

Development Sub Committee – 3rd July

Audit Committee - 27th July 2023



Title	Public Interest Report Recommendations – Action Plan
Purpose of the report	To provide an update on the proposed actions to address recommendations in the Public Interest Report (PIR)
Report Author	Coralie Holman, Group Head of Assets and Paul Taylor, Chief Accountant
Ward(s) Affected	All Wards
Exempt	No
Exemption Reason	N/A
Corporate Priority	This item is not in the current list of Corporate Priorities but still requires a formal report to the Audit Committee.
Recommendations	Committee is asked to: To note and agree the proposed actions to address the recommendations in the Public Interest Report
Reason for Recommendation	To ensure the Development Sub Committee and Audit Committee have fully noted and agreed to the strategy for monitoring the rental income performance of the investment portfolio, mitigating risk and the suite of KPIs that determine the success of this performance and connected risk.

1. Summary of the report

- 1.1 On 8th December 2022, the Council considered and agreed a response to the recommendations made within the Public Interest Report (PIR) issued by KPMG.
- 1.2 Recommendation 4 of the PIR set out **“The Council should develop its investment property portfolio modelling to bring these in line with the expected practice of an institutional investor. This should include robust stress testing and sensitivity analysis which incorporates scenarios that cover the highest level of risk for expenditure, revenue, tenant behaviour and external socio-economic factors. Consideration should also be given to the diversification of the portfolio and whether this should be addressed over medium to longer term.”**
- 1.3 Recommendation 5 of the PIR set out, **The Council should develop an action plan as part of the management of its investment portfolio which addresses each of the weaknesses identified in paragraph 6.9 (of the**

PIR). It was suggested this action plan should be linked to a portfolio risk register, which monitors each of the KPIs, tenant performance and risk to the debt repayment strategy for each investment property asset.

- 1.4 On 23rd March 2023, a follow up report was taken to Audit Committee, where it was agreed an action plan would be developed to address recommendations within the PIR and reported back to Audit Committee in July 2023.
- 1.5 Finance and the Group Head of Assets have now developed an action plan which is appropriate to continue to monitor and action the risk attached to the Council's Investment Assets, refreshes the Sinking Funds earmarked reserves modelling over a fifty year period, which centres on a suite of appropriate Key Performance Indicators (KPIs), linked to an Assets specific risk register with focus on tenancy performance and risk to the debt repayment strategy for each investment property asset.

2. Key issues

- 2.1 The Council purchased 8 investment assets prior to Autumn 2018 as part of a Capital Strategy to generate sufficient long-term income to offset the impact of the disappearance of Government grants, to support the provision of services for residents.
- 2.2 The investment programme benefitted from low-cost fixed (which means the Council is not now exposed to the risk of the interest rates on those loans rising) interest rates to buy high quality investment assets which will generate an income stream. The income generated is significantly greater than the financing costs of which approximately £10m was used in 2022/23 to help maintain Council services, and moving forwards is budgeted to contribute £10m per annum to support the Council's Budget.
- 2.3 When the Council took the decision to purchase the assets, external expertise was used to inform decisions on specific acquisitions to purchase. The Council strategy was always extremely focused on identifying and managing risk. Only high-quality assets were acquired after extensive due diligence both on the assets and the tenants.
- 2.4 The Council's assets team proactively engaged with tenants during the COVID-19 pandemic to ensure tenants continued to pay rent and continues to employ this approach post covid to manage risk. The Council's investment assets have continued to perform extremely well despite the economic downturn. For 2020-21 financial year the Council collected 99% of the rental income invoiced, in 2021-22 we collected 99.8% of investment assets rent invoiced, currently for 2022-23 we have achieved 99,2% with more rent to be received.
- 2.5 Despite several challenges to the portfolio post-pandemic, the occupancy rate across the investment portfolio stands at 87.27% which is better than the industry benchmark for Southeast office assets (84%). During Financial Year (FY) 2023/2024 the occupancy rate will increase above 90%, as the vacant accommodation at 12 Hammersmith Grove is re-let. In addition lettings are

due to be completed on vacant space at Charter Building, Elmbrook House and 3 Roundwood Avenue.

- 2.6 The Council's approach has been focussed on a long term 'hold' of the assets with financing and risk modelling being undertaken over a 50-year period. This modelling includes the future risk of their being dips in rental income when existing leases have break clauses exercised or end potentially resulting in dips of income when space becomes vacant and then rent-free incentives need to be offered.
- 2.7 The Council is setting aside sufficient funds in its sinking funds reserves to ensure that it can cover such dips in income without any impact on the Council's budget or council. During the pandemic and the "Cost of living crisis" the Council has continued to set aside funds from part of the rental income stream into sinking funds to ensure it has contingency funds to cover future potential dips in rental income. At the end of 2022/23, the funds in the sinking funds reserves totalled £37.8m. Our Finance team will actively manage the sinking fund to ensure the contingency funds remain at the appropriate level.
- 2.8 The Council has always had an asset management strategy that sets out how it proactively manages all its assets to ensure they continue to perform well, and all risk is appropriately managed. The KPMG PIR provided an opportunity to reflect on how our assets are performing 5 years after the initial acquisitions and ensure our asset management strategy continues to be robust to manage the risk associated with our investment portfolio.
- 2.9 This report focuses solely on sinking funds modelling, the KPIs, associated risk register for investment assets and management of our tenant performance to minimise risk and set out the debt repayment strategy for our assets, however in the Autumn a further report will be taken to Corporate Policy and Resources Committee updating our Asset Management Strategy (AMS) to which the individual Asset Investment Strategies and Business Plans form part of. The AMS will also set out how KPIs are monitored to demonstrate how the assets are performing, plus how this will be reported.
- 2.10 Sitting under the Asset Management Strategy are a suite of specific investment specific documents that set out the portfolio Asset Investment Strategy (AIS) (Appendix 1) for the forthcoming 12 months. This strategy includes Asset specific appendices (Appendix 2) and is supplemented by Asset specific Business Plans which look at the longer 3–5-year period. The management approach set out in these documents is linked to the agreed Key Performance Indicators (Appendix 3). These KPIs are captured within the risk register (Appendix 4) which shows the associated risk scoring before the management strategy is applied and the reduced risk with the management approach in operation. These KPIs will be reported on going forward twice yearly if agreed.
- 2.11 At the Corporate Policy & Resources Committee meeting held in February 2023, the Committee agreed to the following:

- (a) The Sinking Fund Policy, which will be reviewed every five years or earlier in the event of a material change (Appendix 5).
 - (b) The Sinking Fund is to cover unplanned short-term issues, to minimise risk, protect the Council's Revenue Budget and Council Taxpayers from exposure to short term dips in rental income and build sufficient cash backed reserves to provide the Council with future options, which may include funding refurbishments (net of dilapidations) development and or sale of any of the current property portfolio, in particularly in 14 years' time, when BP could exercise their lease break and vacate the entire site at Sunbury.
- 2.12 Officers agreed to develop a 50-year model of the Council's Sinking Funds to further define and produce more detailed scenario planning, so that Council could review and agree:
- (a) The annual contribution to the Council's revenue budget (General Account)
 - (b) The annual contribution to be made into the Sinking Fund from the General Account
 - (c) The annual payments to be made from the Sinking Funds to the General Account.
 - (d) The level of the Sinking Fund balance to meet future Council objectives, plans and contingencies.

3. Asset Portfolio Management Action Plan

- 3.1 The Investment Assets Portfolio Risk Register (Appendix 4) sets out the key risks to the Council if the investment portfolio is not managed effectively. This document also sets out our approach to manage each of those risks, with scoring methodology used to demonstrate the level of risk pre and post mitigation action.

The mitigation actions set out the basis of our management strategy to ensure the portfolio is effectively managed to protect our income from the assets. In summary this mitigation is a proactive approach to understanding the performance, needs and plans of our tenants. This is achieved via:

- regular and early engagement in respect of lease events i.e., break options and lease renewals.
- external checks on tenant performance financial strength
- regular engagement with external consultants in respect of market conditions, tenant demand and rental levels.
- instructing external expertise where necessary i.e., letting of new space
- Annually prepared Investment Strategies for each asset, together with medium term 3–5-year business plans, all informed by (a) – (d) above.
- Regular budget setting and monitoring over a 5-year period, based upon the information within the AIS and business plans.
- Using budget information and lease event data to prepare sinking fund projections and budgets.

- 3.2 The documents within the appendices set out an approach that supports an annual review of the portfolio performance, together with focused actions for the forthcoming 12-month period and a medium-term view on the future of the asset, tenants, and void costs.
- 3.3 The performance of each asset can be measured via a robust set of KPIs, linked to the risk register demonstrating the increased risk without a proactive management approach being adopted.
- 3.4 The development of the 50-year financial model, will provide even greater confidence that the Council will be able to manage its Investment and Regeneration portfolio properties and ensure that it will continue to provide the annual revenue contribution to support services, housing and regeneration plans in the Borough over the coming years.

4. Options

- 4.1 Option 1 – Agree the action plan to adopt a robust asset and tenancy management strategy that manages tenant risk, reduces void periods and empty premises costs, and delivers certainty of income receipt which supports the debt repayment strategy set out for each asset. Approve the proposed KPIs. **This is the recommended option.**
- 4.2 Option 2 – Develop an alternative action plan to manage tenant risk. **This option is not recommended** on the basis the action plan set out within this report is comprehensive, robust and includes the recognised measures and industry standard approach to understanding tenant risk and performance.
- 4.3 Option 3 – Do not formally record an action plan to set out the approach for managing tenant risk, which in turn allows tenant failure, tenant vacation of premises and other indicators that impact on the certainty of rental income to be forecast in advance. Instead rely on there being strong market demand with financially sound occupiers to move into accommodation as space becomes vacant. **This option is not recommended** as it will impact on certainty of income, with longer than necessary void periods and vacancy costs having to be incurred by the council.

5. Financial implications

- 5.1 The PIR Action Plan is intended to build on existing arrangements and further enhance our ability to mitigate and manage financial risk.
- 5.2 By developing the 50-year model, Council will be able to advise Officers of their strategy and how they would propose to grow the Sinking Fund Reserves, to meet the Council future aspirations for the Borough, particularly in 2036.

6. Risk considerations

Please refer to the risk register in Appendix 4.

7. Legal considerations

- 7.1 The Local Audit and Accountability Act 2014 (“2014 Act”) governs and prescribes the way in which the Council should deal with an external auditor’s formal Report in the Public Interest.
- 7.2 The recommendation in this report demonstrates that the Council has considered the Public Interest Report in accordance with the 2014 Act and is taking the necessary action to address matters raised regarding management of the investment portfolio in a longer term financial model.

8. Other considerations

None.

9. Equality and Diversity

N/A

10. Sustainability/Climate Change Implications

The performance and expenditure in relation to our portfolio is where appropriate and cost effective to do so based on implementing ‘green’ and sustainable initiatives that support the on-going effective day to day running of the portfolio.

11. Timetable for implementation

Immediately

Autumn – Asset Management Strategy report to be considered by CPRC

12. Contact

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Background papers: Appendix 1 Asset Investment Strategy
Appendix 2 Asset Business Plan Summary Template
Appendix 3 Key Performance Indicators
Appendix 4 Portfolio Risk Register
Appendix 5 Sinking Fund Policy