Appendix A

Corporate Asset Investment Fund

ANNUAL REPORT 2017/18

Leicestershire County Council

Building Business. **Boosting** Communities.

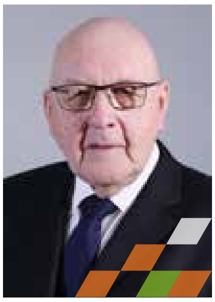
FOREWORD

The council has a long and strong track record in owning and managing property. Over the past 12 months, we've stepped up our approach to investment and our portfolio has grown from £43m to £101m – not only boosting the local economy but also generating vital income for front line council services.

Our premises range from office to industrial and from development opportunities to the rural sector. Businesses want quality accommodation – and we know that start-ups are looking for space, and that firms want to expand. By bringing new life to old commercial sites – and building new workspaces - we're making it attractive for companies to set up shop in Leicestershire, creating hundreds of jobs and investment. Multi-million-pound business parks in Market Harborough and Coalville are already moving forward, and more are on the way. Innovative plans to build a 62-acre solar farm – producing clean, green energy – are also under development.

Our portfolio is performing well - and an above average return of nearly 12 per cent generated £2.7m of net income in 2017-18 as well as significant capital growth. We're ploughing this money back into our front line services to reduce the impact of national funding reductions. It means we can spend extra cash tackling potholes, bringing down the cost to business and inconvenience to people who use our roads, and bolster social care services, supporting vulnerable people.

Leicestershire is the lowest funded county in the country, meaning our scope for savings is limited. This report underlines that by being more commercial and innovative, we're not only boosting Leicestershire's economy, but also doing everything we can to lever more funding for our Council Taxpayers.



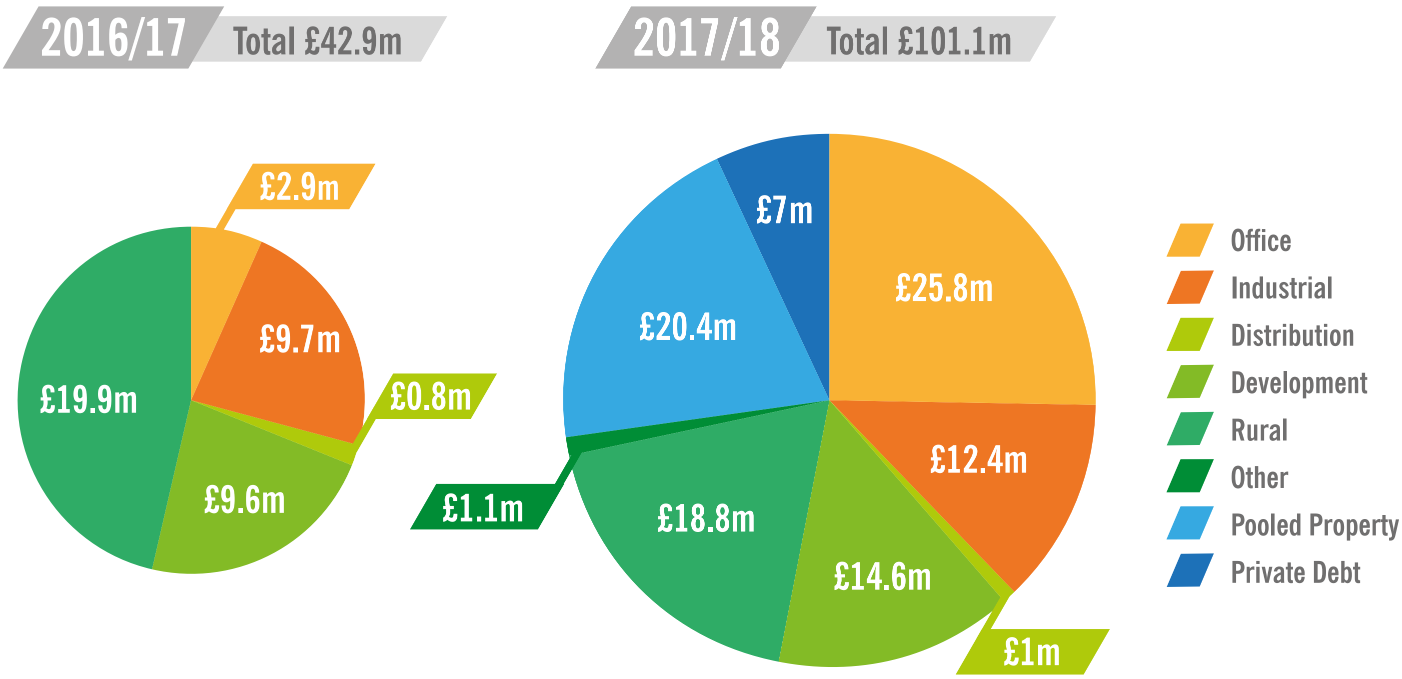
Byron Rhodes
Deputy Leader
Leicestershire County Council

SUMMARY

This report forms the annual review of the Corporate Asset Investment Fund (CAIF) portfolio, reporting on the property performance for the year to 31st March 2018.

The CAIF is fundamental to the economic, social and environmental wellbeing of the people of Leicestershire especially given the current financial climate coupled with service demand growth (56.3% reduction in government funding for local authorities by 2019-20 (CIPFA). The income generated by investment in high quality property assets provides increased financial resilience and will underpin the Council's ability to deliver a comprehensive range of quality services in the future.

The report examines the development and performance of the overall property portfolio, the potential of the future investment programme to deliver enhanced returns and the future outlook for the wider investment market and how it might impact on investment strategy.



As at 31st March 2018, the capital value of the property portfolio was £101.2 million compared with the value as at 31st March 2017 of £42.9 million which represents a net uplift of £58.3million (135% increase).

Capital Value of Fund

	Value at 31st March 2017 (£m)	Transactions			Transfer (£m)	Valuation Change (£m)	Value at 31st March 2018 (£m)
		Acquisitions (£m)	Capital spend (£m)	Sales (£m)			
Office	2.9	23.9	0.1	-	-	-1.1	25.8
Industrial	9.7	-	0.4	-0.3	-	2.6	12.4
Distribution	0.8	-	0.2	-	-	-	1.0
Development	9.6	2.3	0.2	-	-	2.5	14.6
Rural	19.9	-	0.7	-5.2	-	3.4	18.8
Other Prperties	-	-	-	-	1.1	-	1.1
Pooled Property	-	-	-	-	19.2	1.2	20.4
Private Debt	-	7.0	-	-	-	-	7.0
TOTAL	**42.9**	**33.2**	**1.6**	**-5.5**	**20.3**	**8.6**	**101.1**

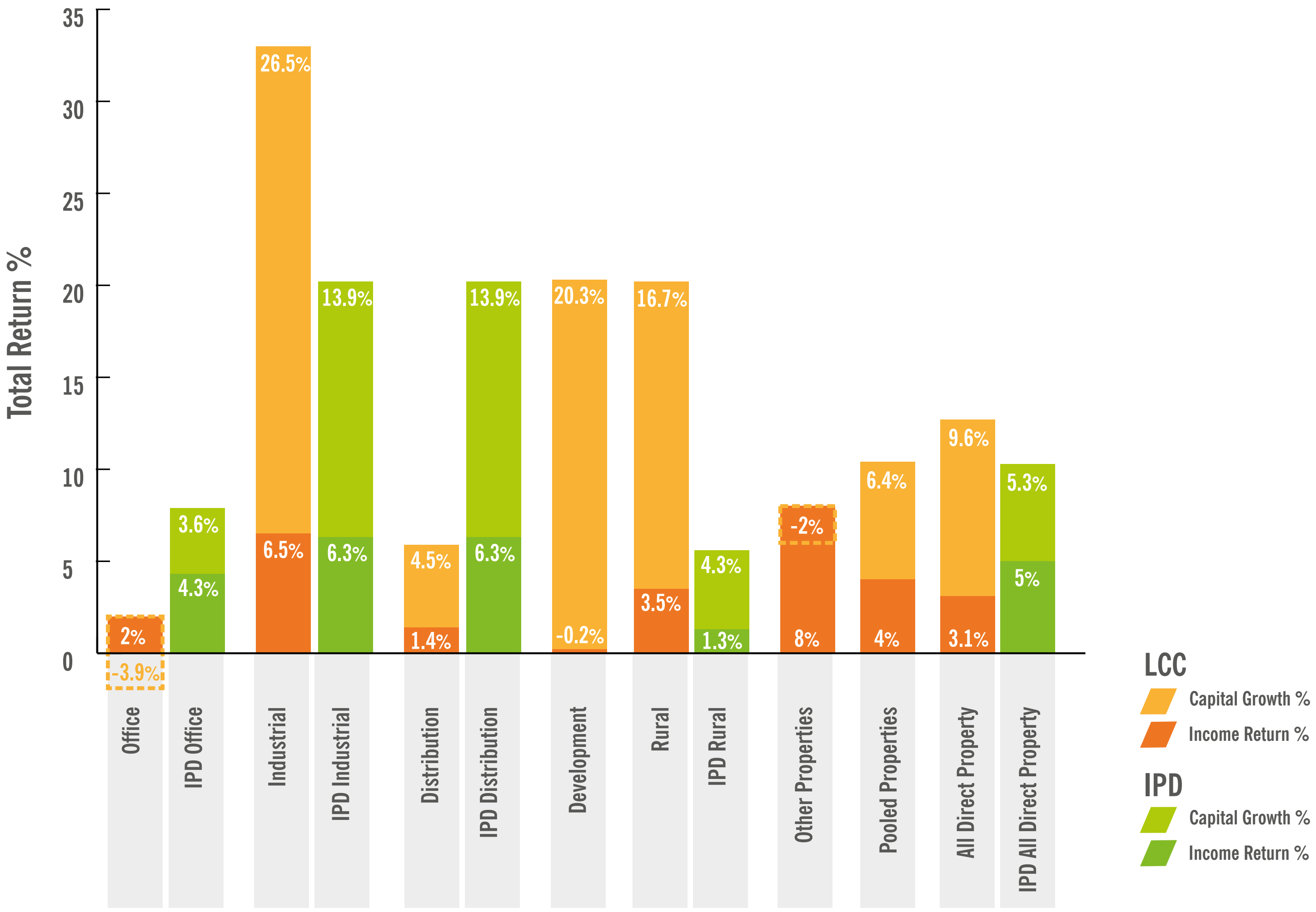
Comparisons between years on capital valuations are affected by a change in valuation rules between years. This won't impact on comparisons in future years.

At 31st March 2018 the Fund held direct property assets of £73.7 million together with pooled property fund and private debt investments totalling £27.5 million.

Net income from the Fund has increased to £2.7m over the year as a result of investment acquisitions and rental income increases (net of income producing disposals). This is expected to grow to about £10m per year by 2022 as developments are completed and tenants secured.

In addition to the increase in the value of the Fund, the balance between sectors also showed a significant shift from the pattern that existed at the start of the year reflecting the influence of the purchases, disposals, transfers of other property in the Fund, changes in valuation that occurred during the year. These changes can be seen in the pie charts above

There were two significant acquisitions during the year (multi let office schemes in Lichfield and Nottingham).



- It is estimated that the internal costs of managing the Fund's assets total £0.35m. These are not included in the table below but if it was it would reduce the overall income figure from 2.8% down to 2.5%;
- The projected income returns for Offices are constrained by the Lichfield South and Embankment House as both assets were acquired in Quarter 4. Also, there was no appreciable capital growth in the year. Furthermore, the initial costs of acquisition over and above the capital valuation result in an overall negative capital performance (for the portion of the year that the assets were held). Assessment of the future capital performance of these assets over a full financial year will result in a true indication of capital growth and income performance for future years.
- Development income is low but this reflects the fact that tenants won't be in place until the development is complete. However, the high capital yields reflect the future earning potential from the sites;
- The investment in Private Debt was made late in the financial year and so it is too early at present to properly assess the performance;
- Overall, the Fund produced a total return for the year to 31st March 2018 of 11.8% compared to the IPD All Property Quarterly Index of 10.3.

Fund Performance

	LCC			IPD Comparator		
	Income	Capital	Total	Income	Capital	Total
Office	2.0%	-3.9%	-1.9%	4.3%	3.6%	8.3%
Industrial	6.5%	26.5%	33.0%	6.3%	13.9%	20.2%
Distribution	1.4%	4.5%	5.9%	6.3%	13.9%	20.2%
Development	-0.2%	20.3%	20.1%			
Rural[1]	3.5%	16.7%	20.2%	1.3%	4.3%	5.6%
Other Properties	8.0%	-2.0%	6.0%			
Pooled Property	4.0%	6.4%	10.4%			
All Direct Property	3.1%	9.6%	12.7%	5.0%	5.3%	10.3%
Private Debt	-	-	-			
TOTAL	**2.8%**	**9.0%**	**11.8%**	**5.0%**	**5.3%**	**10.3%**

[1] IPD comparators not available for Rural – Figures quoted are Savills England Wales Benchmark report 2018

CHANGES TO THE PORTFOLIO DURING THE YEAR

Summary of Changes

During the year, the property portfolio increased in value from £43m as at 31st March 2017 to £101m as at 31st March 2018. This increase was due to a combination of valuation changes and further investment in assets and indirect holdings, as set out in the chart below.

Value at year start
£42.9m

Change during year
£58.2m

Value at year end
£101.1m

Net transactions
£27.7m
Purchases £33.2m
Sales -£5.5m

Valuation/transfer change
+£28.9m

Miscellaneous net capex
+£1.6m

Transactions During the Year

Direct property acquisitions

Lichfield South

Description	42,943 sq ft of Offices
Completion Date	28th December 2017
Purchase Price	£10,800,000
Rental Income	£805,971 per annum
Yield	7%

Embankment House Nottingham

Description	59,448 sq ft of Offices
Completion Date	23rd February 2018
Purchase Price	£11,850,000
Rental Income	£879,940 per annum
Yield	7%

In addition, the Fund acquired Walton Holt Farm and 23 acres of potential development land at Lutterworth.

Private debt acquisitions

In December 2017, the Cabinet agreed to use cash balances to make an investment of £20m in Private Debt. By the 31 March 2018, a total of £7m had been invested with the balance due to be invested in early 2018/19.

Investment in Private Debt funds will provide an increase in the interest earned relative to what could be earned by utilising cash deposits [with banks and other counterparties]. Private Debt can be broadly defined as loans from one party to another that are not tradeable on a recognised securities exchange. For many years the banking sector originated the vast majority of debt required by medium-sized companies (who are the main borrowers from the Partners Group funds) but a much tighter regulatory capital regime means that there are now attractive investment opportunities for investors with capital to commit to the asset class.

Disposals

In line with agreed strategy, the following disposals were achieved during the year and resulted in total capital receipts of £5.38 million through a combination of realising development potential and the restructuring of the farms and industrial portfolios.

Property	Disposal Date	Receipt	Sector
Springboard Centre, Coalville	22nd June 2017	£310,000	Industrial
Limes Farmstead, Kilby	6th October 2017	£550,911	Rural
Land at Heather Lane, Ravenstone	3rd April 2017	£2,108,000	Rural
Land at Ashby Road, Ullesthorpe	22nd March 2018	£2,200,000	Rural
Buildings, Walton Holt Farm	21st February 2018	£210,000	Rural

Transfers

Other properties

A number of existing properties that are owned by the authority, but were held outside of the Corporate Asset Investment Fund, have been transferred into the fund during the year. These are shown in the table below.

Property	Value 31/3/18
Nanpantan nursery	101,000
Epinal Way, Loughborough	405,000
Glebe House, Loughborough	386,000
Swallow Walk, Hathern	99,000
Cotton Croft, Shepshed	99,000
Geeta Bhawan Centre, Loughborough	25,000
TOTAL	**1,115,000**

Pooled property

The authority's investment in Pooled Property was also previously held outside the Fund. During 2017/18 they have been transferred in. Details are shown below.

Product	Value 31/3/18
Hermes Property Unit Trust	7,800,000
Lothbury Unit Trust	7,600,000
Threadneedle Unit Trust	5,000,000
TOTAL	**20,400,000**

PERFORMANCE AND COMPARISON AGAINST INDUSTRY BENCHMARK

The Fund's benchmark is the "All Property" total return (capital growth plus income return) of the IPD Monthly Index (All Assets). The total return for the property portfolio for the year to 31st March 2018 is 11.8%, 106 bps in excess the IPD Monthly Index benchmark total return of 10.3%.

Office Sector

The office sector was relatively small at the commencement of the year comprising 20% of the commercial portfolio. During the year, as a result of strong demand for premises in the Loughborough Technology Centre and positive rental growth the sector a total return of 16.6% (IPD Office return 7.9%). With the purchase of Lichfield South and Embankment House, increasing its proportion of the commercial portfolio to 36.9%, the performance of the office sector will have a major influence on future year's results.

Industrial Sector

In common with the general market, the Industrial sector was strong in the year to 31st March 2018 producing a total return of 14.2% (IPD Industrial return 19.6%) . Demand and rental growth have both remained strong during the year for all grades of property within the sector which coupled with the strong demand for pre-lets of those units under construction underlying market conditions seem set to continue.

Rural Sector

Once again the rural sector has performed very well producing a return of 31.6% (rural benchmark figures yet to be released). Income return was strong at 13.3%. Capital growth at 18.3% results largely from the realisation of development potential with the expectation that positive results will continue in the medium term.

PORTFOLIO REVIEW

Current Yield

The current yield from the portfolio is 6.0% compared to IPD at 5.7%. Yields fell slightly during the year, both for the Fund and in the IPD index, but the relative margin was largely maintained.

Sector Proportions (indirect holdings apportioned to their relevant sectors)

The effect of purchases, sales and movements in value during the year has resulted in a significant shift in the sector weightings as illustrated earlier in the report. The long term aim is to maintain a balance between sectors that maximises the potential for achieving financial resilience. However, during the year to 31st March 2018 given the primary aim of increasing both the extent and quality of the portfolio over a relatively short time frame, the Fund has focussed on the purchase of assets that deliver the prospects of good long term income, sound tenant covenant and produce a better than market yield rather than maintaining the desired sector balance. Over time as new developments and further acquisitions come on stream it is envisaged that the desired long term balance will be restored.

Rent Reviews and Lease Expiries and Tenant Only Breaks

There are 37 rent reviews, 11 lease expiries and 20 tenants only break options that are falling due this financial year. The negotiations regarding the reviews, lease renewals and dealing with the break options will form part of normal day-to-day property management.

Future Investments

During the year the CAIF has on the basis of further funding made available through the Medium Term Financial Strategy (MTFS) committed to the following investments that will have the effect of further transforming the portfolio, achieving excellent rates of return and delivering significant additional income.

In addition to further phases of investment at Airfield Farm Business Park and Leaders Farm, Lutterworth, a pipeline of future development schemes have been identified with proposals for the sites at Bardon Interlink and Quorn progressed to the detailed feasibility/business case stage.

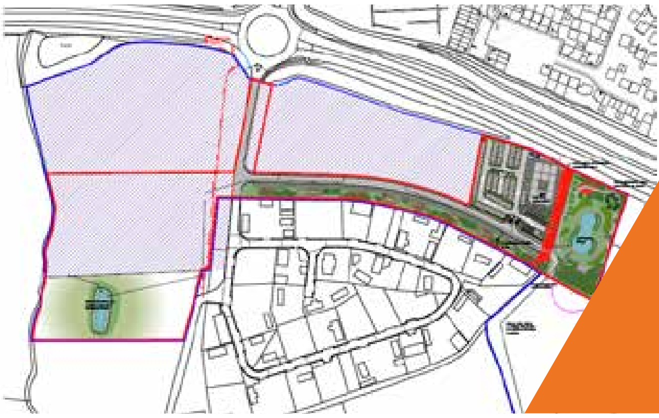
In addition funds have been committed to acquisition of further properties including that required to complete Land Assembly to facilitate the delivery of the East of Lutterworth SDA.

Airfield Farm Business Park (Phase 1)

Description	80,000 sq ft B1/B2/B8 units
Completion Date	September 2019
Development Cost	£7,130,000
Rental Income	£480,000 per annum
Yield	6.8%

Loughborough Science and Enterprise Park (LUSEP)

Description	100,000 sq ft offices
Completion Date	June 2020
Development Cost	£24,250,000
Rental Income	£1,600,000 per annum
Yield	6.6%



Leaders Farm Lutterworth (Phase 1)

Description	90,000 sq ft industrial units
Completion Date	June 2019
Development Cost	£2,080,000
Rental Income	£140,000 per annum
Yield	6.7%

Vulcan Business Park Coalville

Description	40,000 sq ft industrial units
Completion Date	June 2019
Development Cost	£4,037,000
Rental Income	£325,000 per annum
Yield	8.0%

Voids

With the exception of those properties held vacant to facilitate restructuring or future disposals, at 31st March 2018 the level of voids across the portfolio stood at 3.1% reflecting strong market demand.

Rent Arrears (direct portfolio)

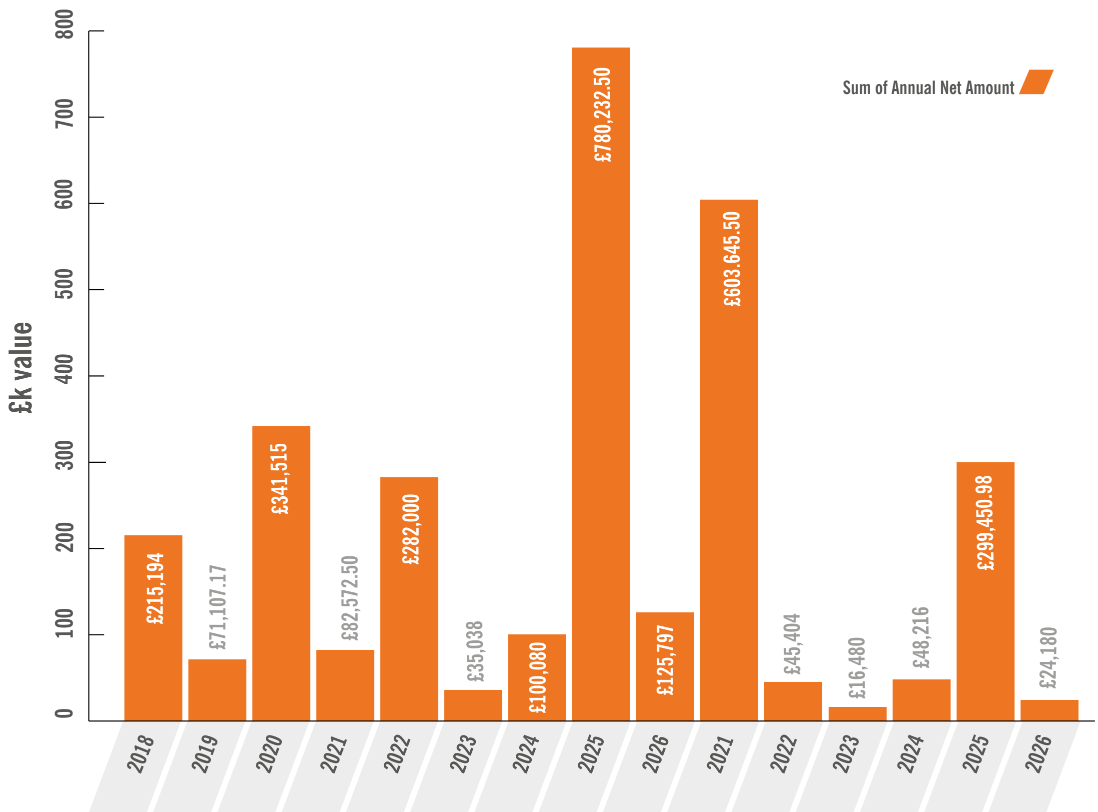
At 31st March 2018 total unsecured 90 day debt amounted to £29,017 which equates to 1.4% of gross income and represents a fall of 0.9% on 2017. Payment of all outstanding debts is being actively pursued through debt management procedures.

In the longer term as the proportion of properties devoted to economic development continues to fall in line with the CAIF Strategy the covenant status profile should improve significantly reducing the fund's exposure to debt risk.

Lease Expiry Profile (direct portfolio)

The graph below shows the percentage of rents held on leases expiring in each year within the portfolio. Where a tenant has an option to break within a lease, we have assumed the worst case scenario that the tenant will exercise such an option, whereas in practice it is likely that not every tenant will elect to do so.

The largest bar in the graph above relates to the year 2025. Income in this year is derived from the tenants in Embankment House, Nottingham. We will approach the tenants in due course to see if the tenants will be renewing their leases.



PROPERTY INVESTMENT MARKET REVIEW

Property Investment Market Review

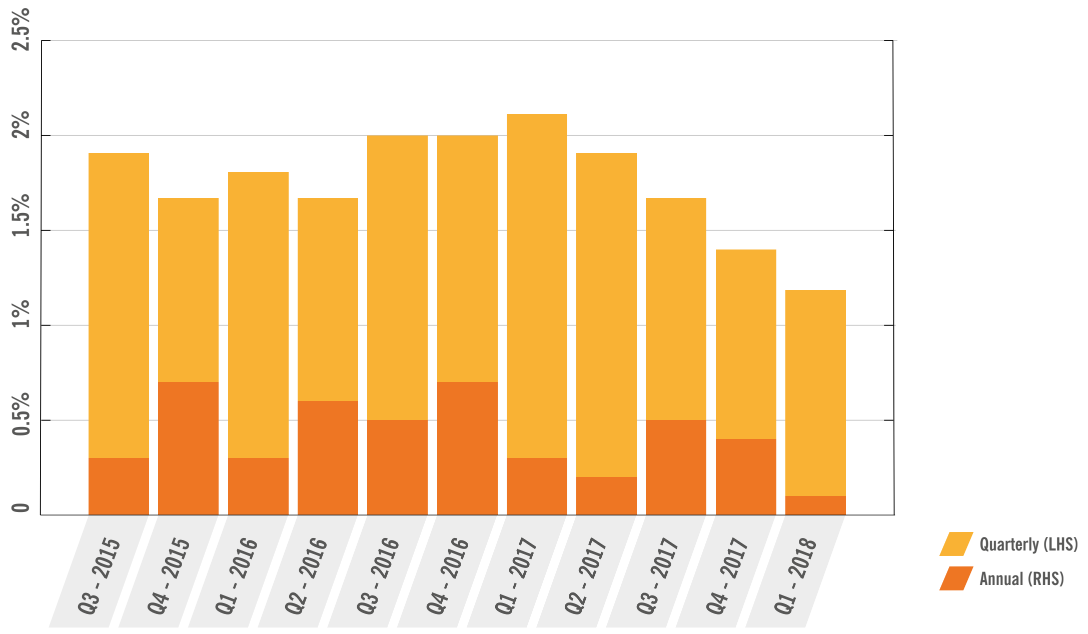


Chart 1 – GDP growth (source : ONS)

Economic growth slowed towards the end of last year (GDP growth figure for Q1 2018 of 0.1%, confirms a slowing down in economic activity over the past year (Chart 1); the main source of growth being the service sector in which transport, storage and communication services performed particularly well. Encouragingly, industrial production increased driven by a rise in manufacturing output in comparison with the construction sector which has now experienced three successive quarters of negative growth.

Household spending growth has remained very subdued and whilst government spending has accelerated business investment is flat and net trade has continued to decline. Performance in the Q1 2018 is likely to be constrained by weather related events in a similar way to those which occurred in 2010 however it is thought that more positive performance will come through in Q2. Business confidence data suggests that sentiment improved at the start of 2018 but remained negative as a consequence of the base rate rise in November 2017 and ongoing political uncertainty.

The pound appreciated by more than 8% against the dollar as a result of the base rate rise. Any further increase in this year is likely to strengthen the pound further. In response annual consumer price inflation has already started to fall back from January's 3% figure. Signs of a return to positive real wage growth are now apparent given falling inflation and under supply in the labour market. As a consequence the potential exists to boost household spending which will be the cornerstone of future economic performance.

Against this background it is anticipated that the economy will experience modest growth of 1.5 - 2% over the period to 2020. These weaker GDP figures have eased any immediate upward pressure on interest rates. The previously strongly anticipated increase in the base rate by the MPC in May did not take place. However, commentators suggest that this has just been deferred rather than cancelled out.

Property forecasts

Commercial property returns are predicted to fall to 6.1% in 2018 down from 10.2% in 2017 comprising 1.2% capital growth and 4.9% income return. At 5.6% yields are expected to remain virtually unchanged due to stable investment demand before rising to 5.8% over the period to 2022. Beyond 2018 returns may fall back further as capital growth flat lines and income becomes the main component of returns. However, this flat projection disguises the significant variations in the future performance forecasts across the main commercial sectors.

Industrial is expected to remain the best performing sector with yield predicted to contract by a further 0.25%. Total returns, including 7.4% capital growth, are expected to reach 12.5%. The ongoing lack of good quality space throughout the country will continue to support rental growth of 3.7% in 2018 and 3.2% over the period to 2022.

A similar picture exists for Distribution with returns of 10.8% predicted for this year and 7% through to 2022.

The office sector is likely to see much weaker returns this year, with total returns across the market falling from 7.9% to 4.7%. However, this reduction is largely attributable to the poor performance predictions for Central London which up to the end of 2017 has remained resilient against an uncertain economic and political backdrop. However, in the coming year Central London rents are likely to be subject to downward pressure and with yields set to move out negative capital growth is predicted. However, within the provincial office market with low vacancies and a limited development pipeline there remains a steady demand for Grade A offices leading to modest rental growth leading to returns of 8.6% being forecast for 2018.

The retail sector will struggle in 2018 with weak consumer confidence and increased costs, especially business rates and staff cost driven by the National Living Wage.

Positive real wage growth by mid-2018 would support a recovery in consumer confidence and bring respite to many retailers. Returns are predicted to be 3.5% reflecting an income return of 5.3% and negative capital growth of -1.7%. Yields are predicted to soften by 0.5% over the next two years as a general repricing of the market driving capital values into negative territory. Changing consumer behaviour and increasing on-line sales are driving the demand for retail warehouse space resulting in stable rents and the prospect of modest capital growth beyond 2019.

The rural sector remains a safe haven for many investors. Whilst in the short term there is strong demand in the let sector and good rental growth in the longer term, with

Britain's exit from the EU, uncertainty around future farm incomes could have significant impact on rental levels and overall returns. However, there is still a good demand for sound investments with good diversification potential.

Investment Strategy Update

The CAIF Strategy was reviewed in 2017 and adopted by Cabinet at its meeting held on 15th September 2017. The key objectives of the strategy are as follows:-.

- Ensuring that there is a more diverse range of properties available to meet the aims of economic development;
- Increasing the size of the portfolio;
- Improving the quality of land and property available;
- Ensuring the sustainability of the County Farms and industrial portfolio by replacing land sold to generate capital receipts; and,
- Providing a revenue income stream that can be used to support ongoing service delivery.

The implementation of this strategy coupled with the development of robust performance monitoring measures will ensure that the portfolio operates effectively and delivers value for money.

CAIF Strategy continues to be reviewed on an ongoing basis to take account of market trends and wider Council strategy in order to maximise the benefits the Fund delivers. An updated strategy is being presented to Cabinet alongside this report.

Leicestershire County Council

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