South Somerset District Council

Investment Assets Quarterly Update Report

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Purpose of the Report

1. To provide a quarterly update to members on progress with implementing the commercial investment component of the Commercial Strategy agreed by Council.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of September 2020. This report commences quarterly reporting rather than the previous half-yearly in response to the COVID-19 pandemic.

Public Interest

3. The Council's commercial strategy forms an important part of the Council's Corporate Plan ("Council Plan") and its 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.
4. 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 updates on progress every six months with the previous update being reported to District Executive in June 2020. At that meeting, District Executive decided to receive quarterly summary update reports on Investment Assets until further notice in light of the economic effects of the COVID-19 pandemic.
5. The report includes updates on rent collection, tenancies, the financial performance of investments, the purchasing of new commercial investments, and progress with projects.
6. These contribute 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.

7. The aim of this report is to give Members and the public an update on the performance and impact of the commercial investment to date including its contribution to mitigating the impact of reductions in Government funding and protecting services.

8. 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

9. 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 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.

Background

10. 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 detailed reports have normally been provided at six monthly intervals but are now to be presented quarterly with a summary report in between the full six monthly reports.

11. This report is a succinct update of high level figures for new investments since 1 May 2020, updated to 31 July 2020 with commentary on the management of the investment property assets.

12. The Commercial Property Team has been stable in terms of staffing since the last report.

COVID-19

13. The pandemic has impacted on all aspects of society and is affecting economies across the world. The Office for National Statistics has reported that the UK economy is in a technical recession after Quarter 2 (Apr to June) 2020 saw a record fall of 20.4%, following a significant shock since the start of the COVID-19 pandemic; this follows a fall of 2.2% during Quarter 1 (Jan to Mar) 2020. Monthly GDP rose by 8.7% during June 2020 but is 17.2% below February 2020 levels.

14. A recent forecast published by Deloitte gives their analysis and opinion that the most likely scenario assumes a rebound in economic activity in the second half of this year, following the sharp squeeze to activity in the second quarter. The rebound is constrained by continued, though reducing, social distancing requirements, and caution exercised by businesses and consumers. They expect the recovery to continue throughout 2021, with activity reaching pre-pandemic levels only in the following year, two years after the sharp decline. They model cases either side of this base case which perhaps demonstrate the challenge of producing forecasts.

15. Looking internationally, Deloitte recognise that other major economies also registered record contractions in GDP and face the expectation of similarly prolonged periods for recovery.

16. Looking at UK commercial property investment, as would be expected, the volume of investment transactions fell dramatically at the start of lockdown. Savills have reported that Q2 2020 saw the weakest quarter on record for investment activity in the UK commercial property market. The volume of investment that quarter overall was only 21% of the 5-year average. But, June was over 60% higher than the April/May levels which suggests the market is starting to return.

17. The very limited market means there is a shortage of comparable evidence. Vendors are still trying to achieve pre-COVID-19 value levels. Some buyers are seeking a lower level.

18. Our analysis and forecasting based on a range of expert commentary is that we believe it likely that market rental and capital values will fall over a period before generally recovering - but the outlook is far from clear. It is likely that the industrial/warehouse sector will be the most resilient and high street retail the most strongly impacted. Office markets have the possibility of structural change following the massive national adoption of home-based working during the pandemic although there are diverse views on how great the long term impact will be for the amount and types of office space required.

Rent collections

19. Commercial rents are typically paid quarterly in advance in late March, June, September and December. Pre COVID-19 we would have expected 100%

collection of rents due from all the "new" assets and a few smaller rents to nurture amongst the earlier local investment properties.

20. For the March quarter, it took considerably longer than normal to recover the rents and a lot of engagement with the tenants. We have recovered 90% of the expected rents. One tenancy amounts to a further 8% of the rent roll and we are renegotiating their lease to gain a longer, inflation linked income and give them some short term breathing space. For the June quarter, we have recovered 65% so far. If all tenants with whom we have agreed monthly arrangements keep paying, then we would achieve 82%. We have the same 8% to resolve as last quarter, so we have about 10% at risk, and continue to work on that.

21. We would hope to see no worsening in September quarter and improvement by December.

22. Reports of large property investors indicate that we have achieved towards the upper end of the range. Typically, landlords specialising in the retail sector have seen the greatest impact. Examples include Howard de Walden Estate, a major central London landlord that reported collecting 53% of the March-June quarter rents due. British Land plc, one of the largest property development and investment companies in the United Kingdom, reported collecting 97% of office rents and 43% retail rent being collected for that quarter, and 88% of office rents and 36% retail rent being collected thus far for the June-September quarter.

Tenancies

23. We have completed legal proceedings to forfeit one tenancy at Trafalgar House, Taunton. The tenant breached the terms of the lease relating to assignment or sub-letting. They had also carried out alterations that did not meet Building Regulation requirements.

24. Also at Trafalgar House, we have completed a new letting on a small unit that was vacant when we acquired the property. The lease was completed in May 2020.

25. There are no other changes to the tenancies across the portfolio. We are maintaining close contact with tenants and supporting them during the pandemic with some short term arrangements that allow rent payments to spread over time.

New Assets

26. We are continuing to seek to acquire good opportunities that meet our investment criteria and particularly the target for 7% initial gross return. We are looking for a discount from pre COVID-19 levels generally of 5-10%. Our analysis shows that for the right assets, that gives enough cover for the risks around serious recession and an extended dip in values.

27. In July and August, we have progressed on several opportunities, including two which we wished to proceed with. One was approved by IAG but another party offered above of our valuation. Another is not currently proceeding, as the seller has changed their expectation and is wanting a price higher than they suggested and giving no discount from pre-COVID-19 levels.

28. Overall, we are sustaining our activity levels. We expect there to be more abortive work than applied before the pandemic with purchases more difficult to conclude, because the market has more disparity of views about value and outlook. We hope that we may be able to secure some better than typical opportunities during this period.

29. We are proceeding with a new energy infrastructure asset. The situation is part way through the set-up process and we are subject to a non-disclosure agreement. We are implementing this through the established SSDC Opium Power Ltd company structure and have made a first stage loan to the company of £2.35m in relation to this new project. We will report publicly on the non commercially sensitive elements of this asset as soon as we are able to do so, which we anticipate to be during September.

30. Recent half yearly reports have included graphs indicating actual progress against budget for income and for capital invested. As there have been no concluded purchases, and the last report was only one quarter ago, new versions have not been produced in order to save the officer time involved in updating.

Residential Development, Marlborough

31. We previously reported that water damage had occurred to a number of flats due to a serious failure in the new hot water installation in one of the upper level flats. Work to repair this, and indeed marketing generally could not proceed during the most stringent period of the lockdown.

32. The three houses are being marketed now. The building contractors have returned to site to reinstate the flats, following which marketing of the flats will resume.

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

34. Residential property sales are being supported by a stamp duty holiday from 8 July 2020 until 31 March 2021. This particularly benefits properties under £500,000 and thus applies to all of the homes in this project.

Energy Storage Scheme

35. The Fideoak, Taunton, battery storage scheme is owned via a company, SSDC Opium Power Ltd (SSDC OPL), a joint venture between SSDC and Opium Power Ltd, which purchased the site in 2018.

36. Official confirmation that the scheme had passed the final test conducted by National Grid was received in early June 2020. This enabled the scheme to commence its trading activity. The returns will become known after the first quarter of trading (as previously reported revenue is paid in arrears) and should be available for the next quarterly report.

37. Work on Phase 2 for an additional 5 MW was delayed by around one month due to COVID-19 lockdown but has since progressed smoothly while meeting COVID-19 guidelines. The main installation works have now been completed and final manufacturer's commissioning is due in late August. This will be followed by the activities required to meet requirements for final approval and National Grid tests. Overall these should be completed by October following which that phase will also be able to commence its trading activity. There will be a further three-month period before results are known. From that stage, the two phases will operate as a single entity. At present it is anticipated that phase 2 will therefore be revenue generating earlier than was originally forecast despite COVID-19 delays.

38. The budget for Phase 2 was £2,500,000 and the final cost is expected to be below budget.

Financial Implications

39. The financial implications for the progress with commercial investments are set out above within the report and also in further detail in the Confidential Appendix.

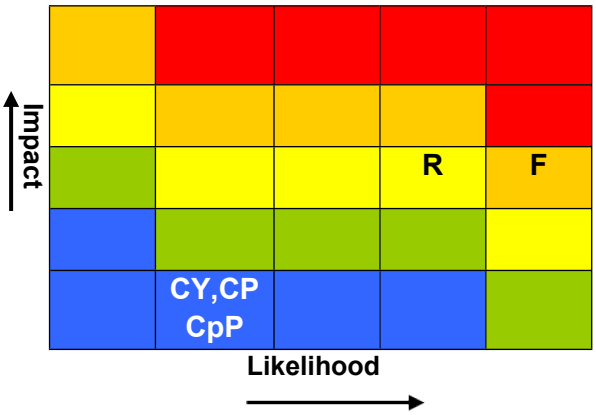
40. SSDC has approved a large sum for commercial investment. The commercial strategy has been operating for 36 months, and excellent progress has been made, ahead of target timeframes.

41. 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.

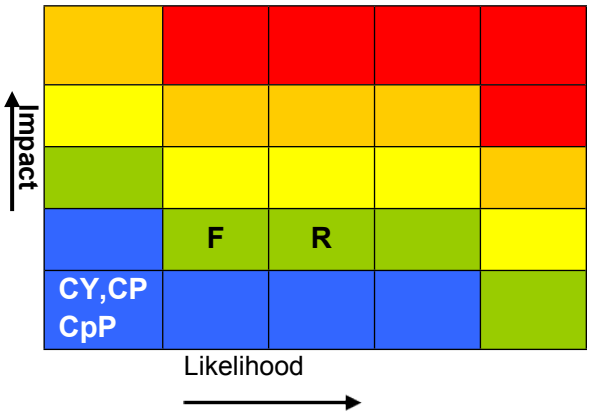
42. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

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 CpP = Corporate Plan Priorities CP = Community Priorities CY = Capacity F = Financial	Red = High impact and high probability Orange = Major impact and major probability Yellow = Moderate impact and moderate probability Green = Minor impact and minor probability Blue = Insignificant impact and insignificant probability

Council Plan Implications

43. 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

44. The council reviews energy performance as part of its purchase due diligence and seeks opportunities for improvement of this with assets it owns. We are prioritising work to identify projects of environmental benefit.

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Equality and Diversity Implications

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

Privacy Impact Assessment

46. There is no personal information included in this report

Background Papers

SSDC Commercial Strategy 2017 and 2019