# Corporate Asset Investment Fund Advisory Board

ANNUAL REPORT 2020/21

Leicestershire County Council

Building Business. Boosting Communities.

# FOREWORD

Leicestershire County Council's continued investment in its Corporate Asset Investment Fund has once again provided significant returns to the people of Leicestershire in difficult times. From relatively modest beginnings in 2016/17 the Fund's value has continued to grow year on year and now stands at £187m. As the value of the Fund increases the income produced also continues to grow and last year the Fund generated a net income of £4.6m

New business parks in Market Harborough and Coalville are now complete and fully let providing 120,000 sq. ft. of commercial 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 was completed in autumn 2020, the tenant has completed its fit out and is now in occupation. A further pipeline of projects is being progressed with a view to realising further increases in revenue in future years.

Overall, the Fund's portfolio of commercial properties, farms, development land and other investments continues to consistently outperform the national average for comparable investment funds. Of particular note is the increased income return which is vital in supporting services throughout the county.

Leicestershire County Council continues to be the lowest funded county in the country. The continued good performance of the Corporate Asset Investment Fund allows the Council to provide important services in an extremely challenging financial environment with COVID-19 putting additional burdens on the Council's finances, whilst continuing to boost Leicestershire's economy and helping the Council to achieve the aims and ambitions set out in its Strategic Plan

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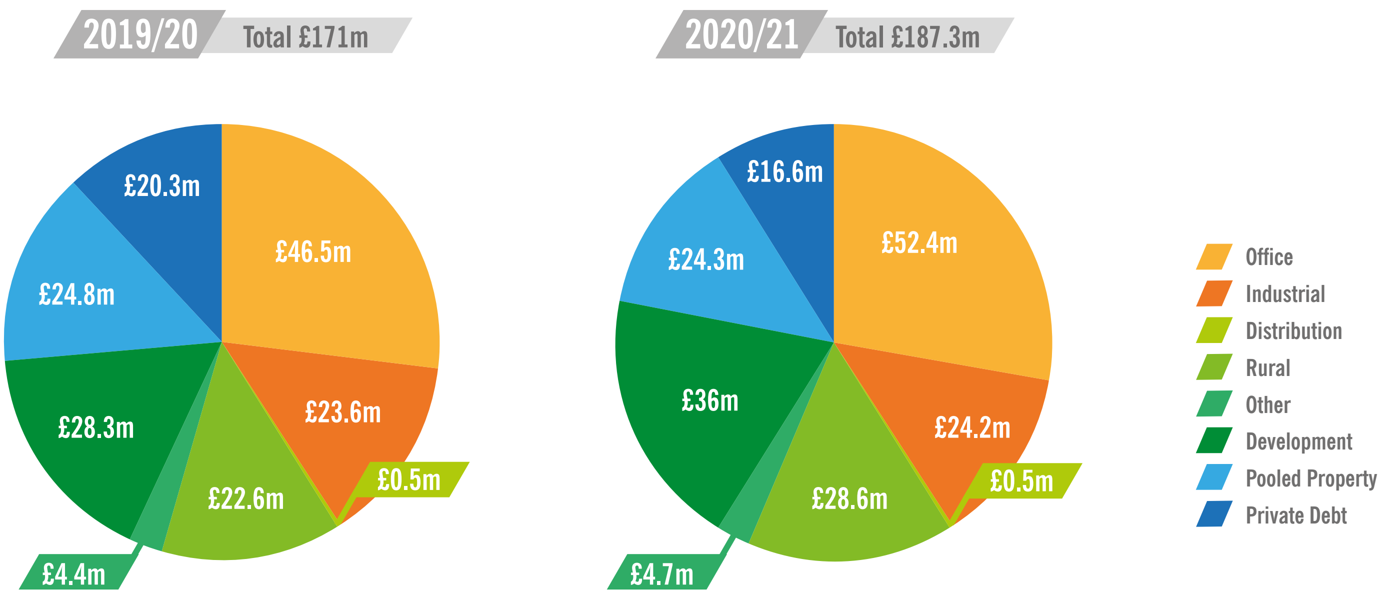
# SUMMARY

This report forms the annual review of the Corporate Asset Investment Fund (CAIF) portfolio, reporting on the performance for the year to 31st March 2021.

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 assets provides increased financial resilience and underpins the Council's ability to deliver a comprehensive range of quality services in the future.

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

## TOTAL VALUE BY SECTOR




As at 31st March 2021, the capital value of the portfolio totalled £187.4 million compared with the value as at 31st March 2020 of £170.9 million. The opening and closing valuations being calculated on the basis of a combination of internal and external asset valuations.

## Financial summary

| | Value at 31st March 2020 (£m) | Transactions Acquisitions (£m) | Capital spend (£m) | Sales (£m) | Transfer (£m) | Valuation Change (£m) | Value at 31st March 2021 (£m) | Net Income (£m) |
|---|---|---|---|---|---|---|---|---|
| **Directly Managed Property** | | | | | | | | |
| Office | 46.5 | | 5.4 | | | 0.5 | 52.4 | 1.4 |
| Industrial | 23.6 | | 0.3 | | | 0.4 | 24.2 | 1.1 |
| Distribution | 0.5 | | | | | 0 | 0.5 | 0.1 |
| Rural | 22.6 | | 0.2 | 0 | | 5.7 | 28.6 | 0.5 |
| Other Property | 4.4 | | | | | 0.3 | 4.7 | 0.3 |
| **Total Property** | **97.6** | | **5.9** | **0** | | **6.9** | **110.4** | **3.4** |
| **Development** | | | | | | | | |
| **Development** | **28.3** | **11.4** | **0.2** | **0** | **4.0** | **0.1** | **36.0** | **-0.1** |
| **External Investments** | | | | | | | | |
| Pooled Property | 24.8 | | | | | -0.5 | 24.3 | 0.9 |
| Private Debt | 20.3 | | | 4.0 | | 0.3 | 16.6 | 1.1 |
| **Total Ext. Invts** | **45.1** | | | **4.0** | | **-0.1** | **41.0** | **2.0** |
| **Sub-Total** | **170.9** | **11.4** | **6.1** | **4.0** | **4.0** | **6.9** | **187.4** | **5.2** |
| Central Charges | | | | | | | | -0.6 |
| **Overall Total** | **170.9** | **11.4** | **6.1** | **4.0** | **4.0** | **6.9** | **187.4** | **4.6** |

Notes: All figures are rounded to nearest 0.1

Central charges are an allowance made against net income in the corporate accounts in respect of debt and sinking fund costs

At 31st March 2021, the Fund held managed direct property assets of £110.4m, and development property of £36.0m (a total of £146.4m). In addition, the Fund holds external pooled property funds and private debt investments totalling £41.0 million.

Returns in 2020/21 showed a marked increase on the previous year as a result of positive income returns and capital growth across all sectors despite the sharp corrections experienced in the wider market as a result of the COVID pandemic causing the greatest economic upheaval in living memory. This sound performance is in part, due to continued very good occupation and rent collection rates.

A debt and sinking fund provision (central charge) has been made within the revenue account in order to more appropriately assess overall CAIF performance in terms of its contribution to generating additional funding for Council services. These charges against the fund reduce the net income figure from £5.2m to £4.6m.

- A sinking fund can be thought of as a savings account which ensures that there are funds set aside to cover one-off expenses in the future required to maintain the assets' capital value.
- A bad debt provision is a reserve used to cover the potential for future incomes (e.g. rent) not being received as expected. Once a provision is established it is reassessed each year in light of what is known about outstanding monies still to be received.

The net income of £4.6m represents a modest increase on the previous year, generating a net income return of 2.5% which is comparable to that achieved in 2019/20. With the benefit of rental increases as further new developments are completed, and tenants secured, this will continue to grow.

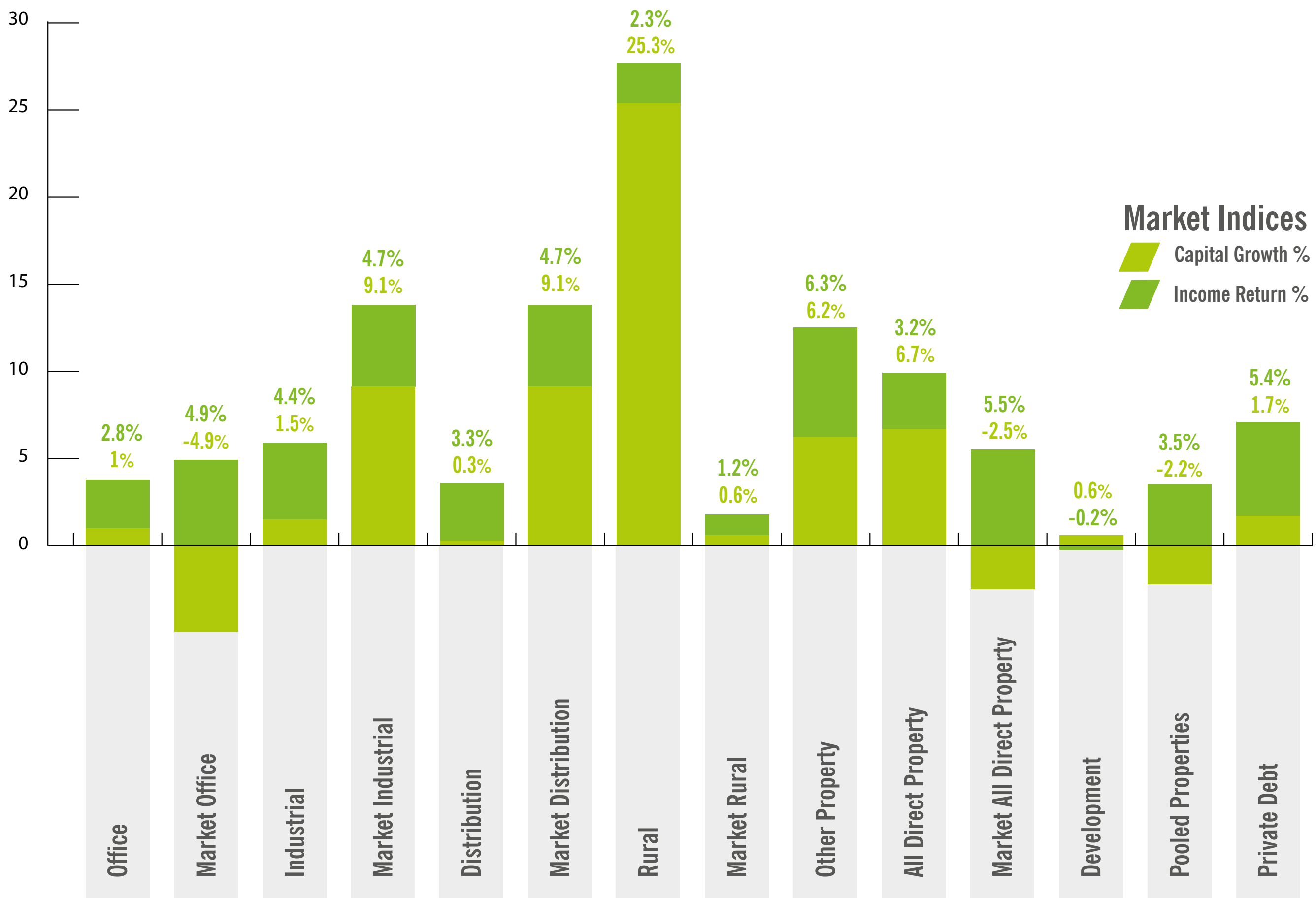
The new business parks at Coalville and Market Harborough (Phase 2) are now both fully let and will produce full market rents in the coming years.

It should be noted that the Fund doesn't hold any retail investments in the direct property portfolio, which will have contributed towards the Fund outperforming the market.

There was one major and two smaller land purchases at Misterton required to complete land assembly and progress the Lutterworth East Strategic Development Area at a cost of £11.4m and are included within the Development Sector

During the year the Fund completed a strategy review of the overall fund, which was undertaken by external consultants, Hymans Robertson. The findings will be incorporated within future reviews of investment strategy.

## Fund Performance




- Overall, the portfolio produced a return* of 6.1% in line with target levels. This represents an increase of 3.4 percentage points on the previous year and exceeded the general market increase in returns.
- The managed direct property portfolio (i.e. excluding the development assets, pooled property, and private debt), produced a total net return for the year to 31st March 2021 of 9.3% (capital and income combined), compared to the market benchmark All Property Monthly Index of 2.8%
- The returns from the rural portfolio remained exceptionally strong, exceeding the market for the 14th consecutive year. The capital growth figure of 25.3% reflecting the benefit of pro-active management and the ongoing pipeline of development sites to be marketed with planning consent. Accordingly, the rural sector continues to make a significant contribution to the overall performance of the portfolio.
- Overall, the returns from the office sector exceeded the market achieving both positive capital growth and a realistic income return given that the terms of all office lettings agreed throughout the year were subject to extended rent free periods (in line with market expectations).

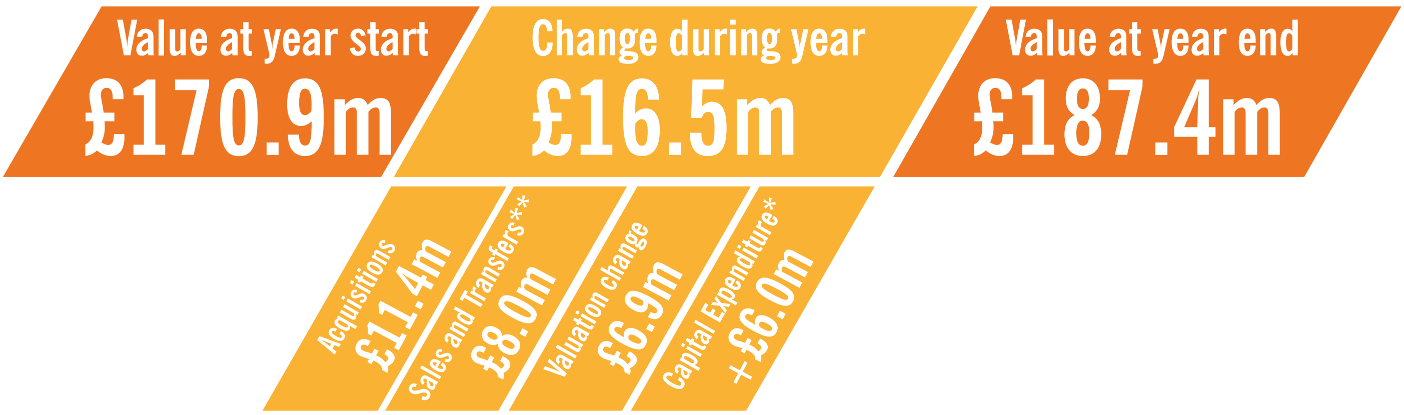
* Whilst the overall return is calculated taking account of the bad debt provision and sinking fund these have been excluded when making comparison for individual sectors to ensure a like for like comparison with the market indices.

- The returns from both the Industrial and distribution were constrained and fell substantially short of market levels. This was due to a number of factors including the nature of the premises, the continued high occupancy rate and most importantly the change in the annual valuation date to 1st October each year. Due to shifts in market yields between October 2020 and April 2021, the effect of the early valuation date had a significant impact on potential capital growth, reducing the return by c.5.0%
- The development sector saw further capital invested in the East of Lutterworth SDA. However, this expenditure has not impacted portfolio performance being reflected in the closing valuation. Whilst, the performance metrics for the development sector currently appear to be "relatively poor" this will be corrected when the developments are completed, and rental income or capital receipts are generated.
- The pooled property investments are spread across four separate investment managers. The returns this year have been impacted by exposure to sectors that have been impacted adversely by covid-19 such as retail. The 3.6% net income yield (3.9% in 2019/20) compares favourably to the market return of minus 9.9%.
- Private debt returns are in line with expectations with £1m interest income during the year and c£4m capital returned. Interest income will reduce over time as underlying loans are repaid and capital is returned.

# CHANGES TO THE PORTFOLIO DURING THE YEAR

## Summary of Changes

During the year, the property portfolio increased from £170.9m as at 31st March 2020 to £187.4m as at 31st March 2021. 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.




*This includes spend on farm estate buildings and the original industrial premises.

** The transfers were made at valuation

# TRANSACTIONS THROUGH THE YEAR

## Direct property acquisitions

**Lutterworth East**

The Fund completed all the outstanding acquisitions necessary to complete full land assembly for the proposed East of Lutterworth Strategic Development Area within the overall budget approved by Cabinet.

## Private Debt Investment

The private debt investments returned £4m capital during the year alongside £1m in interest payments from the original £20m invested and managed externally by the Partners Group. Accordingly, at 31st March 2021, the private debt holding had a net asset value of £16.4m.

## Pooled Property

The Fund also hold externally managed pooled property investments. Whilst there were no transactions completed during the year the value of the investments reduced by 2.2% to £24.3m reflecting the state of the overall property market.

## Property Disposals

In line with the strategy, the following disposals were achieved during the year and resulted in total capital receipts of £68,500 through opportunity sales of property from the portfolio.

| Property | Disposal Date | Receipt | Sector |
|---|---|---|---|
| Easement over land at Sutton in the Elms | 16/04/2020 | £40,000 | Rural |
| Land on the Stephenson Industrial Estate (deposit) | 20/01/2021 | £28,500 | Development |

In addition, to the above there are a number of substantial disposals in the pipeline, most notably the development site at Sysonby Farm, Melton Mowbray where the marketing of the site was delayed by the completion of the Section 106 Agreement. In addition, planning is being progressed on a number of other non-strategic sites with a combined value (with planning consent) of in excess of £12m.

## Property Transfers

Following the transfer of Apollo Court and the Airfield Farm (Phase 2) business units from the Development Sector to the Industrial Sector last year In the 2020/21 year the eight acre site at Bardon Interlink, held by the Fund as a future development site, was transferred back to the Council's Waste Management service to be developed as a waste transfer station; the transfer being made at the opening valuation (£4.0m). Following completion of the waste transfer station project, any surplus land will transfer back to the Fund.

# PERFORMANCE AND COMPARISON AGAINST INDUSTRY BENCHMARK

The Fund's benchmark is the "All Property" total return (capital growth plus income return) of the market benchmark monthly index. The total return for the direct property portfolio for the year to 31st March 2021 was 7.3% significantly outperforming the market benchmark Monthly Index total return of 2.8%.

## Office Sector

The office sector achieved a return of 3.8% compared to a market return of minus 0.3%; the sector achieving both positive capital growth and a solid income return. In future years with all the major office investments fully let income returns are set to improve further.

## Industrial Sector

The Industrial sector produced a modest return of 5.9% compared to the market figure of 14.2%. This was due in part to the nature of the portfolio, being largely older premises, which together with the lack of tenant churn restricted the potential for achieving increased rental income. The portfolio valuation date of 1st October each year further contributed to capital growth being reduced by 5% against the market, as the increase in capital value resulting from a hardening of industrial yields in the second half of the year was not reflected in the portfolio's closing valuation figures. However, if current market conditions persist this will result in a positive catch up in the current year. Demand remains strong for all grades of property within the sector due to the lack of supply, and with full rental levels becoming payable in respect of the newly occupied units at Coalville and Market Harborough, rental income will continue to grow.

## Rural Sector

The rural assets performed very well, producing an overall return of 27.6% which is well in excess of the sector's national performance driven predominately by capital growth (reflecting the development value accruing to individual assets at Melton and Misterton). Potentially, this will be translated in capital receipts in future years as sites are sold with the benefit of planning permission. At 2.3%, income return was significantly above the performance of the rural sector nationally.

## Alternative Sector

The alternative or other property sector produced an excellent return of 12.5% against the minus 5.2% achieved by the market. This was largely due to the fact that the Fund holds a mixed portfolio of assets, including the Citroen garage, a petrol filling station in Loughborough and a supported education school, but does not hold any leisure investments which were severely affected by the COVID-19 pandemic.

# PORTFOLIO REVIEW

## Current Yield

The current yield from the portfolio is 4.0% (4.9% in 2020) this is below the market benchmark national figure of 5.0%. The managed direct property and indirect sector have a combined yield of 5.2% marginally above the market but a low yield from the development assets meant that overall, the yield fell below the benchmark.

## Sector Proportions

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 reduces risk and 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 prospect of good long-term income, sound tenant covenant and produce a better than market yield in line with the recommendations of the independent review undertaken in December 2020 by Hymans Robertson.

## Rent Reviews, Lease Expiries and Tenant Only Breaks

There are 52 rent reviews, 49 lease expiries and 27 tenant-only break options that are falling due in 2021/22. The negotiations regarding the reviews, lease renewals and dealing with the break options will form part of normal day-to-day property management.

The effect of Covid19 on business confidence was a defining factor in all market transactions over the past 12 months, as the financial impact of the pandemic was felt across all sectors. On the whole the Fund's tenants, through the use of the support offered by Central Government and sound business practice have "weathered the storm". With an upturn in business confidence and improving economic conditions, coupled with a lack of supply within key sectors modest rental growth from rent reviews and new lettings should be achieved across the portfolio. The incidence of business failure or higher than usual voids did not materialise, and although some office spaces have remained vacant there has been a significant uptake of industrial leases.

## New Lettings

Over the 2020/21 year despite challenging market conditions the following new lettings have been achieved.

### Airfield Farm Business Park (Phase 2)

**Background**

The Council purchased this 16-acre site to the north of Market Harborough in late 2016 which benefitted from an outline planning permission for a mix of industrial, office and roadside uses. A new planning permission was achieved for 80,000 sq. ft. a mix of industrial and office uses. Construction began on site in early 2019. (Note: Phase 1 was the sale of land to Thorpe's' Joinery)

All 12 units have been let and the site is approaching full occupation securing an initial increase in income of £263,000.

| | |
|---|---|
| Description | **80,000 sq ft Class E & B2/B8 Divided into 12 units** |
| Completion Date | **6 December 2019** |
| Asset value | **£7.1m** |
| Annual rent roll | **£543,000** |
| Yield | **7.69%** |

### Apollo Business Park, Coalville

**Background**

This site was a former undeveloped yard in Coalville leased to a haulage company for open storage at a rental of £25,700 pa. Having obtained vacant possession, planning permission was secured for 17 industrial units and work began on site in late 2018. Following completion in September 2019, all the units have been let and the estate is fully occupied delivering an annual rental of £321,750.

| | |
|---|---|
| Description | **41,000 sq ft Class E and B2/B8 divided into 17 units** |
| Completion Date | **16 September 2019** |
| Asset value | **£4.4m** |
| Annual rent roll | **£321,750 per annum** |
| Yield | **7.27%** |

## Embankment House

Embankment House was purchased by the Fund in 2018 at which time 9,500 sq. ft. of office space was unlet. During the current year, a 10-year lease was completed at an annual rental of £180,000 and the tenant is now in occupation. Embankment House will now have an annual rent roll of £963,000 and produce a yield of 8.1% in line with expectations at the time of purchase.

# Developments Completed in 2020/21:

## The Armstrong Building, Loughborough Science and Enterprise Park (LUSEP)

**Background**

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

Work commenced on site at the beginning of February 2019 and was substantially completed in October 2020. Since that time the lease has been completed and The Access Group has taken possession of the building and has fitted out the accommodation with staff now working in the offices. The scheme won the International NEC Contracts Project of the Year award in June 2021.

| | |
|---|---|
| Description | **102,909 sq ft gross Grade A Office HQ with 320 car parkspaces** |
| Completion Date | **October 2020** |
| Asset value | **£25.9m** |
| Annual rent roll | **£1,609,820** |
| Yield | **6.2%** |

## Future Investments

During the 2020/21 the Fund has, on the basis of further funding being available through the Medium-Term Financial Strategy (MTFS), committed further investment to deliver the following developments that will have the effect of further transforming the portfolio, achieving excellent rates of return and delivering significant additional income.

### Leaders Farm South, Lutterworth

**Background**

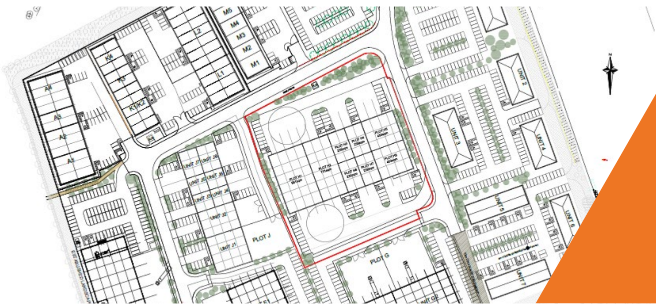
This site formed part of a field within the County Farms portfolio and was identified as having possible office and industrial development potential.

Following extensive marketing of the site a demand has been identified for roadside and storage uses, and terms agreed with several potential occupiers. A planning application is to be submitted shortly and whilst the proposals represent a departure from the local plan changes to the Use Class Orders which took effect in September 2020 should allow more flexibility and help secure the development of this site.

### Airfield Farm Business Park (Phase 3)

**Background**

Following completion and the successful launch of Phase 2 of the new industrial development at Airfield Farm Business Park, a masterplan has been drawn up for the final phases and a planning application for the 97,273 sq. ft. comprising phases 3 & 4 of industrial units was submitted in July 2021. The current proposal is to construct Phase 3 only, extending to 81,835 sq. ft. of industrial space.



| | |
|---|---|
| Completion Date | **Target April 2023** |
| Build Cost | **£8.5m** |
| Expected Rental roll from Phase 3 | **£638,000 per annum** |
| Yield | **7.5%** |

# Solar Farm Development, Quorn

**Background**

The proposal, which is currently at the planning stage involves the development of a 10MW solar farm on County Farms land at Quorn. Once developed the scheme will have the capability of off-setting more than 2,000 tonnes of $CO_2$ annually which is greater than the total carbon emissions of all County Council Buildings,

| | |
|---|---|
| Completion Date | **Target June 2022** |
| Build Cost | **£8m** |
| Expected annual income | **£400,000 per annum** |
| Yield | **5%** |


In addition to the above schemes funds were also committed to the acquisition of further properties to complete land assembly to facilitate the future delivery of the East of Lutterworth SDA and to the promotion of Boundary Farm, Sapcote as part of a potential strategic development area west of Stoney Stanton adjoining M69 J2.

## Development Sites

The Fund holds a number of assets within the portfolio that have been expressly retained or purchased with a view to realising their development potential in order to realise capital receipts or wider financial benefits to support the Council's capital and revenue programmes.

### Sysonby Farm, Melton Mowbray

Outline planning permission has been granted for 290 dwellings, a primary school and local centre by Melton Borough Council on 23rd December 2020: the site forming part of the Melton North Sustainable Neighbourhood. Subsequently, the residential element of the site has been marketed and a sale agreed which is due to be completed later this year. The school site will transfer to the Children's and Families Service and proposals developed for the local centre with a view to its retention within the Fund for as a source of income. Land on the northern boundary of the site has been reserved for the construction of the Melton Mowbray Distributor Road (MMDR) and the allocated employment land to the north of the MMDR may be developed as a depot site for the County Council's Environment and Transportation department.

### Lutterworth East

The allocation of the East of Lutterworth SDA comprising 2,750 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 was secured as part of the Harborough Local Plan which was adopted on 30th April 2019.

A hybrid planning application (in outline for the residential and commercial development and in detail for the spine road and other highways infrastructure works) was considered by Harborough District Council's Planning Committee on 28th July 2020. The planning committee resolved to grant planning permission subject to conditions and the completion of a section 106 Planning Agreement. The Section 106 Agreement is currently being finalised.

Due to the decision by Homes England not to support the County Council's application for Housing Infrastructure Fund money, the procurement of a delivery partner for the scheme was temporarily put on hold. Further discussions regarding other funding sources are being progressed.

On receipt of a free from legal challenge planning permission and confirmation of funding (both internal and external) work could 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 2024.

Furthermore, the procurement of a delivery partner could recommence upon confirmation of funding. However, in the light of continued market uncertainty commencement of works on site may be delayed ensuring that returns from the project are protected in the longer term.

As a result of the planning delays the £8.8m of Local Authority Accelerated Construction funding secured from Homes England may have to be foregone despite a successful application being made to extend the period for the delivery of the grant funded works to 31st March 2022.

### M69 Junction 2 – Stoney Stanton

Following the Cabinet decision in March 2020, work has been progressed on the promotion of up to 152 acres of County Council land as part of a larger residential-led mixed-use development of at least 5,000 houses. Working in collaboration with other landowners and their developer partners, submissions have been made to Blaby District Council's Call for Sites and Issues and Options consultation and work is ongoing to provide the necessary evidence base to support the sites allocation as part of the emerging Blaby District Local Plan which is due to be adopted in 2022. Throughout the process, the Landowner Consortium has engaged with Blaby District Council and the local community, with further briefings and stakeholder events planned for later this year.

### Land at Barton Road, Barlestone

An outline planning application has been submitted for 55 houses and 3.5 acres of public open space on an 8-acre site in Osbaston Parish, fronting Barton Road, Barlestone. The application should be determined later this year.

## Other potential sites

A pipeline of more development sites is being brought forward on an ongoing basis largely through the local plan process, by their submission to Call for Sites consultations at the start of the plan review process and thereafter making appropriate responses to the further consultations. By securing future local plan allocations, investment returns and a stream of capital receipts will be maintained.

## Voids

In the year to March 2021 with the two major schemes at Apollo Court and Airfield Business Park (Phase 2) becoming fully let the level of voids had fallen from the March 2019 level of 22.3% to 10.3% at a time when the market as a whole saw an increase from 5.7% to 9.8% due to the effects of the COVID-19 pandemic; there remains a number of office units vacant across the portfolio totalling 9,648 sq. ft., but with a letting agreed during March 2021 (completed in June 2021) of the remaining vacant office suite at Lichfield South, the situation is showing signs of improvement.

With an improving economic environment and demand outstripping supply it is anticipated that the low level of voids away from the office sector can be maintained, whilst the relaxation of COVID restrictions will likely re-energise office occupancy over the course of 2021.

## Rent Arrears (Direct Portfolio)

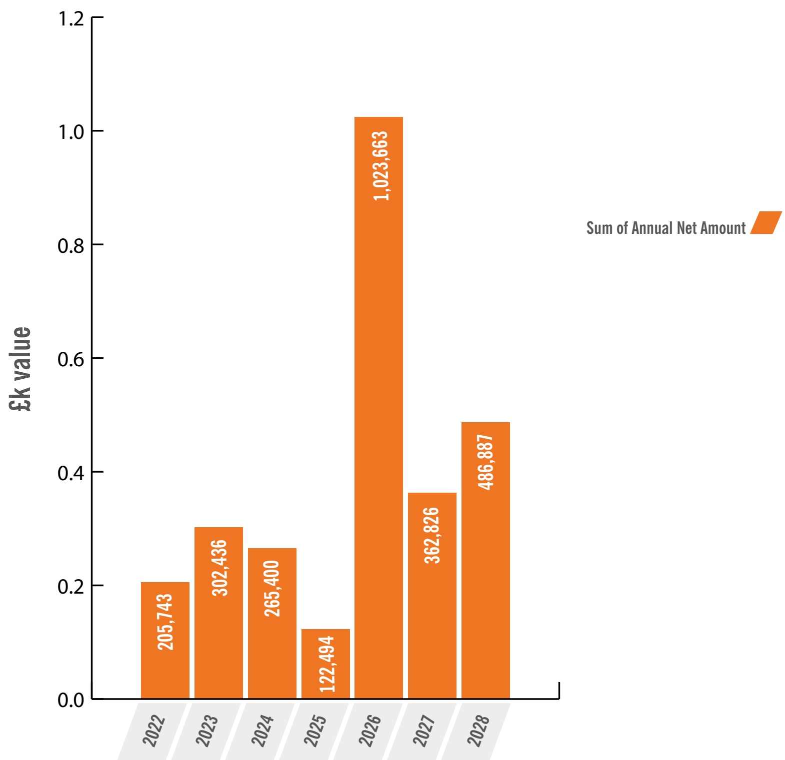
At 31st March 2021, total unsecured 90-day debt amounted to £90,548 which equates to 1.64% of gross portfolio income and although greater than previous years, remains considerably below industry averages especially during turbulent economic conditions. Payment of all outstanding debts is being actively pursued through debt management procedures.

It should be noted that none of the tenants of the 3 major investment property acquisitions (Embankment House, Nottingham/Lichfield South Office Park/car showroom in Leicester) have any rent arrears at all.

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

## Lease Expiry Profile (Direct Portfolio)

The table below illustrates the profile of rents receivable from leases expiring in each year within the portfolio over the next 7 years both in cash terms and a proportion of total rental income. 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 table above, and presenting the greatest risk to the portfolio, relates to the 2026 financial year when two leases at Embankment House, Nottingham and 13 of the 17 leases at Apollo Court expire. In accordance with usual practice it is proposed to engage with the tenants at an early date with a view to agreeing lease renewals.

# PROPERTY INVESTMENT MARKET REVIEW

## Economic Outlook

Over the last year, the UK has experienced the biggest economic upheaval in living memory, with the coronavirus pandemic dominating the way that people live and work since the first lockdown was announced on 23rd March 2020.

In 2020, GDP recorded an annual fall in growth of 9.9%, however following the latest lockdown which was put in place in January 2021 and the successful roll-out of the vaccine programme, there is now evidence that despite a further fall of 1.5% in Q1 2021 there will be a strong rebound in retailer and business confidence throughout the remainder of 2021. Indeed, the Bank of England now projects growth of 7.25% (up from 5.0% in February) over the next 12 months in line with the predictions of Oxford Economics and Goldman Sachs.

Indications are that excess household savings should support consumer spending and business investment is expected to pick up again during the year. Meanwhile, fiscal, and monetary policy remain accommodative for now, but several support measures such as the furlough scheme and stamp duty holiday will come to an end over the coming months, meaning growth could slow towards the end of the year.

Although there has been an increase in unemployment, the furlough scheme has kept the unemployment rate at relatively low levels to date and continued low interest rates and extended government support have helped businesses survive. Unemployment is expected to continue to rise albeit modestly and there is a risk that inflation and interest rates may increase in due course given the scale of the fiscal stimulus, but the immediate economic outlook is one of significant improvement.

Accordingly, it is likely that the Bank Rate will remain at current levels in the short to medium term as the temporary surge in inflation, from the March figure of 0.7%, to levels above the 2% target will be tolerated, but 10-year gilt yields could see further upward pressure as more aggressive US monetary policy has knock on effects globally.

## Investment Market

UK commercial property returns remained unsurprisingly subdued during 2020 but there are now signs of an upturn as investors return to the market as reflected in both the annual total return figures and the quarterly changes in capital value.

The UK commercial property market continued to show resilience to the pandemic in Q1, with investment volumes reaching £11.1bn. While this is around 20% below the five-year quarterly average, the figure was considerably higher than during the first national lockdown in Q2 2020 when only £5bn was transacted. A number of sectors, such as medical, industrial and supermarkets outperformed, while there was only very limited interest for leisure, hospitality, shopping centres and shops. Industrial assets accounted for around a third of all transactions by value, its second-highest share ever, only beaten by Q4 2020. Meanwhile, the share of office investment fell to just 20%, well below the five-year average of 34%.

## Property Market Forecasts

The pandemic had led to a modest 2.3% decline in all property total returns in 2020. By the end of the 2020/21 year the all property total returns figure had improved and showed an increase of 2.8%.

These improving figures however disguise the fact that the polarisation of the UK commercial investment and occupational markets that was being felt pre-pandemic has become even more accentuated during the past year as certain property sectors have flourished (predominantly industrial) with the retail and leisure sectors being badly hit.

It is anticipated that there will be total returns growth of 6.4% in 2021, comprised of 4.8% income return and 1.6% capital growth. This is stronger than initial forecasts, which predicted a 3.8% rise in total returns. It is then expected that there will be total returns growth of 5.9% in 2022 and 5.3% in 2023. Over the five-year forecast horizon, industrial and supermarkets are predicted to be the best performing sectors.

Mild rental growth will result in a slight reduction in yields in the short term, but we expect yields to then generally shift out, in line with the trends for the Bank of England Bank Rate and 10-year government bond yields. At the all property level, equivalent yields will compress by around 20bps this year. Supermarkets and the industrial market segment will record the strongest reduction in yields, although mild compression is also expected across the office segment. Further outward movement will meanwhile continue across the retail and leisure sectors.

## All Property Forecast

| Prediction Date | December 2021 | December 2022 | December 2023 | 5-year cycle |
|---|---|---|---|---|
| ERV Growth (% pa) | -1.8 | 1.1 | 1.8 | 1.0 |
| Equivalent Yield (%) | 5.7 | 5.7 | 5.7 | 5.6 |
| Capital Growth (% pa) | 1.6 | 1.1 | 0.5 | 1.0 |
| Total Return (% pa) | 6.4 | 5.9 | 5.3 | 5.9 |

The retail sector, with the exception of supermarkets, performed predictably badly in the 2020/21 year. The 'High Street' sector produced a total return of -14.1% in the year to 31st March 2021as a result of a fall in capital value of -19.8%, whilst the 'Shopping Centre' sector fared even worse producing a total return of -18.7%,  and a capital fall of -25.7%. Both sectors have been significantly damaged by the effects of the coronavirus pandemic, exacerbating structural shifts in consumer shopping patterns that were already well under way, and an oversupply of retail space in many towns. Due to the fact that Supermarkets have remained open during the pandemic the 'Supermarket' sector produced a total return of +7.6% in the year to 31st March 2021, reflecting an income return of 5.4% together with modest capital value growth. All retail total returns are expected to show marginal growth of 0.6% this year, with income growth being the main driver of total returns growth, whilst capital growth is expected to remain in negative territory over the next few years. Retail warehouses and supermarkets will continue to drive the sector's performance in 2021, with all other sub sectors recording negative total returns.

The total return for the offices sector in the year to 31st March 2021 was -0.3%, based on an income return of 4.9% failing to fully off-set a further decline in capital values It is anticipated that following the UK's vaccination roll-out and a phased resumption of 'normal' working practices, business beginning to return to the office will further boost investor confidence. Total returns are expected to increase by 2.8% in the South East and 3.0% in Rest of UK this year, which compares to 2.5% for Central London. All-office total returns are expected to increase by 2.4% this year comprised of 4.1% income return and capital growth of minus 1.7 -%. All office total returns will average 5.1% pa over the period to 2025.

The industrial sector recorded a total return in the year to 31st March 2021 of 14.2%, reflecting an income return of 4.7% and further strong capital growth. This sector continues to benefit from the inexorable rise of e-commerce and the structural change in retail distribution, combined with a lack of supply of new accommodation. Tenant demand remains robust with take up reaching a record levels in 2020. Although there has been an increase in new development in this sector, much is pre-let and therefore availability remains low in many regions. Accordingly, rental growth prospects remain positive, although the rate of growth is likely to slow. Given the ongoing strength of rental growth and firming of yields, all industrial total returns are predicted to show growth of 16.1% this year, before slowing to a more sustainable rate of 5.4% in 2022.

The alternative sector (which includes leisure property, hotels, restaurants and cinemas) fared poorly overall in the year to 31st March 2021 recording a total return of -5.2%, as a result of capital values falling by10.4% almost entirely due to the COVID-19 pandemic and the effect of lockdowns on those businesses. It is expected the alternative sector will recover quickly once lockdown conditions allow venues to fully open and trade fully once more. However, unlike the retail sector, this sector is not experiencing structural change, and with many people actually having saved money during the pandemic, a consumer surge in demand would not be unexpected.

Whilst constrained by a limited supply of investment opportunities Rural Property remains a safe haven for investors, with income returns of 1.2% (largely unaffected by the Covid pandemic), stable capital values and the prospect of modest long-term capital growth achieved through the realisation of development potential.

In respect of Pooled Property Investments it would appear that the market has now stabilised and performance should therefore recover as the economic conditions improve further through the second half of the year.

## Investment Strategy Update

### The key objectives of the strategy remain: -

- Ensuring that there is a diverse range of assets available to meet the aims of economic development.
- Increasing the size of the portfolio.
- Improving the quality of the assets.
- Ensuring the sustainability of the County Farms and industrial portfolios by replacing land and assets sold to generate capital receipts.
- Providing a revenue stream that can be used to support ongoing service delivery; and
- Ensuring that any development undertaken on land owned by the County Council (or sold to a 3rd party for development) is undertaken in accordance with the aims and aspirations of the County Council's Declaration of Climate Emergency and any development is therefore to be sustainable, low carbon and energy efficient.

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.

The Fund's strategy continues to be reviewed regularly. In addition to the ongoing internal review of the portfolio, an independent review of the Fund was undertaken by Hymans Robertson in December 2020. That review considered the current economic outlook and that of the real estate investment market in light of the COVID-19 crisis and the implications of Brexit.  In line with other commentators, it acknowledged the challenges facing the market at the present time particularly the retail sector. Equally, it identifies the industrial, distribution and logistics sectors as being the most resilient in current circumstances. Further, the report examined the potential to diversify the portfolio further by considering infrastructure investments and the need to consider the environmental, social, and governance credentials of future potential investments.

Broadly, the Hymans Robertson report made the following main recommendations: -

Investment in direct property assets should be focused on the industrial, distribution and logistics sectors especially given Leicestershire's location at the heart of the national transport network.

- Investment in the office and rural sectors should be maintained at current levels.
- Investment in the Pooled Property sector should be reduced over time and the funds reinvested in other more attractive investments such as diversified infrastructure. The private debt investments have potential to deliver stable returns and should be maintained or increased.
- Consideration should be given to investing in infrastructure and renewables either directly or via a pooled investment vehicle. Entry into the residential market is also recommended. To an extent the portfolio has an exposure to the residential market through the bringing forward of development sites However, the development and retention of residential properties within the portfolio would present particular legal problems for the County Council not being a housing authority.

These recommendations will be considered in a forthcoming strategy review together with the latest market trends and the County Council's strategies. The review will address both the short-term effects and potential longer-term impact of the COVID-19 pandemic with a view to protecting the Fund's current portfolio and guide its future acquisitions strategy and development programme moving forward to ensure it maximises the benefits it delivers.

The updated strategy will be incorporated within the Medium-Term Financial Strategy which will be considered by Cabinet and full Council later in the year