



Purpose: For Noting

Committee report

Committee	AUDIT COMMITTEE
Date	28 SEPTEMBER 2020
Title	PROGRESS REPORT – COMMERCIAL ACQUISITION STRATEGY
Report of	CABINET MEMBER FOR CORPORATE RESOURCES

EXECUTIVE SUMMARY

1. This noting report provides members of the Audit Committee with an overall summary of progress in the delivery of the council's commercial property acquisition strategy up to 31 March 2020.

BACKGROUND

2. The council's medium-term financial strategy, designed to help improve the council's financial sustainability made provision for a £100 million commercial property acquisition fund, subject to the approval of a commercial property acquisition strategy. Full Council at its meeting of 20 September 2017 gave its approval to such a strategy. The report recommending the strategy also proposed that reports should be prepared for submission to the Audit Committee, setting out the progress of the property investment fund, including the total income that has or will be accrued by the council on an annual basis.
3. Portsmouth City Council, as commissioned by the Isle of Wight Council, has been managing the property investment fund. The commercial property acquisition strategy approved by members in September 2017 has been used as the framework for all acquisitions. The approved strategy included strict criteria to be used when determining the property to acquire. Those criteria have been adhered to and included the following:
 - To create a balanced commercial property portfolio that provides long term rental returns and growth.
 - A core portfolio of property assets will be sought with a view to diversification on individual assets by sector (industrial, offices and retail), location and risk.
 - Core assets being the best property for the sector in an ideal location with long term income to high quality tenants.

- All investments considered must initially provide income (yield) equal to or above the councils required rate of return (IRR).
 - Prioritise properties that yield optimal rental growth and stable income.
 - Protect capital invested in acquired properties.
 - Location will be dictated by opportunity to acquire investments that meet the strategy, proximity to the Isle of Wight will be a deciding factor when all other attributes are equal.
4. Opened in March 2020, the government's consultation on Public Works Loan Board (PWLB) Future Lending Terms (now closed) has curtailed all acquisition activity. The current property investment strategy is now under review and will be revised following the outcome of the PWLB consultation (later this year) and in light of the current economic conditions.

PROGRESS TO DATE

5. Current fund - statistics

- 5.1 To date circa £35.1 million (inclusive of all costs associated with purchase, including land registry fee; legal expenses; due diligence and agreed costs to Portsmouth City Council as set out in paragraph 9.2) of the £100 million available has been invested. The acquisition of these properties occurred throughout 2018/19 up to March 2019.
- 5.2 The fund has been successful in acquiring four properties containing nine occupational tenants.
- 5.3 The first investment, Olympic Court, Salford was purchased in April 2018, with the most recent purchase being Metabo Nursling in the final quarter of 2018. No further acquisitions have been made during the period 31 March 2019 and 31 March 2020.
- 5.4 Appendix 1 is a schedule of all assets currently held within the investment fund.

6. Rental income

- 6.1 Since the first purchase, there have historically been no rent payment defaults or loss of tenancies across the portfolio. During 2020 the impact of Covid-19 has seen some tenants delay payment of part of the annual rent due on the March and July 2020 quarter days. This has been actively managed; all rent has now been recovered, and there are no tenants presently in rental arrears. Notice has been received in September 2020 from Sunwin Services who occupy a unit in Kent that they do not wish to renew their tenancy; due to expire in January 2021. This is as a direct consequence of the financial impact of Covid-19 on their business. The nine occupational tenants currently in occupation are:

- Mettler-Toledo Safeline Limited;
- In the Style Fashion Limited;

- Betterstore Self Storage Properties III Limited;
- Eriks Industrial Services Limited;
- Sunwin Services Group (2010) Limited;
- Go Installations Limited;
- Nedschroef Fasteners Limited;
- Stagecoach Group;
- Metabo UK Ltd.

6.2 Lease events in the period up to 31 March 2020 included:

- Olympic Park - Manchester - four units let to Mettler-Toledo Safeline Ltd.
- Sandy Lane - Oxford - one unit let to Nedschroef Fasteners Ltd.
- Access 4/20 - Kent - one unit let to Go Installations Ltd - rent review and lease renewal.

6.3 Forthcoming lease events going into 2020-21 will include the following:

- Nursling, Southampton - Metabo - lease renewal and rent review.
- Access 4/20, Kent - Sunwin Services - vacation, dilapidations and re-let.

7. Strategy

7.1 As referenced in section 4 above, given the current implications of the PWLB consultation the approved property investment strategy is under review. Revisions to this strategy will be made in light of the outcome of the PWLB consultation, and taking into account the current economic climate. It is anticipated that the outcome of the consultation will be published later this year and it is recommended that a further report will need to be published to detail the revised strategy.

7.2 With a pause on acquisition activity, the immediate focus for the portfolio will be to manage the impact of Covid-19 on existing assets and tenants with a priority focus on continued cash flow security and debt management. A careful and considered management approach will be necessary for any forthcoming lease events such as rent reviews and lease end to avoid protracted and costly court procedures and potential void risk.

7.3 Continuing to hold and actively manage these assets in the short to medium term while the wider implications associated with PWLB and the economy are assessed is of upmost importance. Continuing to do this will protect the council's revenue position and allow the maximum opportunity for the revision of strategy in due course.

8. Investment market

8.1 Investment activity in the UK commercial market has slowed in the first half of 2020 as a direct consequence of the Covid-19 pandemic. This is being reflected across all areas of the UK Economy which has shrunk significantly across two quarters and placed the UK in an official recession. A sharp decline has been reported in commercial property investment and occupier activity as a response to the economic and financial uncertainty facing businesses.

- 8.2 All property total returns comprising estimated rental growth, equivalent yield and capital growth is forecasting a -7.1 per cent total return for 2020. This is driven by decline in the retail and office sector. However, the industrial and logistics sector is performing positively and is forecast to deliver a positive 0.7 per cent total return in 2020.
- 8.3 Market analysis is indicating a strong demand for industrial sheds with a particular focus on distribution and good links to highways network being key as more businesses grow their online presence.

9. Resources

- 9.1 Portsmouth City Council continues to manage the fund, providing fund management and acquisition/disposal service on behalf of Isle of Wight Council.
- 9.2 Fees paid to Portsmouth City Council between 31 March 2019 and 31 March 2020 in the provision of these services totalled £60,000. No acquisitions were made during this period and so no premium payments were made.

STRATEGIC CONTEXT

- 10. The commercial property acquisition fund was a feature of the council's medium-term financial strategy agreed by Full Council in October 2016. The subsequent commercial property acquisition strategy was approved by Full Council in September 2017. Both the fund and strategy are clearly aligned with priority four of the council's Corporate Plan in that it contributes to "ensuring that all the resources available to the Island are used in the most effective way in achieving the Island's priorities".

FINANCIAL / BUDGET IMPLICATIONS

11. Capital growth

- 11.1 The primary objective for the council is to protect its capital base where possible, maximise income and create a long-term sustainable income stream. The fund is still in its very early stages and as such there has been a steady flow of purchases over the period since inception of the agreed strategy. As it matures over several years and rental income grows, the impact of initial acquisition costs on overall performance should decrease.
- 11.2 The fund is valued annually on 31 March by an external valuer. Capital values are now measurable for the whole portfolio year on year from March 2019 to March 2020. As many of the lease events had not been concluded or taken effect at the time the valuations were assessed the capital values have remained static, however, it is anticipated that the positive effect of these changes should be reflected in the 2021 valuations.

	March 2018 value	March 2019 value	March 2020 value	Percentage +/- since 2018
Access 4:20 Aylesford, Kent	£8,625,000	£8,625,000	£8,625,000	0%
Olympic Court, Manchester	£10,800,000	£10,970,000	£10,970,000	1.57% +
Network Oxford	N/A	£10,000,000	£10,000,000	0%
Metabo Nursling Southampton	N/A	£3,500,000	£3,500,000	0%

12. Rental income (gross return)

12.1 The total gross income received for the year to 31 March 2020 was £1.6million. (rounded up) This period takes us up to the start of the Covid-19 pandemic where many businesses were forced to close.

12.2 The gross return up to March 2020 was 4.53 per cent.

13. Rental income (net return)

13.1 The cumulative net income (excluding debt costs) to the council for the year to 31 March 2020 amounts to £ £1.518 million, this represents income of £1.593m less management costs of £0.075 million, this represents a net yield of 4.32%per cent.

13.2 The council incurred debt costs of £0.879 million and contributed £0.5 million towards the commercial property reserve. This reserve will be used to fund potential lost rental income and future property related costs.

13.3 The net return (including debt costs) for 2019/20 prior to the reserve transfer was £0.639 million, this represents a net yield of 1.82 per cent.

LEGAL IMPLICATIONS

14. The council is empowered to buy and sell land pursuant to section 120 – 123 of the Local Government Act 1972. Section 1 of the Local Government Act 2003 provides that the council may borrow money for any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs.

15. In order to lawfully implement the investment strategy, each proposal (including the funding strategy for purchases) is reviewed as part of a decision to purchase or sell, and tested for value for money, and regulatory compliance. All acquisitions

are reviewed by the council's in-house legal and finance teams as a means to maintain oversight of transactions being completed.

EQUALITY AND DIVERSITY

16. The council, as a public body, is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation. It is not considered that the content of this report has any impact on any of the protected characteristics.

RISK MANAGEMENT

17. All commercial property investments carry a risk. However, the commercial property investment strategy ensures that any risk is minimised in return for an appropriate level of financial gain. There are clear protocols, authorisation processes (overseen by the director of finance and section 151 officer) and due diligence checks in place that allow for risks associated with acquisition to be fully evaluated prior to sale completion. These protocols and processes will continue to be reviewed in response to the evolving impact of Covid-19 on commercial property performance.

EVALUATION

18. Full Council agreed the commercial property acquisition strategy in line with the medium-term financial strategy in September 2017, in order to secure an income stream that would contribute to the overall aim of future financial sustainability of the Island's public services. The full potential of such a strategy could see an income stream in the region of £4.5 million a year. It is currently unclear whether the council will be able to continue with this strategy due to the impacts mentioned in this report at.

RECOMMENDATION

19. To note the progress in the delivery of the council's commercial property acquisition strategy, and that a further report will be provided detailing the required revisions to the strategy.

APPENDICES ATTACHED

Appendix 1: Schedule of assets held.

BACKGROUND PAPERS

20. Full Council 20 September 2017 – Commercial Property as Investment Paper C

<https://www.iow.gov.uk/Meetings/committees/mod-council/20-9-17/Paper%20C.pdf>

21. Audit Committee 3 December 2018 – Progress Report Commercial Acquisition Strategy – Paper

<https://www.iow.gov.uk/Meetings/committees/Audit%20Committee/3-12-18/PAPER%20J%20-%20Progress%20Report%20-%20Commercial%20Aquisition%20Strategy.pdf>

22. Audit Committee 30 September 2019 – Progress Report Commercial Acquisition Strategy – Paper G

<https://www.iow.gov.uk/Meetings/committees/Audit%20Committee/30-9-19/PaperG-ProgressReport-PropertyAquisitionsStrategy.pdf>

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