NOT FOR PUBLICATION
This report contains exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act 1972 (matters affecting the financial affairs of the Council) - (applies to Appendix 2 and 3)

Report to:	**Audit Committee**
Date:	**21 July 2020**
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:

That the performance and risks of the commercial property portfolio to date be noted.

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 (an ancillary benefit) after allowing for management, maintenance and risk mitigation is £290,000 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 9 months a number of opportunities have been and continue to be considered, however, no purchases have been made since the last report in September 19.

1.7. The increase in PWLB borrowing rates in the autumn of 2019 has affected the opportunities that officers have been considering over the previous 9 months.

1.8. The report sets out the latest portfolio valuation information as shown in Appendix 3.

1.9. The impact on the COVID crisis on the portfolio and its tenants is also reviewed in Appendix 2.

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 £290,000 in the financial year, which is an ancillary benefit which contributes to the financial sustainability of the Council, enabling it to continue to deliver, and where possible improve, frontline services.

2.3. 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 (for all Council services, including the commercial property portfolio) 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 providing a better risk profile to the portfolio and financial position.

2.6. PWLB (Public Works Loan Board) interest rates increased by circa 1% in the autumn of 2019 which was unexpected. This rise directly affects the net income that could be achieved from an opportunity. Therefore opportunities with a higher yield have needed to be considered 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. A net income of £290,000 per annum is currently generated as an ancillary benefit of the commercial investment portfolio. This is 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 property in each of the main asset classes – Office, Industrial and Retail.

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

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

3.7. The Revenue Earmarked Reserve for the Management, Maintenance and Risk Mitigation (MMRM) currently stands at £190,000 at 31.3.2020. This is shown in the Earmarked Reserve Note to the Statement of Accounts for 2019-20. 10% of rent from the portfolio goes into the Revenue Earmarked Reserve for MMRM which will fund void periods, management costs and repairs as and when they arise.

3.8. 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.

3.9. 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.

3.10. The Portfolio was revalued in March 20, details are shown in Appendix 3 (Exempt).

3.11. Full details of the portfolio performance can be found in Appendix 1. Details relating to the rental income are in Appendix 2 (Exempt).

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 very cautiously consider retail, in particular supermarket and smaller convenience store opportunities, 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	Y	The public interest test has been applied as to whether Appendix 2 & 3 should be published and the public interest lies in non-disclosure at this time.
Financial	Y	The commercial property strategy was implemented in April 2018 and four commercial properties have been purchased to date. The net income (an ancillary benefit) is anticipated to be £290k in 2020/21. Further details are shown in Appendix 1.
Risk	Y	Refer to section 4 and Appendix 1
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		

<u>Supporting Information</u>

Appendices:
Appendix 1 – Portfolio performance reports
Appendix 2 – Covid-19 non-payment of rent position
Appendix 3 – Portfolio revaluation information

Background Papers:

- Commercial Investment Property – Update and monitoring report – Audit Committee 29th October 2019

- 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