Report No. London Borough of Bromley

PART ONE - PUBLIC

Decision Maker:	**EXECUTIVE, RESOURCES & CONTRACTS PDS COMMITTEE AND EXECUTIVE**
Date:	**5 October 2022 (ERC PDS) and 6 October 2022 (Executive)**
Decision Type:	Non-Urgent Executive Key
Title:	**PROPERTY INVESTMENT FUND PORTFOLIO – PORTFOLIO PERFORMANCE UPDATE, INVESTMENT STRATEGY & MITIGATION FUND**
Contact Officer:	Amy Milton, Head of Estates & Asset Management Tel: 020 8461 7172 E-mail: amy.milton@bromley.gov.uk
Chief Officer:	Sara Bowrey, Director of Housing, Planning, Property and Regeneration E-mail: sara.bowrey@bromley.gov.uk
Ward:	N/A

1. Reason for report

1.1 This report relates to the Council's Property Investment Fund Portfolio, providing an update to Members on the Portfolio's performance, and setting out the proposed Investment Strategy and supporting Key Performance Indicators to be adopted.

---

2. RECOMMENDATIONS

2.1 Members of the ERC PDS are asked to note the contents of this report and recommendations to the Executive to approve.

2.2 Members of the Executive are asked to note of the contents of this report and approve the following recommendations:

a) The adoption of the Investment Strategy (Strategic Objectives) as set out in Section 3.3 (3.3.21)
b) The adoption of the Key Performance Indicators as set out in Section 3.3 (3.3.23 – 3.3.25)
c) The creation of a mitigation fund equating to 10% of the rental income generated by the Investment Fund properties as set out in Section 3.3 (3.3.26 – 3.3.30) with reporting on this to be included within the annual ERC PDS portfolio performance reports.
d) Delegate authority to the Director, Assistant Director & Head of Estates & Asset Management in consultation with the Portfolio Holder for Resources to act within the adopted Strategy and Key Performance Indicators
e) The disbandment of the Property Investment Advisory Board to be replaced with regular Officer briefings to the Portfolio Holder for Resources for general asset management and performance

updates with reporting to the Executive for material deviations from the adopted Investment Strategy and for key decisions such as acquisitions and disposals alongside the annual comprehensive performance report currently in place.

Impact on Vulnerable Adults and Children

1. Summary of Impact: N/A

Corporate Policy

1. Policy Status: Existing Policy
2. BBB Priority: Excellent Council

Financial

1. Cost of proposal: up to £0.5m pa
2. Ongoing costs: TBD (potentially cost neutral / benefit in the longer term)
3. Budget head/performance centre: Investment Income
4. Total current budget for this head: £5.334m
5. Source of funding: Revenue Budget 2022/23

Personnel

1. Number of staff (current and additional): Not applicable
2. If from existing staff resources, number of staff hours: Not applicable

---

Legal

1. Legal Requirement: Not applicable
2. Call-in: Not applicable

Procurement

1. Summary of Procurement Implications: Not applicable

Customer Impact

1. Estimated number of users/beneficiaries (current and projected): Not Applicable

---

Ward Councillor Views

1. Have Ward Councillors been asked for comments? No
2. Summary of Ward Councillors comments: N/A

3. COMMENTARY

3.1 Background

3.1.1 The London Borough of Bromley investment portfolio comprises an investment fund totalling 20 assets with a total value of circa £64m which currently generates in the region of £4.7m pa, with a yield on cost of 5.28%.

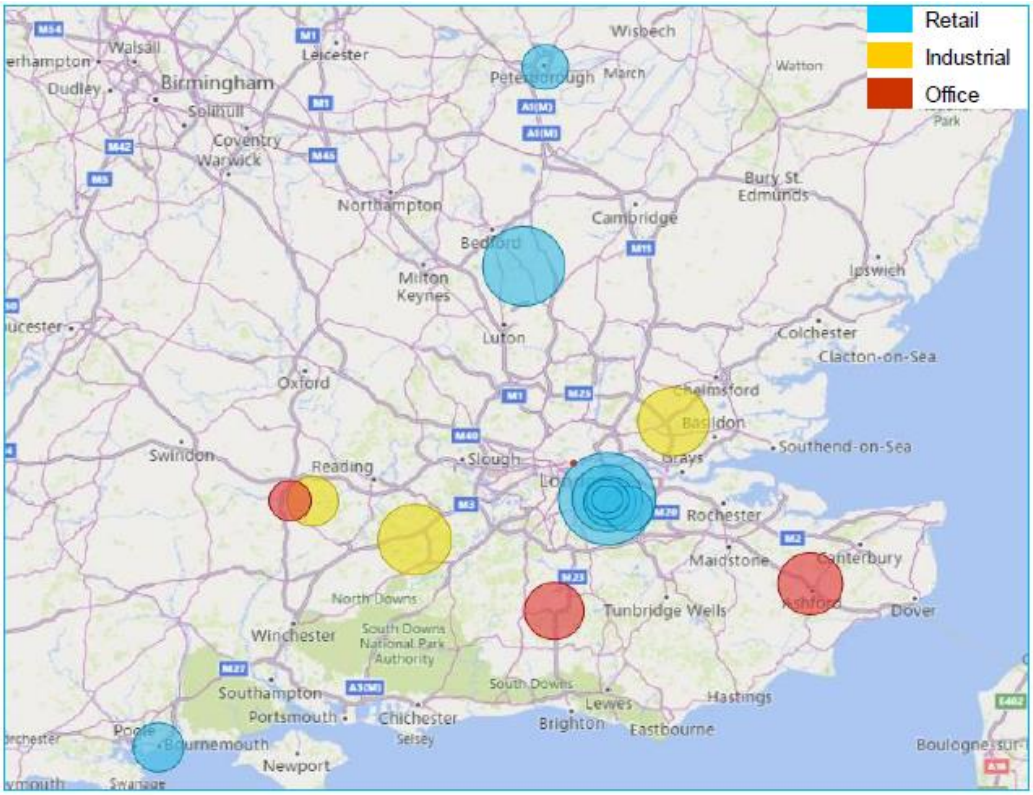
3.1.2 These 20 assets were purchased, as per the definition of a Property Investment within the International Public Sector Accounting Standard and are now held in order to generate an alternative revenue stream for the Council.

3.1.3 A list of the 20 assets is provided below:

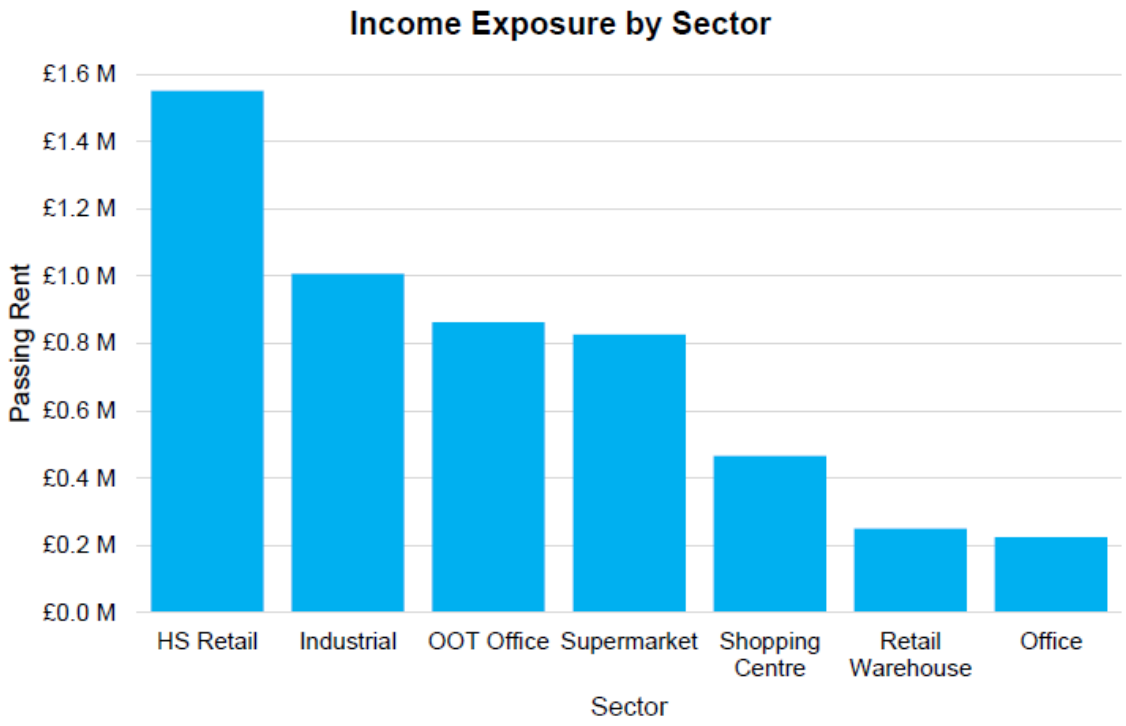
- 95 High Street, Bromley
- 98 High Street, Bromley
- 145 High Street, Bromley
- 147 High Street, Bromley
- 149 High Street, Bromley
- 151-153 High Street, Bromley
- 104-108 High Street, Bromley
- 27 Homesdale Road, Bromley
- Supermarket, St Francis Way, Shefford
- 33-35 Christchurch Road, Bournemouth
- 4 Tilgate Business Park, Brighton Road, Crawley
- Unit G, Hubert Road, Brentwood
- 1 Newbury House, 20 Kings Road, West Newbury
- Training Centre, Colthrop Way, Thatcham
- Unit C2, Southwood Summit Centre, Farnborough
- Unit C3, Southwood Summit Centre, Farnborough
- Trinity House, Eureka Park, Ashford
- Unit 1, 54 Bridge Street, Peterborough
- *63 The Walnuts, Orpington*
- *Market Square, Bromley*
- *The Glades, Bromley (freehold and share of leasehold – this asset is held within the Investment Fund and managed accordingly, but is not included within value/revenue calculations due to fixed rent period)*

3.1.4 The content of this report relates to the investment fund as set out above, but it should be noted that in addition, the Council also owns a number of other income generating properties that are held outside of the investment fund. For the avoidance of doubt, any reference to the investment fund or portfolio within this report only relates to the 20 assets mentioned above.

3.1.5 The investment portfolio comprises a mix of property types including offices, industrial and retail units which are primarily (but not all) let to a single tenant. The below graphic identifies the location and use class of the investment assets held in the fund.



3.1.6 As shown below, the portfolio is heavily weighted towards retail assets:



3.1.7 In July 2020 the Leader made the Executive Decision that a full asset management approach to the Investment Portfolio be adopted by seeking to award a contract for the full management of the portfolio to a suitably experienced and qualified firm of Chartered Surveyors. In April 2021, following a competitive tender process, Montagu Evans firm of Chartered Surveyors were appointed as the Council's Investment Portfolio Advisors.

3.1.8 The work instructed can be categorised in three parts as follows:

a) Assessment of portfolio performance. Benchmarking this against the market, other similar portfolios (such as those of other Local Authorities and Pension Funds), and against alternative investment options such as PWLB / Government Bonds.
b) Advise on an appropriate investment strategy to govern decision making that meets the Council's portfolio objectives and set appropriate KPIs to measure the success of the portfolio's performance against the Investment Strategy.
c) Individual asset plans that lay out strategies for each individual asset at a granular level to meet the overarching investment strategy objectives, maximise possible returns, and minimise risk exposure.

3.1.9 Point a) above was reported to the ERC PDS in February 2022, and an update on the portfolio's performance since then has been provided within this report. However, the primary purpose of this report is to seek Member authority to adopt the proposed investment strategy and key performance indicators (KPIs) in order to crystalise the benefits of the professional advise procured and move onto the next stage of 'implementation' following the Executive Decision to adopt a full asset management approach to the Investment Fund. The individual asset plans that set out at an operational level the actions required to meet the recommended Investment Strategy and KPIs will be detailed in Part 2 due to the commercially sensitive nature of the information.

3.2 Portfolio Performance

3.2.1 When reporting on a property portfolio's performance it is important to have regard to the purpose for which the portfolio is held, and for the Council the primary objective of holding properties within the Investment Fund is to generate an alternative income stream to financially support Council functions.

3.2.2 Performance can therefore be assessed on three separate bases;

- Capital values,
- Return on investment (yield),
- Return against alternative investments (i.e. opportunity cost of investing in property as opposed to an alternative income deriving investment Government Bonds)

3.2.3 But as the Council holds properties within the Investment Fund to generate an alternative income stream to support the funding of Council functions, monitoring, de-risking and maximising the income derived from the fund is of primary importance which was a key driver for the decision to appoint a suitably qualified firm of Chartered Surveyors to advise the Council on the optimum approach to managing the fund.

Capital Values / Rental Income

3.2.4 As demonstrated in the table below, the aggregate value of the Council's Property Investment Fund has been broadly falling since acquisition (with a slight bounce back in 21/22 after a sharp Covid-19 related fall in 2020/21), with the 2021/22 statutory asset valuations providing an aggregate portfolio value of £64m which is 29% less than the acquisition values. (Note that no assets have be acquired or disposed of during this period)

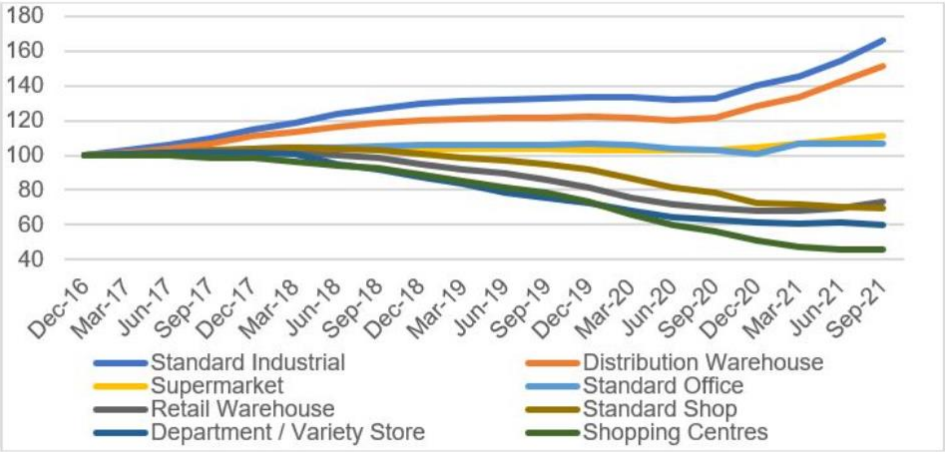
	At Date of Acquisitions*	2018/19	2019/20	2020/21	2021/22
Investment Fund Aggregate Capital Value	£89m	£85m	£72.5m	£60m	£64m

**Assets were acquired between April 2012 and December 2017*

3.2.5 The below graph demonstrates the performance of the UK Commercial Property Market from December 2016 until October 2021. Whilst the industrial sub-market has been performing extremely well, the office and supermarket markets have been steady and the retail markets, particularly department store and High Street retail, have been steadily and rapidly declining.

3.2.6 Unsurprisingly, there is a clear and strong correlation between the Council's property portfolio performance and that of the market.

UK property market capital value index, 100 = December 2016

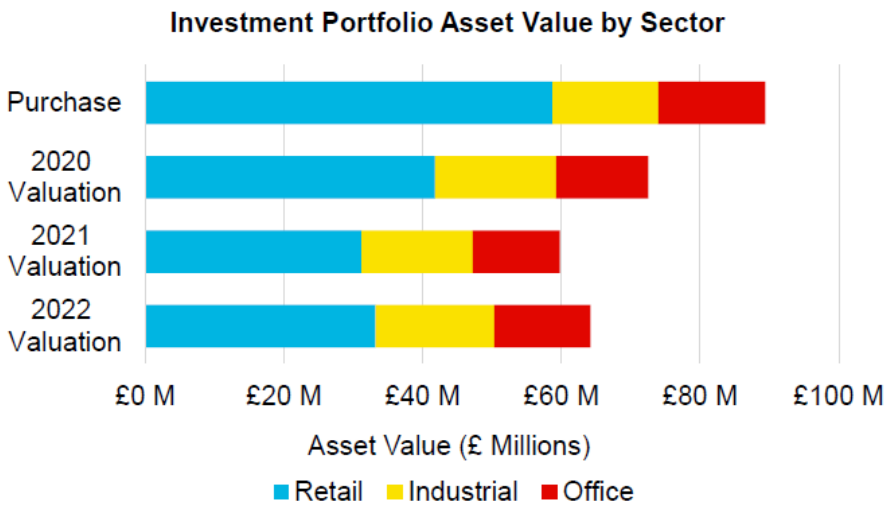


Source: MSCI, Nuveen Real Estate October 2021. Capital values rebased to 100 at December 2016.

3.2.7 It is worth highlighting that the Council's portfolio is heavily weighted towards High Street retail, which was not only one of the hardest hit sectors by the Covid-19 pandemic but has also been steadily suffering from declining values over the last 6 years as the online retail market has grown and consumer tastes evolved at a pace the High Street has failed to keep up with. In the UK, High Street Retail values have fallen 30% between 2018 and September 2021, in line with the Council's Investment Fund capital value performance over the same period.

3.2.8 The below graph illustrates the value change across the Portfolio since purchase, noting that the purchase date of the assets was not uniform.

3.2.9 The value has reduced from £89m at purchase to £64m as at the latest March 2022 statutory asset valuation. The value has been broken into sub-sectors to illustrate that the retail assets have suffered greater valuation reductions than the industrial or office properties.



3.2.10 Whilst the Council benefits from some strong performing assets, particularly those in the industrial sub-markets which have been steadily increasing in value since acquisition, the heavy weighting of the portfolio towards retail means the overall aggregate position has seen a fall in capital values.

3.2.11 To demonstrate this point further, if the office and industrial assets are removed from the analysis, the aggregate capital value of the portfolio would have fallen 45% (rather than 29%) which highlights to downward drag that the portfolio weighting towards retail has unfortunately had.

3.2.12 However, whilst the capital value of the individual assets is an important factor to monitor, it is normal for capital values to fluctuate over the course of the property cycle, and unless assets are sold these fluctuations are not actually realised. In addition, it should be noted that the income the Council has benefitted from since the acquisition of these assets amounts to circa £36.5m, and therefore if we assumed all assets were immediately sold and achieved the capital values noted above, the net position to the Council would be a gain of £11.5m, or a 13% return on the initial investment.

3.2.13 As the Council holds properties within the Investment Fund to generate an alternative income stream to support the funding of Council functions, assessing the portfolio's rental income should be the primary measure of performance.

Rental Income

3.2.14 As demonstrated in the table below, the rental income has also been falling, although due to lease terms and lengths this has been to a lesser degree than the fall in capital values.

3.2.15 As at the date of the 2021/22 statutory asset valuations, rental income was 18% lower than at the assets' acquisition income. However, it should be noted that this data provides an overview at a snapshot in time which coincided with a number of High Street properties being void pending offers being accepted and lease terms negotiated. Terms have now been agreed for the re-letting of 98, 95, and 145-153 High Street, Bromley, which once complete, will increase the aggregate rental income of the portfolio to £5.1m and a yield on cost of 5.7%.

3.2.16 Including the soon to be completed lettings, the overall rent receivable equates to an 11% fall in income since acquisition and shows an improvement in return on investment (yield) than in 2020/21 which was the hardest hit financial year from the Covid-19 pandemic, demonstrating that the portfolio's performance is starting to show signs of recovery in line with the wider UK property market.

	Date of Acquisition	2018/19	2019/20	2020/21	2021/22
Investment Fund Aggregate Rental Income P/A	£5.7m	£5.5m	£5.4m	£4.6m *(Excluding the Arcadia rent as in Administration)*	£4.7m (£5.1m*)
Yield on Cost (i.e income / acquisition price)	6.4%	6.17%	6.06%	5.16%	5.28% (5.7%)

**£5.1m includes the anticipated rental income of new lettings which are currently in legals.*

Alternative Investment Performance

3.2.17 The purpose of providing the performance of alternative Investments (namely Government Bonds) is to compare the return of Council's Investment portfolio against alternative investment opportunities that could reasonably have invested in to assess the opportunity cost of investing in property as opposed to an alternative income stream.

3.2.18 The graph below identifies the yield attributed to 10 year Government Bonds based on an initial investment date from 2012 through to 2022. Returns during this period peaked at 3% in December 2013 and were at their lowest in August 2020 at 0.1%.

3.2.19 As at mid May 2022, the yield fell to a four-week low of 1.78% after a 6.5 year high of 2% earlier in the same month, as investors grow increasingly concerned about the weakening of the economy. The British GDP expanded by a less-than-expected 0.8% in Q1 2022 and in March only it contracted 0.1%. At the same time, the odds are rising the UK will enter a recession this year which would make it more difficult for the Bank of England to continue to raise borrowing costs although inflation remains elevated at levels not seen in 20 years.

3.2.20 The Council's property investment portfolio comprises assets acquired between 2012 and 2017. Had the same £89m investment been made into 10-year Government Bonds instead, the average return would

have equated to circa 1.25% or £712,000 pa, significantly less than the annual return received by the rental income from the property assets.

	10-year Government Bonds (avg. yield of 1.25%)	**Property Investment Portfolio**
Total Initial Investment	£89,000,000	£89,000,000
Total Return on Investment received from 2017 - 2022 *(As the property assets were acquired over a 5 year period, for ease of analysis, the return has been based from the date the full £89m was deployed i.e. 2017, the reality is the Council has also benefitted from additional returns received prior to 2017 from those assets that were acquired prior to that date)*	£3,560,000	£31,975,000
Ongoing Return on Investment pa / yield *(rent based on 2022 figures)*	c.£712,000 pa / 1.25%	c.£5,100,000 pa / 5.7%

**The inputs within the table above are based on some crude assumptions utilising averages for Govt Bond performance over the investment period and has been provided to demonstrate a high level comparison only.*

3.3 Investment Strategy & Asset Management

Previous Investment Strategy

3.3.1 The Council's current investment strategy was last reviewed in 2017 when the Executive Committee approved the investment criteria summarised below. Since then, market changes, asset specific issues and changes to the financial and regulatory landscape means that the time is right for review of the Strategy, as agreed by the Leader under his Executive Powers in April 2020.

3.3.2 This will better enable the Council to actively manage the portfolio, reflect current demand and risk, and ensure that there is a plan that enables active reinvestment to ensure that the revenue streams are maintained over the longer term.

3.3.3 Existing Strategy – Adopted July 2017:

- Net investment return – 5% +
- Diversification – Requirement is limited but points towards having a diversified portfolio
- Liquidity – 1 year disposal window
- Tenant Risk – Option to retain a degree of Landlord control, with aim of reducing exposure to tenants with Security of Tenure
- Repair Liability – Reduce landlord exposure to repairing covenants
- Capital Values – Investment into suitable locations, mitigating risk of a fall in capital values
- Lot Size – In excess of £5m

Improving Returns Through Active Management

3.3.4 As with many Councils, the London Borough of Bromley primarily invested into commercial property for an income return.

3.3.5 Property and economic cycles impact values and income and, as explored in earlier sections of this report, sub-market and asset specific risks impact the Portfolio at different times. Consequently, to ensure continued positive returns, the Portfolio needs to be actively managed: reviewing and taking profits where possible, to mitigate risk elsewhere and ensure long-term, robust income.

3.3.6 Whilst some of the assets within the portfolio are relatively dry, requiring low intensity asset management such as Unit G, Brentwood, others require a more active approach such as the High Street retail properties in Bromley. Hence, contrary to a more traditional asset management approach, which might entail a more passive approach and a fixed hold period, active asset management will include constant monitoring and adjustment of the asset performance with respect to the overall investment strategy.

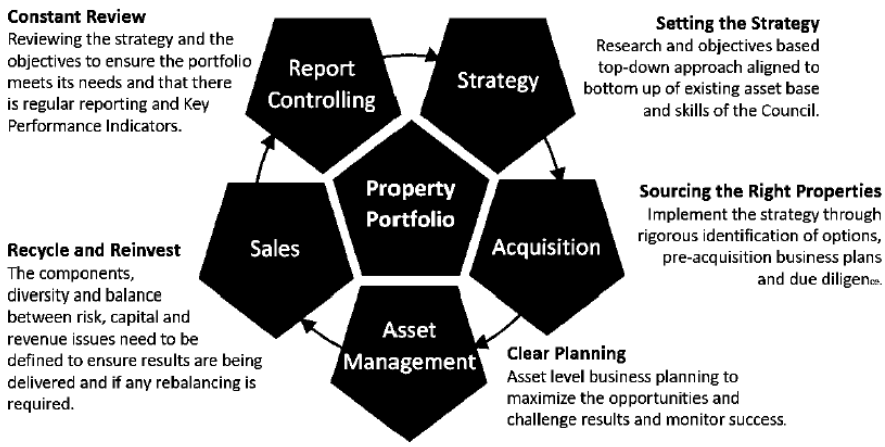
3.3.7 Active asset management will ensure that the income return generated from the portfolio is as stable as possible and has a suitable degree of longevity.

3.3.8 Income only provides part of the picture of portfolio management. It is likely that over a typical 5–10 year hold period the portfolio will incur various cost items to cover void periods, re-letting, interest, tenant defaults, scoping exercises for alternative uses and capital investment for reposition and non-recoverable repairs and improvements.

3.3.9 However, in addition to securing a net income position, margins can also be made on the increase in capital values, however, this is typically dependent on the point in the real estate cycle at which the asset is disposed.

3.3.10 Income, capital values and costs contribute to determining the total 'Internal Rate of Return' (IRR) of the asset and the portfolio. The IRR is defined as 'the rate of return as a percentage that discounts the investment flows to a net present value of zero'. This metric can be used as a benchmarked to assess the portfolio performance against other investment alternatives.

3.3.11 The below infographic of the asset management lifecycle demonstrates the dynamic nature of property investment:



3.3.12 Unlike passive income generating investments (such as Government Bonds), property portfolios require dynamic, rather than static asset management to optimise returns. If property is simply acquired and held passively, without ongoing management and investment, over time the returns will diminish.

3.3.13 It is critical that the portfolio is actively managed and appropriate levels of investment are made to protect and enhance the revenue streams. It is therefore not only best practise but considered normal practise, to have an active approach to asset management and the appropriate budgets set aside to continually reinvest into the portfolio to protect and maximise returns.

3.3.14 It should be noted that currently the Portfolio does not have an expenditure budget allocated to it at all.

Property Investment Advisory Board

3.3.15 The Council previously created a Property Investment Advisory Board (PIAB) which was intended to provide formal governance and oversight of the Investment Portfolio and act as a rapid decision-making body required at a time when the Council was actively acquiring investment properties.

3.3.16 As part of the ongoing Investment Strategy review, it is recommended that this Board should be disbanded, to reflect the Council's current focus on managing the existing portfolio rather than acquiring additional properties.

3.3.17 To provide greater transparency and to better align with the already adopted practises as set out in the Council's scheme of delegation, it is recommended that meetings to report on the granular detail of the asset management strategy and portfolio performance are held between Property Officers and the Portfolio Holder for Resources as and when required, but with all key decisions such as acquisitions and disposals coming forward to the full Executive Committee for approval.

Proposed Investment Strategy

3.3.18 There are risks and opportunities within the Portfolio that can be mitigated and exploited respectively via active management, reinvestment and redeployment. Where assets are within the Borough, there may be additional local considerations around local economic growth, job creation or protection, land assembly and housing delivery, for example, in addition to traditional portfolio management performance metrics. This reduces risk that the activity in the Portfolio might impact the Council's ability to access the Public Works Loan Board (should it in the future wish to do so) and correlates with the Environmental & Social Governance agendas that are carrying increasing weight in investment markets.

3.3.19 The strategic objectives below are proposed to ensure that the portfolio aligns with the Council's wider objectives and ensures best performance from the investments, with the following section detailing the KPIs against which to assess performance.

3.3.20 Individual asset plans will be provided within Part 2 of this paper (due to the commercially sensitive nature of this information). Alongside this, a plan for targeted investments and routes to market will be prepared in order to ensure that there is a framework for decision-making, accountability and scrutiny in deploying the proposed investment strategy.

3.3.21 Strategic Objectives:

- **Income to Exceed Treasury Management Alternative**

  Ultimately the risk and effort must meaningfully exceed the alternative

- **Recycle Capital into Less Risky Investments**

  Reducing risk will reduce yield but better align with a cautious approach to securing income

- **Maintain High Standards on Energy Efficiency**

  Ensure compliance with rules and reflect the movement in the market towards environmentally better performing assets

- **Ensure Forward Plan for Planned and Responsive Capital Investment**

  Reinvestment will be required either for alternative uses for challenging assets or for improvements to tenant retention and attraction

- **Install and Maintain Robust Governance**

Property Officers to report on the asset management plans for each asset alongside overall portfolio performance to the Portfolio Holder for resources as and when required, with comprehensive portfolio performance reports to be taken to the ERC PDS on an annual basis (as is the current practise).

Key Performance Indicators

3.3.22 In order to measure the ongoing performance of the Portfolio against the strategy, a set of KPIs are proposed under three areas: financial, governance and operational. Together, they provide parameters for active management of the portfolio and the ability to delegate authority to the Council's Director, Assistant Director, and Head of Service for Property in consultation with the Portfolio Holder for Resources to manage the portfolio within the performance parameters adopted (noting that all key decisions will be subject to Executive approval such as disposals / acquisitions).

3.3.23 Financial KPIs

Item	KPI	Commentary
Running Yield	>5%	Running yield as a factor of income versus purchase price weighted across the portfolio. This should be the primary or base measure of financial performance, which can then be compared to the secondary KPIs which are not portfolio specific listed below. These secondary measures add context to the portfolio and act as the sense check on future investment / divestment.
Opportunity Cost	3x Treasury Management	Ensures outperformance compared to a base case alternative use of capital. TM rates are currently 0.85%
Variance to Income Forecast	Within 10%	Allows for forward planning with a reasonable view on property risk. Applies to both revenue and capital expenditure, noting that more detailed capex budgets can eb agreed under the operational KPIs
Total Return	Sense Check performance against MSCI Balanced Open Ended Property Fund Index – objective to be broadly aligned or exceeding MSCI. *(MSCI is an investment research firm that provides stock indexes, portfolio risk and performance analytics, and governance tools used by institutional investors and hedge funds)*	Provides a benchmark against the wider market. Although not directly comparable to the Council's portfolio it provides a good indication of the wider property investment maret to benchmark Total Returns against. The MSCI currently 5.6%.

3.3.24 Governance KPIs

Item	KPI	Commentary
Portfolio Holder for Resources Oversight	Delegated authority to the Director, Assistant Director & Head of Estates & Asset Management in consultation with the Portfolio Holder to act within KPIs	To provide greater transparency it is recommended that the PIAB is disbanded, however, it is still useful for Officers to have a point of contact for more regular and informal reporting when acting within the Strategy / KPIs and Asset Management Plan already agreed by Executive.

ERC PDS Performance Reports	12 monthly	Performance report to be delivered to the ERC PDS for Members to note, outlining progress on strategy and performance, including significant change or risks. Proposed material deviations from the strategy or significant underperformance compared to financial KPIs to be reported to Executive Committee.
Lease Transactions	Within +/- 15% of Asset Plan or ERV	Rent reviews and lease renewals dealt with and managed via LBB's Property Team as per the Scheme of Delegation
Sector Diversification	Not greater than* - 30% retail - 40% industrial - 40% office - 30% alternative	Ensures that there is not an over exposure to any given sector. *Exception where there is a land assembly play to support specific development within Borough.
Geographical Diversification	South-East England, or major cities (Leeds, Manchester, Birmingham, Bristol etc.)	Ensures that geographical disparate investments remain as liquid as possible
Redeployment / replenishment of capital (liquidity)	Within 12 months of transaction	Where assets are traded in line with good portfolio management practise, capital to be redeployed within 12 months, or in the event of acquisition, capital to be replenished via disposal within 12 months.
Opportunity Cost	3x Treasury Management	Also a feature of Governance. S.151 to provide PIAB and Property Team with medium term financial plan forecast and reconciliation to ensure that opportunity cost metric is complied with by the portfolio.
Strategy Review	6 monthly updates, annual review	To ensure that the strategy remains relevant both to the market and the Council's strategic objectives

3.3.25 Operational KPIs

Item	KPI	Commentary
Income Risk Timeline	<25% of income to be at risk in any given year	To mitigate risk of lease renewals and break options, leasing activity, disposal and acquisitions to target limitation on single-year income risk through lease events
Vacancy Rate	<7% of floorspace	Reduce risk and potential void costs on more difficult to let assets. Exceptional circumstances may exist where there is land assembly, but likely to be in-Borough in such an event.

Lease Event Diary	24 month forward look	Schedule and risk register to be kept regarding upcoming break options, lease renewals and rent reviews with accountable person and regular updates to PIAB
Mitigation Fund	10% of gross income	Proposed retention of income slice to smooth risk items such as tenant failure (e.g insolvency, CVA) non-recoverable repairs and shortfalls in dilapidation claims. This should be deployed across all property rental income and is considered normal practise in the industry.
Forward Capital Plan	Provided annually and deployed with +/- 10% variance	Forward capital plan to deal with capital items such as refurbishments, incentives for lease re-gears, repositioning or improvement of assets, landlord works or similar to secure new tenants.

Mitigation Fund

3.3.26 As identified through the initial phases of the Montagu Evans work, without a proactive and strategic asset management plan in place, there is a significant financial risk to the Council that will lead to an avoidable fall in revenue returns over the next 8 years.

3.3.27 One of the critical aspects of the proposed approach is the creation of a mitigation fund, equating to 10% of the gross rental income received from the Council's property which form part of the Investment Fund (i.e. the properties identified within this report). Based on the current rental income of £5.1m pa, this would equate to a mitigation fund of £510,000. The purpose of this fund is to provide appropriate provision for required reinvestment and capital expenditure that ultimately leads to the retention of tenants, maximises and future proofs income streams, minimises voids and mitigates the risk of larger capital expenditure requirements in the future through past inadequate maintenance.

3.3.28 The creation of a mitigation fund is considered normal practise for any landlord, and typically equates to between 10% - 25% of the gross rental income. Given the condition and quality of the assets held within the Council's fund, and the wider demands on the Council's revenue, the lower end of this scale is considered appropriate. The objective is to strike a balance between having an appropriate sum in reserves to cover planned and unplanned expenditure, without this building up into a 'war chest' greater than reasonably required, which would have a negative impact on the Council's revenue expenditure and/or ability to generate interest from surplus reserves.

3.3.29 There is currently no expenditure budget associated with the Council's Investment Properties, with any required expenditure such as for EPCs / Asbestos Surveyors / professional fees etc. having to be funded as a deduction from future revenue, which is not always possible, and which puts pressure on revenue budgets and impacts robust financial forecasting.

3.3.30 Regular reporting on expenditure (and forecast spending) from the mitigation fund will be reported directly the Portfolio Holder for Resources to ensure appropriate levels of governance are in place on a day-to-day basis.

3.3.31 In addition, for extra assurance and scrutiny, an annual review of the mitigation fund is to be provided as part of the annual portfolio performance report taken to ERC PDS in February of each year. This will set out the fund's income, expenditure and provide recommendation for any balance (i.e. retention for future expenditure requirements or full or part return to the general funds of the Council to avoid an unnecessary build-up of savings).

3.4 Portfolio Performance Forecast / Risk Identification

3.4.1 Montagu Evans have produced a 10 year cashflow projection based on the recommendations within this report being adopted, to demonstrate the anticipated income, costs, and net position.

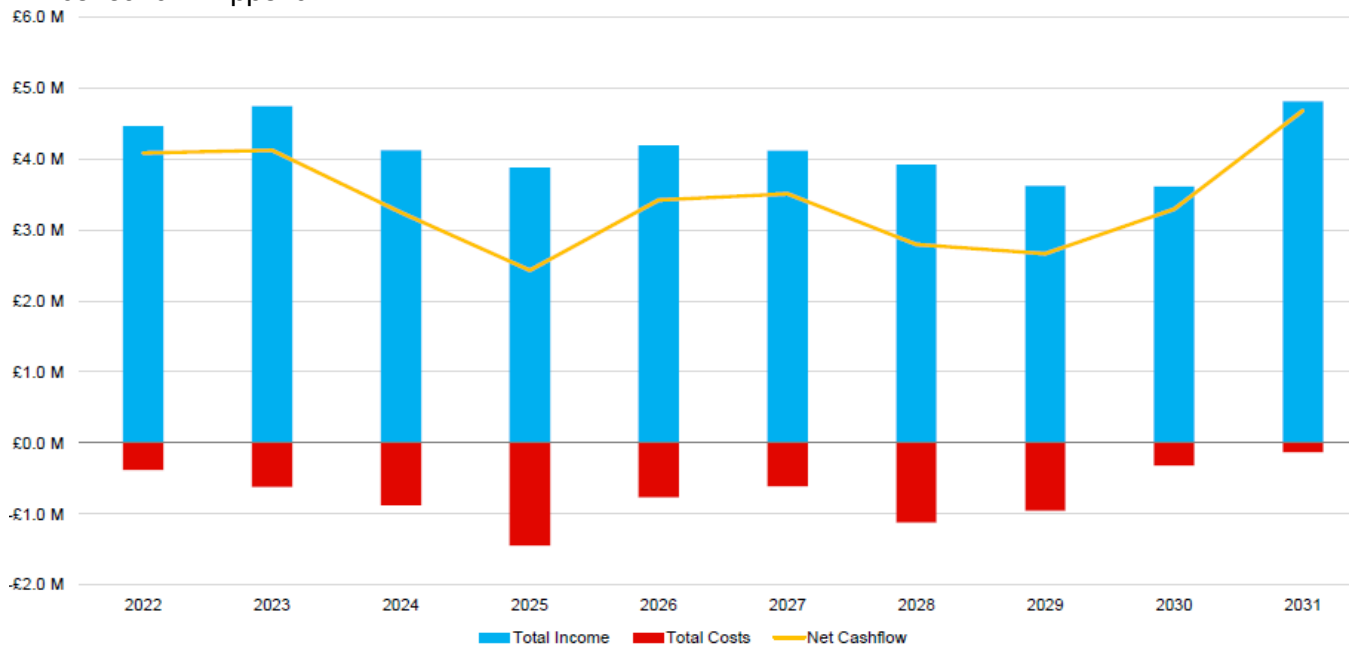
3.4.2 In order to quantify the risk of not adopting the proposed recommendations, an additional 10 year cashflow projection has been produced, based on a 'do nothing' approach - whereby properties are re-let as and when they become vacant, but no proactive asset management is undertaken above and beyond our statutory obligations. It should be noted that this still requires an element of expenditure.

3.4.3 As will be identified below, there are not only qualitative and risk mitigation benefits to the proposed approach, but also a financial business case for doing so. By investing an additional c. £3.17m into the assets over the 10-year period, additional revenue of c. £4.15m is secured, which provides a net revenue increase of c.£1.02m, equating to a 30% return on investment on purely revenue terms (excluding capital appreciation benefits).

3.4.4 Therefore in conclusion, not only is this approach considered normal and best practise for landlords holding investment property, but it also makes financial sense and meets the Council's fiduciary duties relating to its duty of care to public money.

Cashflow Forecast (assuming adoption of recommendations)

3.4.5 The cashflow forecast across the next 10 years indicates the anticipated level of income and expenditure requirement for the Portfolio to provide a net revenue position. A tabular version of the below graph can be found in Appendix 1.



3.4.6 Following detailed assumptions on re-letting's, capex, anticipated costs, the net cashflow position remains relatively stable. The largest impacts on the cashflow position surround the loss of key tenants and the associated void and re-letting costs. These assumptions are asset specific and reflect the current position, the wider property market, and the risk management outputs.

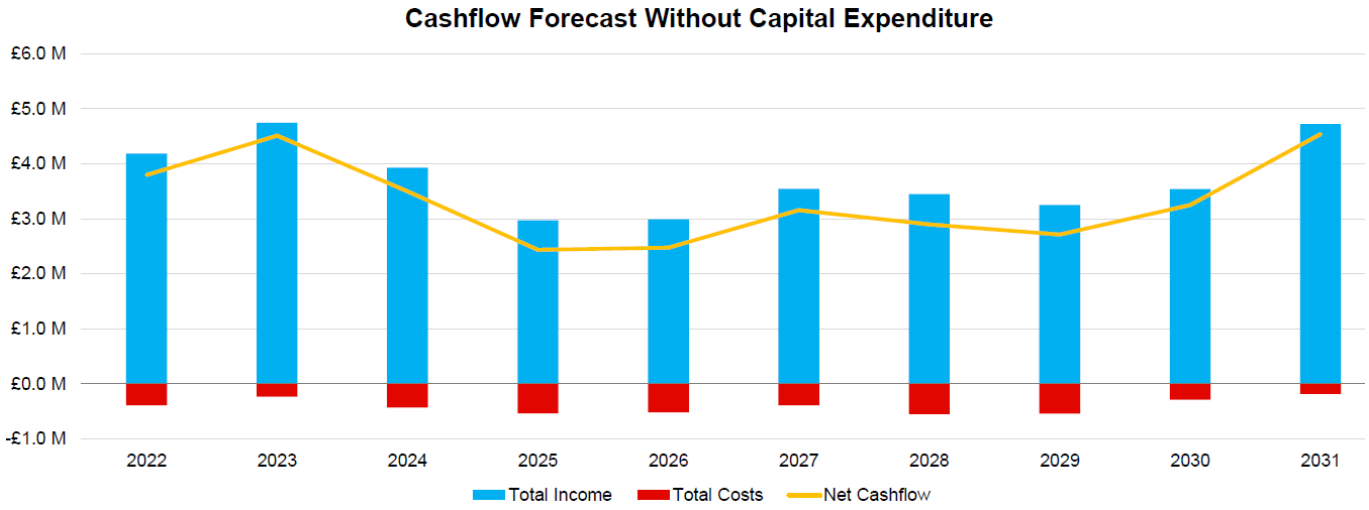
3.4.7 General assumptions have been made throughout the cashflow to ensure continuity:

- Estimated rental values have been informed by the March 2022 Asset Valuations
- Where a tenant break option exists, compensation at 50% of the ERV has been assumed to remove the break
- Letting agent and Legal fees have been assumed at 15% of rental sum on all re-lettings
- Empty rates payable on all voids, subject to 3-months rates relief
- £25,000 expenditure has been included to allow for the professional review on any alternative uses for three assets (considered further in part 2 of this report)

3.4.8 Following the short-term increase in revenue in 2023, once incentives have been spent on the new lettings, a cyclical decline in the net position is seen when the majority of the Portfolio's occupational leases expire. The reverse is seen in 2026, once the bulk of the assumed re-lettings and renewals have occurred. A subsequent dip in income is fed by the remaining expiries and voids. Overall, the income fluctuation is inevitable with the current ERVs across the portfolio, existing voids and critical lease events. However, this cashflow represents a forecast and is subject to real-time changes.

Cashflow forecast (assuming passive approach)

3.4.9 The graph below provides an indicative 10-year cash flow based on no capital investment being made, with costs being limited to dilapidation shortfalls, empty rates and letting fees. A tabular version of the below graph can be found in Appendix 2.



3.4.10 This cashflow when compared to the cashflow above, highlights the risk to revenue of not adopting these recommendations, identifying an income fall of £4.5m and a net shortfall of c.£1m.

3.4.11 Importantly, the scenario test only accounts for the impact that reduced capital expenditure would have on income and costs. Impact on the portfolio value is not factored in. Capital values are derived from both the income received and the risk associated with security of income. Therefore, induced by properties in poorer condition, tenant breaks, short lease terms, weaker covenants and depressed revenue, the capital value of the portfolio would also fall over the longer term.

3.4.12 Appropriate management and investment into the portfolio also provides additional benefits in relation to the mitigation of wider risks such as legal risks/challenges, future proofing the assets, and ensuring the Portfolio is best placed to respond to unforeseen market changes by having an agreed set of performance parameters to guide decision making which do not translate on the cashflows above, but which, nevertheless, can have significant financial implications.

3.5 Concluding Comments

3.5.1 The Council's primary objective for holding a Property Investment Fund is to generate an alternative income stream to support the wider functions of the Council.

3.5.2 Setting of strategic objectives, a revised investment strategy, and supporting KPIs to measure the portfolio's performance against the agreed approach have been proposed to minimise revenue risk exposure and focus on steady and future proofed performance.

3.5.3 In order to maintain performance, an active asset and portfolio management strategy is required, which is in line with typical practise across the UK. Capital investment is required to maintain and enhance income flows. The proposed governance structure will allow active and accountable management within

agreed performance parameters and a clear escalation process where there is any material deviation or risk.

3.5.4 To therefore optimise the performance of the fund, and to meet the original objective that led to investment into commercial property in the first place (i.e. to generate an alternative income stream to support Council functions), Members are recommended to approve the investment strategy and KPIs as detailed within this report.

4 IMPACT ON VULNERABLE ADULTS AND CHILDREN

4.1 There is not considered to be an impact on Vulnerable Adults and Children as a consequence of this decision.

5 POLICY IMPLICATIONS

5.1 N/A

6 FINANCIAL IMPLICATIONS

6.1 The annual income budget in 2022/23 for Investment Portfolio properties is £5.3m.

6.2 However, the impact of Covid and changing consumer habits has resulted in pressure on high street retail trading in recent years, with one significant tenant – Arcadia – going into administration. This loss of income accounts for the variation between the budget and latest rental values of £4.7m, although as reported, a new lease has recently been agreed for that site which would increase rental values to £5.1m.

6.3 The cost of the specialist investment portfolio advice from Montagu Evans is £118k over the four-year life of the contract. In Property Services officers' opinion, appointment of a strategic advisor reduces the risks of a detrimental impact on the revenue generation opportunities that can be achieved from the portfolio.

6.4 The report recommends the creation of a mitigation fund equating to 10% of gross rental income from the Investment Fund. Property officers' rationale for this fund is that it would enable appropriate investment and capital expenditure on rental properties which would lead to the longer-term benefits set out by officers in Section 3.3.27. However, the establishment of this fund would require an overall increase in the revenue budget of c. £510k p.a. in respect of investment properties and would need including in the financial forecast.

LEGAL IMPLICATIONS

7.1 Section .111 Local Government Act 1972 - The Council has power to do anything calculated to facilitate, or is conducive or incidental to, the discharge of any of its functions and accordingly therefore pursuant to this power there is no impediment to the proposals set out in this report

7.2 Furthermore s1(1) of the Localism Act 2011 gives the Council a general power of competence.

Non-Applicable Sections:	HR and Procurement
Background Documents: (Access via Contact Officer)	

Appendix 1 – Cash Flow Table Assuming Recommendations Adopted

YEAR COMMENCING	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	TOTAL
TOTAL INCOME	£4,462,518	£4,743,296	£4,122,081	£3,874,854	£4,189,284	£4,119,119	£3,918,293	£3,619,640	£3,609,662	£4,809,392	£41,468,140
TOTAL COSTS	(£379,180)	(£620,294)	(£875,125)	(£1,444,315)	(£768,406)	(£609,550)	(£1,122,889)	(£954,616)	(£316,694)	(£128,253)	(£7,219,321)
NET CASHFLOW	£4,083,338	£4,123,002	£3,246,956	£2,430,539	£3,420,879	£3,509,570	£2,795,404	£2,665,024	£3,292,968	£4,681,140	£34,248,818

Appendix 2 – Cashflow Table Assuming Passive Approach

YEAR COMMENCING	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	TOTAL
TOTAL INCOME	£4,185,428	£4,743,296	£3,927,301	£2,970,824	£2,991,953	£3,542,251	£3,447,710	£3,252,091	£3,537,333	£4,721,454	£37,319,640
TOTAL COSTS	(£387,888)	(£232,656)	(£429,229)	(£533,583)	(£516,265)	(£385,946)	(£550,164)	(£539,194)	(£287,566)	(£182,275)	(£4,044,768)
NET CASHFLOW	£3,797,540	£4,510,639	£3,498,072	£2,437,241	£2,475,687	£3,156,305	£2,897,546	£2,712,897	£3,249,766	£4,539,179	£33,274,872