Open Agenda

Cabinet

Tuesday 11 December 2012
4.00 pm

Item 24: Released Closed Report

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The cabinet considered an open and closed version of the report relating to the proposed acquisition of the freehold interest in office accommodation at 160 Tooley Street, London SE1 2QH at its meeting on 11 December 2012. Recommendation 6 of the report recommended the full disclosure of the purchase price and financial benefits arising from the acquisition for the benefit of openness and transparency once the issue of commercial confidentiality was no longer required.

In line with this recommendation, the strategic director of finance and corporate services has agreed that the closed report may now be released into the public domain. The closed report considered at the cabinet meeting on 11 December 2012 is attached and has been published on the council's website.

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Date: 14 February 2013

Agenda Item 24

Item No. 24.	Classification: Closed	Date: 11 December 2012	Meeting Name: Cabinet
Report title:		Proposed Acquisition of Freehold Interest in Office Accommodation, 160 Tooley Street London SE1 2QH	
Ward(s) or groups affected:		All wards	
Cabinet Member:		Councillor Richard Livingstone, Finance, Resources and Community Safety	

Not for publication by virtue of category 3 of paragraph 10.4 of the Access to Information Procedure Rules of the Southwark Constitution.

FOREWORD – COUNCILLOR RICHARD LIVINGSTONE, CABINET MEMBER FOR FINANCE, RESOURCES AND COMMUNITY SAFETY

This council has pledged itself to spend every penny as if it was our own.

We currently pay £7.7m each year in rent on our council headquarters at 160 Tooley Street, and this figure is likely to increase through rent reviews. The terms of our lease continue to 2033, without a break clause.

The decision of the owners of the building to sell it has therefore presented the council with a unique opportunity. The choice we have is analogous to someone renting their home being offered the opportunity to buy it for a mortgage that costs less each month than the rent.

If the council decides to buy the building it will both reduce its annual costs in these difficult financial times and gain ownership of an important asset for the council. Owning the building also increases the flexibility we have in how we use it.

Whilst the figures currently remain commercially confidential, once the sale is completed we will release these to the public.

RECOMMENDATIONS

1. That cabinet note the circumstances leading to the sale by the current owners of the freehold interest in 160 Tooley Street and actions taken by officers and their advisors to assess the council's position in respect of this sale.

2. That cabinet approve the acquisition of the freehold interest in 160 Tooley Street, subject to the agreement of Final Heads of Terms and purchase price, the maximum amount of the bid not to exceed £170 million (One Hundred and Seventy Million Pounds Sterling), exclusive of all professional fees and Stamp Duty Land Tax and exclusive of VAT.

3. That cabinet delegate to the chief executive, advised by and in consultation with the strategic director of finance and corporate services and head of property, authority to:

   a. Negotiate terms and enter into binding contracts for the purchase of the freehold interest in 160 Tooley Street;
   b. Agree the amount of the final bid offered and other transactional terms;
   c. Agree the financing structure adopted to fund the acquisition of the asset

4. That cabinet request the strategic director of finance and corporate services to include the ongoing savings to the council within the policy and resourcing strategy to be considered by cabinet and council assembly in January and February 2013.

5. That cabinet requests that the strategic director of finance and corporate services, subject to successful completion of the acquisition, report any in year savings that accrue within the third quarter revenue monitoring report due to be received by cabinet in February 2013.

6. That cabinet notes that subject to commercial confidentiality the cabinet and members of overview and scrutiny committee will receive confirmation on completion of the purchase, full disclosure of the purchase price and financial benefits arising from the acquisition for the benefit of openness and transparency.

BACKGROUND INFORMATION

7. As part of the council's Modernisation Programme, in 2008 the council agreed terms with the then owner of the freehold interest of 160 Tooley Street, UBS Global Asset Management (UK) Limited. The agreement was for a full repairing and insuring lease for a term of 25 years from 11 June 2008 without break. This lease agreement was subject to rent reviews every fifth year. The lease allowed for use by the council of 160 Tooley Street as its primary office building. At the time, the building was not available for purchase by the council.

8. The freehold was subsequently sold to the current council's landlord, Tooley Street Investments Limited. This is an 'offshore' company registered in Guernsey (Channel Islands), and clients of HSBC Private Bank (UK) Ltd.

9. The council occupies the building as a tenant and is bound to comply with the terms of the original 25 year lease, with regard to how the building must be used and maintained. The main terms of the lease are set out for information in Appendix 1, along with the plan showing the location of the property.

10. Beside other provisions, the lease requires the rent, which currently stands at £7.7 million per annum exclusive, to be reviewed on an upward only basis to Market Rent every five years. This means that the rent may stay the same, or go up as a result of each review; under the terms of the lease, the rent cannot be reduced. The first such review is scheduled to take place in June 2013. The head of property considers that the rent would be likely to increase at this time.

11. However, immediate consideration of the rent review has been overtaken due to a recent decision on the part of the freehold owner to sell its interest and the commencement of a marketing exercise to achieve this. As a result the

opportunity has arisen for the council to acquire the unencumbered freehold ownership of the building, subject to the availability of funds, a sound business case and relevant approvals to do so.

KEY ISSUES FOR CONSIDERATION

Sale Process

12. The building has been actively marketed by the seller's agents, Whitmarsh Holt & Young.

13. The prospectus for the property, published on 8 November 2012, indicated that offers would be accepted in excess of £150m. This valuation within the prospectus effectively operated as a guide price to potential bidders and a minimum price at which the vendors would consider a sale.

14. The agents subsequently conducted a competitive bid process. They received sufficient interest to call for full and final bids, subject to prescribed conditions including limiting the timescales, with final offers being required by 22 November 2012. They also required bidders to state any conditions that purchasers would wish to have considered. It is understood that the present owner is now seeking to complete a sale by Christmas 2012. To be considered a serious contender in this process, the council has needed to evidence its ability to fund and to execute a purchase within this timescale and through the council's democratic approval processes. All dealings in this matter have taken place with the highest levels of commercial confidentiality.

15. There is limited knowledge with the council of the competing prospective bidders, but they are believed to be predominantly middle or far Eastern investment concerns. They would be expecting to find a 'safe haven' for cash in a UK based asset, or an investment fund with exposure to institutional property. Regarding this second class of prospective purchaser, it should be noted that once properties come to be held within investment funds it is rare for them to be traded on with any degree of frequency. As a result there is a reasonable likelihood that this will be the first and only opportunity the council will have to buy the freehold.

16. It should be noted that demand for UK property, and particularly central London, offices, remains very buoyant despite the current economic climate. Current indicators suggest that this is set to continue.

17. As a consequence and subject to the criteria of the business case presented within this report, a provisional offer was submitted on behalf of the council (Midday 22 November 2012) but conditional upon formal consent of the council's cabinet.

18. In advance of submission, the offer was reviewed by independent property, financial and legal advisers, each of whom are known to the council and have specialist knowledge of the acquisition and disposal of Investment property.

19. Subsequently the offer has been accepted in principle by HSBC on behalf of their client, subject to formal council approvals and subject to exchange of contracts and completion on or before the 14 December 2012. Draft Heads of Terms have been agreed on 3 December 2012 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.

Benefits of Ownership - Freehold v Leasehold

20. The financial rationale for an acquisition of the freehold by the council is considered in below in this report. In addition to savings that would be realised immediately within the council's revenue budgets and an improved Net Present Value in the council's property holding, a series of asset-related benefits (Soft Benefits) would arise directly from the change in tenure from leaseholder to freehold owner:

No.	Factor	Leaseholder	Freehold Owner
1.	**Business Operations**	Restricted. The terms of the lease are geared towards protecting the value of the landlord's investment. They may be at variance with the council's aspirations as an occupier. Changes such as modifications to the building need consent, which incur cost, take time to obtain, may result in additional rent, or may simply be refused.	Full flexibility subject only to legislative requirements affecting building owners (e.g. planning, building control, health & safety, etc.)
2.	**Dealings**	Onerous. Limited to assignment and limited subletting subject to landlord's approval and ongoing liabilities. For example, the council can assign the whole of the building but would need to procure an assignee with an AAA credit rating <u>and</u> then guarantee against assignee default.	The council would have total flexibility to treat with the building and parts of it as it saw fit. Examples: • subletting a floor of the building to commercial concerns at a market rent ; • sale of residential parts to generate capital receipt; • sale and leaseback should financial context for holding the building change and there is a compelling business case to restructure holding arrangements. Equally importantly the council would be better able to time any strategic exit from the property in the future should it wish to relocate.

No.	Factor	Leaseholder	Freehold Owner
3.	**Holding Costs**	Significant risk. Exposed to periodic rent reviews. The potential impacts are considered in the Higher Growth models appended. Also, contractually there is no option other than to maintain the building to the highest standard – irrespective of what might be deemed affordable. Some services are provided by the landlord e.g. insurance, but the council is likely to be able to procure at a saving.	Hedge against risk of high-level rental growth in an improving business district (e.g. impact of Shard, establishment as recognized office location for corporate occupiers, regeneration gains, London Bridge Station transformation, etc.).
4.	**Asset Value**	Deteriorating. At the end of the lease the council will be left with nil asset value, a dilapidations liability and would need to secure a further lease (in the same building or elsewhere, depending on its requirement at the time as an occupier)	There will be corresponding refurbishment costs (c.f. dilapidations costs). However, even at the end of the building's useful life the owner would retain a site with a strong residual value for exactly the same reasons that a lessee would be likely to see its rent inflating in future reviews (see above).

Summary of Business Case

21. The financial analysis undertaken sets out a number of options to purchase and shows comparative costs against the current lease and rent increases. Over the initial 10 year period the acquisition of the freehold offers a net present value (NPV) benefit compared with the rental option of £55.5m. The NPV benefit increases to £144m if taken over a 40 year period. In both cases the principal repayment of internal borrowings is not included in the NPV computation as this is a non cash transaction from the council's perspective.

22. Additionally the council will hold an asset with an estimated market value at year 10 of approximately £200 million, with flexibility to alter; sell part or sublet without restriction, which currently apply under the conditions of the lease.

23. To achieve the best rate of return for both capital and interest it is proposed to borrow internally from council resources over a 40.5 year term. This follows a detailed evaluation of a number of options including debt financing (borrowing) and a mix of both internal and external borrowing.

24. The financing period of 40.5 years is within the life cycle of the building and any costs incurred for planned maintenance and refurbishment are taken as similar to those that would be necessary should the council continue under the terms of the lease.

25. The NPV is driven primarily by the lower costs of principal and interest repayments on the building when set against the current rent payable, current rent being inflated to take account of the estimated uplift in future rent reviews. The NPV also provides at the end of life an asset which is in council ownership and that may be disposed of or relet at any point. While there is no intention to do so, the location and nature of the building means that it is a desirable acquisition for potential buyers and this marketing exercise has helped illustrate the viability of the building.

26. Initial revenue savings on the basis of the internal borrowing model are estimated at £68m over 20 years. Savings of at least £1.5m per annum will be included within the policy and resourcing reports to cabinet and council assembly in the New Year and will be reviewed annually as part of the normal budget process.

Financial Implications

27. This report examines the economics of the acquisition of the freehold interest in 160 Tooley Street, through the evaluation of models under net present value (NPV). This section sets out the source of financing for the acquisition and the revenue budget implications arising.

28. The preferred model for financing the acquisition is the 100% equity or "internal borrowing" model. Internal borrowing uses cash currently in hand to defer or avoid taking on new external debt. Internal borrowing does not count as external borrowing for prudential indicator purposes until such time as the need to borrow which has been deferred crystallises and the cash is actually borrowed.

29. Internal borrowing is only feasible when there is sufficient cash in hand. Cash in hand arises from the funds set aside as the council's reserves and balances, and those funds are the invested as short term deposits until such time as the reserves and balances are required to be used. Internal borrowing uses the cash resources available on a temporary basis until such time as the reserves and balances are needed to be spent. At that time, the borrowing need that had been deferred will need to be reviewed and may be actioned if necessary. The use of cash for internal borrowing for this purchase does not 'use up' or otherwise apply the reserves and balances set aside by the council for other projects, activities or priorities.

30. The council currently holds cash balances in investments. The table below shows the value of these at different dates:

	£m
31/03/12: per Statement of Accounts 2011/12	272
30/09/12: per monitoring report to Council Assembly	366
27/11/12: closing daily balance	356
31/03/13: projection at year end without this transaction	275

31. Cash balances are projected to be £275 million at the year-end of 31 March 2013 and all projections indicate that there are sufficient resources of this type to acquire Tooley Street at £170 million plus costs, meet all spending plans, and maintain operational cashflow liquidity without the need for borrowing in the short to medium term at least.

32. The rationale for using internal borrowing over external borrowing is the difference between the loss of investment income and the direct cost of borrowing. Whilst the world economy has brought interest rates down to unprecedented low levels, there is still a significant difference between investment and borrowing rates, which represents a major cost when a transaction of this size takes place.

33. The average rate of return on the council's investments for 2012/13 is expected to be 0.77%, which is representative of the council's risk appetite as set out in the treasury management reports to council assembly. In comparison, long term borrowing from the Public Works Loans Board for 40 years currently runs between 3.80% and 4.20% although some of this could be reduced by 0.20% through the council's access to the "certainty rate", a permitted discount by the government on new or refinanced debt. The weighted average differential at the outset is an initial saving at approximately a rate of 2.91%, which is very material on a transaction of £170 million plus costs. This differential, and the movement in the differential over time based on market projections, has been a key factor in the option appraisal of the different models evaluated for the purchase.

34. Borrowing, irrespective of whether internal or external, attracts a requirement for an annual Minimum Revenue Provision (MRP) charge, which is a real cost against the council's revenue budget. For external borrowing, MRP sets aside funds to repay the principal of the amount borrowed. For internal borrowing, MRP replenishes the cash that has been used in lieu of borrowing, such that over the life of the scheme the full cash balance has been restored. The council's MRP policies, in accordance with regulations and the Prudential Code, are set out in the treasury reports to council assembly. For this acquisition MRP will be in equal instalments over the 40 years expected life. The impact of MRP against the council's budget is set out in more detail below.

35. Internal borrowing exposes the council to borrowing risk at a later date, at which time borrowing interest rates may be higher than current rates. Borrowing need may arise depending on the future use of the council's reserves and balances. From the levels of cash balances currently held, as set out above, a borrowing need is not likely to arise in the short to medium term. As time passes, the annual MRP charge to the budget will replenish cash balances and reduce the need to borrow.

36. In addition, should a borrowing need arise, it will not be necessary to borrow the full amount but only the minimum amount required to maintain liquidity, thereby minimising any increase in cost. The scenario analyses have considered different mixes of internal and external borrowing, including 100% external borrowing, which all conclude a positive net present value for an acquisition. But the internal borrowing model represents the best opportunity, and generates significant short term benefits as well as long term gains.

37. The following table shows the effect on the revenue budget of financing the acquisition from internal borrowing. The table includes the estimates of the next two rent reviews (2013/14 and 2018/19). The table also uses market projections of future interest returns, and as interest rates rise over time the cost in terms of lost investment income also rises. 2012/13 is part year, for the last quarter only.

	2012 / 13	**2013 / 14**	**2014 / 15**	**2015 / 16**	**2016 / 17**	**2017 / 18**	**2018 / 19**	**2019 / 20**
	£000	£000	£000	£000	£000	£000	£000	£000

	2012 / 13	2013 / 14	2014 / 15	2015 / 16	2016 / 17	2017 / 18	2018 / 19	2019 / 20
	£000	£000	£000	£000	£000	£000	£000	£000
Assumed rentals	1,923	7,926	8,004	8,004	8,004	8,004	8,960	9,279
Internal borrowing:								
MRP	0	4,497	4,497	4,497	4,497	4,497	4,497	4,497
Loss of investment income	346	834	1,125	1,635	2,281	2,905	4,266	4,142
Cost of internal borrowing	346	5,331	5,622	6,132	6,778	7,402	8,763	8,639
Net saving in year	1,577	2,595	2,382	1,872	1,226	602	197	640

38. On originally taking the lease on Tooley Street, the council was given an 18 month rent free period. For accounting purposes this benefit needed to be smoothed out over the first five years of the lease. The smoothing was managed through the use of reserves, with the reserves being restored in the later years of the 5 year period, with no net effect on the revenue budget, in accordance with approved accounting practice. The acquisition of Tooley Street will lead to the unwinding of the remaining accounting adjustments, but has no effect on either the revenue budget or the modelling of the potential acquisition.

39. It can be noted that the internal borrowing solution has only become viable since the HRA self-financing reform from 1 April 2012, whereby borrowing by the HRA and the General Fund can now be separated. Previously the calculation of interest cost chargeable to the HRA, on an overall average basis, would had led to a lower charge of interest to the HRA, and consequently a high cost of actual interest to the General Fund. In these circumstances the benefits from internal borrowing would not have been achieved.

40. The acquisition of Tooley Street is subject to the payment of VAT. The council is able to fully recover this VAT, and so has no effect on the NPV model evaluations or other financial implications. Stamp Duty Land Tax of £8,160,000 is also payable, and forms part of the £9.86m (1.8%) estimated costs of acquisition, which are included in the NPV models and financial implications. The council have negotiated a substantial reduction in cost of Professional fees and this will produce an estimated reduction in costs of £1.425m off the £9.86m reported above.

Community impact statement

41. This decision has been judged to have no or a very small impact on local people and communities. However, savings realised as a result of the transaction will be applied in pursuit of the council's corporate objectives, achieving its stated budget principles, and working together with communities towards a “fairer future for all".

SUPPLEMENTARY ADVICE FROM OTHER OFFICERS

Director of Legal Services

42. The report seeks cabinet approval to purchase the freehold interest in 160 Tooley Street at a maximum bid price of £170 million. The report also seeks cabinet approval to delegate to the chief executive in consultation with the strategic director of finance and corporate services and head of property to negotiate the terms of the contract, agree the amount of final bid and the financing structure adopted to fund the acquisition of the property.

43. Section 120 (1) of the Local Government Act 1972 ("the 1972 Act") authorises the council 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. By virtue of Section 120 (2) of the 1972 Act the council may acquire by agreement any land for any purpose for which they are authorised by the 1972 Act or any other Act to acquire land, notwithstanding that the land is not immediately required for the purpose; and until it is required for that purpose, it may be used for the purpose of any of the council's functions.

44. In addition S1 of the Localism Act 2011 grants local authorities a general power of competence whereby a local authority has power to do anything that individuals generally may do. This power can be used even if legislation already exist that allow a local authority to do something. However the general power of competence does not enable a local authority to do anything which it is unable to do by virtue of a pre-commencement limitation. The power can be exercised:

    - For a commercial purpose or otherwise.
    - For a charge or without a charge.
    - For the benefit of the authority, its area, or persons resident or present in its area.

45. Cabinet attention is drawn to paragraphs 27 to 40 of the report which provides a detailed explanation of the financial implications of the purchase, how the purchase of the property will be funded and the estimated budget savings arising from the acquisition of the property.

46. The report also notes that the reasons for urgency and lateness are due to current owner seeking to complete the sale by the 14 December 2012.

47. The report recommends that authority to agree the detailed terms of the acquisition are delegated to the chief executive. Under Part 3C (a) of the constitution cabinet has authority to delegate this function to the chief executive

48. Cabinet should also note that external legal advisers and have been appointed to act on behalf of the council and have provided a legal 'Due Diligence' report attached at Appendix 2.

Strategic Director of Finance and Corporate Services

49. The strategic director of finance and corporate services notes the recommendations in this report, and the anticipated effects of the acquisition of the freehold interest in 160 Tooley Street. This is subject to a maximum

acquisition cost, excluding Stamp Duty, VAT and fees of £170m as set out in this closed report.

50. The details of the financial analysis are contained within the body of the report, along with the business case for the acquisition of the building and the outcome of the NPV analysis.

51. The strategic director also notes the positive NPV attached to this acquisition and notes the revenue savings that will be generated in future years. Subject to completion of the purchase, the revenue savings generated by the acquisition will be included within the policy and resourcing strategy reports that will be presented to cabinet and to council assembly early in 2013 savings will be kept under view and updated in future years as further benefits flow.

52. Subject to early completion, savings on the building rental will be achieved in the 2012/13 and this windfall saving will be reported in future revenue monitoring reports to cabinet.

53. The council's external auditor has reviewed the financial analysis undertaken by GVA and by the council with regard to the proposed acquisition. Their findings are set out in a letter dated 5 December 2012 (see Appendix 3). The auditor has confirmed that the methodology adopted by GVA is consistent with best practice for investment analysis and forms an appropriate basis for the council to determine the costs and benefits to support a decision on the purchase of the freehold.

REASONS FOR URGENCY

54. If the council is to proceed in its acquisition of 160 Tooley Street, the seller requires exchange of contracts and completion of the transaction on or before 14 December 2012. Therefore the opportunity to acquire will be lost if the decision is delayed to a further meeting to be held. The consequences of such a delay would be to forego the substantial financial advantages and operational flexibility (arising as a result of no longer being bound to the terms of the existing lease) identified elsewhere in this report.

REASONS FOR LATENESS

55. The report has not been available for circulation five clear days' before the meeting because negotiations between the parties have been ongoing to a late stage, with Heads of Terms setting out the agreed terms for the transaction only being settled on 3 December 2012.

BACKGROUND DOCUMENTS

Background Papers	Held At	Contact
Copy of leases; title reports financial assessments valuation and professional advise; audit report and legal due diligence	Property Department 5th floor 160 Tooley Street	Jeremy Pilgrim 020 7525 1133

APPENDICES

No.	Title
Appendix 1	Lease terms & plan (not to scale) (see open report)
Appendix 2	Summary of Legal due diligence
Appendix 3	Audit Letter from Grant Thornton

AUDIT TRAIL

Cabinet Member	Councillor Richard Livingstone, Finance, Resources and Community Safety	
Lead Officer	Eleanor Kelly, Chief Executive	
Report Authors	Jeremy Pilgrim Acting Head of Property Matthew Jackson, Manager Corporate Property	
Version	Final	
Dated	6 December 2012	
Key Decision?	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES		
Officer Title	**Comments Sought**	**Comments included**
Director of Legal Services	Yes	Yes
Strategic Director of Finance and Corporate Services	Yes	Yes
Cabinet Member	Yes	Yes
Date final report sent to Constitutional Team		6 December 2012

StepienLake

Report on Contract Terms.

Client London Borough of Southwark

Property 160 Tooley Street, Southwark London SE1 2JP

Date 6th December 2012

Introduction

The Contract is between Tooley Street Investments Limited (the Freehold Registered Proprietor) and the Council and confirms the sale of the Property for £170,000,000.00 exclusive of any VAT.

The Contract anticipates completion taking place on 14th December 2012 (by 2pm) and the parties are, in any event, proceeding on the basis that there is a simultaneous exchange and completion, accordingly some of the terms of the draft Contract are not particularly relevant (as there will be no period between exchange and completion.)

The Contract is in accordance with the Heads of Terms subject to certain refinements which we will come onto below.

Main Operative Provisions

The Contract incorporates the Standard Commercial Property Conditions (Second Edition) so far as relevant and on the basis that we are proceeding to a simultaneous exchange and completion, very few of those standard conditions are actually applicable to the Contract, in any event. To the extent that the Standard Commercial Property Conditions apply, they are standard terms that one would expect to find in a freehold sale purchase contract.

Title

The Seller shall transfer the registered freehold title with full title guarantee (which is the best form of title available) and we can confirm that subject to payment of stamp duty land tax that upon completion of this transaction the Council will be registered with Freehold Title Absolute at the Land Registry.

Under clause 5 in the Contract, the Council acknowledge that the Seller has deduced good title and we can confirm that this is the case under the terms of the Contract and we have reported to you on the terms of the title so deduced and have put in place protective searches in order to deal with completion and post-completion matters.

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With reference to clause 6 of the Contract, the incumbrances affecting the Property are a standard list of items and as you occupy the Property, you are probably best placed to provide information on whether or not any third party is occupying or otherwise claiming any unregistered interest in the Property. In relation to the other items in clause 6:

6.1.3 – We confirm that we have carried out all appropriate enquiries and have reviewed the registered title and this is acceptable; the Charge registered against the Title to the Property will be cancelled upon completion and the appropriate documentation handed over at completion (see clause 4.7);

6.1.4 - The Letting Documents primarily relate to your Agreement for Lease and Lease and any occupational interest (being the Lease of the Substation and the Residential Block); we have reported on these documents elsewhere in this Report and we would note that the main interest here (the Council's Lease) will be merged in the freehold and thereby cancelled at the time of completion.

6.1.5 - The documents referred to here essentially comprise the original Section 106 Planning Agreements (there are two of them) and the Deed of Easement relating to the rear access; these documents are reported on elsewhere in this Report. In relation to the first Section 106 Agreement, we understand that this was supplemented by the second Section 106 Agreement and is therefore of no relevance, albeit the Seller is not able to confirm this point. We note that the Council have checked their records and there are no outstanding issues under either of the Section 106 Agreements.

6.1.6 - This is a cross-reference to the standard conditions and the Conditions refer to matters specified in the Contract, discoverable upon inspection, matters which the Seller does not or could not reasonably know about, matters disclosed by searches and public requirements. You will be aware of any matters apparent upon inspection and there are no adverse matters revealed by our Local Authority Search. [1]

Completion

As mentioned above, completion will take place immediately following exchange of Contracts. The latest time for completion under the terms of this Contract is 2pm however it is anticipated that the monies will be transferred in time for completion in the morning of completion and the

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[1] It should be noted that the Seller is a Guernsey Company and as such, we suspect will not have any assets available to it in the event of a breach of any contractual term including the obligation to provide good title. That being said, there are very limited obligations on the part of the Seller under the terms of the Contract (as one would expect) and on the basis that the Transfer is executed in accordance with Land Registry requirements, there is no reason why Land Registry would reject any application. We have carried out limited due diligence in relation to the Seller and are not aware of any particular issue with regard to the Seller or its solvency; Land Registry searches have been carried out on the Council's behalf which provide the Council with protection following completion.

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Seller's solicitors have confirmed that they are prepared to accept the transfer of the monies direct to their client account in readiness for completion.

Insurance

You need to ensure that you have all appropriate insurances in place in relation to the Property at the time of completion including comprehensive insurance in respect of the Building itself together with any lift, plant, machinery and equipment insurance.

At the time of completion, the Seller shall cancel the insurance which it has in place in relation to the Property [*and will apply for a refund from the insurers of any insurance premiums paid in advance. There is a risk here to the Council in that the Seller is an offshore Company and even if it receives the refund of the insurance premium (and we see no reason why this would not occur) it might be difficult to recover the same from the Seller after completion. Although this is a standard arrangement under contracts, the sums involved are relatively substantial (for the buildings insurance alone, we are looking at something in the region of £20,000).*

With reference to clause 9.4 of the Contract, this is just to cover the remote possibility that there is a terrorist attack during the course of the rest of the insurance year (expiring June 2013) in which case there would be a re-adjustment to the insurance premium for terrorism. It has been accepted on the basis that the risk is highly remote.

The Seller has confirmed that there are no arrears of insurance or rent at the moment.

Clawback

This clause has been the most heavily negotiated and the current position, whilst reflecting the Heads of Terms, does go into more detail.

The basic aim behind the clawback was to ensure that the Seller was not "embarrassed" by a subsequent sale by the Council at a much higher value. Given the fact that the Council is paying market value for the Property today, the likelihood of the Seller being "embarrassed" is remote. That being said, the Seller has insisted (despite subsequent negotiation) on a three year period and if there is a disposal by the Council during the three year period (from completion) then the clawback provisions will apply.

In brief, if the clawback provisions apply, then the Council has to pay the Seller 25% of any uplift. The uplift is calculated by deducting from the disposal proceeds received by the Council all the acquisition costs, any holding costs, any costs which go to an actual improvement in the value of the Property and the further sum to allow for indexation of the £170,000.00 to cover off against inflation.

A "disposal" is widely defined and effectively captures any disposal of the beneficial or legal interest by way of transfer or otherwise of the Property (or a part of the Property) but the grant of a lease at a rack rent is specifically excluded from the definition of disposal. Also certain disposals are specifically permitted including:-

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- A disposal to a local or central government body;
- A disposal of the residential block – albeit if you subsequently dispose of the Property then the receipts from the disposal of the residential block would be added back into the calculation;
- The grant of a lease of the plant and equipment in the Property for the purposes of releasing capital allowances.

The Seller may assign the benefit of these provisions to a third party (indeed it is likely that it will do so following completion) and if the Seller obtains a Deed of Novation of its interest in favour of that third party, then the Seller is released from its obligations under clause 10 – the only really material obligation under clause 10 is confirmation that the clause will not be registered at the Land Registry.

VAT

VAT on the purchase price at 20% will be payable - £34,000,000.00.

This figures does not actually need to be paid at the time of actual completion and can be delayed until (at the latest) 31st January 2013 – subject to receipt of a valid and appropriate VAT Invoice. If the Council receive the VAT credit any earlier, then it has to be paid within 1 working day of receipt.

Capital Allowances

The Seller has confirmed that it has not made any capital allowances in relation to any plant and equipment and other items in the Property (clause 17 of the Contract) and has also further confirmed in replies to enquiries that a similar provision was obtained from the previous/first owner. Therefore there have not been any claims for capital allowances in respect of the plant and equipment within the Property. That equipment will pass to the Council upon completion.

We understand that the Council is not able itself to claim capital allowances but there may be the ability to grant a lease of that plant and equipment to a third party in order to release some "value" back to the Council.

Building Contract

On the date of completion, a Deed of Assignment of the benefit of the Building Contract will be completed in favour of the Council. This should be viewed in conjunction with the various letters that will need to be sent out to the individual consultants which is a separate exercise and which we will attend to following completion.

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5 December 2012

Dear Duncan,

Acquisition by Southwark Council of the Freehold of 160 Tooley Street

The Council is considering the purchase of 160 Tooley Street and has been advised externally by GVA in relation to property issues. GVA have developed a detailed financial model which evaluates the potential costs and benefits to the Council of the acquisition and the GVA model and the associated analysis forms the basis of the Council's business case for the proposed acquisition.

We have been requested by the Council to review the analysis undertaken by GVA and reflected in the Cabinet Report dated 11th December and provide comment as we feel appropriate.

Our analysis is based solely upon the GVA model as distributed by Neil Dovey of GVA on 28th November and the Cabinet report dated 11th December. We have not undertaken a formal model audit in relation to the GVA model.

GVA Model

The GVA model has the following inputs and outputs:

Inputs

- Purchase price £170m
- Purchase costs 5.8% of purchase price
- Building value in 2052 at 2012 price base - £115m
- Initial rent £7,693,370 pa
- Interest received on Council cash balances 0.77%pa in 2012 rising to 3.5% by 2022
- Interest paid on additional debt 3.55% to 3.75%
- Internal and external borrowing repaid on equal instalments over a 40 year period
- Refurbishment/dilapidation costs in year 20 at 2012 cost base - £15.0m
- Rental and residual value growth - three scenarios: low growth, higher growth and in line with RPI which is assumed as 3.19% for the first 5 years and 2.8% thereafter
- Discount rate for NPV calculation 6.09%
- Three scenarios are modelled: 100% internally funded, 100% externally funded and 50% internally 50% externally funded
- It is assumed implicitly within the model that the current lease could be renewed on similar terms in 2033 for a further 20 years.

Outputs

- Undiscounted and discounted financial assessment over 10.5 years and 40.5 years for both the acquisition of the freehold and remaining on a leasehold basis.
- For both options sensitivity testing is included to show the results reflecting assumptions relating to future rental growth and debt and equity financing mixes.
- For both options an economic appraisal, in line with Treasury Green Book requirements, is included to test the overall value generated in all scenarios.

Analysis and Conclusions

The methodology adopted by GVA is consistent with best practice for investment analysis and forms an appropriate basis for the Council to determine the costs and benefits to support a decision on the purchase of the freehold.

The Council has within the Cabinet report accurately reflected the GVA analysis and has not distorted the analysis through the omission of any material output of the GVA model.

The assumptions made in relation to interest rates, value and cost changes over a 40 year period are within parameters which are reasonable for an exercise of this nature and do not lead to a distortion of the analysis in favour any particular outcome.

In summary the approach taken by the Council in assessing the costs and benefits of the purchase of the freehold of 160 Tooley Street is in line with best practice and the analysis within the Cabinet report is appropriate for a project of this nature and reflects the outputs from the GVA model.

Our analysis to date has been focused on the business case and supporting analysis as set out above. In due course, as part of the statutory audit, we may review additional issues, for instance the accounting and balance sheet treatments.

Yours sincerely,

S. M. Exton

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