

Investment Board Annual Report

Financial Year 2018/19



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The council's strategic framework for investment is supporting the development of new income streams to enhance the financial resilience of the council. This has led to the creation of the Investment Board to approve acquisitions that contribute to the achievement of the agreed investment strategy, to monitor the performance of the portfolio and ensure satisfactory performance and effective risk management. The financial returns delivered from investment will help to ensure that we continue to deliver quality services for our residents.

The Annual Report of the Investment Board provides an overview of the progress we have made in developing a property investment portfolio and enhancing the financial resilience of the council. The Council has also made non-property investments, for example by providing equity funds for the creation of the Municipal Bonds Agency. The Shareholder Board produces an annual report about each company in which the council owns shares and therefore to avoid duplication this report of the Investment Board focusses just on the Property Investment Portfolio.

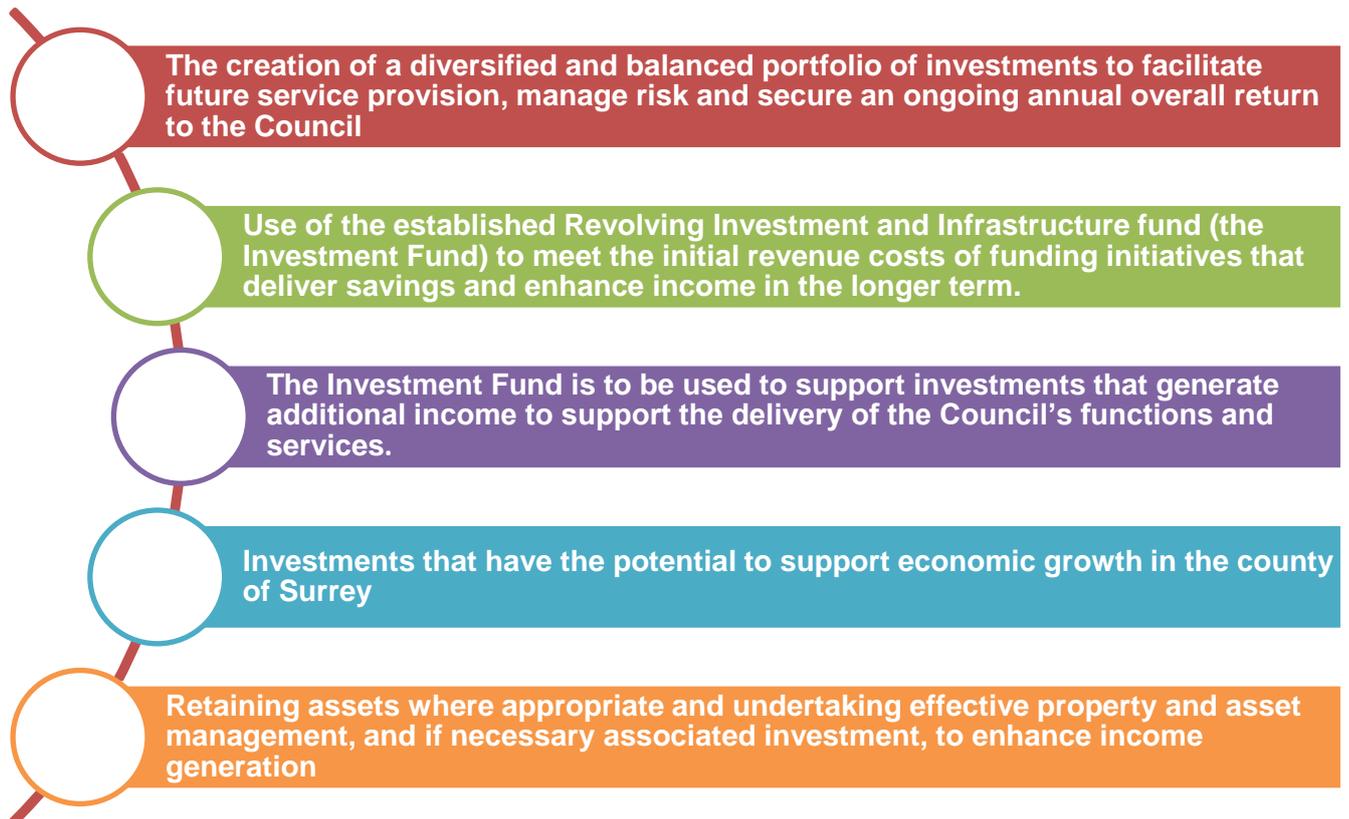
The functions of the Investment Board and Shareholder Board will be combined into a new Board following full Council in May 2019. The new board, the Strategic Investment Board, will undertake a review of the investment strategy as part of the updated governance arrangements.



Tim Oliver
Leader of Surrey County Council

The Investment Strategy

The Investment Strategy was agreed by Cabinet in July 2013 and was developed in response to the requirement for the Council to enhance its financial resilience in the longer term. The main principles of the Investment Strategy are as follows;



The Investment Strategy provides the council with the ability to make investments that have the potential to support economic growth or deliver economic regeneration within the county. This may mean that schemes with lower returns are considered however all investments need to demonstrate a return in excess of the cost of capital in order to be affordable for the council. The council is also able to purchase properties that provide for long-term future service use, whilst delivering an investment return. These assets provide flexibility in the estate whilst delivering an investment return.

Cabinet approved the business case for the creation of the Property Company and its associated subsidiaries in May 2014 in order to enable it to invest in property outside the county and to invest for the commercial income return. The companies making up the Halsey Garton Property Group (HGP) were incorporated between June and July 2014.

The investment portfolio of the Council is therefore a combination of assets acquired or developed by the Council for future service need or economic development and those acquired or developed by HGP.

Governance

The Investment Board

- The Investment Board was created in March 2017 following the review of the Investment Strategy by Cabinet and in order to facilitate the further growth of the investment portfolio. Prior to this the Investment Advisory Board was in place to make recommendations for Cabinet approval.
- The Board and its role is noted in the constitution of the council. The Board works in accordance with its Terms of Reference and in line with an agreed Responsible Investment policy.

The members of the Investment Board are the Leader, the Deputy Leader and three Cabinet Members chosen by the Leader. The Leader may also, from time to time, appoint further members to undertake a non-voting role. The board is supported by officers of the council.

Members

- Leader
- Deputy Leader
- Cabinet Members x 3 [Charlotte Morley, Mel Few & Mike Goodman]
- Non-Voting Members [Wyatt Ramsdale & Nick Darby]

Advisors

- Chief Executive
- Executive Director of Resources (Section 151 Officer)
- Director of Law & Governance (Monitoring Officer)
- Senior Property Advisor
- Head of Strategic Finance (Board Secretary)
- Supported by external specialist professional advisors

The board is responsible for –

- Ensuring that investment opportunities are thoroughly evaluated, that there is an appropriate balance between risk and reward and that the acquisition contributes to the achievement of the aims of the strategy.
- Approving property investment acquisitions, property investment management expenditure, property investment disposals and the provision of finance to enable the council's property company to purchase assets.
- Monitoring the progress made in respect of achieving an appropriately balanced and diversified portfolio of assets and its performance.

Investment Portfolio

Property Investment

Other Investment

The Investment Board is also responsible for evaluating and recommending non-property investments for decision by Cabinet or Cabinet Member depending upon value. These decisions are made in accordance with the protocol for “key decisions” as set out in the Council’s constitution, e.g. a Cabinet decision is required for an investment spend of £1m and over. The council’s non-property investment assets include debt & equity finance provided to FutureGov Ltd and equity investment in the Municipal Bonds Agency.

The Shareholder Board provides oversight for the council’s shareholdings – it safeguards the council’s interests and takes decisions in matters that require the approval of the council as owner or as a shareholder of a company. The Shareholder Board produces an annual report which provides information about each company and therefore to avoid duplication this report of the Investment Board focusses just on the Property Investment Portfolio.

The Shareholder Board is responsible also for the oversight of the property company HGP in the same way that is responsible for the oversight of other trading companies created and owned by the council. The link between the two boards is summarised in the table below.

Property Investment & Halsey Garton Property Ltd

Investment Board

- Approves the business case for asset purchase or development by HGP
- Approves the provision of finance (equity & debt) to enable HGP to purchase asset
- Reviews and considers the performance of the total property investment portfolio- assets held by both SCC and HGP
- Considers the financial results of HGP from the point of view of the council - e.g. the interest received from providing loans (debt finance) to the company and the expected annual dividend.

Shareholder Board

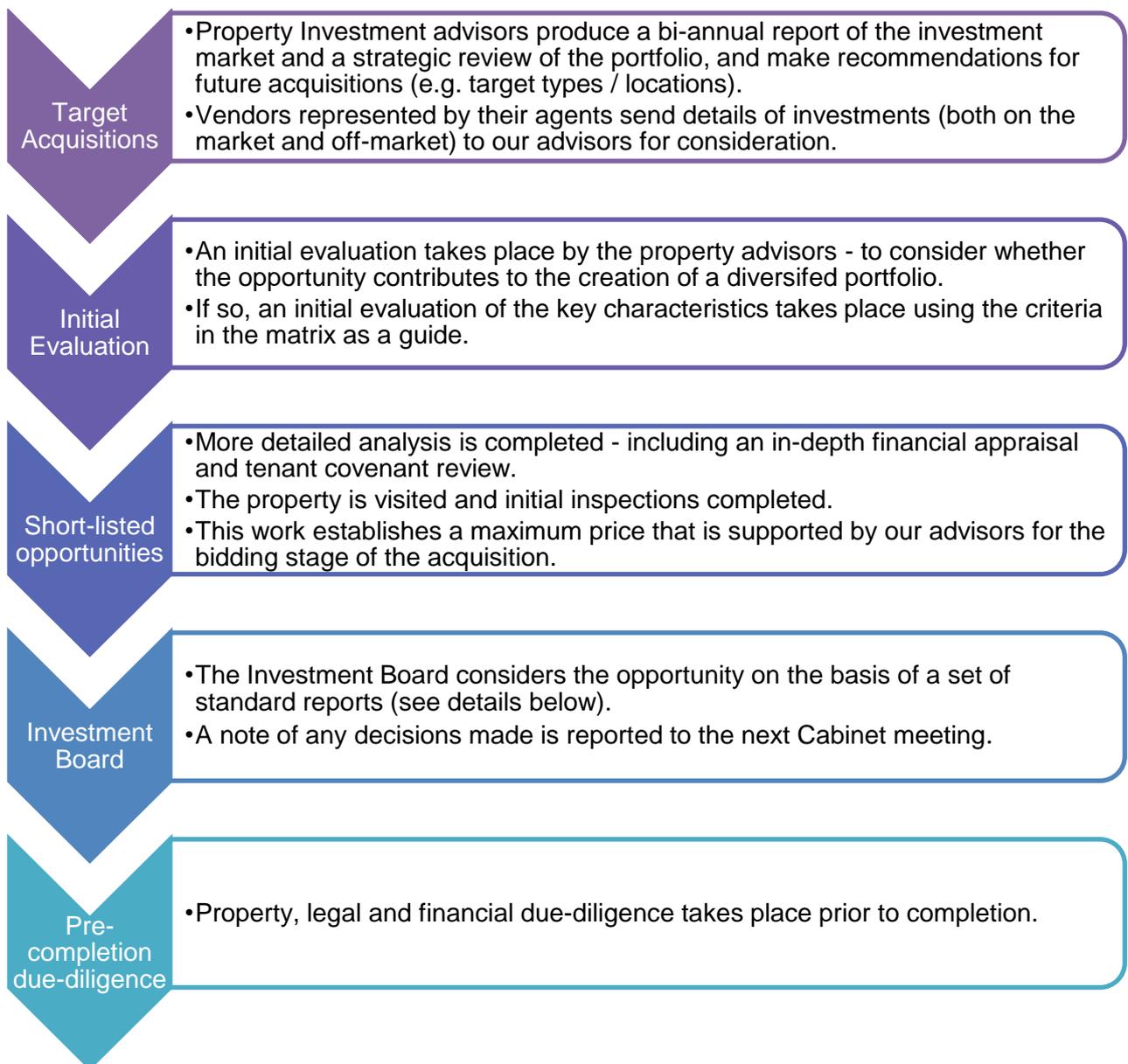
- Receives and considers the year-end financial accounts of HGP and approves the proposed dividend
- Approves the annual business plan
- Appoints and removes Directors
- Approves changes to the Articles of Association
- Reviews the financial results of HGP from the point of view of the company - e.g. rents received less expenses including interest payable to the council and administration costs.

The functions of the Investment Board and Shareholder Board will be combined into a new Board, the Strategy Investment Board, following full Council in May 2019.

Governance

Acquisition selection and appraisal

The Investment Board have delegated authority to approve property investment acquisitions and developments that are in accordance with the Investment Strategy. All investment expenditure is approved on the basis of a robust business case, developed using appropriate specialist property investment advisors and which gives due and proper consideration of the balance between risk and reward and an assessment of the underlying security of the investment. In order that the council undertakes borrowing in accordance with the Prudential Code which requires that borrowing is affordable, sustainable and value for money, all investments are required to demonstrate a return in excess of the opportunity cost of capital and other associated costs of delivery. The diagram below outlines the process for acquisitions-



Investment Appraisal Reports

The following standard reports, together with the sales brochure (if available) are presented to the Investment Board for each potential acquisition-

Investment Report

- A narrative report providing details of the opportunity including, for example, its location, age and tenure. The report discusses key risks and provides information about the tenants and their financial covenant. It provides a summary of the expected returns and describes the scenarios that have been evaluated. If agreed, the report comments on the heads of terms for the purchase.



Investment Matrix

- A standard scoring matrix which is used as a guide to decision making to ensure that opportunities are measured and assessed in a common manner. The matrix looks at the following characteristics-strategy alignment, location (both macro and micro), building quality and age, lease type & length, tenure, property management intensity and tenant repair obligations and whether there are any asset management opportunities.



Financial Analysis

- A financial analysis in a standard format demonstrating the long-term expected income returns from the opportunity. At least two scenarios are prepared - to show a better and a worse case. Both are prepared using prudent assumptions - for example no rental growth is usually assumed unless the lease provides for fixed uplifts or increases are based upon RPI or similar indices.



Property Investment Performance

The council's property investment portfolio has an asset value of £443m delivering a net income of £4.7m in 2018/19 bringing the total net income achieved to date from the investment strategy to over £10m.

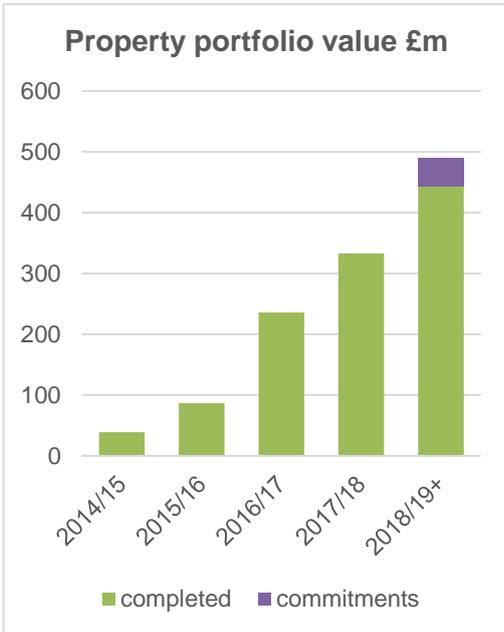
| Investment Portfolio Summary Actuals to March 2019 | Capital Expenditure (including prior years) £m | Net (Income) / Expenditure | | |
|--|--|----------------------------|---------------|-------------|
| | | Prior Years £m | 2018/19 £m | Total £m |
| Property Acquisitions | 383.6 | 10.3 | 6.6 | 16.9 |
| Property Development fees & contingency | 70.6 | -4.7 | -1.9 | -6.5 |
| | | -0.2 | 0.0 | -0.2 |
| TOTAL / Net (income)/expenditure | 454.2 | 5.4 | 4.7 | 10.1 |

Existing, agreed acquisitions and future developments, will deliver an average net income of £7.5m per annum from 2019/20 onwards. These figures are net – after the deduction of all costs incurred including assumed borrowing cost.

The figures in the tables above and below include the capital cost of providing finance to HGP and the net income achieved from investments from the point of view of the council. The income consists of the net interest margin receivable by the council on the loans provided to the company plus the estimated annual dividend.

Capital expenditure includes all costs associated with each investment acquisition including the costs of purchase – in particular stamp duty. The capital expenditure incurred will therefore be higher than the value of the asset purchased unless the value of the asset increases in time. The purpose of the investment strategy is to deliver an annual income stream in support of the council's services and in doing so the council is not assuming any gain from the value of the underlying assets. Instead a long term view is being taken since the value of the assets may decrease as well as increase over time. The assets are revalued each year for the year-end financial accounts and further information about this is provided in the part two report.

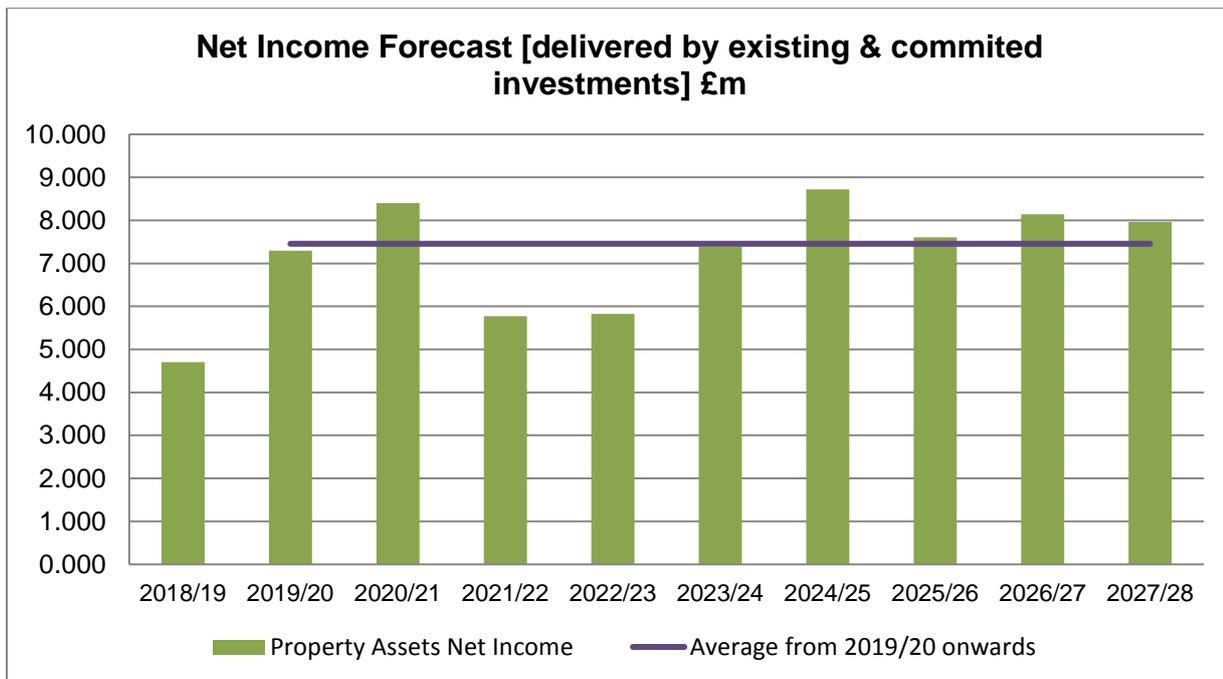
This report provides information about the results achieved so far and the expected results from investments and developments to which the council is committed – potential returns from future potential acquisitions are not included. Due to the confidential nature of individual investments, this report provides high level summary information about the total portfolio. More detailed results, on an investment by investment basis, are provided by the Part Two confidential annex which accompanies this report.



The current portfolio has been established over a number of years with the rate of growth increasing more recently. The council has created a good reputation in the market by demonstrating our ability to complete acquisitions to agreed timescales and this means that the council and its property company are increasingly being invited to consider various potential acquisitions, including some that are off-market. Our ability to grow the portfolio further will be dependent upon the right opportunities coming to market.

Assets that are being developed will not produce an immediate income stream and there will be occasions when a tenant triggers their break clause or vacates at the end of the lease resulting in a potential letting void. The council approved the creation of the Revolving Investment and

Infrastructure Fund in the budget report approved by the council in February 2013 to meet the initial revenue costs of initiatives. The reserve is not used to provide for the initial capital expenditure but to provide for the cost of any additional borrowing that is not being offset by income, as is the case for development spend. This has not however been necessary since the net income delivered by acquisitions has offset development spend to date. The reserve may also be used to smooth the return from investment such that an average income can be relied upon when setting budgets.

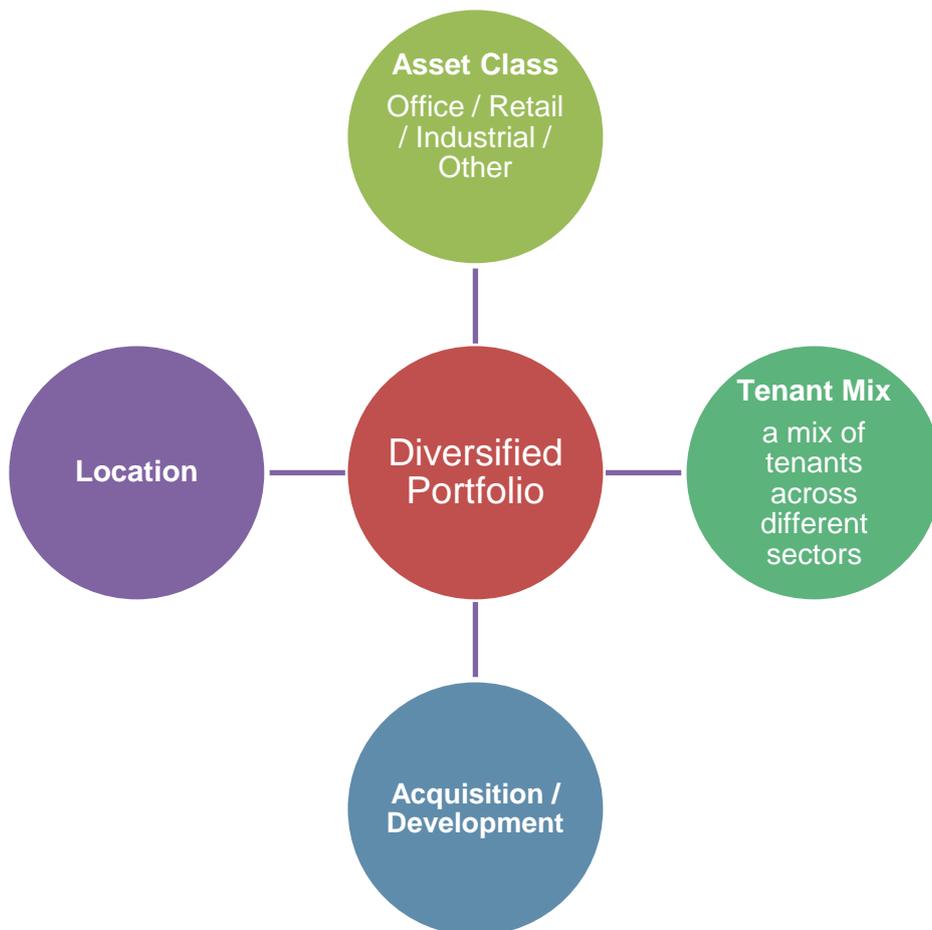


The net income is reported after deducting assumed funding costs and all other costs associated with the investment. The council may fund its capital expenditure through the use of reserves, capital receipts and prudential borrowing. As the council does not hypothecate (match) these funding sources against individual projects or acquisitions, we assume that all the Council's activities in progressing the Investment Strategy will increase the requirement to borrow. The council therefore requires all investments to demonstrate a return in excess of the assumed cost of capital which it calculates based on assumptions in the MTFP which are adjusted if required for market conditions and in accordance with long-term interest rate forecasts. The council charges the assumed cost of capital to each individual investment (including the cost of finance provided to HGP) in a similar way to an inter-company charge.

Property Investment Portfolio

The investment strategy means that the council is managing different financial risks. Investments will be subject to inherent economic and market risks, and therefore a balanced portfolio of investments is being created. The Investment Strategy notes a preference toward assets within Surrey that are of good quality, in good or growth locations however in order to create a diversified portfolio a mix of geographical locations will be required.

The IB monitors the portfolio to ensure that an appropriately balanced and diversified portfolio is created over time, across the combination of directly Council-owned assets and those owned by HGP. Officers, supported by independent specialist professional advisors, support the IB. These specialist advisors periodically evaluate the recommended portfolio of property investment, taking into account market conditions and achievable returns. The IB also manage the portfolio in order to avoid over-reliance upon single tenants or types of tenants in terms of their impact as a percentage of the portfolio.



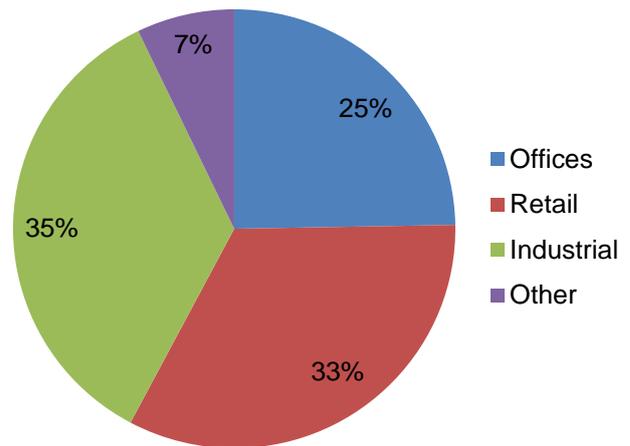
The total asset value of the current property portfolio based upon the valuation exercise undertaken on 31st March 2019 is £443m. The portfolio incorporates assets held by the council and by HGP.



The tables and charts in this section of the report provide further information about the current portfolio - the aspects of the portfolio and its diversification – the asset class, the geography and the tenant mix. The charts do not include acquisitions or developments not yet completed since the information is based upon year-end balance sheet values and the current rents position.

Asset Class

| Property Portfolio as at 31.03.2018 | Asset Value £m |
|-------------------------------------|----------------|
| Offices | 109.4 |
| Retail | 146.2 |
| Industrial | 155.3 |
| Other | 31.6 |
| Total | 442.5 |

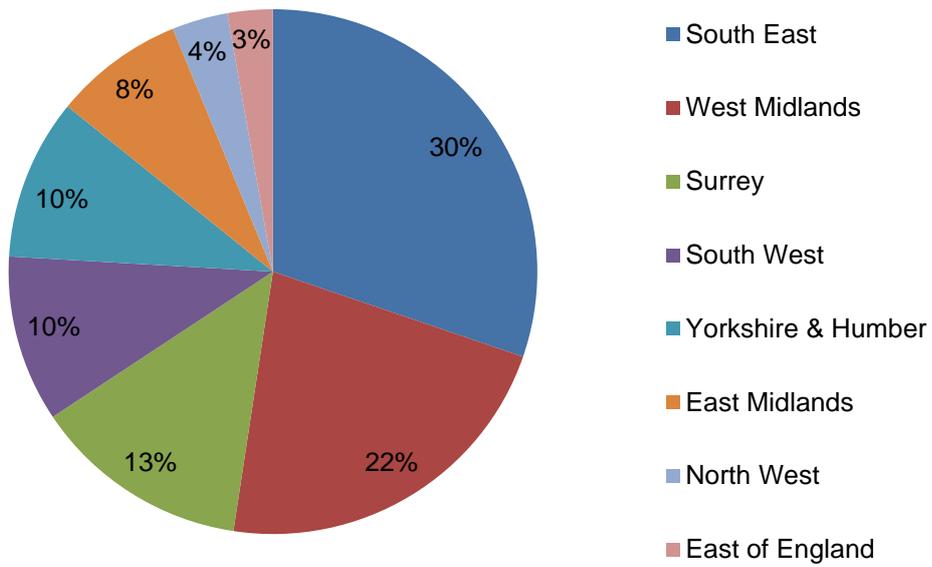


Achieving a fully diversified portfolio will take time and will be dependent upon the opportunities in the market. The portfolio is currently under-weight in the office sector and will further alter with the completion of the Farnham Brightwells acquisition which will increase the retail holding once the development is completed. Further acquisitions will be considered following the review of the strategy by the Strategic Investment Board.

Geographic Mix

The Investment Strategy notes a preference towards assets within Surrey however a mix of geographic locations is required in order to achieve a diversified portfolio. The total asset value of property held for investment purposes within Surrey is £59m / 13% of the portfolio.

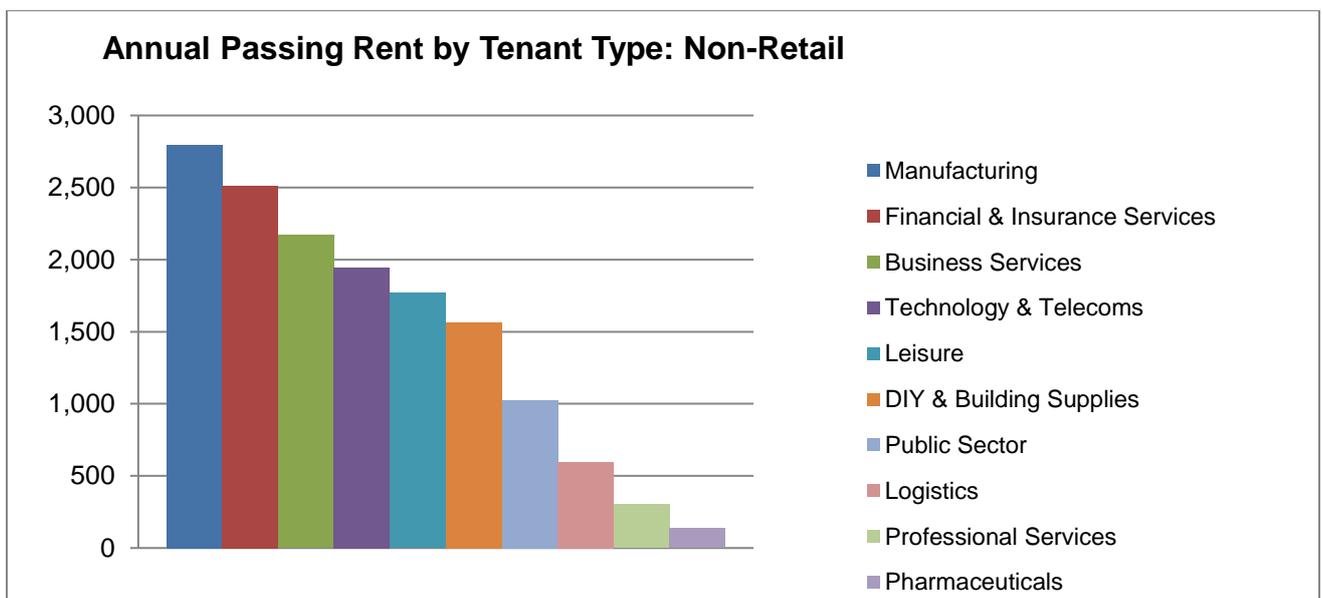
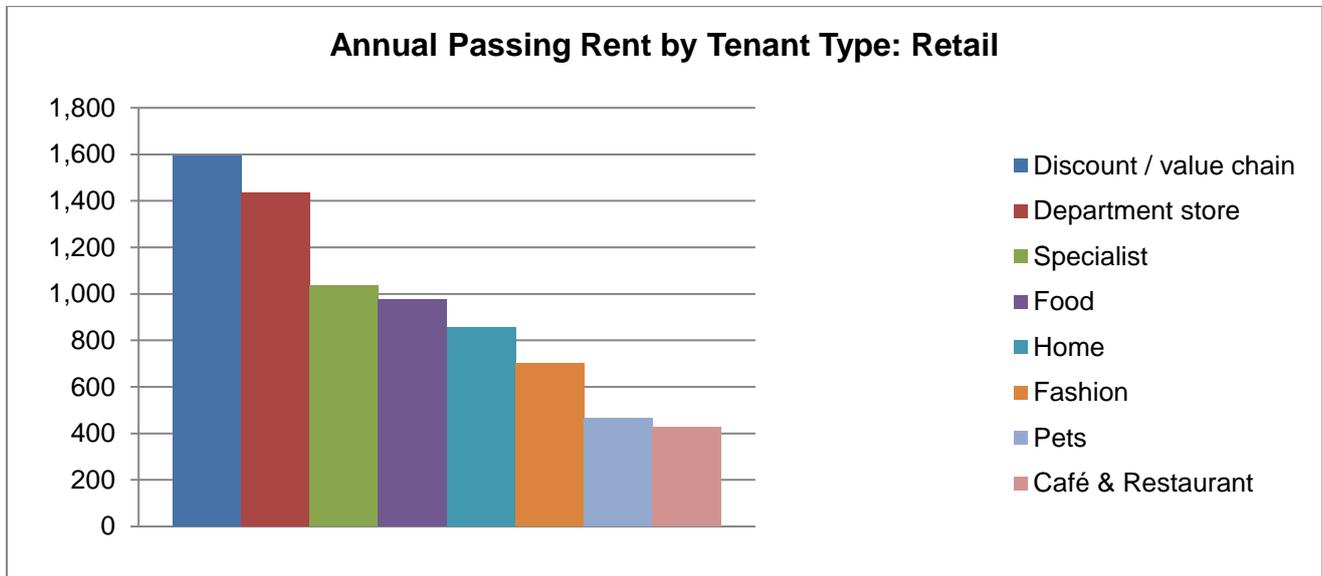
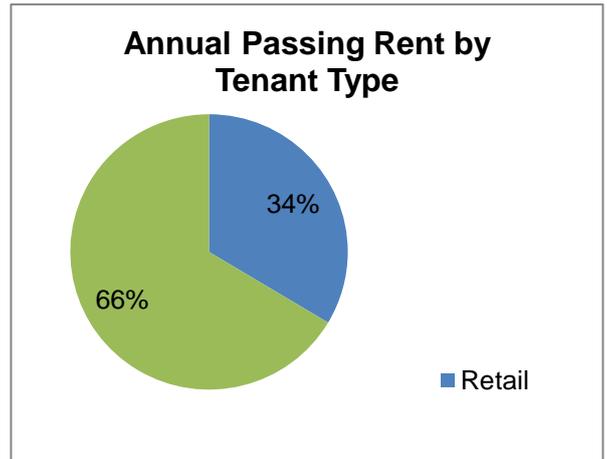
Asset Value by Location



Tenant Analysis

The following charts provide an analysis of the annual passing rent by type of tenant. The most significant exposure is to retail tenants, followed by tenants in the financial and insurance services industries.

Retail tenants are 42% of the portfolio when analysed by the annual passing rent – of this, the biggest type of tenant is in the value chain or discount sector with tenants that include Poundstretcher, Poundland, Argos and B&M.



Property Purchases

The tables that follow provide a list of purchases made by both SCC and HGP up to 31st March 2019 as part of the Investment Strategy. These tables exclude the cost of development activity which is commercially sensitive and therefore covered more fully in the part two report. The part two report also includes a note of the current valuation for each asset.

| Assets held by SCC | Purchase Price | Acquisition Date | Description |
|--------------------------|----------------|------------------|---|
| Abbey Moor, Chertsey | 1,100 | Sep-12 | Golf Course (public 9 holes) & Club House |
| Ranger House, Guildford | 13,700 | Apr-13 | Multi-tenanted town centre office |
| Kingfisher House, Egham | 1,750 | Apr-13 | High Street shop |
| Waterman's House, Woking | 695 | Jun-13 | Office redevelopment opportunity |
| Bridgehead House, Ashted | 1,075 | Dec-13 | Single tenanted office |
| Nexus Crawley | 9,750 | Mar-14 | Land purchase |
| 61 High Street, Staines | 3,573 | Apr-14 | High Street shop |
| Pixham Lane, Dorking | 34,545 | Feb-16 | Single tenant headquarters office |
| Brightwells, Farnham | 3,000 | Feb-18 | Long leasehold land purchase |
| Park Lodge, Dorking | 3,000 | May-18 | Multi-tenanted office adjacent to Pixham Lane |

| Assets held by HGP | Purchase Price | Acquisition Date | Description |
|---------------------------------------|----------------|------------------|---|
| Hampton Park West, Melksham | 10,455 | Nov-15 | Manufacturing and warehouse facility |
| Washford Mills, Redditch | 7,451 | Mar-16 | Retail warehouse units |
| Hawkley Drive, Bristol | 11,219 | Apr-16 | Manufacturing and warehouse facility |
| Manton Wood, Worksop | 8,460 | May-16 | Distribution warehouse |
| Aztec West, Bristol | 19,900 | Jun-16 | Single tenanted office |
| Wiggs House, Salford | 7,760 | Jul-16 | Distribution warehouse |
| Friar Street, Worcester | 11,800 | Nov-16 | Cinema and retail / restaurant units |
| Birmingham Rd (Travelodge), Stratford | 9,200 | Nov-16 | Hotel and retail units |
| Willowbrook, Loughborough | 18,850 | Nov-16 | Retail units (out of town location) |
| Oakgrove, Milton Keynes | 26,461 | Dec-16 | Retail units (out of town location) |
| Stratham Street, Macclesfield | 6,900 | Dec-16 | Retail warehouse unit |
| High Street, Winchester | 15,825 | Mar-17 | High Street department store |
| Blenheim Park, Nottingham | 2,852 | Aug-17 | Land purchase for warehouse development |
| Malvern Shopping Park, Worcestershire | 75,038 | Sep-17 | Retail units (out of town location) |
| Travelodge, Hatfield | 12,250 | Oct-18 | Hotel |
| Park Spring Road (Symphony), Barnsley | 43,900 | Dec-18 | Manufacturing and warehouse facility |
| Kitemark Court, Milton Keynes | 14,400 | Dec-18 | Single tenanted office |

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