Title of meeting:	Cabinet / Full Council
Date of meeting:	17th June 2019
Subject:	Significant Property Acquisition
Report by:	Tom Southall Assistant Director - Property & Investment
Wards affected:	All
Key decision:	Yes/~~No~~
Full Council decision:	Yes/~~No~~

1. Purpose of report

1.1 This report sets out the details of an opportunity for the City Council to acquire the city's out of town business park, Lakeside North Harbour.

1.2 The proposal to acquire the Lakeside campus, like many commercially sensitive transactions, is subject to a Non-Disclosure Agreement (NDA) between the parties. Consequently limited financial information is presented in this public report; the financial information prepared to support this proposal has been made available / presented to all members separately.

2. Recommendations

2.1 That Cabinet approves the following:

2.1.1 Subject to the approval of the City Council of the recommendations in paragraph 2.2 below, that delegated authority be given to the Director of Regeneration and the Director of Finance & Section 151 Officer, taking advice from the City Solicitor, and in consultation with the Leader of the City Council to approve the completion of the acquisition of Lakeside North Harbour

2.2 That Cabinet recommends to the City Council:

2.2.1 That the acquisition of Lakeside North Harbour Business Park be added to the Council's Capital Programme and financed by borrowing, subject to:

i) The satisfactory completion of the outstanding due diligence

ii) A financial appraisal (based on the completed due diligence) being approved by the Director of Finance & Section151 Officer which demonstrates that the total financial impact and financial risks are affordable and manageable by the Council over the longer term.

2.2.2 That the following Treasury Management Limits be approved:

i) That the authorised limit for external borrowing be increased to £807m

ii) That the operational boundary be increased to £777m

2.3 That the Council notes that the following urgent decisions have been taken by the Chief Executive in accordance with Standing Order 58 of the Council's Procedure Rules in order that advance treasury management preparations could be made for the transaction should the Council approve the acquisition:

i) That the investment counter party limit for Barclays Bank Plc has been temporarily increased to £100m

ii) That the sector limit for investments in money market funds has been temporarily increased to £104m.

2.4 Note that in approving the temporary changes to the treasury management limits, no obligation to acquire the property has been entered into and no long term financial liabilities have been incurred. The changes simply enable the Council to accumulate the necessary funding in a risk managed and cost efficient manner and have funds available should the transaction be approved, the risks are considered negligible.

3. Background

3.1 Subject to approval of the acquisition, suitable terms have been agreed between the owners of Lakeside North Harbour and the City Council to enable an acquisition of the 120 acre site (Appendix 1).

3.2 The City of Portsmouth is unusual in that almost its entire office market is located in a campus development (Lakeside) outside of the City Centre.

3.3 The Lakeside North Harbour Site was originally developed by IBM in the 1970's with the current owner purchasing the site in 2005 by way of a sale and leaseback arrangement. Since 2005 the owner has successfully developed the asset into the office led mixed-use campus that we see today.

3.4 The availability of refurbished offices at Lakeside, with on-site amenity, has proved to be an attractive option with Lakeside accommodating much of the office demand for the eastern M27. There is also very little available space within the city centre (largely due to change of use) and given the age of the stock (predominantly 1960's and 1970's) limited availability of any quality.

3.5 In the past Portsmouth has been less favoured than Southampton as an office location, but the success of Lakeside has changed that perception.

3.6 Lakeside North Harbour is now one of the key business parks in the South East and comprises circa;

- 120 acre site
- 590,000 square feet of office accommodation
- 3,000 parking spaces
- 8,505 square feet of retail
- A day nursery
- 153 bed village hotel
- Porsche Dealership
- 8.7 acres of development land

3.7 The opportunity for the City Council to acquire the Lakeside campus, is unique, and presents the Council with the opportunity to take control of one of the most strategically important sites in the City. The Lakeside campus' current use and its future are of strategic importance to the City and sub-regional local economy. Ownership of the site will enable the Council to directly support and influence its aims and objectives as set out in the emerging Portsmouth Economic and Regeneration Strategy.

3.8 As well as its economic importance the campus has become an important community in its own right, with frequent regional business events, its weekly park run and annual dragon boat race.

3.9 Acquiring the freehold of the Lakeside site will enable the Council to benefit from the revenue it generates, exercise control over the future use and development of the site, and thus directly influence the economic prosperity of the City.

3.10 An acquisition of this size has multiple layers of complexity and risk. A significant consultancy team to undertake the required due diligence has been established and deployed.

3.11 The due diligence process is following the tried and tested approached deployed successfully by the Council over the course of its investment fund asset purchases for the last few years.

3.12 Matters considered by the due diligence team include but are not limited to;

- Legal matters
  - Real estate - contracts, title, leases, tenancies, rights etc
  - Tax advice
  - Company - services, people
- Building matters
  - Building surveys

    - Specialist surveys - M&E, cladding, lifts, drainage
- Investment agency advice
- Environmental Assessment
- Planning status

3.13 The campus is running at a current occupancy rate of 94% and the acquisition will provide the Council with a robust, significant income stream secured against the 80 + occupiers, giving a good level of diversification. The largest tenant, IBM, accounts for 26% of the total rent payable and in aggregate, the 10 largest tenants account for 56% of the total rent payable.

3.14 Last year over 72,000 sqft of leasing transactions took place at Lakeside, with the strength of the park giving a good retention rate. Between 2016 and the end of 2018, 183,000 sqft was subject to breaks / expiries with only 37,671 sqft being vacated (80% retention rate).

3.15 A detailed cash flow model has been prepared, using data and assumptions that have been drawn out of the due diligence exercise, and advice from the Council's investment advisers Avison Young. Given the long-term hold nature of the property, several scenarios have been run alongside the "expected base case" which seek to alter the key financial drivers of the property which are most likely to impact on the overall financial viability. The scenario analysis illustrates the potential range of possible financial outcomes over the period and therefore is an illustration of the likely level of financial risk that the acquisition of this property would involve. It is important to note that the fundamental assumption underpinning these cash flow scenarios is that the property will be operated and managed on commercial market terms over its whole life (as described below).

3.16 In brief the financial model assumes a 35 year life, and gives consideration to;

- Tenants - income, lettings, incentives
- On-going revenue costs - management, service charge, non-recoverable costs such as landlords maintenance obligations, empty property rates and service charge voids
- Funding costs
- Capital works - refurbishment works etc
- Future development opportunities

3.17 The model assumes that the asset is continued to be managed as a commercial entity maintaining its unique brand identity. This is of vital importance to ensure that the asset continues to perform to provide services to the existing tenants and continue to attract new occupiers moving forward on a sound commercial footing. This mirrors the principles applied to the management of the Council's National Property Investment Fund assets.

3.18 Lakeside Business Park is allocated in the adopted Portsmouth Plan (policy PCS5) as an office campus providing 69,000 sq m of Class B1a office floorspace, in line with an outline planning consent 08/02342/OUT. The Council is currently bringing forward a new Local Plan which will address new evidence on development needs and changes in planning policy. In response to the Council's *Issues and Options* Local Plan consultation in 2017 the current owners stated the continuation of the existing site allocation at Lakeside does not reflect the changes that have occurred in the office market since the outline permission was granted in 2010, and sought greater flexibility. The Council's initial response at the time was that the planning approach to the whole of the Lakeside site is being reviewed in this new Local Plan.

3.19 Work on the new Local Plan is on-going. At present, subject to consideration of further evidence, testing and consultation, it is likely that the new Local Plan will seek to ensure Lakeside remains a key employment site for the city and the wider area, while being more flexible over land uses.

3.20 In order to take on the management of such a significant asset a relationship will be established with a series of Facilities Management (FM) providers under an Estates Management contract with a third party.

4. Reasons for Recommendations

4.1 Sections 3.7, 3.8, and 3.9 above give the reasons for recommendation 2.1

4.2 In relation to recommendation 2.2.2 - the authorised limit for external debt is the maximum amount of debt which the authority may legally have outstanding at any time. When the Authorised Limit was set as part of the Treasury Management Policy in March it included headroom to enable the Council to take advantage of unexpected movements in interest rates and to accommodate any short-term debt or unusual cash movements that could arise during the year. At that time an acquisition of this size financed by borrowing was not foreseen. It is therefore necessary to increase the authorised limit by £70m from £737m to £807m in order to accommodate unexpected cash flows and to maintain the flexibility to borrow to fund the capital programme should it be opportune to do so. It should be noted that the increase in the authorised limit is not the acquisition price for the property, it is simply the uplift in the borrowing limit required taking into account many other factors including changes in assumptions relating to other planned borrowings.

4.3 In relation to recommendation 2.2.2 - the Operational Boundary is based on the probable external debt during the course of the year. It is not a limit, but acts as a warning mechanism to prevent the authorised limit (above) being breached. In order to enable the operational boundary to continue to act as an effective warning mechanism, it needs to be increased in line with the authorised limit for external debt by £70m from £707m to £777m.

4.4 In relation to recommendation 2.2.3 - the Council can arrange for the borrowed funds to arrive into the Council's bank account on the same day that they are transmitted to the vendor. However, it may be possible to borrow more cheaply before the day of the transaction. Similarly it may also be possible to sell tradable investments before the day of the transaction in order to reduce the borrowing requirement in the short term. Either of these actions would result in the Council having to hold additional cash in the very short term on an instant access basis. In order to accommodate this the investment counter party limit for the Council's principal banker, Barclays, and the sector limit for investments in money market funds have been temporarily increased until the completion of the transaction or a decision not to proceed has been taken. These limits have been increased by way of an urgent decision taken by the Chief Executive in accordance with Standing Order 58 of the Council's Procedure Rules.

4.5 The investment counter party limit for Barclays Bank Plc has been temporarily increased to £100m. The Council's Treasury Management Policy places a limit on each investment counter party (apart from the UK Government) in order to prevent an over concentration of risk should there be a default. However, the risk posed by increasing the counter party investment limit of a highly rated bank for less than a month will be negligible. Barclays Bank Plc is rated A / A2 with a stable outlook by S&P and Moody's. "A" ratings denote expectations of low default risk. The capacity for payment of financial commitments is considered strong. Fitch credit rating agency have rated Barclays Bank Plc A+ but placed it on negative watch. This means that Fitch could affirm the current rating or potentially downgrade their rating within the next six months. It is also possible to measure credit quality through credit default swap (CDS) prices. These are insurance policies against a counter party defaulting. CDS prices do not provide the in depth analysis of a credit rating, but being a market price, they are much more current than credit ratings. The current CDS price of Barclays Bank Plc is in line with its credit rating.

4.6 Money market funds offer security and same day access. As such they are very useful for holding cash which could be required immediately. By aggregating investments they can also invest in financial institutions that may not be interested in the relatively small sums that the Council can invest alone. Although money market funds are well diversified in their investments, there is a risk that more than one fund could have investments with the same bank or that the Council may also have invested funds in the same bank as a money market fund. Therefore the Council's Treasury Management Policy limits overall investments in money market funds to £80m. It is recommended that the sector limit for investments in money market funds be temporarily increased to £104m until the completion of the transaction or a decision not to proceed is taken. The money market funds used by the Council have an AAA credit rating, the highest credit rating, from all three major credit rating agencies and the risk posed by increasing the counter party investment limit of a highly rated bank for less than a month will be negligible.

5. Equality impact assessment

5.1 A preliminary EIA assessment has been undertaken for this project and it has been deemed that a full EIA is not required.

6. Legal implications

6.1 The acquisition of Lakeside North Harbour is within the range of powers available to the authority to purchase land. It is within the general power of competency subject to the financial constraints alluded to in paragraphs 4.2 and 4.6 of this report being complied with.

6.2 An external legal firm has been appointed to deal with the acquisition due to the scale and complexity of the acquisition.

7. Director of Finance's Comments

7.1 The acquisition of Lakeside North Harbour is considered to be a strategic acquisition for the longer-term. The primary aim of the acquisition is to support the Council's regeneration aspirations and to help shape the future development across the entire City. Nevertheless, the acquisition of such a substantial asset is conditional on the property generating a reasonable financial return that is sufficient to guard against a range of financial risks that could reasonably arise. In order to understand and mitigate against any risks, a comprehensive due diligence exercise is under way and will need to be completed satisfactorily.

7.2 The purchase price of the property is substantially in excess of £100m but is subject to a Non-Disclosure Agreement that will remain in place until such time as the acquisition is completed. Furthermore, the actual purchase price will not be finally determined until all of the due diligence is satisfactorily completed. Once the transaction has completed, the purchase price will be made publicly available.

7.3 The overall 35 year financial appraisal will not be able to be finalised until the due diligence has been complete which is expected to conclude after the date of the Council meeting of 17the June 2019 and be on or around 21st June 2019 for a completion on 24th June 2019. It is recommended that any decision by the Council to acquire Lakeside North Harbour is subject to satisfactory completion of the due diligence and the subsequent finalisation of a financial appraisal approved by the Director of Finance & S.151 Officer which demonstrates that the total financial impact and financial risks are affordable and manageable by the Council over the longer term.

7.4 At this stage of due diligence, it is expected that the acquisition of Lakeside North Harbour will generate an overall financial return of £22m in cash terms over the 35 year period after taking account of all income received less all maintenance and borrowing costs. In today's value (after discounting the effects on inflation) the overall financial return is estimated to be £14m.

7.5 There are a number of key assumptions underpinning the expected financial return which are described below, the assumptions are considered to be prudent and represent a cautious expected case (i.e the "Base Case"):

- An economic life of the buildings on the site ranging up to 35 years (and borrowing is undertaken over the same period in order to match rental income streams with debt repayments and ensure that once the asset is at the end of its life there is no further ongoing debt repayments)
- Rental income growth of 1% per annum
- A 94% Occupancy Rate
- Landlords repair costs according to detailed surveys arising from the due diligence exercise
- Provision for the loss of some key rental income streams in accordance with when buildings become are expected to become life expired and then the sale of the footprint of those buildings

7.6 Given the variable nature of the key assumptions which are the key drivers of financial return and the 35 year period over which those assumptions have the prospect of change, a number of more pessimistic scenarios have been modelled in order to quantify the likely rage of financial returns that could reasonably be expected to occur in a more pessimistic environment. The "Base Case" (described above) and the alternative more cautious scenarios are summarised below:

Scenario	Description	Financial Return (Cash)	Financial Return (At today's value)
Base Case	94% Occupancy plus expected repairs	£22m	£14m
Scenario 1	90% Occupancy	£12m	£7m
Scenario 2	85% Occupancy	£1m	£0m
Scenario 3	94 % Occupancy and repairs costs +5% higher p.a	£18m	£12m
Scenario 4	94% Occupancy and repairs costs +10% higher p.a	£2m	£3m

7.7 The range of scenarios above illustrate that across a likely range of potential cautious financial scenarios, the overall financial impact is expected to be better than break-even, with the central assumption of the "base case" making a £14m return. Should the Council approve the acquisition of the property, it is recommended that it is financed from prudential borrowing.

7.8 There is also the possibility of a more positive environment with associated optimistic scenarios. Whilst not modelled, included within a range of realistic scenarios, the following could be included:

- Higher than 1% p.a growth in occupational rents
- Higher occupancy rates
- Increase lives of the buildings yielding rents for longer periods than modelled

- Development of under-utilised areas of the site
- Re-development of the buildings (once life-expired) for uses that deliver financial returns greater than those modelled (i.e. sale of the building footprint)

7.9 The financial risks centre around the ability for the properties rental income streams, less any landlords maintenance repair obligations, to be sufficient to cover the borrowing costs over a 35 year period. The scenario analyses demonstrate in a range of cautious to pessimistic scenarios that the overall financial impact is likely to be break-even or better. Worse case scenarios are possible but there are strong risk mitigation features of this property that provide protection for the Council. Of particular importance is the flexibility of the site and its longer term development options as well as its likely continued demand for the site given its access and proximity to the strategic road network.

7.10 Whilst the acquisition is underpinned by borrowing and therefore a long term debt liability, it has been undertaken through the Prudential Borrowing Framework. That framework is designed to meet the tests of Affordability, Sustainability and Prudence. In essence all such borrowing is on the basis that it is for "Invest to Save" purposes where the income streams derived from that borrowing are relatively strong (to cover the annual debt repayments) and where the underpinning asset investment has a value that is aligned with the amount of outstanding debt over its lifetime (to allow the flexibility to sell in the event that the Council wishes to reduce its level of outstanding debt). This approach is consistent and similar to the majority of all of the Council's circa. £700m long term borrowing described in the body of the report.

7.11 In order to facilitate the acquisition and transaction, four of the Council's Treasury Management Limits will need to be increased. Two of those limits only need to be increased temporarily in order to amass the funds necessary in instant access accounts to then be able to make the transaction. The other two limits relate to a permanent increase in the Council's borrowing limits.

7.12 The temporary increases to limits in order to hold the necessary funds in instant access facilities to make the transaction have been approved by the Chief Executive under Standing Order 58 of the Council's Procedure Rules, the risk is negligible.

7.13 The permanent increases in the Council's borrowing limits are necessary for the Council to finance the acquisition and, as previously described, the increase in the Council's debt will be underpinned by an asset with a similar value to the debt as well as strong future income streams to cover future borrowing repayments.

………………………………………………
Signed by:

Appendices:

Appendix 1 - Site Plan

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by ……………………………… on ………………………………

………………………………………………
Signed by: