and invest in the green energy sector. This smaller but final Phase for the site maximises the licence before that opportunity is lost, and use of site area suitable for Battery Energy Storage at this location. It also makes use of the infrastructure and connections developed for Phase 1 (25 MW) and will deliver more income to SSDC for the future, as well as aiding the balancing of the National Grid with cleaner energy. This will assist with fossil fuel production of energy being phased out more swiftly.

54. The valuation of the site, as at 31 March 2020, for accounts purposes confirmed that the facility and land was valued at more than the project costs expended. It also confirmed that, by maximising the site with an additional 5 MW, this would remain the case and increase appropriately. The investment Market Value, once energisation and trading are established may well mean that the value increases again and we are now on the point of that position. In summary, national data confirms that this project demonstrates 'value for money' when the cost per MW is considered against the national averages for similar installations in the UK to date. In addition, energy storage is recognised as a growing market with an increasing number of commercial companies now looking to follow SSDC's lead, as well as significant interest from other councils.

55. SSDC is the funder of this project by means of a loan to SSDC OPL. Interest costs have been rolling up while the project has not been generating revenue, but the basis of the loan is that once revenues are flowing, generating profit, this is first applied to covering interest payments on the loan, then to repayment of the loan capital.

56. Loan and interest repayments are scheduled to reflect the expected cash flows of the business. In the longer term, once the loan facilities are fully repaid, the Council expects to receive its investment income through dividend distribution of profits. As a result of the way the investment has been structured the delay in energising the site also delays interest being paid back to SSDC; but this is recovered due the agreement requiring SSDC OPL to pay more interest to SSDC.

Commercial Investment Acquisitions

57. Activity has been sustained to continue strong progress to meet the Council's objectives for commercial investment. Before the lockdown, we typically considered some 40 investment opportunities each month and have a regularly updated set of criteria for agents identifying target yield, lot size, sector, unexpired term, location and tenant. The property investment market sharply reduced activity once the lockdown was announced although transactions have continued to complete. There is the expectation that market activity will start to increase as the mid-May announcement by the Prime Minister has been followed by guidance on how property inspections may be safely carried out.
58. The Commercial Property Team has developed a reputation in the property investment market for acting quickly and professionally. This ensures that SSDC is offered the most attractive opportunities and does not overpay for property.
59. SSDC's Commercial strategy also aims to create a risk-mitigated and balanced portfolio and therefore we will continue to be highly selective, in order to meet our strategic objectives.

Asset Management Update

60. Since the last District Executive update in January 2020 the asset team have continued reviewing the portfolio and identifying opportunities to explore. This led to the identification of a number of relatively low value, but still worthwhile easements, primarily for services to new dwellings.
61. The arrival of COVID-19 in March had a disruptive impact on the team, and the wider property and construction sector. The imposition of social distancing led to fundamental changes in the way property viewings and general person to person interactions could take place. Despite these constraints the team managed to let Unit 2, Goldcroft to a local charity at a market rent. This alone is a great achievement under the current circumstances.
62. The small development sites project now has two sites with planning consent secured, and marketing is to begin shortly. Further sites are being added to the development pipeline, and although progress has been slowed by the COVID-19 outbreak, design and feasibility work is still progressing.
63. The post COVID-19 local market is likely to be challenging, however the small scale of many of our development sites is likely to make them popular with local builders and investors seeking low risk opportunities.
64. Specific asset management transactions are included in the Confidential Appendix.

Financial Implications

65. The financial implications for the progress with commercial investments and of asset management activity are set out above within the report and also in further detail in the Confidential Appendix.

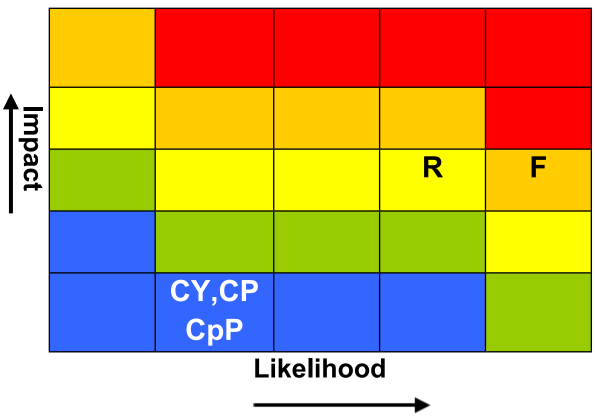
66. SSDC has approved a large sum for commercial investment. The commercial strategy has been operating for 33 months, and excellent progress has been made, ahead of target timeframes.

67. Detailed and robust due diligence has been completed with extensive involvement of SSDC's finance and legal specialists together with external advisors (e.g. valuers, tax specialists, legal advisers, sector specialists) to support the property team in completing robust business cases that underpin recommendations and investment decisions. The decisions made have been through the agreed governance arrangements as approved by SSDC with the Investment Assessment Group providing deferrals, refusals and unanimous recommendations to the Council Leader and Chief Executive for final decisions. Arrangements have been reviewed by Internal Audit and the minor improvements recommended have been implemented.

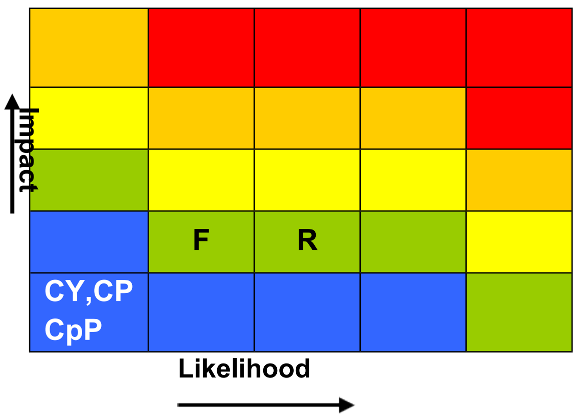
68. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

Risk Matrix

Risk Profile before officer recommendations



Risk Profile after officer recommendations



Key

Categories	**Colours** *(for further detail please refer to Risk management strategy)*
R = Reputation	Red = High impact and high probability
CpP = Corporate Plan Priorities	Orange = Major impact and major probability
CP = Community Priorities	Yellow = Moderate impact and moderate probability
CY = Capacity	Green = Minor impact and minor probability
F = Financial	Blue = Insignificant impact and insignificant probability

Council Plan Implications

69. 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

70. None

Equality and Diversity Implications

71. This report does not involve any equality or diversity implications

Privacy Impact Assessment

72. There is no personal information included in this report

Background Papers

- SSDC Commercial Strategy 2017 and 2019