Appendix 1

TRANSPORT FOR LONDON

INVESTMENT MANAGEMENT STRATEGY 2023/24 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) 2023/24 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 2023/24 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 issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) as updated in 2021 (the Prudential Code);

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

(iii) Treasury Management in the Public Services issued by CIPFA and last updated in 2021 (the Treasury Management Code).

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 2023/24 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 updated in 2021 and have been fully reflected in this Investment Management Strategy.

3 STRATEGIC OBJECTIVES

3.1 The objectives underpinning the IMS 2023/24 are to:

(i) by 2031, have started on sites capable of delivering 20,000 homes 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, creating significant social value. 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 for investment in Transport through growing 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 Limited (TTLP) through a mix of external borrowing, land sales, asset disposals and development returns;

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

(vi) to ensure investments made by TfL for commercial purposes are proportionate to financial capacity of TfL; and

(vii) to confirm compliance with paragraphs 51 to 53 of the Prudential Code.

4 INVESTMENT PROGRAMME

4.1 The IMS 2023/24 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, while others are set up to deliver an ongoing rental stream and associated asset value.

4.2 The majority of capital expenditure on non-financial assets is allocated to non-financial assets following an annual prioritisation process, published as the TTLP business plan and investment strategy.

4.3 As TfL's commercial property company, TTLP will be the delivery vehicle for property within TfL (items 1 to 4 in the table below). Items 5 and 6 are delivered by the operational businesses of TfL.

Table 1 – Main programmes of capital expenditure 2022/23 to 2031/32

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

Residential – For Sale Joint Ventures and Build to Rent

4.4 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 well located for residential development, with good transport links. TTLP’s Business Plan would see TTLP starting on sites capable of delivering 20,000 homes by 2031. Schemes to deliver over 1,800 homes are currently on site and this number is projected to rise to just under 4,000 by the end of March 2023. Development of For-Sale residential properties will deliver future profits, and provide cash flow to reinvest, while contributing to new home delivery in London. Our largest developments are managed through joint ventures mainly with housebuilders, providing expertise and superior buying powers to offset risk in planning and construction. TTLP is close to announcing a new joint venture in West London with the potential to deliver over 2,500 new homes including affordable housing and Build to Rent homes.

4.5 To deliver the BtR programme, TTLP is investing through a joint venture with Grainger plc, a major residential rental specialist. We have started on site at Montford Place and expect to start on site at Nine Elms, Southall Sidings and Arnos Grove by March 2023.

4.6 Almost £3.2 billion of capital was committed to the UK BtR sector during the first three quarters of 2022, up 10.2 per cent year-on-year. Some £1.5 billion was spent in the third quarter alone, the second strongest quarterly investment figure on record. Investment activity has been more subdued in recent months, reflecting a period of ‘price discovery’ following the recent increase in interest rates and the reduction in debt availability. Pricing is expected to adjust, albeit the impact is expected to be less acute than other sectors, due to the robust and resilient nature of the income.

4.7 Grainger’s February trading update saw like-for-like rental growth of 6.1 per cent and record occupancy levels at 98.7 per cent. Driven by an acute supply and demand imbalance, alongside wage inflation, rental growth is expected to continue to be strong in 2023. CBRE forecast growth of four per cent in 2023, rising to five per cent in 2024. These are whole of market forecasts, and the BtR sector has the potential to outperform this. This strong rental growth is expected to mitigate against yield expansion.

4.8 While investment demand is expected to remain strong for BtR assets, development viability is challenging in the short term, given asset value re-pricing, continued construction cost inflation and rising debt costs. This is leading to a reduced construction pipeline and fewer forward funding opportunities.

4.9 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 2022/23 with the submission of a new masterplan application in 2024 with consent and start on site envisaged in 2025. The consolidation of the site was finalised in 2022 with the transfer of development rights of London Underground’s adjoining Lillie Bridge Depot to Earls Court Partnership Limited (subject to a leaseback to London Underground Limited until vacant possession is provided). Earls Court Partnership Limited now controls a 40-acre Zone 1 development site. 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, albeit with a recent small decline.

<u>Retail Expansion and Estate Improvement</u>

4.10 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.

4.11 Our arches portfolio offers iconic, unique commercial spaces, home to restaurants, cafes, gyms and maker spaces and has the potential to do much more to enhance local communities. Businesses located in railway arches make a significant contribution to making London a thriving city, as well as to the economy. With 93% Small & Medium Enterprise occupants (from music studios to mechanics), the portfolio is agile and can react to market conditions. The portfolio extends to over 800 arches and is worth around £180m generating over £11m a year. The Arches Strategy will provide and future-proof the right spaces for London's small business entrepreneurs. The portfolio will generate and grow sustainable net income through partnership and mutual growth plans. However, as with much of the estate there has been a historic underspend on maintenance works. Given the intrinsic operational interface and nature and condition of arches this needs rectifying with significant capital investment and will be a short-term focus. In addition, several key arch estates have been identified for repurposing and redevelopment.

4.12 A strategic plan has been created to deliver enhanced income by focusing on a number of prime sites with small interventions at other locations. Historical 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 returns throughout the portfolio. TTLP will improve asset utilisation 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.

<u>Commercial Office Development</u>

4.13 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.

4.14 The independent research firm Property Market Analysis LLP forecasts annual rental growth for prime central London offices to average between 1.6 per cent and 2.1 per cent until 2026. 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.

4.15 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.

Digital Media

4.16 TfL has invested significantly in the upgrade and expansion of its digital advertising assets across the rail estate. This has included the implementation of new formats across LU with the implementation of Digital Escalator Ribbons and large format landmark displays, as well as Videowalls and Digital screens integrated into the platform edge doors on the Elizabeth Line. This investment is in line with wider market developments regarding the move to more digital advertising infrastructure.

4.17 Returns across all media (digital and traditional posters) were significantly disrupted by the pandemic, with our Rail estate hit extremely hard as initial we directed customers not to travel. Even though the last few years have been volatile, we have continued to rebuild and drive commercial media revenues, including the building of successful commercial partnerships which help to showcase our estate. We have continued to maintain our ability to attract brands to our advertising network and to deliver creative executions that have made national, and even global, headlines.

Telecommunications

4.18 In July 2022, we announced that customers using all four major mobile operators are set to have access to BAI Communications' 4G and 5G-ready mobile network across the London Underground and Elizabeth line, including within tunnels.

4.19 We believe that this project will give customers on these networks access to uninterrupted coverage while on the Tube and within the stations. When completed, the network will be the most advanced of any city in the world.

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. A large proportion of external funding will be from TTLP's committed £200m revolving credit facility.

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 in the process of being identified and included in plans although, as previously noted, the disposal programme has slowed through the pandemic, however it is expected to grow again as a core funding source for TTLP.

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 and limit risk.

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 contractual 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 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 let-ability, 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. 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 income 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 the locations of 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 continue to work closely with the Land and Property Committee, which gives strategic guidance and direction.

6.14 Governance structures for TTLP follow the standing orders for TfL, and the regular Investment Group chaired by the Chief Finance Officer oversees investment decisions. Governance will continue to be reviewed with input from the Independent Investment Programme Advisory Group (IIPAG) and TfL Assurance, to ensure that governance structures are appropriate for the level of risk.

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 will be used by TfL to assess and monitor investments. These metrics were endorsed by the Land and Property Committee in June 2022 and will be reviewed at least annually.

(i) all projects will be expected to produce a positive net present value discounted at an appropriate Internal Rate of Return (IRR) hurdle rate;

(ii) target IRR in a range between seven per cent and fifteen per cent. This metric 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

(iii) TfL will measure return on capital employed, showing levels of profit compared to TfL capital invested, and targeted at 20 per cent; and

(iv) incremental yield on expenditure greater than 3.6 per cent, ensuring that we are allocating capital and generating a return on investment that is aligned with our strategic objective of delivering net income growth.

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.

7.4 We will also review liquidity and 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.

7.6 To ensure that commercial investments made by TfL remain proportionate to financial capacity, TfL will monitor the debt and equity of subsidiary entity TTL Properties Limited as set out in 6.5 above.

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.
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.

Investment Area	Overview	Rationale
Commercial Office Developments	Opportunity to create prime Central London commercial office space with leading environmental sustainability credentials. Options exist to rationalise TfL's existing office facilities and estate.	Will provide a long-term income stream from assets. Station environment enhancement. Create options for new, high quality TfL head offices in attractive locations.