Extraordinary Cabinet

02 June 2017

Title	Investment acquisition C		
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 lease.** **The income stream will assist in the future long term 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 progressing towards 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 stands at £580,000 for 2016/17. In the 2017-18 financial year the Council will receive no RSG. Beyond this, 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 income streams, difficult decisions will need to be made in the future about the level of provision of services.

1.4 The reductions in RSG have been on-going for a number of years, and this, combined with the need to 'stand on our own two feet' financially, means it is imperative that the Council focuses on the most effective ways of increasing on-going income streams.

1.5 Financial Sustainability is one of the four key priorities under Spelthorne's new 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.

1.6 Cabinet will be aware that the recent acquisition of the BP main site means that we have balanced the budget for year 2017/18 and are more or less balanced in 2018/19. However by 2019/20 we will still be facing a £2.5m deficit per annum due to a number of factors (paying grant to central government, reduced New Homes Bonus, impact of Universal Credit, increased pressure on homelessness and additional statutory housing responsibilities, increased provision for maintenance of assets, impact of

Surrey County Council funding reductions such as reduction in recycling credits to name a few). This will increase to £3m in 2021/22.

1.7 It is therefore critical that we look to continue to secure ongoing income streams in the future.

Current budget position on acquisitions

1.8 The Council agreed in February 2016 as part of the Capital Programme "the use of borrowing under the prudential regime can be considered on a scheme by scheme basis where appropriate. On an invest to save or invest to generate income scheme, if the savings exceed potential borrowing costs then there may be a business case to borrow".

1.9 Two months later, in April 2016, the Council approved a revised Capital Programme for asset acquisitions of £45.455m for 2016/17. This allowed the Council to acquire assets to (1) assist in the economic and social regeneration of Staines upon Thames and our other town centres (2) to assist in service provision and/or (3) to generate an on-going income stream.

1.10 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.

1.11 A very considerable portion of this was spent on acquiring the main site at BP in Sunbury, along with the subsequent purchase of BP's South West Corner site, and Elmbrook House in Sunbury. In December 2016, Cabinet approved the acquisition of a Travel Lodge site in Sunbury which is still under active discussion with the freehold owner (for up to £13.8m).

1.12 In February 2017, Cabinet agreed:

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

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

Assessment of opportunity

1.13 An opportunity has arisen which would (if acquired) secure an asset capable of generating good levels of income, and increase our asset base. The acquisition in question is known as 3 Roundwood Avenue, at Stockley Park. It is located both to the north of Heathrow airport and the railway from Reading to Paddington (close to West Drayton and Hayes and Harlington stations).

1.14 Stockley Park:

(a) Is a premier business destination (established 30 years ago) offering 1.86 m sq ft of high quality office accommodation in 26 buildings and set within 450 acres
(b) It has a very good record in terms of tenant retention
(c) Current tenants include IBM, Apple, Sharp, Suntory and Cannon
(d) Prime rental growth now reaching £39.50 psf
(e) Crossrail arrives in 2019 with access to the city and beyond (currently 25 minutes to Paddington)
(f) 58% of take up over past 10 years has been between 10 – 50,000 sq ft
(g) There are comprehensive leisure facilities on the park including a golf course, the Arena (amenity hub) with bars, shops, and restaurants, health club facilities and an onsite nursery

1.15 Key points for Cabinet to bear in mind are that the premises comprises 43,110 sq ft of high quality office accommodation arranged over two floors. The property is of steel frame construction beneath a pitched roof. A comprehensive refurbishment (£2.67m) was completed in Q1 of 2016 to provide contemporary grade A HQ office which features a double height reception. The fit out has been to an 'institutional' specification and there are 144 surface parking spaces (1 space per 296 sf ft net).

1.16 There are currently two tenants:

(1) Verifone UK Ltd on the ground floor. The lease for Verifone commences July 2017 for 10 years with a five year break (as such any acquisition would be subject to an exchanged agreement to lease).

(2) Volga Dnepr UK Ltd (logistics) on the first floor – underlet to Cargo Logic Management Ltd. Volga's lease commenced January 2016 and again runs for 10 years with a break at five.

The gross rental income for the property as a whole is £1.426m pa (£33.5) psf) - see **Confidential Appendix 1** for key information.

1.17 Transactions of this size and quality are relatively rare. We were advised that the vendors were currently speaking to three parties with an option for them to go out to the market if they failed to secure an offer from one of these three parties. They operated a 'first past the post' system for submission of bids of £21.4m which is why the Council had to submit an offer letter on Wednesday 24 May (Confidential Appendix 2).

1.18 Upon submission of our bid they confirmed that we will have a 15 day exclusivity period (ten days to exchange and a further five days to complete).

Case for acquisition

1.19 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 small borough and there are very limited opportunities to transact on large scale acquisitions. 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 or counter party with a long track record) with a good length of lease. These give us a high degree of certainty when it comes to a guaranteed income stream over a reasonable period of time. These will almost certainly be in the office sector but potentially also the leisure sector (e.g. Travel Lodge). It will take a lot of small scale acquisitions to achieve the rental income stream that the Council still require.

1.20 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 very short leases).

1.21 Nor is Spelthorne currently contemplating buying assets which require of lot of active management (for example a shopping centre where an asset manager would be required to secure tenants – retail leases are now rarely more than 5 – 10 years in length with the first year very often rent free and where the landlord has to pay for fit out works) or where comprehensive redevelopment is required in order to realise the value of the asset. This may change in the future, but is not part of the current thrust of our acquisition work.

1.22 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). Whilst this opportunity is outside the borough it is within the local economic area and Heathrow's sphere of influence.

1.23 The weighted average unexpired lease term by income (WAULT) is 9.5 years to expiry and 4.5 years to break. It is what would normally be accepted for tenants renting accommodation of this size (they are not very large global companies like BP). There are no rent reviews due to the length of the leases. There is some chance of some vacancy (of part) in only 3.5 years. However the location is strong as are re-lettings. The opportunity 'fits the profile' of the acquisitions we are targeting. If opportunities arise even 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.

1.24 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 3 is the market report which has been provided by Cushman Wakefield which sets out the rationale in more detail).

1.25 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.

1.26 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. <u>Options analysis and proposal</u>

Options

Formally agree *the bid which has already been submitted for £21.4m (with an upper clearance of £23m) 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 a gross total rental income of approximately £1.426m per annum (from which borrowing, repayment costs and set aside prudent provision for refitting costs at end of lease will need to be deducted). The financial and valuation advice to support the purchase is contained in confidential Appendix 3 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 £21.4m (see para 2.4 below). It is recommended that we get clearance to have access to £23m 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 secure exchange and completion within the exclusivity period of 15 working days. (Beyond this period, 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, 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 (f required) 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 the anticipated rate, or at all (ii) costs more to deliver than it yields in income (iii) there is a void period if the current tenants do not extend their lease and we need to find an alternative occupier (iv) rights to assign leases may result in a dilution of the covenant strength.

2.6 In addition, the Council will need to be satisfied that (1) simultaneous or almost simultaneous exchange and completion is required to protect our interest rate position, (2) must be sure of the validity / enforceability of the lease or assignability to us of the Verifone lease. We cannot exchange unless totally satisfied of security of tenancies including assignment to the Council (3) confirmation that the vendor will top up or rebate us to cover the current rent free periods. Specialist advice will be used to ensure this is achieved.

or

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

2.7 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 do not grasp this opportunity we may find future opportunities may deliver a lower net return if borrowing rates rise further.

Proposal –

2.8 ***It is recommended that Cabinet formally agree the bid that has been submitted for £21.4m (with an upper clearance of £23m) 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% to 2.75% (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. 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 until recently 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. The Chief Executive recently wrote to the Treasury on this point who confirmed that this will remain the case. There is therefore a risk that the average interest rate assumed will increase above the level shown by the time any acquisition takes place.

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.

3.7 Confidential Appendix 2 includes a full Investment Appraisal with inputs, an income profile, sensitivity analysis, rental income plus an annual cash flow. This Investment Appraisal is used on all investment acquisitions of this type. An assumption has been made that the average finance rate will be 2% (correct at time of writing). The net income has been adjusted to account for periodic refresh/refurbishment costs which is deemed prudent.

4. <u>Other considerations</u>

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. This will happen if our offer is accepted. 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 to ensure that the security of the tenancies are assured (including assignment), that there is a top up of any outstanding rent free, rates or service charge liability and that satisfactory collateral warranties are provide for the recent refurbishment works. All of these may potential 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 freehold. 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 investment purposes (and do not have to set up a separate company to do so).

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 and Wakefield (Property) and Clyde and Co (Solicitors) are likely to breach that requirement if the Council participates in a meaningful way in this tender. 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 new 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 Revenue Support Grant (RSG) and other funding pressures. It will also assist towards providing a surplus which should enable the Council to protect essential services.

Risk and mitigation

<u>Acquisition</u>

4.8 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 lag between the acquisition (if successful) and the rental income stream coming on-line.

4.9 There is a risk that the bid may not be the final price that is eventually paid in order to secure the opportunity. In order to manage this risk, it is strongly recommended that Cabinet authorise the Chief Executive to finalise negotiations. On the basis of recommendations from our advisors, some degree of 'headroom' has been built in to cover this eventuality, and the fees for specialist advisors brought in to secure the deal and undertake the necessary due diligence (a clearance of up to a total maximum of £23m).

Ongoing

4.10 If successful, the Council will be receiving £1.426m per annum **gross** rental over the 9.5 years of the tenants' leases. It will not be subject to fluctuating income levels over that period of time, which gives a good level of security and reduces any risk around income streams.

4.11 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).

4.12 One tenant has a lease with 9.5 year unexpired and the other will have a 10 years lease once completed in June 2017. The terms are fairly standard for this type of lease.

4.13 There is the option for both tenants to break after 5 years. One tenant has to give 12 months' notice (Volga) and the other 9 months (Verifone). Should either terminate their leases, the Council will need to bring on board professional marketing expertise to secure another tenant. There is a risk that this may not happen immediately, and there may be a void period when we are not receiving any income. As is currently the case, there would be scope to sublet on a floor by floor basis. It is understood that there is limited accommodation of a similar size on Stockley Park and this is likely to provide attractive to tenants. If either tenants choose to 'break' then by that stage Crossrail will be operational which will add to the already considerable attraction of the building. In addition, the Council will set aside a contingency sum (from current income) to help offset any void periods.

Resources and skills

4.14 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 will be considering what additional resources will be required in the Property section as the portfolio continues to grow.

4.15 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 by a partner organisation/authority or an external property management company (but is likely to be the latter based on the distances involved). We will be receiving advice on the most appropriate route forwards. Members need to be aware that whilst the office tenant is on a long lease there is likely to be a greater 'churn' with the retail element (a very small proportion of the total rental income).

4.16 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).

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

5. Timetable for implementation

5.1 Due to the process being run by the vendors agent a bid was submitted on Wednesday 24 may. The Council has a 15 day exclusivity period within which to exchange and complete. This runs to 14 June 2017.

Background papers:

Appendices: (all of these documents are confidential and not to be disclosed)

1- Investment brochure
2- Offer letter 24 May 2017
3- Market report by Cushman and Wakefield