Cabinet Member Report

Decision Maker(s):	Cabinet Member for Finance and Smart City
Date:	22 March 2022
Classification:	For General Release with the exception of the Appendices 1, 2, and 3.
Title:	90-104 Berwick Street – Surrender and Re-Grant of Headlease
Wards Affected:	West End Ward
City for All:	N/A
Key Decision:	Yes
Financial Summary:	The proposed Surrender of the current head-lease with a co-terminus grant of a new long-lease over the retail element of the completed re-development will significantly enhance the net income that the Council will receive from the Property. The Council will no longer have any exposure to potential income volatility from the letting and management of the retail units. The total up front cost will be in the region of £10.9m inclusive of stamp duty and fees.

1. Executive Summary

1.1. This report relates to the restructuring of lease arrangements at 90-104 Berwick Street, London W1F ("Property"). In this report officers seek authority and delegated authority to complete the Surrender of the existing head-lease granted to Berwick Street Securities LLP (as tenant) and PMB Holdings Ltd (as guarantor) ("BSS/PMB") in 2012 to facilitate the re-development of all the commercial space situated at the Property. Simultaneously a new 200 year ground lease for no premium at a peppercorn rent of the current vacant 11 retail units including the one let to Co-operative Group Food Limited is to be granted by the Council to BSS (the "**Retail Lease**"). BSS will immediately (as a condition of the grant of the ground lease) assign the Retail Lease to Shaftesbury Soho Limited ("SSL"). SSL will enter into a Deed of Covenant with the Council on assignment to comply with the terms of the Retail Lease The report seeks delegated authority to complete the surrender of the existing head lease and grant the Retail Lease and all necessary related documentation.

1.2. The proposed re-structuring of the head-lease arrangements will mean the Council as freeholder will receive all the income derived from the letting of the new hotel to Whitbread Group Plc/Premier Inn which currently is the sum of £2 million per annum.

1.3. The costs to the Council of undertaking the proposed re-structure include a consideration payable to BSS/PMB ("the Developer") to surrender the head lease and a further sum to obtain full benefit of the Latent Defects Insurance Policy which BSS procured and for which they have paid part of the premium. SSL will be paying an undisclosed premium on assignment of the Retail Lease to BSS/PMB.

2. Recommendations

2.1. That the Appendices to this report be exempt from disclosure by virtue of the Local Government Act 1972 Schedule 12A, Part 1, paragraph 3 (as amended), in that it contains information relating to the financial or business affairs of any particular person (including the authority holding that information).

2.2. That the Cabinet Member for Finance and Smart City approves:

1. the surrender of the existing head-lease of 90-104 Berwick Street and the payment of monies up to £10.888million (net of VAT and insurance premium tax);
2. the simultaneous grant of the Retail Lease to BSS; and
3. the subsequent assignment of the Retail Lease by BSS to SSL and the entry by the Council into a necessary deed of covenant.

2.3. That the Cabinet Member delegates authority to the Director of Property and Strategic Asset Management, in consultation with the Director of Law, to approve the necessary final form of legal documentation and the payments to effect these transactions.

3. Reasons for Decision

3.1 The key reasons and rationale for approving the recommendations in this report are as follows:

1. Under the existing head-lease the Council receives a net rent equivalent to 54.5% of the commercial income derived from the Property, which includes 11 vacant retail units. The total income currently received totals £1 million per annum.
2. As such, the Council's future income receipts will be dependent on the success or otherwise of letting the vacant space and mitigating any void periods as and when they arise in-between the initial and future lettings.

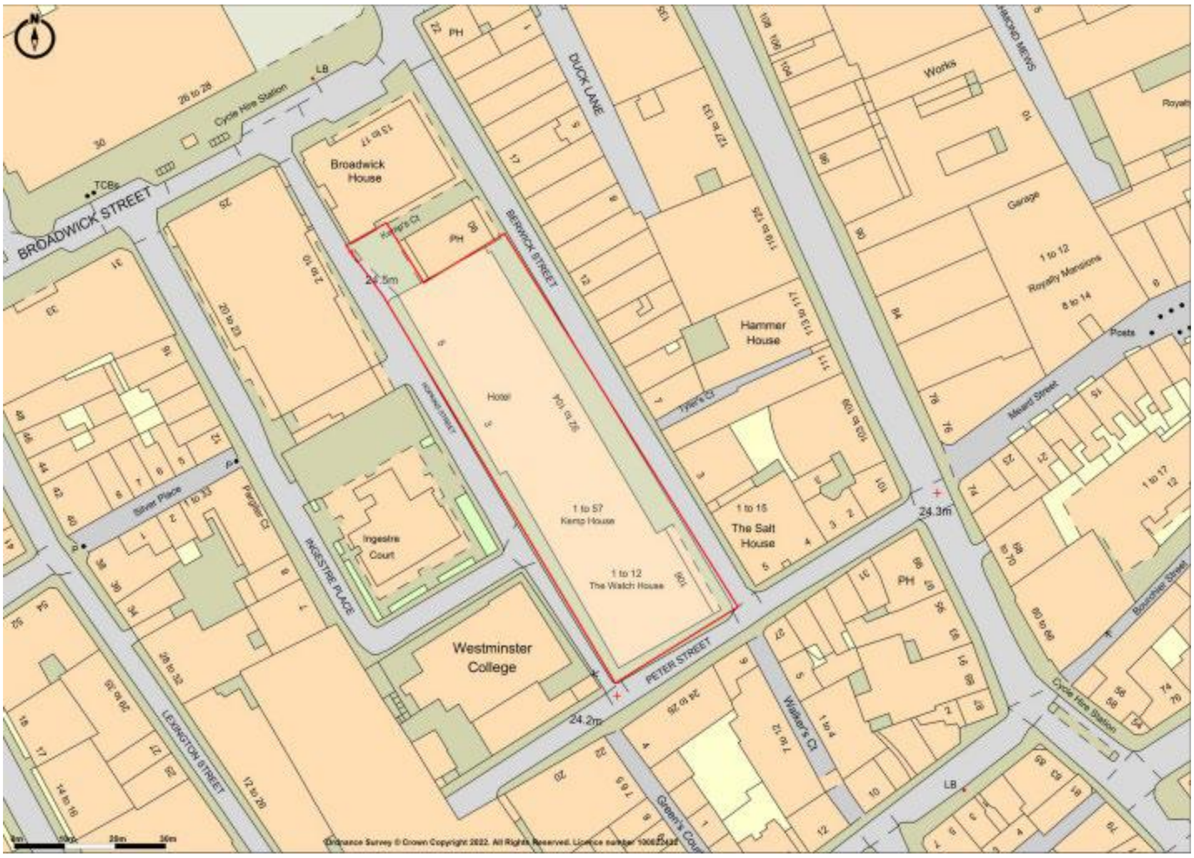
3. The income stream under the existing head-lease will potentially be volatile year to year since the length of leases now granted to retailers are now usually no more than 10 years in length.

4. Following the proposed surrender and grant of a new head-lease, the Council's income will be solely derived from the letting of a new hotel within the re-development to Whitbread/Premier Inn. This is currently the sum of £2 million with uplifts linked to the consumer price index in 2026 and every 5 years thereafter.

5. The premium payable by the Council to facilitate the surrender of the current head-lease will be more than offset by the increase in the open market valuation of the freehold as confirmed by a RICS Red Book Valuation at a figure of £50 million undertaken by Avison Young (UK) Limited dated 31st January 2022. It confirms that the grant of the lease by the Council to BSS is part of the consideration for the deed of surrender. Avison Young has also separately confirmed in writing that the proposal in its entirety represents best value in accordance with Section 123 of the Local Government Act 1972.

4. Background

4.1 The subject site and property occupy a strategic and prominent location on Berwick Street, Soho, as shown below outlined in red.



4.2 The buildings on the site which were re-developed by BSS/PMB partially adjoin and sit underneath the Council's housing building known as Kemp House.

4.3 The development undertaken by BSS/PMB ("the Developer") was following the grant of a head-lease by the Council, details of which head-lease are set out at Appendix 1 of this report.

4.4 The scheme experienced delays and significant cost over-runs and the Developer's main funder, Beaufort Capital ("Beaufort"), took over full control and management of the completed scheme towards the end of 2020.

4.5 Discussions between the Council and Beaufort commenced Spring 2021 regarding the future of the head-lease and their aim of exiting the scheme in an orderly fashion.

4.6 The proposed re-structuring of the head-lease provides the Council full benefit of an existing lease granted on a new hotel within the scheme. Details of the hotel lease are set out at Appendix 2 of this report.

4.7 The Retail Lease is to be granted by the Council to BSS for no premium at a peppercorn. BSS will then assign the Retail Lease to SSL for an undisclosed premium. The terms of the Retail Lease are set out at Appendix 3 of this report.

4.8 On-going discussions between officers and SSL have revealed that currently there is good interest in a number of the vacant units on the basis they are available for occupation ahead of Christmas 2022 trading. As such, SSL are keen to take control of the units as soon as possible so that the necessary works can be undertaken to enable the units to be let and handed over for final shop-fitting.

4.9 An additional sum will also be paid to the Latent Defect Insurer by the Council at completion to enable the transfer of the full benefit of the Latent Defects Insurance Policy procured by BSS to the Council. Advice in relation to the Latent Defects Insurance Policy was requested and was provided from the insurance broker Gallagher by BSS. BSS requested appropriate insurance to provide cover to correct any structural defects after PC of at 90-104 Berwick Street.

4.10 In summary the proposed transaction has 3 key components:

1. Collapse of existing head-lease granted by the Council to BSS/PMB in 2012.
2. Premium paid by the Council to BSS to obtain full benefit of lease granted over new hotel to Whitbread/Premier Inn which is transferred.
3. Remaining retail elements of the scheme are transferred by the Council back to BSS by way of the grant of a 200 year lease at nil premium for a peppercorn rent. This 200 year lease is then immediately assigned by BSS to SSL for an undisclosed premium.

5. Financial & Risk Implications

5.1. The proposed restructure will be an overall cost to the Council of £10.888m (net of VAT and insurance premium tax). This will change the guaranteed levels of income that the Council will receive, with a minimum of £2m per annum. At a discounted rate, up to the lease break clause in December 2045 there will be a shortfall in recovery of the investment of £0.709m, but if Whitbread remain until the end of the lease in 2054, this will be a net benefit of £3.445m.

5.2. The budget for the proposal will be derived from the £120m Property Investment Acquisitions capital scheme, and existing capital receipts (General Fund capital receipts as at 31 March 2021 were £98m) will be used to fund the purchase. As such there will be no increase to the Capital Financing Requirement, and no associated borrowing or MRP costs.

5.3. The rental income under this lease will be £2m per annum, which is £1m over the current budget of £1m for this Property. This will achieve the £1m MTFP increased income for investment Properties.

5.4. This proposal is to rearrange the head-lease structure, and while the new arrangement will be financially beneficial to the Council, this is active management of an existing asset, and is considered a less risky arrangement of the head lease.

5.5. Although local authorities can make their own decisions on capital investment, under Part 1 of the Local Government Act 2003 they are required to make these decisions taking into account CIPFA's Prudential Code. This transaction is considered to be management of an existing asset, through the restructure of a lease arrangement. The Council owns the freehold to 90-104 Berwick Street; this is a restructure of the head lease and is therefore considered to be "prudent active management and rebalancing of their portfolios".

5.6. As freeholder of 90-104 Berwick Street, and with the management regime to be put in place and the covenants within all the leases granted mean that there will be no service charge shortfall, hence WCC as Landlord will be able to recover all costs in respect of repairs and maintenance.

5.7. The existence of the Latent Defect Insurance Policy ensures that risk is mitigated around any issues with the building itself, as defects insured by the policy would be covered by the insurance subject to the limit of indemnity of the policy and the exclusions and excess of the policy as confirmed by the Council's lawyers.

5.8. The income scenarios are as follows:

- Currently the Council has the right to receive the greater of £1.0m or 54.50% of rents received.

- Assuming the retail is fully let it is estimated this could be up to £1.8m per annum. However, due to void and rent-free periods, this is expected to average in the region of £1.566m over the first five years. This level will increase as the CPI increases are applied to the rent, leading to an average up to the break clause period of £2.187m per annum.

- Rents actually received have not surpassed the minimum of £1.0m as the retail units remain empty.

- Under new lease arrangement – the Council will have an interest in the hotel only and will receive a guaranteed £2.0m per annum. There will be compounded CPI increases up to a CAP of 4% every 5 years. This results in an average annual rental income of £2.955m up to the break clause.

- The above are summarised in the table below:

Actual Rent currently received (11 of 12 retail units not occupied)	£1.0m
Expected case rent receivable under current arrangement (allowing for rent-free periods and potential voids – average for first five years)	£1.566m
Guaranteed rent through head-lease restructure	£2.0m

- This new lease arrangement will ensure that the income levels are less risky, and that the Council will have guaranteed rent from Whitbread Plc for a minimum of 24 years. Due diligence work completed indicates that Whitbread is very low risk and has maintained that level over the three years that were looked at. The hotel at the site is a "hub by Premier Inn" which target overnight short stays. Operating costs for these hotels are circa 25% lower compared with their standard hotels, which means a lower profitability threshold and potential for greater reliability for rental payments to the Council.

- The income from the retail units is considered riskier, not least because they are currently unfinished and would require additional capital investments, and an expectation that it could be 36 months before all of the units would be let. The units may be let on five-year terms, with most likely a 6-12 month rent-free period. Given the number of units there is likely to always be some income void, either as a result of vacancy or rent-free period. While the £1.8m from the current arrangement may be achievable, in the current market it is unlikely that these levels of rental income will be seen for some time.

5.9. A summary of the expected cashflows under the current lease arrangement against the proposed re-structure of the lease can be seen in the table below using the following assumptions:

- Discount rate of 3.5%
- Expected lease terms on retail units of 5 years with 12 months rent free and void periods built in, as well as full rent not being achieved until April 2025
- The new lease arrangement has compounded CPI built in every 5 years (with a cap of 4%) – assumed 4% for first 5 years, and 2.5% thereafter
- Position shown at break clause – December 2045, and then for full lease term to March 2056

		To break Clause (Dec 2045)		To end of Lease (March 2056)	
		Cash £m	**NPV £m**	**Cash £m**	**NPV £m**
Existing lease arrangement	**Rental Income**	**47.493**	**31.838**	**74.362**	**41.966**
Proposed lease restructure	Rental Income	62.619	42.017	100.502	56.300
	Acquisition Cost	(10.888)	(10.888)	(10.888)	(10.888)
	Net	**51.731**	**31.129**	**89.614**	**45.412**
	Benefit to the Council	**4.238**	**(0.709)**	**15.252**	**3.445**

5.10. The table above shows that there will be a shortfall in recovery of £0.709m (at a discounted value) up to the break clause in December 2045 if the lease is rearranged. If Whitbread remain in the lease for the entire lease period to March 2056, this benefit will be £3.445m at the discounted rate. Despite the potential exercise of the break clause, the Council would still be able to issue a lease to a new tenant and so start generating further income into future years and so the net present value of the proposal is considered to be positive and supports the recommendation.

- The discounted average annual cash for each arrangement up to the break clause is shown below:
  - Existing lease arrangement - £1.338m
  - Proposed Lease restructure - £1.766m

5.11. The income yield derived from the hotel income has been independently assessed as 3.75% per annum. The IRR on this lease structure (based on the cash value of the income stream to the end of the lease) is 5%.

6. Legal Implications

6.1 The Council has the power to enter into the proposed arrangements under section 1 of the Localism Act 2011 (the “General Power of Competence”). The General Power of Competence states that a local authority may do anything a person can do so long as it is specifically prohibited (under that Act or other legislation not prohibited).

A local authority may exercise the General Power of Competence for its own purpose, for a commercial purpose or for the benefit of others.

6.2 The Council has the power to acquire the reversion of the head-lease (by virtue of the surrender transaction). Under section 120 of the Local Government Act 1970 (“1970 Act”) a local authority may acquire by agreement any land, whether situated inside or outside their area, for any purpose for which they are authorised by the 1970 Act (or any other enactment to acquire land) notwithstanding that the land is not immediately required for that purpose; and, until it is required for the purpose for which it was acquired, any land acquired under this subsection may be used for the purpose of any of the Council’s functions.

6.3 The Council has the power to grant a new lease under section 123 of Local Government Act 1972. The only constraint is that a disposal must be for the best consideration reasonably obtainable (except in the case of short tenancies). Anything less than best value will require Secretary of State consent unless the difference between the unrestricted value of the interest to be disposed of and the consideration accepted ("the undervalue") is £2,000,000 (two million pounds) or less and the disposal is to help it secure the promotion or improvement of the economic, social or environmental well-being of its area. The disposal of the lease of the commercial units for 200 years will need the Secretary of State consent if it is does not meet the best value consideration criteria and does not fall within this paragraph 6.3 . It appears from paragraph 3(5) of the report that the Council’s valuer is of the opinion that it does meet the best value consideration criteria outlined in this paragraph 6.3.

6.4 Under section 111 of the Local Government Act 1972, a local authority shall have power to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.

7. Staffing Implications

N/A

8. Consultation

Ward Members were contacted in October 2021 when terms for the proposed transaction were originally agreed.

The matter has also been discussed in detail with the Council's Property Investment Panel who unanimously support the transaction.

If you have any queries about this Report or wish to inspect any of the Background Papers, please contact:

Phil Owen (Head of Strategic Asset Management, Finance and Resources) powen@westminster.gov.uk / 020 7641 1490

List of appendices:

Appendix 1 - Summary of Existing Head-Lease

Appendix 2 - Summary of Lease for Premier Inn Hub

Appendix 3 - Summary of Agreed Form of new Head-Lease

NB: For individual Cabinet Member reports only

For completion by the **Cabinet Member** for Finance and Smart City

Declaration of Interest

I have no interest to declare in respect of this report

Signed: ______________________________ Date: ____________________

NAME: ____

State nature of interest if any …………………………………………………………..……

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(*N.B: If you have an interest you should seek advice as to whether it is appropriate to make a decision in relation to this matter*)

For the reasons set out above, I agree the recommendation(s) in the report entitled

90-104 Berwick Street – Surrender and Re-Grant of Head-Lease

Signed ………………………………………………………….

Cabinet Member for Finance and Smart City.

Date …………………………………………………

If you have any additional comment which you would want actioned in connection with your decision you should discuss this with the report author and then set out your comment below before the report and this pro-forma is returned to the Secretariat for processing.

Additional comment:

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If you do not wish to approve the recommendations, or wish to make an alternative decision, it is important that you consult the report author, the Director of Law and City Treasurer so that (1) you can be made aware of any further relevant considerations that you should take into account before making the decision and (2) your reasons for the decision can be properly identified and recorded, as required by law.

Note to Cabinet Member: Your decision will now be published and copied to the Members of the relevant Policy & Scrutiny Committee. If the decision falls within the criteria for call-in, it will not be implemented until five working days have elapsed from publication to allow the Policy and Scrutiny Committee to decide whether it wishes to call the matter in.