



# CHELTENHAM

## BOROUGH COUNCIL

### Notice of a meeting of Council

**Tuesday, 14 April 2015**

**6.30 pm**

**Council Chamber, Municipal Offices**

<b>Membership</b>	
<b>Councillors:</b>	Simon Wheeler (Chair), Duncan Smith (Vice-Chair), Matt Babbage, Flo Clucas, Adam Lillywhite, Chris Mason, Dan Murch, Chris Nelson, John Payne, Max Wilkinson, Wendy Flynn, Andrew Chard, Paul Baker, Garth Barnes, Nigel Britter, Chris Coleman, Bernard Fisher, Jacky Fletcher, Colin Hay, Tim Harman, Rowena Hay, Sandra Holliday, Peter Jeffries, Steve Jordan, Andrew Lansley, Helena McCloskey, Andrew McKinlay, David Prince, John Rawson, Anne Regan, Rob Reid, Chris Ryder, Diggory Seacome, Malcolm Stennett, Klara Sudbury, Pat Thornton, Jon Walklett, Roger Whyborn and Suzanne Williams

### Agenda

<b>9.</b>	<b>ACCOMMODATION STRATEGY</b> Please note that the exempt appendices submitted to the Council meeting for consideration have been made public on 20/03/18 and are therefore attached in this updated supplement	(Pages 3 - 10)

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**Pat Pratley**  
Chief Executive

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### **Outcome of negotiations**

1. Complex and prolonged, off market, negotiations have been undertaken by officers over a considerable period of time in respect of the preferred option, Delta Place, Bath Road, Cheltenham.
2. The owner of the building originally wanted £14m for the building but is now prepared to sell at £13.75m but will not accept any less.
3. The property is currently let to a third party who has a head (full repairing) lease (at a cost per foot<sup>2</sup> well beyond current market rates) which runs to April 2023. The head lessee does not wish any exposure to external publicity.
4. Originally negotiations had been concluded to acquire the building with the Council contribution of £5.4m plus a surrender premium of £8.35m from the head lessee to relinquish the outstanding lease and liabilities to the term end of the lease, at a combined figure of £13.75m. Unfortunately, because of VAT implications with regard to the surrender premium, the tenants are unable to conclude their part of the deal and as such the acquisition of the building using the original approach is now no longer an option.
5. The council has considered a number of options and is now proposing to acquire the freehold of the building, initially as an investment property, by paying the owner the full amount of £13.75m with the current third party lease in place which will provide a guaranteed income stream of £1.288m per annum which to the end of the term, totals £10.2m.
6. The additional acquisition cost will be financed by a combination of additional Public Works Loan Board (PWLB) and short term internal borrowing but the income stream will help to finance the increased borrowing costs.

### **Strategy for relocation**

7. As the original proposal of the current head lessee surrendering their lease and the council purchasing the property from the freeholder with vacant possession will now not proceed the council has considered a number of alternatives which are discussed below and supported by Discounted Cash Flows.
8. If the decision is made to acquire the building, the most favourable financial model suggests holding the property as an investment for 8 years until the current head lease expires as the tenant will be responsible for all the costs as they have a full repairing lease, and then CBC relocate from the Municipal Offices, but renewing the sub tenants lease on the second floor or seeking a new tenant for the space as this will be surplus to requirements and will continue to provide an income stream for CBC.

9. The current head lessee is presently seeking to mitigate their financial liability and they are currently marketing space. Terms have been agreed with two sub tenants; one for most of the ground floor for a term of 3 years which will expire in April 2018, the other being for the whole of the second floor for 8 years (up to April 2023) but with a tenant option to break the lease at the end of year 5 and annually thereafter. The first floor is currently empty and available.
  - (1) As the first floor space is available and the ground floor will be available in 2018, the council could consider committing to the space now which would allow the marketing of the Municipal Offices to commence. It is considered that the process including the Boots Corner experimental closure as part of the Cheltenham Transport Plan, securing planning as necessary and agreeing the terms of the joint venture with the preferred bidder, would take approximately 2/3 years which would coincide with the availability of the space in Delta Place. However, this in financial terms is a more costly option than relocating in 8 years' time.
  - (2) As an alternative CBC could take a lease of the ground floor in 2018 and if the first floor is still available take a lease of that space too for the remainder of the head lease (5 years) when their interest falls away. This will still be a more expensive option than option 2 but lower cost than option 3. However, whilst the availability of the ground floor space can be guaranteed the same cannot be said of the first floor as there is the risk that the head lessee may have sublet the space to someone else, for a period co-terminus with the head lease.
  - (3) A further option would be to take a lease of just the ground floor only when it becomes available in 2018 and move some of the staff across from the Municipal Offices: the cost implications of which are set out in option 8. However, there are disadvantages of running space in 2 different buildings.
10. If the property is acquired as an investment but with the objective of providing a permanent long term home for the council in 8 years' time, it is recommended that there continues to be an ongoing dialogue with the head lessee with the view of negotiating a surrender of their lease, so that the Council could then bring forward the relocation aspirations sooner. However this would only be realised if the settlement was mutually financially viable for both parties.
11. Discounted Cash Flows have been provided for the other options considered e.g. new build or remaining at the Municipal Offices but as can be seen from the financial analysis the build costs to provide a new building and the planned maintenance cost over the next 20 years of staying at the Municipal Offices indicate that these are the least favoured options.
12. There is also the potential for a joint venture for the redevelopment of the MO. In this case the JV partner may wish to facilitate the relocation of CBC to Delta Place when ready to commence the redevelopment of the Municipal Offices ie before the expiry of the 8 year Delta Place lease period.

### Best Consideration

13. The council has an obligation to demonstrate value for money for taxpayers and best consideration in terms of any purchases it makes. The council has obtained independent valuation advice from a commercial specialist who has international coverage. They have provided two valuations; the first one being based on the original proposal which was to determine the market value of Delta Place on the basis of vacant possession, subject to the sub tenanted leases in place, but the head lessee having paid the surrender premium to the freeholder and therefore relinquishing their lease. The advice on this basis was that the value would be in the region of £5.4m which is what was offered as part of the original proposal.
14. The second valuation requested is for the current proposal which is to provide a market value reflecting the benefit of the rent currently payable by the head lease until the term end in April 2023, this produces a value of £11m which is £2.75m below the figure required to by the landlord. However the Net Present Value clearly demonstrates that despite the proposed purchase being in excess of the valuation, the acquisition of Delta Place still represents the best financial option for CBC.
15. The commercial valuation of £11m ignores the fact that the Council would wish to occupy the building after 8 years and assumes and makes allowance for a significant fall in rent (given that the site is currently over-rented), hypothetical voids and incentives to let the space. Should the Council purchase the property the intention will be to occupy the majority of the ground and first floor for its own occupation including CBH, and pre-let the remaining surplus ground floor space to the other public sector providers. These lettings will be at open market value. In addition CBC would continue to sub-let the second floor hopefully to a single occupier as the floor is of a scale that is consistent with demand for space in Cheltenham. The market is robust in the 5,000 – 20,000ft<sup>2</sup> demand zone but there is seemingly no appetite for whole buildings approaching 60,000ft<sup>2</sup>. The red book valuation reflects that the current rent being paid for the property is considerably in excess of current market rental values and takes a realistic if conservative view on the demand for the entire space, reflecting that Cheltenham is no longer a town that attracts head office occupiers.
16. Other factors considered in a traditional red book valuation and which impact on the valuation yield include the strength of the tenants covenant, potential voids, cost of re-letting void space and any outstanding building maintenance issues.
17. For example the recent Quadrangle transaction had the benefit of the remainder (4 years) of lease with RBS, perceived as a strong covenant and St. James's House had a mixed group of tenants, rather than a sole letting. Delta Place has also recently seen a surge in interest reflecting the level of demand for space of this quality, its availability and an office market moving towards equilibrium. Cheltenham has seen the loss of up to 500,000ft<sup>2</sup> of stock over the last few years (e.g. Kraft, Rivershill

House etc), much of it of lower quality, reflecting the market to convert for other uses. However rental rates for Delta Place whilst improving are far short of the existing head lessee exposure hence willingness to co-negotiate with CBC over lease termination and site sale.

18. The potential re-let market has improved in the last 12 months with St. James's filling the last (substantially refurbished) floor and a significantly improving position at the Quadrangle. The real determinant in achieving lettings would appear to be the quality of the stock, as both Ellenborough House and Festival House have secured lettings since being refurbished.
19. We know from recent sub-lets at Delta Place and viewings from potential public tenants that Delta Place is attractive to potential occupiers and that tenants will be secured for any future space within the building should parts currently sublet become vacant. Delta Place has recently been surveyed for dilapidation purposes due to the lease expiry of the sub tenants' lease and approximately £500k worth of expenditure has been identified. As the head lessee occupies under a full repairing lease the onus lies with the head lessee to undertake the required works. Should the proposed acquisition proceed then CBC will ensure that these works are carried out in full and the property restored to the required level of repair. Some works can be expected to occur beyond the expiry of the head lessee's lease and these are factored into the NPV calculations. However, notwithstanding the valuation, in this case it may be prudent to also weigh some of the wider benefits that the proposed town centre building could bring to the town if in public ownership, critically the potential to unlock the potential redevelopment of the Municipal Offices.

### **Head of Property and Asset Management Comment**

20. At first glance the fact that the market valuation is below the sale price required by the freeholder suggests that we should not proceed with the proposal to acquire Delta Place. However despite this when considering the other options the acquisition is by far the best in financial terms and for this reason it should be seriously considered.
21. The Council could decide to wait and see if Cheltenham House (previously considered) is offered to the market in 2016 or indeed Delta Place in 2023 when the head lease expires. However this would be a risky strategy as the council would not be in control and would be vulnerable to being outbid.
22. The current proposal to acquire now is an off market transaction and will provide the Council with certainty as it will have the comfort that upon completion of the purchase it has secured a future long term home albeit that there is the possibility that occupation may not be possible until 2023. This can be overcome by a commitment upon acquisition to take a lease on the first floor from the head lessee and the ground floor in 3 years' time when the current sub lease expires but at a financial cost. At the same time dialogue and discussions with the head lessee could continue to secure a mutually agreeable financial surrender package. The ultimate fall-back position is to remain in the Municipal Offices which is generally accepted is far too

large for our needs. The building is inflexible and not suitable or adaptable to current office requirements, and therefore unattractive to any potential tenant. The main concern is the £6.5m of maintenance expenditure identified as being required over the next 20 years. This has not been budgeted for and is a future financial time bomb that will have to be addressed were we to remain. The poor state of repair of the external envelope and the lack of disability access are testimony to the extent of works required, but even then the building form internally would not be improved due to the historic nature of the fabric and restrictions on remodelling.

23. For the requested red book investment valuation the consultants using their knowledge and experience have determined a yield of 7.5% for the initial term and 9% for the reversion; these reflect the initial certainty and security of the existing tenant and hypothetical uncertainty once the tenant has vacated. As the proposed purchase figure is in excess of the valuation dependant on how this is analysed produces a yield of between 6.25% and 9%.
24. The option to remain in the Municipal Offices would trigger the need to forge ahead with the planned maintenance programme. This option not only does not deliver a saving but would add to the MTFS by an average of £325k per annum for the next 20 years. Additionally it must be recognised that PWLB finance would not be applicable to this option, as the works would not be eligible under the PWLB criteria. As a result the only way of financing the refurbishment costs would be to either fund from other disposals or seek significant cuts from the base budget which would necessarily impact upon services.

### Section 151 Comment

25. Whilst the book value of the building is below the asking price, the financial projections indicate that acquisition of Delta Place is the best option since this delivers a contribution to the MTFS and has the potential to deliver additional business rates and ground rental income from the redevelopment of the Municipal Offices.

An alternative view of the valuation compared to the amount paid is as follows:

	Initial negotiation £m	Final negotiation £m
Acquisition price paid by CBC	5.400	13.750
SDLT	0.216	0.550
<b>Total cost</b>	<b>5.616</b>	<b>14.300</b>
Less third party rent to 2022/23	-	(10.200)
Net cost to at 2022/23	<b>5.616</b>	<b>4.100</b>
Cost of borrowing to 2022/23	1.437	1.664
<b>Net cost to CBC at 2022/23</b>	<b>7.053</b>	<b>5.764</b>
<b>Difference in approaches</b>		<b>1.289</b>

26. Despite the Council paying £13.75m for the building, it would recover £10.2m of this outlay by 2022/23 and would effectively acquire the building for £5.764m including the cost of financing.

27. The variance in the price for the acquisition approach reflects the strength of covenant and inflated rental stream paid by the third party for the property head lease compared to the market rate, which is driving the price upwards.

28. As such, in my opinion, a decision to acquire Delta Place would be a sound commercial decision for the Council.

**Mark Sheldon – Section 151 Officer**

**Budget allocations arising from the option to acquire Delta Place to be approved by Council at recommendation 4.**

29. The council are approving the detail allocations at exempt Appendix 3, including the following for 2015/16:-

	£
Acquisition price paid by CBC for Delta Place	13,750,000
Stamp Duty and Land Tax (SDLT)	550,000
Professional Fees associated with purchase	25,000
Funded by:	
Prudential borrowing from Public Works Loan Board	6,250,000
Internal borrowing	5,000,000
Use of capital receipt from sale of North Place / Portland Street £2.5m set aside to support funding of option	2,091,533

30. It should be noted that, if the decision to purchase Delta Place were to be deferred, the owner would not adjust the price of the building downwards to reflect additional rental income received beyond 30/04/15. This would cost the Council approximately £100k per month in lost income which would be paid to the owner rather than the Council.





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