Cabinet

12 December 2017

SPELTHORNE
MEANS BUSINESS

Title	Investment acquisition (H)		
Purpose of the report	To make a Key Decision		
Report Author	Terry Collier, Chief Finance Officer Heather Morgan, Group Head Regeneration and Growth		
Cabinet Member	Councillor Ian Harvey	**Confidential**	Yes
Corporate Priority	Financial Sustainability		
Recommendations	**Cabinet to:** **Approve the acquisition of the investment asset identified in this report** **Formally agree the offer submitted, and authorise the Chief Executive to undertake any necessary subsequent negotiations (including a further bid if required) and complete the acquisition of the asset (in consultation with the Chief Finance Officer, the Leader and the Cabinet Member for Finance)** **Authorise the Chief Finance Officer to decide (i) the most financially advantageous funding arrangements for the purchase, (ii) the most tax efficient method of holding the asset, and overall to ensure the acquisition is prudentially affordable** **Authorise the Head of Corporate Governance to enter into any legal documentation necessary to acquire the asset** **Agree to exempt Contract Standing Orders in respect of our advisors**		
Reason for Recommendation	**It will bring in a steady income stream for the term of the multiple leases with different durations.** **The income stream will assist in the future ongoing financial stability of the Council.**		

This report contains exempt information within the meaning of Part 1 of Schedule 12A to the Local Government Act 1972, as amended by the Local Government (Access to Information) Act 1985 and by the Local Government (Access to information) (Variation) Order 2006 Paragraph 3 – Information relating to the financial or business affairs of any particular person (including the authority holding that information) and in all the circumstances of the case, the public interest in maintaining the exemption outweighs the public interest in disclosing the information because, disclosure to the public would prejudice the financial position of the authority in the bidding process for the site by allowing other bidders to know the position of the Council. This in turn prejudices the Council by (i) distorting the bids process and (ii) prejudicing the opportunity for the Council to acquire a site through the Council for the prudent management of its financial affairs.

1. Key issues

Towards a Sustainable Future

1.1 The Council is implementing a wide reaching transformation programme - known as 'Towards a Sustainable Future' (TaSF). There are three strands: (1) use of assets and income generation (2) Knowle Green programme and new ways of working (3) structural review. This report links to assets and income generation.

1.2 The TaSF programme has been developed to ensure Spelthorne is in a strong position to withstand the financial challenges the Council currently faces. Since 2013/14 the Council's Revenue Support Grant (RSG) has fallen from £2.5m and is now zero for 2017/18. From 2019-20, the Council may well be responsible for paying back up to an estimated £750,000 each year to Central Government.

1.3 As part of its TaSF strategy, the Council has said that it effectively needs to be fully self-financing by 2020 in order to continue to deliver the services that it currently provides. Unless it is able to continue to generate significant additional ongoing income streams, difficult decisions will need to be made in the future about the level of provision of services.

1.4 Financial Sustainability is one of the four key priorities under Spelthorne's Corporate Plan for 2016 -19 and highlights the Council's plans to invest in commercial properties to obtain ongoing, sustainable revenue streams and capital appreciation.

1.5 Cabinet will be aware that the acquisition of the BP main site means that we balanced the budget for year 2017/18. However, as a result partly of knock on effects of Surrey County Council's spending reductions and other pressures we are facing a budget gap of potentially over £1m in 2018-19. If we do not deliver additional income generation streams or find additional efficiencies by 2021-22 we will possibly be facing a deficit of c£3m per annum due to a number of factors (paying grant to central government, SCC funding reductions, reduced New Homes Bonus grant, impact of Universal Credit, increased pressure on homelessness and additional statutory housing responsibilities, increased provision for maintenance of assets, and reduction in recycling credits to name a few).

1.6 It is therefore critical that we look to continue to secure ongoing income streams for both the medium and longer term future.

Current budget position on acquisitions

1.7 At the Extraordinary Council meeting on 21 July 2016 Council approved supplementary capital expenditure of £400m, increasing the capital provision for property acquisitions to £445.455m for 2016/17,

1.8 In February 2017, Council agreed:

(a) a further capital provision for property acquisitions of £200m;

(b) that the operational boundary for external debt (our borrowing limit) for 2017/18 be increased to £720m (then dropping by £8m for the next financial year and the year thereafter).

1.9 The Council still has sufficient headroom to cover this proposed acquisition within our current borrowing limits.

1.10 A further paper on this Cabinet agenda proposes further extending our borrowing limit to enable the Council to make additional acquisitions going forward.

Assessment of opportunity

1.11 An opportunity has arisen which would (if acquired) secure an asset capable of generating strong levels of income, and increase our commercial asset base. The acquisition in question is known as 12 Hammersmith Grove. 12 Hammersmith Grove represents the second phase of the Hammersmith Grove development and is located to the west of Kensington.Key points for Cabinet to bear in mind are that the building will be newly constructed and provide c.170,985 sq ft of grade A office space over the ground and ten upper floors. (BREEAM rating 'Excellent'). The property is multi-let to six high quality office tenants with a minimum term of 10 years. Medidata Solutions founded in the USA in 1999 is now one of the global leaders in clinical software development and medical business analytics. Medidata. Creative Artists Agency (CAA), originally founded in 1975 has grown into one of the largest talent and sports agencies. Perform is a global media company that specialises in the production and distribution of sports media content. Perform saw an increase in revenue in 2016 up by 12% from 2015. WeWork, founded in 2010 is an American company which specialises in the provision of shared workspace and business services for entrepreneurs, start-ups and small businesses. WeWork total sales turnover increased by over 500% from 2015 to 2016. All Nippon Airways and Medical Research Instruments have just signed up for 10 years leases - see **Confidential Appendix 1** for key information. As part of the due diligence process a thorough analysis of the financial robustness of the tenants and associated parent guarantees and sureties is being undertaken.

1.12 We have agreement, subject to conditions, that a price of £170m would secure 12 Hammersmith Grove, and our professional advisors have indicated that this is a sensible price for the acquisition on offer.

1.13 As set out in preceding sections, the Council still needs to look at ways of generating income for future years. BP gave the Council a huge income boost but in itself was not sufficient to deal with the gap in its entirety. Spelthorne is a medium size borough and there are very limited opportunities to transact on large scale acquisitions. It would take a lot of small scale acquisitions to achieve a similar level of income. .We are continuing to look within the borough and our immediate surroundings wherever possible. However our focus is on securing assets where there is a strong tenant covenant (e.g. a solid company(s) or counter party(s) with a long track record) with a substantial length of lease. These give us a high degree of certainty when it comes to a guaranteed income stream over a long period of time. These will almost certainly be in the office sector but we are also mindful of benefits of appropriate diversification of our portfolio in order to spread risk.

1.14 The Council is not currently going down the route of buying assets where there is potentially a greater rate of return for a higher level of risk (e.g. where we have to invest in extending or upgrading properties in order to secure tenants for a currently vacant building, or where rental increase can only be secured by very active asset management through a quick turnover of multiple tenants on short leases).

1.15 Working on this basis, it is almost inevitable that the Council will have to look outside the borough (a number of other Councils have done this and continue to do so). If opportunities arise closer to home (and they fit the profile) then the Council will consider these where there is a financial and business case to do so. Cabinet will be aware that they are also considering a report on ‘Strategic Property Investment Parameters’. This acquisition is in line with the guidelines set out in that document.

1.16 The lease terms of this acquisition (between 10 and 20 years with no breaks upon practical completion) are longer than you would usually expect to see. It is also subject to upward only rent reviews. The opportunity fits the profile of the acquisitions we are targeting.

1.17 Officers are acutely aware of the need to be very clear about the benefits which the Council will reap from such an acquisition in light of the potential glare of adverse publicity. It is for this reason that we are using expert external advisors and have thoroughly investigated the financial dynamics around the acquisition. (**Confidential Appendix 1** is the market report which has been provided by Cushman & Wakefield which sets out the rationale in more detail).

1.18 Financially, the case is good (see below). The acquisition would help further minimise the future revenue funding gap the Council would otherwise face. It would reduce our dependence on securing other forms of income, or radically reconfiguring services.

1.19 It should be noted that until we exchange the Council is not committed to the acquisition, which is subject to formal Cabinet approval (this report), plus legal and other due diligence, and is ultimately subject to contract.

2. Options analysis and proposal

Options

Option 1 - Formally agree *the conditional bid which has already been submitted for £170m (with an upper clearance of £180m) and agree that the Chief Executive undertake any necessary subsequent negotiations and* *complete the acquisition (in consultation with the Chief Finance Officer, the Leader and the Cabinet Member for Finance)*

2.1 This will provide the Council with an asset providing an initial full year net annual surplus (after interest, principal repayment, set aside for supervision of asset, and set aside for sinking fund to build up provision for void/rent free/refurbishment) in the range of £1.5m to £2.1m at a price of £170m and depending on the PWLB rates applicable at time of draw down. This range represents a range from a ten basis points drop in rates applying at time of writing to a thirty basis points increase in rates. The financial and valuation advice to support the purchase is contained in **confidential Appendix 1** and is covered in more detail in section 3 below.

2.2 Cabinet need to note that there is a chance the Council may need to bid higher than £170m (see para 2.3 below). It is recommended that we get clearance to have access to £180m should it be required.

2.3 If the Council succeeds with its offer and the opportunity is removed from the market, there is still a slight risk that a number of other competitors may still wish to acquire the site if we fail to complete quickly enough. (The sellers' agent is obliged by law to advise their client of any offers received even if they are proceeding with the transaction with us – which is not to say that their clients automatically have to accept a counter offer, especially as councils are seen to be less risky than other entities).

2.4 It is for this reason that delegated authority is being requested to enable those negotiations to take place. Those delegations will be with the Chief Executive in consultation with the Leader of the Council and the Cabinet Member for Finance. It should be noted that ultimately it will be the Chief Finance Officer who will need to be satisfied that any final offer is prudentially affordable.

2.5 The main risks to the Council are in purchasing a property which (i) fails to appreciate in value at a sufficient rate, or at all (ii) costs more to deliver than it yields in income (iii) there is a void period if the one of the current tenants does not extend their lease and we need to find an alternative occupier(s).

or

*Formally agree **not** to submit a bid*

2.6 Failure to acquire will mean the Council will need to continue to look elsewhere, and will increase the likelihood of very difficult decisions needing to be taken on future service provision. The state of the property market is such that similar opportunities are likely to be difficult to come by, although the effect of the EU exit process may generate buying opportunities. It should also be noted that by historical standards the borrowing rates the Council is able to access are still relatively low. If we not do grasp this opportunity we may find future opportunities may deliver a lower net return if borrowing rates rise.

Proposal -

2.7 ***It is recommended that Cabinet formally agree the unconditional bid that has been submitted for £170m (with an upper clearance of £180m) and agree that the Chief Executive undertake any necessary subsequent negotiations (including a further bid if required) and complete the***

acquisition (in consultation with the Chief Finance Officer, the Leader and the Cabinet Member for Finance).

3. Financial implications

3.1 Councils are in a strong financial position to acquire property due to their ability to access capital, coupled with the low cost of borrowing (for example Spelthorne could borrow at 2.25% to 3% long term at fixed rates from the Public Works Loans Board PWLB effectively the Bank of England) depending on the amount and length of a loan, whereas a developer would be likely to pay 5 - 6%. The Council is also able to borrow at cheaper rates from other councils and other financial institutions lending to the public sector (around 1%). The Council is likely to use a blend of loans from other councils for years 1 to 5 inclusive and, for years 6 to 50, loans from PWLB. This blend reduces the overall average rate of interest paid by the Council whilst maintaining certainty of fixed rate payments.

3.2 It makes financial sense to borrow money at these rates rather than using the Council's own capital reserves, which in the most recent financial year achieved an average of more than 5% return when re-invested in property funds. Whilst there may be some short term fluctuations associated with the UK Brexit decision, properties acquired are likely to appreciate in capital value over the longer term.

3.3 Historically this Council has been debt free, but in the current fiscal climate we have made the bold decision to borrow to fairly significant, but affordable, levels in order to enlarge our property portfolio with secure quality investments.

3.4 Councils are able to set whatever borrowing limit they judge to be appropriate. However it clearly needs to be prudent and affordable. Importantly, we need to consider carefully the impact of increasing levels of debt, our ability to repay and the risk of increasing interest rates for those repayments. We continue to work very closely with our Treasury Management advisors Arlingclose.

3.5 It should be noted that PWLB interest rates move on a daily basis and cannot be fixed in advance. There is therefore a risk that the average interest rate assumed will increase above the level shown by the time any acquisition takes place (although this will be mitigated to some extent with intra council lending initially and through sensitivity modelling).

3.6 The proposed loan would be on a maturity basis, with annual interest payments being made and a separate set aside of principal repayments under the statutory minimum revenue provision (MRP) rules applicable for councils. This would be in compliance with national treasury management guidance for councils. This will ensure that the loan is steadily paid off on an annual basis.

4. Other considerations

Legal

4.1 Our appointed advisors at Clyde and Co are undertaking a full due diligence exercise. A number of the reports will need to be obtained on the title and condition of the site. In addition Clyde and Co will help us assess the risk on the property and standard of development works. The Council is not fully committed to buying the building until exchange of contracts which would only happen once all due diligence had been undertaken. Particular care will need to be taken in assessing the best way of structuring the deal, the lease terms as they apply to the various tenants (which look on the face of it to be standard) and obtaining appropriate collateral warranties for the completed build and fit. All of these may potentially affect the value of the purchase.

4.2 The Council is not as constrained when it acquires land or property as when it wishes to dispose of it. There are no EU procurement requirements which have to be met when buying a leasehold interest. There is the acid test of whether the general public would agree it was a sensible investment to make. The robustness of the valuation advice ensures this test could be met.

4.3 Queen's Counsel opinion was previously sought on the Council's powers to purchase investment assets. This advice confirms that the Council has the appropriate legal powers to acquire land, to invest for the purposes of the prudent management of its financial affairs and to borrow. These are the key elements which distinguish this project. In more recent advice the same Queen's Counsel has confirmed that we are able to acquire property outside of our own borough for such investment purposes (and do not have to set up a separate company to do so) in order to generate income to support the provision of services.

Contract standing orders

4.4 In order to consider participation in this bidding process, officers needed to make immediate provision to receive appropriate professional advice. Contract Standing Orders state that contracts over £100k should be authorised by Cabinet. Both contracts for our advisors Cushman & Wakefield (Property) and Clyde & Co (Solicitors) are estimated to be above this level if the Council participates in a meaningful way in this acquisition. The arrangements for both contain provisions for success fees and also early termination payments if we decide not to continue to the final stages.

4.5 Cabinet is therefore asked to set aside Contract Standing Orders for the appointment of both advisors.

What we can do as a result

4.6 This acquisition would enable Spelthorne move further along its journey towards becoming financially self-sufficient, which is one of the four corporate priorities contained within our Corporate Plan for 2016-19; and also the primary aim of our Towards a Sustainable Future programme

4.7 In practical terms, the projected income generated from this investment would help offset a portion of the loss in Spelthorne's RSG. It will also assist towards providing a surplus which should enable the Council to protect essential services.

Risk and mitigation

<u>Acquisition</u>

As per standard practice, we have sought out the necessary professional advice in short order. It is critical that the appropriate advice is brought in at the outset. This will ensure that the Council is protecting taxpayers' money, and is acting in a prudent and rational manner. This professional advice will be relied on in making this transaction, in order to minimise the risks. It is particularly important in this case as there will be a difference between rent top ups paid by vendor and the rental stream following rent free periods.

Ongoing

4.8 If successful, the Council will be receiving £9.5m per annum **gross** rental (including top ups) over the period of the tenants' leases.

4.9 Cabinet need to bear in mind that the net income stream to the Council will be considerably lower than this once borrowing and repayment costs have been taken into account (see section on Financial Implications above).

4.10 The tenants will have leases for periods between 10 and 20 years with no breaks. We understand the terms are fairly standard for this type of lease - five yearly upward only rent reviews but legal will undertake a due diligence process in any event.

4.11 Should the tenants not renew their leases, the Council will need to bring on board professional marketing expertise to secure another tenant(s). There is a risk that this may not happen immediately (especially in light of the size of the building), and there may be a void period when we are not receiving any income. The building is currently being let on a floor by floor basis and we would continue to pursue this strategy. Cabinet should note however that the Council would have advance notice were this to happen which should help minimise any risk. In addition, the Council will set aside a contingency sum (from current income) to help offset any void/rent free periods and cover refurbishment spend.

Resources and skills

4.12 Enlarging the Council's investment property portfolio will have an impact on workloads within the Asset Management section. The Group Head of Regeneration and Growth has considered what additional resources will be required in the Asset section as the portfolio continues to grow. We are currently advertising for a Property Manager to deal with the growing estate. A resource allocation has been built into the financial modelling to cover this eventuality.

4.13 Both the asset and the tenants will need to be managed and a resource will be required. It has not yet been determined whether this will be undertaken in house, by a partner organisation/authority or an external property management company. We will be receiving advice on the most appropriate route forwards.

4.14 It is anticipated that existing staff time and resources will be adequate to complete this acquisition, if we are successful in our bid for the site. (These include internal and external property, legal and financial resource).

4.15 There are no specific equality, diversity or sustainability considerations which need to be taken into account.

5. Timetable for implementation

5.1 The conditional offer was made on the 4 December 2017 and has been accepted, with Heads of Terms issued. The proposed deadline for exchange of contracts is 21 December 2017, with anticipated completion on 28 December 2017.

Background papers:

Appendices:

1 - Draft Executive Summary – Cushman & Wakefield
2 – Investment Brochure