Brighton & Hove City Council

Strategy, Finance & City Regeneration Committee

Agenda Item 74

Subject: **Commercial Investment Property Strategy**

Date of meeting: **7 December 2023**

Report of: **Executive Director Economy, Environment & Culture**

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Ward(s) affected: **All**

For general release

1. Purpose of the report and policy context

1.1 The Commercial Investment Property Portfolio provides income to the council to support its Medium-Term Financial Strategy and Corporate Investment Programme. The portfolio generates revenue through rents and also capital receipts via strategic disposals. The portfolio requires capital investment to reduce risk and maintain future income streams. This report presents an investment strategy as well as recommendations for the disposal of some properties to rebalance the portfolio. It is supplemented by a Part 2 report.

2. Recommendations

2.1 That Committee agrees to the disposal of properties listed in Appendix 1 of Part 2 of this report and delegates authority to the Executive Director Economy, Environment and Culture and the Executive Director Governance, People & Resources to approve terms and take any necessary steps to facilitate this recommendation.

2.2 That Committee agrees to the provision of an annual commercial asset investment fund as described in paragraph 3.18 of this report to be included as part of the Capital Strategy for 2024/25 onwards.

2.3 That Committees agreed to the allocation of the net capital receipt from the disposal of 8-9 Kings Road for investment in the Commercial Investment Property Portfolio to address the council's repair liability as described in paragraph 3.22.

3. Context and background information

<u>Property Portfolio</u>

3.1 The council's Commercial Investment Property Portfolio provides a gross income in excess of £10m pa to support the council's financial strategy and also supports the council's Corporate Investment Programme through the provision of capital receipts from strategic disposals and lease regears.

3.2 The portfolio has been acquired over time, often for purposes other than property investment, such as road widening schemes. As such it was not originally acquired for income production and does not therefore conform to institutional property investment principles, where risk is spread. It has

3.3 The portfolio does contain a wide range of property types including nurseries, sports clubs, cafés, pubs, industrial units, offices, banks and a cinema, but is heavily weighted towards retail, and is therefore reliant upon the performance of this sector. It also contains a large number of heritage buildings that have suffered from lack of investment over a long period.

3.4 During and post covid the retail market has seen a shift in tenant requirements. This has impacted directly on the council's portfolio as retailers and high street businesses including banks adapt their operation to out of town or online formats. This in turn has impacted adversely on the annual rental income across the commercial portfolio leaving the council unable to reach revenue targets. Examples of the impact this has had on the council's portfolio include:

- Lloyds TSB vacating Preston Circus
- Natwest vacating Pavilion Buildings
- Cooperative Bank reducing their occupation Western Road
- Currys vacating Western Road
- C&H vacating Western Road, following liquidation

3.5 The demand for office space has reduced as a result of covid as home and hybrid working has risen. This has created a surplus of space in the market further impacted by the current cautious business sentiments amid economic uncertainties. Market demand is being met by new buildings and newly refurbished space in prime locations across the city, leading to voids within the council's portfolio, particularly for the larger units at New England House and Phoenix House which do not represent high quality office space due to lack of investment.

3.6 The portfolio includes some prime retail units on Western Road but also a number of secondary and tertiary quality properties. Their location and age present a higher risk and they are poorer performing assets attracting lower market rents and tenants who are less financially resilient. This results in a higher proportion of tenant default, bad debt and non-recoverable expenditure.

3.7 The portfolio's industrial properties, such as Freshfield Industrial Estate and The Hyde, are leased on long leases. As the lease terms diminish and/or the lessees consider redevelopment there are opportunities to regear leases and extract further value by way of premiums paid.

3.8 The portfolio also contains several large multi let commercial properties, where tenants contribute towards a service charge for running and maintaining the properties. These properties have suffered from an accumulative lack of capital investment by the council and all require some significant level of repair or improvement. They continue to be important assets for economic development. These include:

- New England House
- Hove Technology Centre

- Industrial House
- Lyndean House
- Phoenix House

Portfolio Weaknesses and Risks

3.9 Whilst the council took action to support its tenants during the covid lock down periods, negotiating rent reductions and rent abatements, there were a number of tenants who were unable to weather the storm and went into liquidation. The impact of covid whilst universal was felt greater in the retail and office markets and particularly for those tenants whose financial sustainability was at risk prior to the pandemic. The demand for office and retail space has changed and the portfolio must adapt to meet these changes.

3.10 The majority of the properties within the portfolio are leased out on fully repairing and insuring leases (FR&I) where the tenant is responsible for the property repairs, maintenance and compliance. As and when a tenant vacates a property, they will either put the property back into repair or pay the council a sum equivalent to the repairs needed, as part of the council's dilapidations claim against the tenant. However, the dilapidation repairs or settlement cannot take into account improvements and refurbishments that are needed in response to market changes.

3.11 In addition, our portfolio is currently compliant with the Minimum Energy Efficiency Standards (MEES) as a consequence of surveys, investment and certification over the last five years since MEES was introduced. However, it is expected that the threshold for compliance will in the future be raised requiring further investment to ensure continued compliance.

Property Strategy - Rebalance

3.12 A rebalance of the portfolio is proposed, to reduce inherent risk and address the reliance on retail. Particularly poor performing secondary and tertiary properties where income is low, income growth is not maintaining pace with inflation, management costs are proportionately higher and the risk of tenant default much higher. A list of properties identified for disposal is set out in Part 2 of this report.

Property Strategy - Investment

3.13 Capital investment is required in our core properties in the commercial portfolio to ensure these properties remain relevant to market requirements and are energy efficient fulfilling future MEES requirements, fit for purpose producing a good market rent and a sustainable income. Within the commercial property portfolio the core properties are those that:

- Provide or have the potential to provide secure income and income growth;
- Have the potential to provide capital receipts through long lease regears;
- Support economic development;
- Provide or have the potential to provide social value benefits.

3.14 Capital investment will be required to refurbish properties, change their use, improve access, reconfigure space, improve energy efficiency or complete structural repairs. These are not costs covered by a tenant's repair or dilapidations liability but are investment costs to be borne by the council as landlord.

3.15 Capital investment in the form of an annual commercial asset investment fund would also mitigate the financial exposure and reduce the risks associated with vacant commercial properties and lack of income by providing funding for re-investment and refurbishment to bring the properties up to a standard fit for purpose. This would help reduce the void period allowing properties to be marketed sooner thus reducing the time and risks of lack of income and vacancy costs.

3.16 Within the Agricultural property portfolio the core properties are those that support the objectives of the City Downland Estate Plan (CDEP) to:

- Reduce the amount of carbon in the atmosphere and store it;
- Enhance wildlife and their natural habitats;
- Improve health and wellbeing, by providing public access to nature;
- Provide an affordable and sustainable local food supply, through farmer, producers and community food growing.

3.17 The Agricultural property portfolio is tenanted and the management of the land is reliant upon the viability of the tenants' farm businesses to not only provide income through rent payments but also to support delivery of the CDEP objectives. Investment in the portfolio is required to repair, replace or provide new farm buildings, support diversification and change of use and improve energy efficiency.

3.18 It is proposed that a programme of strategic capital works is developed and managed annually for both the Commercial and Agricultural property portfolios. This would be financed in part by an annual commercial asset investment fund with an indicative allocation of £0.500-0.750m. For larger projects, a specific capital budget supported by a business case will be brought to committee. This will address the issues associated with lack of investment over the years in the commercial portfolio.

3.19 Officers will continue to look for opportunities to negotiate lease-regears on our long leasehold industrial properties to not only secure capital receipts but also facilitate redevelopment and regeneration.

<u>8/9 Kings Road</u>

3.20 A report was presented to Policy & Resources Committee on 1 December 2022 recommending the disposal of 8/9 Kings Road from the council's Commercial Investment Property Portfolio. This was a secondary retail property that had become vacant following the failure of the tenant's restaurant business. Options were explored over many years to change the property to a homeless hub, to be let commercially to a service provider, but the scheme was unviable. This was due to the level of investment required to fund the conversion with both Social Care and Housing officers deciding not to seek use of the property.

3.21 Following amendment of the recommendations, Committee agreed that:

the net capital receipt be invested in the existing commercial portfolio to reduce inherent risk and secure revenue streams by funding *landlords repair liability and reducing obsolescence, subject to a future report to Policy & Resources Committee, via Asset Management Board, that considers the use of the capital receipt being directed towards investment in social housing/homeless support services, in line with the original intended use of the asset.*

3.22 The amendment did not take some factors into account. Whilst a change of use for the building was originally proposed, it was intended to be let commercially to a homeless hub service provider and retained within the commercial portfolio. Housing have confirmed they do not have proposals for homeless support services requiring this investment. Committee is therefore requested in para 2.3 to approve use of these funds for investments in repairs to the commercial portfolio to reduce risk and secure revenue streams for the council.

4. Analysis and consideration of alternative options

4.1 The retention of properties identified for disposal will result in the continuation and worsening of the risks identified in the Commercial Investment Property Portfolio. The properties identified for disposal are high risk and poor performing assets which attract lower market rents and tenants who are less financially resilient resulting in a higher proportion of tenant default, bad debt and non-recoverable expenditure. In addition, these properties offer little opportunity for income growth and so income over time is impacted by inflation resulting in stagnant or falling income. These properties also incur disproportionately high levels of management because of the risks associated.

4.2 The council has already experienced the impact of a lack of investment in its Commercial and Agricultural Investment Property Portfolios. Where tenants vacate commercial properties investment is required over and above a dilapidations claim to ensure the properties meet market requirements. In addition investment is required for all of the multi-let properties to address the council’s repair liability and again, ensure the properties remain relevant to the market.

4.3 Within the Agricultural Investment Property Portfolios, investment is required to address the legacy of under investment over the decades and support the viability of farm businesses to ensure their sustainability to deliver and support CDEP objectives. Failure to do this will restrict what can be achieved in terms of both future income and CDEP.

5. Community engagement and consultation

5.1 The council has sought advice from its managing agents, Avison Young and Savills as well as building surveyors. Advice has also been sought from Housing officers.

6. Conclusion

6.1 The Commercial Investment Property Portfolio was not originally acquired for property investment purposes and as such the portfolio is unbalanced. Parts of the portfolio are poor performing and high risk. A rebalance of the portfolio is recommended facilitated by disposal of some of properties.

6.2 Unlike any institutional commercial investment property portfolio the council has not had a programme of investment and the impact of covid and changes to the property market – particularly in retail, banking and offices - has resulted in a ‘perfect storm’ where there are now several void properties, both single units and units within multi let buildings, which do not meet market requirements and are in need of investment in advance of reletting. As well as not earning income these properties are costing the council in void management costs. A programme of investment is therefore vital and recommended.

6.3 The agricultural portfolio has suffered from a legacy of low investment over several decades, however to support the implementation of the CDEP, investment is required to support the viability of our farm tenants who are key to the delivery of CDEP objectives.

7. Financial implications

7.1 The proposed disposals of properties listed at Appendix 1 of Part 2 will deliver substantial capital receipts. The capital receipts will be used to cover built up costs of holding the vacant properties prior to sale, disposal costs and will be used to repay council debt or for investment to offset the loss of rental income created by the disposals. The net receipt will support the capital investment programme in line with the approved capital strategy.

7.2 The proposal to create an annual commercial asset investment fund will support a clearer proactive management of the commercial portfolio to sustain and improve financial returns to the council. Annual Investment Funds are reflected in the councils approved capital strategy which will be updated along with the Budget and Council Tax report to this committee in February 2024. The Strategy will set out the minimum allocation to the fund subject to the overall availability of net capital receipts. It is anticipated the proposed detailed allocation of the fund would be presented to this committee in March 2024 along with the other rolling capital programme reports.

7.3 The proposal to earmark the net proceeds from the disposal of 8-9 Kings Road for investment in the commercial portfolio will help address immediate investment requirements prior to the establishment of an annual commercial asset investment fund.

Name of finance officer consulted: James Hengeveld Date consulted: 23/11/2023

8. Legal implications

8.1 There is a general obligation on a local authority when disposing of land to achieve the best consideration reasonably obtainable as set out in Section 123 of the Local Government Act 1972. Each disposal proposed will need to be evaluated and subject to professional valuations to ensure this duty is complied with.

Name of lawyer consulted: Elizabeth Culbert Date consulted: 14/11/23

9. Equalities implications

9.1 It is not considered that the proposal would negatively impact on any particular group in relation to their ‘protected characteristics’. Therefore, no equalities implications have been identified as arising from this report.

10. Sustainability implications

10.1 For those properties to be disposed of it is anticipated that following disposal the purchaser would likely make improvement to the properties which would include element to improve energy efficiency.

10.2 For properties retained within both the Commercial and Agricultural Investment Property Portfolios a programme of capital investment will include at every opportunity improvements to the energy efficiency of the buildings.