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Title of meeting:	Cabinet
Date of meeting:	23 rd July 2024
Subject:	Property Investment Fund
Report by:	Tom Southall - Assistant Director Property & Investment
Wards affected:	All

1. Requested by

- 1.1 This information report has been produced to comply with the resolutions contained within the report to Full Council at its meeting of 7th July 2015 which included a requirement: *"That an annual report be submitted to Cabinet summarising the activity within the Property Investment Fund including the fund's financial position"*.

2. Purpose of report

- 2.1 This report summarises the activity within the Property Investment Fund including the funds financial performance as stated in the report to Full Council in July 2015. Over the period July 2015 to March 2024, the overall return (taking account of both cumulative net income returns and net capital value returns) the Property Investment Fund has yielded a positive return in challenging market conditions.

3. Information Requested

- 3.1 The Full Council meeting of the 7 July 2015 approved the amendment to the Capital Programme to permit the formation of the Property Investment Fund. The minutes of the relevant meeting record that the actions within the Property Investment Fund would be reported to council.
- 3.2 There have been several additions to the original report; these additions have created a fund with circa £183 million to invest.
- 3.3 The Property Investment Strategy 2015/16 - 2019/20 (PIS) approved by members in July 2015 has been used as a framework for acquisitions. The approved strategy included strict

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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.
- 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 city of Portsmouth will be a deciding factor when all other attributes are equal.

Current Fund - Statistics

- 3.4 To date circa £172.4 million (inclusive of all costs) has been invested and is generating an income of £9.5m per annum. The fund is now fully invested, no further purchases are planned, the balance of £10.6 million (£183 million - £172.4 million) will be used for renewal, repair and updating of properties as required (see 3.45 below).
- 3.5 The fund has been successful in acquiring 15 properties containing circa 33 occupational tenants. The majority of transactions have been the purchase of standing investments on and off market.
- 3.6 The first investment, Schlumberger, Gloucester was purchased in December 2015, with the last acquisition, AGA Rangemaster, Leamington Spa in early 2020.
- 3.7 Appendix 1 is a schedule of all assets currently held within the Property Investment Fund and provides data on mix of locations, sector and tenancies.
- 3.8 Ten covenants of note being:
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 - DHL

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- Saint-Gobain
- Sharps
- RS Components
- Waitrose
- BSS (Travis Perkins)
- UPS (United Parcel Service)
- Antalis
- Decathlon

Portfolio Position Review

- 3.9 Portsmouth City Council have demonstrated its technical knowledge base and performance and is considered by the wider market as an established well-structured and highly knowledgeable purchaser and fund manager.¹
- 3.10 The original Property Investment Strategy was followed and appropriate assets to meet its objectives have been successfully acquired.
- 3.11 The fund is now fully invested and providing income for council services. Active asset management to maximise income and protect capital value continues.
- 3.12 The fund has followed a medium risk profile and achieved a progressive risk-adverse to risk-seeking (core to core +) strategy over time, often described as "moving up the risk curve".
- 3.13 The overarching theory that the relationship between assets reduces risk of the whole is referred to in simple terms as "diversification". This theory which aims to protect the capital invested whilst maximising the income has been at the core of decision making on all purchases and continues to form the basis of future decisions on sales.
- 3.14 To provide sufficient diversification, it follows that a fund of £183m requires single asset lot sizes of circa £8-18m spread across a UK national geographical area with a suitable sector mix.
- 3.15 The portfolios average purchase price lot size for individual assets is circa £11m, with the minimum lot size of £4.9m and a maximum lot size of £16.2m.

¹ testimony has been received from leading Agents confirming this

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- 3.16 The fund has been weighted to the best performing sectors in the market as of the date of this report but has maintained the diversification (location / sector / tenant) required to create a well-balanced sustainable portfolio including a mix of multi-let and single let property.
- 3.17 To achieve diversification and properly manage risk for a portfolio of this size of financial investment requires the portfolio to be built over the whole UK geography.
- 3.18 Financial risk and how it combines within the wider portfolio were considered during assessment and appraisal stage of each individual property.
- 3.19 Discounted Cash Flow techniques have been used in evaluating the expected financial return for each acquisition and continue to be used in the active management of the assets. The level of detail within the cash-flows are detailed at Appendix 2.
- 3.20 Investment analysis considerations take into account UK location, sector, tenant, age, size, lease length, building condition, environmental, future capital expenditure, rental growth prospects, investment hold period and asset liquidity to name but a few. These are cross referenced against associated market sector drivers such as micro and macro demographics, technology, consumer and business trends, and the wider economic position, and form the basis for the investment appraisal.
- 3.21 Commercial property portfolios depreciate in value over time, exit dates of assets are influenced by the need to minimise depreciation and maintain income. Material events, such as break clauses, lease expiries or refurbishment play into this decision as do market sector dynamics, changes in regulations and the economic position at any given point in time.
- 3.22 The portfolio requires active management to curb the depreciation of value and re-balance the inherent risk in the long term. This is achieved broadly through:
- Day to day active property and asset management; rent reviews, lease renewals, lease re-gears, new lettings, dilapidations claims, physical monitoring and the like.
 - Property trading (liquidity) and replacement, renewal, repair and updating of existing assets; particularly those purchased historically for such strategic future use.

Market, performance, and future strategy

- 3.23 Sustainable commercial property investment is long term, fluctuations in capital values given either market forces or lease events are entirely normal and will correlate with wider macro-economic cycles.
- 3.24 The past 3 years have been extremely challenging for the commercial property market, a combination of pandemic, extreme inflation, high interest rates, low economic growth and

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periods of recession has created downward pressure on the market not seen since the years following the financial crisis of 2008.

- 3.25 The test of any property fund during these periods of severe downturn is to maintain or increase income and outperform the market in value terms, in both regards the portfolio has performed exceptionally.
- 3.26 The sustained rental performance, tenant demand and retention of high-quality covenants can be considered a testament to the stock selection and diversification strategy, where required assets have been successfully re-let during this period with little or no rental voids and there have been no unexpected tenant defaults or arrears which have not been recouped.
- 3.27 The capital value of the fund has significantly outperformed the market average during the past 2 years of downturn. From a high of £185m in March 2022 to its current value as of March 2024 of £154m, this represents a valuation yield shift of some 1% (100 basis points) whereas the All-Commercial Property Equivalent Yield² shifted close to double this at 2% (200 basis points) during the same period, noted by Carter Jones Investment Market Update June 2024:

"All-property average equivalent yields have been shifting upwards since mid-2022 in reaction to rising interest rates and gilt yields, political uncertainty, and elevated occupier demand uncertainty.

"This rate of upward movement peaked in late 2022, continuing at a more modest pace during 2023. This year has seen the all-property equivalent yield has starting to level off."

"The current all-property equivalent yield of 7.1% as at April 2024 represents an upward shift of 193 basis points since June 2022 (MSCI Monthly Index), but a rise of eight basis points over the last three months (and almost no change over the last month)"

- 3.28 Commercial property is considered a long-term investment 10+ years, this allows time to generate net income (after purchase costs) for rental growth and for capital values to increase and a long enough period to avoid considering sales of assets during economic downturns and periods of recessions. It is almost always the case (assuming an average market

² MSCI index considering all costs associated with owning property.

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position) that an early exit will be financially challenging given the costs of purchase and limited time for rent and rental growth to accrue.

- 3.29 The initial purchase completed at the end of 2015, all subsequent purchases were made during the following 4 years up until 2020. The vast majority of the portfolio has been held for 6 years or less. All properties were appraised and considered as appropriate financial investments requiring a minimum 10-year hold at the time of purchase; this position has not changed.
- 3.30 Individual assets do not have defined holding periods; when appropriate, and dependent on the market at any given time redevelopment, refurbishment or sale/replacement would be considered (unless purchased for early "value add" development). The fund itself was created; "open-ended" meaning the investment and income would continue in perpetuity.
- 3.31 Subsequent changes to the financial rules for local authorities has removed some of the ability to rebalance the risk and sustain income through sales and new acquisitions. Spending for the renewal or to maintain an existing asset to protect income and capital value continues to be permitted.
- 3.32 The fund is fully invested and is meeting the objective of creating sustainable long-term income. To assist in maintaining the objective individual asset refurbishment, renewal or sales may be required at an appropriate time in the future.

Financial Performance

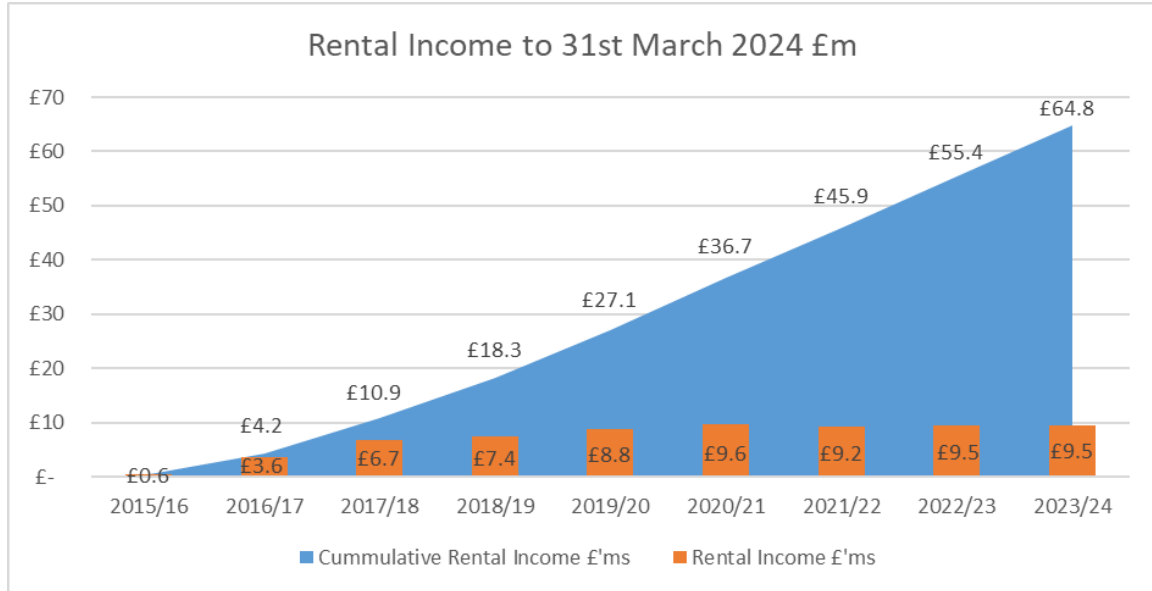
- 3.33 Performance on property investment is measured by the overall return; that being the income generated plus the increase or decrease in capital value.
- 3.34 The Council's assets including the fund are valued annually on the 31st March and therefore financial performance has been measured using holdings to the 31st March 2024.

Rental Income (Gross Return)

- 3.35 In 2023/24 the amount of rental income received was £9.5m which represented a return against total capital investment (including costs) of 5.5% as at the 31st March 2024.
- 3.36 Since 2020/21 Rental income has been stable, despite the impact of the pandemic, with total income to March 2024 totalling £64.8m

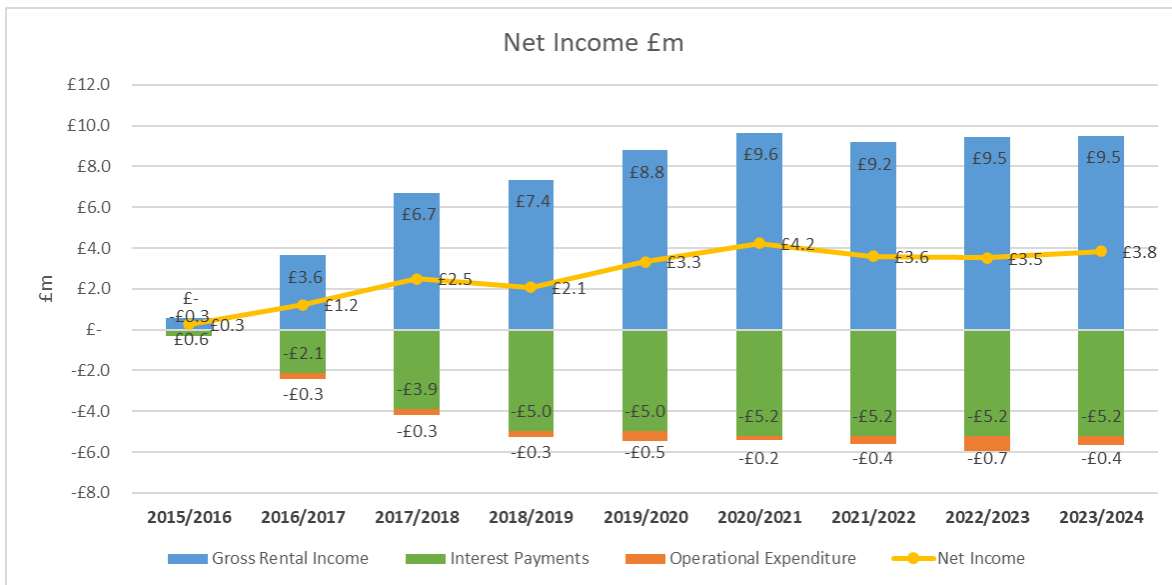
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Rental Income (Net Return)

3.37 The cumulative net income to the Council (after borrowing costs and operational expenditure) since the Funds inception to 31st March 2024 amounts to £24.6m. Net Income in 2023/24 amounted to £3.8m which represents a return on investment of 2.3% on the Market Value at acquisition.



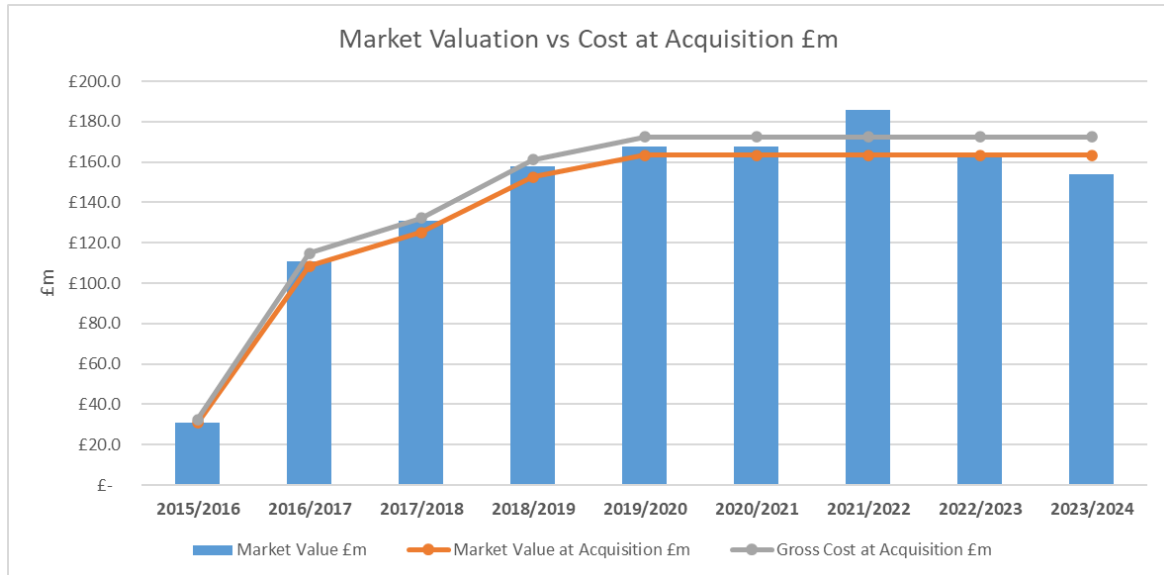
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3.38 Borrowing costs are calculated assuming the interest rate at the time of acquisition. For Public Works Loan Board funded acquisitions this is 3.8%. For cash secured through the Wightlink sale and leaseback this is 2.8%.

Capital Growth

3.39 According to the most recent valuations undertaken by Avison Young in March 2024, the market value of the Council's fund properties has, on average, declined by 5.71% compared to the cost at acquisition.



3.40 The Council has spent £163m of the fund on property (£172m including acquisition costs). The market value of all property investment assets as at 31st March 2024 has dropped by 5.71% to £154m, therefore the capital value of the holding is currently lower than the total cost of acquisition. This does not take account of the income generated.

3.41 The confidential exempt Appendix 3 shows the movement in Market Value of each property measuring the cost of the property and acquisition fees against the Market Value of the property as at 31st March 2024.

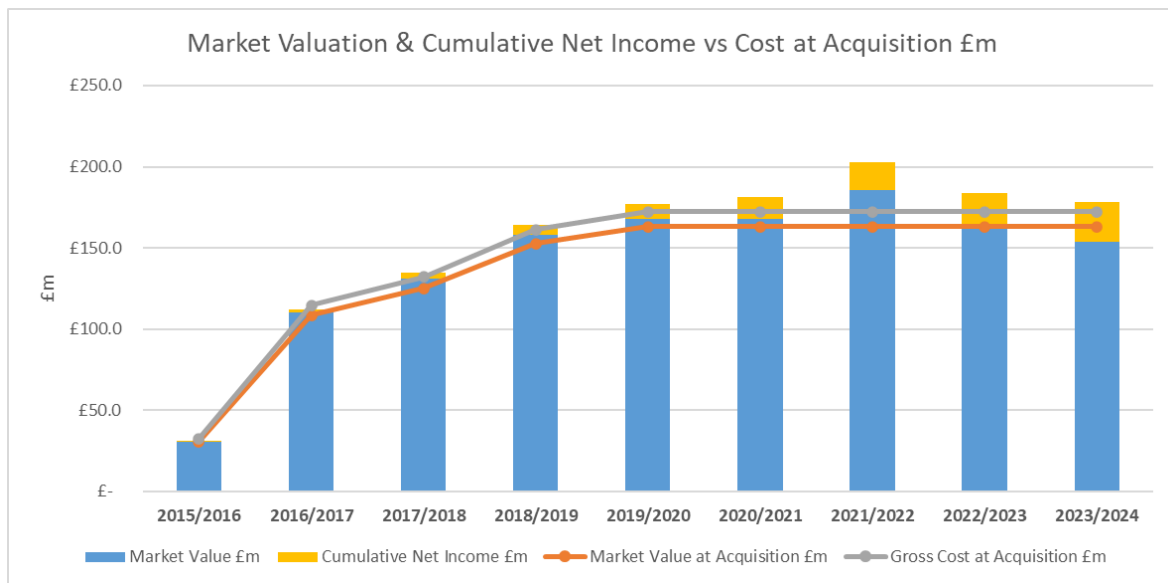
Overall Performance

3.42 The gross income to the Council to March 2024 since the fund was established is £64.8m. Net income, taking account of borrowing and operational costs is £24.6m.

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3.43 The reduction in the Market value compared to the cost at acquisition is £9.3m (£18.5m including costs). This would only be realised if the fund were to be disposed of now. £3.9m of this reduction is specifically related to the two vacant properties under renewal, and updating which are due for completion in 24 - 36 months' time. These two assets will return a combined additional net income of circa £1 million and have consequential increases in capital values.



Conclusion

- 3.44 The fund is fully invested and is meeting the objective of creating sustainable long-term income.
- 3.45 Continued active asset management is required to ensure the objectives of the fund are met and maintained over the long term.
- 3.46 Whilst capital values have dipped from a high in 2021/22 the performance of the fund assets in comparison to the market benchmark is excellent and demonstrates the strength of the assets relative to the wider market.

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Signed by Director of Economy, Transport & Planning:

Appendices:

- Appendix 1 - Asset Schedule
- Appendix 2 - Cash Flow Inputs
- Appendix 3 - Market Value - Exempt Confidential

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location
Original Cabinet property investment paper	<u>Agenda for Cabinet on Friday, 3rd July, 2015, 1.00 pm Portsmouth City Council</u>



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Appendix 1 - Asset Schedule



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Appendix 2 - Asset cashflow assumptions and considerations

Type of information	Current data	Forecasts
Tenure	<ul style="list-style-type: none"> Title, including headlease details (if applicable) Outgoings Head rents Unfulfilled statutory obligations 	
Physical attributes	<ul style="list-style-type: none"> Floor areas (net and gross) Ancillary areas and car parking Building specifications Tenants' improvements 	<ul style="list-style-type: none"> Planned or possible changes in areas/ parking provision
Lease/sublease and occupational interests	<ul style="list-style-type: none"> Tenancy details Lease expiry dates Break clauses Rent review dates Rent review terms 	<ul style="list-style-type: none"> Lease events forecasts, including probability of breaks being operated and leases renewed Duration of future voids Perpetual void allowance
Rental value	<ul style="list-style-type: none"> Rents passing (including stepped rents) Estimated rental values 	<ul style="list-style-type: none"> Growth in rental value for the location to model refurbishment/ redevelopment options Growth in actual property rents
Costs of property ownership and holding costs	<ul style="list-style-type: none"> Vacancy/void costs Unrecoverable service costs Unrecoverable management costs Letting and review costs Purchase and sale costs 	<ul style="list-style-type: none"> Inflation in maintenance and running costs Future periods on lease expiry and periods of refurbishment
Redevelopment/ refurbishment	<ul style="list-style-type: none"> Costs of redevelopment/ refurbishment Dilapidations 	<ul style="list-style-type: none"> Inflation in building costs
Finance	<ul style="list-style-type: none"> Loan details Break costs 	<ul style="list-style-type: none"> Changes in interest rates
Gearing	<ul style="list-style-type: none"> Level of debt Return on equity employed 	
Taxation	<ul style="list-style-type: none"> Income and capital gains VAT election Capital allowances 	



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Appendix 3 (Exempt Confidential)