GBC INVESTMENT PROPERTY FUND PORTFOLIO ANNUAL REPORT 2022/23

Fund Report – 2022/23

OBJECTIVE OF FUND

The investment property portfolio aims to provide a secure level of income for the Council and seeks to maintain and grow capital values of the properties held in the portfolio. This is achieved by keeping vacancy and associated costs to a minimum and by growing income through new lettings, rent reviews, refurbishments, active asset management, and investment in a diversified commercial property portfolio.

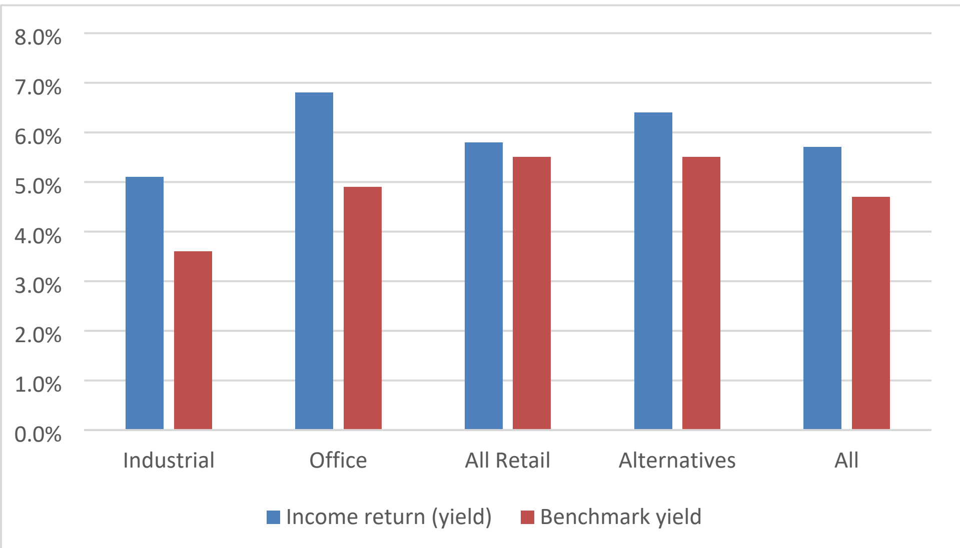
KEY POINTS – 2023 VALUATION

- Fund size c.£168 million
- Rental income £9.5 million p.a.
- 100 Assets over 4 main sectors
- High yielding (5.7% gross yield)
- Low vacancy rate (4.19%)
- Long average unexpired lease terms

TOP FIVE SINGLE INVESTMENTS

1. 1.Wey House, Farnham Rd
2. 2.Midleton Enterprise Park (phase 2-3)
3. 3.Moorfield Point, Slyfield
4. 4.Friary Street, West Side
5. 5.10 Midleton Road (Lexicon House)

FUND PERFORMANCE AGAINST UK BENCHMARK 2022/23



NB: Benchmarking taken from MSCI data – calculated as average over the year.

KEY ACQUSITIONS & DISPOSALS 2022/23

The Asset Investment Strategy set out the Council's objective to increase its rental income through new commercial property acquisitions. However, HM Treasury introduced new guidance in 2022 that limits opportunities for all Local Authorities to borrow from the Public Works Loan Board (PWLB) and Local Authorities are no longer able to acquire assets solely to increase rental income. Officers are therefore in the process of preparing a new Strategic Asset Acquisition Strategy setting out how the Council can borrow from the PWLB to either acquire assets for strategic or regeneration purposes or invest in the refurbishment and redevelopment of its existing assets. It should be noted that the Council did not acquire or dispose of any investment assets in 2022/23.

Property Investment Fund – 2022/23

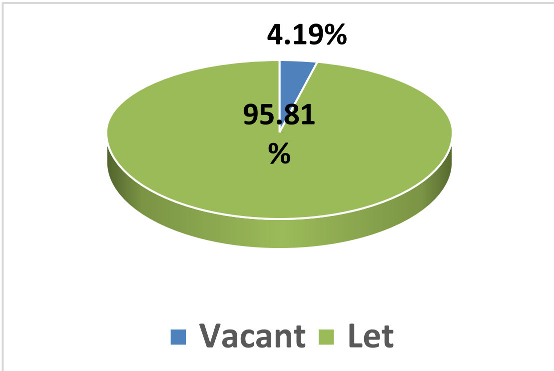
FUND STRATEGY

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 22/23 was 4.19%[1].

VACANCY RATE

Based on days per property

Qtr 1	Qtr 2	Qtr 3	Qtr 4	Year
4.49%	4.49%	3.88%	3.90%	4.19%



PERFORMANCE

In January 2023 the investment fund was valued at £168 million, decreasing by £5.8 million from the previous financial year due to a shift in yields. There was a large increase in capital value in 2021/22 from the previous year and the decrease this year is considered as a correction. Despite the fall in the overall capital value of the investment portfolio, the rental income increased significantly by £757,000 to £9.5 million per annum, representing a total return of 5.9%. The significant rental growth was to a great extent a direct consequence of the successful letting of the newly built units at Midleton Enterprise Park alongside the letting of The Rock at Slyfield Industrial Estate. Furthermore, there were several significant rental increases at rent review following post-pandemic growth in the industrial sector.

Factors that affected the portfolio in 2022/23 include:

- **Yield softening** – The first part of the financial year saw yields suppressed to an all-time low, particularly the industrial sector which saw prime southeast multi-let industrial estates showing sub 3%. However, with the turmoil in central Government, the war in Ukraine, the energy crisis and high inflation, there was a shift in market sentiment leading to yields moving outwards across all property types in Q3/4. There has been an element of correction in this sector as well, which after an initial spate of abortive transactions and general turmoil stabilised towards the end of the year largely with a recognition that occupier demand has remained reasonably constant particularly for

[1] Excluding intentional voids and Finance leases.

industrial property**.** The net result of these capital market shifts has been a reduction in the overall capital value of the portfolio.

- **Midleton Redevelopment** – Our ongoing strategy to regenerate this estate, replacing older, obsolete assets with new fit for purpose buildings continues. Construction works in respect of phase 1 and phase 2/3 were completed in March 2021 and January 2022 respectively and these units are almost fully occupied and income producing. As at the 2023 annual asset valuations, only 1 out of the 16 units remained vacant. Income from these phases will be £647,551 per annum once fully let. The final phase (Phase 4) has been under construction and is therefore reflected as land value in the 2023 asset valuation. The is due for completion in the summer of 2023 and will generate additional rental income in 2023/24.

FUND PERFORMANCE (TOTAL RETURN) *

	Industrial	Office	All Retail	Alternatives	All
Rental income*					
2015/16	2,679,571	1,831,900	1,750,254	885,636	7,147,361
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
2022/23	5,016,552	2,067,013	1,326,638	1,100,389	9,510,592
Capital value **					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**
2015/16	39,077,755	19,227,500	34,270,000	11,233,500	103,808,755
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
2022/23	97,820,000	30,350,000	22,735,000	17,225,500	168,130,500
Benchmark return***					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**
2015/16	6.1%	4.7%	5.4%	4.7%	5.2%
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%
2022/23	3.6%	4.9%	5.5%	5.5%	4.7%
Income return (Gross yield) ******					
	Industrial	**Office**	**All Retail**	**Alternatives**	**All**

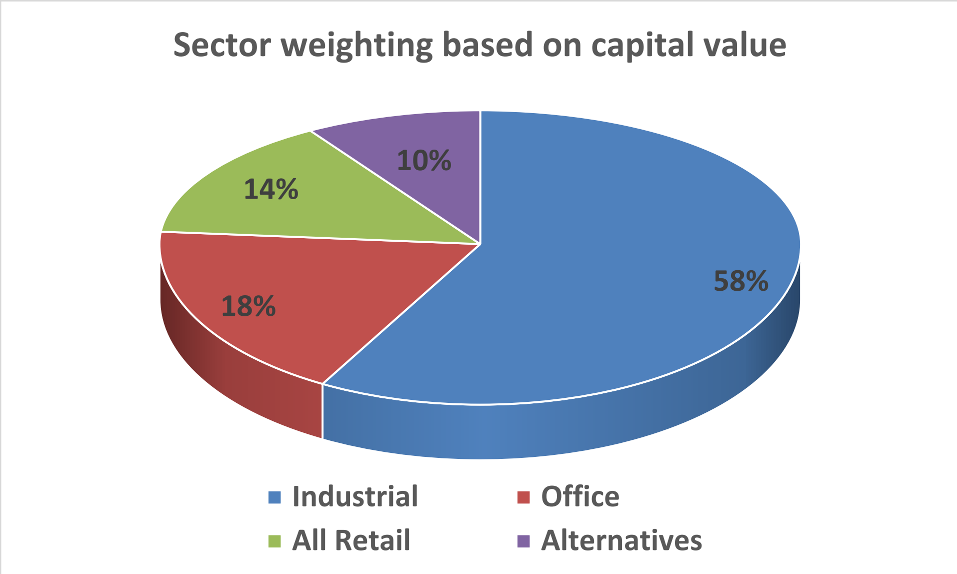
2015/16	6.9%	9.5%	5.1%	7.9%	6.9%
2016/17	7.1%	7.2%	5.6%	6.7%	6.7%
2017/18	6.8%	6.4%	5.5%	6.2%	6.4%
2018/19	5.4%	6.2%	5.6%	6.0%	5.7%
2019/20	4.7%	6.0%	5.6%	6.3%	5.3%
2020/21	4.6%	6.2%	5.2%	6.1%	5.2%
2021/22	4.2%	6.7%	5.6%	6.4%	5.0%
2022/23	5.1%	6.8%	5.8%	6.4%	5.7%

*Excludes Finance Leases
**Capital Values and rent at 31/1/23
*** MCSI data for the Southeast (average across the year)
**** Note the basis of analysing income return was switched to gross yield across each Asset Class as opposed to adopting an average yield used in previous years.

- **Voids** – 40A Castle Street and 40 Castle Street are vacant but there is an ongoing strategy review of these assets which may involve disposal. The vacant space at The Billings (unit 4 and two floors in unit 2) continues to remain vacant despite ongoing marketing with the potential rental value of all vacant parts being circa £135,000 p.a. plus empty rates liability. Two units at Moorfield Point have been vacant for part of the year but have encouragingly been the only significant industrial voids.

- **Rent reviews** – we concluded a number of rent reviews across our portfolio and in the main these resulted in significant rental uplifts particularly in the industrial assets. One significant rent review at 37-39 Moorfield Road saw a rental increase from £39,500pa to £87,000pa though this was in part as a result of a change of use agreement. We continue to monitor rent review events closely and appoint external consultants where appropriate.

- **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 came to an abrupt end at the time of the turmoil in Central Government when Liz Truss became prime minister along with the war in Ukraine and energy crisis. At this time prime industrial yields slipped from around 3% to 5% but have since regained some ground with a gradual return of investor confidence. Fortunately, occupational demand for industrial space remained reasonably robust throughout and rents have not been impacted. Overall, our industrial assets now represent 58% of the portfolio but lost around 3.6% in value compared to the previous year due to the yield shift.



- **High Street Retailing facing ongoing challenges** – the weakened performance of the Council's retail assets has not recovered post the pandemic. Instead, there has been a reset in the market with prime rents estimated to be at around two-thirds of their original levels. Whilst there is a little more positivity and some new tenants coming into the town, the market is difficult with a trend towards shorter leases with tenant breaks, lower turnover rents, requests from Tenants for rent holidays/abatement and so forth. Retailers are experiencing ongoing staffing issues and there is a lingering risk of heavily indebted businesses going into administration. Our retail exposure is for the most part via geared long leases (where we collect rent based on a % of sublease income that our direct tenants generate) but we do hold several directly let single assets. Shopping mall retailing is suffering more than the High Street to some extent due to the increasing cost of services feeding into the service charge. The total capital value of our retail assets exhibited a relatively small decline, though there was a marginal increase in income.

As a result of these factors/market dynamics, the Fund performed well overall and significantly above benchmark. Asset & Property managers continue to maximise income generation through rent reviews, new lettings, and active asset management.

KEY 4 TRANSACTIONS

	Property	Transaction
	The Rock, Thornberry Way	Refurbished by the Council and let to Ninja Warrior from October 2022 for 15 years at a headline rent of £400,000pa and 6 months rent-free.
	Wey House, Farnham Road	The previous lease was regeared for 16 years at a rent of £1.3M p.a. The Council agreed a 6-month rent-free period and a capital contribution of £800K towards the refurbishment of the building.

	Phase 2/3 Midleton Enterprise Park	14 out of 15 units let, generating a total rent of £521,000 p.a.
	37-39 Moorfield Road, Slyfield Industrial Estate	Agreed a rental uplift at rent review alongside a widening of the permitted use in relation to a long let. Rent increased from £39,000pa to £87,500pa backdated to December 2020.

STRATEGIC ASSET INVESTMENT POLICY AND INDUSTRIAL ESTATES STRATEGY

Strategic Asset Investment Policy (**Revised)** – an 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. With changes to PWLB borrowing rules imposed by HM Treasury, the Council can no longer invest purely for income. However strategic acquisitions may still be possible in accordance with the changes in requirements for borrowing, such as for regeneration projects, to address market failure or preventative action. These changes, coupled with the amended MEES regulations, prompted the Council 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. Officers are working on a revised/updated Policy to guide our strategy going forward.

Industrial Estates Strategy – in 2022 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. Officers are working on the strategy out of which a series of Projects will be identified. Integral to this is planning a path to deal with Assets that are becoming obsolete/failing MEES standards.

LOCAL PROPERTY MARKET 2022/23 REVIEW

2022/23 saw unprecedented political turmoil with the outbreak of war in Ukraine, the energy crisis and high inflation. Further negative pressures on the UK economy came in September 2022 following the election of Liz Truss as Prime Minister and the mini budget which promoted policies that was not received well in the markets. Subsequent to this, sentiment gradually improved. That said, although there was a significant impact in the capital markets, occupier demand seemed to remain relatively unaffected particularly in the industrial sector. The office market has been subdued but some positive signs 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 and take up of new space particularly from multiples continuing to be impacted by more sales moving online.

Following the pandemic, new challenges have emerged that are likely to 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 in the first half of the year drove yields down to new levels with the shift to online sales continuing to grow, seemingly unaffected by the economic and political turmoil. 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 growth during the year. Yields on the other hand softened mid-year but with limited supply, the local occupier market demonstrated remarkable resilience and even some rental growth evident. An example is on the Cathedral Hill Industrial Estate which was comprehensively refurbished by the owners Diageo and off the back of a letting to Screwfix in 2021 some flagship tenants were attracted at record rents – first with Topps Tiles signing up at £15psf and then Porsche at £18psf. In early 2023 there was a further letting to Howdens at £20psf. Additional supply is likely to come on stream from 2024 at Burnt Common, where planning consent has now been granted on the first small unit phase and further larger units planned thereafter.

The Council's redevelopment of Midleton (see section 'Major Projects' below) has continued with the construction of phase 4 which will comprise 20 new small Enterprise units built to a green agenda and with some pre-let interest in advance of completion. These units act as a seedbed for local enterprise and has been remarkably successful.

Office

Take-up in 2022 hit 105,789 sq ft, closely in line with the ten-year annual average and comprising 19 transactions. Notably, reflecting Guildford's growing reputation as UK gaming cluster, Supermassive Games was behind four of 2022's deals, with its 20,842 sq ft lease at Ranger House being the largest deal of the year. While demand has been slow more recently, momentum started to pick up in Q2. April brought Guildford's first deal of 2023, Fuse Gaming's 4,000 sq ft at Eastgate Court, while 45,000 sq ft is under offer at the Priestley Centre, Surrey Research Park. However, demand generally remains focused towards the town centre rather than out of town – it accounted for 83% take-up in 2022, while the current active requirements are all seeking out solutions within the town centre.

Total supply has bumped up to a four-year high of 445,000 sq ft. However, close to two thirds of this is situated out of town with much of the increase accounted for by British Land's refurbishment of the Priestley Centre (83,000 sq ft) and CIM's refurbishment of 3000 Cathedral Square (44,700 sq ft), both of which are scheduled for delivery in Q3 2023. By contrast, supply in the town centre is tight with only 84,000 sq ft of up and built space available, of which 50,000 sq ft is grade A. Large options are extremely scarce, with the only immediately available building providing in excess of 10,000 sq ft being 3 London Square (14,600 sq ft).

Offices outside the town centre suffered including Cathedral Square and Guildford Business Park where there is significant vacancy, but positively, several schemes are coming forward that will provide a notable boost to town centre supply over the next few years. A refurbishment of White Lion House (15,760 sq ft) delivers summer 2023, while Kingsbridge Estates' Bottleworks (41,000 sq ft) is currently under construction and arrives in early 2024. Longer term, key projects in the pipeline comprise 1 Farnham Road (75,000 sq ft), which is in the early stages of planning, and One Onslow Street, which has recently received planning consent to deliver 99,000 sq ft near to The Friary shopping centre.

Despite the economic headwinds, tight supply in the town centre continues to exert upward pressure on rents for best-in-class space. Guildford's prime headline rent was at £37.50 per sq ft as at Q1 2023, though agents are forecasting this to grow in the next year.

Retail

While the 'Cost of Living Crisis' has dominated the national news headlines, this was not reflected in retail sales as they grew by 6.1% over the 2022/23 financial year. Clothing saw the strongest growth in sales volumes of around 3% while household goods fell by around 5%. The share of online retail remained consistent over the course of the year at about a quarter of all UK sales.

Guildford Town Centre has been a beneficiary of this post-pandemic recovery with several new brands arriving in the town. These have mostly been food and beverage operators who appear to have been attracted by the strong consumer spend and availability of prime pitches. Joe & The Juice, Coppa Club, Ole & Steen Bakery and Megans have all taken on prominent retail units with a coffee plus food offering and appear to be trading very well. Clothing stores Free People and Charles Tyrwhitt have taken on smaller yet highly visible premises. However, there are still a number of empty shops, with Claire's Accessories, Ernest Jones, Jack Wills and Links of London all recent departures from the town.

Prime retail rents have been re-based at around two thirds of their previous peak levels, dropping from circa £325-350 psf Zone A before the Pandemic to circa £175-200 psf Zone A thereafter. Rents have not increased from last year, remaining more or less at the same levels. Landlords are generally granting 10-year terms with a combination of initial rent free and stepped rents. The willingness of these tenant businesses to invest in high quality shop fitouts show their confidence in the continued recovery and success of Guildford Town Centre.

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 £39.50 per sq. ft. by the end of 2023, while the delivery of new space in the town centre is expected to 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 the political turmoil around the Liz Truss Premiership appears to have settled and the effect of rising interest rates should start to bring inflation under control. It is hoped this should underpin a healthy economic recovery towards the end of 2023 and the fundamentals underpinning the growth of the industrial and logistics sector in which demand is anticipated to continue strongly both by occupiers and with more investment activity in the capital markets.

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 wider economic factors, particularly getting inflation under control and in turn interest rates. Many within the industry also continue to advocate a wider reform of the business rates system.

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MAJOR PROJECTS

Midleton Industrial Estate Redevelopment

The Council continued to progress the phased redevelopment of Midleton Industrial Estate during 2022/23. This was the only major project relating to investment Assets during the year.

A timeline of the phased speculatively built scheme is as follows: -

Phase 1 – GBC speculatively built a pair of semi-detached industrial units comprising 9,338 sq ft in 2020/21. This was let to Havwoods Accessories on a 10 year lease from April 2021. Income generated - £126,063pa.

Phases 2 and 3 (Branded as Midleton Enterprise Park) - GBC speculatively built a further 15 units ranging in size from 860 to 6,500 sq ft. This was branded as 'Midleton Enterprise Park' and was remarkably successful in quickly attracting tenants in advance of practical completion Q1 2022. During 2022/23 14 out of the 15 units were let, achieving rents of around £15-16.50psf. The total income generated once fully let will be circa £520,000 p.a.

Phase 4 Midleton Enterprise Park – under construction during the year and likely to reach practical completion in the next financial year. This will provide a total of 20 small units to form a 'seedbed' for small local businesses similar to the existing Enterprise units on Slyfield and at Ash Vale. Unit sizes will range from 549- 807 sq ft. The total rental income anticipated will be in the region of £250,000 p.a. once fully let.