



Part 1: for Strategic Investment Board July 2023
Short Term Company Strategy
2023 – 2025

Background

This Report reviews the strategic pathway for Halsey Garton Residential Ltd (the “Company”). It sets out the future strategic principles and delivery opportunities.

The current structure of the companies is as follows:



The Company was incorporated in July 2014 and began trading in August 2020. It currently holds 80 residential properties on long-term leases, the majority of which are inside the Surrey County boundaries.

Market Commentary

Economic Overview

The real estate market took a significant downturn in the second half of 2022, with the cost-of-living crisis, the rise in interest rates and inflationary pressure. Inflation in the UK has been relentlessly moving upward over the past 18 months. Initially this reflected a marked post-Covid pick-up in consumer demand, coupled with global supply chain issues. This has been exacerbated by rising energy prices resulting from Russia's invasion of Ukraine.

To contain inflation, the Bank of England has continuously increased interest rates, with the base rate being 0.75 bps in March 2022 rising to 5.0% by June 2023. Inflation has been at its highest level in 40 years. Core inflation, which strips away fuel and food items has continued to increase, suggesting that underlying inflationary pressures are still strong.

Q4 2022 was dominated by the September 2022 mini-budget. Whilst property values had already started to decline by this time, this sped up the downwards trajectory and market movements forced the Bank of England to intervene by buying up Government Bonds at an urgent pace to restore orderly market conditions, in order to protect vulnerable parties like pension funds. Whilst this had a stabilising effect, it was not enough to stem the surge in bond yields.

Property Market

The UK real estate market was already facing headwinds prior to the September 2022 mini-budget announcement, notably due to construction cost inflation and the rising cost of debt weighing heavily on the market. This has resulted in an increased level of uncertainty in the property market and some softening of pricing across all sectors, particularly those sectors of the market that are assessed in line with gilt markets such as long dated income.

With the cost of borrowing and uncertainty in the market, investment across the UK declined in Q4 2022. The reduction was largely attributable to the volatility surrounding the government's Autumn mini-budget and its timing leading to the crucial fourth quarter of the year. Challenging economic conditions and recession forecasts further contributed to cautious investor sentiment. Although 2022 started strongly with a record £16.1 billion transacted in Q1 alone, volumes decreased through the year. The impact of the reduced transactional activity has been felt across the board with all sectors seeing below average investment volumes in the second half of the year.

There are clear signs of downward pressure on property values as on-going transactions falter in the face of market uncertainty and rapidly changing funding requirements.

Housing Sector

Average UK house prices increased by 4.1% in the 12 months to March 2023, down from 5.8% in February 2023. The market looks set to further slow in the coming quarters as pressures on household budgets intensify and labour market conditions start to soften, while mortgage rates remain well above the lows prevailing in 2021.

In the lettings market, tenant demand continues to outstrip supply causing rental levels to rise. However, due to forthcoming legislative changes coupled with the rising cost of capital loans, the number of buy-to-let landlords looking to sell their properties continues to increase.

Company Background

HGR Company Profile & Business Case

The Company was incorporated in June 2014, to fully implement the recommendations of the Investment Strategy approved by Cabinet in May 2014. The Company enables the Council to invest and lease out residential assets to deliver an alternative revenue stream and enhance the Council's financial resilience over the longer term.

Local authority investing for commercial return is not a new concept, albeit the scale of it has seen an increase over recent years as many councils have used this to respond to reduced Central Government funding. Investment has been connected to both regeneration and income generation. The practice of commercial investment peaked during the period 2016-2019 when approximately £6.6bn was invested across the UK. This precipitated greater scrutiny and new guidance, which culminated in HM Treasury stepping in and restricting access to the Public Works Loan Board (PWLB) for all councils that intended to invest 'primarily for yield'.

The Company is governed by a strategy that was last reviewed when it commenced trading, in August 2020. Since this time, the Company has:

- Appointed a Managing Director
- Reviewed the quality of service and reappointed the External Property Management Supply Chain; and
- Confirmed the PWLB funding position.

Consequently, it is now timely to review the Company's historic performance, and to agree a medium to long-term strategy for the strategic realignment of the Company.

Governance

The governance process for the Company is set out in Appendix 1.

Original Purpose and Strategy of the Company set by the Shareholder and Returns

When The Company was incorporated, its purpose was to generate commercial returns from investment in a specific portfolio of residential property for the Shareholder. The Company was not set up to purchase or develop any additional assets.

Future Strategy of the Company

In considering the future strategic principles for the Company, the Board has reviewed the historic financial performance of the Company and taken into account pending legislation changes which are considered to be a significant risk.

Performance to date has been broadly in line with the original Business Case.

However, due to recent increases in interest rates, the Company is returning considerably lower than the Shareholder's annual risk-free opportunity cost, which demonstrates that from a financial perspective it is better to dispose of the properties than continue to operate them.

In addition, the Company has identified future risks, some of which include capital expenditure :

- 12 properties in the portfolio have been identified as requiring significant capital expenditure to bring them to an appropriate standard to lease out.
- Pending legislation change regarding the minimum Energy Performance Certificate (EPC) will require significant capital expenditure to ensure that all the properties are compliant.
- The introduction of the Renters Reform Bill which will end 'no-fault' evictions by repealing S.21 of the Housing Act 1988, and the introduction of the Decent Homes Standard to the private rented sector, will require significant capital expenditure.

Future Strategic Principles

Given the identified capital pressures and performance of the Company compared to the risk-free opportunity cost outlined above, the Future Strategy of the Company has been set against the principles below. On this basis the Company will:

1. Not renew existing occupational tenancy agreements when they come to expiry.
2. Divest assets that do not deliver Surrey County Council Policy (SCC)*.
3. Retain and repurpose existing assets forecast to deliver SCC policy.

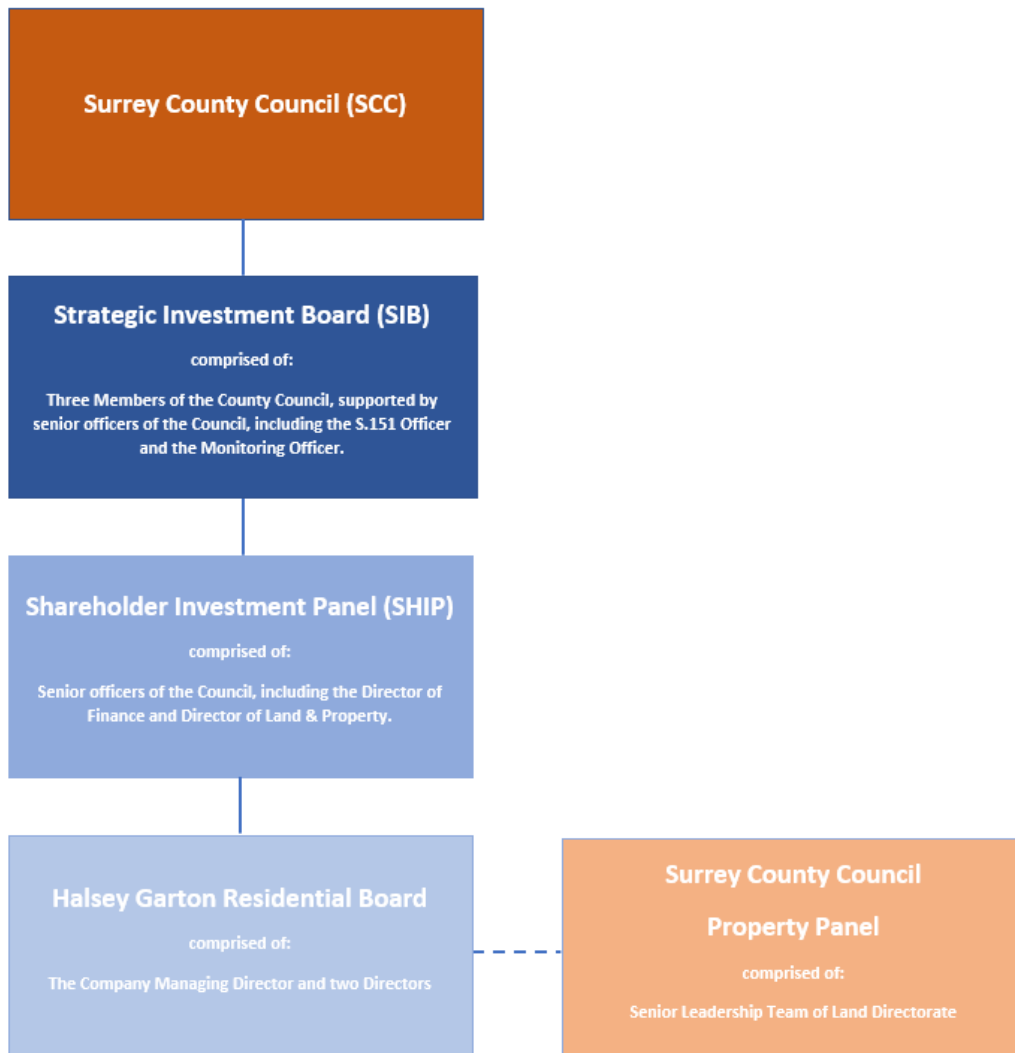
*Subject to confirmation from the Shareholder that those identified to deliver SCC policy under point 3 are confirmed as such and are agreed to proceed at that time.

Appendix 1

Company Governance

Company Governance

The governance process for the Company is as follows:



The HGR Board has the delegated authority to make formal decisions which support the ongoing strategy and day to day operations of the Company. Decisions relating but not limited to, a change in company strategy, capital investment, and acquisition and disposal of Assets are restricted by the Shareholder within the reserved matter of the Company's Articles of Association.

The decision-making Board on reserved matters is the Strategic Investment Board (SIB), with some matters in turn referred to Cabinet. The SIB monitors the Council's trading activity and its investments in companies to ensure satisfactory performance and effective risk management.

The Shareholder Investment Panel (SHIP), an Officer led panel, chaired by the Director of Finance – Corporate and Commercial (Deputy s151), works within delegated authority limits set by the SIB. The

Panel's remit is to review and challenge the Company's performance in year and assist with the approvals and operational workings of the Company.

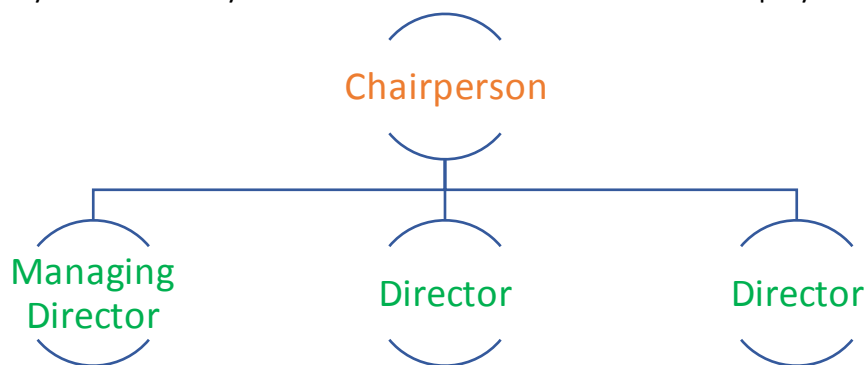
SHIP has delegated authority by SIB to approve:

- Addition and removal of Directors
- Capital Investment between £0.1m - £1.0m (the Company has authority to approve up to £0.1m in a single accounting period)
- Approval and ongoing review of annual business plans aligned to the SIB approved strategy of the Company.

Prior to consideration at SHIP, any property related proposals relating to HGR will be considered at SCC Property Panel for endorsement. This is to ensure proposals are compatible with other activities within the property estate of the Shareholder.

Company Board

The Company Board currently consists of three Directors who are also employees of the Shareholder.



All Board Members are required to ensure that the decisions are made in the best financial and commercial interests of the Company and Shareholder. In addition, the skills and experience expected from each position is summarised below:

Director(s):

- Provides expert knowledge from associated fields to the one that the Company operates.

Managing Director:

- Provides expert property investment and asset management knowledge.

The role of Chairperson is undertaken alternately by the current Directors of the Company.

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