

Corporate Asset Investment Fund

ANNUAL REPORT 2018/19



FOREWORD

Leicestershire County Council has had another successful year of investing in its Corporate Asset Investment Fund. From a value of £43m at the end of the financial year 2016/17, rising to £102m in 2017/18, the Fund's value has grown to £145m – a rise of nearly £100m in 2 years.

As well as substantial capital growth, the income produced by these investments has also grown significantly from £2.7m pa in 16/17, to £4.7m pa in 17/18 to a new high of £6.9m pa.

What's more, we're now converting the planning permissions we secured last year into buildings.

We are on site with our business parks in Market Harborough and Coalville and they will both be open for business later this year providing 120,000 sq. ft. of new business space for new and existing businesses in the county. The new office HQ for The Access Group on the Loughborough University Science and Enterprise Park is also underway and on target to be completed next Summer.

Overall, our portfolio is performing very well - a total (capital plus income) return of nearly 10 per cent is above the national average for investment funds.

Leicestershire continues to be the lowest funded county in the country and so this continued great performance means we have more ability to fund important services at a time of decreasing funding from central government, boosting Leicestershire's economy and also helping us achieve the aims and ambitions set out in our Strategic Plan.



Byron Rhodes
Deputy Leader
Leicestershire County Council

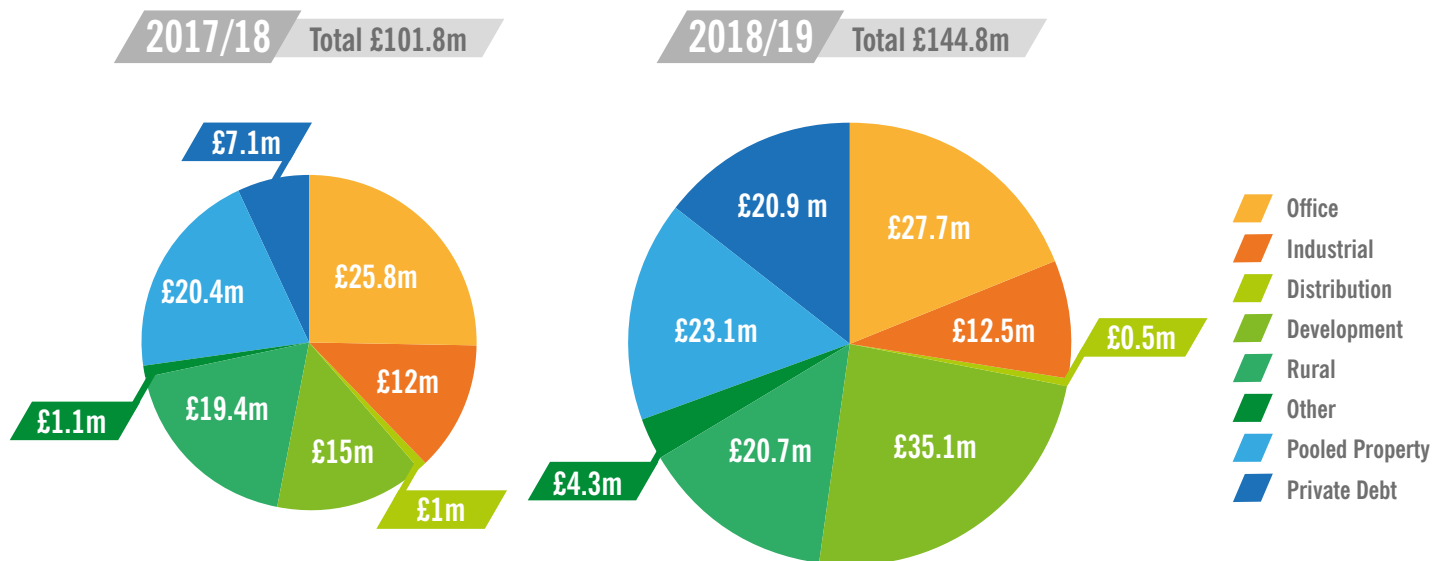
SUMMARY

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 2019.

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. Whilst making a significant contribution to the Council's Strategic Plan 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.

Total Value By Sector



As at 31st March 2019, the capital value of the property portfolio was £144.7 million compared with the value as at 31st March 2018 of £101.8 million which represents a net uplift of £42.9 million following the increase from £58.3 million achieved in 2017/18.

Capital Value of Fund

	Value at 31st March 2018 (£m)	Transactions			Transfer (£m)	Valuation Change (£m)	Value at 31st March 2019 (£m)
		Acquisitions (£m)	Capital spend (£m)	Sales (£m)			
Office	25.8		0.1	-	-	1.8	27.7
Industrial	12.0	-	0.1	-0.4	-	0.8	12.5
Distribution	1.0	-	-	-	-0.5	0	0.5
Development	15.0	6.2	11.3	-	0.5	2.0	35
Rural	19.4	-	0.7	-2.0	-	2.6	20.7
Other Properties	1.1	3.1	-	-	-	0.1	4.3
Pooled Property	20.4	2.5	-	-	-	0.2	23.1
Private Debt	7.1	13.0	-	-	.	0.8	20.9
TOTAL	101.8	24.8	12.2	-2.4	0	8.3	144.7

At 31st March 2019 the Fund held direct property assets of £100.7 million together with pooled property fund and private debt investments totalling £44.0 million.

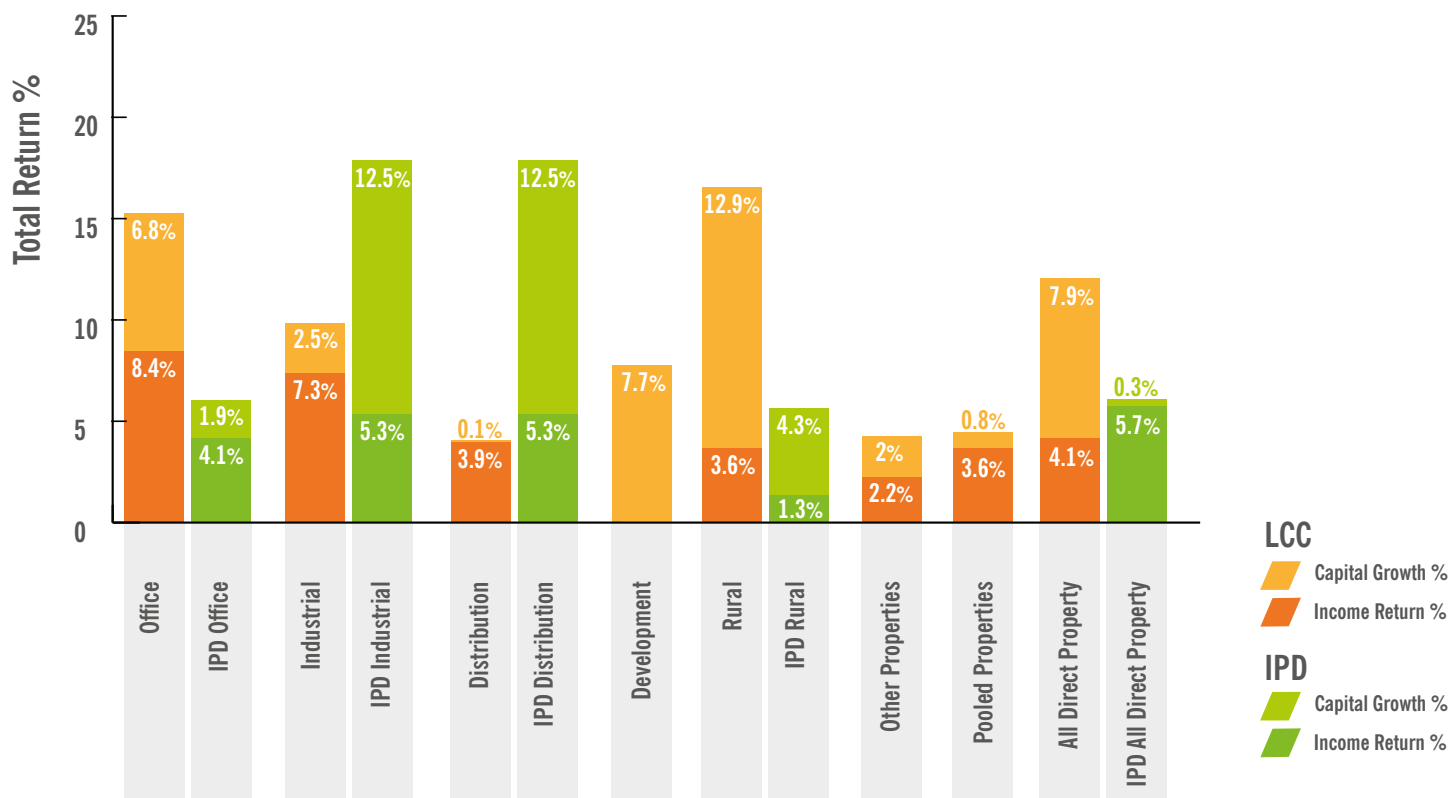
Net income from the Fund has increased to £4.7m over the year as a result of investment acquisitions and rental income increases (net of income producing disposals) an increase of £2.0m on the previous year. This total is forecast to grow to about £10m per year by 2022 as developments are completed and tenants secured.

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

There was one significant investment acquisition during the year (Citroen car dealership in Leicester City) together with two further land purchases at Misterton required to progress the Lutterworth East SDA.



Fund Performance

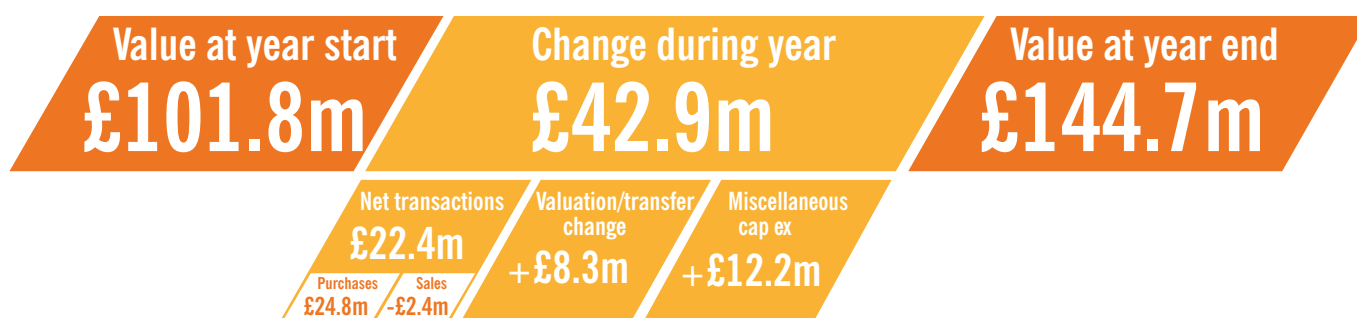


- IPD comparators not available for Rural
- Figures quoted are Savills England Wales Benchmark report 2018
- The returns for our office assets significantly out-performed with market with Lichfield South and Embankment House, acquired in Quarter 4 of 2017/18, being major contributors providing excellent returns of 8.45% and 24.0% respectively. The latter increase is due to improvements in yields and the vacant suite being formally under offer. There was no appreciable capital growth in the year.
- The returns from the rural portfolio remained stronger exceeding the market for the 12th consecutive year reflecting the benefit of pro-active management and the ongoing pipeline of development sites.
- The industrial portfolio showed a good income return of 7.3% percent however, capital growth was constrained (largely as a result of the portfolio overachieving in 2017/18 when 26.5% was realised).
- Development income is low, but this is as expected as it reflects the fact that many tenants will not be secured on the business park until the developments are complete. However, the continued capital growth reflects the future earning potential from the sites.
- The investments in pooled property and private debt provided a stable return in line with market expectations.
- Overall, the Fund produced a total return for the year to 31st March 2019 of 9.6%. Within that figure, Direct Property produced an overall return of 12.0% compared to the IPD All Property Quarterly Index of 6.0%.

CHANGES TO THE PORTFOLIO DURING THE YEAR

Summary of Changes

During the year, the property portfolio increased in value from £102m as at 31st March 2018 to £145m as at 31st March 2019. This increase was due to a combination of further investment in assets and indirect holdings, as set out in the chart below.



Transactions During the Year

Direct property acquisitions

Citroen Dealership

📅 Date Purchased	14 December 2018
£ Purchase Price	£2.95m
🏠 Income	£192,208 per annum
📅 Lease term remaining	11.75 years
🏢 Tenant	Bristol Street Fourth Investments Ltd.

Lutterworth

In addition, the Fund acquired two further areas of potential development land at Lutterworth to from part of the proposed East of Lutterworth SDA.

Private debt acquisitions

In December 2017, the Cabinet agreed to use cash balances to make an investment of £20m in Private Debt. By 31 March 2018, a total of £7m had been invested. The balance of £13m was invested in 2018/19 in accordance with the agreed strategy.

Pooled Property

A further £2.5m was invested in pooled property during the year bring the total investment up to £23.1m.

Disposals

In line with agreed strategy, the following disposals were achieved during the year and resulted in total capital receipts of £2.37 million through a combination of realising development potential and the restructuring of the farms and industrial portfolios.

Property	Disposal Date	Receipt	Sector
Land at Samson Road, Coalville	26th June 2018	£360,000	Industrial
Land at Welford Road, Husbands Bosworth	4th May 2018	£1,485,000	Rural
Winfrey Farmstead, Stapleton	26th October 2018	£270,000	Rural
Broadway Farm buildings, Kilby	11th March 2019	£256,000	Rural



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 2019 is 12%, twice the IPD Monthly Index benchmark total return of 6.0%.

Office Sector

Following the two major investments in 2017 /18 no further investments have been made during the year. However, the performance of the sector has benefitted significantly as a result of these two major investments lifting the overall return from offices to 15.2% compared to the market return of 6%. Within the overall figure a particularly strong income return of 8.4% was produced.

Industrial Sector

The Industrial sector produced an excellent income return of 7.3% compared to the market level of 5.3%. Capital growth at 2.5% was subdued in 2018/19 showing a market correction from the previous year when 26.5% was achieved. However, demand and therefore 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

The rural assets performed very well, producing a return of 16.6% (Savills' rural benchmark figures yet to be released). Income return was strong at 3.6%. Capital growth at 12.6% 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 5.3%; comparable to the IPD figure with yields falling slightly during the year both for the Fund and in the IPD index.

Sector Proportions (indirect holdings apportioned to their relevant sectors)

The effect of purchases, sales and movements in value during the year has resulted in further shifts in the sector weightings as illustrated earlier in the report. Whilst the long-term aim is to maintain a balance between sectors that maximises the potential for achieving financial resilience in the shorter term, in considering future acquisitions, the Fund will continue to focus 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 any particular desired sector balance.

Rent Reviews, Lease Expiries and Tenant Only Breaks

There are 15 rent reviews, 13 lease expiries and 16 tenant-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 developments 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 in Market Harborough, Apollo Court in Coalville and Leaders Farm in Lutterworth, the pipeline of future development schemes identified for the sites at Bardon Interlink and Quorn are being progressed to the planning application/delivery phase on the completion of the feasibility/business case stage.

Funds have also been committed to acquisition of further properties including that required to complete land assembly to facilitate the delivery of the East of Lutterworth SDA.



Developments On-site at present :

Airfield Farm Business Park (Phase 1)

Background

The Council purchased this 16 acre site to the north of Market Harborough in late 2016 having obtained outline planning permission for a mix of industrial, office and roadside use. Having sold an initial plot off immediately after purchase to obtain an instant capital return, full planning permission has been received for industrial units and construction has begun on site.

We have advertised the development and have terms agreed on two units, amounting to approximately 7,400 sq ft at a rent of £51,770 p.a., and interest in a further two units.



📄 Description	80,000 sq ft B1/B2/B8 units
📅 Completion Date	November 2019
£ Build Cost	£5.2m
🏠 Rental Income	£480,000 per annum
📈 Yield	6.8%

Apollo Business Park, Coalville

Background

This site was a former undeveloped site in Coalville leased to a haulage company for open storage. Having obtained vacant possession back we secured consent for 17 industrial units and work has begun on site and we already have interest from a number of potential tenants . Terms have been sent to occupiers for 5 Units



📄 Description	40,000 sq ft industrial units
📅 Completion Date	August 2019
£ Build Cost	£5.6m
🏠 Rental Income	£325,000 per annum
📈 Yield	8.0%

Loughborough Science and Enterprise Park (LUSEP)

Background

The County Council entered into a ground lease with Loughborough University with effect from January 2019 whilst simultaneously entering into an agreement for lease to Access Group UK Ltd for an initial term of 15 years.

Work commenced on site at the beginning of February 2019. To date the ground works, retaining wall features, balancing ponds, car park attenuation features and pile foundations are completed. It is anticipated that construction of the superstructure will commence in July 2019.



📄 Description	100,000 sq. ft. gross Grade A Office HQ with 320 car parking spaces
📅 Completion Date	July 2020
£ Build Cost	£22.03m
🏠 Rental Income	£1,600,000 per annum
📈 Yield	7.1%

Leader Farm South, Lutterworth

Background

This site formed part of a field within the County Farms portfolio and was identified as having possible office and industrial development potential.

After obtaining outline permission for a mix of commercial uses we have proceeded and completed the estate road construction and have interest from a roadside food retailer and coffee retailer. We are exploring uses on the remainder of the site, most likely industrial.



Heads of terms agreed with a major fast food provider for a Unit on site		Heads of terms agreed with Costa Coffee for Unit on site	
📅 Likely Completion Date	April 2020	📅 Likely Completion Date	June 2020
£ Build Cost	£567k for the unit	£ Build Cost	£260k for the unit
🏠 Rental Income	£92,825 per annum	🏠 Rental Income	£67,500 per annum
📈 Yield	5.5%	📈 Yield	5.5%
£ Site preparation costs :		£700,000	
(includes site preparation for fast food retailer & the Costa unit)			

Voids

With the exception of those properties held vacant to facilitate restructuring or future disposals, at 31st March 2019 the level of voids across the portfolio stood at 5.0% reflecting the current market demand; the figure having increased last year due to the existing vacant suites in the acquired office buildings at Lichfield and Nottingham and general movement within the portfolio.

Developments in planning stages at present

Sysonby Farm, Melton Mowbray

An outline planning application for 290 dwellings, a primary school and local centre has been submitted to Melton Borough Council and is due to be considered in July 2019. Masterplanned in collaboration with Richborough Estates, the promoter of the adjoining land, the site will contribute to the comprehensive development of the land between Nottingham Road and Scaford Road as an early phase of the Melton Northern Sustainable Neighbourhood with further land reserved for the construction of the Melton Mowbray Distributor Road. To support the delivery of enabling infrastructure £4.5m of Local Authority Accelerated Construction funding has been secured from Homes England; the work to be completed before March 2021.

Lutterworth East

The allocation of the East of Lutterworth SDA comprising 2750 dwellings, 23 hectares of B1, B2 and B8 employment land, a community hub, two primary schools, 110 hectares of open space including a country park together with substantial highways infrastructure has now been secured as part of the Harborough Local Plan which was adopted on 30th April 2019. A planning application for the main development in outline and spine road and junctions in detail was submitted on 27th February 2019 and, under the terms of a planning performance agreement with Harborough District Council, is due to be determined in late September. Following the receipt of planning consent work would commence on the enabling infrastructure within 6 months with a view to the first houses and an early phase of commercial development being occupied in 2022/23. To support the delivery of the infrastructure £8.8m of Local Authority Accelerated Construction funding has been secured from Homes England with a Housing Infrastructure Fund bid for a further £31.8m currently being considered.

Bardon

In March 2019 an OJEU Invitation to Tender was published with a view to identifying a developer who would develop a minimum of 175,000sqft of commercial development space on the 8.86 acre site at Interlink Way South in Bardon. The developer would be required to either identify a suitable tenant prior to the commencement of the build or would commence with the speculative development of the site whilst actively marketing the scheme. If a suitable tenant had not been identified upon practical completion then the developer would be required to cover the rent and running costs of the building for a period of 24 months following completion or until such time as a suitable tenant is secured with the 24 month period.

Following the deadline two tenderers submitted tenders which are currently under review. It is hoped that the tender will be awarded in July 2019. Following the submission of a planning application in autumn 2019 it is anticipated that construction will start on site in early 2020 with an anticipated construction period of around 45 weeks.

It is anticipated that the development of 175,000sqft will generate a rent for the County Council in the region of £1.09m per annum (£6.25 per sq ft) with a lease of 15 years being agreed. The anticipated costs of the build contract are £12.5m which includes the developer's fees.

The above actions will only be pursued if suitable alternative site(s) are found for the proposed Waste Transfer Station as reported to CAIFAB in April 2018.



Quorn

At Poole Farm, Quorn we have a vacant farm where we are applying for planning permission for a 62 acre solar farm that will cost £8.25m but generate a projected income of £720k p.a.

We are also seeking planning permission for commercial use and consider we can construct 69,000 sq ft of industrial units at a cost of £6m and generating £515k p.a. income

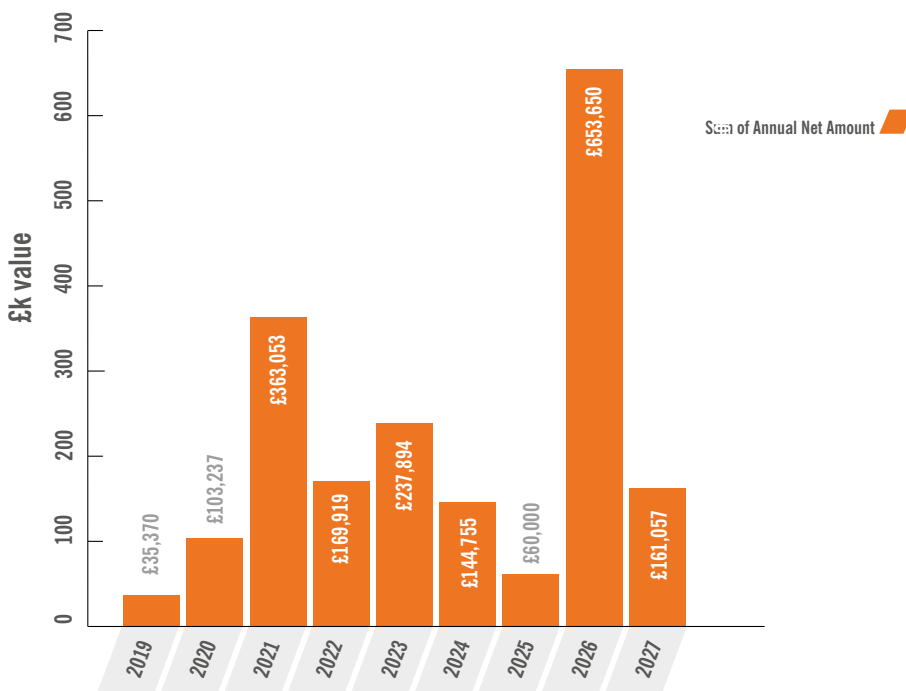
Rent Arrears (direct portfolio)

At 31st March 2018, total unsecured 90 day debt amounted to £49,851 which equates to 0.1% of gross portfolio income and although an increase in total value on previous years, is still considerably below industry averages. 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 figures below show the profile of rents receivable from leases expiring in each year within the portfolio. Where a tenant has an option to break within a lease, the worst case scenario that the tenant will exercise such an option is assumed, whereas in practice it is likely that not every tenant will elect to do so.



The largest figure in the period above relates to the year 2026. The majority of income in this year is derived from the tenants of Embankment House, Nottingham. We will approach the tenants in due course to negotiate renewal of those leases in line with normal practice.

PROPERTY INVESTMENT MARKET REVIEW

Property Investment Market Review

Economic Outlook

Economic growth slowed further in 2018 with GDP only expanding 1.4% year on year, down from 1.8% in 2017; the lowest rate of growth since 2012. Services remain the main driving force with the sector experiencing growth of 1.7% compared to the industrial sector with output rising 0.7% compared to 1.8% the previous year. However, construction activity saw the most significant slowdown falling from 7.1% in 2017 to 0.7%. The future outlook remains uncertain with the Bank of England lowering its growth estimate for this year to 1.2% the weakest since the global financial crisis. This uncertainty being amplified by the unexpected 0.5% increase in GDP in the first quarter of 2019 largely due to stockpiling in advance of the 29th March EU withdrawal date.

Brexit is clearly having an impact on the UK economy with business investment falling for four consecutive quarters the longest continuous decline since 2008/09. Data for 2019 paints a mixed picture of the health of the economy. The PMI surveys suggest the economy came to a standstill in January with the all sector index dropping to 50.3 its lowest level since 2012. The ICAEW Business Confidence Monitor painted a similar picture with the headline figure falling to its lowest level in nearly a decade.

Although the Bank of England raised the Base Rate from 0.5% to 0.75% in August 2018 the rate rise did little to boost sterling with the exchange rate against the US dollar remaining relatively stable in recent months at c.1.30 USD. However, forecasts that the pound will strengthen against the dollar by the end of this year to a figure of 1.39 USD with further rises in 2020 to 1.47 USD.

Annual CPI has slowed from 3.0% to 1.8% over the year to January 2019 with RPI inflation falling from 4.0% to 2.5% over the same period. With low unemployment feeding through to earnings growth real wages continue to increase which should support consumer spending. Further recent public borrowing figures show that government borrowing has fallen significantly in the period since April 2018 providing some headroom for financial stimulus to support economic growth should it be required.



Investment Market

Although slightly down on 2017, at £62.1bn investment volumes in 2018 remained well above the 10 year average highlighting the ongoing demand for UK commercial real estate. In 2018 Offices remained the most sought after sector with overall investment volumes of £23.5bn. Whilst the industrial sector also remained healthy the alternatives / mixed use sector saw a rapid expansion of almost 10% to £17.9bn reflecting the move away from core sectors. However, the retail sector saw a significant slowdown with investment volumes falling 30% from 2017 levels to its lowest level since 2000. Rural investments, which represented 23% of all transactions, increased in 2018 in response to an increased supply with farms offering opportunities for diversification, energy production and future strategic development potential being attractive.

Overseas buyers continued to invest in UK commercial property accounting for 44% of all transactions with particularly strong interest from Far Eastern investors and whilst European investment remained comparable with previous years US investors continued to reduce their exposure to the UK market. Over the year UK Institutions increased their level of investment following 2 years of decline with private property companies moving in the opposite direction as net sellers in 2018.

The market, however, in the first 3 months of 2019 was very subdued with transaction volumes well down on 2018 at between £4.0bn and £5.0bn. At such time as an EU withdrawal is concluded it is anticipated that there will be a noticeable improvement.

All property equivalent yields hardened during the first half of 2018 levelling out at 5.45% in Q4 12bps lower than at the end of 2017. Within the overall figure industrial yields reduced by 39bps, followed by offices at 19bps. By comparison retail equivalent yields have started to soften reaching 5.66% at the end of the year an increase of 13bps.

Property Forecasts

Total commercial property returns are forecast to slow further in 2019 to a cyclical low of 1.2% with income return becoming the only source of growth as capital growth returns turn negative (-3.5%, 0.1% residual). This is down from 6.0% in 2018 and 10.2% in 2017. However, the level of total returns will recover in 2020 and remain at 5% - 6% over the period to 2023. Yields are likely to soften in 2019 with all property equivalent yields moving out by 19bps this year with the overall trend continuing until 2022, although by 2020 stabilisation may begin in individual sectors.

The retail sector will continue to struggle in 2019 with total returns set to fall from -0.5% in 2018 to -4.0% in 2019: positive income returns failing to off-set negative capital growth with values expected to fall by a further 9.2%. With continued unfavourable market conditions impacting negatively on the sector a substantial softening of yields is expected across the whole sector.

Despite remaining the best performing sector the main downward pressure on all property returns comes from the cooling industrial sector with the double-digit returns of recent years forecast to reduce to 7.3% in 2019 and thereafter average 6.4% over the next 5 years with demand for “last mile” delivery units, distribution centres and interest from retailers driving growth. Against this background equivalent yields are only likely to move out slightly.



Offices whilst showing negative capital growth of -2% total returns are expected to show positive overall return of 2% in 2019 (down from 6% in 2018) increasing to an average of 4.7% over the 5 years to 2023.

Returns within the rural sector have weakened over the past year due to a 2% downward readjustment in market prices coupled with its traditionally low but stable income return. However, within the sector forestry is currently the best performer at 16%. In the longer term it is expected that capital growth will return to its historical levels of c.5% before the realisation of development and environmental potential are taken into account.

Overall rental growth will see a decline of 0.7% in 2019 before return to modest growth of averaging c. 1% in the period to 2023. Within this figure rents within the retail sector are predicted to fall most sharply with standard shops outside London declining by an average of 7% and shopping centres by 6% with more modest falls within the supermarket segment only 1.7% despite the increase in online activity. Office rents will remain relatively stable underpinned by rental growth outside London due to the sustained demand for Grade A offices against a limited development pipeline. With a low market vacancy rate and continued demand the industrial sector is likely to see sustained rental growth of c.3% over the whole period to 2023.

Investment Strategy Update

The CAIF Strategy was reviewed in 2018 and adopted by Cabinet at its meeting held on 14th September 2018. 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. The only substantive change in the CAIF Strategy is that in future, CAIF developments will aim to be low carbon, sustainable developments wherever possible.

