

Executive

13th October 2016

Report of the Director of Place and the Director of Corporate Services

Proposals for the disposal of the freehold of Stonebow House and further options for changes to the Commercial Portfolio

Summary

1. This report proposes to dispose of the council's freehold interest in two low income generating assets. The sale of Stonebow House for £750,000 would generate a significant commercial return on a low income asset whilst also facilitating the redevelopment of a vacant and run-down city centre property. It is also proposed to dispose of the freehold of 10 and 11 Redeness Street for £256,500, which also currently generates a low annual income. The report considers whether to use the capital receipts from these disposals to reinvest in the purchase of the head leasehold interests in two industrial sites at Hospital Fields Road in order to increase revenue income, or to use the capital receipts to reduce council debt and therefore borrowing costs.

Recommendations

2. Executive are asked to:

- a) Dispose of the freehold interest of Stonebow House and grant a long leasehold to Oakgate PLC on the small area of land identified in Annex 1 for a total price of £750,000

***Reason:** To allow the redevelopment of Stonebow House to proceed, bringing back in to use and renovating a vacant run down building whilst achieving a significant capital receipt from a poorly performing commercial asset*

- b) Dispose of the freehold interest of 10 and 11 Redeness Street to Maple Grove Developments for £256,500

Reason: *To dispose of a poorly performing asset*

- c) To approve the purchase of the leasehold of sites 36 and 23 Hospital Fields Road for sums set out in the Confidential Annex 1, with delegated authority to the Director of Place to make the final purchase decision based on the outcome of surveys

Reason: *To increase the revenue income of the commercial portfolio and create potential future development opportunities*

- d) Recommend to full council to create a capital budget of £1.145m to secure these new assets and for this to be funded from the capital receipts from Stonebow House and Redeness Street (£1.006m) with the remaining £138,500 being funded from borrowing, with the associated interest and repayment of the debt being met from the additional revenue income generated by the new acquisitions.

Reason: *To reinvest capital from the commercial portfolio in order to increase the revenue income from that portfolio, and to unlock the development potential of the sites in the future*

Background

3. The council has set an ambitious target to increase revenue generation from the commercial portfolio by £1m over the next 4 years. This will largely be achieved through the disposal or redevelopment of poorly performing assets and the acquisition of commercial interests with better financial returns. A comprehensive plan for the delivery of this saving is being developed. As part of this strategy a number of immediate opportunities have arisen relating to the disposal and acquisition of assets.
4. Disposal of Stonebow House - The most significant disposal is the freehold interest in Stonebow House, which currently generates an annual income of just £6,100. The building has suffered from a lack of investment, and the low grade office accommodation has struggled to attract tenants in recent years. In an attempt to redevelop Stonebow House the Oakgate Group have acquired the various leasehold interests in the property. They submitted a planning application to convert the offices into residential apartments and the ground floor into a range of commercial uses. The application was considered at planning sub-committee on 6th October with an officer recommendation for approval.

Oakgate intend to begin construction in January 2017, with completion in January 2018.

5. To be able to proceed with the development Oakgate would need to either acquire the freehold of the building or reach agreement with the council to extend their lease. This is because the current lease has only 44 years remaining, which is an insufficient period of time for lenders to offer mortgages on the new apartments. Consequently, Oakgate approached the council to either extend the lease or to acquire the freehold of the building, and to acquire a small area of land in front of the former Heron Foods store (see area outlined in red in Annex 1). This piece of land would form outdoor seating for a proposed restaurant operator.
6. As the redevelopment will result in significant investment in Stonebow House and bring back in to use a neglected vacant building, officers are of the view that an agreement that realises the commercial value of the freehold or lease and facilitates the development would be of benefit to the city. The plans also allow for the public footpaths to be widened and improvements to the bus stops that currently have a very poor setting below the existing building's intimidating first floor overhang which will be removed.
7. As Oakgate have the sole leasehold interest in the building it necessitates an off market sale or agreement between freeholder and leaseholder. As such an agreement cannot be tested by going out to tender it is important that the council achieves best value for its interest. Consequently an open book approach was undertaken with Oakgate, and the council appointed framework partners Sanderson Weatherall to provide specialist advice on the market value of the freehold.
8. Oakgate's initial offer for the freehold of the building and the small area of land identified in Annex 1 was £500,000. Having undertaken detailed analysis, and supported by external advice, officers have been able to negotiate an increased sale price of £750,000. This purchase price has been agreed with Oakgate and both parties are ready to progress on this basis should it be the Executive's preferred option. Sanderson Weatherall has recommended proceeding at this price (see Annex 6). The sale would be dependent on completion of the proposed scheme to ensure that the approved plans are implemented and the redevelopment is completed. At this stage it is proposed that the land in front of the former Heron Foods is transferred on a long leasehold basis as part of this figure to ensure that the council has control over any proposals for future use.

9. The option to extend Oakgate's lease on Stonebow House rather than selling the freehold was considered. However, this would potentially only return an annual yield of between 4% and 5% (circa £35,000 per annum). Whilst this does generate an increased annual income it is less than either the reduction in interest should the £750,000 be used to reduce the council's outstanding debt or the potential yield from the alternative investments outlined later in this report. As a consequence disposing of the freehold for £750,000 represents the best option for the council.
10. Disposal of 10 to 11 Redeness Street – The sites are set out in Annex 2 and 3 and are located on the periphery of the city centre and the area is characterised by dated industrial accommodation. This asset's current income reflects a low yield of 2.1% against that potential capital receipt. The area has witnessed recent redevelopment with modern, purpose built student accommodation being developed. Maple Grove Developments are acquiring a comprehensive interest across the area to create an expansion to the student housing that adjoins the site. They have offered a total of £256,500 for the freehold of the site, with £156,500 up front and £100,000 on commencement of any future development, subject to a long stop date. Having acquired other land holdings, Maple Grove Developments are effectively a special purchaser who are offering significantly in excess of an expected capital receipt should the sites be placed on the open market (see valuations in Annex 7 and 8).
11. Acquisitions opportunities at Hospital Field Road – The council own the majority of the Hospital Fields Road estate and the ownership comprises predominantly ground and long leases, ground leases being where the council own the freehold of the land and has granted long leases over such, with the occupiers constructing and owning the respective buildings. The total area of the council's interest within Hospital Fields Road is 10.9 acres (excluding highway) and the income produced currently £278,000 per annum through 26 individual leases. Future rent growth will be limited due to the nature of many of the leases and the age of the buildings.
12. The estate is located directly off the main A19 road lying midway between the city centre and the York Bypass (A19/A64), being approximately 1.5 miles from each. The estate borders the River Ouse and is in close proximity to Rowntree Park and the Millennium Bridge with the Fulford Barracks across the A19. The buildings and uses within the estate vary considerably. The site was originally used for the storage of ordnance during World War One and some of the original depot buildings remain to this day, having been converted. Other uses include; removals/ vehicle storage; steel storage; children's nursery and a tool hire and bus depot.

The most recent development was that of ACM Global which provided a speculatively built 14,500 square feet of office/ laboratory accommodation in 2008 and known as “The Edge”.

13. The majority of the estate is of a dated appearance and it is considered that there may be potential for mixed use redevelopment in the future. The proximity of the river and central location with good access from the A19 should provide for good demand land values. As an illustration of nearby development, a scheme comprising 91 flats on the eastern end of Hospital Fields Road was developed in 2000. That site comprised 1.6 acres.
14. Acquisition of the leasehold of site 36 Hospital Fields Road – The council have the opportunity to secure the leasehold interest of site 36 Hospital Fields Road. The site currently houses a large industrial unit adjacent to the River Ouse (see Annex 4). The council already own the freehold of the site which generates an income of £8,750 per annum. This leasehold runs until 2104, though the tenant has a statutory right to renew under the Landlord and Tenant Act 1954. They in turn have an underlease agreement with a tenant that runs until 2026 (with a tenant’s break clause on 1st August 2022) though the tenant also has a statutory right to renew under the Landlord and Tenant Act 1954. From December 2016 this agreement will generate the leaseholder £80,000 per annum, with an upwards only open market rent review on 17th June 2021. Securing the leasehold would give an annual net increase in rent of £71,250.
15. The opportunity to buy the leaseholds on this and on 23 Hospital Fields Road are part of commercially confidential negotiations at this time and are therefore set out on detail in Confidential Annex 1, with a valuation report of this site in Exempt Annex 2. The leaseholders are prepared to dispose of the leasehold, in an off market sale to the council if an immediate deal can be secured creating an immediate commercial return to the council. Furthermore, the marrying of both leasehold and freehold would provide the council with the opportunity to develop out the site in either 2022 or 2026 depending on the end of the current underlease.
16. Acquisition of the leasehold of site 23 Hospital Fields Road – The council also have the opportunity to acquire the leasehold interest in site 23 Hospital Fields Road (see Annex 5). The site is substantial, covering 2 acres, and has significant development potential. Again the council are the freehold owners, which currently generates £61,000 per annum from the leasehold which runs until 2037 (though again the tenant has a statutory right to renew under the Landlord and Tenant Act 1954). The leaseholder has underlease agreements that run until December 2017.

These agreements generate £79,650 per annum; giving the leaseholder a net rent of £18,650 per annum.

17. The leaseholders are willing to dispose of their leasehold interest to the council at a price identified in Exempt Annex 1, with valuation advice in Exempt Annex 3. The current net rental income would provide a healthy yield in the short term, but more importantly this creates a potential development opportunity on the expiration of the underleases in 2017.

Consultation

18. All of the proposed disposals and acquisitions have been discussed with officers in finance and property services, and have been approved by Capital Asset Board. In addition, specialist advice has been provided by Sanderson Weatherall, and their reports are attached as annexes.

Options

19. There are two options for consideration:

Option 1 – Approve the disposal of the freehold of Stonebow House and 10 and 11 Redeness Street and use the proceeds to purchase the leasehold of sites 36 and 23 Hospital Fields Road

Option 2 – Approve the disposal of the freehold of Stonebow House and 10 and 11 Redeness Street and use the proceeds to repay council debt

Analysis

20. **Option 1** – proposes to use the income generated from the sale of low yield assets at Stonebow House and Redeness Street to fund the purchase of high yield assets at Hospital Fields Road. This would provide a significant increase in the return on investment. With current yields of 0.8% and 2.1% against the negotiated freehold sale values, these assets do not justify retention financially and their release would enable the dated assets to be regenerated. The newly acquired assets at Hospital Fields Road would have significantly higher yields which would justify the investment even without consideration of future opportunities to unlock the development potential of both sites.
21. Under this option the Council would receive capital receipts of approximately £1m for assets that currently only achieve £11k per annum in income. The receipts would then be used to purchase assets for £1.1m

(including an estimate of associated purchase costs such as Stamp Duty Land Tax and Land Registry fees). The capital shortfall of £139k would be funded through borrowing over 15 years, with the associated interest and repayment of the debt covered by the additional revenue income generated. This will achieve a significantly higher annual income of £160k which would give a net annual revenue increase of £66k once borrowing costs have been met and the existing income levels netted off. Once the borrowing has been repaid after 15 years, the net annual income generated would increase to £78k per annum. Importantly this option offers two significant opportunities for future development which would increase either future revenue generation or create large capital receipts.

22. There would be a short term cash flow gap that would need to be funded as 90% of the payment for the freehold of Stonebow House would be paid on completion of the redevelopment, anticipated to be in January 2018. For Redeness Street £156k would be paid initially, with the balance being paid on commencement of any future development, subject to a long stop date of 2 years from date of sale by the council. This would mean a total of £831k would need to be funded up front until the other disposals complete, a period anticipated to be just over a year. This can be managed within the existing corporate treasury management budget.
23. **Option 2** – Option 2 proposes to dispose of the two low yield assets at Stonebow House and Redeness Street but to use the receipts generated to create revenue savings by repaying existing debt and therefore reducing the council's current cost of borrowing. The reduction in borrowing would be £70k per annum, but with the loss of the £11k annual income from the disposal of the assets this would reduce the annual saving to £59k. Consequently this option generates lower revenue savings than the income from securing the new assets, and the council would lose the ability to generate higher development income in the longer term.
24. A summary of the financial implications for both options is set out in the table below:

Summary of financial implications	£'000
Option 1 – dispose and reinvest receipts (recommended option)	
Receipts received	1,006
Expenditure incurred	1,145
Net capital investment required	139
Early years annual net increase in revenue generated	66
Future net increase in annual revenue saving generated	78
Option 2 – dispose and use receipts for repayment of debt	
Receipts received	1,006
Annual revenue saving generated	59

Implications

25. The following implications have been identified:

- (a) **Financial** – The financial implications are covered in the options, and make an allowance for some associated purchase costs and consider the impact on cash flow of the timing of receipts and payments made. However, any additional delays in the sale of the assets could have an impact on the Council's treasury management budget, although it is anticipated that this could be managed within the overall resources available. It is also assumed that the newly purchased assets will be fully occupied. If at any point these sites were not let, this would again have an impact on the overall financial viability of the proposal. It is assumed that no additional investment or management overhead costs will be required.
- (b) **Human Resources** – There are no human resource implications.
- (c) **Equalities** – There are considered to be no equalities implications.
- (d) **Legal** – The subtenant of Unit 36 has security of tenure under the Landlord and Tenant Act 1954 (though the subtenants at Unit 23 do not appear to have such protection/rights). This means that the subtenant of Unit 36 will have a statutory right to renew their lease on similar terms when their current lease expires unless the Council can prove at that point that we need to regain possession of Unit 36 in

order to redevelop the premises in accordance with clear, achievable development proposals in which case we would be obliged to pay them compensation related to the rateable value of the premises.

The subtenant of Unit 36 has the benefit of a break option which means they can terminate their lease early on 1st August 2022 provided they serve notice on their landlord before 1st February 2022.

It is noted from paragraph 8 of this Report that the proposed sale of the Council's freehold interest in Stonebow House to Oakgate "would be dependant on completion of the proposed scheme to ensure that the approved plans are implemented and the redevelopment is completed". If the contract for sale of the Council's freehold to Oakgate imposes an obligation on Oakgate to carry out particular works to the building by a particular date/within a particular period then the contract may be categorised as an agreement for works which must be procured in accordance with the Public Contracts Regulations. It is considered that this would be avoided if the sale contract does not impose an obligation on Oakgate to redevelop the property but is instead structured so that the transfer of the freehold to Oakgate will not take place unless and until Oakgate have redeveloped the property in accordance with a scheme approved under a specified planning permission, failing which the Council can terminate the sale contract.

Provided that the Council is satisfied that the price being obtained for our freehold interest in Stonebow and our freehold interest in 10 & 11 Redeness Street is best consideration/full market value, then the consent of the Secretary of State is not necessary for disposal under S.123 of the Local Govt Act 1972.

In relation to the recommendation that the Council sell our freehold interest in 10 and 11 Redeness Street for £156,000 plus a further payment of £100,000 on commencement of any future development subject to a long stop date of 2 years from date of sale by the Council. In this sale it is recommended that the sale contract grants the Council a Legal Charge over the property to secure the payment of the remaining £100,000 and imposes a restriction preventing any onward disposal of the property by the buyer to someone else without the Council's consent (so the Council can ensure that any onward purchaser within the 2 year long stop period covenants to pay the remaining £100,000 to the Council by the end of that period). A potential alternative would be for the sale to be conditional upon the

prospective purchaser obtaining planning permission for their desired development by a specified date in which case the Council transfer the land and receives full payment at that point (either party being able to terminate the sale contract and 'walk away' if the buyer does not obtain planning permission by the specified date).

If the Council proceeds to purchase our head tenants' interests in Unit 23 and Unit 36 for the prices mentioned above, we would be liable to pay Stamp Duty Land Tax for Unit 23 and Unit 36 (more if VAT is payable on the purchase price for either Unit, which Property Services are seeking confirmation of from our tenants' agents).

- (e) **Crime and Disorder** – Due to the current poor condition of Stonebow House the building has attracted anti-social behaviour problems. Facilitating the redevelopment of the building, with secure by design principles required by planning, should reduce incidences of crime and disorder.
- (f) **Information Technology** – There are no information technology implications.
- (g) **Property** – The sale of the Stonebow and Redeness assets will facilitate redevelopment of the sites and provide a capital receipt. Utilising the capital receipt to purchase further interests will provide a good financial return and enhance the council's ability to bring about further redevelopment in the future. It is however, recognised that the purchase of the assets, which are of a dated nature could increase the exposure of the council to added repair and maintenance costs, under the terms of the occupational leases however, it is considered that any additional repair cost would be funded from existing tenants and any future liabilities when these tenancies end could be considered as part of a future investment strategy or funded from the commercial portfolio repair budget.
- (h) **Other** – There are no other implications.

Risk Management

- 26. In purchasing the assets the council will take on greater liability for the repair and maintenance of the assets. Consequently, further surveys and due diligence should be undertaken before committing to any deal. There

is evidence of asbestos which will need to be further considered before any final purchase price is agreed.

27. There is, as with any investment property, always the possibility of voids at the end of lease periods where income will not be forthcoming. For site 23 Hospital Fields Rd this risk will arise in December 2017 when the current under lease ends, but this is offset by the potential for significant development uplift at this point.
28. The development timetable for Stonebow House is indicative, and a delay to completion would delay the payment of the final capital receipt. This would expose the council to further interest payments on the initial investment. In addition, part of the agreed sale price of Redeness Street is subject to commencement of development (although with a long stop date of 2 years). Failure or delays in achieving planning and construction would consequently affect the financial returns upon which this report is modelled.

Contact Details

Authors:

Andy Kerr

Commercial Project
Manager
Directorate of Place
Tel: 01904 554 153

Nick Collins

Commercial Property
Manager
Tel: 01904 552 167

Chief Officer responsible for the report:

Ian Floyd

Director of Corporate Services
Tel: 01904 552 909

Neil Ferris

Director of Place
Tel: 01904 551 448

**Report
Approved**



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Specialist Implications Officer(s) List information for all

Financial

Debbie Mitchell
Corporate Finance Manager
Tel: 01904 554 161

Legal

Gerard Allen
Senior Solicitor
Tel: 01904 552 004

Property

Philip Callow
Head of Asset & Property Management
Tel: 01904 553 360

Wards Affected: *Guildhall and Fishergate*

For further information please contact the author of the report

Annexes

Annex 1 - Site plan for Stonebow House

Annex 2 - Site plan for 10 Redeness Street

Annex 3 - Site plan for 11 Redeness Street

Annex 4 - Site plan for 36 Hospital Fields Road

Annex 5 - Site plan for 23 Hospital Fields Road

Annex 6 - Stonebow House valuation letter

Annex 7 - 10 Redeness Street valuation

Annex 8 - 11 Redeness Street valuation

Exempt Annex 1 – Proposed acquisition of sites at Hospital Fields Road

Exempt Annex 2 – 36 Hospital Fields Road valuation

Exempt Annex 3 – 23 Hospital Fields Road valuation