Investing in Leicestershire Programme

ANNUAL PERFORMANCE REPORT
2022 - 2023

Leicestershire County Council

NET ZERO LEICESTERSHIRE

Building Business. **Boosting** Communities.

FOREWORD

I am very pleased to present the 2022-23 Investing in Leicestershire Programme annual report.

Once again, the pressures on Leicestershire County Council's finances remain unprecedented and we recognised some time ago the benefits of owning a diverse portfolio of property and other investment assets.

We have been sensible and strategic in our approach to these investments and, as you will see from this report, this has seen another increase in the value of our Investing in Leicestershire Programme portfolio.

Our portfolio has grown each year since it began in 2014/15 and now stands at £233 million, helping to provide significant income for the council.

As well as income, our portfolio and investments have helped to boost our local economy through jobs and business opportunities. We're also taking our responsibilities for the environment seriously by maintaining a portfolio which is not only sustainable but also builds towards the goal of being a net zero county by 2045.

We're planning to continue this work with the development of more diverse projects which generate clean, renewable energy in order to continue to reduce Leicestershire's carbon footprint.

There are still challenges, including the pressure of high inflation which will make things tough, alongside the backdrop of our funding continuing to be among the lowest of any council.

For all these reasons, it is vital we use what tools we can to improve our own situation and IILP (and CAIF in earlier years) has shown it can contribute to funding 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

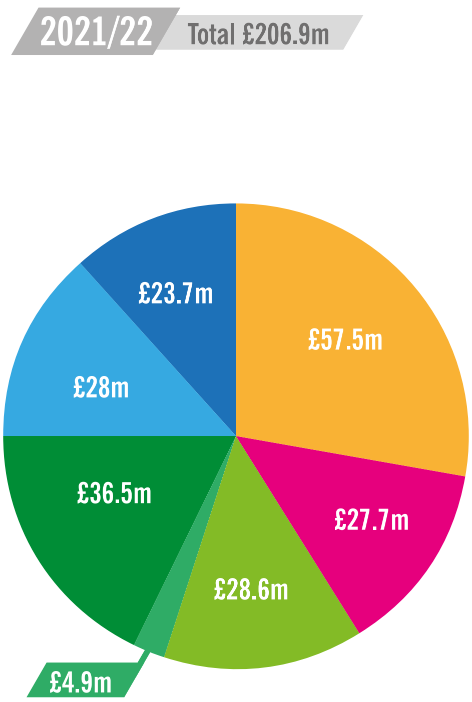
SUMMARY

This report forms the annual review of the Investing in Leicestershire Programme (IILP) portfolio, reporting on the performance for the year to 31st March 2023.

The IILP contributes 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 of 31st March 2022)



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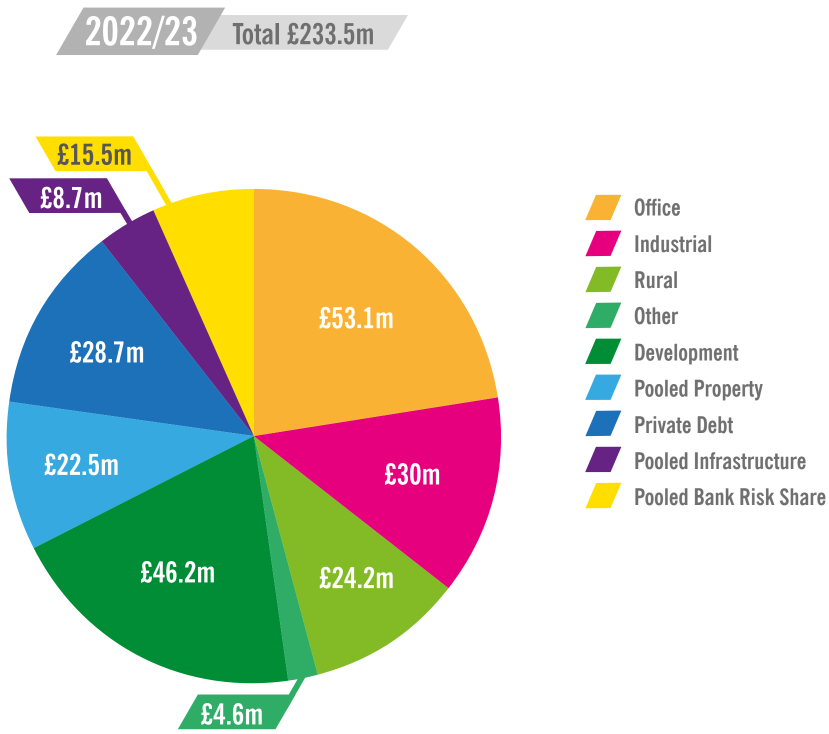


As of 31st March 2023, the capital value of the portfolio totalled £233.5 million compared with the value as of 31st March 2022 of £206.8 million. The opening and closing valuations being calculated on the basis of a combination of internal and external asset valuations; external valuations being undertaken in 2022 – 23 in respect of the whole direct portfolio.

Financial summary

	Value on 31st March 2022 (£m)	Transactions			Valuation Change (£m)	Value on 31st March 2023 (£m)	Net Income (£m)
		Acquisitions (£m)	Capital spend (£m)	Sales & Transfers (£m)			
Office	57.5				(4.4)	53.1	3.3
Industrial and Distribution	27.7		0.1		2.4	30.0	1.4
Rural	28.6		0.1	(9.4)	4.9	24.2	(0.0)
Other Property	4.9			(0.2)	(0.1)	4.6	0.3
Total Managed Property	**118.6**		**0.2**	**(9.6)**	**2.7**	**111.9**	**4.9**
Development	**36.5**		**0.4**		**9.3**	**46.2**	**(0.2)**
Direct property	**155.1**		**0.6**	**(9.6)**	**12.0**	**158.1**	**4.6**
Pooled Property	28.0				(5.5)	22.5	0.9
Private Debt	23.7	3.8			1.2	28.7	0.2
Pooled Infrastructure	0	8.7				8.7	0.1
Pooled Bank Risk Share	0	15.0			0.5	15.5	0.0
Total Diversifiers	**51.7**	**27.5**			**(3.8)**	**75.4**	**1.2**
Overall Total	**206.8**	**27.5**	**0.6**	**(9.6)**	**8.2**	**233.5**	**5.8**

Notes: All figures are rounded to nearest 0.1m

At 31st March 2023, the Programme held managed direct property assets of £111.9m, and development property of £46.2m; a total of £158.1m representing an increase of £3.0m on the previous year. In addition, the portfolio includes external pooled property funds and private debt investments, together with holdings in pooled infrastructure funds and pooled bank share funds which have been acquired in 2022 – 23 (the ‘diversifiers’); the diversifiers have a total value of £75.4 million.

Overall returns have shown a modest decline on the previous year but still compared very favourably with the wider market where the full effect of economic pressures caused an outward movement in yields negatively impacting capital values across all but the rural sector. Cushioned from the full effects of sharply falling values by the portfolio’s mid-year valuation date the only direct property sectors to suffer negative capital growth were the office and alternatives (other) sectors whereas the value of the pooled property fund fell in line with the market. However, the impact is likely to be felt in the forthcoming year as values reflect the full extent of the market correction.

A debt and sinking fund provision (central charge) has been made within the revenue account in order to better represent overall IILP 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 required in the future 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 value held as a bad debt provision may fluctuate as income is received to clear debtor accounts.

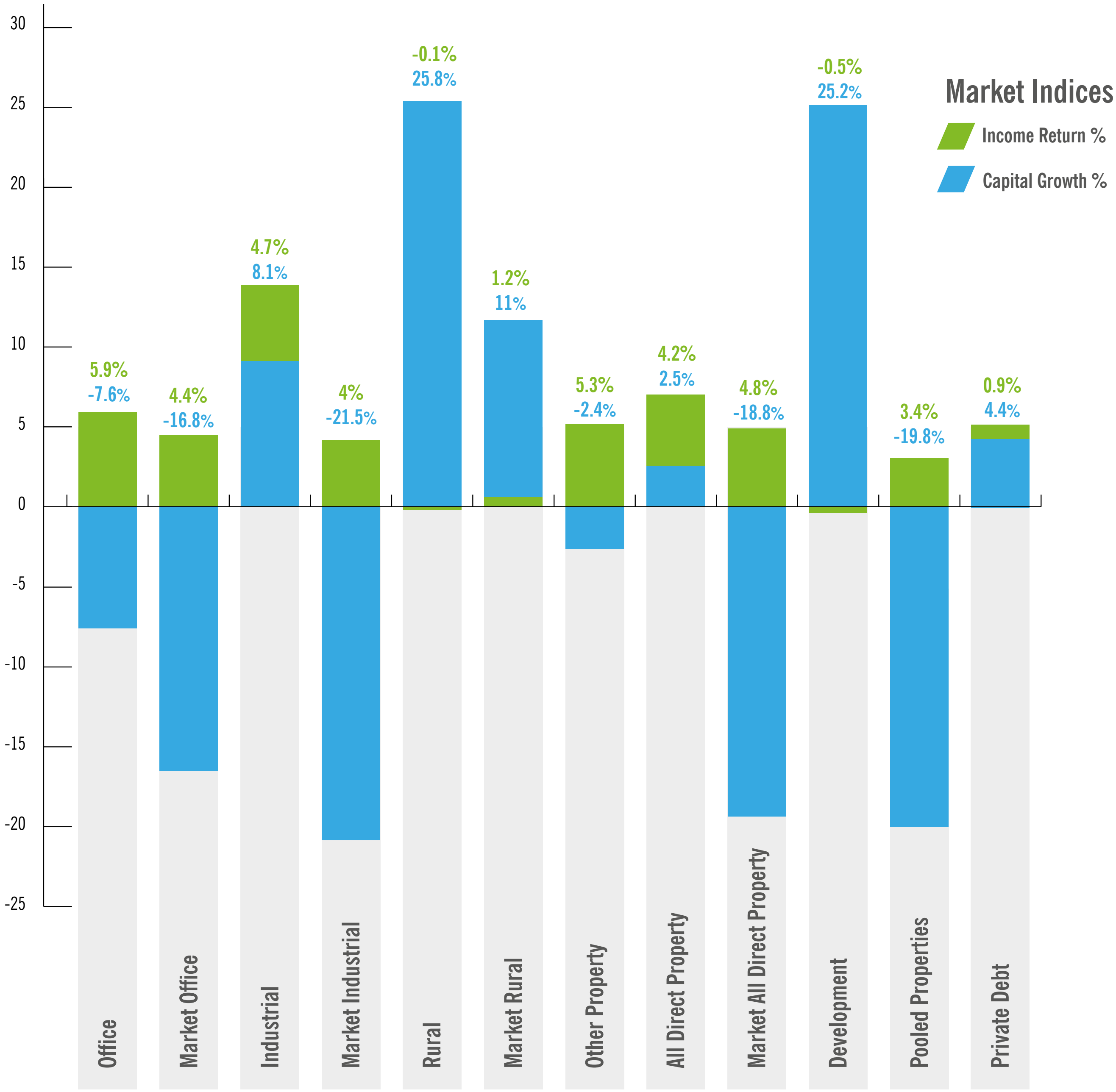
Net income includes centrally incurred costs which are allocated to the main direct property sectors. These costs include employee costs, bad debt provisions and sinking fund contributions. The current target level for the sinking fund to be built up over the period to 2026/27 is set at £5.1m.

Taking into account central charges of £1.1m set against the direct property portfolio the net income for the 2022 – 2023 year totals £5.8m.

The net income from the direct property portfolio was £4.6m for the year. Together with the income from diversified investments the total net income was £5.8m. The net income in the previous year was £6.2m which benefited from a higher income from the pooled private debt investments within the diversifiers. In the current year ended, the total portfolio generated a net income return of 2.6% compared to the 3.2% achieved in the previous year. It is worth noting that the income return expressed as a percentage is lower at the year end, due to investments made to diversifiers (pooled infrastructure and pooled bank risk share) with a total value of £24m not having paid any significant income. This is to be expected given the timing and structure of the investments, and has been factored in to future years, as we expect the pooled infrastructure fund to provide a full year of income in the coming financial year and the pooled risk share investment to start generating income in the second half of the year.

PERFORMANCE AND COMPARISON AGAINST INDUSTRY BENCHMARK

Programme Performance



The Programme'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 2023 was 6.7% compared to the target level of 6%. This represents a fall of 1.3 per cent on the previous year, but is significantly above the market level of -14.9% due in part to the nature of the assets held in the portfolio, but more importantly to the fact that the property portfolio continues to be valued as 1st October each year with the result that the value of the property assets did not suffer the full impact of the yield adjustments caused by the overriding economic conditions which prevailed in the second half of the year. However, this effect counterbalances the underperformance in capital growth in 2021/22 at a time when the wider market enjoyed sharply rising prices. Due to the full effect of the yield shift occurring after the valuation date, the value of the portfolio will likely be subject to a further downward adjustment in 2023/24.

The managed direct property portfolio (i.e., excluding the development assets, pooled property, and private debt, etc.), produced a total return for the year to 31st March 2023 of 6.7% (capital and income combined), a fall of 3.9% on the previous year. However, the direct portfolio, including the development sector produced a total return of 11.2% (up from 8.1% in 2021 - 22), both, for the reasons given above, substantially better than the of the market benchmark All Property Index of minus 14.9%.

- The office sector performed well against the market benchmark. Whilst producing negative capital growth of minus 7.6%, income return was strong at 5.9% delivering an overall return of minus 1.7% better than the market return of minus 13.0% which includes negative capital growth of minus 16.8%. Net income saw an increase of £0.5m over the previous year rising from £2.8m to £3.3m due largely to significant rental growth with the rent-free periods from earlier year's new lettings coming to an end.
- The returns from the combined Industrial and distribution sectors were 12.8% compared with the previous year at 16.6% but produced positive capital growth of 8.1% and an income return of 4.7% both of which exceeded market levels. Having fallen well short of the market return in 2021/22 due to the contraction in yields post valuation, this year saw the situation reversed with yields moving outwards in the second half of the year resulting in the market benchmark falling into negative territory at minus 17.5% including negative capital growth of 21.5% with income returns edging back to 4.0% from 4.1% in the previous year. Capital growth across the sector has also benefited from a comprehensive revaluation bringing strong uplift to individual estates values.
- The rural portfolio produced a total return of 25.7% comprising 25.8% capital growth and, with central charges exceeding net income, a minus 0.1% income return (1.3% before central charges). Accordingly, the income return fell below the market level of 1.2%. The capital growth figure, enhanced by the increased value of land at Osbaston attributable to the grant of planning permission, was well above the market level which saw freehold agricultural land prices rising sharply during the year as the sector became an increasingly attractive safe haven for investors. Agricultural land prices are by their nature less volatile than other sectors, however, there has been strong growth in freehold values over the year after several years of low growth. Investment land values have also strengthened to some extent, a trend which is reflected in the rural portfolio values.

- The alternative or other property sector produced a return of 2.9% against the minus 4.3% achieved by the market. This was largely because the portfolio holds a mixed, unconventional, range of assets within this sector, including the automotive garage in Leicester city, a petrol filling station in Loughborough and a supported education school which overall makes it less vulnerable to market volatility.
- The performance of the development sector saw significant capital growth of 25.2% arising as a result of a comprehensive external revaluation of all development assets. Development properties by their nature are unlikely to be generating more than nominal income during the development phase. It is therefore normal that the cost of planning and promoting schemes will exceed any income received and consequently an anticipated small revenue loss resulted in an income return of minus 0.5%. However overall, the sector showed a total return of 24.7% compared to the minimal returns achieved over recent years. The sector should continue to show positive returns as further developments are completed, generating either rental income or capital receipts.
- The pooled property investments are spread across four separate investment managers. The returns this year reflecting wider market conditions with capital change of minus 19.8% reflecting the annual change in the value of assets held by the managers. All four managers reflected capital losses of between 16% and 24%. Those managers who held higher levels of certain asset classes (such as highly valued industrials) were affected by the resultant repricing of assets as risk free interest rates in the UK rose sharply through 2022/23. Unlike the direct estate, the pooled property assets are valued as at 31st March 2023 and so reflect the full effect of the interest rate increases on property valuations. Whilst the capital values were impacted, the effect on income generation was more business as usual with near identical levels of net income produced year on year. The effect of the capital value decrease meant the income return percentage for pooled property increased to 3.4%.
- Private debt income returns were lower than expectations in the year largely due to one of the two investments holding higher cash levels rather than distributing cash to investors whilst the volatility in exchange rates persisted during the second half of 2022/23. The investment is hedged to GBP and as such additional collateral would have been needed to maintain hedges during the selloff in GBP versus USD during 2022 which at one point reached 1.04 GBP to the USD post the mini budget announcement on the 23 September 2022. As at the end of the year the health of underlying loans was as expected and as such the investments should generate overall returns in line with expectations for the investments. The since inception internal rate of return (IRR) for both private debt investments were 4.7% and 4.8% respectively.
- During the year new investments in pooled infrastructure funds and pooled bank risk share funds were made totalling £23.7m. The aim of these investments is to provide further diversification and regular income to the IiLP, which will be realised in the coming years.

ANNUALISED RETURNS

Total – All Direct Property Portfolio (excluding development)

	2022-23	3 year	5 year
Net Income Return	4.2%	3.7%	4.0%
Capital Growth	2.5%	5.3%	5.0%
Total Return	6.7%	9.1%	9.1%

As the IiLP has now been in operation for several years, the data for returns over the longer period better demonstrates the stability of the returns achieved by the assets in the portfolio by reducing the visible impact of any in-year peaks or troughs in performance. Over the 3 year period including 2022/23, the total return of 9.1% performed extremely well against market 3 year annualised returns of 1.2%; over 5 years, the market returns perform slightly more favourably, achieving 1.8%, but still well below that achieved by the IiLP.

Valuation Sensitivity Analysis

As outlined above, due to the timing of the annual asset valuation (as part of the corporate asset valuation), the full effect of subsequent yield movements in the half year to April 2023 are not reflected in the capital values and returns reported. Due to changes in the external valuer contract, this valuation information was not readily available for April 2023.

Internally, a simple sensitivity analysis has been undertaken of the main asset classes to demonstrate the effect of the revaluation on capital values, and consequently returns. With a new valuation consultant appointed, it is intended that the 2023/24 capital values will be revalued as at 31st March 2024 (as well as October for the corporate asset register).

Asset	Capital Value (1st October 2022)	Effect on Capital Value against October valuation.	Adjusted Income Return	Adjusted Total Return
Office	£53.1m	-£6.9m	6.3%	-13.5%
Industrial & Distribution	£30.0m	-£0.4m	4.7%	11.3%
Rural	£24.2m	n/a	n/a	n/a
Other	£4.6m	-£0.1m	5.3%	1.6%
ALL DIRECT PROPERTY	**£111.9m**	**-£7.4m**	**5.7%**	**1.3%**

Although these calculations are high level, they clearly demonstrate that the market correction occurring in the second half of 2022/23 would have a marked effect on the overall returns achieved by the IiLP. Concentrated on the office sector, the significant decline in capital values reflects the falling demand for all types of office accommodation across the sector. However, there is evidence that demand for Grade A offices, such as LUSEP, Lichfield South and Embankment House remains reasonably strong, and it is likely that these will weather the changing market situation better than lower-grade office space.

Despite yields across the industrial and distribution rising, the portfolio's assets still fare better than the wider market due to the composition of the assets; as the IiLP holdings are outside of the large Grade A and warehouse sub-sectors (which saw significant loss of value), pre-existing higher yields for secondary and tertiary investments display a smaller proportionate shift in value.

The more slow-moving rural investment market has shown some increase in capital values, but this has largely been represented in the figures reported at 1st October, subsequent activity will have had little effect on the valuation of these assets.

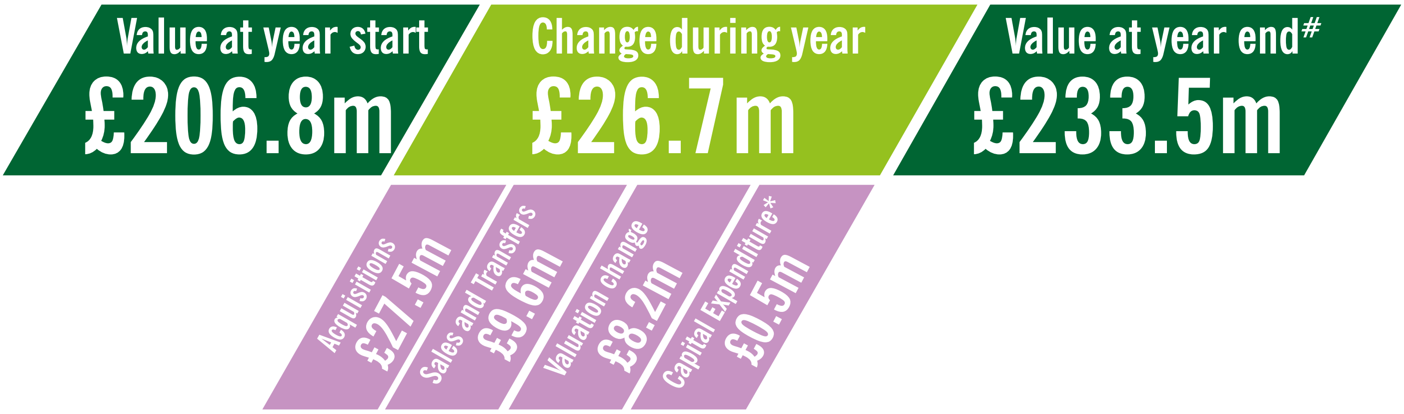
However, countering the widespread fall in capital values, hardening yields does serve to improve the Income Return performance, moving this well beyond the returns achieved in the wider market across both the industrial and office sectors.

Forecasts, borne out by first quarter 2023/24 results, indicate that the trend of increasing yields has continued, however the pace of change has slowed significantly. The current market forecasts suggest this situation will continue for the remainder of the current year, only turning around later in to 2024. On this basis, the October valuation will likely show continued negative capital growth for office and industrial investments, albeit at a slower pace; revaluation as at March 2024 may well demonstrate a turnaround, however this will be influenced by wider market factors including the ongoing inflationary pressures influence on interest rates, and rental demand.

CHANGES TO THE PORTFOLIO DURING THE YEAR

Summary of Changes

During the year, the portfolio increased in value from £206.8m as at 31st March 2022 to £233.5m as at 31st March 2023. 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.



#Direct portfolio properties valued as at 1st October 2022.

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

TRANSACTIONS THROUGH THE YEAR

Direct property acquisitions

There were no property acquisitions during the year.

Diversified Investments

Further private debt investments to the value of £5.8m were made during the year, when balanced against repayments of £2.0m and allowing for an increase in the net asset value of the private debt investments the holding now totals to £28.7m.

In addition, investments to the total value of £23.7m have been made in Pooled Infrastructure Funds (£8.7m) and Pooled Bank Risk Share Funds (£15m).

The pooled infrastructure fund investment invests in global core infrastructure. It is relatively low risk as a result, investing into essential assets which are operational and with little investment into undeveloped markets. The investment aims to provide an income return between 4-6% pa paid quarterly with moderate capital gains.

The pooled bank risk share investment product is a mechanism that banks use to transfer the risks on existing loans, as such permitting them to hold lower levels of capital against existing loans. Because raising capital is expensive for banks, they are able to pay a healthy return to the counterparty to whom the risk is transferred to. Returns to investors in the fund come from the insurance premium paid by the bank which will be distributed quarterly to investors. There is an increased level of risk in such an investment, but this is reflected in the fact that expected returns are in excess of 8%. The returns are also directly linked to interest rates, as such there will be limited erosion of the value of returns in the light of increases to interest rates.

Pooled Property

There were no transactions completed during the year.

Property Disposals

Two property disposals were completed during the year and resulted in total capital receipts of £230,000 through the sale of a small area of access land on the Kilby Farms Estate and a residential property, 5 Cotton Croft, Shepshed.

In addition, to the above there are a number of substantial disposals in the pipeline, most notably the residential element of the development site at Sysonby Farm, Melton Mowbray which having been declared surplus, marketed and contracts exchanged this part of the property was transferred out of the portfolio at a value of £9.4m (a deposit of £458,500 being paid on exchange) being regarded, for asset management purposes, as an asset held for sale. Together with the residential site at Barton Road, Barlestone where planning permission has been secured and the property marketed combined receipts in excess of £12m will accrue in future years.

Property Transfers

Apart from the transfer of the land at Sysonby Farm, outlined above, no transfers have been made during the year.

PORTFOLIO REVIEW

Current Yield

The current yield from the direct managed portfolio is 4.0% (5.1% in 2022) somewhat below the market benchmark national figure of 5.2%, largely due to the impact of sinking fund and debt charges on the rural estate's income. The portfolio's overall yield is impacted by a low yield from the development assets which has a disproportionate sector weighting compared to other portfolios meaning that overall the portfolio will likely always fall just below the benchmark until such time as those developments are completed and become income generating or are released from the portfolio.

Sector Proportions

Although there have been relatively few direct property transactions during the year, the further purchases of diversifier assets and movements in value have 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 Programme will continue to focus any property purchases on assets that address market failure and provide wider economic and community benefits and the capability of contributing to the achievement of the County Council's strategic goals as well as a long-term income stream as set out in the IILP Strategy.

Rent Reviews, Lease Expiries and Tenant Only Breaks

There are 3 rent reviews, 40 lease expiries and no tenant-only break options that are falling due in 2023/24, of which 3 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 11 rent reviews undertaken, with a further 27 remaining to be agreed or held in abeyance, 75 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, 14 new lettings were agreed.

New Major Lettings

Over the 2022/23 year the following major new letting(s) were achieved:

- **7 Apollo Court, Coalville** - £32,625 per annum rent (previous Tenant vacated on break notice)
- **17 Apollo Court, Coalville** - £37,250 per annum rent (previous Tenant vacated on break notice to expand to larger premises)
- **Oback Cottage Farm, Misterton** - £14,400 per annum rent (11-acre smallholding)

Future Investments

During 2022/23 the future funding made available through the Medium-Term Financial Strategy (MTFS) additional investment was committed to continuing the delivery of the following developments; these will have the effect of further transforming the portfolio, achieving excellent rates of return, delivering significant additional income, and contributing to the realisation 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 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 a departure from the Local Plan, because of a lack of demand for the Class B1 – office uses, the prospective tenants have been successful in securing planning permission for the proposed drive through units.

The drive-through units will generate an income of £190k pa. A contractor is currently being procured to build the new units. It is anticipated practical completion will be June 2024.

The future development of the balance of the 6.1-acre site is now being progressed for Light industrial/ Distribution use. Again, this would be a departure from the local plan. If the County Council is successful in obtaining planning for the employment units, they are projected to generate a rental income of 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%.

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. 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 and despite marketing over a six-year period no potential occupiers have come forward. This has now been accepted and, subject to agreement of design principles, the application will move forward to determination.

As a consequence of substantial increases in construction costs since submission the scheme, as proposed, is no longer viable. Accordingly, a revised strategy and masterplan has been developed to ensure adequate returns are secured from the final phase of development.

The potential exists to deliver a viable 105,794 sq. ft. development on 7.69 acres of the site; 102,194 sq. ft for E class light industrial units (formerly known as B1 use) and 3,600 sq. ft for two Drive-thru units (Sui Generis). An indicative masterplan has been produced which incorporates within the layout one 60,000 sq. ft unit and the two Drive-thru units, for which end users have already been identified, plus a range of starter and grow on units of between 1,500sq ft and 10,000sq ft. being those elements of the original proposal for which there is a strong market demand and remain viable.

A planning application will be submitted for the revised proposal in September 2023 following the receipt of Pre-application advice. Thereafter it is envisaged the scheme will proceed as follows:

October 2023	Submission Regulation 3 planning application to the County Council
September 2023	Commence formal marketing of unlet units
March 2024	Planning permission secured
September 2024	Appointment of contractor
January 2025	Commence construction
February 2026	Practical completion of the scheme
February 2026	First occupation of units

The cost estimate is currently £16.5m (including a 10% contingency) and has an estimated annual rent roll from Phase 3: £1,075,000 producing an estimated income return of 6.8%.

Solar Farm Development, Quorn

Background

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.

The work required to discharge all pre-commencement planning conditions including further on-site archaeological investigations has commenced this summer. Tender documents are currently being finalised with a view to seeking formal tenders Autumn 2023 and appointing a contractor by December 2023 enabling construction work to commence on site in summer 2024.

- **Completion Date:** Target Summer 2025
- **Build Cost:** £10.0m subject to confirmation from formal tender
- **Based on current market prices estimated net annual income:** £900,000 (for a 5 year power purchase agreement)
- **Current estimated income return:** 9.0%

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 at such time as the site access is delivered as part of the Melton Mowbray Distributor Road scheme. The school site will transfer to the Children's and Families Service.

The site of the proposed local centre has been marketed. Offers, which would also secure the delivery of either an Extra Care Scheme or a private nursing home are currently being considered. The allocated employment land to the north of the MMDR will be brought forward and as a depot site for the County Council's Environment and Transportation department upon completion of the MMDR.

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, however, University Hospital Leicester lodged an application to seek a judicial review of the district council's decision. After an appeal, their challenge was dismissed.

Now that the judicial review has been rejected, the procurement process has been restarted with some initial soft market testing. The outcome of this is that there is still an interest from the private sector developers for the site, however, funding for the initial infrastructure requirements of circa £120m is going to be challenging. It is anticipated the procurement of a Joint Venture partner will commence January 2024.

Whilst the search for a delivery partner has re-started, it is important to recognise how the context for the proposed development has changed since the application was submitted over 4 years ago. the impact of COVID on where people work (less office space needed) and escalating costs due to build cost price inflation (as well as the lack of grant funding for this 'over ready' scheme), has made the scheme unviable in its current form. Productive discussions with the planning officers at Harborough District Council have already commenced to agree a way forward to improve the scheme's viability and ensure that the district benefits from the delivered houses that it had provided for in its Local Plan.

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. The local plan process has been significantly delayed with the result that the Regulation 19 Pre-Submission consultation is not now likely to take place until September 2024 pushing the likely date of adoption back to autumn 2025. Subject to the scheme being included as a proposed allocation in the Pre-Submission Draft, it is currently proposed that an outline planning application be submitted in January 2025 in advance of the Examination in Public. The timing of surveys and site investigations is now being geared to the revised timetable.

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 is being used to help shape the master planning of the scheme.

Other potential sites

A further pipeline of 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 by 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 2023 the level of voids increased marginally from the 2022 level of 2.5% to 3.0%; the low level reflecting the continuing strong demand in the market for the types of premises LCC holds and compares very favourably to a market rate of 10.6%; currently there remains a small number of 24 units vacant across the portfolio totalling 23,058 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)

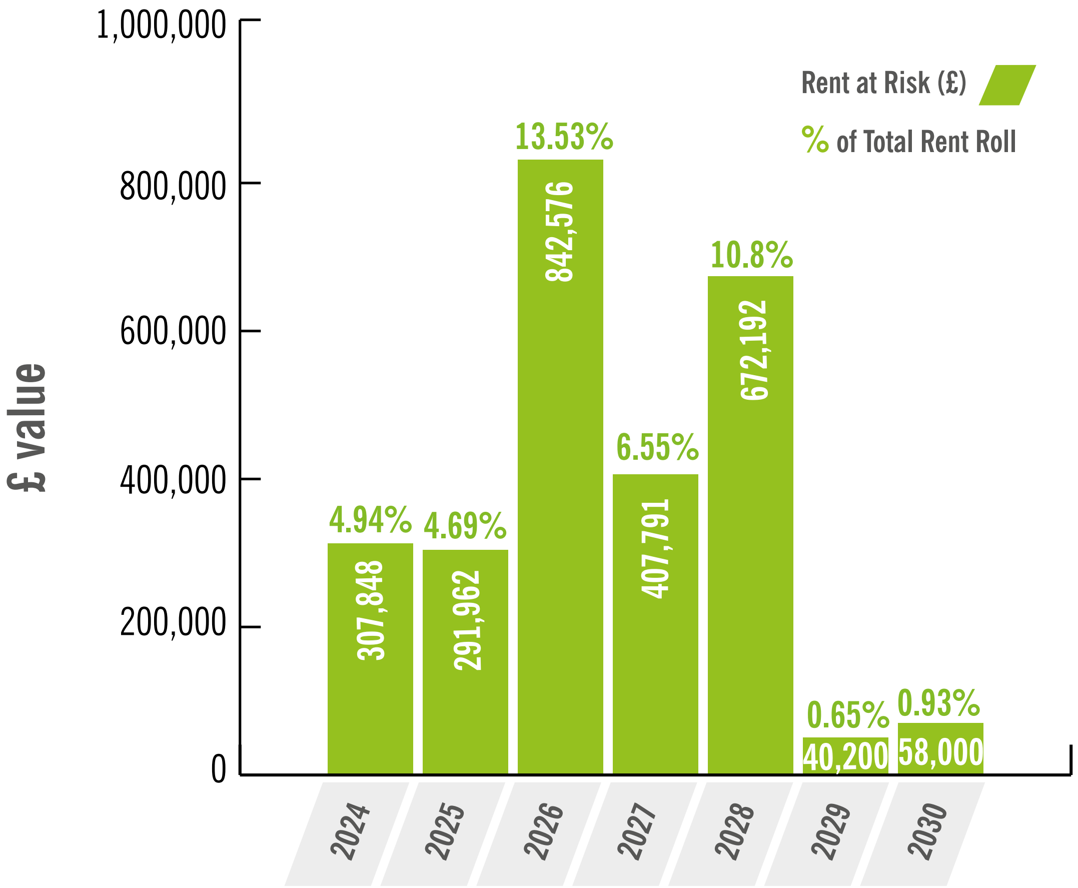
As of 31st March 2023, total 90-day debt amounted to £1.3m which equates to 18.9% of gross portfolio income and although systemic debt is greater than previous years, rent collection remains in line with wider industry performance especially during the ongoing turbulent economic conditions with over 63% of rural rents and 53% of industrial and office rents collected on time for Q4. Recent reporting suggests that the rent collection in the wider market has suffered from the impact of worsening conditions in the economy, with 63% of rents collected on time for Q1. This figure is not directly comparable with the IiLP performance due to the range of collection due dates within the portfolio but illustrates that the whole property sector is under pressure as tenants struggle. Payment of all outstanding debts is being actively pursued through debt management procedures.

It should be noted that around a fifth of the outstanding debt relates to a single property, with issues arising from the transfer of Ministry of Justice financial management to the Government Property Agency (GPA). Whilst there is minimal risk of the debt not being paid, the issues continue with both Finance and Estates colleagues in regular discussion with the GPA to provide the relevant information and bring about a resolution. Alongside this, there are a small number of long-term debtors on the rural portfolio where solutions to accelerate debt recovery and terminate tenancy arrangements are being brought forward.

In the longer term as the proportion of properties devoted to economic development continues to fall in line with the Programme's strategy, the covenant status profile should improve further reducing the 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 terms of rental value 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, Coalville 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.

Firs Farm, Husbands Bosworth

As reported in previous years, the portfolio has been engaged with remediation and land restoration following the illegal dumping and disposal of non-hazardous waste at Firs Farm, Husbands Bosworth.

Following detailed consultation with the Environment Agency the specification for the removal of the waste was agreed and the contract let at a cost of £2.3m, (which is within the original cost budget) and works commenced on site on 26th June 2023. Completion is programmed for late September 2023 at which point the land will be returned to a condition suitable for agriculture and made available for re-letting as a livestock holding.

Although events such as this are rare, a sinking fund was established (together with the debt provision) to meet or contribute towards the costs of unforeseen expenditure such as that incurred at Firs Farm. The annual contribution to the sinking fund ensures that the potential for unforeseen events is recognised and the impact from an event can be absorbed. The sinking fund accrued over previous years, together with additional funds reserved in 2021/22 are expected to cover the full costs of the remediation and restoration of Firs Farm.

The experience gained from this incident will inform a review of the processes of management and re-letting, which following an initial internal appraisal, is now being expanded by external consultants to ensure the most robust structure possible is in place to further reduce the potential of a similarly damaging incident in the future, and strengthen the management procedures and processes in place for the wider benefit of the portfolio and County Council.

Environmental, Social, Governance Reporting

In line with most other “funds”, and reflecting the refreshed focus for the programme, the IiLP is looking to establish a reporting structure for non-financial outcomes. The reporting will feature aspects of environmental, social and corporate governance (ESG), in line with the emerging market norms.

The IiLP portfolio is well placed with a diverse range of assets across a wide, strong performing, economic area to deliver robust outcomes against the main target areas identified and connect with the wider corporate aspirations and strategy.

Environmental: Climate risk, carbon emissions, green supply chains, energy consumption, biodiversity, and habitats.

Social: Health, wealth, safety, diversity

Governance: Corporate governance

Whilst the wider market is establishing reporting mechanisms, and key benchmarks for some elements of ESG reporting, the individual portfolio performance will be very dependent on the nature and composition of the assets comprised in a portfolio. To best represent the IiLP performance during the development phase of this reporting it is proposed to demonstrate year on year performance where possible.

PROPERTY INVESTMENT MARKET REVIEW

Economic Conditions

Most recent GDP estimates from the Office for National Statistics indicate that the UK avoided recession at the end of 2022 with the economy stabilising in the final quarter, following a 0.2% contraction in Q3. However, monthly figures showed a significant economic slowdown in December, with GDP contracting by 0.5% m/m with the economy returning to growth (+0.3% m/m) in January 2023. Thereafter the economy has continued to show resilience to higher interest rates with UK GDP increasing by 0.1%q/q in Q1 2023, following a 0.1% q/q rise in Q4 2022. The UK has therefore avoided recession for now which had been predicted by the Bank of England in November last year. Whilst monthly figures continue to fluctuate overall it is considered that there will be continued albeit very slow growth.

Annual retail sales volumes fell by 3.0% in 2022, which is the largest decline since data records began in 1997 and follows a solid 5.2% increase in sales volumes in 2021. At the same time, retail sales values in 2022 were 6.8% higher than in 2021 which is a direct result of higher prices. However, indications are encouraging with retail sales volumes rising by 0.4% m/m in April and whilst they remain weaker than a year ago, the April shortfall was the smallest in just over a year. In addition, consumer confidence continues to improve, reaching a 15-month high in May.

Having increased marginally to 3.8% over the past 3 months the official unemployment rate still remains extremely low by historical standards. The number of people in employment is now back above pre-pandemic levels. However, the number of job vacancies continues to slowly decline with evidence that people in the 50+ age brackets are returning to the workforce. Due to the tight labour market wage growth remains strong but real wages continue to fall.

CPI inflation reached a peak of 11.1% in October 2022 but had fallen back to 8.7% in April and May with latest forecasts suggesting it will continue to slow throughout this year. Given higher than expected inflation, a tight labour market, and a resilient economy, the Bank of England may continue raising interest rates from the current 5.25% rate over the coming months. Financial markets are currently pricing in a peak in the base rate of 5.75%, but most forecasters expect rates to peak at a lower level.

Economic Outlook

High inflation and elevated mortgage rates will limit household spending and the global economic slowdown is likely to limit business investment in 2023. June HM Treasury consensus forecasts suggest the UK economy will avoid an outright GDP decline in 2023, growing by 0.3%.

The Bank of England's central forecast now suggests a peak to trough decline in GDP of -0.8%, which is significantly milder than the 2.9% decline published in its November report. The economy is then expected to grow by around 1.0% in 2024.

Investment Market

The 2022 full-year investment figure of £60.6bn was marginally above the five-year average of £59.4bn. However, following a very strong first half of 2022 during which £35.9bn was transacted, quarterly investment volumes slowed to £14.5bn in Q3 and to £11.3bn in Q4, marking the slowest end to a year since 2008 being 40% below the five-year Q4 average of £19bn. This trend has continued into 2023 with quarterly investment volumes slowing further to just under £10bn in Q1 2023, 35% below the five-year quarterly average of £15.1bn. While office and industrial investment volumes were both around 40% below their respective five-year averages, retail investment was 23% above average.

The All-Property benchmark equivalent yield softened by 0.8% in Q4 2022, having already moved out by 0.3% in Q3. according to the quarterly MSCI index. However, early evidence at the start of 2023 suggests that the outward shift in yields has slowed; the Q1 2023 outward shift was only 0.1% to 6.2%.

Property Market Forecasts

Having increased by 16.5% in 2021 all property total returns suffered a 9.1% decline in 2022, the steepest drop since 2008. Capital values fell by 12.8%, with particularly steep declines across the industrial sector (-17.4%). Equivalent yields moved from 4.90% in Q2 to 6.1% by the end of 2022. Further, although much milder, outward movement has continued into moving to 6.2% in Q1 and potentially could continue into Q2 2023 before yields stabilise with some scope for re-compression in the second half of 2023. The All Property yield is forecast for the end of 2023 at 6.2% and then it will begin to fall in line with anticipated drops in both gilt yields and interest rates.

As detailed in the table below it is now expected that total returns of 4.2% will be achieved in 2023 and 10.6% in 2024. Over the 2023-2027 forecast period, All Property total returns will average 8.3% pa. with Industrial (10.0% pa) and Retail Warehouses (9.0% pa) outperforming the other sectors.

All Property Forecasts

	Dec 2023	Dec 2024	Dec 2025	5 years to 2027
Rental Growth (% pa)	2.1	2.3	2.6	2.6
Yield (%)	6.2	6.0	5.8	5.7
Capital Growth (% pa)	-0.3	6.1	5.3	3.9
Total Return (% pa)	**4.2**	**10.6**	**9.7**	**8.3**

Whilst property values in the main real estate sectors declined in 2022 and may continue to do so in the early part of this year agricultural land, often regarded as a safe haven during uncertain economic times and a good hedge against inflation, remained resilient with prices for freehold land rising 11% over the past 12 months.

The property yield/gilt spread narrowed to a 15-year low of 2.44% at the end of 2022 but is expected to widen again from 2023 onwards. By the end of the forecast horizon in 2027, the gap will stand at 3.32%.

Office investment, in common with the market generally, was 24% below the 5-year average in 2022. However, the uptake of office space increased by 22% returning to the 10-year average before slipping back in Q1 2023. However, the demand for Grade A space continues to exceed supply with selected pre-lets achieving “premium” terms. Occupier appetite for quality over quantity is starting to feed through into revision of size requirements by blue chip companies. This may further impact 2023 transaction levels which will likely reduce year-on-year.

All office returns fell by 9.8% in 2022, marking the steepest drop since 2008 when returns declined by 22.8%. While rental growth of 2.2% was sustained last year, yields rose by almost 1% in H2, resulting in a 13.2% decline in capital values. It is anticipated that yields will continue to rise over the year, ending 2023 at 6.7%, up from 6.5% at the end of last year. Office rents will fall this year because of the anticipated recession although there are large differences between prime, where rents are stable, and secondary/tertiary where rents are expected to decline. Total returns growth is predicted to be modest this year at 1.3% before accelerating to 7.3% in 2024. Over the forecast horizon to 2027 total returns growth will average 6.1% per annum.

Whilst investment in the Industrial and Logistics sector was 23% above the 5-year average in 2022 there was sharp decline in the H2 following a strong start to the year. Demand for space was also well above the long-term average, without reaching the record figures of 2021, resulting in continued double digit rental growth across many regions including the East Midlands. However, this is predicted to fall back to 3.7% in 2023 with an average of 4.2% per annum in the period to 2027.

Yields rose faster than had been anticipated in Q4 2022 ending the year at 5.6% resulting in a sharp decline in values. Further small rises are anticipated in Q1 and potentially Q2 2023 before stabilising and re-compressing towards the end of the year. Beyond 2023, yields will compress, moving from a predicted 5.70% at the end of 2023 to around 5.00% by the end of 2027.

All Industrial total returns fell by 14.6% in 2022 but are expected to return to 6.0% growth in 2023. Total returns growth will then accelerate to 13.4% in 2024 and remain in double-digits until the end of the five-year forecast horizon.

The pricing adjustment of the Retail sector due to long term structural changes experienced over the past few years looked to be coming to an end. All retail equivalent yields having reached a recent high of 6.8% in Q4 2020 had compressed to 5.7% in mid-2022 driven by sharp yield movements across retail warehouses and supermarkets. However, the wider economic and investor uncertainty later in the year resulted in yields shifting back out to 6.6% in Q4. Given the sharp pricing adjustments that have already taken place some segments appear to have stabilised and therefore All retail yields are expected to end this year at 6.6%. Yields will then move in to 6.4% in 2024 and continue to compress slowly thereafter with Retail Warehouses seeing the sharpest fall in yields over the forecast horizon.

Total returns fell by 4.8% in 2022 but, driven by income return, will return to growth of 5.8% this year as capital values remain flat. Over the 2023-2027 period, total returns growth will average 7.9% pa, driven by Retail Warehouses at 9.0% pa.

Whilst constrained by a limited supply of investment opportunities Rural Property remains a safe haven for investors, with income returns of 1.2%, increasing capital values, especially for freehold assets, and the prospect of modest long-term capital growth achieved through the realisation of development potential.

Investment in, demand for and the general performance of the alternative sector in 2022 mirrored that of the market generally. A strong demand for investments in segments such as student accommodation in the H1 2022, which supported an average level of transactions over the year, declined sharply in Q4; a trend that appears to be continuing into 2023 especially in the leisure and hotel sector. Yields increased across the sector by 0.8% - 1% in H2 2022 resulting in negative capital growth with the further outward movements in Q1 2023 likely to impact returns this year.

In common with the market in general it would appear that the market for pooled property investments is also beginning to stabilise following significant falls in value and negative returns in 2022. However, the level of returns going forward are likely to remain modest as the wider economy continues to face challenging conditions with inflation and interest rates remaining high making gilts and other alternative investments more attractive.

Investment Strategy Update

The Portfolio Management Strategy for 2023 to 2027 is aimed at supporting the development of the Portfolio to further enhance its contribution to the delivery of strategic goals whilst continuing to improve the Council's financial resilience as demand on services and operating costs continue to rise. It outlines how the Council will look to direct investments during this period developing the Portfolio to address areas of specific economic or social market failure and how it will manage these to help achieve the strategic priorities of the Council.

The Strategy is an integral part of the Council's Medium-Term Financial Strategy (MTFS) and intrinsically linked with the Corporate Asset Management Plan (CAMP) and the Treasury Management Strategy and Annual Investment Strategy and it should be read in conjunction with these documents.

The specific aims of this Strategy are to ensure investments funded or held in the Portfolio:

- Support the objectives of the Council's MTFS, Corporate Asset Management Plan, Strategic Plan, its Economic Growth Plan, and the County-wide Local Industrial Strategy.
- Support growth in the county and its economic area of influence and ensure there is a more diverse range of properties and land assets available to meet the aims of economic development.
- Maximise returns on Council owned property assets
- Supports the delivery of front-line services through increased income generation from existing investments, or through capital investments that will reduce operating costs.
- Maintain a diverse portfolio of energy efficient and sustainable direct property and other investment assets which support economic growth and environmental sustainability
- Support the Council's strategic objectives by working with partners to maintain momentum in the development of strategic sites and renewing existing employment sites and premises where there is demand thereby addressing areas of market failure.
- Contribute towards the development and implementation of a Net Zero Carbon 2030 Plan for the Council by reducing demand for energy and increasing the generation and use of renewable energy
- Channelling new investment into schemes that:
- Maximise the potential to address economic and social market failure
- Improve property assets for a direct strategic/policy purpose
- Enhance the value and marketability of property assets enabling capital receipts to be used to support improved service delivery
- Manage investment risk by investing in diverse sectors.
- Support the Council in maximizing the benefit from its financial assets in a risk aware way (not including standard treasury management activity)

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 Programme's strategy continues to be reviewed annually 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.

Rural Estate Management Review

In parallel with the strategy update an internal review has been undertaken in respect of the management procedures and processes for the rural estate with the aim of ensuring these reflect current best practice and continue to be fit-for-purpose and reduce risk in the current financial climate, and in to the future with expected changes in agricultural, environmental and rural policy.

The review examined a number of areas that it was considered could be enhanced in order to mitigate future risk. Broadly, these fall into the following categories: -

- Frequency of farm inspections, the enforcement of tenant's obligations and monitoring of tenant performance.
- Re-letting procedures.
- Tenancy Agreement terms and conditions.
- Ongoing financial checks.

As a result of the review the following measures have been actioned or are in progress to reinforce and update the management of the rural estate:-

- Recruitment of additional staff resource is now underway which will enhance the frequency of farm inspections and help improve the monitoring of tenant performance and compliance.
- Routine farm inspections are being increased, on a risk assessed basis, with newer tenants, those in arrears, or displaying any other risk factors, being targeted for more frequent formal visits, at least annually, and depending on the risk assessment and any frustrating factors, more often provided this does not breach the Landlord covenants in the tenancy. A formal reporting record will be re-established, which will also include notes of third-party status reports, etc. Regular drive-by inspections are undertaken of most farms currently, but these will be recorded more rigorously. The lowest risk tenants will be visited in the next 12 months to re-establish the baseline for future visits.
- The Council's standard farm business tenancy agreement has been reviewed by external legal advisors to ensure that terms appropriately reflect statutory changes since the last internal review, alongside some minor adjustments to the legal drafting they have recommended enhancements to the break clause provisions to enable a more robust response in the event of issues arising during the course of a tenancy. Further advice is being sought on provisions for forfeiture and how best to deal with breaches of the rent covenant.

- Modifications to the re-letting procedure, including the requirement for guarantors and deeper financial checks, have been put in place and will be applied to all future lettings. The main elements of the reletting process, in-line with industry practice, will remain in place, subject to any developments proposed in the external review, with the applicant expected to provide a substantial supporting application including background information, financial records (including capital position) and references.
    - The reletting procedure follows the industry norms, together with the specific statutory requirements relating to Council owned farms. The letting opportunity is advertised, both in the national farming press and on the Council website. Applicants are expected to attend a viewing day, inspect the farm and put together an outline business plan with supporting information for initial shortlisting. The shortlisting process is undertaken internally against a pre-established selection criteria tailored to the farm opportunity. Following shortlisting 4 or 5 applicants are invited for formal interview, providing additional supporting information (including that outlined above), a full business plan setting out their proposals for the first three years of the tenancy. The interviews are conducted at County Hall and are supported by an external, independent, agent who provides a final recommendation report for the selected tenant, based out the scoring outcome from the assessment matrix and the interviewee performance and explanation. Prior to final appointment a review of financial references, personal references and current farming activities (including, where appropriate, farm inspections) is undertaken.
- Additional support is being put in place the ensure that ongoing financial information is available in a timely manner and the system of regular financial checks actioned. Coupled with this, finance resource is being tasked to support debt monitoring and collection across the rural portfolio to help ensure that irregular, and small value arrears does not become a greater problem, and help manage the existing debtors to ensure timely responses to escalation or initiation of legal responses (where appropriate).
- Internal, cross departmental, communication channels have been improved to ensure that relevant information relating to tenant's actions or failures is acted upon at an early stage, thereby helping to reduce the risk of problems escalating with damaging outcomes.

Building upon the initial assessment, an external review of the management of the rural estate (independent of any wider review of IILP Strategy due later this year) is currently being undertaken to challenge existing practices and provide confidence that the systems and processes for management together with the measures outlined above meet current industry standards, best practice and reflect the requirements of the changing regulatory frameworks and expectations for future management of a diverse, leased, rural portfolio. The review will also look for opportunities to further improve economic and social returns and improve alignment with the wider county council objectives.

Whilst the focus of the current review is the rural estate and some of the management recommendations will have wider application, it is proposed that a similar review of the management practices and letting arrangements be undertaken across the wider commercial portfolio to ensure that these are also meeting the requirements and expectations of a modern mixed asset portfolio.

GLOSSARY

Yield: Yield is the net income (i.e., rent passing) expressed as a percentage of capital value. (Net Income)/(Opening Value). In the context of this report, yield is used as a valuation comparator rather than solely as an expression of returns.

Net Income Return: Net Income Return is the net income receivable expressed as a percentage of capital employed. This differs from the Initial Yield as it considers costs of ownership, including capital expenditure. (Net Income)/(Opening Value + Capital Expenditure).

Capital Growth: Capital Growth is the increase of the capital value, net of capital expenditure or income expressed as a percentage of capital employed. (Closing Value – Opening Value – Capital Expenditure + Capital Receipts)/(Opening Value + Capital Expenditure)

Total Return: Total Return is the sum of the Capital Growth and Net Income Return.

All Property Yield: All Property Yield is most commonly a calculation of the Initial Yield taking account a range of property asset classes (i.e., a portfolio yield)

Sinking Fund: A sinking fund is an accounting device whereby funds are held on the balance sheet to offset or mitigate possible future costs incurred such as major incidents, significant revenue expenditure, etc.

Bad Debt: Bad debt is taken as any debtor account (most likely rent) which has remained due beyond 6 months. A bad debt provision is held against the debtor sum, and when the debt is cleared the provision is credited back to the revenue account.

Rent Review: Commercial and agricultural leases usually allow for periodic review of rents. Most commonly on a 3 year cycle, the rent due is reviewed by negotiation and reference to comparable rents or a statutory formula. Occasionally rents will be reviewed by reference to RPI or other inflationary measures, although these are less common for the types of assets held by IiLP.

Lease Expiry: Most commercial and agricultural leases do not automatically terminate on expiry but continue to "hold over" with the tenant bound to perform the obligations of the lease. There is no specific requirement to renew the lease, but the tenant usually gains a more flexible position in respect of notice to quit provisions. The Landlord remains bound by statutory restrictions on termination such as grounds for notice or time limitations.

90 Day Debt: For LCC KPI purposes, debt over 90 days past due is performance benchmarked.

Voids: Where commercial or agricultural property is vacant but physically capable of being leased or occupied it is classified as a void; property which does not meet statutory requirements for letting and is pending refurbishment, or unoccupied but leased is not included within the void figures.

Rent Roll: The rent roll is the total annual income achievable by the property without deduction for rental allowances (i.e., rent-free periods) or other incentives, back-dated charges, premiums, or non-rental charges.

Leicestershire County Council

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