South Somerset District Council

Investment Assets Update Report

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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 June 2020 and quarterly update in September 2020.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of 3rd December 2020. This retains the regular six monthly update pattern from the last report, published 4th June 2020.

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. 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 in June 2020. In light of the exceptional situation with the COVID-19 pandemic, officers have provided a quarterly update in September 2020 and will provide a further report in March. These reports have reduced levels of detail.

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 slower progress in acquiring new commercial property investments as a result of COVID-19.
   c. Note continued rent collection averaging in excess of 95% over the last three Quarters despite the pandemic.
   d. Note the return being achieved across the portfolio which is slightly below the Council's target of 7% as a result of lease renewals, securing the future of the asset.
   e. Note progress being made in securing income from our existing assets and the contribution to the revenue budget towards the revised £3.35m target.
   f. 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. When the June 2020 report was reviewed at District Executive, members decided that for the time being they would also receive quarterly updates. The first of those quarterly reports was provided in September 2020. The level of detail and range of contents is reduced to reflect the officer time needed to report at increased frequency.

9. This report is a succinct update of high level figures for new investments since June 2020, updated to 1 November 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 sales. They may also provide Council Tax, business rates and New Homes Bonus grant funding opportunities.

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 UK saw quarterly GDP fall by 2.5% in Q1 2020 and 19.8% in Q2 2020. For context, the largest quarterly fall in the Global Financial Crisis was 2.1%. GDP has begun to rise, growing by 8.0% in the three months to August, however the second wave is likely to prevent an immediate return to Q4 2019 levels. This is likely to have longer term implications, particularly for High Street retail and leisure industries.

15. Most commercial property leases provide for rent to be paid quarterly in advance in March, June, September and December. We have therefore had three rent quarter days since the initial outbreak. The March quarter day (25th March) was only two days after the initial lockdown began. A number of retail and leisure based funds and landowners were substantially affected.

16. Our rent collection across the investment property portfolio was broadly unaffected, with collection figures of 98%. Our team has focussed attention on the connection with our tenants. We have sought to show appropriate flexibility as part of a supportive attitude, but also to protect the Council’s investments.

17. We had expected the June quarter day to be a substantially harder test, with tenants having had three months of hardship in which to strategize, however we are pleased to report rent collection of 95%. Collection in these two quarters is well above the industry average, assisted by a diverse portfolio, with a low proportion of High Street retail investments.

18. Two months on from the September quarter day, we have collected 94% of rents due and expect this figure to continue to increase.

19. In terms of property acquisitions, we are keeping strategy under review as the economic picture becomes clearer. An increasingly polarised commercial investment market is emerging, with last-mile logistics units and warehousing in higher occupational demand resulting in harder industrial yields, while retail and, to some extent, offices suffer.

20. We remain in the market as it resumes some activity, however opportunities are reduced as vendors seek pre-Covid sale prices and buyers look for discount. 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.

21. 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. We will look to augment the value of the portfolio by actively managing leases to seek longer terms.

Commercial Investments

22. 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, risk reserve and staffing) is £3.35m. Saving in this context is delivered by net revenue income.

23. To date, a total of £73.9m has been invested in commercial property, producing a running yield of 6.68% after the regear of The Ralph's lease. This will improve to 6.95% in 2021/22. The target running yield is 7%.

24. This is a gross target, which does not take into account costs of borrowing, acquisition, risk reserve and staffing. We will continue to manage the assets to improve this figure.

25. A further £18.6m has been invested in BESS Taunton and the Marlborough development. We have excluded from this as their returns operate on a different basis – namely interest on loans and profit on capital. The total investment is £92.5m. The Council has now committed to a second BESS scheme on a site at

Fareham. The commitment was made in late October 2020, with a total of £18.96m to be drawn down as the project requires, with funds being transferred to the joint venture company developing the project.

26. 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 Local Authorities, 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.

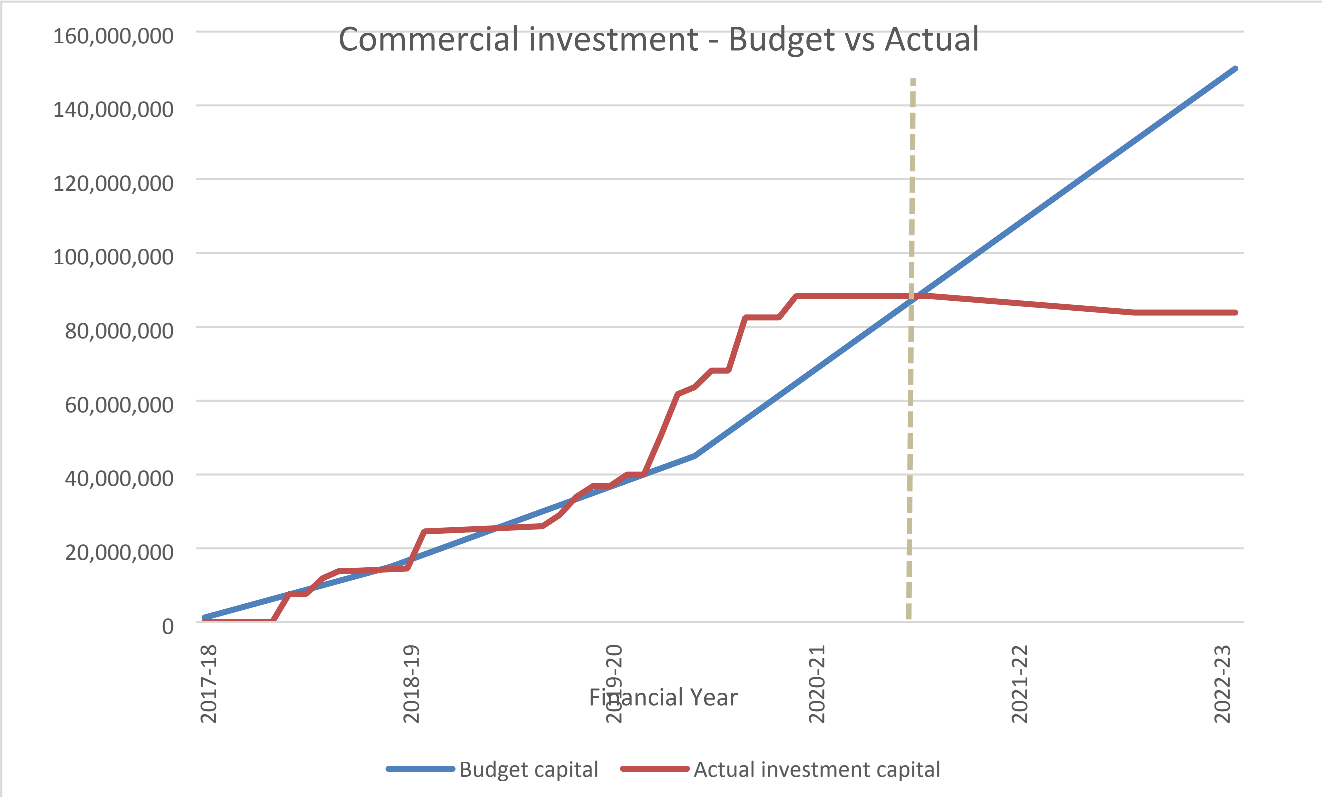
27. In addition, the Council has recognised the risks attached to holding a property investment portfolio and using income for this to support the revenue budget and provision of services. Therefore, the Council is also utilising a proportion of the commercial income to develop a Commercial Asset Risk reserve to protect the Council and the revenue budget from any potential future volatility, income voids or repair costs.

28. This reserve currently stands at £6.3m as previously reported to District Executive. As a result of the Council's prudent approach, whilst the portfolio is generating a return of circa 7%, the Council is able to utilise the true net return to support the revenue budget.

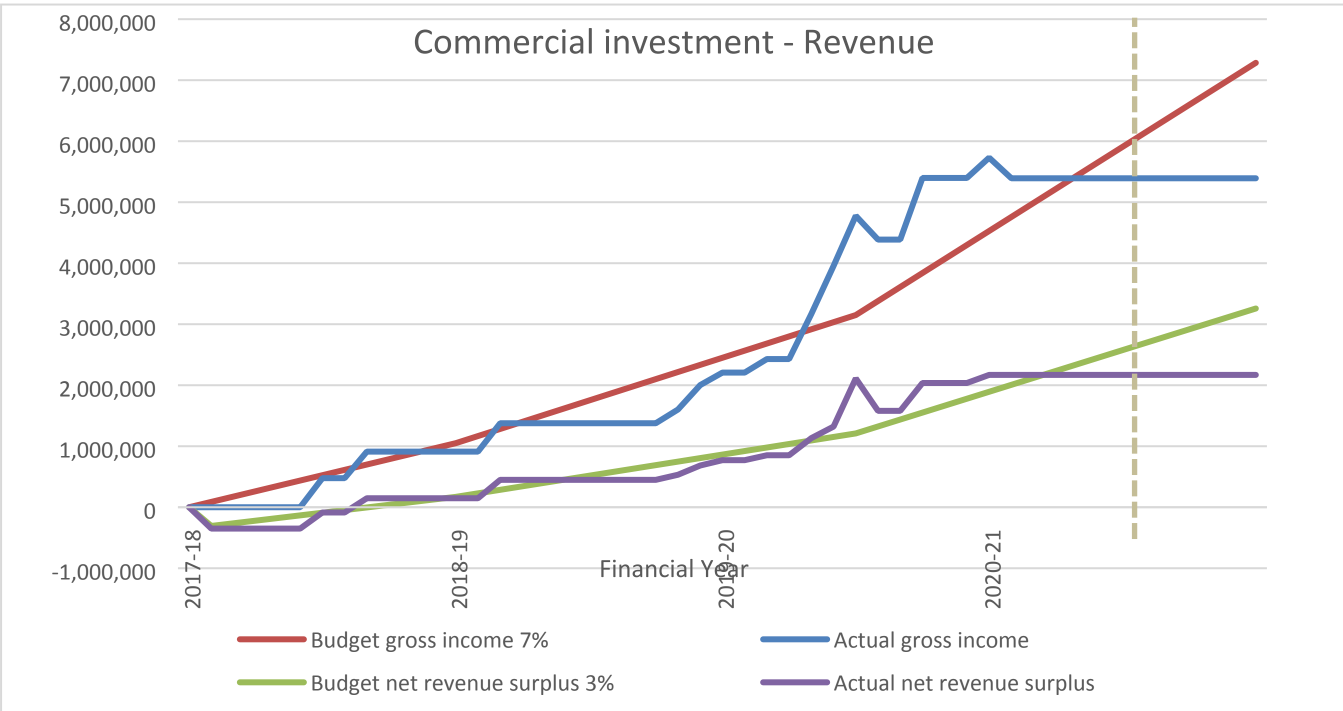
29. Progress is shown on the graph below for the actual capital invested to date in new commercial assets. This is compared with the initial budget objective to invest £75m by March 2021, with the 2019 revision to increase the objective to £150m shown represented by straight line progress with the annual rate increasing from September 2019 enabling progress over the time period to be seen as either below or ahead of the objective. Actual capital investment is not projected in future giving the appearance we will drop behind but work will continue with the aim of maintaining progress.

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

South Somerset District Council



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



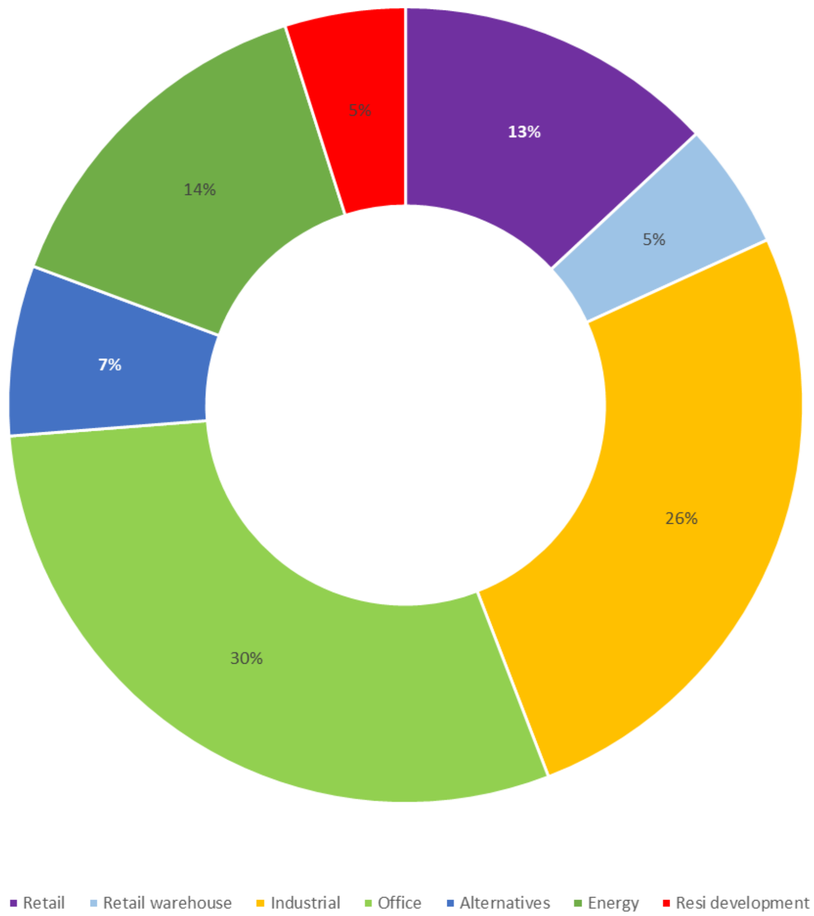
32. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed.

33. 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.

34. The Council currently has eighteen assets in its 'new' portfolio, providing a gross income (before cost of borrowing) of £4.94m 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 BESS Taunton, the Marlborough development project, BESS Fareham which are not in the form of annually recurring income and the income from Travelodge in Faringdon which has not yet been completed.

35. The battery storage facility in Taunton is now fully energised and income producing. This income is paid in arrears by National Grid.

36. 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.

37. As a result of COVID-19 there have been no further acquisitions since our last report in June 2020. The Investment Acquisition Group (IAG) has recommended purchase of a data-centre led, multi-use building in Birmingham, which is currently under offer.

38. 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.

39. 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 portfolio is set out in Confidential Appendix, table 1.

Portfolio Commentary

40. The world is very infrequently dominated by one issue in the same way that COVID-19 has influenced global consciousness and the world economy. Earlier in this report we reported the impact that Covid-19 has had on GDP and rent collection.

41. Since June we have completed the rent review of Screwfix's unit at Sherwood Road, Bromsgrove, increasing the rent from £45,000pa to £65,300pa.

42. We have also completed the surrender and re-grant of the lease of The Ralph, Marlow, agreeing a new 30 year term, which improves the quality of the investment, in return for a package of rental incentives. These incentives will allow the business space to grow and further invest in the property, which will help to improve the covenant and investment value.

43. During the previous report we commented upon media coverage of Local Authority property investment. It is important that this matter is foremost in members minds. Press commentary 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.

44. 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

45. There have been no investment purchases in the half year from June to December 2020. Progress is slowed due to the impact of Covid-19 on the market. 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.

46. In the calendar year 2019, SSDC 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. Due to Covid-19 this figure in the calendar year 2020 stands at £5.4m.

47. There has been the legal commitment to the new BESS scheme at Fareham which is summarised below.

48. We provide below commentary on the two evolving developments SSDC have invested in.

Residential Development, Marlborough

49. The 15 flats and 3 houses were first put on the market in late October 2019 when Practical Completion of the construction works was delivered. Continuing significant contractor presence did not enable the scheme to be seen at its best, and until the General Election in December 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.

50. 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 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 with eventual return to activity during August 2020. Reinstatement works commenced during August and are now virtually complete.

51. Management arrangements for the property are in place, keeping landscape and external areas in order and we are regularly checking the property.
52. We have carried out a review of the marketing approach and decided to appoint new selling agents who could provide a renewed approach. Full marketing of all units is now being mobilised. This activity is of reduced effectiveness due to the new lockdown. We have agreed the sales for two of the houses and those transactions are in solicitors' hands. Our goal is to make the best use we can of the period where the Government stamp duty incentive applies, while achieving robust prices on any sales. 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. Our focus is on delivering the best possible outcome. We will report on the eventual net position once sales and construction cost matters have all been concluded.
53. It is likely that sales will take around 12 months or longer to conclude once we can fully market the residential units, subject to any further the impact on the market of COVID-19.

Taunton Battery Energy Storage Scheme

54. 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 a 25MW battery storage facility for short-term supply of electricity to the local distribution network. The project completion was followed by work to connect and test the SSDC OPL site linking into electricity utility company equipment and then into the National Grid (NG) Sub Station in March 2020, the scheme was then energised to the grid.

55. 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 established safe methods of working that enabled the final commissioning phase to complete, albeit slower than usual in order to mitigate risk to workers.

56. The last testing requirement took place before the end of May 2020 following which the system was fully operational and able to be registered for entry into the energy auctions to earn revenue via our business partners KiWi Power Ltd. Registration takes a month and revenue earning commenced in July as contracts were won and revenue streams began to flow. It takes time to build up the bidding and

winning of contracts and so revenue is not instantly maximised, as contracts are won the revenue builds.

57. Unfortunately, during a storm in August the Western Power Substation (WPD) that the Battery Energy Storage System (BESS) must go through before charging and discharging to the National Grid) was hit by lightning and damaged. This meant that the BESS was unable to operate until the WPD substation could be repaired and become operational again. Others were also adversely affected by this incident, including the local hospital. The insurers will consider a lost revenue claim where loss of income can be evidenced after the first month of non operation. The company are now working through that process. This means that we do not have a full trading quarter of income to report back at present. However, the substation was operational again in mid-October and we are now fully trading with Phase 1 again. Confirmation of actual income to date and forecast income for the next quarters is available in confidential information.

58. Phase 2, the additional 5 MW, was due to be operational and income generating by September, but the above incident with WPD substation meant that commissioning and testing could not be completed. This has now been undertaken and registration for bidding into the energy auctions has now commenced. This smaller final phase for the site maximises the grid licence to ensure that opportunity to generate energy and revenue from this site was not lost. All of site area suitable for Battery Energy Storage at this location is now in use. 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.

59. 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. 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.

60. 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.

61. 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 earlier delay in energising the site also delayed interest being paid back to SSDC; but this is recovered due the agreement requiring SSDC OPL to pay more interest to SSDC.

Fareham Battery Energy Storage Scheme

62. Our joint venture company SSDC OPL purchased Fareham Energy Reserve Ltd this summer, following the undertaking of a full review of the due diligence and business plan for development and future revenue by SSDC, prior to providing the company a loan at commercial interest rates, to approve SSDC OPL to proceed. The company purchased, Fareham Energy Reserve Ltd, holds the lease, planning permission and grid licence to develop and operate a 40 MW Battery Energy Storage Site.

63. The development loan agreement and construction contracts are now completed and full site investigations and preparations are underway. It is anticipated that construction will start in January 2021.

64. Forecast completion of the project will be late 2021 with revenue streams commencing in Spring 2022 after final testing, commissioning and registration.

Commercial Investment Acquisitions

65. Consideration of appropriate acquisitions has been sustained to continue progress towards meeting the Council's objectives for commercial investment. Before the lockdown, we typically considered some forty 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.
66. The RICS announced a period of material valuation uncertainty, which although rescinded across all sectors by mid-September, has restricted investment. We are currently considering circa twenty opportunities a month.
67. 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.

68. 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

69. Since the last District Executive update in June 2020 the asset team have continued reviewing the portfolio and identifying opportunities to explore. There is currently a disposals pipeline of £617,000 expecting to transact within the next 12 months. We have also agreed leases and wayleaves totalling £4,000 per annum.
70. Since our last report we have let Unit 1, Goldcroft to BMB Fitness for a six year term with a three year break at £25,000 per annum, and Unit 15 Yeovil Small Business Centre to Clean Image South West for £3,600 per annum on a rolling annual agreement. We have also agreed licences with Lloyds and Natwest Banks to allow use of local car parks for local bank vans. Whilst the licences are in nominal sums, they benefit our communities by providing access to banking facilities.
71. Work continues to develop a pipeline of small sites for disposal. The majority of these sites will be sold with the benefit of a residential planning consent. Progress on these sites has slowed during the Covid outbreak due to the reallocation of resources. The legal issues surrounding nitrate pollution has also stalled or slowed progress during the planning process. The announcement of proposed mitigation measures is eagerly awaited to allow these sites to progress.
72. 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 has led to fundamental changes in the way property viewings and general person to person interactions can take place.
73. 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.
74. Specific asset management transactions are included in the Confidential Appendix.

Financial Implications

75. 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.
76. SSDC has approved a large sum for commercial investment. The commercial strategy has been operating for 39 months, and excellent progress has been

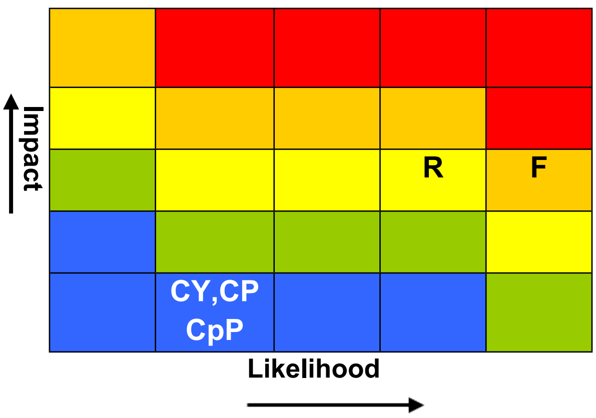
made, ahead of target timeframes. Nevertheless the economic effect of Covid-19 have slowed progress as the market has struggled and less opportunities are available.

77. 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.

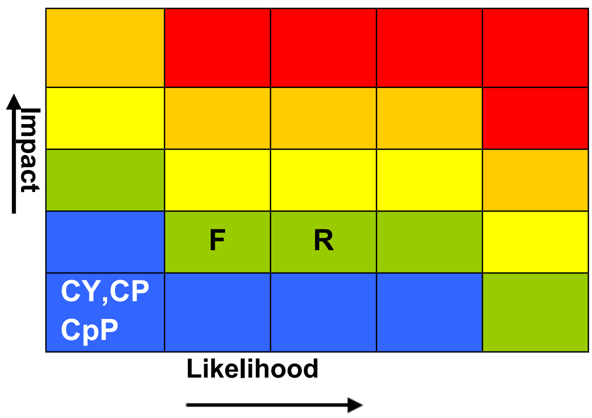
78. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

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

79. 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

80. None

Equality and Diversity Implications

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

Privacy Impact Assessment

82. There is no personal information included in this report

Background Papers

- SSDC Commercial Strategy 2017 and 2019