BNP PARIBAS
REAL ESTATE

Valuation

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For the attention of Richard Long

Your Ref:
Our Ref: DJS/130189

11 November 2016

Dear Richard

Commercial Estate Strategic Review

You have asked us to provide a review on the progress made towards the preparation of a strategy for the management of the Commercial Investment Estate (the "Estate").

We understand that this review will accompany your report to the Policy Development and Scrutiny Panel (the "Panel") on 24 November 2016.

Background

The Estate comprises approximately 220 assets valued at c£250m, the majority of which are retail premises located in Bath city centre. The Estate makes a significant contribution of c£15m pa to the revenues of the Council.

You have been asked to report to the Scrutiny Panel with your proposals for the future management of the Estate.

We have attended two strategy workshops at which the following topics have been discussed:

a) Key strategic objectives
b) Key targets
c) Work streams

You have asked us to review your emerging strategy in our role as your Specialist Adviser and Critical Friend, a role to which we were appointed in 2013. During that time we worked with you to develop a strategy, the suggested key element of which was a Prime Objective of "*The development of the growth of secure net income*" supported by three Secondary Objectives:

- ◊ The building of resilience into future income.
- ◊ The release of capital with limited loss of income for re-investment in the Portfolio.
- ◊ The contribution towards the achievement of wider corporate objectives.

Since these objectives were suggested in 2013, the Council has moved towards a smarter way of looking at its property assets by adopting a whole council approach. For example the Estate is contributing to the objectives of ADL, the Council's residential development company, and the local independent trader tenants are regarded as contributing to the wider economy and hence the achievement of corporate objectives.

The Council has also agreed that the proceeds of sales out of the Estate can be re-invested in the Estate. This was a significant step forward, changing the Estate from a "closed" fund to an "open" fund, thereby significantly improving your ability to rebalance the Estate.

A consequence of this smarter way of looking at your property assets there is a need to revisit the objectives and targets of the Estate, hence the strategy workshops.

The Emerging Strategy

We now review the three topic areas referred to above.

Key strategic objectives

The objectives submitted by you for consideration were:

- I. *To contribute toward the maintenance of the architectural significance of Bath as a World Heritage City*
- II. *To make a significant contribution towards providing the resources necessary to enable the Council to meet its corporate and strategic objectives*
- III. *To promote and encourage a diverse and appropriate range of shopping uses in Bath*
- IV. *To support the Council's Economic Development and Regeneration initiatives*
- V. *To provide accommodation on flexible terms to new and expanding businesses in the Bath & North East Somerset Council area, with an emphasis on achieving a diversity of businesses on each site*
- VI. *To actively promote the beneficial use of upper floor accommodation in retail centres, with the emphasis on introducing residential uses*

Commentary

The adoption of six objectives, only one of which is financial, will in our opinion lead to a lack of clear direction and focus. Our understanding is that the Estate's prime function is the production of sustainable income which can then be applied to the delivery of services by the Council. We recognise the quite proper wish that the Estate also contributes to the wider objectives of the Council such as economic growth.

The Council needs to decide whether the prime objective is indeed financial and if it is to then have in place a mechanism by which a conflict between the financial and wider objectives can be resolved.

The financial objective as drafted (ii.) does not address what we perceive to be the key requirements of any financial contribution to the Council's finances, namely:

- The income should be sustainable to ensure that future reductions of income are avoided and providing budgeting certainty
- The income should grow in order to offset the impact of inflation on the Council's revenues
- The cost of running the Estate should be minimised without impacting on its ability to deliver its objectives

We are not convinced that it is necessary to identify five specific non financial objectives and would suggest that a contribution to the Council's corporate objectives should suffice. If you do retain these objectives we believe they require further explanation and a way of measuring success.

Recommendations

I. That the Prime Objective of the Estate be financial.
II. That the Estate should also contribute to the corporate objectives of the Council.
III. That a mechanism be put in place to resolve any conflict between the financial and corporate objectives.

Key targets

The current targets are:

Key Activities	*Timescales*	*Performance Measures*
Income profiling	*Annual target*	*Actual v target*
Management of voids (empty properties)	*Monthly*	*Level of void properties. Target less than 4% of rent roll*
Management of debt	*Quarterly*	*Rent arrears. Target less than 5% of rent roll*

The following additional targets were submitted by you for consideration:

- ◊ *Increasing the annual net income by £X within three years and y% over IPD thereafter.*
- ◊ *Reducing exposure to the Retail sector to X% of total ERV within three years and Y% within six years.*
- ◊ *Reducing the income secured against very high risk covenants to no more than X% of the total gross rents payable within three years and Y% within six years*
- ◊ *Maintaining the average property voids at X% below IPD*

Commentary

If it is agreed that the Prime objective is financial, it is essential to set targets against which performance can be measured. Those targets should be relevant to both the Prime and Secondary objectives.

We believe the key target to be the annual growth in net income (i.e. the income that is available for the Council to spend after all the expenses of running the Estate have been deducted). This will be made up of income from property inflation (i.e. the additional income derived from normal growth in rental values through rent reviews and lease renewals) and income from asset management activities. Any target should be stretching, achievable and better than the Council's cost inflation.

We agree that the current and proposed targets are relevant. We suggest that as you achieve a target (e.g. rent arrears at 5% rent roll) the target should then be increased/decreased as appropriate in order to drive continual improvement. We also suggest that in addition you should measure your average void periods with the objective of reducing that as low as possible.

We note that you have yet to decide on the actual targets.

Recommendations

I. That a three year net income target be set and adopted.
II. That the suggested additional targets be set and adopted.
III. That an additional average void period target be set and adopted.
IV. That targets be reviewed annually with a view to achieving continual improvement.

Work Streams

You have proposed the following work streams as required to build the strategy and delver key objectives:

- *Review investment criteria for assessing potential acquisitions*
- *Develop asset management plans to inform decision making in assessing performance*
- *Disposal strategy (including the use of IRR's and risk assessments)*

We address these in turn.

Investment acquisitions

You have proposed the acquisition of property investments as a way of increasing income and contributing to the rebalancing of the Estate through buying non-retail property. The Council is currently in an unusually advantageous position because it, like other Councils, is able to borrow 100% of the total acquisition costs at very low capital financing costs.

We understand from the strategy workshops that in order to maximise the net income (i.e. the difference between the rent received and the interest paid) a fixed term (interest only) loan might be secured with the expectation that the asset would be sold at the end of the loan term in order to repay the debt. The investment criteria would therefore need to address the commercial risks associated with having to sell at a particular time, whatever the market conditions at that time. We understand that further work is needed in order to establish the most appropriate method of funding and accounting treatment.

If the acquisition of property investments is to successfully contribute to income growth and a rebalancing of the Estate it is in our view essential that you are permitted to purchase beyond the BANES boundary. We say this because the stock of good quality non-retail investments in BANES is very limited. With industrial and distribution warehouse rents forecast to outperform retail by a significant margin over the next five years, we might well be recommending you to focus on these two sectors in addition to offices and other more niche sectors. There are likely to be significant opportunities to purchase non-retail investments in the adjoining Bristol area.

If advantage is to be taken of what may be a brief window of opportunity it is imperative that a decision is taken quickly on whether or not you are empowered to purchase property investments outside BANES, even if it is only in the Bristol area.

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Asset management plans

Asset Management Plans (AMP) are an essential component in the delivery of your strategic objectives and would range from strategic property sector plans (e.g. retail, office, industrial) through location specific plans (e.g. Milsom Street) to tactical property specific plans.

By way of example the Shaftesbury Estate in London, which owns a primarily retail estate in such locations as Carnaby Street, Covent Garden and China Town, achieved a net income growth of 6.3% (2014/15), an average vacancy rate of 2.6% (over 10 years) and a one month average re-letting period through a combination of:

- Creating distinctive retail and leisure destinations
- Working with tenants to promote locations
- Improving public realm
- Reconfiguring and improving space
- Establishing ownership clusters
- Adopting a range of challenging Key Performance Indicators (KPIs) which it aims to exceed every year in order to drive continual improvement

The Estate offers very similar opportunities for such initiatives and we have discussed with you the opportunity to raise rental tone through the introduction of premium/luxury brands in one location and the creation of a food hub in another location.

AMPs ensure that asset management initiatives are focussed and that property specific decisions can be made quickly within the context of wider objectives.

AMPs will inevitably be "cross-cutting". For example a decision regarding an above a shop office in Milsom Street would be influenced by your objectives for both your office stock and your objectives for Milsom Street, as well as your corporate objective to deliver housing through ADL.

There is a significant amount of work required to put the required AMPs in place. We have a concern that the appropriate level of resources may not be available to achieve this within a reasonable time frame. It would be sensible to identify a complete matrix of AMPs that need to be prepared in order to identify the level of appropriate resources required. Once the task has been scoped and the resources agreed, there should be a time-scaled programme which itself is subject to regular review.

Appreciating that AMPs will not be in place for all properties immediately, we suggest that AMPs are prepared whenever certain "trigger" events (e.g. lease renewal, application to assign) occur.

Disposal strategy

Within the Estate there are likely to be individual under performing assets which it would be prudent to sell in order to build a cash war chest for re-investment in better, preferably non retail, quality stock thus reducing management costs and achieving a re-balancing of the Estate. Alternatively advantage could be taken of opportunity purchases to consolidate your ownership.

This process can only start once your Estate objectives and targets are agreed and as soon as AMPs are in place for individual properties.

Appreciating that AMPs will not be in place for all properties immediately we suggest that you initially target those properties which you instinctively believe are under performing.

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Recommendations

I. That a decision is made urgently on whether or not you are empowered to purchase property investments outside BANES, even if it is only in the Bristol area.
II. That a comprehensive list of required AMPs is prepared, appropriate resources identified and a clear delivery timetable agreed.
III. That a programme for disposing of assets deemed to be under performing is agreed.

Summary of Conclusions

The recent strategy workshops represent a significant step forward towards the preparation and implementation of a comprehensive Estate strategy.

If advantage is to be taken of what may be a brief window of opportunity to increase net income and diversify the Estate through the acquisition of property investments, it is imperative that a decision is taken quickly on whether or not you are empowered to purchase property investments outside BANES, even if it is only in the Bristol area.

It is essential that an Estate Strategy is completed to ensure that existing income is protected and that additional income is extracted from the Estate through a range of measurable time-scaled achievable targets. These must be supported as soon as possible by a range of strategic and tactical AMPs.

There is much work to be done before a comprehensive Estate strategy is in place with comprehensive measurable time-scaled targets. We are concerned that additional suitably experienced resource is needed in the short and long term if the required step change is to be realised.

Yours sincerely

David Stubbs FRICS

RICS Registered Valuer

for and on behalf of BNP Paribas Real Estate