GBC INVESTMENT PROPERTY FUND PORTFOLIO ANNUAL REPORT

2021/22

Current Fund Summary – 2021/22

OBJECTIVE OF FUND

The Investment Property Fund aims to provide a high and secure level of income with the prospect of income growth and to maintain the capital value of the properties held in the Fund. This is achieved by keeping vacancy and associated costs to a minimum and by generating income growth through rental increases, refurbishments, active asset management and new lettings, as well as investing in a diversified commercial property portfolio.

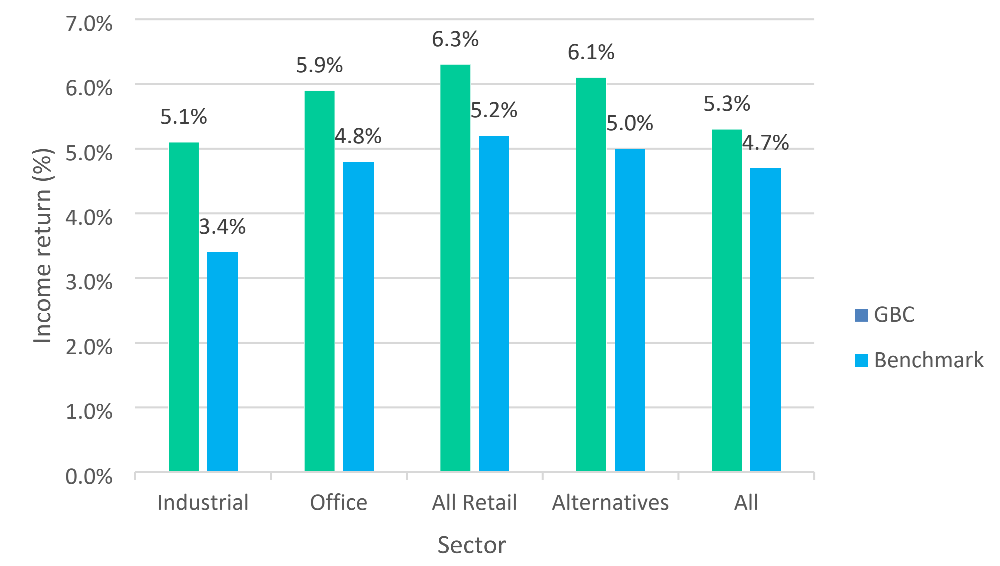
KEY POINTS – 31 MARCH 2022

- Fund size c.£174 million
- Rental income of £8.75 million p.a.
- 145 properties over 4 main sectors
- High yielding (5.3% gross yield)
- Low vacancy rate (5.53%)
- Long average unexpired lease terms

TOP FIVE SINGLE INVESTMENTS

1. Wey House, Farnham Rd
2. Midleton Enterprise Park
3. Moorfield Point, Slyfield
4. The Billings, Walnut Close
5. Friary Street, West Side

FUND PERFORMANCE AGAINST UK BENCHMARK 2020/21



NB: benchmarking based on MSCI data average south-east yields

KEY ACQUSITIONS/DISPOSALS 2021/22

The Council's ability to source the right investment stock at the right price continues to be the biggest driver of performance. However, the outbreak of COVID-19 led to national and international lockdowns and impacted global financial markets. Commercial property market activity was impacted across various sectors resulting in a lack of suitable stock in the market. With the relaxation of the COVID-19 restrictions, it was hoped that market activity would increase in 2021/22 and generate opportunities to acquire. However, it has continued to prove challenging for officers to source the appropriate quality of investment stock at the right price within the Borough. It should therefore be noted that the Council did not acquire or dispose of any investment assets in 2021/22.

Property Investment Fund – 2020/21

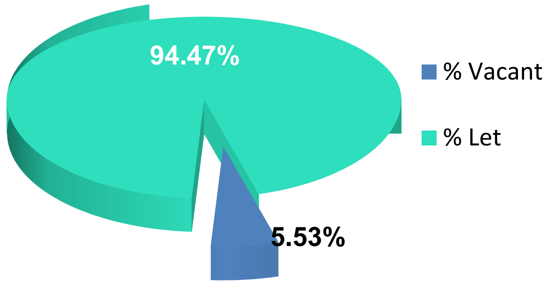
FUND STRATEGY

The Fund comprises the principal commercial property sectors: industrial, office, retail and alternatives (petrol stations, leisure, food & beverage, educational centres etc). Officers aim to achieve an above average income return by keeping vacancy and associated costs (such as empty rates, service charges, repairs, and insurance) to a minimum and by generating income growth through rental increases, refurbishments, active asset management and new lettings. The average vacancy rate over 21/22 was 5.53%[1].

VACANCY RATE

Based on days per property

Qtr 1	Qtr 2	Qtr 3	Qtr 4	Year
5.34%	6.18%	5.93%	4.70%	5.53%



PERFORMANCE

In January 2022 the investment fund was valued at £174 million, increasing by £18.8 million from the previous financial year mainly due to a significant shift in industrial yields. In addition, rental income increased by £600,000 to £8.75 million per annum, representing a total return of 5.3%. The significant rental growth was predominantly a direct consequence of three key lettings at the newly redeveloped Midleton Industrial Estate as well as the completion of two key rent reviews that were put on hold from the previous financial year.

Factors that affected the portfolio in 2021/22 include:

- **Yield suppression** – the positive market indicators, particularly for industrial property with increased investor demand, have resulted in a shift in yields and this has significantly contributed to the increase in value from the previous year**.**

- **Midleton Redevelopment** – Five units on the Midleton Industrial Estate were demolished in 20/21 to make way for the redevelopment of the formerly obsolete assets, the income of which was therefore lost during the construction phase in the previous financial year. Practical Completion in March 2021 and January 2022 of Phases 1, 2 and 3 respectively, resulted in the successful lettings of three brand new units and the additional rent of £253,000 p.a. to the income received. This years' valuation includes all three phases. Phase 4 is in very early stages of construction and so this will be fully reflected in next years' valuation.

[1] Excluding intentional voids and Finance leases.

Fund Performance (total return) *

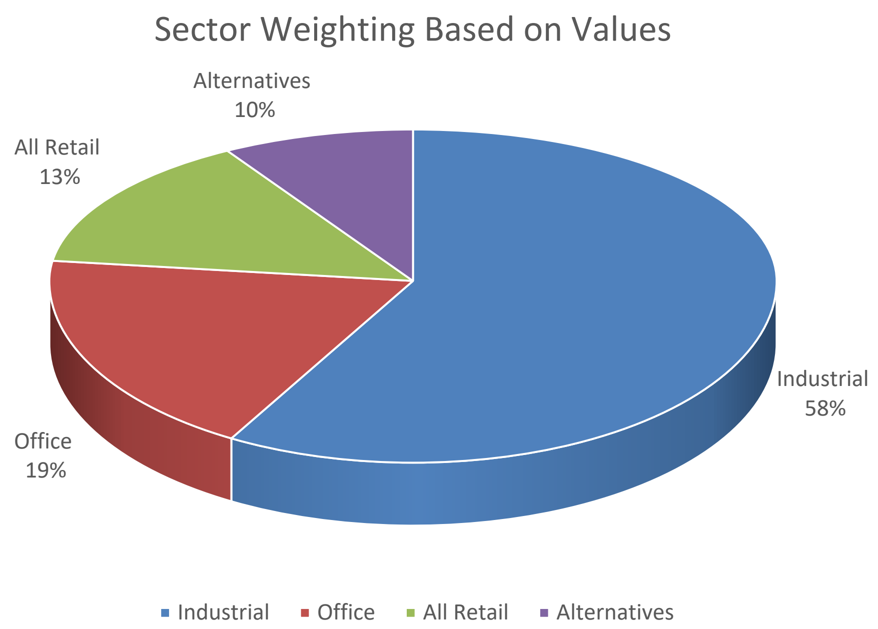
Rental income	Industrial	Office	All Retail	Alternatives	All
2016/17	3,057,302	1,858,638	1,447,672	1,062,137	7,425,749
2017/18	3,493,405	3,186,048	1,426,317	1,080,786	9,186,556
2018/19	3,619,808	3,038,548	1,459,048	1,129,361	9,246,765
2019/20	3,369,452	2,135,460	1,459,548	1,139,397	8,103,857
2020/21	3,565,449	2,112,620	1,284,638	1,139,397	8,102,104
2021/22	4,224,693	2,135,460	1,293,038	1,100,322	8,753,513
Capital value**					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**
2016/17	42,922,450	25,915,000	25,908,500	15,963,500	110,709,450
2017/18	51,509,000	49,574,000	26,065,000	17,471,500	144,619,500
2018/19	66,970,000	49,159,000	26,097,000	18,843,000	161,069,000
2019/20	72,295,790	35,609,000	26,097,000	18,143,000	152,144,790
2020/21	77,670,905	34,165,000	24,527,000	18,540,500	154,903,405
2021/22	101,459,000	32,095,000	23,252,000	17,150,500	173,956,500
Income return					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**
2016/17	7.1%	7.2%	5.6%	6.7%	6.7%
2017/18	8.0%	7.4%	5.2%	5.8%	6.6%
2018/19	6.8%	6.6%	5.9%	5.8%	6.3%
2019/20	6.9%	5.3%	5.9%	5.9%	6.0%
2020/21	6.5%	5.4%	5.6%	5.8%	5.8%
2021/22	5.1%	5.9%	6.3%	6.1%	5.3%
Benchmark return					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**
2016/17	5.4%	4.1%	5.0%	5.5%	4.8%
2017/18	4.9%	4.1%	5.1%	5.3%	4.8%
2018/19	4.4%	4.0%	5.1%	5.0%	4.6%
2019/20	4.4%	4.0%	5.4%	5.1%	4.7%
2020/21	4.4%	4.0%	5.6%	4.8%	4.6%
2021/22	3.4%	4.8%	5.2%	5.0%	4.7%

* Excludes Finance leases
**Capital Values as at 31/01/2022

- **Voids** – 40A Castle Street continues to be vacant and 40 Castle Street became vacant in January 2022 with a minor hit on the 21/22 budget, but which will be felt more severely in 22/23. Unit 2 at The Billings continues to struggle to let, meanwhile unit 4 became vacant in October 2021 equating to a loss of c.£39,000 pro-rated over 21/22. Since the Council's acquisition of 2 Thornberry Way (The Rock) at Slyfield Industrial Estate in August 2019, the property has remained vacant due to the length of time to programme the major refurbishment works which are now complete, but also an abortive negotiation where the tenant withdrew negotiations.

- **Rent reviews** – Several rent reviews were put on hold during the pandemic to assist tenants during an unprecedented time. These were reviewed in 21/22 and added a further £174,000 p.a. to the income received.

- **Sector Weighting** – Industrial remains the Council's largest sector which continues to outperform the office and retail markets, primarily due to a considerable rise in Logistics and E-commerce demand. The upwards trend of industrial values helped mitigate the tail end effect of the pandemic, enabling the portfolio to sustain its value despite a fall in other sectors. Due to the increasing value of the industrial sector, its weighting now represents 58% of the portfolio.



- **Continued decline in High Street Retailing** – the weakened performance of the Council's retail assets reflects the continued impact of Covid-19 on the high street and food & beverage sectors. A decline in headline rents, lower turnover-based rents, rent waivers and increased risk around any upcoming lease renewals and rent reviews led to a marginal devaluation of the retail assets. Deferred rent and rent arrears repayments to be made at a future date over a 3-year period are also adding to increased uncertainty. Longer leaseholds with long-term income security however sustained their value.

As a result of these factors/market dynamics, the Fund performed well and significantly above benchmark. The Team continues to seek to maximise income generation through rent reviews, new lettings, and active asset management.

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KEY 5 TRANSACTIONS

	Property	Transaction
	10 to 12 Moorfield Road Slyfield	Rent review effective from 07/05/2021 achieving an annual uplift of £145,200pa
	122, 124A & 124B High Street	New 5-year lease from 23/04/2021 at £149,500pa
	11A & 11B Midleton Industrial Estate Road	New 10-year lease from 26/04/2021 at £126,000pa immediately following Practical Completion
	Unit 29 Midleton Enterprise Park	New 15-year lease from 01/03/2022 at £113,000pa following successful redevelopment of the estate
	The Brinell Factory, Lysons Avenue, Ash Vale	Rent review effective from 15/04/2021 achieving an annual uplift of £23,000pa

ASSET INVESTMENT FUND

The Asset Investment Fund of £40 million was approved by the Executive in January 2020 as part of the Capital and Investment Strategy 2020-21 to 2024-25. Due to a difficult post-Covid property market, changes in requirements for borrowing from the Public Works Loan Board (PWLB) and changes to the Minimum Energy Efficiency Standards (MEES), the Council decided at its Executive meeting on Tuesday 25 January 2022 to widen the remit of the fund to enable the Council to invest in its existing investment portfolio. The Council endorsed the development and procurement of an overall Industrial Estate Growth Strategy to include an overarching vision for the remaining estates. This will identify all redevelopment, acquisition, and disposal opportunities to enable the Council to protect and grow its financial returns, achieve its strategic objectives and financial excellence, and secure value for money.

LOCAL PROPERTY MARKET 2021/22 REVIEW

The past 12 months have seen the local industrial property market continuing to strengthen, positive signs of a recovery in the local office market with most of the activity resulting from the expansion seen in the gaming sector. The retail market has generally remained subdued with little sign of rental values showing any sustained recovery post lockdown and take up of new space particularly from multiples continuing to be impacted by more sales moving online.

The risks to the economy stemming from the pandemic appear to be receding, but new challenges have emerged that will impact activity in the year ahead. Inflation and the rising costs of living/energy costs and doing business will put a squeeze on households and companies, while labour shortages will continue to constrain output.

Industrial

Continued strong investment demand for industrial property drove yields down to new levels with the shift to online sales continuing to grow. This resulted in a surge in demand from E-commerce and third-party logistics operators. Despite not having a large logistics offering, industrial property within Guildford continued to perform well. A scarcity of supply, particularly for smaller sub-10,000 sq. ft. units, limited new build and strong levels of take up resulted in rental and capital value growth during the year.

With limited supply, the local market demonstrated strong rental growth in 2021. Aviva Investors refurbished 30,000 sq. ft. at Opus Park, which let with a headline rent of £13.50 per sq. ft. Savills IM commenced their refurbishment of the Cathedral Hill estate and additional supply will come from planned schemes, including the forthcoming Burnt Common estate, where planning consent has now been granted on the first phase.

The Council's redevelopment of Midleton (see section 'Major Projects' below) is one of very few pipeline developments in the Borough with the only other notable development being Aviva Investors' refurbishment of a 30,000 sq. ft. unit at Slyfield, launched in Q2 2021.

Office

The trend for home working continued during 21/22 and whilst staff started to return to the office in greater numbers, some occupiers continued to remain uncertain over longer term space requirements with a large proportion of staff continuing to work via a home/office hybrid approach. The Guildford office market did however perform well as one of the top performing South East markets with take up of space over the previous financial year trending well above average.

Activity was dominated by expansion of the gaming sector seen alongside a growing trend for existing corporates to consolidate their existing footprints. Demand for town centre Grade A space was reasonably robust and the strong expansion of the tech sector along with several conversions to residential limiting supply.

Q1 2022 saw strong take-up of 48,000 sq. ft. mainly by occupiers from the tech sector and made up entirely by grade A space. A lack of completions over 21/22 has however left the market starved of sizeable options, although several schemes are coming forward that will provide a substantial boost to Grade A supply.

Retail

With retail sales volumes falling, the increasing cost of living and interest rates approaching 10% fuelling fears of the risk of a recession, demand for new space remained low. Whilst Guildford saw a fall in prime retail rents during COVID-19 from c.£300 psf ZA (2018) to c.£175 psf ZA in 2020/21 there are some limited signs of recovery with several CVA's e.g., New Look now coming to an end. As rents have fallen, greater viability is being seen for some independent retailers moving back into the town.

However, there remains a lack of demand for those units in the 2000-5000 sq. ft. range being the typical space requirement of multiple fashion retailers who have remained inactive. The changes in Class E planning use have provided some greater flexibility in use to occupiers and some new food & beverage offers taking space. Retailers such are those located in the Friary Centre are generally renewing expiring leases where rental levels are considered sustainable on leases typically 5 years or less with flexible terms of occupation.

PROPERTY MARKET – OUTLOOK

Despite growing challenges in the wider economy, limited availability of Office space, continued expansion in the gaming sector and an emphasis on Grade A quality accommodation will continue to fuel incremental growth in prime office rents. Guildford's prime office headline rent is forecast to move to a new benchmark of £37.00 per sq. ft. by the end of 2022, while the delivery of new space in the town centre will drive further growth over the next two years.

The rising cost of living has become an increasing concern in recent months along with the ongoing conflict in Ukraine which is creating additional inflationary pressure primarily through its impact in oil and natural gas prices. Heightened global geopolitical tensions have added an unexpected and unwanted layer of uncertainty to the outlook. Nonetheless, the ending of COVID restrictions should underpin a healthy economic recovery in 2022 and the fundamentals underpinning the growth of the industrial and logistics sector in which demand is anticipated to continue strongly both by occupiers and investors.

The outlook for the retail sector is seeing some gradual improvement at a local level with Guildford having been able to perform better than many other Southeast towns due to its wealthy catchment. The speed of recovery in retail will depend on how quickly consumers spend the savings amassed during the pandemic but also how they react to fears of a recession with interest rates continuing to increase. The next months will also provide a gauge on the propensity of some consumers to keep shopping online post-lockdown. Many within the industry also continue to advocate a wider reform of the business rates system. The re-purposing of retail assets, the growing importance of ESG issues, the evolving impact of Brexit are likely to be key issues for 2022/23.

MAJOR PROJECTS

Midleton Industrial Estate Redevelopment

The Council progressed the phased redevelopment of Midleton Industrial Estate during 2021/22 despite issues regarding the pandemic.

Phase 1 Following the completion of phase 1 in March 2021, both units were let for £126,063pa on a 10-year lease in April 2021. The semi-detached industrial/warehouse units provide c. 10,000 sq. ft. with offices.

Phase 2/3 Construction completed in early 2022 with the first two units being let in March before the end of the financial year, bringing in £127,000pa. Subsequently all units went under offer within 6 months of Practical Completion.

Phase 4 Construction of Phase 4 commenced in March 2022 with an expected completion date of late summer 2023. The development consists of 20 small industrial units between 500 – 800 sq. ft designed to encourage enterprises and to accommodate small, local start-up companies.

Unit 4, The Billings, Walnut Tree Close

At the end of 2021 the Council began refurbishment works to Unit 4 which included full internal redecoration to all floors as well as major roof repairs. The space is currently being marketed and the letting agents report some interest with draft terms in circulation. Although the office market is generally sluggish there is reasonable demand for Grade A newly refurbished office suites in the town centre.

The Rock, 2 Thornberry Way, Slyfield A refurbishment of The Rock completed in 2021 including a full strip out of the mezzanine floor and warehouse racking, a complete refurbishment to the third-floor office and kitchen, and an installation of a new heating and cooling system. The property is currently under offer (conditional on a planning decision) and expected to complete in September 2022 at a rent of £400,000p.a.