APPENDIX

Corporate Asset Investment Fund Advisory Board

ANNUAL REPORT 2021/22

Leicestershire County Council

Building Business. Boosting Communities.

FOREWORD

I'm very pleased to be able to present the 2021-2022 Corporate Asset Investment Fund annual report.

The pressures on Leicestershire County Council's finances are unprecedented and growing but we recognised some time ago that by investing wisely in property and assets we can generate a considerable and welcome income that helps protect our most important public services.

You will see in the pages of this report that the fund's value has grown each year since we set it up in 2014/15 and now stands at £207 million.

And as the fund grows so does the return and I'm delighted it generated a net income of £6.2 million last year – a 35 per cent rise on the previous twelve months.

Our CAIF portfolio of commercial properties, farms, development land and other investments continue to perform consistently well."

To make sure that success continues we plan to develop a further pipeline of projects to increase revenue and importantly to diversify into schemes to generate clean, renewable energy so helping to reduce Leicestershire's carbon footprint and achieve the county's key aim to be Net Zero by 2045.

Our finances have been battered by the Covid-19 pandemic, global high inflation will continue to make things extremely challenging in the future, while historically our funding from Government has been among the lowest of any council.

For all these reasons, it's vital we use what tools we can to improve our own situation and CAIF has shown it can fund the high-quality public services we provide for the people of Leicestershire, boost the county's wider economy while helping us achieve the aims and ambitions of our Strategic Plan.

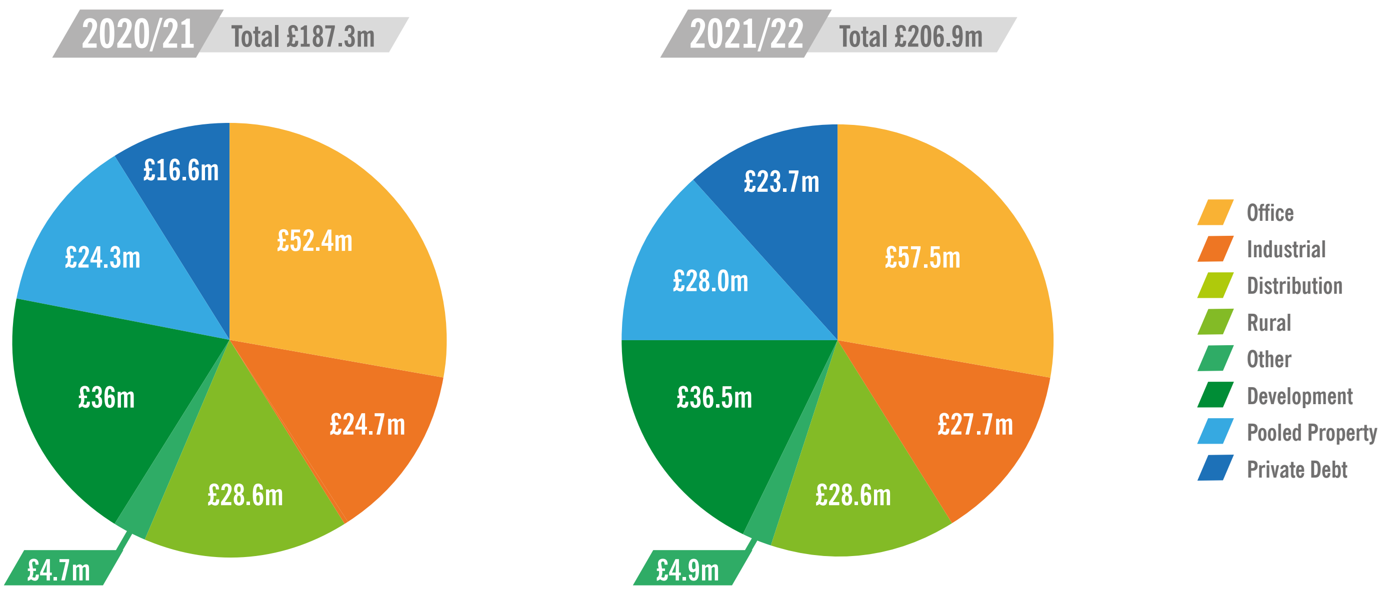
Lee Breckon,
Lead Member for Resources,
Leicestershire County Council

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 2022.

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.



As of 31st March 2022, the capital value of the portfolio totalled £206.8 million compared with the value as of 31st March 2021 of £187.4 million. The opening and closing valuations being calculated on the basis of a combination of internal and external asset valuations; external valuations being undertaken in respect of c. 60% of the total direct portfolio by value.

Financial Summary

	Value at 31st March 2021 (£m)	Transactions			Transfer (£m)	Valuation Change (£m)	Value at 31st March 2022 (£m)	Net Income (£m)
		Acquisitions (£m)	Capital spend (£m)	Sales (£m)				
Directly Managed Property								
Office	52.4					5.0	57.5	2.8
Industrial and Distribution	24.7		0.3			2.7	27.7	1.4
Rural	28.6		0.2			(0.2)	28.6	(2.0)
Other Property	4.7					0.2	4.9	0.1
Total Managed Property	**110.4**		**0.5**			**7.7**	**118.6**	**2.3**
Development								
Development	**36.0**		**0.6**	**(0.3)**		**0.2**	**36.5**	**(0.5)**
Central release of reserves								1.9
Direct property								3.7
External Investments								
Pooled Property	24.3					3.7	28.0	0.9
Private Debt	16.6	13.1		(5.1)		(0.9)	23.7	1.6
Total Ext. Invts	**41.0**	13.1		**(5.1)**		**2.8**	**51.7**	**2.5**
Overall Total	**187.4**	**13.1**	**1.1**	**(5.4)**		**10.7**	**206.8**	**6.2**

Notes: All figures are rounded to nearest 0.1m

At 31st March 2021, the Fund held managed direct property assets of £118.6m, and development property of £36.5m (a total of £155.1m). In addition, the Fund holds external pooled property funds and private debt investments totalling £51.7 million.

Returns in 2021/22 showed a further increase on the previous year as a result of positive income returns and capital growth across all sectors. However, compared to the wider market capital growth was relatively constrained due to the nature and extent of the original industrial and county farms estates. However, the overall positive 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 better represent overall CAIF performance in terms of its contribution to generating additional funding for Council services.

- A sinking fund can be thought of as a savings account or contingency fund 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 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.

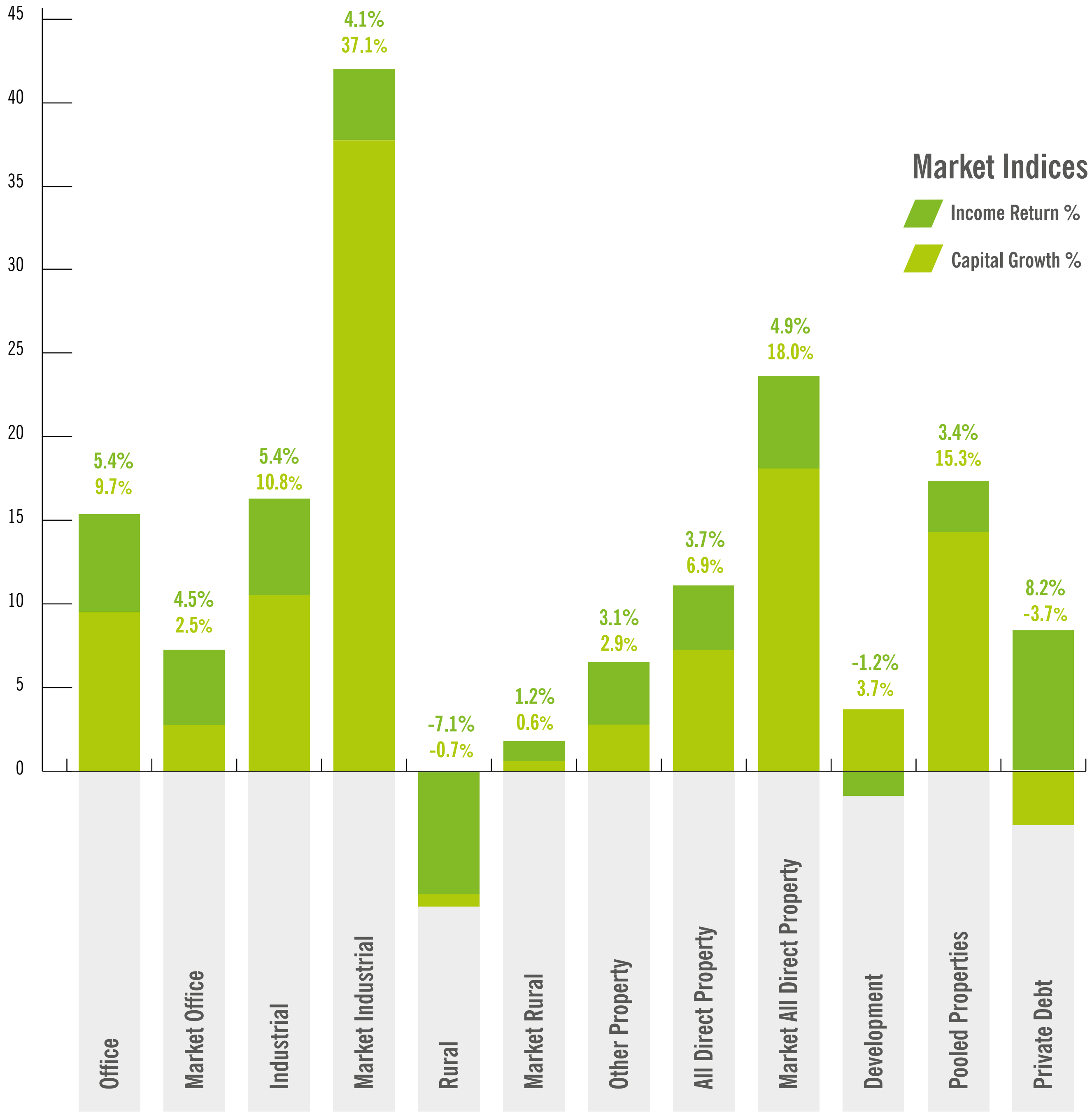
The difference between net income and trading profit are centrally apportioned costs allocated to the main direct property sectors including employee costs and sinking fund contributions. Of particular note is the charge to the rural portfolio which represents the expected financial liability arising from the clean-up and remediation works at Firs Farm, Husbands Bosworth following illegal waste disposal activity on the farm. A release of previously accumulated sinking fund provision of £1.9m has been made in 2021/22. Accordingly, the net income for the year totals £6.2m.

The net income for the year of £6.2m represents a significant 35% increase on the previous year, generating a net income return of 3.2% compared to the 2.5% achieved in the previous two years. With the benefit of rental increases as further new investments start to generate income, this will continue to grow.

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 continued sound performance.

PERFORMANCE AND COMPARISON AGAINST INDUSTRY BENCHMARK

Fund Performance



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 portfolio for the year to 31st March 2022 was 8.1% well above the 6% target level. This represents an increase of 2.0 percentage points on the previous year. However, this was well below the market level of 23.7% largely due to constrained capital growth in the industrial sector and the pooled property portfolio as a result of the age and nature of the premises within the original industrial estate and the stable pattern of occupancy. This was reflected in the previous two years when overall the portfolio significantly outperformed the market by maintaining sustained capital growth and income returns at a time of when market conditions were challenging.

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 2022 of 10.6% (capital and income combined), an increase of 1.3% on the previous year, but falling short of the market benchmark All Property Index of 23.7% (2.8% in 2020/21) demonstrating the more stable nature of the Council portfolio.

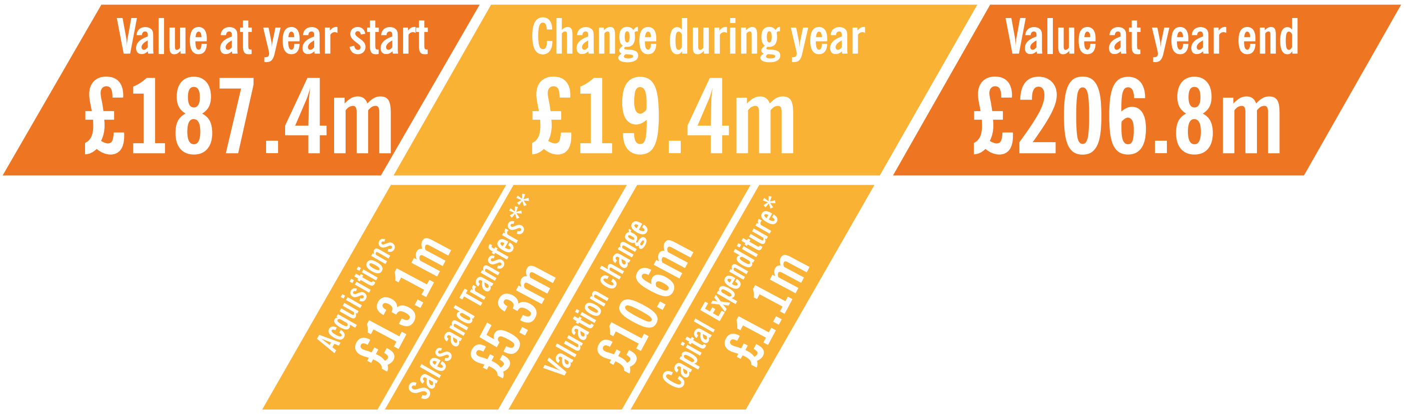
- The office sector performed particularly strongly producing a total return of 15.1% easily exceeding the market level of 7.2%, due largely to significant rental growth with the rent-free periods from the previous year's new lettings coming to an end and a hardening of yields across the market. Both capital growth at 9.7% and income return at 5.4% exceeded market levels.
- The returns from the combined Industrial and distribution sectors showed a further increase to 16.2% and whilst falling short of market level of 42.6% due to constrained capital growth resulting from the high proportion of older premises from the original estate remaining within the portfolio and the continued high occupancy rate creating a stable portfolio of investments less volatile than the wider market. However, the income return at 5.4% was well above the market level of 4.1%
- The rural portfolio reported a negative total return of 7.8% due to the substantial centrally apportioned costs associated with Firs Farm, Husbands Bosworth If these costs were discounted the income return exceeded the wider market at 2.1%. In addition capital growth was negatively influenced by capital investment and the development land pipeline. Whereas in previous years at least one sale or transfer from the rural portfolio has taken place realising development potential and thereby achieving significant capital growth, in 2021/22 this did not occur and although land within the Osbaston Estate had the benefit of a resolution to grant planning consent the valuation, based on Cipfa valuation guidance, could not take account of this as the land remained tenanted as at 31st March 2022. Accordingly, the whole of the uplift in value (and capital growth) resulting from the grant of planning permission will be reflected in the 2022/23 year's performance, positively enhancing that year's returns.
- The alternative or other property sector produced a return of 7.3% against the 9.7% 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 which were largely unaffected by COVID whereas leisure investments, a major driver in the market sector, which were severely affected by the pandemic have bounced back extremely strongly over the past year underpinning overall sector performance.

- Whilst the performance metrics for the development sector currently show a nominal return, this is a result of the long lead-in time that is required to achieve full planning consent and develop out the site where the investment is to be retained. However, once the developments are completed, and rental income or capital receipts are generated the substantial capital growth achieved will be reflected in future years returns.
- The pooled property investments are spread across four separate investment managers. The returns this year reflect the improving market conditions post COVID with capital growth of 15.3% The 3.4% net income yield is in line with last year's return. All four managers exhibited double digit capital growth over the year with the one manager which targets active management through repositioning and improvements having a tougher time impacted by COVID showing the lowest 12% increase.
- Private debt overall returns are in line with longer term expectations but with higher income at £1.6m during the year producing a return of 8.2%. The increased amount of loans repaid during the year from an older investment are to be offset by a new investment made during 21/22. A net £13.1m was invested in the debt portfolio with a view to maintaining income levels in the medium term.

DURING THE YEAR

Summary of Changes

During the year, the property portfolio increased in value from £187.4m as at 31st March 2021 to £205.3m as at 31st March 2022. 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 industrial premises.

**This includes debt repayments of £5.1m

Transactions Through The Year

Direct property acquisitions

There were no property acquisitions during the year.

Private Debt Investment

Further private debt investments to the value of £13.1m were made during the year, when balanced against repayments of £5.1m increased the net asset value of the private debt investment holdings to £23.7m.

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 increased by £3.7m to £28.0m reflecting the improved state of the overall property market.

Property Disposals

One property disposal was completed during the year and resulted in total capital receipts of £256,500 through the sale of a small undeveloped industrial site on the Stephenson Industrial Estate in Coalville.

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 following the marketing of the site a sale has been agreed with the bulk of the capital receipt expected on completion of the Melton Mowbray Distributor Road (Northern section) and the site at Barton Road, Barlestone where planning permission has been secured and marketing commenced. The two sites have a combined value (with planning consent) of in excess of £12m.

Property Transfers

No transfers have been made during the year from the portfolio to the County Council's operational portfolio.

PORTFOLIO REVIEW

Current Yield

The current yield from the portfolio is 5.1% (4.0% in 2021) which outperforms the market benchmark national figure of 4.3%. Similarly the managed direct property and indirect sector have a combined yield of 5.4%, above the market level, but a low yield from the development assets, which has a disproportionate sector weighting compared to other portfolios meant that overall, the yield fell just 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 34 rent reviews, 26 lease expiries and 25 tenant-only break options that are falling due in 2022/23, of which four relate to assets earning in excess of £30k per annum. Whilst the negotiations regarding rent reviews and lease renewals form part of normal day-to-day property management, the particular circumstances of individual leases means that it is not always appropriate to action these as they fall due. In the year being reported there were 24 rent reviews undertaken, with a further 29 remaining to be agreed or held in abeyance, 19 leases expired and remain holding over either pending renewal leases or for other reasons; in many cases the rent review and lease expiry are linked events. During the same period, 24 wholly new leases were agreed.

New Major Lettings

Over the 2021/22 year the following major new letting has been achieved.

Lichfield South

The final vacant 3,285 sq. ft. office suite at Lichfield South was let on a five-year lease from June 2021 at an annual rental of £62,415 to CHBC Investments Ltd, a managed office solutions provider who sublease the premises to Royal London insurance.

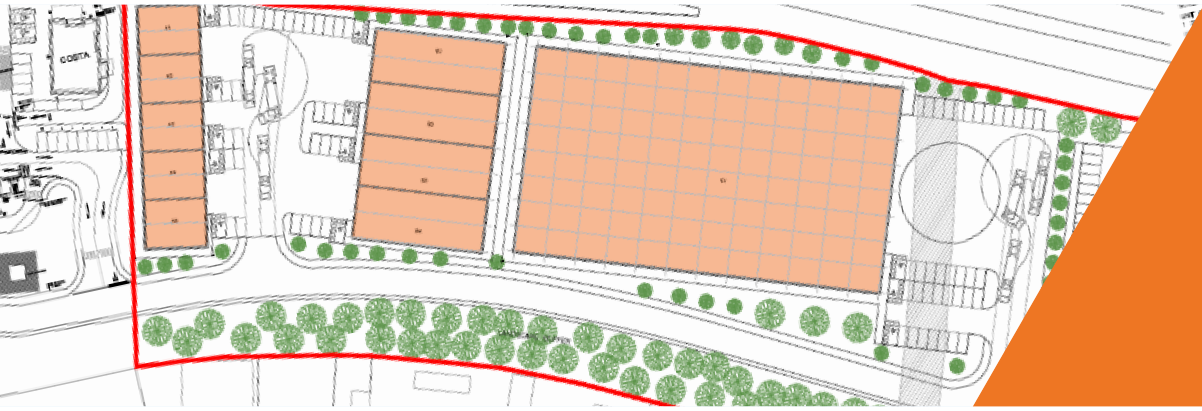
Future Investments

During the 2021/22 the Fund has on the basis of further funding being available through the Medium-Term Financial Strategy (MTFS), committed further investment to continue the delivery of the following developments that will have the effect of further transforming the portfolio, achieving excellent rates of return, delivering significant additional income, and contributing to the achievement of wider strategic goals.

Leaders Farm South, Lutterworth

Background

This site formed part of the County Farms portfolio and was identified as having possible office and industrial development potential some years ago.



Following extensive marketing of the site a demand has been identified for roadside and storage uses. Two major roadside food and drink retailers expressed an interest in a parcel of land, extending to 1.6 acres at the north-western corner of the site. Whilst not in line with the Local Plan there has been no demand for the Class B1 – office / light industrial allocated uses and therefore other viable alternatives were considered. Subsequently, heads of terms were agreed and contracts exchanged in June 2022. In addition, a planning application has been prepared and submitted by one of the prospective tenants to Harborough District Council. It should be noted that use for part of the site is a departure from the HDC Local Plan allocated uses for the site, which will have to be addressed by the applicant through the planning process by demonstrating that there are material considerations which outweigh the Local Plan designation including the lack of any demand for office/light industrial premises at Leaders Farm South.

The drive-through units will generate an income of £160k pa, and the potential employment units are projected to generate circa. £215k pa. The overall construction cost is projected to be in the region of £6m (including the £2.5m already spent on the estate roads and services) giving an expected income return of c.5.3%.

The future development of the balance of the 6.1-acre site will be progressed on the determination of the current roadside use planning application.

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 next 82,436 sq. ft. of industrial units was submitted in July 2021.

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

The application, as yet, has not been determined. The site is allocated in the Harborough Local Plan for a mix of B1, B2 and non-strategic B8 development. The delay to the application being caused by the fact that it seeks to depart from the local plan policy by not providing any office space as part of the development. The proposed development reflects a general lack of demand in the market and in this site in particular, where despite marketing over a six-year period no potential occupiers have come forward.

If planning issues can be resolved the scheme will take approximately 12 months to build out.

Solar Farm Development, Quorn

Background

Completion Date	**Target Summer 2023**
Build Cost	**£9m**
Expected annual income	**£900,000 (for a 5 year power purchas agreement*)**
Yield	**10%**

*based on current elevated market prices. Income will be dependant on power prices when subsequent contracts are entered into.

The proposal, for which planning consent has now been granted involves the development of a 10MW solar farm on County Farms land at Quorn. In addition to the financial benefits detailed below 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. Pre-commencement works have started on site in summer 2022 to discharge the archaeological planning conditions.

In addition to the above scheme's funds were also committed to facilitate the future delivery of the East of Lutterworth SDA and to the continued 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 finance 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 was completed, and the decision notice issued on 17th May 2022 triggering the 6-week judicial review period available to any third party who wishes to challenge any aspect of the planning permission and/or Section 106 agreement. University Hospital Leicester has lodged the necessary application to seek a judicial review of the district council's decision.

If the judicial review is rejected, it will be possible restart the consideration regarding the future delivery strategy for the site

As a result of the planning delays, it has not been possible to undertake the enabling works for which Local Authority Accelerated Construction funding of £8.1m was secured from Homes England within the availability period which ended on 31st March 2022. It has therefore been decided to withdraw from the scheme and whilst it will be necessary to repay the grant of £510k received to date the financial benefits of making the site more attractive to the market far outweigh the costs of retaining the grant and remaining bound to the terms of the funding agreement.

M69 Junction 2 – Stoney Stanton

Following the Cabinet decision in March 2020, work has been progressed on the promotion of 103 acres of County Council land as part of a larger residential-led mixed-use development of up to 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 now due to be adopted in 2024. Throughout the process, the Landowner Consortium has engaged with Blaby District Council, key stakeholders, and the local community, including the establishment of a community liaison group the feedback from which will be used to shape the master planning of the scheme.

Land at Barton Road, Barlestone

An outline planning application was submitted for 55 houses and 3.5 acres of public open space on an 8-acre site in Osbaston Parish, fronting Barton Road, Barlestone in January 2021. The application was determined in December 2021 and following the completion of a Section 106 Agreement planning permission was granted in May 2022 triggering the marketing of the site.

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.

In addition to potential residential and employment opportunities sites with potential to support the delivery renewable energy infrastructure or bio-diversity gains are also being identified and will form an integral part of the pipeline of future sites.

Voids

In the year to March 2022 the level of voids fell from the 2021 level of 10.3% to 2.5% reflecting the strong demand in the market for the types of premises LCC holds and compares very favourably to a market rate of 9.8%; currently there remains a small number of office units vacant across the portfolio totalling 19,512 sq. ft.

Despite a healthy turnover of units, the strong demand suggests that the low level of voids can be maintained, subject to there not being a significant downturn in the wider economy.

Rent Arrears (Direct Portfolio)

As of 31st March 2022, total unsecured 90-day debt amounted to £470,037 which equates to 7.5% 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.

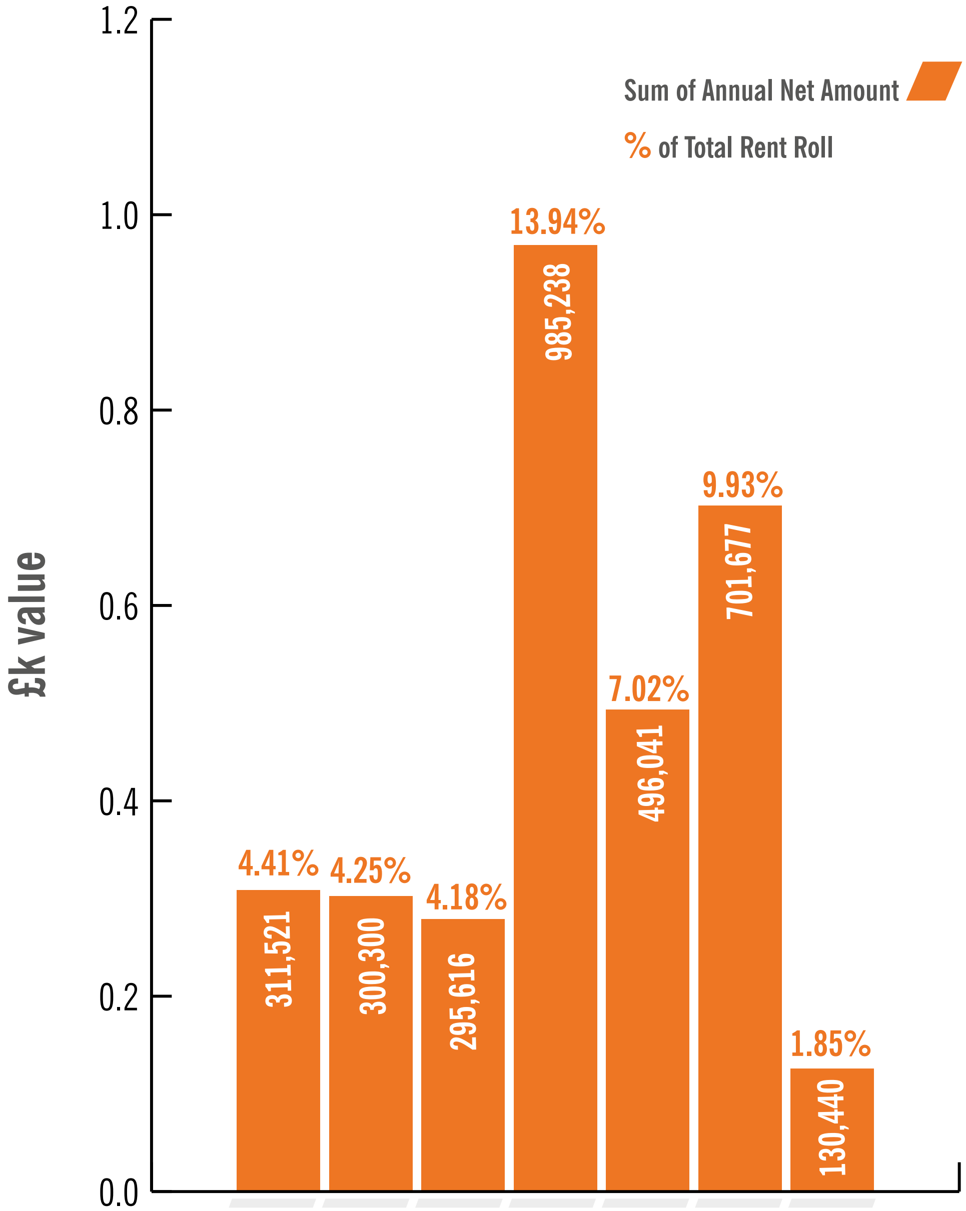
With the exception of one tenant at Embankment House, none of the other tenants of the 3 major investment property acquisitions (Embankment House, Nottingham/Lichfield South Office Park/ car showroom in Leicester) have any rent arrears at all.

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 10 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.



Future Liabilities

The portfolio currently has one major future liability that will impact the performance of the portfolio in the short-term which arises from the illegal dumping and disposal of waste at Firs Farm, Husbands Bosworth. Briefly the situation is as follows:-

Firs Farm, Husbands Bosworth is a 103 acre (42 hectare) farm situated south of the village. Following issues being reported at the farm in February 2020, an inspection was undertaken by officers from Strategic Property Services and the Environment Agency during which waste samples were taken to provide evidence of the illegal waste dumping activity, and initial witness statements taken.

Following the inspection, the Council worked with the Environment Agency to determine the volume and nature of waste and formulate a plan to remove the waste from the farm. The remediation strategy was approved in principle by the Environment Agency in May 2022 and all illegally dumped waste will be removed from site and properly disposed of. The land will be returned to a condition suitable for agriculture and perhaps re-let as a livestock holding.

The remediation strategy forms the basis of the waste removal tender that will be advertised in late September 2022 with a view to letting the contract in February 2023. The preliminary investigations by the Council's consultants estimate the clean-up cost to be in the region of £2.4m but this will be confirmed once tender prices are received.

Although events such as this are rare, a sinking fund was established (together with a debt provision) to meet or contribute towards the costs of unforeseen expenditure such as those incurred at Firs Farm. The annual contribution to the sinking fund ensures that the potential for unforeseen events is recognised and the impact on a single year's budget is reduced.

The experience gained from this incident will inform a review of the processes of management and re-letting will be undertaken to ensure the most robust structure possible is in place to mitigate the potential of a repeat or similarly damaging incident in the future.

PROPERTY INVESTMENT MARKET REVIEW

Economic Outlook

The UK economy has recovered from the sharp falls in GDP seen during the Covid pandemic of the last two years with strong growth continuing into January this year. However, in the later part of the first quarter the economy started to stagnate, and it is anticipated that this trend (or even a decline) is likely to continue throughout the rest of this year due to rising inflation and the cost-of-living crisis hitting disposable income.

The sharp rise in inflation which reached in 9.4% in June, with further rises to a peak of 13.4% predicted, being the key concern and whilst the rate is predicted to fall back in 2023 the exact level is dependent on other factors including wage inflation which could well rise due to the tight labour market.

Interest rates are already rising with Monetary Policy Committee minutes suggesting that base rate will peak at 2.6% in 2023 although the peak rate may fall short of expectations. This was reinforced by a further 0.5% base rate rise in August with the Bank of England predicting that the economy was likely to enter recession later this year and contract further into 2023.

Investment Market

Whilst interest rate rises are set to dampen returns from commercial property investments in the future the market has enjoyed a strong end to 2021 which has continued into 2022 with transactions worth £17bn representing the strongest first quarter for 7 years with all main sectors outperforming their 5-year average. Yields have continued to compress across most sectors. In to the second quarter the market remained buoyant with record levels of investment being made in May. However, since the market has been more cautious with investment levels showing signs of tailing off.

Property Market Forecasts

Despite increases in gilt rates the general hardening of property rates is due to continue with average yields falling from 5.2% at the end of 2021 to 4.9% by December, stabilising at that level for 2023 and softening marginally in 2024

The recovery post-pandemic has seen all-property total returns reach a six-year high in 2021 driven by the industrial and retail warehouse sectors. Further, it is anticipated that double-digit returns of c.12% will be achieved in 2022 before falling back to 6.3% in 2023 and 3.8% in 2024 as yields soften

Led by rents in the industrial and logistics sector rental values are expected to continue to rise by 3.8% this year and an average of 3.1% to 2026

Prediction Date	December 2022	December 2023	December 2024	5-year cycle
ERV Growth (% pa)	3.8	3.1	2.8	3.1
Equivalent Yield (%)	4.9	4.9	4.9	4.9
Capital Growth (% pa)	7.8	2.4	-0.1	2.8
Total Return (% pa)	**12.0**	**6.3**	**3.8**	**6.8**

The combination of high inflation and the cost-of-living crisis has resulted in the consumer confidence index falling to a record low. However, sales appear to be holding up having regained some of the 18.6% of market share lost to e-commerce during the pandemic although footfall remains 10% below pre-pandemic level. Whilst rental values continue to decline, albeit more moderately, across much of the retail sector evidence suggests some sectors, notably retail warehouses have started to see rental growth. This trend is forecast to continue until 2024 when modest increases should be achieved across the whole sector. In common with other sectors yield compression will result in capital growth of 7.8% and total returns of 13.6% for the current year with retail warehouses outperforming other sub-sectors at 22.8%. Thereafter, returns will again be more modest at an estimated 4.5% and 5.9% for 2023 and 2024 respectively.

Following a year of negative returns in 2020 the office sector recovered producing a return of 7.2% and mild rental growth. Whilst occupier take-up figures have been good in the first quarter of 2022, at slightly below the 10-year quarterly average, once those occupiers who have been active in the market finalise searches and commit to space there is evidence to suggest that this trend will not continue as occupiers consider space needs and questions remain as to whether downward revisions of space needs will spread further as hybrid working patterns crystalise. All office total returns will achieve growth of 5.3% this year, in line with the 2021 figure as yields continue to compress slightly and rental growth is sustained. Rest of South-East (+6.4% pa) and City (+5.1% pa) will reach the highest total returns over a five-year forecast horizon with all office total returns averaging 4.8% pa. over the period to 2026.

The industrial sector recorded a total return in the year to 31st March 2022 of 42.6%, reflecting an income return of 4.1% and exceptionally strong capital growth. This sector continues to benefit from the market share gained by e-commerce during the pandemic and the resulting need for structural change in retail distribution, combined with a lack of supply of new accommodation. Tenant demand remains robust with take up continuing to reach record levels. Although there has been a sustained increase in new development in this sector, much is pre-let and therefore availability remains low in many regions. Having already seen rental growth of 3.4% in the first quarter of 2022 the continued demand/supply imbalance is likely to drive sustained strong rental growth for the whole of 2022 resulting in an 8.8% increase over the year. Given the ongoing strength of rental growth and yields reaching record lows, all industrial total returns are predicted to show growth of 17.2% this year, before slowing to a more sustainable rate of 7.1% in 2023.
The alternative sector (which includes leisure property, hotels, restaurants and cinemas) fared particularly badly as a result of the COVID crisis recording a total return of -5.2% in the 2020/21 year with capital values falling by more than 10%. Over the past year the sector has enjoyed the beginnings of a recovery producing a positive return of 10.3% with income returns of 5.9% and modest capital growth. It is expected the alternative sector will continue to recover in 2022 as consumer demand increases, and with the benefit of a sound market structure and stable values it is anticipated that there will be increased investor demand taking advantage of lower prices and higher yields.

Whilst constrained by a limited supply of investment opportunities Rural Property remains a safe haven for investors, with income returns of 1.2%, 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 stabilised and performance has recovered showing its strongest positive returns since 2010 at 20.9%. However, the level of returns going forward are likely to be more modest as the wider economy faces more challenging conditions with inflation worries and an uncertain path of interest and gilt rates continuing to weigh on investor confidence.

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 direct development undertaken by the fund in addition to delivering financial benefits makes a positive contribution to the attainment of the County Council's five strategic outcomes and the achievement of net zero carbon from its own operations by 2030 ensuring that all development are 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 and an updated strategy will be incorporated within the Medium-Term Financial Strategy which will be considered by Cabinet and full Council later in the year.

Review of Tenant Selection and Monitoring Policy

In parallel with the strategy update a review of the management and letting processes and procedures will be undertaken to ensure that they remain fit-for-purpose and reduce risk in the current financial climate. In particular, the Tenant Selection and Monitoring Policy is already subject to a comprehensive review.

In summary the changes being proposed and detailed below are:

- Introduce a more robust system of alerts to facilitate the early identification of risk
- Strengthen the existing financial and personal reference process prior to re-letting
- Increase the monitoring of new tenant's performance over the first 3 years of the tenancy
- Strengthen lease provisions by making break clauses more robust.

In relation to management practices, existing processes have already been made more robust to enable the early identification of potential risk ensuring that issues such as missed rental (or other payments) or other potential breaches of lease obligations can be proactively managed. Where a tenant falls into arrears additional financial checks will be undertaken and arrangements put in place to recover the debt.

Further, in situations where other potential breaches of lease obligations are suspected, whether identified by routine inspection at rent review, as part of condition surveys, or visits when improvements/repairs discussed or third-party intelligence, a regime of more frequent site inspections will be triggered. As a matter of course more regular checks on the financial status of tenants whose annual rent exceeds £30k will be introduced to ensure that their finances remain robust, whilst tenant with annual rents below this threshold will be monitored according to risk.

In respect of the lettings and lease renewal procedures all tenants are required to outline their business plans which includes a 5 year business plan, with the first 3 years in detail including full cash flow projections, with details regarding necessary supply contracts with buyers and available capital and potential borrowings. All tenants undergo strict financial checks (in line with market practice this will include credit references and review of accounts, where applicable) in advance of being offered a tenancy. Further, where potential tenants cannot demonstrate that they possess sufficient assets to substantially fund the business, the Council would not usually grant a tenancy/lease.

The processes currently adopted vary between sectors across the portfolio. In respect of office, industrial and alternative sectors newly built or acquired letting opportunities are marketed through external agents who will undertake any due diligence checks in line with their instructions and terms of engagement on the Council's behalf. Generally, with all commercial lettings and it is normal that even in times of strong demand only a limited number of potential tenants will come forward based on their particular business needs, all of whom are required to make a formal application (including providing suitable business references). It is usual for newly incorporated companies that a rent deposit is held, whilst individuals are personally liable in the event of default.

Conversely, in respect of the rural portfolio there is always a strong demand from multiple applicants for every potential letting. Notwithstanding that there is a statutory basis detailing the wider obligations for Council Farms lettings, in order to manage this demand effectively a formal assessment procedure was introduced in 2013 to manage lettings. This was then updated in 2018. The assessment process includes a scoring matrix which takes account of suitability, soundness of business plan and rent offered.

The re-letting procedure includes oversight by an independent external agent appointed to scrutinise and assist with the selection process and advise on final tenant selection. Whilst this procedure was developed internally it is now widely used across the national county farms estate and has been adopted by a number of leading private sector agents. Nonetheless, although the application process is reappraised frequently it is currently subject to a comprehensive review to further strengthen the financial and personal reference aspects of the selection process to include more detailed references from current and previous landlords supported by inspections of any existing holdings (where applicable). A similar process is applied to the internal letting of promotion holdings and to tenancy extensions and renewals which takes in to account previous performance, financial resilience, and compatibility of business plans with the Council's wider objectives.

Following selection, the performance of new tenants will be assessed more frequently against their business plan and lease obligations over the initial 3 years of the tenancy. This will include regular on-site meetings with tenants and inspections of premises to verify that obligations are being met in full and provide the opportunity for any potential business or investment risks to be identified at an early date and appropriate action taken to mitigate the potential impacts. Once the tenant becomes established the regime of regular site inspections will be maintained and undertaken to coincide with rent reviews and condition surveys.

In respect of future lettings break provisions within tenancy agreements will be strengthened to give greater opportunity to act effectively in situations where a tenant fails to meet business targets or is seen to present a future risk through non-compliance with lease obligations.

To further support the process, the potential for greater cross-service collaboration within the County Council and information sharing will take place in order to enhance measures for the mitigation of major risks, such as occurred at Firs Farm, is being investigated, drawing on the expertise and statutory powers of entry and information gathering available to the Local Authority.