

# Finance and Resources Committee

10.00am, Thursday, 23 May 2019

## Council Commercial Property Portfolio – Update Report

Executive/routine

Wards

City Wide

Council Commitments

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### 1. Recommendations

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1.1 That Committee:

1.1.1 Notes the current status of the commercial property investment portfolio; and

1.1.2 Notes the approach and strategy moving forward.

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## Council Commercial Property Portfolio – Update Report

### 2. Executive Summary

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- 2.1 The Council has a large commercial property investment portfolio extending to over 1,150 interests within 10 asset classes.
- 2.2 As at 31 March 2019, the annual income received from the portfolio was £14.88m.
- 2.3 In order to assist with Council budget targets a strategy has been developed to consider the disposal of certain assets in order to reduce borrowing costs or acquire assets which will contribute to an improved net revenue position.

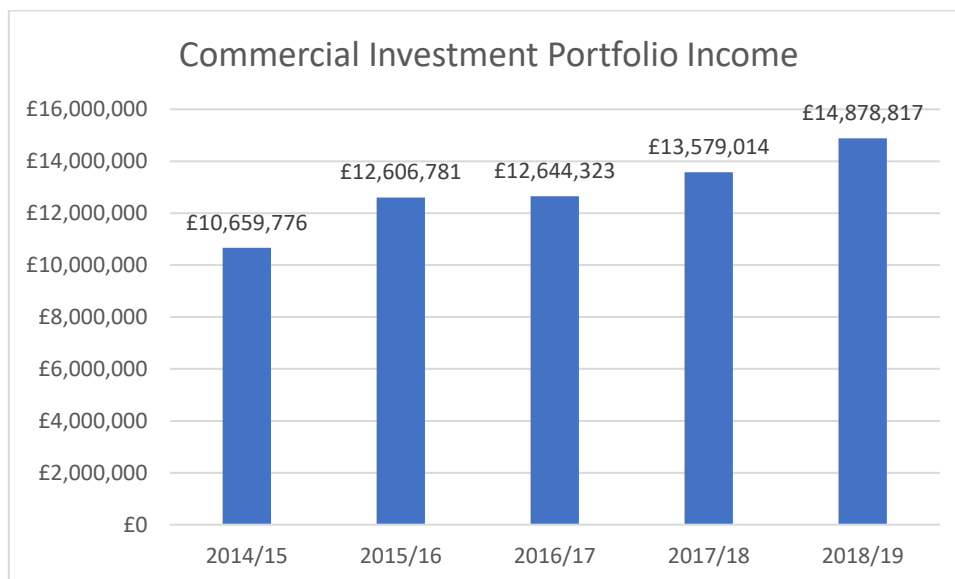
### 3. Background

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- 3.1 The Council owns a substantial commercial investment property portfolio principally comprising of office, industrial and retail properties leased on commercial terms to third party tenants.
- 3.2 The portfolio has grown significantly in the decade due to:-
  - The acquisition of the investment property portfolio of the EDI Group in 2009;
  - The acquisition of the investment property portfolio of Waterfront Edinburgh Limited also in 2009;
  - The acquisition of the HRA investment property portfolio in 2016; and
  - The development of income generating opportunities through direct development and/or utilisation of surplus property assets.
- 3.3 As at 31 March 2019, the portfolio consists of approximately 1,150 interests with an estimated capital value of £200m. In 2018/19 financial year, the portfolio produced a rental income of £14.88m. Properties range from individual ground leases to modern offices, retail units, hotel/public houses and industrial parks.
- 3.4 The portfolio was not originally assembled with the principal aim of creating a commercially driven investment fund. Consequently, the portfolio is very diverse consisting of a wide variety of assets classes, condition and differing levels of return. As such, it is not 'typical' of a standard investment portfolio that would be operated on strict commercial terms.

- 3.5 Historically, some properties are held in support of wider council initiatives, such as economic development, or to provide future development opportunities to assist with meeting council commitments, e.g. change of use to support provision of affordable housing.
- 3.6 The investment portfolio is managed separate from the council’s operational property portfolio which is solely held to provide the infrastructure for council departments to support the operation of the various council services.
- 3.7 As at 31 March 2019, the key aspects of the portfolio are as follows:
- 1,150 interests providing accommodation for over 1,000 businesses;
  - 320 industrial units, 150 retail units, 100 offices, 20 leisure properties (hotel/pubs/restaurants) and in excess of 300 acres of land; and
  - Rental income is spread across the sectors of the portfolio with the key asset classes comprising industrial (37%), retail (16%), offices (16%), car park (11%) and leisure (hotel/pubs/restaurants) 4%.

3.8 Portfolio Performance over the last 5 years has been strong with rental income increasing from £10.66 million in 2014/15 to £14.88 million in 2018/19 as shown in the graph below.



3.9 As part of the Asset Management Strategy approved in September 2015, a target of rental growth of 2.5% per annum for 3 years, reducing to 1.5% thereafter was placed against the portfolio. Through prudent management the target level of growth has been exceeded.

## 4. Main report

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4.1 From a financial point of view, the approach is to ensure that assets within the portfolio are maximised to their full value while placing as much on the lease obligations (insurance, repair etc) onto the tenant. The driving force for this

approach rests with how the Council sets its budget each year. During this process, political groups assume a level of income from the portfolio for the following financial year which, in turn, has a direct impact on the levels of savings that have to be found elsewhere across the Council. On 1 April each year, the Property and Facilities Management Division within the Resources Directorate receives a corresponding deficit budget, which is recouped throughout the year as rents are paid. Consequently, any adverse decision relating to the portfolio, made during the subsequent 12 months, can create a direct budget pressure. For the 2019/20 financial year, the assumed target, inclusive of new assumed income, is £15.125m.

- 4.2 The flexibility as to how the Council strategically manages the portfolio moving forward is restricted for the reasons set out in paragraph 4.1. As such, in order to maintain the strong performance of the portfolio and make use of the opportunity to improve the net revenue position, a three-stage approach will be undertaken that seeks to maximise current income; create new opportunities; and also considers disposals and acquisitions as detailed below.

### **Income Maximisation**

- 4.3 The risk of losing rental income is inherent in any commercial property portfolio and this risk is currently managed by the Investments team, within Property and Facilities Management, as part of business as usual.
- 4.4 Income maximisation seeks to protect and grow the rental income base of the portfolio. Lease events such as expiries or the exercise of tenant break options are likely to result in a loss of rental income unless proactive measures are taken to prevent the loss, or mitigate the impact, by early re-letting. In practice, the following processes and procedures are employed: -
- All new leases, rent reviews and lease renewals are carried out by a small team of RICS Registered Valuers with years of experience in dealing with such matters. Typically, a tenant will appoint a property agent to act on their behalf and therefore a commercial negotiation takes place to establish the new rent and terms;
  - The Council ensures that when a tenant terminates their agreement, they are obliged to allow the Council entry to market the property prior to the lease ended. This ensures that voids are kept to a minimum. When the Asset Management Plan was approved by the Council in 2015, the consultants benchmarked the portfolio against an industry void rate of 7% due to its size and diversity. The actual void rate on the portfolio is running at approx. 2.5%.
  - Vacant property is, in the main, exposed to the market with a predetermined closing date. This ensures that demand is reflected in any subsequent offers, ensuring a competitive process.
- 4.5 The above continues as business as usual for the management of the portfolio and the proactive approach to the identification of lease events (rent reviews/lease expiries) has an impact on the rental income received and mitigates against any impact of any prolonged void periods.

- 4.6 Growing the rental income is achievable through acquisition of new investments, through lease re-structuring or development. The investment strategy places emphasis on actively seeking out opportunities in conjunction with the council's investment advisers.

### **Identify Additional Opportunities**

- 4.7 The Council continues to explore opportunities to reduce the size of the operational property estate through rationalisation and service led design. In previous years, the default position for the majority of surplus assets has been to offer the property to the market for sale.
- 4.8 In recent years, prior to considering the disposal of an asset, each opportunity is considered as an addition to the investment portfolio. The potential for a third party letting of the property and the timescales within which that can be achieved will be analysed and assessed against the potential level of and timing of a capital receipt through a sale.
- 4.9 Other opportunities are considered on their own merits such as the direct development of small industrial units at Sighthill, which now bring in an income of £155k pa; creating additional lettable space within operational properties such as Waverley Court which is in part leased to CGI; and strategic acquisitions such as those referred to in paragraph 3.7.

### **Disposal/Acquisition Strategy**

- 4.10 A key element of the 2019/20 Budget proposals was the use selective sales of the investment portfolio to reduce Council borrowing costs. This would be achieved by the sale of assets which would generate a sufficient level of return to allow a net revenue benefit from using the capital return to reduce existing borrowing.
- 4.11 A number of assets have been identified, which are expected to generate a capital receipt based on a yield of sub 4.5% if offered for disposal. Using the capital receipt to pay down borrowing costs which averages at 6.5% will result in a net revenue saving to the Council on an annual basis. The proposals specifically exclude Royal Mile properties as it was considered that ownership gave the Council the ability to control the use mix over and above its role as statutory planning authority. Any assets to be sold by this approach will be reported to Committee to be considered in its own merits.
- 4.12 Selling such assets will have an impact on the total level of income received from the portfolio but will be balanced against the saving created elsewhere. Therefore, strategic acquisitions will also be considered whereby the receipts from the selective disposals can be used to acquire assets at a higher yield to result in a similar improved net revenue position.

## **5. Next Steps**

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- 5.1 The portfolio will continue to be commercially managed with individual proposals presented to Committee, ensuring we maximise the income available to the Council.

## **6. Financial impact**

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- 6.1 The Council continues to assume the level of rental income achieved in its budget setting exercise. Therefore, it is important that there is a commercial and consistent approach to the management of the portfolio.

## **7. Stakeholder/Community Impact**

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- 7.1 N/A

## **8. Background reading/external references**

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- 8.1 N/A.

## **9. Appendices**

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- 9.1 N/A