Report to:	**Council**
Date:	**26 March 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**

Author: **Chris Brook** Role: **CoP Lead Assets**

Contact: **Telephone/email: Chris.brook@swdevon.gov.uk**

Recommendations:

That the Council NOTES the performance and risks of the commercial property portfolio to date.

1. **Executive summary**

1.1. On 5th December 2017, Council approved the recommendations of a report entitled "Commercial Property Acquisition Strategy Update". This agreed to borrowing of up to £37.45m to implement the strategy that was adopted.

1.2. The Strategy had an envisaged upper limit of £75m plus associated costs and gave a clear risk based approach to building a commercial portfolio of that value. Since 2017, new Government guidance was issued in February 2018 around proportionality of borrowing and subsequently the S151 Officer sought external specialist treasury management advice concerning borrowing limits.

1.3. In light of the external advice received, Full Council on 25/09/18 approved a strategy that blends in-area development and investment with those outside of area, all capped at a borrowing limit of £50m, which superseded the original strategy envisaged in 2017.

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

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

1.6. An income projection from Commercial Investment Property of £100k was built into the 2018/2019 budget. This projection has now been exceeded,

with the net revenue after allowing for management, maintenance and risk mitigation being £274,000 per full year.

1.7. 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.

1.8. It is noted that should the Council wish to mitigate these risks, it would need to continue to build the portfolio, which would now not necessarily be compatible with the new adopted strategy, as it would restrict in area developments, as a result of the overall Borrowing Limit of the Council for all services (£50m).

2. Background

2.1. On the 25th July and 5th December 2017 the Council agreed to borrow up to £35m plus associated costs to acquire commercial investment property. Full Council on 25/09/18 approved a strategy that blends in-area development and investment with those outside of area, all capped at a borrowing limit of £50m, which superseded the original strategy envisaged in 2017.

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

2.3. The project has met its initial projection of a net income of £100k this financial year and will generate £274k in the next financial year, which contributes to the financial sustainability of the Council, enabling it to continue to deliver, and where possible improve, frontline services.

2.4. As only £21.5m 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 both mitigate the risk in the portfolio and further increase the ancillary revenue benefit for the Council.

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 providing a better risk profile to the portfolio and financial position.

2.6. 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 yield of the portfolio is 5.5% which is lower than the 5.85% target for the end of the project but reflects the current 'appetite for risk' of the Council through the Invest to Earn Group. Further purchases can look to raise this percentage if 5.85% remains as the target. This target may be reviewed against the level of risk the Council is content to accept.

3.2. An income of £274,000 (for a full year) 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 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.

3.5. Single and Multi-let opportunities have been acquired, with a mix of tenants (15 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 at which there is a concentration of lease events (2028/2029). 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 (page 5).

3.8. The management, maintenance and risk mitigation (MMRM) fund currently stands at Circa £423k. 10% of rent from the portfolio goes into the MMRM which will fund void periods and repairs as and when they arise, as well as any difference between the 7% acquisition costs envisaged and actual costs.

3.9. The project has included the successful delivery of the refurbishment of Bristol House office building (circa £2m), required to trigger an increased rental level.

3.10. 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.

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

3.12. 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 years 2028/2029 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. If there is not an appetite for retail, begin to seriously consider alternatives such as leisure or renewables 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 must recognise that from a commercial property perspective, the acquisition of further properties would help achieve a more balanced portfolio and risk position. Furthermore, a diversification in the portfolio into other types of asset class (within the approved Strategy) will also assist in balancing risk.

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 in 2018/19. The net income is anticipated to be £195,000 in 2018/19 (against budgeted net income of £100,000 in 2018/19). In a full year the net income from the four properties would equate to £274,000. 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		

<u>Supporting Information</u>

Appendices:
Appendix A – Portfolio performance reports

Background Papers:

- Commercial Investment Property update and monitoring report presented to the Audit Committee 9th October 2018
- 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