Appendix 1

TRANSPORT FOR LONDON

INVESTMENT MANAGEMENT STRATEGY 2022/23 FOR NON-FINANCIAL ASSETS

1 SUMMARY

1.1 Non-Financial Assets are defined as assets that the organisation holds primarily or partially to generate a profit. This Investment Management Strategy (IMS) 2022/23 describes the objectives of TfL's programme of investment in commercial assets, the associated sources of funding, the approach to managing risks arising from it and the relevant key performance indicators.

2 BACKGROUND

2.1 The IMS 2022/23 has been prepared having regard to the Local Government Act 2003 and the Local Authorities (Capital Finance and Accounting) Regulations 2003 (as amended), as well as the key recommendations of:

(i) the Prudential Code for Capital Finance in Local Authorities (the 'Prudential Code') issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) as updated in 2017;

(ii) the Statutory Guidance on Local Authority Investments (the '2018 Investments Guidance') issued by the then Ministry of Housing, Communities and Local Government (MHCLG) in 2018; and

(iii) the Code of Practice and Cross-Sectoral Guidance Notes for Treasury Management in the Public Services (the 'Treasury Management Code') issued by CIPFA and last updated in 2017.

2.2 As recommended by the 2018 Investments Guidance, this strategy will be updated at least annually and submitted for approval.

2.3 The IMS 2022/23 will be implemented, operated and administered under delegations of authority established in TfL Standing Orders.

2.4 The Prudential Code and the Treasury Management Code were recently updated and have not yet been fully reflected in this Investment Management Strategy. Changes to the Investment Management Strategy will be included for the 2023/24 financial year, as permitted under the updated Codes.

3 STRATEGIC OBJECTIVES

3.1 The objectives underpinning the IMS 2022/23 are to:

(i) deliver 20,000 new homes on site over the next ten years as originally envisaged under the Mayor's Transport Strategy, (and recently extended following discussions with HM Government). Fifty per cent of new homes built are targeted to be affordable. Housing developments will seek to include, where appropriate, improvements to the transport system, including step-free access and other rail and bus station improvements;

(ii) recover from the pandemic and deliver long-term income for TfL through a growing and sustainable commercial surpluses;

(iii) drive a capital investment programme for new housing and invest strategically in other asset classes plus improvements to our existing commercial property estate;

(iv) to manage capital expenditure in the TfL property vehicle, TTL Properties Ltd (TTLP) through a mix of external borrowing, land sales, asset disposals and development returns; and

(v) to develop the media and telecommunications activities within TfL generating long-term cash flows, and positive income returns.

4 INVESTMENT PROGRAMME

4.1 The IMS 2022/23 is forward looking with substantial capital expenditure anticipated over a 10-year period. The main programmes of capital expenditure within the plan are listed in Table 1. Some of these investments aim to deliver capital income returns, whilst some are set up to deliver an ongoing rental stream and associated asset value.

4.2 As TfL's commercial property company, TTLP will be the delivery vehicle for property within TfL.

Table 1 – Main programmes of capital expenditure 2021/22 to 2029/30

	Capital Plan Ranking by Expenditure (largest to smallest)
Residential – For Sale Joint Ventures	1
Retail Expansion and Estate Improvement	2
Residential – Build to Rent	3
Commercial Office Development	4
Digital Media	5
Telecommunications	6

<u>Residential – For Sale Joint Ventures and Build to Rent</u>

4.3 The majority of the capital investment proposed in the IMS relates to real estate, with the largest sums directed to Residential. This is both 'For-Sale' projects and Build to Rent (BtR). TTLP's development land is often in areas considered well located for residential development, with good transport links. TTLP's Business Plan would see TTLP starting the sites to deliver 20,000 homes over 10 years.

4.4 Development of For-Sale residential will deliver future profits, and provide cash flow to reinvest, whilst contributing to new home delivery in London. Our largest developments are managed through joint ventures providing expertise and balancing risk, mainly with commercial development and investment partners but also with Housing Associations. Risks include planning and construction cost inflation. Schemes to deliver over 1,300 homes are currently on site, and these will be progressed. Others will be managed through planning, procurement and marketing en route to delivery.

4.5 To deliver the BtR programme, TTLP is investing through a joint venture with Grainger plc, a major residential rental specialist. Four sites (at Cockfosters, Montford Place, Nine Elms and Southall) have planning permission, with further site at Arnos Grove subject to an appeal. Target start on sites for these schemes is December 2022.

4.6 BtR has a track record of delivering real growth in rental income – that is, matching or exceeding inflation – and has remained a strong segment during the pandemic. BtR performed well in 2021 driven by high occupancy levels and strong rent collection. This is reflected in total returns for the sector of eight per cent for the year to Q3 2021 according to latest data from MSCI, a leading real estate index.

4.7 Forecasts from real estate advisor CBRE are that rental growth will increase in 2022, especially in the London market, where CBRE expects four per cent growth this year due to significant pent-up occupier demand. With regard to its continued resilience, BtR investment is anticipated to continue to increase as investors continue to target the sector, supported by favourable debt markets with diversifying lenders expected to increase their residential allocations. As a result, CBRE anticipates that investment into the sector will increase by 65 per cent in 2022. CBRE forecasts total returns of seven per cent per annum over the next five years, driven by steady income and capital growth.

4.8 TTLP's largest and most valuable development site remains Earls Court. TTLP will continue to work with its majority partner Delancey (acting on behalf of its client fund and APG) to progress our investment in Earls Court during 2021/22. Notable activity will include finalising the consolidation of the existing joint venture land with London Underground's adjoining Lillie Bridge Depot to create a 40-acre development site; progressing works to submit new planning (currently targeted at March 2023); and commencing delivery of homes with a first phase at 344-350 Old Brompton Road. These activities will enhance TTLP's investment holding, which decreased substantially in recent years below the original investment value due to market changes, planning and other deliverability issues, but has recently stabilised and is starting to grow again.

Retail Expansion and Estate Improvement

4.9 TTLP will invest in new retail expansion on our current estate. In line with a revised customer experience strategy and a key assets strategy , investment will be targeted at improving the existing retail portfolio. The wider environment for retail remains very challenging, with low footfall and high vacancy rates during the pandemic generally, causing rents to decrease. The market is beginning to recover, and with TTLP's assets generally in excellent locations the opportunity remains to improve our offering.

4.10 A strategic plan has been created to deliver enhanced income by focusing on a number of prime sites with small interventions at other locations Historic investment has been limited, and there is an imperative to bring assets up to the required standard and reshape our offer for the new social environment. Investment will help protect our income streams, including by ensuring we improve Energy Performance Certificate ratings. Over time, we will drive higher asset values and yields throughout the portfolio. TTLP will utilise assets in new ways through more effective data analysis and targeting. We have an established base of Small and Medium Enterprise customers, which is a strength given declines in large-scale retailing. Programmes have been delayed recently due to the funding constraints, but delivery will commence as TTLP stands up with its independent funding stream.

Commercial Office Development

4.11 Three significant TTLP sites at Bank, Paddington and Southwark portfolio are identified for commercial office development. With a clear 'flight to quality,' demand for quality assets with world-leading sustainability and well-being credentials remains very strong. This trend is expected to continue, with London remaining attractive to international capital.

4.12 Central London office growth is forecast to average 1.8 per cent per annum over the five years to 2026 according to Property Market Analysis (PMA), a leading real estate research consultancy. This will drive total returns for the sector to 5.1 per cent per annum during the period for the sector. As highlighted above, there will be a significant variance between the performance of prime offices with strong sustainability credentials against older office stock, supporting our development opportunities which will benefit from the demand for modern, new build accommodation.

4.13 Prime rental levels are now above pre-pandemic levels with stronger growth expected by lower levels of availability of prime space and above trend levels of growth in the London economy. Forecasts by PMA are for prime rental levels to increase by 6.5 per cent in the City of London in 2022 and by 3.1 per cent in the West End before moderating to 2.0 per cent per annum for the five years to 2026. Forecasts by Knight Frank suggest this could be higher at c. 3.5 per cent per annum over the same period as the flight to quality continues.

Digital Media

4.14 TfL has invested significantly in digital advertising assets across the rail estate, in line with market developments. Returns across all media (digital and traditional posters) have been disrupted by the current pandemic. Revenues are beginning to return, and our assets will support this including the newly installed Elizabeth line equipment due for opening this year. Over the plan period, there will be further digital investment in line with a need to refresh assets every six to seven years. Without such investment, revenue streams would decline. All capital expenditure will be carefully assessed based on expected returns.

Telecommunications

4.13 TfL will continue with the Telecoms Commercialisation Programme project which, from the start of 2022/23 includes the Emergency Services Network and continues from the pilots delivered by the public cellular pilot – e.g. 4G on the Jubilee line. Capital relates to implementation activity related to the 20-year concession agreement awarded to commercialise our transport assets. This is delivered through a number of telecommunications service lines, including public cellular throughout the London Underground. This project will produce significant revenue for TfL.

5 SOURCES OF FUNDING

5.1 Funding for property and development of existing assets within the TTLP portfolio will come from a mix of external funding and receipts from land sales, asset disposals and development profits. External funding will initially be sourced from committed bank facilities

5.2 Land sales will in the main be generated from selling land into joint ventures and using the receipt as part of our reinvestment into the joint venture.

5.3 Asset disposals include both unproductive assets from within the TTLP property portfolio as well as income-generating assets that are considered to have weak long-term income prospects. These assets are already identified and included in plans although, as previously noted, the disposal programme has slowed through the current pandemic.

5.4 Due to the relatively illiquid nature of the portfolio of property assets, the timing of receipts is not certain. Due diligence via forecasting will be undertaken to ensure future timings of investment commitments on development sites can be met. It should be noted that if a land sale into a joint venture does not occur, the corresponding Capital Expenditure will also not occur, so there is a natural risk balance.

5.5 The use of joint ventures as a primary delivery route for significant real estate projects brings in skill sets and market specialisms to limit risk and improve return.

6 RISK MANAGEMENT

6.1 The level of risk associated with non-financial investments described above will vary. This section seeks to address how this risk will be minimised to ensure good stewardship of public funds.

6.2 TfL will not enter into long-term project commitments until funding arrangements are clear, whether through external funding sources, land sales or disposals. Investment will be limited dependent on funding capacity.

6.3 TfL will seek to minimise risk to assets and loss of capital value. Control will be retained over assets through ownership retention, step-in rights and other legal protections up to completion and payment. Credit and reputational risks will be assessed and monitored. Long-term contractual commitments will be fully assessed and reviewed.

6.4 TTLP will manage real estate scheme risks through assessments of sustainability of income stream, planning risks, construction risks, stakeholder risks and political risks. In addition, two risks are considered in further detail:

(i) market / sales risk – development value across all joint ventures primarily focuses on the residential sector – TTLP will manage risk levels through prudent assessment of sales values and likelihoods; and also through forward sales of affordable housing to Registered Providers who have a strong appetite to purchase stock; office developments will be assessed with regard to demand and future lettability, with sale retained as an option; and

(ii) credit risk – our joint ventures are expected to raise debt funding independently. There is a risk on availability of such funding initially, on a site-by-site basis plus impacts of prolonged periods of debt and high interest payments if sales or letting demand is weak - TTLP will ensure funding requirements are conservatively assessed in each case and will not progress schemes unless funding sources confirmed.

6.5 TTLP will monitor and set appropriate levels of gearing across the real estate development portfolio to manage risk exposure. Prudent assumptions of 50 per cent gearing within development phases (loan to cost) and 40 per cent within the income-generating investment phase (loan to value) have been set as a benchmark. Alternative funding options will be carefully assessed as needed. Structures will be managed to ensure debt in joint ventures is within overall TTLP borrowing limits. Interest cover ratios (rental values relative to interest to service debt) will be agreed in advance and tested to ensure they can be met prior to finalising any debt packages.

6.6 Measuring and managing forward commitments will be a key part of overall programme management, along with forecasting scheme outcomes regularly and testing for market conditions. TTLP will manage exposures by reducing equity share in joint ventures, thus lowering investment requirements, and will cancel or defer projects as needed, should there be indications of a property downturn.

6.7 When assessing projects TTLP will take a prudent approach to cost growth and value growth.

6.8 The investment programme focuses on markets where we have a natural advantage, namely our land holdings. This puts us in a strong position to invest capital compared with other operators in the market and minimises risk. It also means we can “hold” if market conditions are not conducive.

6.9 Investing in our property estate provides liquidity options in the form of underlying asset value which can be traded to manage overall risk. This is particularly relevant within the BtR portfolio where there is significant investor demand. TTLP will manage exit options as part of its risk approach.

6.10 Valuations will be important factors in ensuring real estate investment decisions are justified. TTLP will regularly assess fair value of assets relative to capital investment and loans to ensure informed decisions are made and compliance with loan terms is assured.

6.11 TfL will use independent experts as required to inform investment decisions. These will be procured on a case-by-case basis around the specific activity. Procurement will occur through frameworks, where a competitive process ensures the most technically competent and most economical advisors are available as required.

6.12 Due diligence and competitive procurement processes are in place for our investment decision making. Suppliers will undergo a rigorous process including credit checks to demonstrate TfL is achieving best value and have financial indicators to protect our interests. Commercial contracts giving us ability to monitor and assess suppliers throughout the life of any project will be part of standard operational practice.

6.13 TTLP will also use experts in property in its real estate governance process. The Commercial Development Advisory Group (CDAG) consisting of property industry experts from a range of backgrounds, ensures all our property investment projects can be challenged and scrutinised.

6.14 Governance structures for TTLP are currently under review and will be established in line with commensurate increase in risk following the proposed debt raise.

7 KEY PERFORMANCE INDICATORS

7.1 Subject to meeting security and liquidity requirements, yields and returns on capital investment will drive all decisions. Specific Key Performance Indicators (KPIs) will be used by TfL to assess and monitor investments:

(i) all projects will be expected to produce a positive **Net Present Value (NPV)** discounted at TfL’s standard rates;

(ii) all projects delivering rental income will be expected to achieve **yields** in excess of our cost of borrowing;

(iii) target geared **Internal Rate of Return (IRR)** will be measured - this will be based on market testing of development schemes as well as internal experience on schemes to date, and will vary according to the project, taking into account the following considerations:

- delivery requirements within the Mayor’s Transport Strategy (e.g. step free access as part of a development scheme, delivery of affordable housing) could reduce the IRR on specific schemes; and

- different market segments have different risk profiles and the IRR expectation will reflect this; and

(iv) TfL will measure **Return on Equity (ROE)**, showing levels of profit compared to TfL capital invested.

7.2 Third-party debt and capital investment will be utilised as required to promote growth. Consideration will be given to the impact of debt including that within minority held joint ventures. Exposure and financial ratios will be measured and reviewed regularly.

7.3 Third-party capital does not in itself boost income returns. The introduction of investment partners will be driven more by the skills they bring, with the expectation of optimised delivery and income returns. This will be tested through governance of each joint ventures.

7.4 We will also review liquidity and I make an assessment as to whether a stake in an investment vehicle is likely to be more or less liquid than direct ownership of the properties.

7.5 TfL will have regular reviews of global innovation in terms of new sources of income around transport nodes.

8. Summary Table

8.1 A summary of key investment areas and rationale is set out below.

Investment Area	Overview	Rationale
Residential – For Sale Joint Ventures	Establish joint ventures with private sector companies to deliver capital receipts from land plus profits. This will include a mixture of tenures, locations and price points.	Supports homes target including affordable. Sites typically have best sales potential with good residential values and strong market interest. Revenue from private for-sale homes will provide capital to be reinvested in income-producing opportunities.
Residential – Build to Rent	Major investment on identified sites. We expect to become a leading operator and owner of BtR with a growing residential asset base. This will enable us to focus resource on delivering quality services to our customers where we are best placed to do so.	Will provide a long-term sustainable net income stream back to the business and asset value growth. Demand and supply dynamic favours rented product in London. Includes affordable homes
Earls Court Development	The largest single development contributing to TTLP's homes target, working with our joint venture partner. Creating a new district and supporting thousands of jobs.	Largest single contributor to homes target.
Retail Enhancement and Estate Improvement	Create new commercial assets and invest in existing assets through asset management initiatives, including exploiting opportunities of long leasehold interests. Investment plans include enhanced maintenance of existing portfolio.	Delivers rapid increase in net income, makes best use of existing assets, delivers enhanced customer experience and improves community.

Investment Area	Overview	Rationale
Digital Media	Go live on Elizabeth line plus replacing life-expired assets.	To protect and grow revenues with consumer expectation of digital product, in conjunction with traditional media.
Commercial Office Developments	Opportunity to create prime commercial office space through over-station developments. Options exist to support rationalisation of TfL’s office facilities	Station environment enhancement and delivering sustainable office space in attractive locations.