Investing in Leicestershire Programme

ANNUAL PERFORMANCE REPORT 2023 - 2024

Leicestershire County Council

NET ZERO LEICESTERSHIRE

Building Business. **Boosting** Communities.

FOREWORD

I am pleased to present the 2023-24 annual report for the Investing in Leicestershire Programme.

The continued success and increased value of our portfolio, as you will see from this report, is an example of the proactive work we're undertaking to try and ease the exceptional financial pressures we face as a county council.

With investment assets and a diverse portfolio of property, we're ensuring that not only are we safeguarding the county council, but also bringing jobs and prosperity to Leicestershire.

Our sensible approach means we have a portfolio which is continuing to provide significant income for the council - which we are ploughing back into delivering vital services for our residents.

It's also our responsibility to ensure we're boosting the local economy with our portfolio, and the jobs and business opportunities we have built is another positive for the work we've done.

A commitment to taking the local environment seriously is continuing, with the portfolio continuing to be sustainable and building on the goal of being a net zero county by 2050.

There are still challenges, and we're still the lowest funded county council in the country, but we're making practical decisions on key projects within the programme to ensure they come to fruition so they benefit residents and the council.

This is why we're using what we have available to us to improve our own situation to help fund the high-quality public services our residents expect of us, continue to boost our wider economy and achieve the goals 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 performance for the year to 31st March 2024.

The IILP contributes to the economic, social, and environmental wellbeing of the people of Leicestershire; 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 2023)

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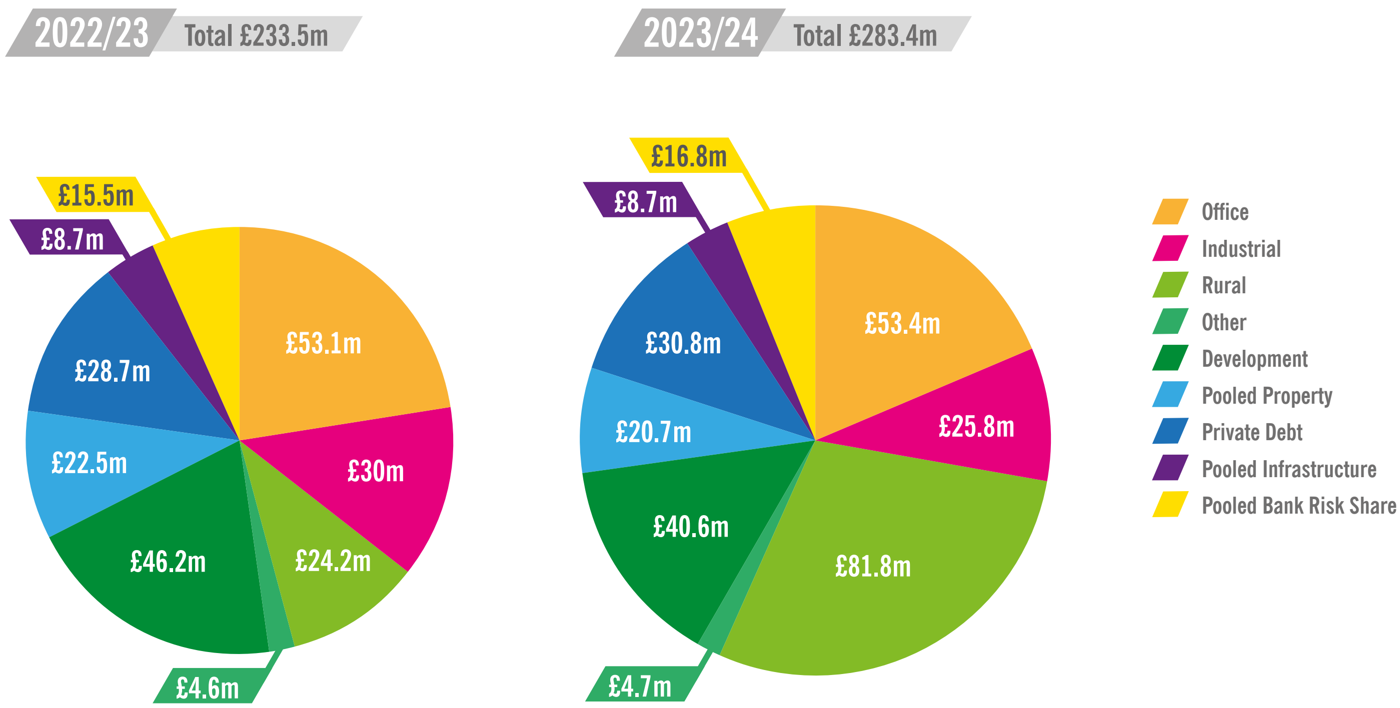


As of 31st March 2024, the capital value of the portfolio totalled £283.4 million compared with the value as of 31st March 2023 of £233.5 million. The opening and closing valuations being calculated on the basis of a combination of internal and external asset valuations; external valuations being undertaken in 2023 – 24 in respect of the whole direct portfolio.

Financial summary

	Value on 31st March 2023 (£m)	Transactions			Valuation Change (£m)	Value on 31st March 2024 (£m)	Net Income (£m)
		Acquisitions (£m)	Capital spend (£m)	Sales & Transfers (£m)			
Office	53.1		0.1		0.2	53.4	2.9
Industrial and Distribution	30.0		0.0		(4.2)	25.8	1.5
Rural	24.2*		0.1	(3.5)	6.2	81.8	0.2
Other Property	4.6				0.1	4.7	0.2
Sub-Total Managed Property	**111.9**		**0.2**	**(3.5)**	**2.3**	**165.8**	**4.8**
Development	**46.2**		**0.6**	**(0.6)**	**(5.6)**	**40.6**	**(0.1)**
Central Costs							**(1.2)**
Direct property	**158.1**		**0.8**	**(4.1)**	**(3.3)**	**206.4**	**3.4**
Pooled Property	22.5				(1.7)	20.7	0.9
Private Debt	28.7		5.6	(5.1)	1.6	30.8	1.7
Pooled Infrastructure	8.7				0	8.7	0.5
Pooled Bank Risk Share	15.5				1.3	16.8	1.1
Total Diversifiers	**75.4**		**5.6**	**(5.1)**	**1.1**	**77.0**	**4.2**
Overall Total	**233.5**		**6.4**	**(9.2)**	**(2.2)**	**283.4**	**7.6**

Notes: All figures are rounded to nearest 0.1m .
*The valuation change of the Rural Sector is based on a figure of £79.0m being the opening valuation adjusted to reflect the change in valuation guidance used to determine the closing valuation.

At 31st March 2024, the Programme held managed direct property assets of £165.8m, and development property of £40.6m; a total of £206.4m representing an increase of £48.3m on the previous year. The majority of the change is due to an upward revaluation of the rural estate. This is a technical adjustment so prior year comparisons, such as the valuation change, have been updated so that the performance in the year is not distorted.

With the exception of industrial and distribution, the other sectors compared very favourably with the wider market; the negative capital growth figures in three sectors being a result of outward yield movements in the second half of 2022/23 that were not reflected in valuation undertaken as at 1st October 2022. Accordingly, the portfolio's mid-year valuation date continues to have a phasing effect on capital values, with subsequent movements in yields resulting in the movement in capital valuations being out of step with the wider market, the effects have now largely corrected themselves as the market stabilises. Although in the current year this effect is shown through negative capital growth in the industrial asset sector, future years should align more closely with the market performance.

A sinking fund provision (central charge) has been charged to revenue in line with previous years. This charge recognises that building a provision for future maintenance or unforeseen costs is prudent. 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.

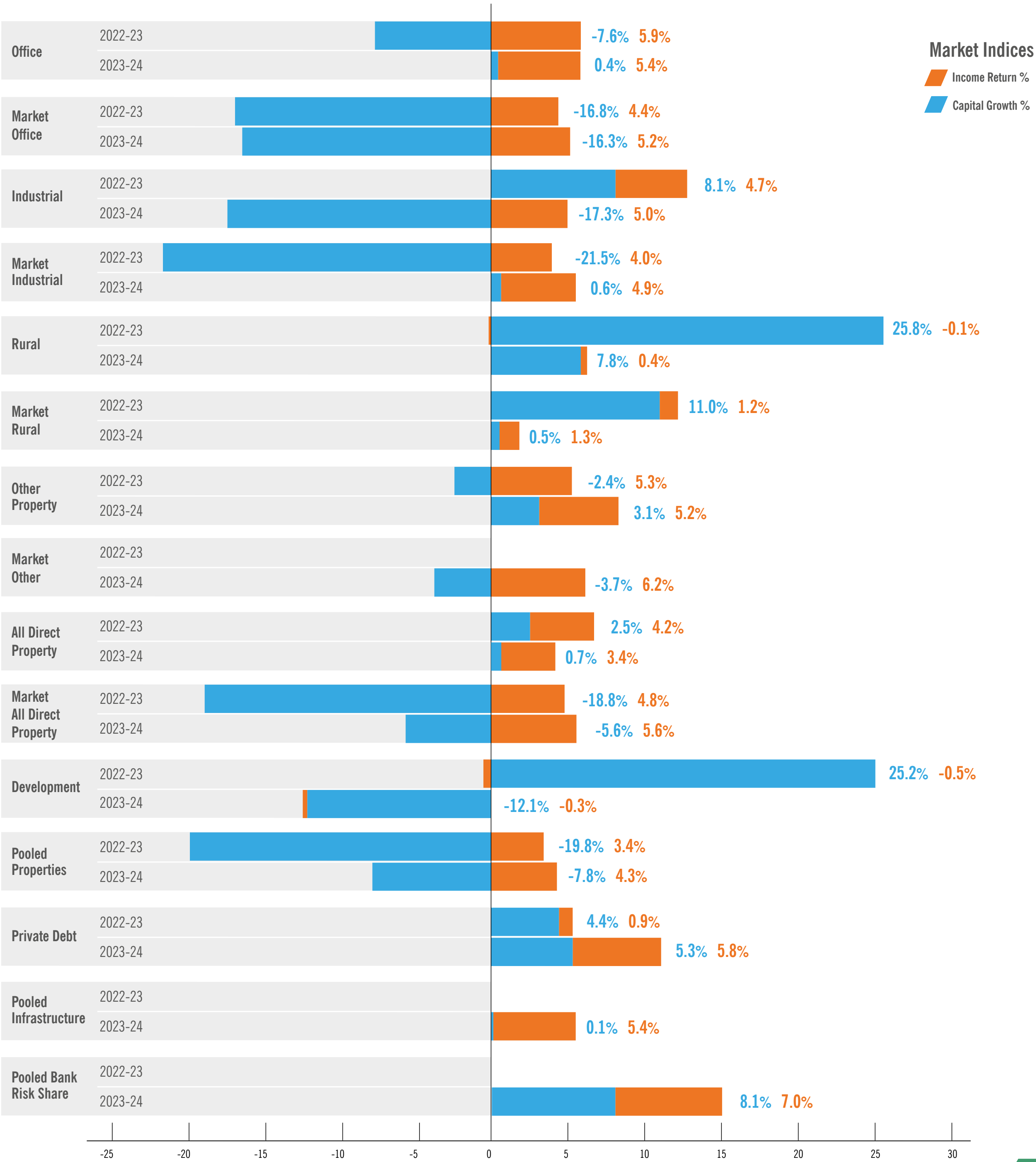
The IiLP also recognises potential bad debts, as such a provision is used to cover the potential for incomes (e.g. rent) not being received as expected. Once a provision is established it is reassessed each year in light of what is known about outstanding monies still to be received. The value held as 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 2027/28 is set at c£6m. This will be reassessed each year based on information regarding the assets within the Fund.

The net income from the direct property portfolio was £3.4m for the year. Together with the income from diversified investments the total net income was £7.6m. The net income in the previous year was £5.8m. The current year benefiting 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 3.3% compared to the 2.6% achieved in the previous year. The Development and Rural assets are predominately held for capital returns, rather than revenue income, removing these assets from the income return calculation gives equivalent figures of 4.6%.

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 2024 was 3.3% compared to the target level of 6%.

The non-rural managed direct properties produced a total return of 0.4% which although well below target aligns with market level of 0.3%. Importantly the fact that the property portfolio continues to be valued as 1st October each year will result in the assessment of the portfolios performance not being fully aligned with its benchmark as the impact of yield changes in the second half of each year are not being reflected in values until the following year. Whilst the effect of this counterbalance over the longer term, as demonstrated by the returns over a 5-year period, at times of economic and market turbulence comparison with the market is difficult to assess accurately.

The managed direct property portfolio (i.e., excluding the development assets and diversifiers.), produced a total return for the year to 31st March 2024 of 4.1% (capital and income combined), a reduction of 2.6% on the previous year but above the market return of 0.3%.

- The office sector continues to perform consistently well against the market benchmark. Whilst producing a small capital growth of 0.4%, income return was strong at 5.4% delivering an overall return of 5.8% significantly better than the market return of minus 11.9% which includes negative capital growth of minus 16.3%. Net income remained constant at £2.9m due largely to maintaining full occupation of the major office assets.
- The returns from the combined Industrial and distribution sectors were minus 12.3% compared with the previous year at 12.8% . Due to negative capital growth of 17.3% as the market corrections of late 2022 and 2023 fed into the valuations for this year. However, the income return of 5.0% matched market levels.
- Whereas in previous years the value of the rural estate was based on an investment value calculated by reference to assets net income in perpetuity, from 2023-24 using the revised guidelines, as interpreted by the Council's external asset valuers, assets will be valued at full market value with an allowance for the tenant's reversionary interest resulting in an increase in value approaching £60 million (250%). However, if offered to the market it is likely that only a proportion of this uplift would be realised given the nature and extent of the rural estate as a whole. To avoid distorting the reported number the change in approach has been applied to the opening values. The rural portfolio produced a net income of 0.4% income. The income return fell below the market level of 1.3%. The effects of the revaluation notwithstanding the capital growth figure was enhanced by the sale of 8 acres of development land at Osbaston. If the uplift in the valuation figures is discounted the returns from the rural sector would have been 7.8% which exceeded those of the market which saw only a nominal 1.0% capital growth and an income return of 1.3%. Agricultural land prices are by their nature less volatile than other sectors, however, in recent years there has been strong growth in freehold values over the year as a result of investors recognising that it represents a "safe haven". This trend has slowed and with an increased supply prices have stabilised.

- The alternative or other property sector produced a return of 8.3% against the 2.3% achieved by the market. This was largely because the portfolio holds a mixed range of assets within this sector, including a car dealership 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 was impacted by the changes in economic conditions which caused the market correction experienced by other sectors resulting in negative capital growth of 12.1% compared to the strong growth of 25.2% in the previous year; the fall in value being reflected in the comprehensive external revaluation of all development assets undertaken during the year. The single most valuable asset being the Lutterworth East development site.. Development properties by their nature are more vulnerable to changes in the wider economy than other investment sectors and as detailed later in the report, in respect of the Lutterworth East development, it is necessary in such circumstances to seek to review aspects of the scheme to mitigate the impact. Equally, development properties 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 0.3%. However, the sector should show positive returns in future years as further developments are completed, generating either rental income or capital receipts.
- The pooled property investments are spread across four separate investment managers. A total of £25m was invested between 2015 and 2019. A 4.3% income return was slightly ahead of expectations, capital values however across the four investments fell by a combined 7.8% in the year to March 31 2024 as the full effect of rising interest rates fed through to property valuations having already suffered in the previous year when Bank of England base rates rose from 0.75% in April 2022 to 4.25% by March 2023.
- One of the investments held by the IiLP is in the process of being wound up following an Extraordinary General Meeting (EGM) on the 28 March 2024. In early June the first return of capital totalling £2.5m was received (the IiLP invested £7.5m in December 2015). The remaining capital will be returned as underlying properties are sold by the manager. It is important to note that this is a forced sale during a period when property values are depressed in comparison to the periods preceding the increase in the Bank of England's base rates. Given the inverse correlation of property values to base rates the decrease in capital values was inevitable, however the forced nature of the sales means the IiLP fund is not able to 'hold' the investment, collect the income and then choose when to exit. The overall expected capital loss (invested capital minus returned capital from asset sales) is expected to be £1.9m based on forecasts from the investment manager. The total return including quarterly distribution shows a small positive return since inception, +0.2% (IRR, internal rate of return).

- The Fund invests in Private Debt via one manager across three different investments. The private debt income returns were higher than budgeted in the year having had a lower income return in the previous year. Over the two years (22/23 and 23/24) income returns are largely as expected. One of the reasons this investment has income volatility is that the private debt fund is hedged to GBP and as such during volatile foreign exchange periods cash would have been retained in order to service hedging requirements by the manager. For example, during the selloff in GBP/ USD in 2022, the rate fell rapidly to 1.04 GBP to the USD which would have required additional cash to service the hedge. The since inception internal rate of return (IRR) for two private debt investments were 4.8% and 7.5% respectively. It is too early to measure the returns for the third investment.
- The infrastructure investment is made via one manager. This is a globally diversified infrastructure fund investing in core assets. The assets are operational and therefore the investment carries very little development risk. The underlying assets are situated by developed markets and offer strong incomes underpinned by contracts, many assets operate in regulated environments further underpinning income visibility. The carrying value of the investment in GBP is £8.7m and generated £0.5m income in 2023/24.
- The Fund has also invested in a bank risk share strategy in 2022/23. The total £15m was fully called by the manager by December 2022. The IiLP fund started receiving income payments in the final quarter of 2023/24. Income received was higher than expected due to the higher underlying bank rates that were in force in Europe when the manager was investing, these led to better priced deals than expected. The interest rate conditions which were unfavourable (higher and rising bank interest rates) for many investment sectors were a positive tailwind for this diversifying investment.

ANNUALISED RETURNS

Total – Portfolio (excluding development and rural sectors)

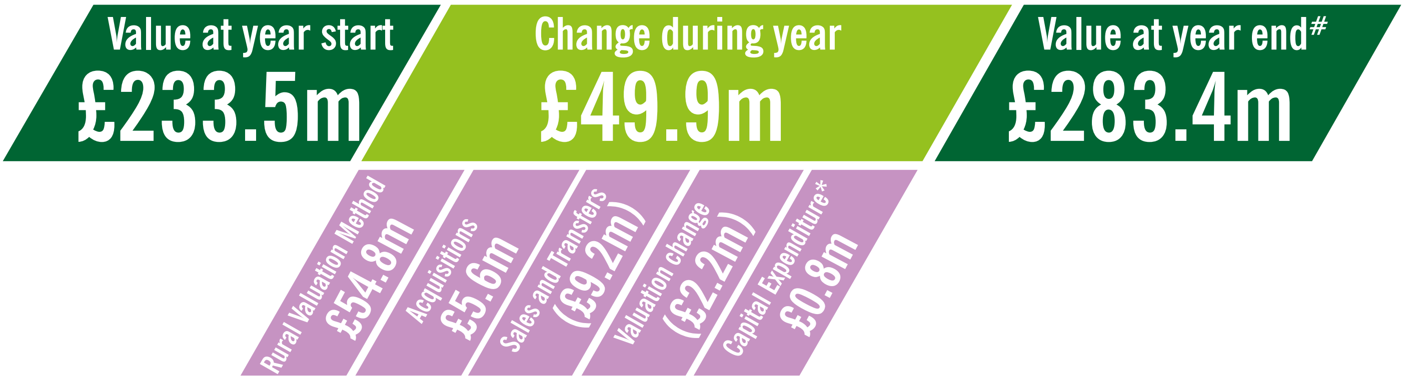
	2023-24	3 year	5 year
Net Income Return	4.6%	4.2%	3.9%
Capital Growth	-4.2%	-1.7%	-0.5%
Total Return	0.4%	2.5%	3.4%

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 2023/24, the total return of 2.5% was achieved against the market 3 year annualised returns of 1.7%; over 5 years, the market returns were slightly less at 1.6% still below that achieved by the IiLP at 3.4%.

CHANGES TO THE PORTFOLIO DURING THE YEAR

Summary of Changes

During the year, the portfolio increased in value from £233.5m as at 31st March 2023 to £283.4m as at 31st March 2024. This increase was due almost entirely valuation changes as set out in the chart below..



#Direct portfolio properties valued as at 1st October 2023.

*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 £5.6m were made during the year, when balanced against repayments of £5.1m and allowing for an increase in the net asset value of the private debt investments the holding now totals to £30.8m.

No further investments were made in Pooled Property, Pooled Infrastructure Funds or Pooled Bank Risk Share Funds.

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 £4.02m through the sale of two development sites at Barton Road, Barlestone (Osbaston Farms Estate (£3.45m) and Highfield Street Coalville (£0.57m).

Property Transfers

No direct property transfers have been made during the year.

PORTFOLIO REVIEW

Yield

The yield from the direct managed portfolio is 4.5% (4.0% in 2023) somewhat below the market benchmark national figure of 5.6%, largely due to the impact of sinking fund and debt charges on the rural estate's income which are at above market levels due to the current debt profile and the need to replace funds used to undertake reinstatement works at Firs Farm, Husbands Bosworth. The portfolio's overall yield is also 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 movements in value, particularly in respect of the rural sector 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 8 rent reviews, 32 lease expiries and 10 tenant-only break options that are falling due in 2024/25, of which 1 relates to an asset 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 9 rent reviews undertaken, with a further 28 remaining to be agreed or held in abeyance, 27 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, 11 new lettings were agreed.

New Major Lettings

Over the 2023/24 year the following major new letting(s) were achieved:

- **Suite B, Loughborough Technology Centre** - £43,980 per annum (tenant relocating within the estate to form main UK headquarters)
- **Units 3 & 5, Oaks Industrial Estate, Narborough** - £50,700 per annum (tenant expansion)

Future Investments

During 2023/24 the future funding made available through the Medium-Term Financial Strategy (MTFS) for additional investment was committed to the delivery of the following developments; these will have the effect of further transforming the portfolio, achieving target rates of return, delivering 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. The planning consent required some s.278 highway works. A contractor is currently being procured to build the new units. It is anticipated that the works will commence Q1 2025.

The future development of the balance of the 6.1-acre site is now being reviewed. There is interest from end users for charge points and the remaining site is being considered for Light industrial/ Distribution use. However, this would be a departure from the current 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. £550k pa. The overall construction cost is projected to be in the region of £6m (excluding the £2.5m already spent on the estate roads and services) giving an expected income return of c.6.2%.

Airfield Farm Business Park (Third & Final Phase)

Background

Following completion and the successful launch of Phase 2 of the new industrial development at Airfield Farm Business Park, a planning application was submitted in January 2024 for the final phase of development for a 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). The layout incorporates a 60,000 sq. ft unit, a 12,500 sq. ft, two Drive-thru units, EV Charging bays and a range of starter and grow on units of between 1,500 sq. ft and 10,000 sq. ft being those elements of the original proposal for which there is a strong market demand and remain viable.

Pre let Agreements are being entered into for the 60,000 sq. ft unit, 12,500 sq. ft unit, one of the Drive Thru units and the EV Charging bays which represents 82% of the proposed scheme reducing risk for the scheme.

The County Councils appointed commercial agents are confident as soon as construction commences on site that interest in the unlet units will be received in the hope of securing pre- lets prior to completion of the overall scheme in October 2025.

A formal tender process has been undertaken and a preferred contractor has been identified. The successful tenderer has submitted a tender price which is within budget.

The planning application was approved on 11th July 2024.

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. Over the past year the delivery options for the scheme have been reviewed and given the constrained resources available to deliver the scheme and the need for it to be delivered in compliance with its planning consent and meet deadlines for its connection to the grid the development opportunity has been offered to the market with a view to achieving a freehold or leasehold disposal and a disposal is being progressed.

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.

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 project 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.

A recent review of the viability of the site has taken place, recognising 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, has made the scheme unattractive to the market in its current form. Productive discussions with the planning officers at Harborough District Council have taken place in order to find a way forward to improve the scheme's viability to ensure that the district benefits from the delivery of houses that it had provided for in its Local Plan and appropriate applications and viability assessment submitted to the planning authority. The applications focus on the review of the level of affordable housing and the size restrictions on the B8 units to the south of the site. As such it is likely that the southern area of the site designated for B8 distribution is likely to be taken to market in the final quarter of this year. This will facilitate the initial phase of the highway's infrastructure making the residential site more attractive to potential delivery partners.

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. In common with many authorities the local plan process has been delayed in order that recently proposed changes to the NPPF, to be introduced later in the year, can be taken into account. As a result it is anticipated that the Regulation 19 Pre-Submission consultation is not now likely to take place until 2025 pushing the likely date of adoption back to 2026. 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 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 biodiversity gains are also being identified and will form an integral part of the pipeline of future sites.

Voids

Despite a good level of leasing activity (over 22,500 sq. ft.) during the year, the net absorption figure of 2,919sq. ft. illustrates the continued turnover of units, with only slightly more space being leased out than returned by tenants. The overall voids level across the portfolio fell slightly to 2.8% (20,824 sq. ft. in 24 units) of core direct net floor area.

Continued strong demand for leases continues to suggest that the relatively low level of voids can be maintained.

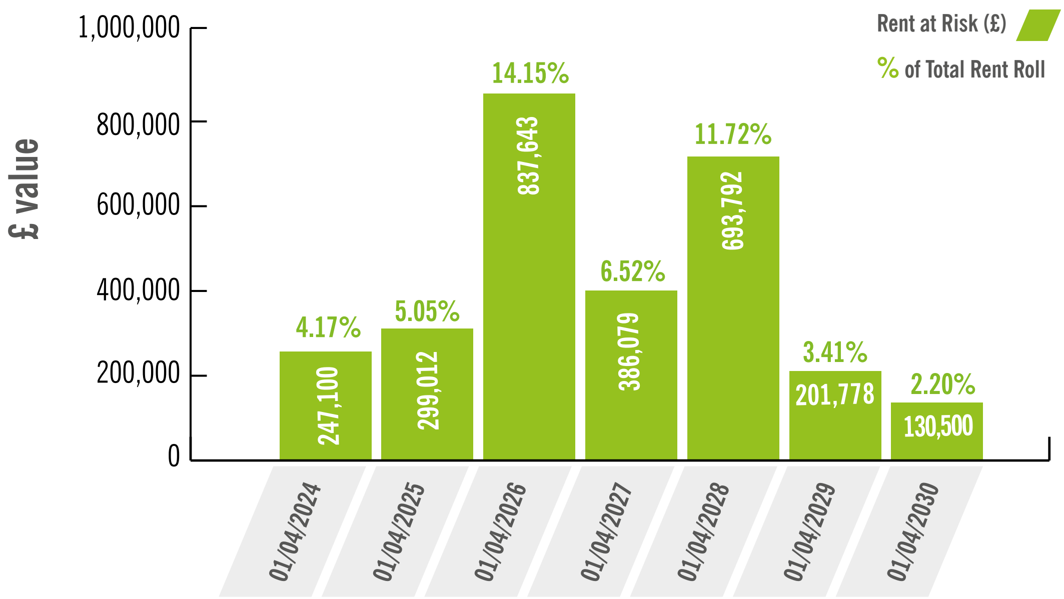
Rent Arrears (Direct Portfolio)

As of 31st March 2024, total 90-day debt amounted to £1.04m which equates to 12.5% of gross portfolio income and although systemic debt remains higher than desirable, rent collection remains in line with wider industry performance especially during the ongoing turbulent economic conditions with over 67% of rural rents and 87% of industrial and office rents collected on time for Q4. Recent reporting suggests that the rent collection in the wider market has improved from the low point of 38% in 2020, with over 90% 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. Payment of all outstanding debts is being actively pursued through debt management procedures.

In the longer term as the proportion of properties devoted to economic development continues to fall in line with the 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 6 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.

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

The recession the UK entered into in the second half of last year ended in Q1 2024, with GDP expanding by 0.7% compared to the previous quarter. This has been followed by a further rise of 0.6% in Q2. Figures released by the ONS highlighted that slowing inflation led to a quarterly rise of 0.2% in consumer spending while total investment increased for the second quarter in a row (+1.4% in Q2 2024). Provisional monthly index results point to sustained growth at the start of Q3, with the index rising to a four-month high of 53.8 in August. Consumer confidence and retail sales figures are improving, but there remains the risk of some more economic weakness coming through in the short term as the full effect of higher interest rates has not been felt yet.

The unemployment rate stands at 4.2% in Q2 2024, down from 4.4% in Q1, a fall of 97,000. Although the number of job vacancies also fell to a 34-month low it remained well above the pre-Covid average. At 22.1%, the economic inactivity rate is 1.6 percentage points higher than it was before Covid.

Annual pay growth continued to fall and stands at 6.0% well above the average of 3.3%. With inflation falling, real wages continue to rise.

CPI inflation continues to fall back reaching the target level of 2.2% in August compared to 4.0% at the start of the year and the peak of 11.1% in October 2022 with latest forecasts suggesting it may fall to levels below the target level later in the year, although the Bank of England forecast suggests it will stand at 2.5% in December. The Bank Rate fell to 5.0% in August having remained constant at 5.25% for over a year. With inflation remaining low a further cut is expected by the end of the year.

Economic Outlook

Latest Bank of England predicts the UK economy will grow by 1.25% in 2024 before falling back to 1.0% in 2025.

Investment Market

Whilst quarterly investment volumes continued to rise slowly at the start of the year reaching £12.3bn in Q2 up from £11.1bn in Q1 they remained around 13% below the five-year quarterly average of £14.4bn as high interest rates and falling capital values continue to create a lack of viability for debt buyers. Industrial investment volumes in Q1 2024 were 25% below the five-year quarterly average, and offices even less attractive at 60% below average. However, retail investment rose by 2% to a one-year high.

The market equivalent yield rose by over 1% in the second half of 2022 and moved out a further 0.45% in 2023. The Q1 outward movement of 0.08% was the smallest since the current repricing cycle began with yields appearing to stabilise in Q2. However, as the Bank of England starts cutting interest rates and gilt rates come down it is forecast that yields will remain stable before eventually starting to compress.

Property Market Forecasts

Significant yield movements since the middle of 2022 resulted in a collapse in capital values. However, quarterly market data suggests that at the all property level, capital values have stabilised in Q2, with retail and industrial recording increases. According to latest forecasts, capital values will

increase across most sectors in H2, resulting in a 4.2% rise at the all-property level in 2024, accelerating to 6.2% in 2025. Equivalent yields have started to stabilise and compress across several sectors in Q2 and it is expected that this trend will continue. Apart from leisure and offices, equivalent yields will end 2024 at a lower level than 2023. With further interest rate cuts and improved investor sentiment expected, yields will continue to fall in 2025 and 2026 before stabilising.

The combination of sustained rental growth and mild yield compression means that following two years of declines, total returns will rise by 9.3% in 2024. Total returns will then peak at 10.9% in 2025 before moderating over the remainder of the forecast period. Industrial and Retail Warehouses are expected to be the best performing asset types between 2024 and 2028.

All Property Forecasts

	2024	2025	2026	5 years to 2028
Rental Growth (% pa)	3.1	3.0	2.7	2.8
Yield (%)	6.4	6.1	5.8	5.7
Capital Growth (% pa)	4.2	5.0	5.0	4.2
Total Return (% pa)	**9.3**	**10.9**	**9.5**	**8.9**

The property yield/gilt spread narrowed to a 15-year low of 2.4% in 2022 but widened to 3.1% at the end of 2023 as gilt rates started to fall and yields continued to rise. Most forecasts suggest the property yield/gilt gap will stabilise in the range of 2.5% and 3.0%.

Office investment volumes were down from £3.1bn in Q4 2023 to £2.5bn in Q1 2024 with a further fall to £1.7bn in Q2 and remain well below the five-year quarterly average. At 16% of total investment volumes office investments accounted for one of the lowest shares on record. The demand for office space has stuttered in Q1 and fallen back in London. However, there is a significant amount of office space under offer of which 60% is for new build or pipeline space. As supply of newly built space dwindles demand may transfer to existing Grade A opportunities providing some stimulus across the sector. With demand concentrated on quality space rents have continued to rise for prime office space across the whole market.

All Office yields are forecast to end this year at 7.35%, down from 7.56% in 2023. Yields will then continue to compress over the next few years. The shortage of prime and premium stock and the oversupply of nonfuture-proofed office space that is 'tired' and no longer fit-for-purpose stock is leading to a steady rise in rental levels for Grade A and A+ quality stock. Accordingly, prime rents are expected that lead to increases across the sector of 2.3% in 2024, before easing to 2.1% and 1.9% in subsequent years. Total returns across the office sector will increase by 7.2% in 2024 and average 7.9% over the 2024-2028 forecast period.

Investment volumes in the Industrial and Logistics sector slowed from £2.4bn in Q4 2023 to a near four-year low of £1.8bn in Q1 2024 before rising to £2.5 bn in Q2 ,24% below the five-year quarterly average. Yields moved out a further 0.1% in H1 2024 taking the total outward shift to more than 2% since mid-2022.

Demand and take-up of space has remained constant over recent quarters with demand being met by the increased delivery of new developments over the past 2 years, leading to slightly higher vacancy rates at 7.2%. However, the prospect of a reduced pipeline of new developments in late 2024 and 2025 has sustained rental growth.

It is anticipated that take-up in 2024 will mirror 2023's levels, as occupiers continue to optimise their logistics networks. It is likely that there will be a substantial increase in market activity in 2025, coinciding with economic recovery and improved trading conditions. It is therefore expected that sustained rental growth will continue over the forecast horizon at sustainable levels of between 3.5-4.5% per annum. Yields will stabilise over the coming months and then re-compress later in the year. All Industrial yields will end 2024 at 5.76%, down from 6.01% at the end of 2023. All Industrial total returns rose by 4.1% in 2023 and are predicted to accelerate to 12.3% in 2024 and 14.3% in 2025.

Quarterly investment volumes across the retail sector increased to £2.1bn in Q2 2024, which is slightly above the five-year quarterly average and the strongest quarterly figure in a year. Across the whole sector, average equivalent yields are now over 1% higher than in the middle of 2022 but the yield movement has slowed over the past few quarters and appears to have stabilised in Q1. There is some evidence that Shopping Centre yields have started to soften from exceptionally high levels with Retail Warehouses also recording some compression. With sales volumes rising, falling inflation, rising real wages, sustained low unemployment, and improving consumer confidence it is anticipated that the retail sector may fare better this year with rents starting to increase despite high vacancy rates resulting partly from the rise in e-commerce with the current level of online sales standing at around 26%.

All Retail yields are expected to end 2024 at 6.49%, down from 6.83% at the end of 2023. Yields will then continue to compress to 6.22% by the end of 2025 with yields for Supermarkets and Retail Warehouses seeing the sharpest fall in yields over the forecast horizon. Having declined in five of the past six years total returns are forecast to grow by 11.3% in 2024, comprising sustained stable income return and a return of capital growth; Retail Warehouses being the sector's best performer over the five-year forecast horizon.

Whilst Rural Property remains a safe haven for investors, with income returns of 1.3% and the prospect of modest long-term capital growth achieved through the realisation of development potential. However, increasing supplies of land on the market and investors moving back into other sectors as the market stabilises have stabilised capital values, especially for freehold assets.

Investment in, demand for and the general performance of the alternative sector in 2023 mirrored that of the market generally. The investment market in this sector has generally been subdued and has been affected like the other sectors from the weak economic outlook, combined with high interest rates and the high cost of debt. The strong demand for investments in segments such as student accommodation in the H1 2022, which supported an average level of transactions over the year has declined sharply since although there are indications of increase activity in all sub-sector including the leisure and hotel sector in Q1 2024. Yields have increased across the sector by 1% over the period since H2 2022 resulting in continued negative capital growth in 2023 although income returns remain strong leading to a positive overall return.

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 over recent years. However, the level of returns going forward are likely to remain modest even as the wider economy recovers making other alternative investments more attractive.

Investment Strategy Update

The Portfolio Management Strategy for 2024 to 2028 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 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.

Hymans Robertson Review 2024

In addition to the ongoing internal review of the portfolio, an independent review of the Fund was undertaken by Hymans Robertson in December 2020 and has guided strategy development for the past 3 years. In line with agreed strategy a further review was undertaken by Hymans Robertson in late 2023 and completed in January 2024. The report recognises the challenges faced by the market resulting from high interest rates and inflation over the past two years and acknowledged the challenges facing the market at the present time.

Broadly, the main findings of the 2024 Hymans Robertson report were as follows:

- The objectives, target return and investment strategy are appropriate given the aims of the Programme and current portfolio composition.
- The composition of the portfolio, subject to some refinements is seen as appropriate, in particular, the mix of directly held assets and diversifying investments held in pooled funds at 67% and 33% respectively. Whilst higher than the normal market threshold of 20% at 29% the level of development projects is considered acceptable given the Fund's twin objectives of generating a financial return and having a positive local impact.
- The performance of the direct property portfolio has been relatively strong in difficult market conditions. Key property indicators are consistent with, or ahead of, the market for good quality secondary properties located outside major metropolitan areas.
- The performance of the diversifier's portfolio has been mixed particularly in recent years. Four of the five pooled Property funds have underperformed. The pooled Corporate Lending funds are performing in line with expectations, whilst the pooled Infrastructure and Bank Risk Transfer funds have performed well.
- Overall, the portfolio has the potential to deliver the target return.

In the light of these findings, the Report makes the following key recommendations:

In relation to the direct property portfolio:

- Set ranges/limits on exposure to individual assets, tenants, sectors and asset classes in order to guide the development of the portfolio;
- In relation to individual sectors adjust the allocations to individual sectors as detailed below:
  - Increase the allocation to the Industrial/Logistics sectors;
  - Maintain or reduce the allocation to Offices;
  - Selectively consider Retail investments;
  - Maintain the Rural allocation;
  - Increase the allocation to other Alternative sectors.
- Explore opportunities to dispose of selected properties, partly to adjust allocations but also cycle funds from sales of underperforming assets with new developments thereby maintaining the level of impact delivered by the portfolio;
- Consider local infrastructure and corporate lending opportunities.
- Regularly review the refurbishment plans and associated capex requirements of directly held properties, particularly in the context of achieving the Net Zero objective and future environmental legislation;
- Consider putting in place systems to measure and track the economic and social impacts achieved by the portfolio and consider setting targets in key impact areas.

In respect of diversifiers:

- Allow the allocation to Property pooled funds to fall to a level of c.25% as closed-ended funds pay back capital, in order to maintain adequate diversification;
- Undertake due diligence on the combined Lothbury and UBS Triton investment proposition and consider whether or not to remain invested;
- Maintain the allocation to Infrastructure pooled funds at 10-15% of the diversifier's allocation;
- Increase the allocation to Private Debt pooled funds but consider opportunities to diversify the exposure.
- Add a second Corporate Lending manager in order to diversify manager risk;
- Recycle the capital released by the Bank Risk Transfer fund (CRF V) into other areas, noting that a small weighting to this asset class is appropriate given the higher risk of capital loss.

In addition, it is recommended that the Council undertakes further work to identify what additional actions need to be taken to deliver the net zero objective.

These recommendations will be considered in a forthcoming strategy review together with the latest market trends and the County Council's strategies with a view to protecting the Programme's current portfolio and guide its future acquisitions strategy and development programme moving forward to ensure it maximises the benefits it delivers.

Rural Estate Management Review

A number of required improvements and changes have been identified to the way in which the County Farms Estate is being managed.

Strategic Property Services have developed an action plan which details the activity that is required to manage the estate effectively. An external rural estate management firm has been engaged to support aspects of the improvements where a wider knowledge base is beneficial.

The plan is comprehensive and covers all aspects of the management of the estate:

- Strategy
- Financial management
- Legal documentation
- H&S and compliance
- Operational management
- Tenant relationship

With debt management, rent reviews / lease renewals, documentation, regularity of inspections and compliance having the highest priority.

It has been reviewed regularly throughout the period of implementation and monitored by both senior officers and the IILP Board.

Progress has been made in the following areas:

- **Rent reviews 2024 -** 14 rent review notices were served for September 2024. Action on 4 farms was held off whilst the debt position was discussed. 3 reviews have been settled at an average of 33% increase with discussion ongoing still for the remaining properties. The rental uplifts that were anticipated by serving notices in September 2023 to be implemented from September 2024 will deliver increased income of £70k p.a.
- Through meetings with tenants and their advisors, discussions are ongoing with 6 tenants (one Tenant holds two tenancies), and it is anticipated that agreement will be reached either directly or through arbitration..
- **Rent reviews 2025 -** 39 notices were served in March 2024 for reviews due in March 2025. The rental levels that could be achieved will be calculated in November to reflect the latest market position.
- **Lease renewal September 2024** - Appropriate notices were served on 7 tenants and 5 have been agreed so far with 2 still under discussion. These incorporated rental uplifts provided that are expected to increase income by £20k p.a.
- **Compliance -** after Legal advice was received clarifying the position in respect of the Landlord's responsibilities, progress is being made to use an external "Compliance Hub" to undertake the ongoing work.
- **Health and Safety –** Smoke alarm and carbon monoxide detectors have been installed and / or tested. Written to all tenants reminding them of their obligations to ensure that the property is kept safe, any failures or issues are reported, and proper maintenance (including certification) is completed in line with tenancy obligations.

- **Outstanding rent -** positive action on debts, including the appointment of a dedicated credit controller resource in EMSS. Total debt levels have been reduced by £165k with payment plans in place and legal action being initiated as appropriate.

  A draft 'Collection Strategy' (subject to consultation with legal colleagues) has been developed for the rural estate, which will detail the decision making and responsibilities at each stage of the process, including - statutory demands, court action for bankruptcy and possession, and write offs.

  Steps are being taken to regain possession of farms where the debt levels of tenants are not expected to be recovered.
- **Documentation –** schedule in place to ensure signed agreements are in place for all tenants.
- **Inspections -** Completed for all main holdings and ancillary land with tenancy / licenses. The information is being used to inform the follow-up schedule of inspections and proposals for repairs and maintenance. It also highlights any themes across the estate. The ongoing aim is to have a clear inspection regime in place, delivered through formal and ad hoc contact with the tenants and the estate.
- **Repairs and maintenance –** to better inform and plan for capital expenditure on the estate, historical knowledge and up to date information from recent inspections, is being used to develop a planned maintenance programme (5 yearly plan) of short/ medium/long term works with estimated costings. The programme will also identify improvements that would be needed for individual farms and the estate overall, to keep abreast of modern farming practice and market expectations – linked to the strategic development detailed further in the report.
- **End of tenancy compensation -** during inspections tenants have been reminded of the process around repair and improvement and that set off against rent at the end of their tenancy will not be accepted unless approved previously.

2024/25

The overarching strategy for the rural estate (2025 onwards) is under discussion and development and will be subject to consultation with internal stakeholders and external expertise over the coming months. It will be written to fit with the Council's Strategic Plan and IILP programme and confirm how Leicestershire's estate operates within a framework of national legislation, policies and agricultural markets, all of which should shape and influence how the estate is managed. The strategy will set out the vision, ambitions, challenges and opportunities for the estate for the next 4 years. The IiLP Board is a key stakeholder and will be consulted on its development.

GLOSSARY

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

Absorption: Represents the uptake in space by leasing activity; a positive number indicates more space leased out than taken in-hand on a tenant's exit, conversely a negative figure shows that more space is taken back than leased out during a period.

All Property Yield: All Property Yield is the calculation of the Yield (defined below) across all property asset classes (i.e., a portfolio yield)

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.

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)

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.

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).

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.

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.

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.

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

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.

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

Leicestershire County Council

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