Item No. 25.	Classification: Closed	Date: 21 March 2017	Meeting Name: Cabinet
Report title:		Commercial Property Portfolio: Addition of Income Generating Assets	
Ward(s) or groups affected:		All	
Cabinet Member:		Councillor Fiona Colley, Finance, Modernisation and Performance	

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FOREWORD – COUNCILLOR FIONA COLLEY, CABINET MEMBER FOR FINANCE, MODERNISATION AND PERFORMANCE

This year the total income receivable from the Council's commercial property portfolio is £11.65m. This is a vital source of income to support council services. However, this income has reduced by £2m over recent years as a number of sites have been either sold to help finance the capital programme or redeveloped to deliver new council homes.

An opportunity has arisen to add to our portfolio by purchasing three commercial properties in the borough. Having carefully assessed the capital value, income yield, financing costs and risks I am recommending the Cabinet approves the purchase of these buildings.

In this period of decreasing government funding for council services, this capital investment will generate much needed additional income into the general fund revenue budget and help support the delivery of our highly valued public services.

RECOMMENDATIONS

1. That Cabinet:

    1) Note the circumstances leading to the proposed acquisition of the freehold interests in 9 Holyrood Street, Shand House and 22 Shand Street, and actions and investment due diligence undertaken by officers and their advisors.

    2) Approve the acquisition of the freehold interests in 9 Holyrood Street, Shand House (14-20 Shand Street) and 22 Shand Street for the sum of £45,025,000 (Forty Five Million and Twenty Five Thousand Pounds), exclusive of all professional fees, Stamp Duty Land Tax and VAT.

    3) That cabinet note the fees associated with the process leading to completion of the purchase.

4) That the cabinet delegate to the Chief Executive, advised by and in consultation with the Strategic Director of Finance and Governance and Head of Property, authority to:

a. Complete the purchase of the freehold interests in the assets;

b. Agree detailed transactional terms pursuant to the Heads of Terms;

c. Agree the financing structure to be adopted to fund the acquisition of the assets.

BACKGROUND INFORMATION

Income from the commercial portfolio

2. Rent from commercial property assets is a crucial funding source for council services. The nature, management and performance of the council's portfolio has been extensively reviewed over recent months; culminating in Cabinet giving its approval for a new Asset Management Plan for commercial property in December 2016.

3. Today the total incomes receivable from the portfolio stands at £11.65 million per annum exclusive. Nevertheless, this represents a £2 million per annum shortfall compared to the figure of £13.65 million in charge for 2013/14:

Year	Income
2016/17	£11.65 millions
2015/16	£12.32 millions
2014/15	£13.60 millions
2013/14	£13.65 millions
2012/13	£13.37 millions
2011/12	£12.24 millions

4. Therefore revenues have fallen by approximately 15% in the last four years alone; despite continuing improvement in the underlying rents obtainable from individual assets and at a time when other service funding streams have also seen overall reductions.

5. Inevitably the cause lies in the release of assets in to other initiatives; to generate capital receipts, or otherwise into regeneration, Southwark Regeneration in Partnership Programme and Direct Delivery schemes to deliver a range of corporate priorities. We anticipate other significant losses in the short to medium term.

6. Although a limited number of new income generating assets may be created through regeneration, appreciating that it is not the primary objective of these programmes to provide new commercial properties, officers have looked for other opportunities to replenish the diminishing asset base and incomes derived from it.

KEY ISSUES FOR CONSIDERATION

The Britel Fund London Bridge portfolio

7. One such opportunity has been identified to acquire an established portfolio consisting of three freehold, multi-let office/studio buildings, situated across Shand Street from 160 Tooley Street:

   - Shand House, 14-20 Shand Street, SE1
   - 22 Shand Street, SE1
   - 9 Holyrood Street, SE1

8. A plan showing the location of the properties is provided in Appendix 1.

9. The buildings are currently owned by the Britel Fund Trustees Ltd. It is understood that the portfolio is being actively rationalised by its fund managers, Hermes Investment Management (founded as the in-house investment manager to the BT Pension Fund).

Sale process

10. The portfolio has been actively marketed by the seller's agents, Tudor Toone. The prospectus for the portfolio, published on 1 February 2017, indicated an asking price of £42.2 million for the three properties.

11. Tudor Toone have conducted a competitive bid process. After an initial round of bidding they received sufficient interest to call for full and final bids on 27 February.

12. Advised by property consultants GVA (see para. 15 below), officers have entered a bid of £45,025,000 (Forty Five Million and Twenty Five Thousand Pounds). The bid is subject to the council's formal approval and subject to contract.

13. The offer was been accepted in principle by the vendor on 28 February, subject to formal approvals, subject to exchange of contracts and completion on or before the 28 March 2017. Completed Heads of Terms have been agreed and the council and seller have entered in to a period of exclusivity to enable completion of the transaction within the timescale specified, if cabinet is agreeable.

14. The purchaser requires Exchange of Contracts in the transaction by no later than 28 March 2017. To signal its intent in this process the council has provided evidence of its ability to fund and to execute a purchase within this timescale and through the council's democratic approval processes.

15. In view of the timescale involved officers have commissioned full due diligence work in the acquisition to commence, including legal and building survey reports.

16. All figures reported are exclusive. The transaction will be taxed (Stamp Duty Land Tax) at £2.24 million. Professional fees (c.£400,000) covering agency, valuation, legal, building survey and all other due diligence, will also be incurred.

The buildings are elected for VAT and it is understood the transaction will be completed by way of a Transfer of a Going Concern.

Financial due diligence and the council's bid

17. In advance of bidding, the investment opportunity and viable bid level was reviewed by independent property advisors GVA, who specialise in the acquisition and disposal of Investment property, and who had successfully advised the council in both the 2007 leasehold and 2012 freehold acquisition of 160 Tooley Street.

18. The bid of £45,025,000 is supported by investment valuations undertaken by GVA in accordance with the requirements of the Royal Institution of Chartered Surveyors Valuation Professional Standards ("the Red Book").

19. The purchase will provide a commercial return to the council as part of its property portfolio. The rationale for the council to invest can be summarised as follows:

    - An established income stream of £1.78 million per annum exclusive currently;

    - A yield in the region of 4.5 to 5.0% per annum, significantly above financing costs and interest rates for money on deposit;

    - Asset management opportunities to increase rents to in the region of £2.6 million per annum exclusive in the short to medium term through lease renewals falling due in the next one to four years, and a programme of light refurbishment;

    - Poorer quality assets released into other initiatives will be replaced by significantly better ones in investment terms.

20. As with any investment there is risk. However the central London property market is perceived to be relatively resilient in times of uncertainty. In acquiring this portfolio there is future investment and strategic potential in an attractive and regenerating location, close to London Bridge Station, More London, Bermondsey Village and Tower Bridge / Butlers Wharf.

Community impact statement

21. In formulating the recommendations of this report the potential impact on the Community has been taken into account, including people identified as having protected characteristics. No specific equality implications have been identified in relation to this report.

Policy implications

22. The holding of investment property to generate income, which in turn is used to fund council services pursuant to agreed policies, is consistent with the new Asset Management Plan for commercial property agreed by Cabinet in December 2016.

Financial Implications

23. The financial implications for the council from this prospective purchase are set out in Appendix 3.

Consultation

24. In view of confidentiality requirements and commercial sensitivity in relation to this as yet uncompleted transaction, external consultation has not been undertaken. Internal consultation has taken place with all relevant departments, including the provision of advice from Director of Law and Democracy and Strategic Director of Finance and Governance.

SUPPLEMENTARY ADVICE FROM OTHER OFFICERS

Director of Law and Democracy

25. The council is authorised in accordance with section 120(1), Local Government Act 1972 to acquire any land by agreement for the purposes of (a) any of its statutory functions, or (b) for the benefit, improvement or development of its area. Further, section 120(2) allows the Council to acquire land even though it may not immediately be required for a particular purpose.

26. The report recommends the acquisition of the freehold interests in the properties situate at 9, Holyrood Street, Shand House at 14-20, Shand Street and 22 Shand Street for the sum of £45,025,000 plus professional fees Stamp Duty Land tax, and search fees. The report recommends that authority will be delegated to the Chief Executive in consultation with the Strategic Director of Finance and Governance and the Head of Property.

27. External legal advisers have been instructed to undertake a legal due diligence report on behalf of the council and this will be appended to the report. This will comment and advise on contract and title issues, the costs which will be incurred in the purchase and on the transaction generally.

Strategic Director of Finance and Governance

28. The financial implications are set out in Appendix 3 and demonstrate a financial benefit to the council both in the short and longer term from this purchase, regardless of the method of financing the acquisition.

29. This acquisition will allow the council to efficiently utilise existing resources and available external borrowing options to generate a secure source of ongoing funding, without exposing the council to undue risk.

BACKGROUND DOCUMENTS

Background Papers	Held At	Contact
None		

APPENDICES

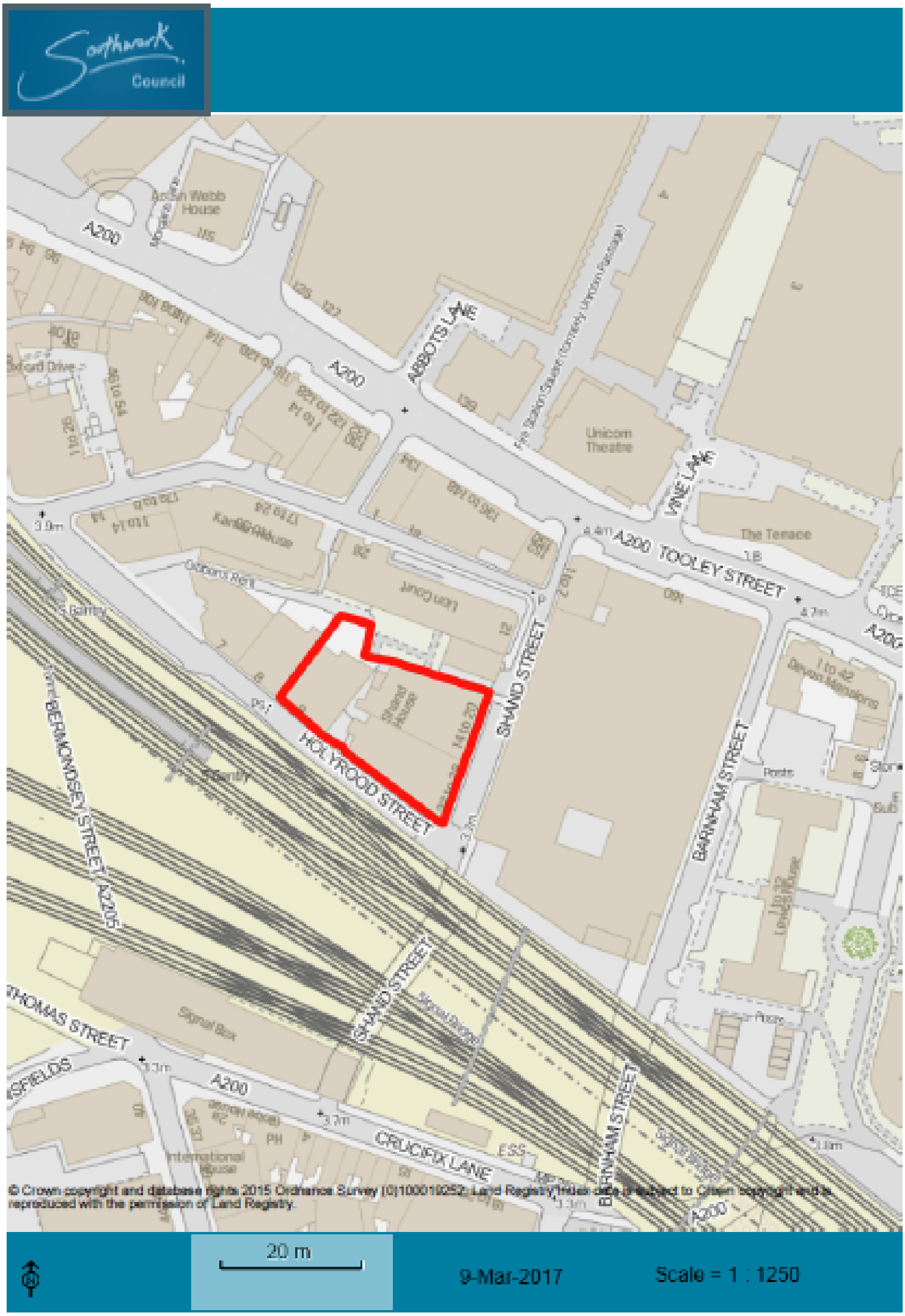
No.	Title
Appendix 1	Plan
Appendix 2	Heads of Terms
Appendix 3	Capital Funding and Revenue Implications

AUDIT TRAIL

Cabinet Member	Councillor Fiona Colley, Finance, Modernisation and Performance	
Lead Officer	Eleanor Kelly, Chief Executive	
Report Author	Matthew Jackson, Head of Property	
Version	Final	
Dated	10 March 2017	
Key Decision?	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Director of Law and Democracy	Yes	Yes
Strategic Director of Finance and Governance	Yes	Yes
Cabinet Member	Yes	Yes
Date final report sent to Constitutional Team/ Team		10 March 2017

APPENDIX 1

PLAN



APPENDIX 2

MAIN HEADS OF TERMS

Vendor	Britel Fund Trustees Ltd c/o Hermes Investment Management 1 Portsoken Street London E1 8HZ
Property	London Bridge Portfolio comprising the following three assets: • Shand House, 14-20 Shand Street, London SE1 • 22 Shand Street, SE1 • 9 Holyrood Street, London, SE1
Tenure	All three assets are held Freehold.
Tenancy	The property is multi-let in accordance with the tenancy schedules within the marketing details attached and provides a total rental income of £1,781,319 per annum.
Price	£45,025,000 (Forty Five Million and Twenty Five Thousand Pounds), exclusive of purchaser's professional costs, Stamp Duty Land Tax and VAT.
Purchaser	The Mayor and Burgesses of the London Borough of Southwark
Conditions	1. Subject to contract. 2. Verification of the information contained within the marketing particulars. 3. All due diligence including structural and environmental surveys, to be cleared by no later than 21st March 2017. 4. Cabinet Approval, to be cleared by no later than the 21st March 2017. 5. Exchange of contracts by no later than 28th March 2017 6. Completion to take place at a mutually agreeable time thereafter.
Exclusivity	Upon agreement of Heads of Terms, the Purchaser shall be granted a period of exclusivity and the details of the transaction shall be kept confidential, until close of business on Friday 31st March 2017.
Costs	Each party is to be responsible for their own costs incurred during the course of the transaction.
VAT	The properties have been elected for VAT. It is intended that the transaction will be treated as a transfer of a going concern.

APPENDIX 3

CAPITAL FUNDING AND REVENUE IMPLICATIONS

1. The purchase of this property portfolio would be treated as capital expenditure for the general fund. As such the funding of this purchase would be incorporated as part of the council's ongoing debt management strategy for capital financing.

2. The debt management strategy for the council is included as part of the Treasury Management Strategy 2017-18 approved by Council Assembly on 22 February 2017. The current strategy is to pursue a policy of internal borrowing, which is the use of existing reserves and balances to fund capital expenditure rather than the use of external borrowing.

3. The use of internal borrowing allows the council to minimise unnecessary external borrowing costs by only borrowing when needed for liquidity or to benefit from advantageous borrowing rates. Borrowing in advance of need creates a 'cost of carry' which is the difference between the short term investment income from holding cash balances compared against longer term external debt financing costs.

4. The annualised rate of investment return earned from cash balances held by the council was 0.60% for the quarter to 31 December 2016 with current interest rates on long term borrowing from the Public Works Loans Board ranging from 2.40% to 2.65% depending on duration. This equates to a cost of carry of 1.80% to 2.05%. The available cash balances for the council were £179.4m as at 28 February 2017.

5. Efficient use of existing council resources to fund capital expenditure through internal borrowing also significantly reduces the council's counterparty risk inherent in the investment of cash balances.

6. Borrowing, regardless of whether it is external or internal, is subject to an annual Minimum Revenue Provision (MRP) charge against the council's revenue budget. The MRP is a provision to reflect the repayment of the principal amount borrowed over the lifetime of the asset. The MRP policy for the council was approved as part of the Treasury Management Strategy for 2017/18. For this purchase the MRP will be charged over 50 years on an annuity basis.

7. The revenue budget and financing implications of the proposed purchase have been evaluated both as if incorporated within the council's overall capital programme and debt management strategy, but also on a stand alone basis assuming that long term debt was drawn immediately to cover the cost of purchase.

   - Model 1 – The purchase to be financed through use of existing council reserves and balances as per the current debt management strategy
   - Model 2 – The purchase to be financed immediately from external borrowing from the PWLB with a duration of 50 years.

8. The MRP and external borrowing interest costs are applied to the purchase price, the associated stamp duty land tax and the expected capital cost of light refurbishment over the period.

Model 1

9. As part of the overall debt management strategy the council is forecasted to be required to borrow externally for capital funding purposes during 2018-19. Model 1 therefore incorporates lost investment returns from short term cash balances for the first two financial years, before external interest costs will be incurred for this purchase.

10. The exact timing, source and duration of external debt will depend significantly upon capital expenditure outflows, available debt opportunities, future expectations for interest rates and the maturity structure of the councils' existing debt. The impact of this purchase is not expected to significantly bring forward future borrowing requirements.

11. For this funding model; external borrowing required to meet the overall capital programme, has been assumed to be a mixture of short, medium and longer term debt.

	2017/18 £000	2018/19 £000	2019/20 £000	2020/21 £000	2021/22 £000	2021/22 £000
Rental income	1,900	1,950	2,200	2,500	2,600	2,600
Total revenue income	**1,900**	**1,950**	**2,200**	**2,500**	**2,600**	**2,600**
Minimum revenue provision	-383	-396	-409	-422	-436	-451
Loss of investment income	-270	-198				
Interest on external debt		-173	-867	-877	-885	-891
Total revenue expense	**-653**	**-767**	**-1,276**	**-1,299**	**-1,321**	**-1,342**
Net revenue impact	**1,247**	**1,183**	**924**	**1,201**	**1,279**	**1,258**
Cumulative revenue impact	**1,247**	**2,430**	**3,354**	**4,555**	**5,834**	**7,092**

Model 2

12. Model 2 assumes the immediate drawing of external borrowing to fund the purchase cost with the duration of external debt to be matched to that of the economic lifetime of the asset for MRP and accounting terms, which would be 50 years. The current rate of interest charged on borrowing from the Public Works Loans Board, part of HM Treasury, for 50 year debt with principal repayable on maturity is 2.41%:

	2017/18 £000	2018/19 £000	2019/20 £000	2020/21 £000	2021/22 £000	2021/22 £000
Rental income	1,900	1,950	2,200	2,500	2,600	2,600
Total revenue income	**1,900**	**1,950**	**2,200**	**2,500**	**2,600**	**2,600**
Minimum revenue provision	-383	-396	-409	-422	-436	-451
Interest on external debt	-1,157	-1,157	-1,157	-1,157	-1,157	-1,157
Total revenue expense	**-1,540**	**-1,553**	**-1,566**	**-1,579**	**-1,593**	**-1,608**
Net revenue impact	**360**	**397**	**634**	**921**	**1,007**	**992**
Cumulative revenue impact	**360**	**757**	**1,391**	**2,312**	**3,319**	**4,311**

13. Both models indicate that the purchase of this property portfolio would provide an immediate revenue benefit in 2017/18, with significant ongoing revenue savings.

14. Greater revenue benefits are available through the efficient use of existing council resources and avoiding the cost of carry on holding short term cash investments funded from longer term external debt:

15. The preferred model of financing the property portfolio acquisition is therefore to utilise existing council resources from internal borrowing. This is estimated to provide an overall revenue benefit of £7.1m over a six year period.

16. This approach will allow the council to address capital funding in a flexible manner and to take advantage of beneficial interest rates when available as part of the overall strategic approach to capital financing