



Committee report

Committee	AUDIT COMMITTEE
Date	25 JULY 2022
Title	PROPERTY INVESTMENT PORTFOLIO ANNUAL REPORT
Report of	CABINET MEMBER FOR STRATEGIC FINANCE, TRANSFORMATIONAL CHANGE AND CORPORATE RESOURCES

EXECUTIVE SUMMARY

1. This report provides members of the Audit Committee with an update as at 31 March 2022 on the four mainland property investments that were purchased in 2018 and which comprise the commercial property acquisition fund.
2. If the portfolio were to be sold for the estimated market price (£41.35m), this would represent an increase since acquisition of £6.25m less costs of sale (legal and agency fees).
3. The fund increased in value between March 2021 and March 2022 by 17.97%.
4. The units are all fully let and the rent roll is currently £1,821,560 per annum.
5. The total income actually received between 1 April 2021 to 31 March 2022 was £1.64m (rounded up), whilst the Council incurred debt costs of £738k during this same period.
6. The cumulative net income (excluding debt costs) for the period 1 April 2021 to 31 March 2022 represented a net return of 4.4%.
7. The Council has a number of lease events taking place in 2022/23 which, when concluded, should increase the rent roll.
8. In addition, if negotiations with our two largest tenants prove to be successful, this should help to increase the value of the fund if, as predicted, the industrial market continues to dominate in 2022.

RECOMMENDATION

9. To note the progress of the property investment fund in the delivery of the commercial property acquisition strategy, including the total income that has been accrued by the Council.

BACKGROUND

10. The Council's medium-term financial strategy, which is designed to help improve the Council's financial sustainability, made provision for up to £100 million to be available for a commercial property acquisition fund, subject to the approval of a commercial property acquisition strategy. Full Council at its meeting on 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.
11. The strategy was used as the framework for all acquisitions and included strict criteria to determine which properties to acquire. Those criteria included the following:
- a balanced commercial property portfolio that provided long term rental returns and growth;
 - a portfolio of property assets 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 must initially provide income (yield) equal to, or above, the Council's required rate of return (IRR);
 - priority to be given to properties that yield optimal rental growth and a stable income;
 - protect capital invested in acquired properties; and
 - location to be dictated by opportunity to acquire investments that meet the strategy, with proximity to the Isle of Wight being a deciding factor when all other attributes are equal.
12. In 2018, the fund acquired four separate property investments comprising thirteen lettable units with nine tenants.
13. Portsmouth City Council (PCC), as commissioned by Isle of Wight Council, managed the fund until 1 April 2021, following which responsibility for management of the properties was then transferred to the Council's Property Services department.
14. The Council's investment strategy has now settled into a management phase and it is not looking to acquire additional properties on the mainland.

PROGRESS TO DATE

15. **Acquisition costs**

15.1 Including all the costs associated with purchase (Stamp Duty Land Tax, land registry fees, surveyor's fees, legal expenses, due diligence and agreed costs to PCC), the Council spent around £35.1 million on investment acquisitions.

15.2 The four investments comprise:

- Olympic Court, Salford, Greater Manchester – acquired March 2018 for £10.8m;
- Network Oxford, Littlemore, Oxford – acquired October 2018 for £10m;
- Access 4:20, Aylesford, Kent – acquired April 2018 for £8.6m; and
- Nursling Industrial Estate, Southampton – acquired November 2018 for £3.5m.

15.3 Appendix 1 is a schedule of all assets currently held within the fund.

16. **Rental income**

16.1 No tenants are currently in rental arrears and all units are fully let.

16.2 The total rent passing is £1,821,560 per annum.

16.3 Lease events in the 12-month period up to 31 March 2022 included:

- A request from Scoto Ltd (Stagecoach Group) to reconsider its current lease arrangements. The proposals were not seen to be in the Council's best interests.

16.4 The tenants currently in occupation are:

- **Olympic Court**
 - Mettler-Toledo Safeline Ltd
 - In The Style Fashion Ltd
- **Network Oxford**
 - Nedschroef Fasteners Ltd
 - Scoto Ltd (Stagecoach Group)
- **Access 4:20**
 - Eriks Industrial Services Ltd
 - Betterstore Self Storage Properties III Ltd
 - MJ Supply Ltd
 - Go Installations Ltd
- **Nursling Industrial Estate**
 - Metabo UK Ltd

16.5 Lease events in 2022/23 include the following:

- **Olympic Court**

16.6 Initial discussions have recently been opened with Mettler-Toledo Safeline Ltd (Units 500, 510, 520 & 530) about a possible lease restructuring as the leases are all due to expire in August 2024.

16.7 Discussions have now begun with In The Style Ltd (Unit 540) about its rent review in May 2022.

- **Network Oxford**

16.8 Nedschroef Fasteners Ltd (Unit 1) is keen to discuss a possible restructuring of its lease, which expires in June 2024; an agent has recently been appointed an agent to advise and negotiate.

- **Access 4/20**

16.9 Eriks Industrial Services Ltd (Unit 1) has a lease expiring in September 2022. A s25 Notice has been served on the tenant and negotiations are expected to commence within the next few months.

16.10 Betterstore Self Storage Properties III Ltd (Units 2 & 3) has two leases due for review in October 2022; an agent will shortly be appointed to advise and negotiate.

16.11 MJ Supply Ltd (Unit 4) took a 5-year lease in April 2022. The tenant was granted a rent-free period and, in view of the 'tired' condition of the unit, a 'schedule of condition' was agreed, which requires it to be returned in no better/worse condition than at the beginning of the lease.

16.12 Go Installations Ltd (Unit 5) has a lease that expired in June 2020. The tenant is 'holding over' under the Landlord & Tenant Act 1954. An amicable and appropriate settlement is currently being sought that should recognise the interests of both parties, whilst also having regard to the negative impact the pandemic has had on the tenant's business.

17. **Strategy**

17.1 With a stop on acquisition activity, the immediate focus for the portfolio is continued cash-flow security and debt management. A careful and considered management approach is central to all ongoing and future lease events (mainly rent reviews and lease renewals) to avoid protracted and costly court procedures and potential void risks.

17.2 Continuing to hold and actively manage these assets in the short to medium term whilst the wider implications associated with the economy are monitored is of utmost importance. In doing so, this should protect the Council's revenue position and allow the maximum opportunity for the revision of the investment strategy as appropriate.

18. Investment market

- 18.1 The demand for space from the UK's industrial and logistics sectors hit another record high in 2021 of 78.0 million sq ft, surpassing 2020's previous high by 29% (Source: Lambert Smith Hampton "ILM 2022"). The impact of the pandemic has been to fast forward structural change which, when combined with a more general recovery in the wider UK economy, has helped to fuel an insatiable appetite from both occupiers and investors alike.
- 18.2 This 'race for space' has also led to unprecedented rates of rental growth over the past 12 months, with prime headline rents rising in 2021 by 15% on average across UK markets (Source: Lambert Smith Hampton "ILM 2022").
- 18.3 Whilst the record-breaking return in 2021 for industrial property may not be repeated in 2022, the sector is expected to continue to dominate with a predicted return of over 16% (Source: Gerald Eve "In Brief March 2022") as the continued weight of global capital comes under pressure to be invested before yields dip that final bit further and debt financing becomes more expensive.
- 18.4 Although recent headlines have focused on the impact of high inflation on households, rising costs are a broad trend also impacting stakeholders across the industrial and logistics sector. In this environment, landlords should be mindful of these risks on the occupier market (Source: Lambert Smith Hampton "ILM 2022").

19. Resources

- 19.1 The fund is being managed within IWC's existing resources.

CORPORATE PRIORITIES AND STRATEGIC CONTEXT

20. The financial performance of the mainland portfolio helps to ensure the Council can meet its stated aspiration to keep the Isle of Wight Council solvent and take all the measures we can to improve the financial position of the Council.
21. **Keep the Isle of Wight Council solvent and take all the measures we can to improve the financial position of the council**
- Refresh the council's commercial strategy and approach towards securing investment and income generation opportunities. Refresh the council's procurement strategy to enhance our approach to social value, environmental sustainability and 'Think Local'.
22. **Responding to climate change and enhancing the biosphere**
- 22.1 The Council will consider all opportunities to improve the efficiency of these buildings as and when they become available to let and the opportunity arises.

23. Economic Recovery and Reducing Poverty

23.1 The Council will try to provide as much support as it can to any tenants who have experienced financial difficulties arising from the pandemic.

24. Impact on Young People and Future Generations

24.1 The report is not expected to have an effect on young people or future generations.

25. Corporate Aims

25.1 Corporate Aims

We will aim to spend and invest as much council money on the Island as is possible

It is a key aspiration of the Council to spend and invest as much money on the Island as is possible. The mainland portfolio currently provides a significant income stream and opportunities for capital appreciation that cannot be quickly replicated on the Island. The performance of the mainland investments is compared with Island-based opportunities to ensure maintaining investments away from the Island is not at the expense of the island.

CONSULTATION

No consultation has taken place as the report is intended to provide 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 2022.

FINANCIAL / BUDGET IMPLICATIONS

26. Capital growth

26.1 The primary objective for the Council is to protect its capital base where possible, maximise income and create a long-term sustainable income stream. As the fund matures over the coming years and rental income grows, the impact of initial acquisition costs on overall performance should decrease.

26.2 The fund is valued annually on 31st March by an external firm of professional property valuers. Capital values are now measurable for the whole portfolio year-on-year from 1 April 2021 to 31 March 2022.

External Valuations 2018 - 2022

	March 2018 Value (£m)	March 2019 Value (£m)	March 2020 Value (£m)	March 2021 Value (£m)	March 2022 Value (£m)	Percentage +/- between 2021 and 2022
Olympic Court	£10.8	£10.97	£10.97	£11.75	£13.675	+16.38%

Network Oxford	Not yet purchased	£10.0	£10.0	£10.2	£12.175	+19.36%
Access 4:20		£8.625	£8.625	£9.1	£10.7	+17.58%
Nursling, Southampton	Not yet purchased	£3.5	£3.5	£4.0	£4.8	+20.00%
TOTAL		£19.425	£33.095	£35.05	£41.35	+17.97% (average)

26.3 The current fund value of £41.35m represents an increase of 25.68% over the initial purchase price of £32.9m (not including acquisition costs).

26.4 The purchase price, including acquisition costs of £2.2m, was £35.1m.

26.5 If the portfolio were to be sold for the estimated market price (£41.35m), this would represent an increase of £6.25m less costs of sale (legal and agency fees).

27. Rental Income (Gross Return)

27.1 The total income received for the period 1 April 2021 to 31 March 2022 was £1.64m (rounded up).

27.2 Based on the acquisition price, the gross return up to 31 March 2021 was 5.08% and up to 31 March 2022 it was 4.66%.

28. Rental Income (Net Return)

28.1 The cumulative net income (excluding debt costs) to the council for the year to 31 March 2022 amounts to £5.71m, which represents income of £6.40m less costs of £0.39m. For the period between 1 April 2021 and 31 March 2022 this represents a net return of 4.4%.

28.2 The Council incurred costs of £94k, which includes the services provided by managing agents of £10k. Other operating costs incurred were £84k. The Council incurred debt costs of £738k for the financial year ending 31 March 2022.

28.3 The reserve balance as at 31 March 2022 is £1.25m. This reserve will be used to fund potential future lost rental income and future property related costs.

28.4 The net return (including debt costs) for 2021/22 was £807k, which represents a net yield of 2.3%.

LEGAL IMPLICATIONS

29. The council is empowered to buy and sell land pursuant to section 120 of the Local Government Act 1972. Section 1 of the Local Government Act 2003 provides a power to the council to borrow for the purposes of any enactment.
30. In order to lawfully implement the investment strategy, each proposal (including the funding strategy for purchases) was reviewed as part of a decision to purchase and tested for both value for money and regulatory compliance. All acquisitions were reviewed by, or on behalf of, IWC to be able to maintain oversight of the transactions being completed.

EQUALITY AND DIVERSITY

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

RISK MANAGEMENT

33. All commercial property investments carry a risk. However, the commercial property investment strategy ensured that any risk was minimised in return for an appropriate level of financial gain. There are clear protocols, authorisation processes (overseen by the Director of Finance/Section 151 Officer) and due diligence checks in place that allowed for risks associated with the various acquisitions to be fully evaluated prior to sale completion. These protocols and processes will continue to be reviewed.

EVALUATION

34. Full Council agreed the commercial property acquisition strategy in line with the medium-term financial strategy in order to secure an income stream that would contribute to the overall aim of future financial sustainability of the Island's public services.

APPENDICES ATTACHED

Appendix 1: Schedule of assets held.

BACKGROUND PAPERS

35. 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>

36. Audit Committee 3 December 2018 – Progress Report Commercial Acquisition Strategy
<https://www.iow.gov.uk/Meetings/committees/Audit%20Committee/3-12-18/PAPER%20J%20-%20Progress%20Report%20-%20Commercial%20Aquisition%20Strategy.pdf>
37. 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>
38. Audit Committee 28 September 2020 – Progress Report Commercial Acquisition Strategy
<https://iow.moderngov.co.uk/documents/s1029/Commercial%20Property%20Report.pdf>
39. Audit Committee 27 September 2021 – Progress Report Commercial Acquisition Strategy
<https://iow.moderngov.co.uk/documents/s4626/Item%207%20-%20Commercial%20Acquisition%20Progress%20Report.pdf>
<https://iow.moderngov.co.uk/documents/s4627/Item%207%20-%20Commercial%20Acquisition%20Progress%20-%20Appendix%201.pdf>

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