Commercial Property Investment - Update

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Report title: Commercial Property Investment - Update	
Report to: Corporate Policy and Scrutiny Committee	
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County Divisions affected: All Essex	

1. Purpose of Report

1.1. This report summarises the Commercial Property Investment portfolio and provides an update on performance and issues since the last report to Scrutiny Committee in September 2020, along with the confidential appendix to this report.

2. Recommendations

2.1. None – the report is for information and discussion.

3. Summary and Background

3.1. In July 2017, Cabinet agreed to add £50m to the capital programme for 2017/18 to create a commercial property investment fund to generate income to help deliver the outcomes key to residents and business in Essex (FP/855/06/17).

3.2. From the initial **£50m** that was allocated to the Property Investment Fund, **£33.9m** has been spent to date.

3.3. The decision was taken to halt the programme due to Brexit uncertainties and changes in Government guidance regarding the use of borrowed funds ahead of need. The final acquisition was in July 2018.

3.4. The governance process and investment criteria for the portfolio, in terms of sector, geography and value, were established in the original decision.

4. Current Investment Portfolio

4.1. The Council continues to own three assets in Keighley, Watford and Guildford. These assets were acquired through, and are also managed by, Lambert Smith Hampton Investment Management (LSHIM). These assets and their date of acquisition are:

- Keighley Retail Park, Keighley *(March 2018)* – retail sector

- Moorfield Centre, Guildford *(July 2018)* – light industrial sector
- 45 Clarendon Road, Watford *(December 2017)* – office sector

4.2. **Keighley Retail Park** provides 65,556 sq. ft of purpose-built retail warehouse accommodation, which was constructed in 1998 and arranged as 8 retail warehouse units in 2 terraces along with a drive through restaurant, a pod outlet and a portacabin outlet. The property occupies a prominent position alongside the A650 Hard Inns Road and covers a site area of 6.5 acres.

4.3. It should be noted that this is an out of town shopping centre rather than high street retail space. During the pandemic lockdowns, some of the tenants were obliged to close while others managed to trade, with some publicly reporting very strong sales performances, such as Halfords and Pets at Home.

4.4. The site is, and always has been under our ownership, fully occupied. There are two units where in recent history the tenants entered either a creditor voluntary arrangement (CVA) or a pre-pack administration, which resulted in short term agreements to pay much reduced rent. Both tenants have now agreed heads of terms for new leases to commence in early 2022 to re-establish more sustainable rental levels as trade has stabilised for the tenants.

4.5. While the impact of the pandemic has hit retail particularly hard, there have been examples of new arrangements being put in place with tenants to secure longer term income.

4.6. **Moorfield Centre** – this property comprises a single terrace of steel portal frame construction which is divided into four modern trade counter units with two adjoining units. Constructed in 1996, the estate provides 23,025 sq. ft (GIA) of trade-counter/warehouse accommodation. The units provide ancillary office accommodation on ground and first floors. The property is prominently located at the entrance to the Slyfield Industrial Estate two miles north of Guildford town centre.

4.7. The industrial sector has performed strongly throughout the pandemic. One tenant vacated a unit at the end of 2021 to move to larger site, but another existing tenant immediately requested to take a lease for that unit. The tenants are on long term leases and have either been through recent rent reviews to market value or are due to imminently. These reviews are generating good increases reflecting the strength both of this asset and the sector.

4.8. **45 Clarendon Road** is a modern office building providing 23,219 sq. ft (2,157.2 sq. m) of open plan accommodation arranged over ground and four upper floors. Clarendon Road is the principal office location in Watford and a key arterial route between Watford town centre and Watford Junction Railway station.

4.9. The site has been impacted by the working from home directive due to the pandemic, which has reduced daily occupancy.

4.10. There were two tenants over four floors, however one tenant exercised an existing break clause in April 2021 on one floor, as they decided that they would require less office space post-covid.

4.11. This floor is now under offer and the new lease should be in place from April 2022.

4.12. The remaining tenant had break options clauses in May 2022 for both floors but has decided not to exercise either option, thereby securing the longer-term rental for those floors.

5. Impact of COVID-19

5.1. Following Government guidance on best practice, the Council sought to work with tenants who requested assistance with their cashflows. Legislation also prevented, and still prevents, Commercial Rent Arrears Recovery (CRAR) being taken against tenants who fell into rent arrears, although ECC are not impacted by this.

5.2. All of the temporary rental concessions entered into with tenants to assist their cashflows have now finished. There was no rental income lost in that time, only rescheduled. One tenant requested a permanent move to monthly payments from quarterly, which was accepted.

5.3. The overall rental collection rate for the 12 months to March 2021 was **91%** compared to the headline lease value, which compared very favourably with the collection rates published by major landlords. The missing rent was due to the retail tenants in administration paying a lower rent and a rent-free period agreed to secure a long term lease. The strong performance is testament to both the underlying covenant strength of the tenants, which was a key variable in the original investment appraisals, and the collaborative approach the Council took. Rental collection in the current year remains high, with no material issues with rental debt.

5.4. While the revenue performance remained strong during the year to March 2021, with the revenue budget delivered, the major pandemic impact for ECC has been in the drop in the market valuations of the assets.

5.5. The portfolio is valued annually by independent property market surveyors as part of the year-end financial closure. In the year to 31st March 2021, the portfolio dropped £3.8m (13%) in value.

5.6. The major decline (£3.3m) was at Keighley where the tenants paying reduced rents caused £1m of the decline. The remainder was in line with the general market reduction in values (-19%) for the area/sector, mainly caused by covid related uncertainty as well as longer standing concerns over the future of retail generally. The new leases at higher rental levels, plus a more positive outlook regarding covid and future restrictions, should improve the valuation in March 2022. The ongoing debate on the future of retail will continue to have an impact.

5.7. The decline at Watford (£0.9m), reflected the tenant leaving one floor, break clauses nearing for the other tenant and general market uncertainty over the future of offices. Again, the new lease and the non-exercising of the break options should improve the valuation in March 2022. There could continue to be some impact from the uncertainty around the future use of offices post pandemic.

5.8. The valuation at Guildford increased by £0.4m based on the two new long-term leases with one tenant, the strong rent review at another and general industrial sector positivity due to the high demand for such property post pandemic.

5.9. It was recognised at the outset that the portfolio would likely be held for approximately 10 years, to allow for the shorter-term market fluctuations seen recently to occur. The UK property market is still considered to be strong and attractive to investors in the longer term.

5.10. It should also be noted that the commercial property portfolio investment is one part of ECC's property estate and while there have been the investments in the portfolio, since 2017/18 there have also been circa £22m of receipts from sales of other estate properties that were surplus to requirements and £12m of housing sales in the same period. Overall, the net view of the activity across the estate is balanced and proportionate.

6. Financial Analysis

6.1. Despite the issues covered in the previous paragraphs, the portfolio delivered its net revenue budget for 2020/21 and is forecast to deliver the same for 2021/22.

6.2. The Council is also holding a provision for unexpected tenancy voids or costs relating to the portfolio on the balance sheet. As at March 2021, this provision stood at £975,000 and will increase to £1.3m by the end of the current financial year, which is circa 75% to 80% of the annual rent forecast. This provision can be used to support any revenue pressures. Please see paragraph 7.6 below for further information on this provision.

6.3. For 2022/23 the draft budget shows a realignment of budgets, moving £0.3m between the budgets for rental income and the budget for the appropriation to the balance sheet provision, leaving no overall budget impact. It is now considered likely that the portfolio will deliver an upside to this draft budget of £0.3m due to the progress on new leases at Keighley and the non-exercising of the break options at Watford.

6.4. In the last financial year, the capital value of the portfolio has declined from £29.1m to £25.3m – a decrease of £3.8m. All assets were evaluated against the backdrop of the market volatility caused by the pandemic as well as some local issues.

6.5. It remains important to remember that all assets are long term holds and are purchased for their long-term income streams. Importantly, the portfolio income has held up, and the value reduction is driven mainly by market sentiment and the impacts of the pandemic, rather than due to deterioration in the core assets.

6.6. Details of yields are shown in the confidential appendix.

7. Risk Management and Investment Criteria

7.1. The Council is following the previously agreed investment strategy, that the fund would only be spent on the acquisition of commercial property located in the UK (not housing sites or development land), outside Essex, and that the Council should seek to achieve a gross return of at least 5%.

There are various criteria within the strategy that are designed to mitigate risk. These are:

- Geographical Area
- Sector Weighting
- Value
- Use of Expertise
- Void Provision

7.2. In line with the strategy, properties have been acquired in a diverse range of locations throughout the UK in order to mitigate risk of declines in the property market in any one geographical area.

7.3. It was proposed to acquire only UK commercial property based on the following indicative split, to ensure that the Council was not over exposed to one sector of the property market

- Offices – 35%
- Retail – 35 %
- Industrial – 30%
- Alternatives – 10%

These percentages add up to 110% because these were indicative maximum percentages although it was acknowledged that in practice the percentages will vary. The actual sector split is currently as follows

- Offices – 35 %
- Retail – 42 %
- Industrial – 23%
- Alternatives – 0%

LSHIM advise that our portfolio is well balanced, although the portfolio is slightly light in Industrial and lacking in Alternatives.

7.4. No single asset should be acquired at a value of greater than £15m. This avoids the risk of a catastrophic event leading to significant loss of income.

7.5. The use of market experts (LSHIM) is in line with Government best practice. It ensures that the Council has access to market expertise to help make the informed decisions with regards to investment and to review ongoing performance. LSHIM produce quarterly performance updates which are followed up in client meetings. Currently contact is very regular; it is an active relationship.

7.6. The Council holds a provision on its balance sheet for any unexpected costs or voids in tenancy. By 31st March 2022, the provision will stand at £1.3m. This would equate to approximately 10 months without any rental income across the whole portfolio. A number of positive and negative scenarios have been run to assess the adequacy of the provision. The results of this evaluation are that it is felt to have reached a sustainable level that will offer ECC protection from any likely downside scenarios in the short to medium term. Consequently, the provision will be held at the current level for the year to March 2023 but will be reviewed regularly as any events occur that might impact the portfolio.

7.7. The revenue saving of £0.3m from not topping up the provision in 2022/23 fully mitigated the similar reduction in the net rental revenue budget outlined in paragraph 6.3 above, to leave a neutral budget position. However it is now anticipated that the net rental income will be higher than the draft budget.

8. Other Considerations

8.1. During 2020, updated guidance on the use of Public Works Loan Board (PWLB) funds was published. The use of such funds for commercial return, especially for commercial property investment, has long been a target for Government and national press criticism. It is now clear that an Authority with projects in their capital programmes that are investment assets held primarily for yield will not be able to access PWLB funds for any project in the programme.

8.2. This change had been expected and anticipated by ECC. The last investment in the portfolio was made in 2018.

8.3. Borrowing to fund investment in housing or regeneration primarily for policy reasons remains available, even if a return is made in the process as a secondary effect. It is expected that such returns would be reinvested in further housing/regeneration projects. Opportunities for such investment is currently under consideration by the Council.

8.4. The revised CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code) was issued in December 2021. Whilst the Prudential Code prohibits borrowing for schemes whose primary purpose is to achieve a financial return, it does not require authorities to immediately sell existing commercial investments. The Prudential Code does however require authorities that have an expected need to borrow, like ECC, to review options for exiting commercial investments, and to use the proceeds from sale to repay debt or reduce future borrowing.

8.5. In practice, sale would only be considered if the Council's investment could be reasonably realised, taking account of financial implications and risk reduction benefits.

8.6. Where authorities continue to hold commercial properties, the Prudential Code requires that the risks of such investments are proportionate to a Council's financial capacity to absorb plausible losses without unmanageable detriment to local services. The Council is compliant with this principle.

8.7. Finally, there is no prohibition on Council's continuing to invest in the repair and renewal of their commercial properties to safeguard their value.

9. List of Appendices

1. Commercial Property Investments Power Point dated 24 February 2022.
2. Commercial Property Investments update report dated 24 February 2022 – confidential appendix.
3. Commercial Property Investments Update Power Point dated 24 February 2022 - confidential appendix.

10. List of Background Papers

None