

AUDIT AND RESOURCES COMMITTEE

Tuesday, 19 July 2022

PROPERTY PORTFOLIO REVENUE UPDATE

Report of the Lead Asset Manager

Recommendation

It is recommended that the Committee:

- 1) consider this report detailing performance relating to the Council's Property (non-housing) Portfolio;
-

Summary

This biannual report provides an update on the Council's Property Portfolio including a summary of the current position of payment plans relating to Covid-19 rent arrears. It provides an update on the commercial property market and details economic and other issues affecting the portfolio. The report outlines steps being taken to manage and mitigate risks to ensure long-term sustainability of the portfolio.

Statutory Powers

Local Government Act 1972

Strategic Implications

1. Income generated by the Council's Property Portfolio helps to support delivery of strategic objectives set out in the Council's Corporate Plan 2015-2025 and wider corporate objectives, including social and physical regeneration, economic development and safeguarding strategic influence and future development opportunities. This report provides an update on the current status of the property portfolio particularly with regards to rental income and actions being taken to protect income and to ensure a fit for purpose property portfolio in the longer-term.

Introduction

2. This report provides an update on the Council's commercial property portfolio including the position with rent arrears resulting from Covid 19, specific issues affecting the portfolio and the outlook for the commercial property market in

general. The previous update was provided to Audit and Resources Committee on 11 January 2022.

Current Market Conditions and Risks by Sector

3. Appendix A provides a breakdown of the Council's Property Portfolio by Sector. The Council has a large and varied property portfolio achieving over £16 million in gross annual rental income (including non-Corporation Estate Properties used for service provision).
4. The property market appeared to be on its way to recovery from the pandemic, however there is now evidence of a slowing economy with the sharp rise in inflation and Russia's war in Ukraine. The commentary below provides an update on the UK property market in general and advises how this is reflected in the Council's property portfolio.

Retail Sector

5. The initial stages of the pandemic brought about major divisions in the subsectors of the retail sector with food stores increasing in value and high street retail seeing a significant decrease. The last year has established a rebalancing of some of the subsectors with retail values and investment values in the larger more modern shopping centres and cathedral towns significantly increasing.
6. However, there continues to be a lack of occupier demand from national operators for the older shopping centres in smaller town centres such as the Swan Centre in Eastleigh. This is not helped by the high rates liabilities usually found in such centres and where new leases are being agreed these are often upon very favourable terms to the tenant which is driving down values further.
7. An increasing number of former retail developments are now being redeveloped for alternative uses such as student housing and private rented accommodation.
8. Demand for retail warehousing remains at a good level with a number of larger retailers such as Home Bargains, Aldi and Iceland actively expanding and seeking units in areas where they have no current presence. This is helping to keep rental values steady and has led to an increase in investor demand for such units driving down yields. The Council's retail warehouse units all remain fully occupied. In the main, the retail investments within the Council's property portfolio are not high risk and fall into the subsectors which are performing well.

Office Sector

9. The situation has not changed substantially from our previous report. The market is generally recovering and 2021 saw a larger take up of accommodation than 2019, although demand is still very focused on quality.

10. Firms are generally seeking to reduce their overall space and the greatest demand is in the sub 5,000 square feet market. Demand is stronger for high quality city centre offices with good transport links and green credentials being highly sought after. With the high costs of development, little new space is coming to the market and supply of good quality older buildings is low with much of the older stock being converted to residential use and even redeveloped for industrial use in some cases. However, whilst rents for prime properties are increasing, investment values are generally reducing, most likely due to the ongoing uncertainty as to future demand. Average yields have seen an upward movement of around 1.25% to 8.5% over the last couple of years. There is an opportunity to sustainably refurbish well-located offices and tempt occupiers to exchange quantity for quality. Prime rents for the best quality space are proving resilient and increasing in many areas, providing a strong case for refurbishing existing assets to counter obsolescence. There are several office buildings within the Council's portfolio, most notably those detailed later in this report, for which active management strategies are being put into place to ensure the properties meet the evolving requirements to maximise income and return.

Industrial Sector

11. The industrial sector, where there is a lack of supply and strong demand, remains the best performing sector of the property market, fuelled by the continuing growth in the online retail market. There is a particular lack of supply in smaller units of under 5000sq ft where building costs are higher. It is predicted that rental growth will continue to be strong over the medium term. Lease terms are generally rising and there is increased demand for units offering ancillary office space. It is expected that prime yields will remain static for the near future at the current 3.25/3.5% level, although there maybe slight increases as investors bear in mind the wider inflationary impacts on occupiers. This is exacerbated by the expected transfer of the business rates burden from retail to industrial property in the next revaluation in April 2023.
12. Industrial land values have grown strongly over the last few years from an average of around £600,000 an acre to £2 million plus per acre in some Hampshire cities, with sites in Eastleigh achieving in excess of £1.3 million per acre. The majority of the Council's industrial portfolio consists of smaller units within secondary estates where demand remains high. The Council have one significant high value industrial unit which is discussed further below.

Leisure Sector

13. The leisure and hospitality market is still in a period of uncertainty with notable variations in subsectors. Some establishments experienced good results in summer 2021 due to limited foreign travel but this is still highly dependent on quality and location.
14. Investment yields over the second half of 2021 to the present date are regarded to have remained relatively steady, although prime London hotels have seen an increase in values after a drop during the start of the pandemic.

15. The national situation is reflected within leisure properties owned by the Council.

Update on the Impact of Covid-19 on the Property Portfolio and Revenue Impacts

16. As previously reported, twelve major tenants experienced difficulties with payment of rent due to the lockdown periods during the pandemic. Payment plans were agreed with each of these tenants covering total arrears of £5,156,594.
17. Of these twelve payment plans, eight tenants have now paid their Covid debt in full. All four of the remaining debtors are making regular payments towards their debt and are on target to clear their debt within the agreed timescales. The total arrears have now reduced to £3,702,311. The last report noted that one debtor was behind with their instalments, however they have now paid their debt in full.
18. Appendix B shows the current summary of the twelve payment plans (as of 18 May 2022) relating to the pandemic. £1,454,283 arrears have been cleared to date with a further £729,332 expected be cleared by the end of the current financial year.

Overall Rent Collection Position

19. Of the total sum of £16,507,041 (rent and service charge) invoiced to tenants in the 12 months between 1 April 2021 and 30 March 2022, £15,582,305 had been collected as of 19 May 2022 equating to 94.4%
20. This compares to 72% having been collected as of 31 March 2021 for the 13 months to 31 March 2021.
21. However, in respect of 2021/22, when the sums subject to Covid payment plans are ignored, the collection rate rises to 98.9% with the majority of the shortfall being due to quarterly invoices issued in March 2022 with payments made monthly in arrears.
22. This is similar to pre-pandemic levels and given that a large proportion of the outstanding debt is covered by payment plans, there is no undue concern regarding collection levels or rent arrears.
23. As previously advised, the deferred payment of debts does not impact the revenue budget and the debt due remains accurately recorded in the relevant financial year. The delayed cash impact of the rental deferrals has no material impact on the revenue budget or cash flow.
24. Whilst the above provides confidence that the total shortfall in income due to the pandemic will be recovered under the payment plans, provision has been made within reserves as discussed in paragraph 29 to cover any shortfall and Asset Managers continue to closely monitor the financial standing of all tenants to ensure potential shortfalls in income can be pro-actively managed.

Property Specific Risks

25. One of the Council's major industrial tenants has recently gone into administration. The business and assets of the tenant have been sold to another company who propose to continue the business operations of the previous tenant. The new tenant currently occupies the premises and discussions are underway concerning their longer-term occupation.
26. Asset Managers continue to review the property strategy for void buildings to ensure that any works to be undertaken will optimise the buildings in line with market requirements. This may include conversion for residential use. The marketing and/or refurbishment of such buildings remains a major focus for Asset Managers in addition to minimising outgoings whilst the buildings remain vacant.
27. With regards to other major events affecting the property portfolio, there are a couple of significant office buildings within the portfolio incorporating break clauses that may be implemented by our tenants within the next 6 months and Asset Managers have adopted a proactive approach to look at ways to avoid such breaks and minimise potential liabilities.
28. It should be noted that specialist advice is sought from external consultants in respect of major transactions where this is considered necessary.

Earmarked Reserves

29. The total property reserves currently stand at £8M, which includes reserves for specific property maintenance and voids. This is considered to be an adequate additional allowance in the current economic climate, particularly whilst the majority of rents are being paid, albeit that some have payment arrangements in place.

Risk Assessment

30. There continues to be an element of ongoing risk and uncertainty relating to the economic situation which could have a significant impact on current and future rental receipts from the Council's property portfolio. This report reflects the current situation. As far as possible, steps have been taken by staff to identify and mitigate risks to ensure there are sufficient property reserves to protect against lost income and to future proof the portfolio to ensure it meets the changing needs of future occupiers.
31. The pandemic has brought substantial pressures on asset management staffing resources and, in order to manage and mitigate the impact to the Council's Property Portfolio, this work continues to be prioritised. This has been a challenging period due to staff vacancies and absences, during which the team have shown their ongoing commitment by stepping up to in order to

cover gaps. It is important to keep resource within the service under continuous review to ensure there is sufficient capacity to proactively manage the Council's property assets, together with providing specialist strategic property support and advice to other service areas and corporate projects, in order to meet wider corporate priorities.

Equality and Diversity Implications

32. The Equality Act is not relevant to the decision in this report as the decision does not relate to eliminating discrimination, advancing equality of opportunity, or fostering good relations between different people. An Equality Impact Assessment has not been carried out.

Climate Change and Environmental Implications

33. Where possible in any property negotiations, Asset Managers seek to ensure appropriate terms and conditions are incorporated to help meet the Council's target of becoming a carbon neutral Council by 2025. In addition, a balanced and sustainable Revenue Budget and Medium-Term Financial Plan (MTFP) enables delivery of the Council's strategic objectives which include supporting the Climate Change Programme.

Conclusion

34. Given the particularly challenging commercial environment over the last few years and reduced capacity due to vacancies and absences within the team, Asset Managers have worked well to maintain the income stream from our investment properties. Whilst there is evidence of a steady recovery within the real estate markets, with growing investor demand and improving occupier trends, specialist staff continue to keep a careful watch over the status of our tenants, including a close analysis of the altered covenant strength as a result of the pandemic, in order that reductions in income can be anticipated and managed as far as possible.
35. Provision for the anticipated reduction in income has been made to protect the Council's financial position.
36. Asset Managers continue to review market changes and to engage with tenants and potential occupiers to ascertain the extent of business change and future property requirements to ensure that the Council have a fit for purpose property portfolio to support the delivery of Council services.

JACQUI BAXTER MRICS
LEAD ASSET MANAGER

Date: 28.06.2022
Contact Officer: Sharon Bishop
Tel No: 023 8068 8249
e-mail: sharon.bishop@eastleigh.gov.uk
Appendices Attached:

Appendix A: Portfolio Breakdown

Appendix B: Payment Plan Summary

LOCAL GOVERNMENT ACT 1972 - SECTION 100D

The following is a list of documents which disclose facts or matters on which this report or an important part of it is based and have been relied upon to a material extent in the preparation of this report. This list does not include any published works or documents which would disclose exempt or confidential information.

Background Papers: None.