Report to:	**Audit Committee**
Date:	**29th October 2019**
Title:	**Commercial Investment Property – Update and monitoring report**
Portfolio Area:	**Assets – Cllr Neil Jory**
Wards Affected:	**All Wards**

Relevant Scrutiny Committee: N/A

Urgent Decision:	**N**	Approval and clearance obtained:	**Y**

Date next steps can be taken: **N/A**

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Recommendations:

1. Note the performance and risks of the commercial property portfolio to date.

1. Executive summary

1.1. This report considers the performance of the portfolio to date and the risks associated therewith looking forward.

1.2. Four purchases have been made to date totalling £21.5m including costs representing 43% of the agreed borrowing for all Council services (£50m).

1.3. The net revenue after allowing for management, maintenance and risk mitigation being £288,585 per year.

1.4. The portfolio has achieved a geographic and sector balance in line with the strategy. It has not achieved a balance of spread between tenants and there are future pressure points in 2028 created by lease events.

1.5. It is noted that should the Council wish to mitigate these risks, it would need to continue to build the portfolio. The revised strategy, in particular the location constraints and agreed borrowing limits will make balancing the portfolio difficult, particularly if funds are retained for in-area development.

1.6. Over the last 6 months a number of opportunities have been and continue to be considered, however, no purchases have been made since the last report in March 19.

1.7. The recent increase in PWLB borrowing rates will affect the opportunities that are considered moving forward.

2. Background

2.1. Four property acquisitions have now been made, totalling £21.5m including associated costs.

2.2. The project has met its initial projection of a net income and will generate £288k in the financial year, which contributes to the financial sustainability of the Council, enabling it to continue to deliver, and where possible improve, frontline services.

2.3. As only 43% of the anticipated initial spend on commercial investment property has been made, the portfolio is currently un-balanced (explained in Sections 3 and 4) and further acquisitions should be considered to meet the strategies objectives, mitigate the risk in the portfolio and further increase the ancillary revenue benefit for the Council.

2.4. The Commercial Investment Strategy (as adopted) was revised in July 19 to include investment in renewable energy.

2.5. In simple terms, the upper borrowing limit of £50m adopted and approved imposes a choice moving forward between in-area developments (if these can be sourced and achieve planning permission) which could offer both financial and social return, or, further commercial acquisitions (to include renewable energy) providing a better risk profile to the portfolio and financial position.

2.6. PWLB (Public Works Loan Board) interest rates recently increased by circa 1% which was unexpected. This rise directly affects the net income that could be achieved from an opportunity. It is likely therefore that opportunities with a higher yield will need to be consider to ensure an appropriate return is obtained.

2.7. This report sets out the risks, statistics and performance of the portfolio to date so as to provide Members with the ability to make informed decisions going forward.

3. Outcomes/outputs

3.1. The average net income of the portfolio is 1.3% which is above the minimum target of 1% and reflects the current 'appetite for risk' of the Council through the Invest to Earn Committee. Further purchases can look to raise this percentage if the available opportunities allow.

3.2. An income of £288,585 per annum after deducting an allowance of 10% for the management, maintenance and risk mitigation fund (a fund set up to deal with maintenance, repairs or unforeseen risks).

3.3. The project has a properties in each of the main asset classes – Office, Industrial and Retail.

3.4. A geographical spread within the SW peninsular has been achieved; Regional - Bristol, Sub-regional – Exeter & Plymouth, Local – Okehampton. Following government guidance the portfolio has been restricted to the South West Peninsular, particularly within the LEP.

3.5. Single and Multi-let opportunities have been acquired, with a mix of tenants (11 in total), including those with the strongest covenant strength. One tenant does represent a significant percentage of the rental income (55%), they are assessed (by a Dun and Bradstreet credit rating report) as having a Risk Indicator of 1, which represents a minimum risk of business failure.

3.6. A spread of lease expiries and breaks have been achieved, however, there are certain points, particularly 2028, at which there is a concentration of lease events. Any future purchases need to avoid having similar lease event dates.

3.7. The acquired properties have various unexpired lease terms – these are shown in Appendix A.

3.8. The management, maintenance and risk mitigation (MMRM) fund currently stands at Circa £360k. 10% of rent from the portfolio goes into the MMRM which will fund void periods, management costs and repairs as and when they arise.

3.9. Further acquisitions will mitigate the risk within the portfolio, by increasing the number of rental streams, spreading the points at which the income into the portfolio ceases (e.g. lease ends and break clauses) and increasing the diversity of tenants.

3.10. Committing to further purchases would increase the likely success of the overall commercial property strategy, due to the balancing of risk, and making these risks easier to manage over the life of the strategy.

3.11. Full details of the portfolio performance can be found in Appendix A.

4. Options available and consideration of risk

4.1. Rather than committing to further purchases, the strategy could end at its current position. This would leave the portfolio unbalanced with the risks as highlighted above.

4.1.1. As an example, if one of our tenants did not renew their lease and another served a break clause, 73% of the current rental income could end in 2028. Alternative tenants would be sought, however, this is one of the risks that would be mitigated by further purchases.

4.1.2. As a further example, 55% of the rental income is currently paid by one tenant (also one of the tenants mentioned in 4.1.1), again this could be mitigated by further purchases.

4.1.3. Therefore the net income into the Council's budget from the strategy could be significantly affected should it suffer a tenant default or tenancies ending coinciding with each other.

4.1.4. The project has a management, maintenance and risk mitigation (MMRM) fund to help off-set the above situations. However depending on the income shortfall encountered, this may just cover debt repayments rather than contribute to the income budget.

4.2. If the strategy commits to further acquisitions, the following could be considered. These are examples rather than requirements/targets as the strategy can only acquire those properties that are available.

4.2.1. Avoid properties with significant lease events in 2028 and balance the portfolio with expiry dates before and after.

4.2.2. The Bristol office is quite a high proportion of the income, particularly being single let. Look to acquire further offices, but to alternative tenants and consider multi-let offices.

4.2.3. Balance the portfolio with further industrial/logistic property – however, noting that this sector is particularly difficult to buy at the moment, particularly within our yield and geographic requirements.

4.2.4. Continue to consider retail, but recognise the structural changes in the retail market.

4.2.5. Continue to explore alternative sectors, such as the recent consideration of renewable energy opportunities.

5. Proposed Way Forward

5.1. It is recognised that the Council has other demands on the level of funds it can prudently borrow. Therefore further funds for this strategy will be balanced against the requirements of other projects.

5.2. When considering how to invest up to the permitted maximum, the Council should recognise that from a commercial property perspective, the acquisition of further properties would help achieve a more balanced portfolio and risk position.

5.3. If in area development projects are considered instead (such as employment assets), the Council should consider this impact on the portfolio balance and remain true to the risk based approach set out in the commercial property strategy, so as not to over expose the Council to one sector or area.

5.4. That the MMRM fund continues to be set aside for its intended purpose; to ensure there is a buffer against any significant unforeseen events and to deal with future likely points of expected expenditure.

6. Implications

Implications	Relevant to proposals Y/N	Details and proposed measures to address
Legal/Governance		N/A
Financial		The commercial property strategy was implemented in April 2018 and four commercial properties have been purchased to date. The net income is anticipated to be £288k in 2019/20. Further details are shown in Appendix A.
Risk		Refer to section 4 and Appendix A
Comprehensive Impact Assessment Implications		

Equality and Diversity		N/A
Safeguarding		N/A
Community Safety, Crime and Disorder		N/A
Health, Safety and Wellbeing		N/A
Other implications		

Supporting Information

Appendices:
Appendix A – Portfolio performance reports

Background Papers:

- Commercial Property Strategy Amendment, presented to Hub Committee July 2019
- Commercial Property Strategy Amendment, presented to Hub Committee September 11th 2018
- Commercial Property Acquisition Strategy Update, presented to Council March 27th, 2017
- Commercial Property Acquisition Strategy Update, presented to Council December 5th, 2017
- Investment in Commercial Property, presented to Council July 25th 2017
- Investment in Commercial Property, presented to Hub Committee June 20th 2017

Approval and clearance of report

Process checklist	Completed
Portfolio Holder briefed	**Yes**
SLT Rep briefed	**Yes**
Relevant Exec Director sign off (draft)	**Yes**
Data protection issues considered	**Yes**
If exempt information, public (part 1) report also drafted. (Cabinet/Scrutiny)	**Yes**