Part A

Report to: Cabinet 21 January 2019
Council 23 January 2019

Date of meeting: 23 January 2019

Report author: Managing Director

Title: Acquisition of Leasehold Interest in Croxley Business Park

1.0 **Summary**

1.1 An opportunity has been presented to Watford Borough Council by investment fund Columbia Threadneedle Investments (CTi) to acquire a 40 year head lease in their asset at Croxley Business Park (The Park). The proposal has been structured as an "income strip" deal and the Council will have the option to acquire the freehold of the Park at the end of the term for £10. CTi is a leading global asset manager (website reference http://www.columbiathreadneedle.com/en/about-us/) managing $485b of investment for institution and retail clients.

1.2 Under the proposal the Council will be entitled to receive the full passing rental income from occupational tenants on the Park in return for paying a rent of £9.2m per annum to CTi which will be indexed linked to RPI subject to a collar of 2% and a cap of 4%. The Council will in addition to retaining the profit rent be responsible for rental risk and all planned and preventative maintenance (PPM).

1.3 CTi will also make a payment to the Council of £88m to cover rent top up and Planned and Preventative Maintenance. This payment is broken down as follows, £20m of this sum represents a rent top up for the first three years to cover any rent free periods on occupational leases whilst the balance £68m of the sum is set aside to be used for planned and preventative maintenance over the term of the proposed lease which will become the Council's responsibility going forward. This funding will be required in later years so will be invested to generate returns for the Council in the interim period.

1.4 The Park is a key economic driver in the region, the majority of the Park is located in Three Rivers District Council's area with part being located within Watford.

1.5 The Park is one of the UK's premier office parks, is in single ownership, and comprises some 510,000 sq ft of office accommodation and 189,208 sq ft of industrial accommodation in a high quality parkland environment. The Park also includes a generous number of car parking spaces totalling 2,772 a ratio of 1:251 sq ft which is higher than normal for a south east business park. Numerous

international, national and regional firms have a presence in the Park which employs 2,500 people in quality jobs and supports the wider local supply chains.

1.6 CTi will additionally pay for the construction of a new 85,000 sq ft office building which will commence construction in the first quarter of 2019 which will offer the Council an opportunity to generate further income. Due diligence is being undertaken on the building contract to assess the risk of cost overrun and where the responsibility for those risks lie. CTi have put £4m into escrow to cover the risk of cost overrun and also have secured a fixed price building contract. Due diligence is also being undertaken on the procurement implications.

1.7 CTi will pay for Stamp Duty Land Tax payable by the Council associated with this transaction which equates to circa £5m.

1.8 The Council has been advised on the transaction by Lambert Smith Hampton (LSH) on the property acquisition, Grant Thornton (GT) on the financial aspects and Trowers and Hamlin LLP (Trowers) on the legal considerations.

2.0 **Risks**

2.1 The table below highlights the key risks associated with the proposal. A more detailed discussion of risk is contained within the relevant sections of the report and in the Part B report which should be read with this report.

Nature of risk	**Consequence**	**Suggested Control Measures**	**Response** (treat, tolerate, terminate or transfer)	**Risk Rating** (combination of severity and likelihood)
RPI is above that included in the financial model	The amount paid over to CTi is in excess of the amount included in the financial model and could lead to a smaller return to the Council.	The financial model has included a figure for RPI, based on current projections. The proposal has RPI capped at 4% and this limits the Council's exposure, and a maximum figure will be known. In addition the tenants leases should also increase if indexation is above that forecast, so this will in part mitigate the impact.	Tolerate	8

		Active monitoring of future indexation rates should help to mitigate the impact of this risk.		
Anticipated rental growth is lower than thought	The rental income is less than anticipated.	Sensitivity analysis has been carried out to anticipate changes. See the financial section. The financial position of the Park will be monitored and managed on a regular basis to ensure the impacts are known and managed.	Treat	8
Voids are greater than anticipated.	Income is less than anticipated and void costs are greater than planned.	Active Asset Management to be put in place to manage risk including a letting strategy which will be regularly reviewed.	Treat	8
A tenant goes into administration	A lower rental, or no rental and service charge income received.	A review of new tenants should highlight any new issues and active management of tenancies would help to mitigate this situation.	Treat	8
Interest on the reserve fund is less than forecast.	A lower interest rate on the reserve fund would generate less income.	A new investment strategy will be put in place to actively manage the reserve fund to ensure that the best returns can be achieved. This will be regularly reviewed to ensure that investments are still appropriate.	Treat	8

Demand for office and industrial accommodation reduces.	A structural change in demand for office/industrial accommodation resulting in a shortfall between head rent paid and rent collected.	The strength of office demand has been reviewed in detail in the short to medium term by our property advisers and officers are satisfied that there will continue to be a demand. The agreement with CTi allows for change of use other than office or industrial uses in certain circumstances.	Treat	8

3.0 Alternative Options

3.1 Cabinet will be aware of the Budget Report on the same agenda. This shows currently a budget gap of circa £1.5 M pa over the MTFS period. It is not necessary for the Council to enter into this transaction to address the budget gap. The gap could be managed by a full cost review, reducing expenditure on non-statutory services and in particular by cutting the capital programme on discretionary schemes such as Woodside, Watford Business Park, the Town Hall redevelopment, transport initiatives and reducing partnership funding into the Council's joint ventures. The impact of this would be to reduce the corresponding revenue spend and the costs of borrowing. This approach is not recommended as it would generate short term MTFS benefits but disadvantage the Council in terms of the longer term investment returns from capital schemes or would impact the infrastructure priorities identified by the Mayor as critical in supporting the town's growth.

3.2 Cabinet alternatively could decide not to undertake this transaction and instead, borrow circa £220m to acquire an asset that would generate an equivalent net income of £1.5m - £2m a year. However making minimum revenue provision and funding the costs of repayment are both revenue calls and it would prove challenging to find the right asset at the right cost. CTi were not, for example, willing to sell the freehold of the Park to the Council. The Property Investment Board has been recycling assets into higher yield investments but it has reached a point whereby major asset sales (such as intu) would be required to fund any significant new investment.

3.3 The advantage of the transaction with CTi is that there is no borrowing or upfront capital contribution necessary for the Council albeit it takes on a substantial head

lease rent commitment and takes the inflation and occupier risk. Risk is mitigated by the £88m top up fund and the asset management strategies the Council can take. Whilst there is the downside risk, LSH have made clear that their assumptions are cautious so there is also an upside potential. These sensitivities have been modelled by GT.

4.0 Further points for consideration

4.1 The legal advice below draws attention to the Council's fiduciary duties. Proper consideration has to be given to the risks & rewards of the transaction as set out in the reports from GT & LSH. The return on investment over the 40 year lease has been extensively modelled by GT and their financial model estimates a cash positive transaction over the life of the lease which is proportionate to the risks. Risk mitigation is also clearly set out in the Part B report in light of the sensitivity testing on financial and market variations. In addition the legal advice states that the Council owning and operating a leasehold interest in a business park is, in state aid terms, economic activity and is permitted providing the Council acquires and operates the business park on terms which would be acceptable to a private sector owner, acting as a private sector operator would. Officers are recommending the appointment of CTi to manage the asset on this basis.

4.2 Notwithstanding that, on the terms the Council has achieved, LSH have advised that '*Because of the relatively unique nature of this investment we have carefully considered the value of the proposition to CTi. As far as possible we have tried to ensure that the return they receive is not excessive when considered against the risk (for them). Relevant factors include:*

1. *Investment yield for 40 year annuity type income.*
2. *Potential for inflation to deviate outside of the collar and cap (to the detriment of CTi).*
3. *Proposed top-up fund.*

Analysing the proposed transaction from a liquidity or wider market perspective is in this instance not relevant because the asset in question is not liquid.'

4.3 LSH also make clear that the Park is a unique asset '*While business parks have shown that they can adapt and refresh their offer, it's unlikely we will see the development of any new schemes for the foreseeable future, owing to the high upfront infrastructure costs and tighter car parking standards, even when the current downturn is behind us.*

4.4 The Council is unlikely to find an alternative regeneration opportunity of this scale and quality to support its economic objectives.

4.5 Chapman Petrie LLP, independent surveyors were appointed by LSH to validate their assumptions. They have concluded that:

- *'We have considered the Park as a whole at both micro and macro levels and have concluded that the Park, as it presents itself today, represents a sound and potentially value accretive investment (despite the leasehold tenure of the proposed agreement it will ultimately become a freehold investment in due course).*

- *The Park as it stands today is performing at a level that is above that achieved through the entire lifecycle of the asset. Income received is at record levels and the Park has benefitted enormously from a healthy programme of capital investment in both the built real estate and through pressing income management.*

- *We have in conjunction with LSH reviewed all of the cash flow inputs in terms of ERV, letting voids, rent free assumptions and professional fees. We can confirm at this stage that we are in complete agreement with the assumptions made and that they are generally conservative which we feel is appropriate in this instance. In practice the void situation will evolve in a far more varied fashion, but the assumptions included take this into account and represent a fair average of past, current and likely future trends.*

- *It is our understanding that the cash flow appraisal is only capable of producing the required level of return when the capital contribution from CTi is fully included. With this in mind it is essential that the Council take appropriate steps to ring-fence this capital in order that it may be made available at any given time. It is impossible to forecast precisely when particularly large items of capital expenditure will be required and so it is imperative that these funds remain liquid and available.*

- *In summary we are supportive of the proposed transaction subject to the recommendations and guidance set out in this report. '*

5.0 **Recommendations**

5.1 To recommend to Council entering into a 40 year lease on the Park with CTi including the option of acquiring the freehold of the Park at the end of the lease term for £10 on the terms set out in this report, and in particular as specified within the various legal agreements (Part B) including:

5.1.1 – the summary of the Agreement for Lease
5.1.2 – the summary of the Head Lease Agreement
5.1.3 – the summary of the Asset Management Agreement

5.2 To recommend to Council that the starting assumption should be to withdraw £1.5m pa to support the Council's budget in Years 1-10, reducing to £1m inflated thereafter until year 35, noting that the financial model would enable the Council to withdraw up to £2m pa over the first ten years if required.

5.3 To recommend to Council that the Managing Director be given delegated authority in consultation with the Mayor to give final approval to the terms of the transaction.

5.4 To APPROVE the appointment of Threadneedle Portfolio Services Limited (TPSL) as Asset Managers and Workman LLP as Facility Managers as set out in the Park Management Agreements subject to 5.3 above to provide asset management continuity for a maximum period of 5 years during which period a full procurement process would then take place.

5.5 To APPROVE the appointment of Grant Thornton as the Council's financial advisers.

5.6 To Recommend to Council a budget of £300,000 for the procurement of professional advice relating to this transaction.

5.7 To recommend to Council that the existing advisory board to the Mayor, the Property Investment Board chaired by the Portfolio Holder for Housing & Property, provides oversight of the governance, business plan and performance of the Park, with an annual report to Cabinet and Budget Panel and also has oversight over the use of the £88m top up fund and that the terms of reference of the Property Investment Board be amended accordingly.

5.8. To recommend to Council, noting that the reserve fund is earmarked specifically to mitigate risk within the proposal, that the Director of Finance be authorised to make appropriate investment of the top up fund of £88m in accordance with the financial model, providing the right balance between security, liquidity and yield, based on advice from the Council's investment manager and amend the Treasury Management Policy accordingly.

5.9 To recommend to Council the Council's Capital Strategy be amended for the impact of this transaction on the operational boundary and authorised limit. That the:

- Council's operational boundary be £194M
- Council's authorised limit be £209M.

5.10 To NOTE the risks and mitigation strategies that will be put in place.

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6.0 **Detailed proposal**

6.1 A unique opportunity has been presented to the Council to take a 40 year head lease of the Park and to acquire the freehold of the asset at the end of the term for £10. A plan of the Park is attached in Appendix 1.

6.2 The Park adjoins and compliments the Western Gateway core policy area and the 67 acre Watford Business Park which the Council owns the freehold of. The Park sits in 75 acre parkland and the space provided includes 510,000 sq. ft. of office accommodation with a further 85,000 sq. ft. to be built and funded by CTi in 2019, 189,000 sq. ft. of industrial space. Additional amenity space comprising circa 15,000 sq. ft. will be provided and funded by CTi in 2019, this space will provide a gym, café and meeting space for 200 people which will aid in tenant attraction and retention as well as being a useful facility to have on the site.

6.3 The office accommodation that dominates the Park is provided in 9 standalone buildings which are let to a variety of tenants. Most buildings contain multi-let tenants apart from one. The Park is home to around 60 businesses including corporate occupiers such as Smith & Nephew, Kodak, Howden Joinery, Medtronic, Corona Energy and Glenmark Pharmaceuticals.

6.4 The industrial accommodation consists of industrial warehouse accommodation totalling 189,000 sq. ft. and is contained in four separate blocks and split into 25units the majority of which are under 8,000 sq. ft.

6.5 As part of the Council's consideration a two stage due diligence exercise was undertaken. The first stage reviewed the deal structure and key elements of the proposal whilst the second went into a more granular level of detail. This two stage process resulted in re-negotiating with CTi the original Heads of Term. A reduced rent to be guaranteed from £9.5m to £9.2m pa was agreed and the overall capital contributions was increased by CTi to deal with voids and PPM , the extra funding increased from £75m to £88m.

6.6 Informing the above process a detailed due diligence exercise has been undertaken by the following consultants who are experts in their field:-

Legal Advice

- Trowers and Hamlin LLP- the scope of this brief included general due diligence, procurement, and governance advice, and finalising the property and construction documentation.

Property Advice

- Lambert Smith Hampton Investment Management (LSH) - Including, market and letting advice and coordinating bespoke due diligence on specific areas of the proposals. LSH are also the Council's investment property advisors and asset manage the present investment portfolio.

- Montague Evans- service charge analysis focusing on appropriate market supportable levels of service charge, likely voids and elements of service charge that might be unrecoverable through tenant default and legal challenge. Inputs from these findings have been included into Grant Thornton's financial model.

- Lambert Smith Hampton Building Services- this worked focussed on Planned and Preventative Maintenance, building surveys and life cycle studies of the buildings taking into account non recoverable dilapidation amounts and the general economic life of the buildings. The findings and assumptions were used in the financial model.

The property advisors have been working closely with our financial advisors on the appropriate assumptions to input into the financial model.

Financial advice

- Grant Thornton (GT) – the development of a financial model, undertaking sensitivity testing and providing accounting and tax advice on the proposals.
- Link Asset Services – Have given advice on Treasury Management

6.7 In addition a meeting with the Council's external auditors, Ernst Young, was held on 13th November 2018 where the structure of the deal was discussed. They were made aware of the proposed deal and the timeframes for the decision. The Council has taken account of the discussion which focussed around the governance of the decision making process. They have also been updated on the final proposals.

In assessing the assumptions to use for the financial model, RPI, Rental growth, Letting incentives, Voids, Tenant break clauses, PPM/Life cycle costs and Service charge costs have all been prudently forecast based on detailed research of historic, present and future trends from a variety of third party sources.
A number of different scenarios have also been stress tested to take account of variances in the economy.

Regeneration and Planning Context

6.8 The Local Plan, (Part 1, Core Strategy) 2006 – 31, adopted in 2013 sets out objectives for the development of Watford. Strategic Objective No. 3 is to enhance Watford's strategic economic and transportation role, highlighting the significance of its major transport interchange and how this helps promote sustainable development and regeneration. It envisages improvements to the quality and diversity of employment space across the borough. The Core Strategy's objectives for economic development and employment are to:

- Enhance the town's economic prosperity and potential by supporting business investment, learning and job creation, in accessible and sustainable locations.

- Ensure a range of premises are provided to meet the modern business needs of the local economy, including for small and medium sized enterprises (SMEs) and the area's existing and potential new economic clusters.

6.9 Watford plays a key sub-regional role in servicing approximately 500,000 people with 5,000,000 people within 45-minute travel time. It needs to maintain a prime position in servicing and complementing the economy of London, to maintain its capacity to accommodate and foster important, high value industries and to capitalise on the opportunity to accommodate supply chain activities associated with Leavesden and Elstree. The Watford Borough Council Monitoring Report for 2018 suggests that job growth in Watford could be as much as 21,900 for the period 2006 - 2031. Employment rose in Watford by 15,100 jobs alone between 2015-17 (Source: BRES). A further 9,520 new jobs are projected to arise from the borough's major development schemes (Watford Riverwell, Watford Junction, town centre regeneration Cassiobridge and Watford Business Park regeneration). Together, these opportunities can be expected to bring about a significant expansion of the Watford economy but with it a growing demand for employment floorspace.

6.10 Watford has had the highest annual average take up of offices within Hertfordshire, averaging at around 17,000 m² per annum between 2008-17. Given that office rental growth has been amongst the highest in Watford (reaching £24.26 psf in 2017 against £19.48 psf in 2009), it should be noted that Watford is one of the only districts in Hertfordshire in which office development remains viable given that other districts have rental levels which are too low.

Shortages of Employment Space

6.11 There is a lack of supply and very limited new development of office space. Watford now has a mere nine months' supply, against an average of 1.4 years across Hertfordshire. There has been very limited development since 2009 in Watford other than around 3,500 sq. m. in 2018. This is been exacerbated by a loss of office stock. Since 2006, there has been a net loss of 85,374sqm of employment floor space with the largest being losses in the B1a (Office) (Source Watford's AMR 2018).

6.12 Watford also has amongst the lowest supply of industrial space of all Hertfordshire districts at under 10,000 m². Vacancy is now at a record low with shortages of supply becoming critical at under six months' supply. Most of the industrial stock available is second-hand with minimal supply of Grade A space and there is virtually no development in Watford currently taking place. Of 24,657 m² of industrial floor space since 2008, 5424 m² has been lost to residential uses. (Source: LSH)

6.13 SMEs in Watford do not have access to Grade A stock as this tends to be available in the larger units and they therefore have to make do with the Grade B/C premises. Growing businesses are struggling to find the space they need to expand whilst existing businesses that want to remain in Watford are having to operate within outdated premises whose costs are rising.

6.14 Without intervention to reverse this trend, negative consequences may ensue. The attraction of future inward investment will be constrained; expansions of many growing businesses will not take place; some growing businesses may move out of the area leading to job losses and personal disruption; vacant space may be re-occupied by lower grade uses; and pressures may continue for change of use from employment to housing.

6.15 In terms of the limited office and industrial floorspace in the Watford area, it is clear that the supply chain is currently below the needs for a healthy market across all quality and size requirements. There will be clear benefits to the broader Watford economy, SW Herts & wider if the Council acquires the Park. Indeed the County has set up a growth board, the terms of reference of which are included at Appendix 2.

6.16 The safeguarding of employment and regeneration of employment space as a result of the Council making the acquisition would strongly support the growth board agenda.

6.17 The Revised NPPF 2018 (paras 8A and 80) requires planning policies to positively and proactively support sustainable economic development and regeneration. The WBC Core Strategy (2013) Western Gateway Policy SPA6 objective seeks to deliver redevelopment that improves and upgrades this area from an economic development and environmental perspective. The TRDC Core Strategy (2011) Policy

CP6 Employment and Economic Development specifically identifies the Park as a key Employment Location. To help meet these objectives, long term regeneration will be necessary similar to those being planned for the Watford Business Park which would also help to optimise the site and provide more modern floorspace for businesses. The synergy with Watford Business Park is very important as it would allow the Council to balance commercial and office space across the two sites, allowing for appropriate development and relocations to maximise growth and investment returns.

Adapting to Patterns of Long-Term Change

6.18 In parallel, there is a need to consider future changes of an economic, technological, spatial and logistical nature likely to affect Watford over the coming decades. There is likely to be a continued shift in demand for locations with strategic rail access such as Watford as continued growth in road traffic increases congestion and travelling times. Continued growth of London as a global financial centre can be expected and with it and associated dependence on satellite locations like Watford for support activities. There is a need to maintain a lead in emerging sectors such as 5G telecommunications, the internet of things, big data applications, new health technologies, and steady increases in high value manufacturing. There will be a need to address new logistical challenges associated with electric, driverless cars, associated traffic systems, smart city development and related monitoring systems.

6.19 Taken together, the above challenges call for a strategic and comprehensive approach to the management and redevelopment of commercial property in Watford, where possible. This is necessary to address the severe mismatch of employment space with demand, in terms of quantity, type and quality and the need to adapt to changing operational patterns of office and industrial tenants in line with market, technological and logistical changes. To effectively address these challenges, two key conditions will need to be addressed.

a) An adequate supply of high quality commercial and industrial space suitable for meeting demand from existing businesses including SMEs and from emerging industries.

b) The conditions for adapting provision of employment space to amplify supply and to address future operational needs driven by the introduction of new technologies and future operational and logistical patterns.

6.20 Taking over control of the Park enables WBC to acquire a scarce property resource of critical importance to addressing employment space shortages and in meeting the demands from ongoing economic growth demands and future changes to operational patterns.

6.21 The Park will add to the supply of employment space through development of a new 85,000 sq. ft. office building and car park due to for completion in 2019 and planning consents achieved for a 350,000 sq. ft. office campus and for c.15,000 sq. ft. for new-build industrial units to achieve premium rents. In addition, the project will enable the types intervention needed to meet the above conditions. It will be possible for the Council to implement appropriate regeneration initiatives within the Park, control its on-going development and future adaptation that may be necessary to meet future operating requirements. This will bring about a number of key advantages.

- Unconstrained ability to recycle, refurbish or redevelop vacant existing stock.
- Opportunities to intensify development in order to enhance floorspace supply.
- Ability to install advanced urban infrastructure on the Park (e.g. for driverless cars).
- Enabling comprehensive redevelopment of parts of the Park if required in the future.
- Encouraging and accommodating further investment in Watford by being ready to adapt to changing market requirements through appropriate future proofing.

6.22 Overall the transaction addresses the shortages of scarce land and employment space in and around the borough. It would be a major regeneration driver with scope for intensification and thereby increasing the amount of employment space available whilst providing adequately for emerging industries and future operating patterns. These will be conducive to enhanced investor confidence and the future competitiveness and vibrancy of the Watford local economy.

7.0 Legal Powers

7.1 Trowers have provided advice to the Council in relation to the Council managing the legal risks of entering into this transaction. They together with Fenella Morris QC have also provided advice in relation to the Council's powers to acquire and operate the Park.

8.0 Financial Appraisal

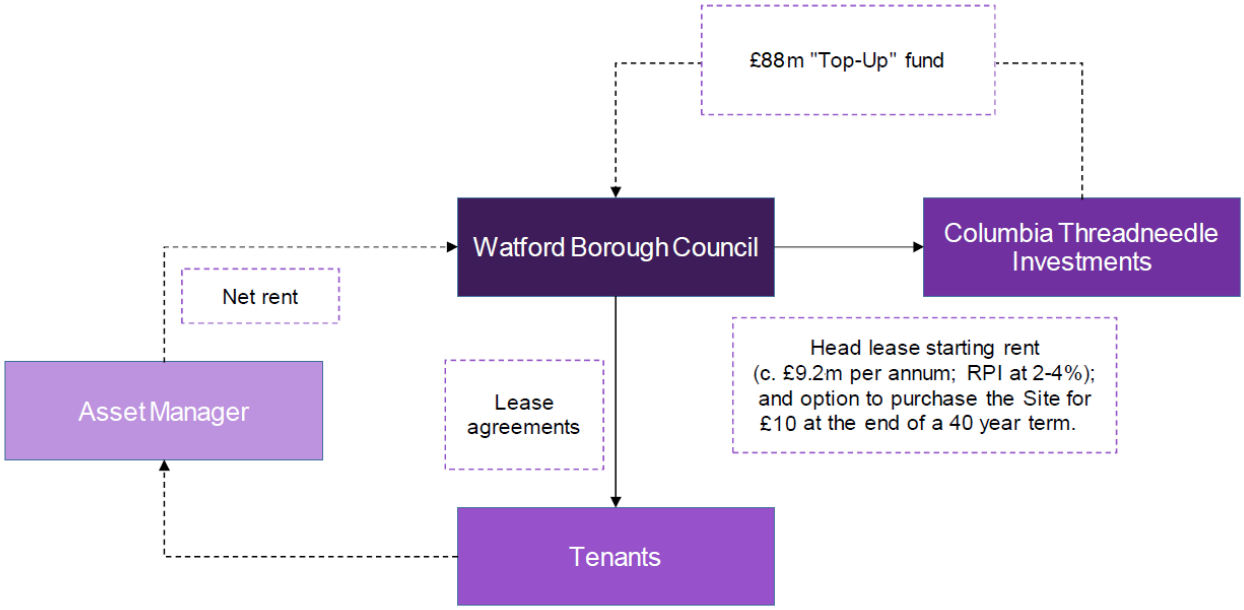
8.1 The Council has been advised by GT throughout the project to date. Their financial modelling work relies heavily on the work of LSH in providing the property inputs into the financial model. GT were have been engaged to:

- review the Transaction structure;
- carry out a financial appraisal using revised input assumptions provided by LSH and the Council to support the full financial business case;
- comment on whether the financial appraisal outputs pass the investment criteria set by the Council;
- comment on how the Council may finance lifecycle expenditure as forecasted in the final years of the Transaction;
- undertake an assessment of the financial model from a VAT perspective and provide confirmation of the appropriate VAT assumptions that should be incorporated into the model; and
- undertake an assessment of the accounting considerations for the Council of the Transaction structure.

8.2 GT's work has been carried out in stages. Stage 1 was to carry out an initial assessment of the proposed deal as part of the initial feasibility process prior to starting detailed due diligence. Stage 1a re-ran the model as required during negotiations with CTi and Stage 2 consisted of the final report following detailed due diligence. The Stage 2 report is included in the Part B report

9.0 Transaction Structure

9.1 The diagram below illustrates the structure of the proposal.



From a financial perspective the deal contains two main components the head lease between the Council and CTi and the operation of the Park with sub leases between the Council and the business park tenants. On entering the lease CTi will pay over to the Council £88M in cash to fund projected shortfalls in rent (top up) and money for PPM to help mitigate the risks within the transaction.

9.2 The head lease is between the Council and CTi for the business park for a period of 40 years, on an annual rental of £9.2 M to increase annually by RPI with a collar of 2% and cap of 4%, with an option to purchase at the end of the 40 year term for £10. The collar and cap mean that the rental will increase annually by at least 2% but not more than 4%. It is assumed in the financial appraisal that the Council will exercise the option to buy the Park at the end of the lease period. The head lease places stringent requirements on the Council in respect of planned programmed maintenance which means that the condition of the Park will be maintained throughout the period of the lease. As a result the asset that the Council receives at the end of the lease period will have the same service potential as the asset at the beginning of the lease.

10.0 Accounting and Financing Implications

10.1 The head lease with CTi will be a finance lease. This will have the impact of the asset appearing on the Council's balance sheet as a 'right of use' asset along with a corresponding liability in respect of the finance lease outstanding. The value of the asset, and corresponding liability, is calculated using the NPV of the expected lease payments; in this case the base rental increased by the 2% collar on inflation plus £10 at the end of the lease to purchase the asset as it is assumed that the Council will exercise the option to purchase. This is equivalent to £241.7M

10.2 There are a number of implications arising from the finance lease:

- The finance lease will be counted as borrowing for the purposes of the Prudential Code and will increase the Council's authorised and operational borrowing limit.

- The Council will be required to make minimum revenue provision (MRP) against the outstanding finance lease obligation.

- Interest will be charged to the Council's revenue account equal to the difference between the payment under the finance lease and the MRP chargeable on a straight line basis over the length of the lease.

- The Council in line with its MRP policy set out in the Capital Strategy will charge MRP to its General Fund each year dependant on the life of the underlying asset. In this case a period of 50 years has been used in line with the maximum period allowed by regulations.

10.3 The subleases granted to tenants and operating expenditure of the Park will be credited/debited to the revenue accounts in the same way as the Council's investment properties. In addition interest will be credited directly to the reserve fund to ensure that the value is maintained and the integrity of the financial model maintained.

11.0 Implications for the Capital Strategy

11.1 The Council's Capital Strategy governs the Council's investment in assets. The acquisition of the Park is in line with the authority's capital strategy which requires the development of a full business case and appropriate external professional advice has been taken.

11.2 As the head lease will constitute a finance lease this will count as borrowing for the purpose of the Prudential Code. As a result of the proposal the Council's Capital

Financing Requirement (CFR) will increase by £241.7M. This increase in CFR will be reduced over time by the amount of the MRP equivalent to £4.8M per annum.

11.3 The increase in the Council's Operational and Authorised Boundaries will be offset by the £88M initial reserve fund which will be invested. For 2019/20 the Operational Boundary will be increased to £194M and the Authorised Boundary to £209M. In future years these figures will be adjusted by the amount of debt redeemed as the finance lease liability is reduced and the change in the value of the reserve fund.

11.4 The Council's Treasury Management Policy will need to be reviewed in order to invest the reserve fund to achieve a balanced portfolio that mitigates the financial risks inherent in the transaction whilst maximising returns consistent with that risk management objective. The Council will seek advice from its Treasury Management Advisers as to the short term management of the reserve fund to ensure the safeguarding of the capital sum invested and allow procurement of regulated advice for the ongoing management of the reserve fund to ensure the Council's objectives of security and liquidity are maintained and that yield is maximised in line with the councils risk appetite.

12.0 Risk Analysis

12.1 GT have carried out extensive modelling on the sensitivities of the cashflow to changes in the underlying assumptions. At stage one a detailed sensitivity analysis was carried out to identify those factors that had a greatest impact on the overall financial viability of the proposal. This work, set out in Part B, has been used to inform the sensitivity analysis carried out on the final proposal where three scenarios have been modelled:

- An increase/decrease in RPI of 0.5% on the head lease with only a corresponding 0.25% increase/decrease in the sub leases. Whilst rents are likely to move with inflation this scenario looks at the impact if the RPI change is greater.

- An increase/decrease in the voids period by one month.

- An increase/decrease in the interest rate charged to the top up fund by 0.5%.

12.2 The Council will mitigate the risks of adverse economic impacts in the following ways:

- The financial model has included a figure for RPI, based on current projections. The proposal has RPI capped at 4% and this limits the Council's exposure, and a maximum figure will be known. In addition the tenants leases should also

increase if indexation is above that forecast, so this will in part mitigate the impact. Active monitoring of future indexation rates should help to mitigate the impact of this risk.

- Active Asset Management to be put in place to manage risk including a letting strategy which will be regularly reviewed.

- A new investment strategy will be put in place to actively manage the reserve fund to ensure that the best returns can be achieved. This will be regularly reviewed to ensure that investments are still appropriate.

12.3 Detailed due diligence has been carried out on the underlying assumptions around the income and costs of the final proposal. As a result, officers advised that no provision should be made within the model for a contingency on the planned programmed maintenance costs but that the programme could be managed within the available resources or funded through the Council's own capital programme.

12.4 The cost of planned and preventative maintenance in the final ten years of the term of the lease is higher than the earlier years. Should the "profit rent" be insufficient to pay for these costs then the level of maintenance could be scaled back. WBC have negotiated that in the final 10 years of the term that the repairing obligations are not as stringent whilst preserving the economic life of the buildings. In addition new or refurbished development could be explored with a third party as the assumption is that the Council will exercise its option and acquire the freehold of the Park after 40 years for £10.

12.5 Should the office market deteriorate and demand fall for office users the Council has negotiated that other uses could be implemented on the Park to generate income provided the value of the reversion of the asset to CTi is not materially affected.

12.6 There are synergies in relation to the adjoining Watford Business Park owned by the Council, this is an industrial park of 67 acres which adjoins the Park. There will be opportunities created for both assets and opportunities to increase both revenue and capital values and marriage value opportunities.

12.7 An external Asset Manager will be appointed to pro-actively drive the letting and management of the Park who will be supported by an Investment Management team. In managing and letting such a prestigious asset the Council will need to reach out to International, National, Regional and local markets and will bring that knowledge base to optimise opportunities

12.8 The Council has obtained preliminary advice from its Treasury Advisers, Link Asset Services, on what the return on a balanced investment portfolio for the £88M reserve fund the Council may obtain. A prudent view of this figure has been taken and reduced by 1%, with a 2.5% return on the reserve fund applied. The Council will take further advice on the ultimate investment portfolio to ensure a return commensurate with the need to use the reserve fund to manage the risks of the transaction.

12.9 Ongoing monitoring of the financial model will be critical to managing risk and will be carried out by the Council's Property Investment Board. It is recognised that the resources available to the Board will need to be reviewed to ensure that the Council has access to appropriate advice.

12.10 The proposal will require the Council to take a significantly extended view of its financial planning horizon and deal with significant short-term variations in cash flow. There is a risk that if the Council gives undue weight to the short term without taking a prudent view of the longer term that this will be to the detriment of future financial sustainability. Proper advice will be provided to ensure that a long term view is taken of the financial sustainability.

13.0 Implications

Financial

13.1 The Shared Director of Finance comments that the financial implications are outlined within the body of the report.

Legal Issues

13.2 The Head of Democracy and Governance comments that:

13.3 Trowers have provided advice to the Council in relation to this transaction their full legal advice is contained in the Part B report.

13.4 <u>Acquisition of the leasehold interest</u>
Section 120 of the Local Government Act 1972 (the 1972 Act) allows the Council to acquire land for either:

- the benefit, improvement or development of its area; or
- for a purpose relating to any of its powers or pursuant to duties under any enactment.

In the context of the acquisition of the Park this report sets out the potential benefits for Watford's economic development, to enable appropriate space for local

businesses and the potential improvement of the local economy. In agreeing the recommendations the Council will have concluded that the economic development information set out in this report and in the part B report means that the acquisition of a leasehold interest in the Park will benefit and/or improve and/or develop the local area and its economy.

13.5 Operation of the Park

The Council is entitled to operate the Park using its general power as is set out in chapter 1 of the Localism Act 2011. The general power permits the Council to do anything which an individual may do. The Council's general power is subject to a number of limitations which include that it cannot be used to circumvent any prohibition or restriction which exists in legislation which precedes the general power. Trowers and Officers are not aware of any contravening legislation which would apply to the proposed transaction.

13.6 Entering into asset management and ancillary agreements

The Council will have the power to enter into ancillary documents either through section 111 Local Government Act 1972, section 1 Local Government Contracts Act 1997, or to the extent such ancillary agreements are not commercial relying on its general power (Chapter 1 Localism Act 2011).

13.7 The Council's Fiduciary Duties

The Council's fiduciary duties could be briefly summarised as it is acting as a trustee of tax and public sector income on behalf of its residents, rate and tax payers. The Council in effect holds money but does not own it; it spends money on behalf of its residents' business rate and council tax payers.

The Council in agreeing the recommendations should give proper consideration to the risks and rewards and potential future liabilities of approving them together with the proportionality of the potential liabilities of the proposal in relation to the Council achieving its stated objectives.

On a practical basis, this means that Members should also consider, in terms of achieving the Council's economic development objectives, whether the potential rent liabilities are proportionate to securing these objectives and why this is consistent with the wider interests of its local tax payers/residents. Members should also so consider whether there is a viable alternative to deliver the economic development objectives set out in this report, and if so, the relative merits of any viable alternatives.

13.8 Procurement

The Council will be acquiring a leasehold interest in an operational business park. The acquisition of such a property interest is not subject to the Public Contracts Regulations 2015.

13.9 State aid

Owning a leasehold interest in and operating a business park is, in state aid terms, an economic activity. Under the 'state aid rules' this is permitted providing the Council acquires and operates the business park on terms (including financial terms) which would be acceptable to a private sector owner. To evidence this the Council should ensure it acts as a private sector operator would (meaning the terms it agrees should be those which the private sector would agree to in the same circumstances). The Council has sought evidence from a suitably qualified/experienced adviser as to their opinion on whether other market/private sector parties in the same circumstances would be likely to agree to comparable terms as the Council proposes to agree. This is set out in this report and in more detail in the Part B report

13.10 Other considerations

The Part B report sets out legal commentary on a number of commercial matters together with relevant legal risk management steps.

14.0 Equalities, Human Rights and Data Protection

This is a property acquisition and as such there are no Equalities, Human Rights or Data Protection implications for the Council.

15.0 Staffing

There are no staff to be transferred to the Council as a result of this transaction, although Workman LLP with whom the Council will be contracting for Facilities Management do employ 3 members of staff who work solely at the Park, therefore the Council will need to be mindful of TUPE at the end of the agreement with Workman

16.0 Accommodation

Not Applicable

17.0 Community Safety/Crime and Disorder

The Park is privately managed and has security provision paid for via the service charge and the newer buildings have been designed to be secure and visible detracting from crime and anti-social behaviour activities

18.0 Sustainability

The most recent buildings conform to BREEAM standard Very Good and the Energy performance certificates for all buildings are C or above. A programme of refurbishment of the older buildings on the Park is also updating energy saving techniques to improve on these ratings.

Through the service charge a dedicated bus service is provided which runs every 15 minutes in peak time connecting the Park to Watford Junction improving the Park's accessibility and the need to rely less on car based transport.

The buildings on the Park are set out in a well kept park environment. Employees are encouraged to cycle and provision is made for the storage of bikes and the bikeways link into to the wider borough wide network.

Appendices

- **Appendix 1 - Plan of Park**
- **Appendix 2 – Hertfordshire Growth Board Terms of Reference**

Background papers

There are no background papers.