TITLE	**Property Investment Group - Covid 19 impact**
FOR CONSIDERATION BY	Community and Corporate Overview and Scrutiny Committee on 22 September 2020
WARD	None Specific;
LEAD OFFICER	Deputy Chief Executive - Graham Ebers

OUTCOME / BENEFITS TO THE COMMUNITY

A positive net income stream to fund Council services provided to the community.

RECOMMENDATION

That the Committee considers the impact of Covid 19 pandemic on the Council's commercial property investment fund.

SUMMARY OF REPORT

Terms of Reference:

This report has been requested by Overview and Scrutiny Committee for consideration at their meeting on Tuesday evening 22nd September 2020.

Please note the Committee considered a detailed report on the Council's Property Investment Fund and the work of the Property Investment Group at its meeting on 6th January 2020. Members are referred to this report for a full explanation of the Council's property investment strategy, procedures and activities.

This report addresses three specific aspects of the impact of Covid 19 on the Council's investment programme:

a) What impact has Covid 19 had on investment markets?

b) Has the investment strategy changed as a result of Covid 19?

c) Has the Council's investment risk changed as a result of Covid 19?

Background:

WBC Investment Strategy:
The starting point for the Council's property investment activity is the Investment Strategy which was approved by Executive on 28th Sept 2017.

Implementation of the Strategy was delegated to the Director of Corporate Services. The director makes all investment decisions in consultation with three Executive Members supported by the Property Investment Group ("PIG"). This group comprises specialist officers and members who provide advice to the Director when making investment decisions.

The Investment Strategy explains the Council's approach to building a balanced investment portfolio for income return using both debt and cash funding to acquire assets in and out of borough. This was fully explained in the report to the Committee on 6th January 2020.

The commercial investment fund represents about half of the Council's overall property business. Historically the Council's property exposure had been relatively modest compared to many other local authorities but it has grown significantly in the last 5 years through delivery of our Regeneration and Commercialisation agendas.

The Commercial Property Team is currently responsible for managing approximately £8.0m p.a. rental income split across the three key portfolios Regeneration, Operational and Investment.

Covid 19 Pandemic:
The Covid 19 pandemic began in December 2019 and spread through many parts of Europe by February 2020 causing disruption to international business and travel. The virus took hold in the UK in early March and by the date of the Budget on 11th March was considered to be a serious and imminent risk to the NHS and the Economy.

In response the Chancellor introduced in the budget the first of a range of special financial measures (£300bn+). The Prime Minister declared a National Emergency on 23rd March closing down society and much of the economy ("lockdown") except for key workers and essential services.

The Government quickly introduced many measures to mitigate the impact of the pandemic and the economic shock. Key methods of controlling transmission include limits on social gatherings, 2 meter social distancing, self-isolation, travel quarantine and the NHS "track and trace" system. All business and educational premises remain subject to significant constraints to create safe working environments.

The initial 3 month nationwide lockdown was gradually eased from June onwards in response to the end of the initial spike in infections and deaths. However, most sectors of the economy remain affected by ongoing transmission control measures. Some sectors have been unable to return to business other than in extremely limited ways, principally the arts, sports, travel and leisure sectors.

The international search for a vaccine to fully control the disease continues but the government has been unable to announce when a vaccine will be available. The current expectation is during 2021.

Analysis of Issues

1) What impact has Covid 19 had on investment markets?

From WBC's perspective the impact across investment markets has not justified any change in choice of investment vehicle.

Commercial property remains the only suitable asset class in which WBC could invest to satisfy the Investment Strategy and to achieve a suitable income return and balance of risk and reward. Investment in commercial property allows the Council to spread risk across a range of assets yielding contractual levels of income in excess of the cost of borrowing and management costs.

The equities markets have seen unprecedented reductions or cancellations of dividend returns even within the FTSE 100 (e.g. Shell, BT, house builders, banks, insurers). Government securities and cash deposits are now yielding almost no return and way below the cost of borrowing.

Whilst the Pandemic has had an immediate impact across property markets this has not caused the Council to deviate from its commitment to the fundamentals of the Investment Strategy. The response of the property market to the pandemic has created a wide range of challenges as well as opportunities which continue to evolve. These are carefully considered and managed by the Property Investment Group supported by our professional advisors.

In general terms the reaction of the UK property investment market to the Covid pandemic has involved three phases:

Shock – initial reaction leading to cessation of non-essential capital activity leading to lack of pricing evidence. Both sellers and buyers in most non-resilient market sectors withdrew to wait and see what would happen. This did not directly result in price reductions but caused price uncertainty. This uncertainty subsequently had a depressing effect on prices for sellers who were compelled to sell.

The timing of this uncertainty coincided with year-end valuations for many investment funds (including WBC). To support the valuation profession at this critical moment the Royal Institution of Chartered Surveyors ("RICS") advised valuers to qualify nearly all valuations with a "material uncertainty" qualification relating to the lack of available market evidence on which to base a current opinion of value. The RICS has cancelled this advice across most sectors as lockdown has lifted.

This valuation qualification had the effect of slightly depressing market valuations if only because of the valuers instinct to err on the side of caution.

Adjustment – after several months of inactivity the market has moved into a phase of adjustment. Investors have been revising their plans where performance is perceived to be either undermined or enhanced by the impact of the pandemic.

It is not the purpose of this report to explain in any detail the behaviours of the many sectors of the market. But it is important to understand that the market comprises a complex range of stakeholders active in a wide spread of sectors and regions all of which have reacted in different ways to the pandemic. What becomes a challenge for one player frequently translates into an opportunity for another. This dynamic has been crucial to the recovery of the markets in previous cycles.

Generally speaking active investors have pursued the usual flight to quality in search of resilient tenant businesses occupying prime properties let on high quality leases such as the big four supermarkets. Investors do not necessarily require long fixed term leases but are equally attracted to properties let to strong business that typically occupy under short but repeat leases such as the logistics sector.

Increased demand for these safe sectors has inevitably resulted in positive pricing sentiment and therefore enhanced liquidity. This is a benefit to WBC because our portfolio includes a healthy spread of assets including logistics and food store properties let on long leases to top quality tenant covenants.

Conversely property sectors that have been hit hard by Covid consumer behaviour have had to cope with falling demand in both the occupational and investment markets. Notably this includes high street retail and especially shopping centres which have increasingly relied upon leisure attractions to drive footfall (e.g. Intu malls).

Distressed retail and hospitality businesses hit hard by lockdown have threatened or employed Administration or Company Voluntary Arrangements ("CVA's") to avoid debts and to divest onerous leases to the disadvantage of many landlords. Companies in this category include many well known names such as M & Co, T M Lewin, Monsoon Accessorize, Oasis, Warehouse, Debenhams, Kath Kidston, Laura Ashley, Pizza Express, New Look, Jigsaw, Yo Sushi, Travelodge, Zizzi, Frankie and Benny's, Carluccio's, Prezzo etc.

This is a market sector that the WBC investment fund has deliberately avoided and so it is sheltered from this particular risk.

Recovery – recovery will depend upon the balance between continued suppression of the virus and the loosening of lockdown to enable economic activity to increase again. Lasting recovery is unlikely until a vaccine has been widely implemented or at least until the UK government can commit to a timetable for a vaccination programme.

The government is struggling to balance these conflicting priorities without risking a second outbreak. For example the government says it aims to encourage 80% of civil servants back to their normal work places by end October as part of an initiative to stimulate central business districts. At the same time it is re-introducing limits on social gatherings to a maximum of 6 people in response to increasing transmission rates amongst young adults.

Recovery in all aspects of life is being discussed in terms of the "new normal" as opposed to pre Covid normal. This is likely to be true for the property market too. For example there is much speculation about the lasting impact on the office sector of the Covid imposed work from home expedient. Again, it is not the purpose of this report to analyse any particular market sector but simply to note that the temporary disruption to

the office market has created challenges as well as opportunities. WBC is alert to them and reacting accordingly supported by our professional advisers.

The new normal will not involve a change in the way the property market works but in the way it prices and responds to different asset classes and any lasting changes to their risk profiles. Pricing for core well located assets remains robust with a rapid increase in activity levels since June.

2) Has the investment strategy changed as a result of Covid 19?

No, the strategy remains the same. The impact of Covid requires no deviation from our established focus on the fundamentals of sound property investment based on:

- Careful selection of resilient buildings and locations
- Length and quality of income stream
- Strength of tenant covenant/commitment
- Prospects for tenant renewal/replacement
- Alternative asset strategies to underpin capital value
- In borough opportunities to deliver multiple policy objectives

The application of these criteria to future stock selection requires, as ever, a continuing understanding of both the occupational and investment markets and pricing trends. PIG maintains this market understanding via internal specialist officers supported by external advisors who are retained to focus on each specific investment target.

Since the onset of Covid the market has progressed through the Shock and Adjustment phases of the market cycle and this has seen the usual flight to quality. WBC has built its investment portfolio on a number of early key purchases of high quality institutional calibre stock well let to strong covenants. These are the type of high quality low risk/return assets that are currently in high demand and which WBC has focused on during the pandemic.

For example, the Council has very recently acquired a small property in Twyford which meets many of these criteria. It is a mixed use high street block predominantly let to Tesco Express. The property has many positive investment features underpinned by low site cover and alternative development angles. Most importantly it adjoins the Council's existing ownership of the Waitrose in Twyford. The two sites combine to afford the Council much greater flexibility for the potential long term redevelopment or regeneration of the town centre. So this purchase was both prudent in investment terms and also strategic in terms of long term site assembly.

This class of asset helps WBC to counterbalance the higher risk/reward assets that the Council has acquired in pursuit of in borough alternative policy objectives, such as the Denmark Street Car Park estate.

In terms of WBC's efforts to continuing to increase the size of the investment portfolio it remains flexible in approach, looking to take advantage of suitable opportunities as they arise without compulsion to invest in adverse market conditions. However, as all our investment acquisitions are income enhancing it remains desirable for WBC to seek to fully invest at least the initial £100m fund where it can be done safely in compliance with the strategy.

PIG constantly monitors new investment opportunities and typically has several under review at any time. Work in progress at the onset of Covid has been subject to specific re-evaluation and most cases have been delayed or revised.

3) Has the Council's investment risk changed as a result of Covid 19?

The consequences of Covid on the market has brought about a temporary and evolving change in a range of risks that could affect the Council's investment fund. These risks fall into two very broad categories:

- **Capital** – including the sale, purchase and value of assets and stakeholder behaviour
- **Revenue** - including the management of income, tenants and rental value of individual premises

Capital:
At the onset of the pandemic the Council was not committed to any new purchases and therefore was not "caught out" by the sudden impact of Covid.

The only acquisition completed during the pandemic (Twyford, see above) was conceived, priced, negotiated and contracted based on a careful consideration of the Covid environment and related risks and necessary mitigations.

The Council's property fund is still relatively new and PIG is not yet contemplating any proactive sales, so market uncertainty remains a very low risk from that point of view.

Like most local authority investors WBC retains a competitive advantage in the debt driven real estate markets because of privileged access to cheap flexible debt via the Public Works Loan Board ("PWLB"). This is not the only or necessarily preferred source of funding for WBC but it provides long term cheap debt unencumbered by the significant risks of normal private sector banking covenants (e.g. loan to value limits, income/interest margins, fixed expiry dates).

In the event of sudden economic shock it is often the banking covenants rather than the interest cost of debt that precipitates the collapse of highly geared property ventures. This is an area of risk that the Council is not exposed to when borrowing so flexibly from the PWLB. This is a very significant mitigating factor when assessing the risk of the Councils property related debt.

Due to this funding advantage the Council's property fund is unlikely to face a liquidity crisis and so there is no prospect of forced sales into an uncertain or depressed market. However it is worth noting that if the Council needed to raise funds it would be well placed to sell one or more if its high quality assets at premium value. This is because of the market "flight to quality" instinct which increases demand for institutional quality assets in an unstable market when institutions are least likely to sell them.

At the onset of Covid the investment market suffered an initial period of uncertainty and inactivity from March to July which affected opinions of value at the critical year end period. This uncertainty was created by a lack of transactions and therefore a lack of pricing evidence. It did not reflect a de facto fall in value. WBC's valuation at 31st March 2020 was on a par with the previous year.

Even before the pandemic there have been many reports of significant falls in the value of local authority investment assets. Needless to say they tend to focus on the more spectacular falls which have usually related to local authorities buying failing local shopping malls for proactive regeneration.

For example Shropshire County Council purchased three shopping centres for £52m at the peak of the local authority buying bubble in January 2018. A year later they had been down valued to £40m and by end 2019/20 they were valued at just under £20m. Canterbury City Council paid £154m in two phases 2016-2018 to acquire a local shopping centre for regeneration but lost £47m in down valuations by end of 2019-20.

The scale and focus of WBC's investment fund is very different. This is because the Investment Strategy was designed to avoid this sort of spending and potential valuation adjustments.

In the longer term capital risk will be reduced significantly as the market stabilises and the new normal for each sector is priced into expectations. This stage will free up the market to normal levels of activity increasing turnover and therefore confidence and price stability.

Overall WBC investment fund exposure to **capital risk** is very low because:

- it is neither contemplating nor compelled to sell any assets
- it holds stock principally for income rather than short term capital gain
- it has access to flexible and unsecured debt
- debt is comfortably serviced by long term rental income
- rental income is secured from a range of strong tenants and long leases.

Revenue:
This is the principal reason why WBC invests in property and therefore it is the most important area of risk. But these risks are more temporary in nature and evolving fairly quickly in response to the management of the pandemic.

In simple terms rent is the price an occupier is prepared to pay to occupy property and so it is very sensitive to business sentiment. It is vulnerable to short term market shock such as Covid 19. But tenants do not normally have an opportunity to adjust rent during the course of a lease other than in an upwards only direction at fixed intervals (with the notable exception of "turnover" rents).

This means that WBC's tenants remain locked into specific rent payment obligations regardless of changing circumstances and are obliged to pay the same level of rent regardless of the impact of Covid 19. This means that so long as our tenants continue to trade profitably then they will pay the same level of rent and the Council will be unaffected.

It is only at lease expiry that a tenant can choose to relocate or agree new terms with their existing landlord. Therefore so long as WBC's leases do not all expire at the same time in the middle of the pandemic (when tenant take up might be temporarily supressed) the risk of a significant decline in income will be avoided.

WBC's investment fund includes a wide range of properties and tenants with lease expiry dates well spread out over the short and long term. Approximately 60% of the

fund's income is secured on leases with unexpired terms of at least 10 years. This provides a high level of risk protection.

The key risk to a property investor in a time of economic shock is not so much a temporary decline in rental value but the ability of tenants to continue to afford to pay rent. Economic shock is often the final catalyst for tenant failure in sectors that were already under pressure. The Pandemic has added significantly to the pressure on high street retailers and the struggling casual dining sectors. These sectors have been avoided by the WBC investment fund.

WBC's investment fund is well protected from this key risk because about 75% of its income is derived from institutional calibre tenants that remain resilient through the pandemic and pay their rent in full (Stapletons, Waitrose, Wickes, Tesco).

A relatively small number of the Council's SME and independent tenants have found themselves in challenging circumstances and have sought rent support from the Council.

At the onset of the pandemic WBC immediately prepared a Covid 19 rent support policy setting out a range of practical measures to support tenants whilst maximising Council income for the longer term. This policy has been successful in supporting many of our smaller tenants by allowing rent deferments to be repaid after the crisis, monthly as opposed to quarterly instalments and occasionally specific lease adjustments.

In addition the government intervened early on to provide a range of grant funding to support businesses to pay their way through the lock down. This has helped many tenants to see their way through the crisis so far.

The government has not provided any specific rent support measures to either landlords or tenants but left it for parties to agree individual arrangements to ease cash flow difficulties. It has published a Code of Practice to guide landlord and tenant discussions.

WBC's Commercial Property team has ensured that all qualifying tenants have received government grants which in turn has assisted tenants in paying rent and rates back to WBC, significantly mitigating this key risk.

The June rent quarter day saw unprecedented low rates of rent collection across the property industry. However, WBC and in particular the investment fund fared much better than the industry average due to the quality of its core investment assets, the strength of tenants and the positive impact of the Council's customer care programme. To this extent the investment fund is making a positive contribution to the Councils income collection profile as well as total receipts.

Inevitably a small number of Council tenants are likely to suffer medium to longer term set- backs to their business profitability. This will undermine their ability to continue to pay rent at their contractual rate through the crisis and beyond. In a small number of cases the Council is working with individual tenants to support them with concessions to assist their long term survival so they can continue to employ their staff and pay rent for the longer term.

The likely impact on total rent receipts is difficult to specify at this stage because the situation is still evolving. For example, some tenants that initially asked to defer rent

payments have in fact paid as usual. Other tenants that initially expected their business would not be affected have subsequently sought assistance, and vice versa. The picture is further complicated by the impact of Covid frustrating letting negotiations that would have resulted in additional income streams and conversely triggering new requirements that otherwise wouldn't have resulted in new income streams.

The impact on revenue is kept under constant review. At the end of the first half of the year the likely impact on the investment fund's existing contracted rental income is estimated as follows:

	Deferred payments	At risk, tbc	Irrecoverable
Half Year 2020/21	£90,589	£15,516	£112,669
	2.37%	0.41%	2.95%
Full Year 2020/21	£196,323	£93,103	£186,862
	5.15%	2.44%	4.90%

The negative impact of Covid on some tenants ability to pay rent will continue until a vaccine is implemented and the new normal arrives. In the meantime the balance between transmission control and freedom of economic activity will remain critical to stabilising property income across all the Councils property funds including the investment fund.

Overall WBC investment fund exposure to **revenue risk** is low but requires very careful ongoing monitoring and management because:

- The Council's key property risk (across the Operational, Regeneration and Investment portfolios) is tenant retention and tenant profitability in the face of Covid 19 economic shock.
- A number of smaller tenants are struggling to pay rent through the pandemic but the Council is working with them to protect their long term survival and ability to pay rent.
- The Council has been managing the revenue risk by close tenant support primarily via cash flow flexibility and in extreme cases further concessions frequently counterbalanced by other non-monetary lease improvements or extensions.
- The full extent of the revenue risk will depend upon the implementation of a Covid vaccine. In the meantime the risk is very varied across different sectors of the market affecting different landlords in different ways.
- The highly respected research group the Investment Property Forum ("IPF") has just published its view that the impact of Covid on UK real estate will be less immediately severe but the bounce back slower than originally expected with a period of low capital and rental growth. This is more in keeping with the Bank of England view that GDP is likely to recover by end 2021.

- Generally speaking rental income from the WBC investment fund is secure based on a range of high quality assets let to strong tenants on long leases operating resilient businesses.

FINANCIAL IMPLICATIONS OF THE RECOMMENDATION
The Council faces severe funding pressures, particularly in the face of the COVID-19 crisis. It is therefore imperative that Council resources are focused on the vulnerable and on its highest priorities.

	How much will it Cost/ (Save)	Is there sufficient funding – if not quantify the Shortfall	Revenue or Capital?
Current Financial Year (Year 1)	*****Current estimate £280k	Y	Revenue
Next Financial Year (Year 2)	0	Y	n/a
Following Financial Year (Year 3)	0	Y	n/a

Other financial information relevant to the Recommendation/Decision
***** Although there has been some negative impact on rental returns due to the economic shock of Covid 19 this has already been factored into the Council's Revenue Monitoring reporting for 2020/21 and is being kept under regular review. The estimated cost £280k (noted above) equates to 7% of contracted income and includes a significant contingency sum (c.33% of the total provision) for rents that are not yet distressed but might become so, depending upon tenant circumstances as the situation evolves.

Cross-Council Implications
PIG revenue funds service delivery to the community

Public Sector Equality Duty
Please confirm that due regard to the Public Sector Equality Duty has been taken and if an equalities assessment has been completed or explain why an equalities assessment is not required. Due regard is given to the Council's equality duties as relevant to any investment decision.

Reasons for considering the report in Part 2
n/a

List of Background Papers
None

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