South Somerset
District Council

Investment Asset Update Report

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Purpose of the Report

1. To update members on progress with implementing the commercial investment component of 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 2021 and quarterly update in September 2021.

Forward Plan

2. This report appeared on the latest District Executive Forward Plan with an anticipated Committee date of December 2021. This report provides the regular six monthly report, reverting to that frequency having reported quarterly during the first year of the COVID-19 pandemic due to the heightened economic volatility.

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. This report is to update members on progress made to date on the investment component of the Commercial Strategy. The Council originally agreed to receive update on progress every six months. 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. The last report was in September 2021.

4. The report includes updates on the purchase 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. New acquisition of additional commercial investments was ceased by a decision of District Executive in December 21

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 progress made to date in acquiring new commercial property investments and the asset management following acquisition.

   b) Note the return being achieved across the portfolio which is in line with the Council's target of 7%.

   c) Note progress being made in securing income from our existing assets and the contribution to the revenue budget towards the revised £3.35m target.

   d) Note progress being made in disposals and transfers of existing assets, resulting in a reduction of future liabilities associated with these assets.

Background

8. Council approved a commercial approach to Land and Property management in August 2017 as part of the Commercial Strategy which was supporting the objective of becoming financially self-sufficient.

9. The commercial approach to Land and Property management is the major financial component of the Commercial Strategy. The objectives are to invest in additional commercial property assets and to manage existing land and property assets more commercially

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).

11. This report is an update of high level figures for new investments between 1st August and 31st October 2021.

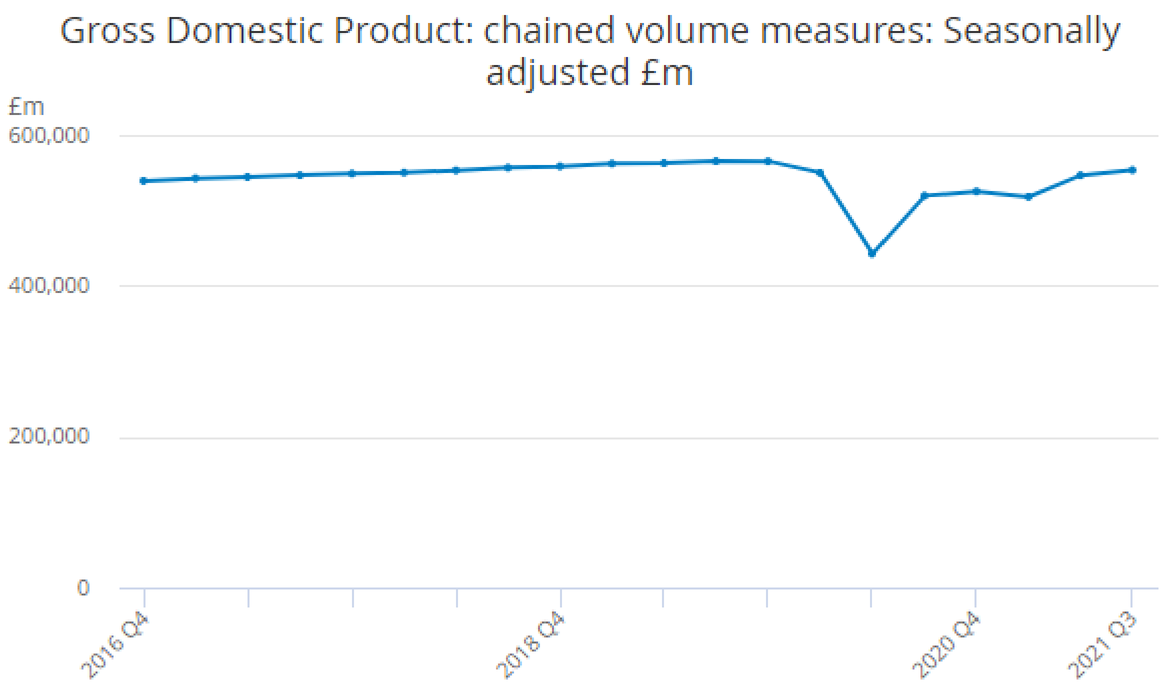
12. We have agreed to revert to the six-month frequency of reporting originally requested by District Executive now the UK economic impacts of Covid-19 are steadying.

Covid-19

13. The pandemic has impacted on all aspects of society and is affecting economies across the world. Whilst the pandemic is ongoing, the death rate is in decline and the global economy is recovering (although that recovery is slowing).

14. British GDP is estimated by the Office for National Statistics to have grown by 0.6% in September 2021, but remains 0.6% below pre-pandemic peak attained in February 2020.

15. With 75% of the adult population in the UK now double vaccinated, and all areas of the economy now open for business, a steady growth in the economy is now predicted by most forecasters.



16. We have noted, as a result of the crisis, a negative impact on parts of the office market and particularly High Street retail property markets.

17. Most commercial property leases provide for rent to be paid quarterly in advance in March, June, September and December. We have therefore had seven rent days since the initial outbreak. 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.

18. Following careful management we are pleased to report that rent collection across the pandemic was well above the industry average, at in excess of 95% of rents contracted. This has been assisted by a diverse portfolio, with a low proportion of High Street retail investments.

19. Our investment acquisition programme paused from March 2020 until February 2021, as we took stock of the market and turbulence caused by Covid-19. Broadly, an increasingly polarised commercial investment market emerged following the

outbreak of Covid-19, with last-mile logistics units and warehousing in higher occupational demand, whilst retail and, to some extent, offices suffered.

20. Industrial property remains in high demand. There are signs that retail warehousing in particular is improving and that demand may be returning to the High Street and offices as brave investors seek to spot the bottom of the market.

21. The prices being paid for industrial property have caused concerns over a potential bubble in that market and meant that we have not been able to acquire property in the sector. The portfolio contains a sufficient proportion of offices and High Street retail values have been in freefall, restricting potential acquisitions in those markets. As a consequence, we have invested in property in alternative sectors such as data centres, retail warehouses and gyms in the past 12 months.

22. The volume of market activity for property investment transactions remains suppressed when compared with pre-Covid levels of activity. Owners of office and retail assets that do not need to sell are holding on in the hope that a swift bounce back in the economy will reverse some of the damage caused by the pandemic. Owners are holding industrial assets because of their strong performance and continued rental growth. An increased number of deals are now taking place ‘off-market’ as vendors attempt to offload assets quietly to free up capital. Industrial and retail warehouse properties that are being widely marketed are achieving figures well in advance of asking price.

23. We will continue to augment the value of the portfolio by actively managing leases to seek longer terms, however the Council should note that in the office and retail markets tenants are taking advantage of market uncertainty to seek more attractive terms.

Commercial Investments

24. 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, staff costs and risk reserve) is £3.35m. Saving in this context is delivered by net revenue income.

25. In December 2021 District Executive made the decision to cease any new “investment primarily for yield”. This follows changes to PWLB (Public Works Loans Board) lending terms which mean that source cannot be used to finance further investments. This was confirmed in the Prudential Code 2021 published in December 2021.

26. To date, a total of £93.93m has been invested in commercial property (including costs), producing a running yield of 7.12% allowing for the rent free incentive on the renewal of the lease with the tenant of our property The Ralph, Marlow (6.88% otherwise). This is an improvement from the 7.03% (and 6.77%) reported in the previous quarter following the acquisition of St John’s Retail Park, Taunton.

27. In a reasonable worst case scenario this will decrease to 6.51% in 2022/23 (6.37% reported last quarter). We will however continue to work to renew leases and review rents to achieve improved results. The target running yield is 7%.

28. 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.

29. £42m has been invested in battery energy storage systems (BESS) - Taunton (Fideoak) and FERL 1&2 through a joint venture company: SSDC Opium Power Ltd. The returns from these to SSDC come by way of interest on capital lent to the joint venture company, repayment of capital, and dividends from the profits of the company. As these projects must first be constructed, there is an initial period of investment without immediate return. That construction period is behind us on Taunton but currently applies to FERL.

30. A further £5m has been invested in the Marlborough residential development. Any return from this would be in the form of a single lump sum profit. We have excluded these investments from the charts below as their returns operate on a different basis from investment property – namely interest on loans and profit on capital.

31. Detail on capital invested and earnings from these is included in the confidential appendix, as the detail impacts on our commercial relationships with tenants or other parties, and future reports will include more performance commentary on these.

32. Our total investment is therefore £141.9m, leaving a further investment budget of £8.1m to maximise the remit.

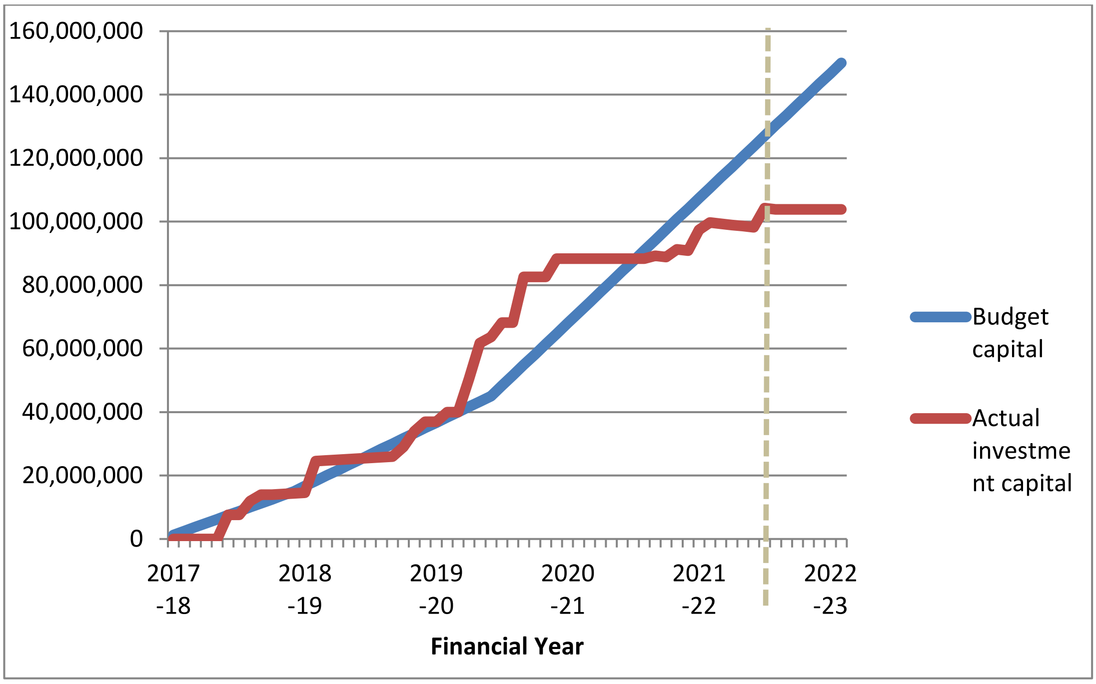
33. In assembling this investment portfolio, the Council is not applying all of the revenue generated to support the Council's revenue budget. The Council is fully meeting the requirement to set aside money annually to repay the principal. This is distinct from the approach taken by many commercial property companies and some 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.

34. 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.

35. This reserve currently stands at in excess of £6.6m 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.

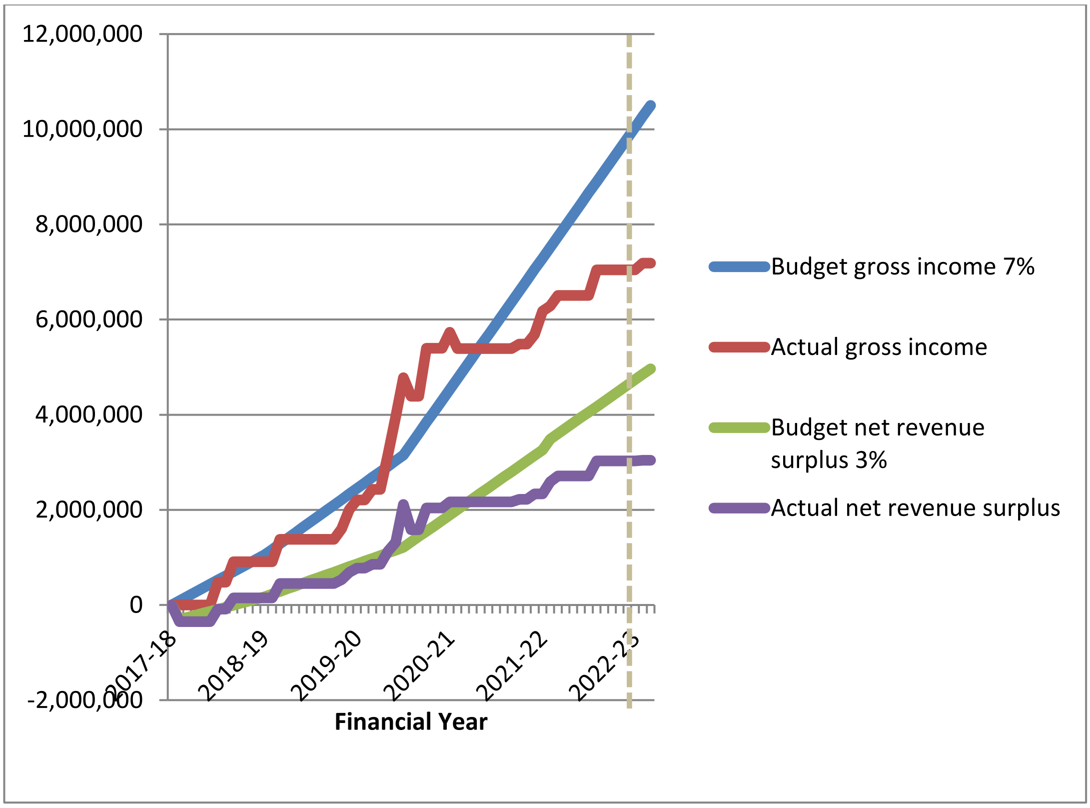
36. Progress is shown on the graph below for the actual capital invested to date in new commercial property investment assets. This is compared with the initial budget objective to invest £150m by March 2022. The fund was allocated across five financial years and to assist review is shown as a straight line budget progression enabling progress over the time period to be seen as either below or ahead of the objective.

Figure 1 shows commercial property investment capital – Budget v Actual



Note: Figure excludes investment in FERL 1 & 2

Figure 2 shows commercial property investment – Gross and Net Income



Note: excludes any income from FERL 1&2.

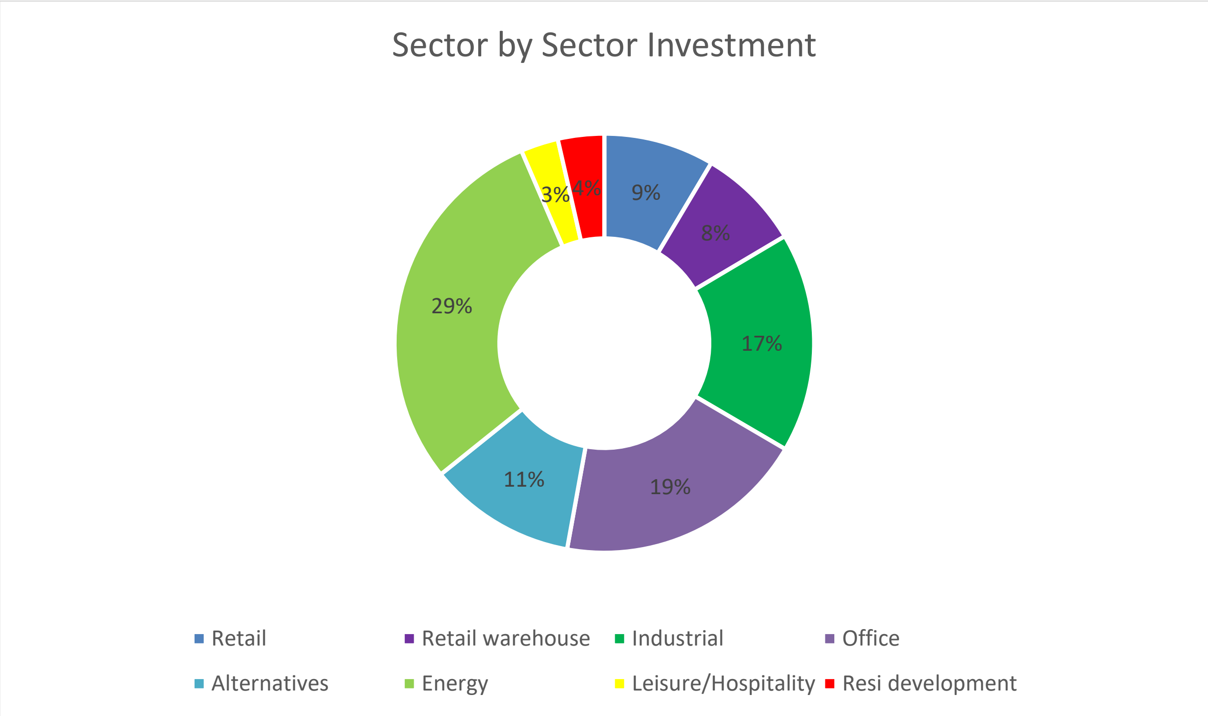
37. The income used in the graph above uses the contracted income (rent) from commercial property investments where the purchase has been completed.

38. Since the introduction of the Commercial Strategy, SSDC has purchased a portfolio 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.

39. The Council currently has twenty-three investment property assets in its 'new' portfolio, providing a gross income (before cost of borrowing and managing) of £6.46m per annum using the whole year income for 2021/22 from assets in SSDC ownership as at 16th November 2021.

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

41. The current sector split of capital invested in all of these assets, including Marlborough, BESS Taunton and FERL 1&2 is as follows:



42. Since our last report in September 2021, the Council has added a single investment to the portfolio. Commentary on St John's Retail Park is provided in 'Asset Acquisitions' later in this report.

43. 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.

44. 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

45. We have previously commented upon media coverage of Local Authority property investment. 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.

46. 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.

47. We are beginning to see new leases and agree lease renewals of our own office properties at new rents equivalent to passing rents. High Street retail rents have begun to bottom out, although it should be noted that the Council's High Street retail units are now well over-rented. Industrial rents have increased almost universally and we would expect to achieve an uplift at review or renewal at almost all industrial units in the portfolio.

Asset Acquisitions

48. St John's Retail Park is a development of two units, 1.5 miles north east of Taunton town centre. The units are accessed from the A3038, the principal arterial route from the M5 motorway to the town centre, via Priory Way. Both units are of steel portal framed construction, with brick and blockwork infill and occasional steel profile clad and glazed elevations.

49. They are tenanted by Go Outdoors and DFS, providing a total income of £537,753 per annum, with a five year weighted unexpired lease term. The council acquired the asset for £6,000,000 (plus costs), a net initial yield of 8.36%.

50. In the long term, the site's low build density and good quality "medium box" construction make a contender for intensified development and repurposing for industrial or last mile logistics space, if required. Continuation of the current use while the lettings and rents are sustained is the preferred approach.

51. In the calendar year 2021, SSDC has acquired four properties with a total investment of £18.7m, in addition to the £56.3m acquired in 2019 and £5.8m acquired in 2020 (not including BESS schemes).

52. The new version of the Prudential Code, released in December 2021, led to a decision by District Executive that the unspent Commercial Investment budget should be removed from the capital programme (£8.643m).

Residential Development, Marlborough

53. The Marlborough residential development has been considerably delayed against original programme as reported previously, COVID-19 disrupting both completion of outstanding work and marketing activity. These delays and other detailed aspects of results compared with budgets means that this project is not expected to deliver any profit when all is finalised.

54. We have appointed new selling agents. Three house and one flat sales have now completed. We have four flats under offer. There is a good level of interest in the flats generally. We consider progress with securing buyer is now good and we are expecting to continue good progress with the sales in the coming months.

BESS Fideoak and Fareham

55. The Fideoak BESS continues to be fully operational and revenue producing. The system has continued to be operated by SSDC OPL in the most lucrative Stability Services market - the Dynamic Containment (DC) market. This is the highest earning market for Grid Scale Batteries, and as such has the most challenging technical requirements that must be met in respect of power delivery reaction time, accuracy of metering, stability of power delivery, and consistency of service availability.

56. The figures in the table below include actual income received to 30 September 2021 and the projected income for the October 2021 to March 2022. All the sums are the gross income received by the joint venture company and do not represent net income to SSDC, this will be reported at a later date.

Month	£
April	209,773.23
May	252,656.35
June	288,995.95
July	314,041.23
August	307,404.91
September	284,157.66
Actual income as at 30 September	**1,657,029.33**

Projected income October to March	1,419,630.40
Projected 2021/22	**3,076,659.73**

57. As a reminder to members, the National Grid has a 45-day payment policy, therefore revenue for May is not received until the end of July, June until the end of August and so on. From a cashflow perspective the company will be at least two months behind the actual generation.

58. On 1 November 2021 Limejump replaced Kiwi Power as the optimiser for the site. Limejump will also be optimising the 40mw and 20mw Fareham Batteries (that are operational in January and May 2022). The optimiser's role is to control and dispatch the battery asset into the National Grid's energy marketplace in order to maximise revenue for the site.

Fareham Project update

59. The Fareham 40mw Phase 1 is in the final commissioning phase, construction is complete and on schedule. Import power energisation has been completed and full commissioning is expected by the end of February 2022.

60. The Fareham 20mw Phase 2 BESS is in construction, on budget and scheduled for completion and connection to the substation six months ahead of schedule in May 2022. Final commissioning should be well ahead of schedule but is dependent on work arranged by the electricity utility that cannot be directly controlled by the owning company.

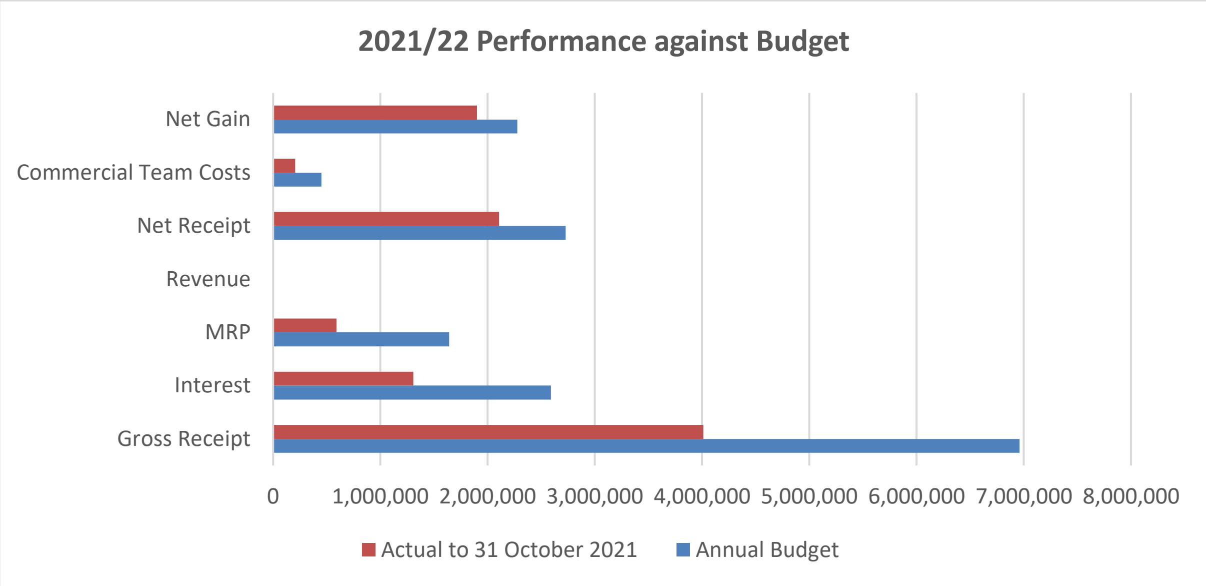
Investment Strategy

61. With the decision to stop the build up of the portfolio by new acquisition, the focus is now on portfolio and property management. We aim to maintain the lowest level of tenancy voids possible, and to protect and increase medium to long term growth in value of individual properties and the portfolio.

Financial Implications

62. The financial implications for the progress with commercial investments and of asset management activity are set out within the report and in further detail in the Confidential Appendix where the detail impacts on our commercial relationships with tenants or other parties.

63. The bar chart below shows the income and expenditure vs budget for April to October 2021. The budget is the approved amount included in the 2021/22 budget setting report agreed by Full Council in February 2021.



64. SSDC have approved a large sum for commercial investment. The commercial strategy has been operating for 51 months, and good progress has been made, in line with target timeframes. Nevertheless the economic effect of Covid-19 have slowed progress as the market has struggled and less opportunities are available.

65. 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.

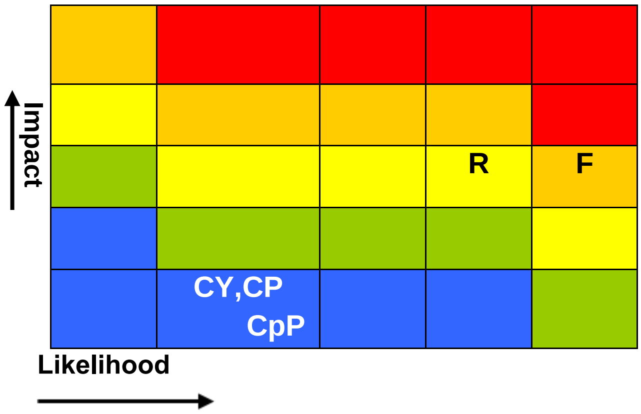
66. The financial implications of completed acquisitions including costs, income and funding arrangements will continue to be incorporated in budget setting and monitoring processes, in line with SSDC's financial procedures framework.

Legal implications (if any) and details of Statutory Powers

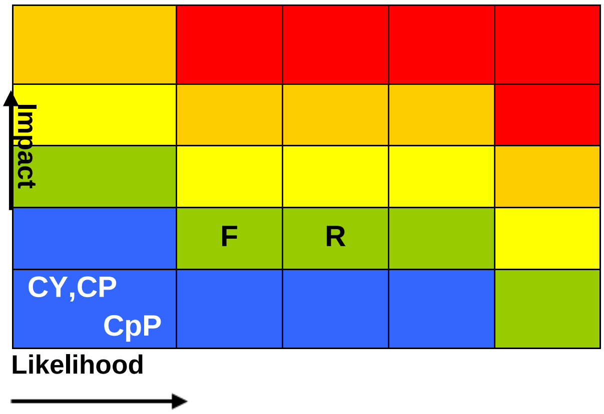
67. None.

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	High impact and high probability
CpP - Corporate Plan Priorities	Major impact and major probability
CP - Community Priorities	Moderate impact and moderate probability
CY - Capacity	Minor impact and minor probability
F - Financial	Insignificant impact and insignificant probability

Council Plan Implications

68. 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

69. None.

Equality and Diversity Implications

70. None.

Privacy Impact Assessment

71. There is no personal information included in this report

Background Papers

72. SSDC Commercial Strategy 2017 and 2019