Property Investment Strategy Review

Committee considering report:	Executive
Date of Committee:	2 November 2023
Portfolio Member:	Councillor Iain Cottingham
Date Portfolio Member sent/agreed report:	13 October 2023
Report Author:	Shannon Coleman-Slaughter
Forward Plan Ref:	EX4402

1 Purpose of the Report

1.1 In the current financial year, the Council reported a quarter one forecast overspend of £6.3 million against a General Fund provision of £7.2 million. In response the Council has: Implemented expenditure limitations, reviewed capital financing provisions and undertaken a review of the commercial property portfolio which is informed by the Property Investment Strategy. This report provides a review of the Property Investment Strategy which was initially implemented by the Council under the previous administration in May 2017, and makes recommendations designed to support the financial resilience of the Council in the current economic environment.

2 Recommendations

2.1 It is recommended to Members that:

(a) The Council disinvests from the commercial property portfolio over the medium financial term (MTFS) in order to generate capital receipts.

(b) Resulting capital receipts should be applied to future capital financing of the approved capital programme and agreed transformation projects with a view to generating longer term revenue savings.

(c) Approve the proposed disposal in the Part Two appendix E.

3 Implications and Impact Assessment

Implication	Commentary
Financial:	Changes to the Prudential Code and PWLB lending facility determined that it is not prudent for local authorities to make investment or spending decision that will increase the Capital Financing Requirement (CFR), unless directly and primarily

	related to the functions of the authority. This change in guidance resulted in the Council's approved Property Investment Strategy being partially invested. The portfolio currently generates a net £1 million (approximate), contribution to the Council's revenue budget. A move towards disposal will result in a loss of net income, however this is mitigated by avoidance of future high-cost capital financing supporting the Council's approved capital programme and funding of revenue transformation programmes.			
Human Resource:	Not applicable			
Legal:	Not applicable			
Risk Management:	Risk is around disposal value as the commercial property sector is relatively depressed. If the recommendation is agreed, risks will be mitigated through advice from the Council's procured management specialist Montagu Evans with regard to timing and valuation for asset sales.			
Property:	No impacts on operational Council properties. Report focuses solely on the commercial property portfolio.			
Policy:	This is a change in policy moving from maintaining a property investment portfolio for yield.			
	Positive	**Neutral**	**Negative**	**Commentary**
Equalities Impact:				
A Are there any aspects of the proposed decision, including how it is delivered or accessed, that could impact on inequality?		X		

B Will the proposed decision have an impact upon the lives of people with protected characteristics, including employees and service users?		X		
Environmental Impact:		X		
Health Impact:		X		
ICT Impact:		X		
Digital Services Impact:		X		
Council Strategy Priorities:		X		
Core Business:		X		
Data Impact:		X		
Consultation and Engagement:	Joseph Holmes, Executive Director for Resources and s151 Officer.			

4 Executive Summary

4.1 The Council has invested in a commercial property portfolio of £62 million (inclusive of purchasing costs). The portfolio currently generates income which supports the delivery of Council core services, total gross income generation since adoption of the strategy is approximately £18 million.

4.2 The portfolio above provides a portfolio split of 41% office, 29% retail warehouse, 22% retail and 8% petrol filling station. The portfolio is widely distributed, with two assets (27.9% of the portfolio based on 31 March 2023 valuations), located within district.

4.3 The current economic climate presents an opportunity to review the portfolio. The challenging economic environment has resulted in declining property valuations, as at 31 March 2023 the portfolio was valued at £51.4 million, compared to a net asset at purchase value of £58.6 million. Details of fluctuations in the value of the portfolio is detailed in appendix B. In 2022/23, £3.3 million of gross income and £1.188 net of financing costs was included within the Council's revenue outturn. Current contractual rentals for 2023/24 total £3.5 million of gross income, with forecast net yields of £1.3 million.

4.4 Taking into consideration the current economic climate faced by Councils with rising inflationary pressures, surges in looked after / supported populations and increasing capital financing costs, this report seeks to recommend that the Council disinvests from the existing commercial property portfolio and utilises resulting capital receipts to future fund capital financing of investment in the Council's core estate and transformation programmes. This recommendation is based on the fluctuating PWLB rates, a 25-year annuity rate (on which revenue setting is based) is 5.7% (including certainty rate), compared to historic averages of 2-3%. Releasing £1 million of capital receipts therefore avoids a capital financing cost of £75.5k against future annual revenue budgets. The Council has ambitious capital and transformation programmes designed to enhance the district and long-term financial sustainability, generation and application of financial receipts will support delivery of these programmes.

5 Supporting Information

Introduction

5.1 The Council's Property Investment Strategy was approved and implemented in May 2017 with an initial investment envelope of £50 million. At Council in July 2018, the envelope for investment was extended to £100 million with the following parameters:

(a) Limiting the size of any single acquisition to £15 million.

(b) Limiting acquisitions in any single sector to 40% of the total portfolio (35% for offices).

(c) Limiting exposure to any single tenant income to £750k per annum.

(d) Limiting total investment in any single region (investment in all regions of England, Scotland and Wales allowable), to no more than 35% and further limited to no more than 25% in any single town/city.

(e) Acquiring properties with tenants having a Dunn & Bradstreet covenant of 5A1.

5.2 The Property Investment Board (PIB), with the support of procured external advisors were granted delegated authority to undertake acquisitions and ongoing review and management of the portfolio. The PIB terms of reference are detailed in appendix A.

Background

5.3 In August 2021 HM Treasury significantly revised guidance for the Public Works Loan Board (PWLB), lending facility. Councils intending to purchase investment assets primarily for yield would no longer be able to access the PWLB except to refinance existing loans or externalise internal borrowing. Alongside this, CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes focused on permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. To comply with the revised Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the Capital Financing Requirement (CFR), unless directly and primarily related to the functions of the authority. Existing commercial investments are not required to be sold; however, Councils with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

5.4 At the time of the legislative changes, the Council had invested £62 million (inclusive of purchase related fees), across the following assets:

Asset Name and Address	Property Type	Purchase Price Including Fees	Net Asset Cost
		£000s	£000s
Dudley Port Petrol Filling Station, Tipton	Petrol Filling Station	3,724	3,510
79 Bath Road, Chippenham	Retail Warehouse	9,651	9,106
Lloyds Bank, 104 Terminus Road, Eastbourne	Retail	3,078	2,900
Aldi/Iceland, Cleveland Gate Retail Park, Gainsborough	Retail Warehouse	6,424	6,048
303 High Street and 2 Waterside South, Lincoln	Retail	6,010	5,665
3&4 The Sector, Newbury Business Park	Office	18,802	17,760
Sainsbury's, High Street, North Allerton	Retail	7,463	7,050
Ruddington Fields Business Park, Mere Way, Nottingham	Office	6,931	6,545
Total Portfolio Expenditure Outlay at Purchase		**62,083**	**58,584**

5.5 The portfolio above provides a portfolio split of 41% office, 29% retail warehouse, 22% retail and 8% petrol filling station. The Quarter One 2023/24 market update provided by the Council's appointed management consultants (extract included in appendix C), indicates a challenging period for the commercial property sector with rising costs resulting in income and margins being impacted. Businesses are expected to continue to contain costs until the inflationary pressures ease, reducing rental growth potential across the sectors. The high street retail and office sectors have been particularly impacted through the Covid era and resulting hybrid working. This is paired with investors' rising cost of capital, UK gilts (five and ten years), are currently at approximately 4.5% compared to 1.3% in early 2022.

5.6 The Council's current portfolio split is sensitive to valuation risk, as at 31st March 2023 the total value of the portfolio was valued at £51.5 million. Annual valuation data on an individual asset basis is detailed in appendix B. A £4.4 million reduction in value has occurred from purchase to valuation as at 31st March 2023 across the retail element of the portfolio (original purchase price net of fees). A further £3.3 million reduction in value has been incurred in respect of the office portfolio.

Property Type	Valuation as at 31/03/2023	Net Asset Cost	Variation in Portfolio Value
	£000s	£000s	£000s
Petrol Filling Station	£4,155	£3,510	£645
Retail Warehouse	£15,000	£15,154	-£154
Retail	£11,260	£15,615	-£4,355
Office	£21,050	£24,305	-£3,255
Portfolio Value	£51,465	£58,584	-£7,119

5.7 Post changes to the Prudential Code and PWLB lending facility rules, no further investment activity in respect of further acquisitions has been undertaken. However, £199k of capital expenditure across the portfolio (planned maintenance and enhancements), has been financed through the capital programme. The current, approved capital programme for the period 2023/24 – 2032/33 makes provision for a further £2.3 million of Council funded expenditure on planned maintenance and enhancements across the portfolio.

5.8 Capital financing of the original portfolio purchase was undertaken through maturity loans with a weighted average interest rate of 2.46%. At the time of producing this review the principal balance of £62 million remains outstanding. Annual interest of £1.5 million and £700k (approximately) of Minimum Revenue Provision payments (MRP), annually, is forecast for the next term of the Medium-Term Financial Strategy (MTFS).

5.9 Capital financing costs associated with the portfolio are offset via rental income. The annual revenue budget is set with an assumed gross income generation of £3.5 million, and net contribution of approximately £1 million to support delivery of core Council services. The estimated rate of return on the portfolio for 2022/23 is summarised below. The rate of return is based on the valuation of the portfolio as of 31st March 2023. The estimated net income for 2022/23 is based on the revenue outturn as of 31st March 2023. The 2022/23 rates of return disclosed as part of the Council's treasury outturn were negative based on the income yields in year being less than the annual decrease in value of the portfolio.

Property Investment Portfolio	**£000s**
Valuation as at March 2022	£58,985
Valuation as at March 2023	£51,465
Loss on change in market value during 2022/23	-£7,520
2022/23 Net Income	-£3,383
2022/23 rate of return excluding financing	**-7.0%**
MRP Costs 2022/23	£666
Interest costs 2022/23	£1,529
Outturn net of MRP and interest	-£1,188
2022/23 rate of return including financing	**-10.7%**

5.10 Due to the nature of direct investment in property there is additional risk (upside and downside) that the value of the investment may change. In respect of commercial property, this risk is carried alongside the risk of voids and no rental income being recovered adversely impacting on achievable rates of return. These risks have historically been managed through allocation of General Fund Reserve to Earmarked Reserves as part of annual budget setting processes. However, for financial year 2023/24 no such provision has been made due to pressure on the Council's overall reserve position.

Proposals

5.11 **Recommended option**: The proposal is for the Council to disinvest from the property portfolio. Disinvestment should take the form of a phased approach over the term of the MTFS.

5.12 **Impacts of disinvestment – Balance Sheet**: Disinvestment will result in crystallisation of a loss on disposal if disposal occurs at the current portfolio valuation level. The impact on the Council's Balance Sheet would be a reduction in the net asset base. The crystalised loss will not impact on the Council's General Fund as it will be reversed out below the line to unusable reserves (in accordance with the CIPFA Code of Practice). The resulting capital receipt(s) will be held in usable capital reserves for deployment as transformation funding (under current flexible use of capital receipts guidance), or to finance future years capital expenditure.

5.13 **Impacts of disinvestment – revenue**: Since 2020 PWLB rates have significantly increased and currently are particularly volatile. Current PWLB rates for a 25-year annuity (the basis of budget setting for capital expenditure) are 5.7% (including certainty rate). £1 million of capital financing requirement effectively equates to an annual interest charge £57k and a cashflow impact of £75.5k. Over the period of the MTFS (2024-25 to 2026/27), Council funded capital expenditure of approximately £60 million is anticipated based on historic expenditure trends, this level is below the level of the approved capital programme. Capital receipts effectively avoid the requirement to undertake higher cost debt financing, reducing capital financing budgetary increases over the midterm. The loss of net income (approximately £1 million annually by year three of the disinvestment period), will effectively be offset by avoiding any new annual capital financing costs associated with debt financing.

5.14 **Considerations to strategy adoption:** MRP and capital financing costs associated with the borrowing to support the original purchases of the portfolio would remain payable. The revenue impacts of the ongoing financing equate to annual interest of £1.5 million and annual MRP on average of £700k. Income bearing assets would be sold crystalising loses held on the Balance Sheet. There is a risk that the more desirable assets with higher income yields would be more likely to be disposed of initially creating a lag between disposal and loss of income against cumulative capital finance savings. Revenue savings are dependent on PWLB rates remaining high over the mid to longer term. Effectiveness of the strategy will be dependent on the level of capital receipts generated, and reduced by any reallocation of receipts to transformation, where any transformation project does not deliver tangible revenue savings.

6 Other options considered.

6.1 To do nothing. For the reasons detailed within the report this is not recommended.

7 Conclusion

7.1 The Council's property investment portfolio since adoption and implementation in 2017 has generated gross revenue streams of approximately £18 million, with an approximate annual £1.2 million net contribution to provision to core Council services. The economic turbulence of recent financial years in response to the Covid pandemic, fiscal event of September 2022 and cost of living crisis, has impacted on the Balance Sheet valuations of the portfolio. Over the duration of strategy, the portfolio (which has been fully invested since 2018), has reduced in value by £7.1 million.

7.2 Historically Councils were able to access PWLB rates of 2 – 3%, since January 2022 the rate of borrowing (focusing on a 25-year annuity rate), has significantly increased, with current rates (at the time of writing this report) of 5.7%. Capital receipts now have tremendous power for a Local Authority enabling transformation funding and offsetting future high-cost capital financing. £1 million of future Council funded capital expenditure equates to a revenue financing requirement and cash flow impact of £75.5k annually.

7.3 If the current portfolio was to achieve the values as per the 31 March 2023 valuations (£51.4 million), potential future capital financing savings over the term of the MTFS would equate to £6.9 million annually, inclusive of MRP. This is compared to an approximate £1.3 million annual net contribution of income from the portfolio to the Council's revenue budget, see table below.

Costs / Savings:	2024/25	2025/26	2026/27	Total over MTFS
	£000s	£000s	£000s	£000s
Anticipated Annual New Council funded capital expenditure	£16,523	£19,828	£23,793	£60,144
Application of capital receipts *(note 1)*	-£16,523	-£19,828	-£15,114	-£51,465
Revised capital expenditure requiring financing	**£0**	**£0**	**£8,679**	**£8,679**
Avoidance of new annual capital financing costs (interest and principle repayments) (Note 3)	-£783	-£1,560	-£2,125	
Avoidance of new annual MRP costs (Note 3)	-£351	-£832	-£1,232	
Avoidance of cumulative new annual interest and principle loan costs	-£783	-£2,344	-£4,468	-£4,468
Avoidance of cumulative new MRP costs	-£351	-£1,183	-£2,415	-£2,415
Total financing savings over MTFS	**-£1,134**	**-£3,526**	**-£6,883**	-£6,883
Comparison to income yields if retain portfolio:	**2024/25**	**2025/26**	**2026/27**	**Total over MTFS**
Loss of 23/24 budgeted annual gross income yields	-£3,497	-£3,497	-£3,497	-£10,491
Annual portfolio financing costs *(note 2)*	£2,200	£2,200	£2,200	£6,600
Net annual income yields supporting the revenue budget	**-£1,297**	**-£1,297**	**-£1,297**	**-£3,891**

Notes:

1. Assumed disposals at 31 March 2023 valuations and no allowance for costs (£51.4 million)

2. Maturity loan financing would remain as no change made to the Council's CFR.

3. Cost avoidance calculations generated through the Council's adopted liability benchmark.

7.4 When considering adopting the strategy of complete portfolio disinvestment, key factors are: MRP and capital financing costs associated with the maturity borrowing to support the original portfolio investment would remain payable. The revenue impacts of the ongoing financing equate to annual interest of £1.5 million and annual MRP on average of £700k. Income bearing assets would be sold crystalising loses held on the Balance Sheet of approximately £7 million based on 31st March 2023 valuations. There is a risk that the more desirable assets with higher income yields would be more likely to be disposed of initially creating a lag between disposal and loss of income against cumulative capital finance savings. The offsetting revenue savings are dependent on PWLB rates remaining high over the mid to longer term. Effectiveness of the strategy will be dependent on the level of capital receipts generated, and reduced by any reallocation of receipts to transformation, where any transformation project does not deliver tangible revenue savings.

7.5 The modelled financials assume full disposal of the portfolio over the term of the MTFS, disposals have not been profiled as to order of disposal which may impact on the above figures. However, the financials above provide a guide as to the current financial potential through unlocking the portfolio, allowing the Council to refocus future capital funds whilst protecting the revenue budget position in the mid-term.

8 Appendices

8.1 Appendix A – Property Investment Board Terms of Reference

8.2 Appendix B – Property Investment Portfolio – Assets Valuations

8.3 Appendix C – Montagu Evans – Quarter One Financial Year 2023/24 Market Analysis

8.4 Appendix D – Property Portfolio 2023/24 Annual Rentals as Reported at Quarter One

8.5 Appendix E – Confidential Part Two Report

Subject to Call-In:

Yes: ☒ No: ☐

The item is due to be referred to Council for final approval	☐
Delays in implementation could have serious financial implications for the Council	☐
Delays in implementation could compromise the Council's position	☐
Considered or reviewed by Scrutiny Commission or associated Committees, Task Groups within preceding six months	☐
Item is Urgent Key Decision	☐
Report is to note only	☐

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Appendix A

Property Investment Board Terms of Reference

Release Date:	**March 2021**

1	**Background**

1. At a full meeting of West Berkshire District Council on 9th May 2017 (C3283) the Council approved the Property Investment Strategy. The Strategy is regularly reviewed and was updated at the March 2020 meeting. The Property Investment Strategy is an appendix to the Capital Strategy 2020/21 to 2022/23;

2. Delegates to the Service Director : Strategy and Governance in consultation with and having received agreement from the Property Investment Board to dispose of property in accordance with the above Strategy up to a maximum of £15m per transaction where it would not be expedient for the Executive to make this decision;

3. Delegates to the Service Director: Strategy and Governance to inform the next available Executive of any disposal decision;

4. Delegates to the Head of Finance and Property in consultation with the Portfolio Holder with responsibility for Property, authority to appoint suitable consultants in accordance with the Contract Rules of Procedure (Part 11 of the Constitution);

5. West Berkshire Council will pause investment at the investment levels as at 31.3.2020 following the outcome of the PWLB consultation on its use

2	**Purpose**

The members of the Property Investment Board (PIB) or their substitutes will collectively be responsible for the recommendations made by them having received reports related to the acquisition (or disposal) of commercial property.

The PIB will play a critical role in the governance of the property investment strategy including ongoing monitoring of performance in order to make informed decisions.

3	**Terms of reference**

The PIB terms of reference are:

1. In circumstances where a report proposes the acquisition of a property known to be outside the scope of the Delegated Authority criteria, to make recommendation(s) to approve or reject the proposal to progress with the acquisition to the Executive;

2. To make recommendation(s) to approve or reject the proposal to progress with the disposal of an individual property to the Executive. Where it would not be expedient for the Executive to consider a proposal to dispose of an asset authority be delegated to the Service Director Strategy and Governance in consultation with the portfolio holder(s) with responsibilities for finance and property, having received a report from Property Services to do so;

3. To receive quarterly performance reports (including an Annual Review report) conveying information on acquisitions, costs, total capital commitment and performance of the investment.

4	**Membership**

The PIB is to be a joint Officer and Member board formed from the following:

1. Executive Director (Resources) (Chair)
2. Service Director: Strategy and Governance (or substitute)
3. Executive Portfolio Holder for Internal Governance (or alternative Executive member)
4. Executive Portfolio Holder for Finance (or alternative Executive member).
5. Head of Finance & Property services

Reporting Officers to the PIB will be the Property Services Manager (or substitute) and the external consultant property agent.

5	**Roles and responsibilities**

The members of the PIB will collectively be responsible for the recommendations made by the PIB, having given regard to the knowledge and expertise brought by individual members (such as legal, financial or political).

Strategy and Governance will:

- Produce agendas and minutes to record the meetings

The Property Services Manager will:

- Arrange meeting dates, venue;
- Produce formal reports (for individual acquisition/disposal or reviews);
- Produce formal reports for quarterly reporting/monitoring and annual reviews;
- Record and maintain property data for acquired property;
- Attending PIB meetings;
- Liaise with WBC colleagues within relevant teams sufficient to conclude proposals and the satisfactory outcome of recommendations made by the PIB.
- With the input of WBC appointed Property Investment Adviser, monitoring performance of the investment, including identifying any issues with the property portfolio.

6	**Meetings**

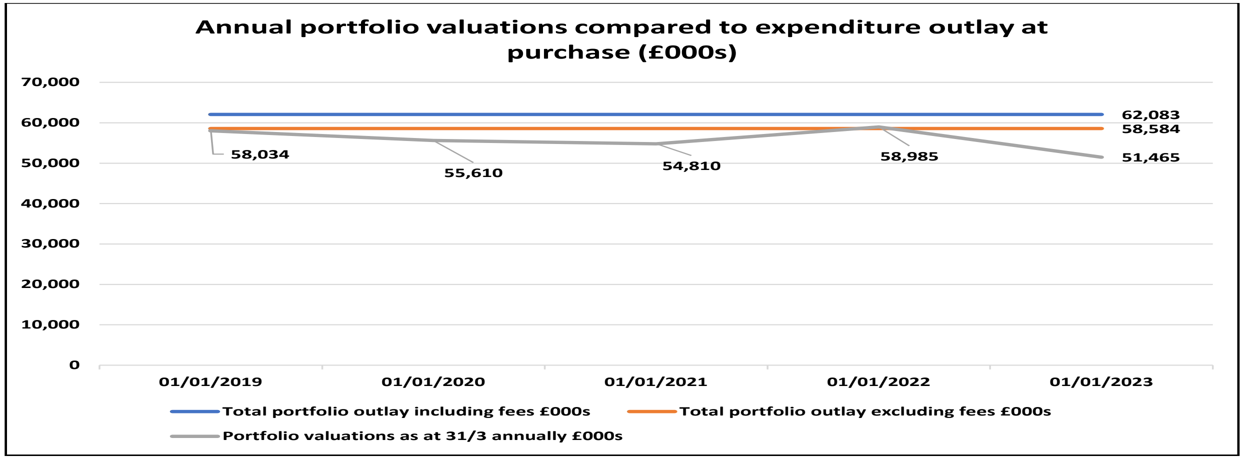
Scheduled quarterly PIB meetings will be arranged to monitor the implementation of the strategy and performance of investments. Additional ad hoc meetings will be arranged when required as a property acquisition or disposal is proposed.

Appendix B

Property Investment Portfolio – Assets Valuations

Valuation data as supplied by the Council's appointed external valuers Avison Young. The current portfolio was fully invested from the financial year ending 31/03/2019.

Asset Name and Address	Property Type	Purchase Price Including Fees	Net Asset Cost	Valuations as at 31/3/2018	Valuations as at 31/3/2019	Valuations as at 31/3/2020	Valuations as at 31/3/2021	Valuations as at 31/3/2022	Valuations as at 31/3/2023
		£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s
Dudley Port Petrol Filling Station, Tipton	Petrol Filling Station	3,724	3,510	0	3,720	3,595	3,700	3,765	4,155
79 Bath Road, Chippenham	Retail Warehouse	9,651	9,106	0	9,648	9,200	9,500	11,775	9,250
Lloyds Bank, 104 Terminus Road, Eastbourne	Retail	3,078	2,900	1,845	2,590	2,300	1,800	1,800	1,675
Aldi/Iceland, Cleveland Gate Retail Park, Gainsborough	Retail Warehouse	6,424	6,048	3,655	5,150	5,725	5,725	6,300	5,750
303 High Street and 2 Waterside South, Lincoln	Retail	6,010	5,665	3,419	3,734	3,400	2,850	2,950	2,750
3&4 The Sector, Newbury Business Park	Office	18,802	17,760	0	18,801	17,760	17,435	18,010	14,350
Sainsbury's, High Street, North Allerton	Retail	7,463	7,050	0	7,460	7,050	7,050	7,185	6,835
Ruddington Fields Business Park, Mere Way, Nottingham	Office	6,931	6,545	0	6,931	6,580	6,750	7,200	6,700
Total Portfolio Expenditure Outlay at Purchase		**62,083**	**58,584**	**8,919**	**58,034**	**55,610**	**54,810**	**58,985**	**51,465**



Appendix C

Montagu Evans – Quarter One Financial Year 2023/24 Market Analysis

MARKET UPDATE

UK ECONOMIC OVERVIEW

ECONOMIC PERFORMANCE & IMPACT ON REAL ESTATE

UK GDP is estimated to have grown by 0.2% in April 2023, after a fall of 0.3% in March 2023. Looking at the broader picture, GDP grew by 0.1% in the three months to April 2023, and annual GDP output is estimated to have grown by 4.1% in 2022, following growth of 7.4% in 2021.

The UK narrowly avoided falling into a recession in 2022, which is defined as two three-month periods of GDP shrinking in a row. Although the economy is in a better position than forecasters expected, families and businesses continue to feel the pressure of rising bills.

(UK GDP. Source: ONS)

CPI rose by 8.7% in the 12 months to May 2023, unchanged from April 2023. Despite inflation remaining flat, economists had widely predicted a fall in the inflation rate to 8.5% in the year to May. It is also still four times higher than the Bank of England's 2% target. The IMF predicts that inflation will not return to the target level until mid-2025, which is later than it had forecast previously.

The Bank increased interest rates in June 2023 for the 13th time since December 2021, with rates rising by 50 bps to 5.0% following May's disappointing inflation figures. It is forecast that rates could climb to as high as 6.0% by the end of the year.

The commercial property market witnessed mixed conditions throughout 2022, as the investment and leasing markets adjusted to the changing macro-economic backdrop. Early signs suggest that investors and occupiers still remain active, albeit the reality of the increasing cost of living and rising expenses for businesses mean that disposable incomes and margins will be negatively impacted. As a result, market activity is likely to be adversely affected as businesses look to contain costs, at least until inflationary pressures ease. This will almost certainly impact rental growth in the short term.

SECTOR SPECIFIC OVERVIEW

HIGH-STREET RETAIL

The High Street sector's difficult set of challenges during the course of, and off the back of the pandemic were well-documented as many retailers on the high street were not able to trade during the mandatory national lockdowns, revenues dramatically decreased.

Retailer's online platforms boomed throughout this period as a result of changing consumer patterns which have now settled into an established alternative to in-store retail with a broader consumer base.

Following on from the Covid era, the road to recovery has not been easy with retailers facing a combination of new challenges including the cost-of-living crisis, high wage inflation, industrial action and rapidly increasing energy bills with weaning government support. The combination of these challenges in addition to decreased consumer confidence has led to considerable volatility in the relationship between in-store and online retail.

In April 2023, UK retail footfall was 4.7% higher than the same month in 2022, according to Springboard data. Compared to April 2019, footfall was down by 12.0%. High streets saw a 4.6% increase in April footfall on an annual comparison, while shopping centres were up by 6.6% and retail parks by 2.9%. Springboard said footfall on weekdays has suffered due to hybrid working.

KEY STATISTICS

- Footfall figures witnessed an increase of 16.1% year-on-year.
- MSCI retail rental growth index grew by 0.04% in March 2023.
- Retail investment volumes totalled £6.8 billion in the year to March 2023.
- Retail capital values have rebounded in March 2023 with the MSCI index showing a rise of 0.72% month-on-month in March 2023, compared to a fall of 0.45% in February 2023. The return to growth was entirely drive by retail warehouses.

SUPERMARKETS

The food sector has retained a strong, resilient position in the past few years with sales forecasts predicted to grow 3.8% in 2023, reaching £180.6 billion (Source: Retail Economics). Retailers are reporting further shifts in shopper behaviour as consumers shy away from online (a marked change from pandemic-induced lockdown habits), preferring physical stores, including the discounters in order to find best value.

In the occupational market, the return of superstore requirements has emerged as national multiples continue to be acquisition-hungry. Stores offering omnichannel characteristics, including the ability to fulfil online orders, are increasingly important within major retailers' strategies moving forward. The increased occupier demand has translated into rental growth on food stores. This is more evident in London where pressures on land means diminished supply. Increased build costs and weakened yields further pushes rental growth as retailers increase their rental bids so that developers can achieve viability.

In the investment market, where there is long income secured to strong covenants, there is an increasing depth of investor demand, notwithstanding general market uncertainty. However, investors do remain focused on the quality of location, trading fundamentals, sustainable rents, omnichannel capability, alternative use potential covenant strength and increasingly the recent takeovers of Asda and Morrisons. The market correction, commencing in May 2022 and intensified in September 2022 as a result of the 'Mini Budget' has had a huge impact on supermarket investment yields. Prime supermarket yields (20+ years, rack rented, RPI indexation, dominant omnichannel stores) are now in the 5.25% NIY territory, compared with 3.75% 12 months ago. A 150bp yield shift at these levels represent a huge loss of value in the order of 25% - 30%.

A buy-side reason for this shift in value is investor's rising cost of capital. Although rates have settled to an extent since the Mini Budget, 10-year gilts and 5-year SWAPS are now trading at c. 3.3% and 3.5% respectively, a huge increase since the beginning of February 2022 where both were trading at around 1.3%. These huge swings in value have led to a step-change in the levels investors are willing to pay for prime supermarket assets, and clearly an appropriate discount for non-prime assets thereafter.

KEY STATISTICS

- From January-April, investment volumes hit £804.1 million.
- Aldi and Lidl have seen greater than double the year-on-year growth of any other UK grocer in May 2023.
- Large supermarkets have seen an average reduction of -15% in business rates.
- Overall profit of major supermarket brands has been affected as operators commit to shielding customers from inflation by keeping prices low.

INDUSTRIAL

The UK Industrial & Logistics Property market has weathered the challenges presented by Covid-19 well over the past 24 months, with positive sentiment and activity continuing to be driven by:

- Acceleration of Online/ E-comm operations
- Desire for overseas operators/ businesses to secure a physical presence in the UK
- Manufacturers' need to hold more inventory within the UK to mitigate any potential future delays at the UK border.

Following a strong economic rebound in 2021, 2022 proved to be a challenging year for both the occupational and investment markets with slowing economic growth, sharp increases in inflation and Bank of England Rates.

During the current market correction, the industrial sector has seen values fall the most out of the three main commercial property sectors since the June 2022 market peak. A predominant factor is the slowdown in the acquisition of Big Box units that was prevalent in 2022 and has continued into 2023 as a result of hindered activity. However, this is not a cause for major concern as the multi-let and mix box market caters for a wide range of occupiers and in many major urban markets, the stock of land available to meet demand has been in decline for a long time. At the end of March 2023, there was a 7% increase in supply compared to six months ago but 2% down on 12 months ago. This suggests the pressure on occupiers looking for good quality warehouse space will remain, which will subsequently see rents remain robust for prime stock.

Therefore, even as the economy potentially slides into a recession, supply and demand dynamics are still widely expected to underpin growth in the medium-term.

KEY STATISTICS

- Take-up across the UK for Grade A space over 100,000 sq ft reached circa 8 million sq ft in Q1 2023 – a 49% increase compared to the same period last year and 13% ahead of the 5-year quarterly average.

- The MSCI industrial rental growth index grew by 0.73% month-on-month in March 2023 compared to 0.55% in February 2023. This was the strongest rental growth from the main sectors but marks a slowdown on last summer.

- Investment volumes in the industrial sector reached £11 billion in the year to March 2023, down from £13.1 billion in the year to February 2023.

OFFICE

Occupiers are continuing to assess their occupational need as the widespread pandemic-driven hybrid working model transitions into the post-covid working environment. For some, this has seen a return to the office full time whereas as others have chosen to retain remote and flexible working options.

Buyers continue to favour high quality stock, with secondary assets posing significant challenges for buyers, both in terms of tenant attraction/retention, as well as capex risk owing to increasingly stringent environmental legislations imposed by the government. Grade A space accounted for 68% of take-up recorded in 2022, which was the highest proportion since 2018. As such, yield disparity between prime and secondary offices has continued to widen. Additionally, ESG credentials continue to be very high on investor and corporates agendas, whereby assets need to already deliver on these criteria, or it be part of buyers' business plans to deliver best-in-class assets. This is driving a significant polarity in pricing between prime, institutional grade assets, and secondary stock.

Over the next 6-12 months, the following trends are expected to be seen:

- Yields to begin to stabilise as inflation slows and interest rates moderate.

- Experienced cash buyers buying from forced sales at significantly discounted prices.

- UK assets more appealing to overseas buyers due to weaker Sterling.

• Continued demand for assets that deliver on the ESG agenda from both occupiers and investors – this will drive rental growth and pricing resilience in best-in-class buildings.

• Continued need for an Alternative Use Value (AUV) underpin and repurposing where required.

KEY STATISTICS

▪ The MSCI Market Rental Growth Index for offices increased by 0.17%, compared to a rise of 0.19% in February 2023.

▪ Investment volumes in the year to March 2023 totalled approximately £11.1 billion across the UK office market. This is down on the £13.4 billion invested in the year to February 2023.

▪ The MSCI Capital Growth Index for offices decreased by 0.86% month-on-month in March 2023, compared to the February 2023 figure of -1.11%. This marks the nineth consecutive negative monthly figure, although the rate of decline peaked in October and has slowed since.

RESIDENTIAL

Following tentative signs of improvement in April, annual house price growth softened again in May, falling by 3.4% (from -2.7% in April). However, this largely reflects base effects with prices broadly flat over the month after taking account of seasonal effects. Average prices remain 4% below their August 2022 peak.

The housing market looks set to slow in the coming quarters as pressures on household budgets intensify and labour market conditions start to soften, while mortgage rates remain well above the lows prevailing at this point last year. Over the last few weeks, the average two-year fixed residential mortgage was 6.26% and the average five-year fixed residential mortgage rate was 5.87% as of the 27th June 2023. Increased rates have added to stretched housing affordability at a time when household finances are already under pressure from high inflation.

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While activity is likely to remain subdued in the near term, Nationwide are not expecting a dramatic downturn in the housing market, given that labour market conditions remain solid and household.

Appendix D

Property Portfolio 2023/24 Annual Rentals as Reported at Quarter One

Extract from Montagu Evans quarterly performance report.

TOP 10 TENANTS BY RENT

The table below highlights the top 10 tenants within the portfolio which is assessed off their rental income as a percentage of the total portfolio income. The table highlights the level of rental exposure to each of the top 10 tenants and their most recent Dun & Bradstreet (D&B) rating, which comprises a risk indicator for financial covenant strength.

D&B is one of a series of business credit rating agencies and provides in depth information on business financial covenants. The standardised rating system used by D&B assesses a firm's fiscal size and overall creditworthiness, and is split into two parts:

Tenant	Asset	D&B Rating	Rent (pa)	Years to expiry	Years to break option
Wincanton Holdings	79 Bath Road, Chippenham	5A2	£554,250	4.30 years	4.30 years
Computerland UK Ltd	Ruddington Fields Business Park, Mere Way, Nottingham	4A3	£444,174	6.22 years	6.22 years
Sainsburys Supermarkets Ltd	Sainsbury's, High Street, North Allerton	5A1	£437,500	8.47 years	8.47 years
Cirrus Logic (1st)	3&4 The Sector, Newbury Business Park	5A2	£336,708	7.93 years	2.93 years
Mitsubishi HC Capital	3&4 The Sector, Newbury Business Park	5A1	£288,930	6.22 years	6.22 years
Signet t/a Ernest Jones	303 High Street and 2 Waterside South, Lincoln	5A1	£270,000	3.76 years	0.76 years
Aldi	Aldi/Iceland, Cleveland Gate Retail Park, Gainsborough	5A2	£238,956	4.49 years	2.49 years
Rontec	Dudley Port Petrol Filling Station, Tipton	5A1	£220,816	5.75 years	0.00 years
Lloyds Bank Plc	Lloyds Bank, 104 Terminus Road, Eastbourne	5A1	£175,000	3.72 years	0.72 years
Cirrus Logic (GF)	3&4 The Sector, Newbury Business Park	5A2	£160,080	8.00 years	3.00 years

Financial Strength – Based on Tangible Net Worth from a company's latest financial accounts. Financial Strength is denoted by a number and a letter i.e. 5A, 4A, 3A etc. and relates to a range of Tangible Net Worth. 5A reflects a Tangible Net Worth of >£35,000,000, 4A reflects a range between £15,000,000 and £34,999,999, and so on as the scale continues.