

Item No. 24.	Classification: Open	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	

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 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 in principle the acquisition of the freehold interest in 160 Tooley Street, subject to the agreement of Final Heads of Terms and purchase price.
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. A plan showing the location of the property is provided for information in Appendix 1.
9. The freehold was subsequently sold to the current council landlord, Tooley Street Investments Limited. This is an 'offshore' company registered in Guernsey (Channel Islands), and clients of HSBC Private Bank (UK) Ltd who act as their agents.
10. 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.
11. Beside other provisions, the lease requires the rent must be reviewed on an upward only basis to Market Rent every 5 years. Upward only means that the rent may stay the same, or go up; it cannot be reduced under the lease terms. 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. Due to the substantial changes in the locality with the completion of the Shard; the extensive changes to London Bridge Station; the success of More London; and the proposals for further office and residential developments, the 'London Bridge Quarter' is expected to see continued growth in terms of rents and capital values over the next 10 to 20 years.
12. The Modernisation Programme and the move to Tooley St have allowed the council to make substantial savings in respect to its occupied estate. The disposal of former office buildings has allowed for revenue savings and capital receipt by increased inward investment from occupying companies and has afforded local community groups space which they would otherwise not be in a position to occupy.

13. A recent decision on the part of the freehold owner to sell its interest has resulted in this opportunity for the council to evaluate its tenure in Tooley St and seek to acquire the unencumbered freehold ownership of the building so that it can further its aims to occupy the building as its core civic and administrative base more efficiently.
14. The proposed purchase will allow the council to make additional savings as well as at the same time, if the purchase proceeds, to utilise the building for community uses at specific times which under the lease it cannot currently do.
15. Additionally it will afford the council the ability to adapt changing environment and occupy the building more efficiently by having opportunity to sub-let which is penalised under the current lease.

KEY ISSUES FOR CONSIDERATION

Sale Process

16. Agents acting for the seller have conducted a competitive bid process.
17. 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.
18. 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.
19. 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.
20. In advance of submission, the offer was reviewed by independent property, financial and legal advisers, each of whom are known to the council and specialise in the acquisition and disposal of Investment property.
21. The offer has been accepted subject to exchange of contracts on or before the 14 December 2012, if cabinet is agreeable.

Benefits of Ownership - Freehold v Leasehold

22. The financial rationale for an acquisition of the freehold by the council is considered in some depth below (see “Resource Considerations”). In addition to savings in the General Fund Account that would be realised immediately 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.	<p>The council would have total flexibility to treat with the building and parts of it as it saw fit. Examples:</p> <ul style="list-style-type: none"> • 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. <p>Equally importantly the council would be better able to time any strategic exit from the property in the future should it wish to relocate.</p>

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 (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

23. 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 preferred funding route offers a substantial saving in revenue costs. This saving is greater if taken over the full 40 year life of the building.
24. To achieve the best rate of return for both capital and interest it is proposed to internally borrow 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.
25. 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 should the council continue under the terms of the lease.
26. The improved position is driven primarily by the lower costs of principal and interest repayments on the building when set against the current rent payable, inflated to take account of future rent reviews. The purchase 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.

27. Savings will be included within the policy and resourcing reports to cabinet and council assembly in the new year.

Financial Implications

28. 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.
29. 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.
30. 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 until such time as the reserves and balances are required to be used. Internal borrowing uses the cash available on a temporary basis until such time as the reserves and balances are needed to be spent, at which time the borrowing need that had been deferred will need to be reviewed and may need to be actioned. The use of cash for internal borrowing for this purchase does not ‘use up’ the reserves and balances set aside by the council.
31. The council currently holds cash balances in investments. Projected cash balances at the year-end of 31 March 2013 are sufficient to acquire Tooley Street, meet all spending plans, and maintain operational cashflow liquidity without the need for borrowing.
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. 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.
33. 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.
34. 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 term. As time passes, the annual MRP

charge to the budget will replenish cash balances and reduce the need to borrow. In addition, should a borrowing need arise, it will not be necessary to borrow the full amount but only the minimum amount necessary 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.

35. The effect on the revenue budget of financing the acquisition from internal borrowing is detailed in the closed report.
36. 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 have 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.
37. The council's auditor has reviewed independent financial appraisal work undertaken and has confirmed that the methodology used has been consistent with best practice and forms an appropriate basis for the council to determine the costs and benefits to support a decision on the purchase of the freehold.

Community impact statement

38. 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

39. The report seeks cabinet approval to purchase the freehold interest in 160 Tooley Street. 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.
40. 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.
41. 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.

42. Cabinet attention is drawn to paragraphs 27 to 40 of the closed 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.
43. The report also notes that the reasons for urgency and lateness are due to current owner seeking early completion.
44. 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
45. Cabinet should also note that external legal advisers have been appointed to act on behalf of the council and have provided a legal 'Due Diligence' report attached at Appendix 2 of the closed report.

Strategic Director of Finance and Corporate Services

46. 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 as set out in the closed report.
47. The details of the financial analysis are contained within the body of the closed report, along with the business case for the acquisition of the building and the outcome of the NPV analysis.
48. The strategic director also 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.
49. 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.
50. The council's external auditor has reviewed the financial analysis undertaken by the council with regard to the proposed acquisition. Their findings are set out in a letter dated 5 December 2012 (closed report). The auditor has confirmed that the methodology adopted 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

51. 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

52. 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 (listed in the closed report)	Property Department 5 th floor 160 Tooley Street	Jeremy Pilgrim 020 7525 1133

APPENDICES

No.	Title
Appendix 1	Lease Terms & Plan (not to scale)

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