Lambeth

Cabinet Member Delegated Decision 09 September 2019

Report title: Grant of Refurbishment Lease of Phoenix House

Wards: Oval/ All

Portfolio: Councillor Andy Wilson: Cabinet Member for Finance and Performance

Report Authorised by: Christina Thompson Acting Strategic Director Finance and Investment

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Report summary

Phoenix House is one of the 14 offices that has been released as a result of the Your New Town Hall (YNTH) office accommodation programme. This report seeks approval to grant a 20 year fully repairing and insuring refurbishment lease of Phoenix House to a serviced office operator on the basis of a 'pre-let' with a pre-agreed outline specification and cost and for the refurbishment to be funded by the Council, which is undertaken under a contractually binding lease.

The refurbishment requires capital expenditure funding requirement. Borrowing will be required to fund the expenditure which will be repaid from the revenue generated from letting the fully refurbished premises. The estimated duration of the refurbishment programme is 8 months with tenant's fit-out works completed 4 months later.

Finance Summary

The proposed serviced office operator tenant will take a 20 year fully repairing and insuring lease at a rent in line with the market (details of which are provided in Part II of this report). The rent will be reviewed on an upwards only basis to open market value at the end of every 5 years.

To benefit from the full market rent, the Council will fund the works, for an amount of less than £14m, which the tenant will be legally obligated to complete in accordance with an agreement for lease. Borrowing will be required to fund the cost of the works and this will be repaid from the revenue generated from letting the fully refurbished premises. This will generate a substantial revenue surplus for the Council over the term of the lease and will generate revenue two years sooner than if the Council undertook the refurbishment works itself. This will help the Council to meet its financial requirement and to ensure the self funding of the YNTH programme.

Recommendations

1. To grant an agreement for lease and a 20 year fully repairing and insuring refurbishment lease to the serviced office operator on the basis of the Heads of Terms proposed (details are provided in the Part II report), subject to carrying out appropriate financial and other due diligence
2. To approve the capital funding requirement of an amount not more than £14m in respect of all costs associated with the refurbishment and to add a budget to the Capital Investment Programme to fund the expenditure, with full details provided in the Part II report.

3. To delegate approval of the outline specification and subsequent details to the Head of Valuation and Strategic Assets.
4. To delegate authority to the Head of Valuation and Strategic Assets for the procurement of professional services to advise the Council, as landlord, on refurbishment design specification, implementation and validation of certificates for payment with regular updates to the Cabinet Member with responsibility for Finance.

Reason for Exemption from Disclosure

The accompanying Part II Report is exempt from disclosure by virtue of the following paragraphs of Schedule 12A to the Local Government Act 1972:

Paragraph 3: Information relating to the financial or business affairs of a particular person (including the authority holding that information).

1. Context

1.1 The implementation of the Council's accommodation strategy resulted in Phoenix House, a core office building, being declared surplus to requirement. The original intention was to dispose of Phoenix House based on a market appraisal, however our current analysis of the market in the Vauxhall Nine Elms area supports the idea of retaining the building and letting it in order to receive an ongoing revenue stream.

1.2 Phoenix House was purchased on a long (999 year) lease in 2004 for c. £26m. The freeholder is St George South London Ltd, part of the Berkeley Homes group. The building offers 62,156 sq ft of accommodation over ground, mezzanine and 10 office floors plus basement car parking. It is now at a stage where refurbishment and modernisation are required to meet the demands of office occupiers and current legislation.

1.3 The building services are nearing the end of their useful life and are at the point where even with planned preventative maintenance they will start to fail and require replacement rather than repair. Importantly, the building has an energy performance certificate (EPC) rating of 'E' and means that Phoenix House can currently be let on tenancies up to April 2023 when further expected changes in the Minimum Energy Efficiency Standards (MEES) Regulations may require a higher energy efficiency standard.

1.4 External Consultants were commissioned to undertake a Feasibility Study and have provided a range of options which demonstrated that it was in the Council's best interest to extensively refurbish, modernise and ideally reconfigure the building with a view to letting the building on the open market at the maximum possible rent. The refurbishment would represent investment which will add long term value to the asset both in income and capital terms.

1.5 The Feasibility study focused on the building's technical aspects, possible enhancements and its marketability for letting. Works required have been identified and fall into two categories

- Works to bring the building up to a lettable standard and:
- Extensive works to enhance the building including complete overhaul of the M&E, lifts and services and create additional value in terms of the income attainable.

Three main refurbishment options were considered for low, medium and high levels of intervention ranging from light repair and redecoration to full refurbishment with major building/services modifications and increase in overall floor area.

2.0 Proposal and reasons

2.1 The following options were considered:

- Option 1: Low intervention
- Option 2: medium intervention
- Option 2A: full refurbishment without building modifications
- Option 3: high level intervention

Initial thinking favoured the high level intervention option (Option 3) or one of its sub-options as this maximised rental and capital value, however, following a further review, it is felt that the medium intervention option (Option 2) of full refurbishment without building modifications but with some market facing additions (Option 2A) would be a prudent and less risky option to pursue and still generate a good return.

2.2 The low intervention option (Options 1) is not attractive because it is essentially a 5 year light touch cosmetic refresh to keep the building running pending a more substantial refurbishment which will be needed in 5 years' time. If systems fail and require replacement during this timeframe, this will be piecemeal without the benefits of a properly planned refurbishment. Building costs are likely to increase resulting in higher overall expenditure and two 'rounds' of capital expenditure will be needed – money spent now to redecorate and bring it up to lettable standard, and the money spent in 5 years when the M&E, lifts and services will all need replacing.

2.3 Projected net income after allowance for deductions would be likely to be less than shown in the appraisals because the building would most likely let to multiple tenants on shorter leases. This would require Lambeth to provide a fully serviced building and exposure not only to rental voids and rent free periods, but also to service charge voids and shortfalls as tenants would most likely insist on service charge caps on what will become an increasingly expensive and inefficient building to run. Rental levels will also tend to fall over time as the building tires further. This will make it more challenging to rebrand and reposition the building in the market post comprehensive refurbishment as it will have acquired a reputation as a rundown, non-optimal space.

2.4 Option 3 seeks to maximise rental income by reconfiguring the services core and changing the services regime for the building to increase net internal floor area. This involves infilling existing penetrations in the floor slab and creating new ones in different locations, extending the 10th floor to take new plant and fitting ceiling rather than perimeter mounted air conditioning units. However, the main source of the increased floor area results from the removal (under further sub-options) of the secondary staircase which allow the service core to be re-oriented. Even though this is a commercial building, there are obvious sensitivities around the removal of a secondary escape stair. While this option anticipates the highest rent for the comprehensive refurbishment to Cat A offices, it also comes at a higher cost and with greater project risk, particularly in relation to securing planning and landlord's consent.

2.5 Option 2A is the medium intervention involving a full Cat A office refurbishment including internal finishes, extensive but not full replacement of main services plant but leaving the servicing strategy, layout and general functionality unchanged. It anticipates improving the visibility and brightness of the reception area with new glazing, signage and façade treatment and addition of a glazed wall to the mezzanine above the reception area. Lifts would be replaced including bespoke lift car finishes. Roof terraces would be brought into use with level access created from office floors and replacement finishes. New bike spaces and shower facilities would be provided in the basement. Planning and landlord's consent would be required for changes to the external terraces, external glazing and signage but these are likely to be perceived as less disruptive than the changes proposed under Option 3.

2.6 While this option adds no additional floor area and does not offer the design improvements afforded by Option 3, it requires a smaller capital outlay to deliver a refurbished building at an attractive rent and the flexibility to accommodate multiple lettings either on a floor by floor or part floor basis. As such it is likely to appeal to a wide range of occupiers in an area set for growth with excellent transport links.

2.7 Pre-letting

One of the three key risk areas for a project of this type is letting (the other two being planning and construction). In the case of a full refurbishment option, our appointed agents would seek to mitigate our letting risk as far as possible by securing a pre-let. This is where an occupier contracts in advance to take the lease of the completed and refurbished building. The Council is therefore not exposed to market risk further down the line (but has to wait until the time of the first review to benefit from any intervening market uplift). The tenant would of course have a say in the fit-out and look of the building, but the Council would procure and deliver the project.

2.8 Serviced Offices

In the wake of the unprecedented rise of the serviced office market, this sector of the occupier market was expected to have a keen interest in Phoenix due to its location at the gateway of the Nine Elms development 'ribbon' as well as being less than a minute's walk from Vauxhall tube and railway station. The Office Group have extended and refurbished Tintagel House, 5 minutes' walk away from Phoenix and 90% let within 9 months. The model adopted by serviced occupiers is that they would take a pre-let of the space, but they would undertake the works themselves to their specific requirements and 'brand' with the Council paying for the works (we would be billed in monthly instalments). However the fundamentals of new lifts and M&E would be undertaken which would be common to any refurbishment option.

2.9 Marketing

Our agents have been marketing the property on both a short term unrefurbished basis for terms up to 5 years (but capable of securing vacant possession for refurbishment after 3 years) and on the longer term refurbished basis. Despite interest in taking the building on a short term basis and negotiations which appeared promising, none has resulted in a letting. The additional challenge of letting short term, to avoid a negative income scenario, is to let a sufficiently large amount of floor space at the outset to cover service charge voids, empty rates and management costs.

2.10 It is as a consequence of this marketing that three of the major serviced office operators have viewed the building resulting in the current offer coming forward. The offer anticipates a specification along the lines of Option 2/2A, the scheme which officers and our appointed agents would recommend as the preferred option, if carrying out the refurbishment ourselves. The funded refurbishment lease provides an alternative procurement route to the Council undertaking the refurbishment itself without detriment to the level of rent attainable.

2.11 The offer, as set out in the Heads of Terms, is a very good offer and one which we and our agents do not believe is likely to be bettered in the current market and is therefore recommended for acceptance, subject to appropriate due diligence to protect the Council's position.

3. Finance

3.1 The Council commissioned a detailed feasibility study in December 2017 which looked at a range of intervention options in terms of the level of investment that could be made in Phoenix House. Overall the feasibility study demonstrated that the Council would benefit from a significant investment in the premises as this would result in proportionately greater increases in asset value and the level of rental income that the Council could expect to receive from letting the premises.

3.2 The additional rent expected to be generated by the higher intervention options is a combination of both a higher expected annual rent resulting from the refurbishment of the asset and are expected to have a greater proportional impact on the value of the property.

3.3 Lower intervention options have the advantage of a shorter duration of programming, meaning that there is an opportunity to commence generating rental income sooner, although Option 1 would require further refurbishment in 5 years' time when the property will also have a reputation as a run-down, non-optimal property.

3.4 Concluding a lease now will ensure income is generated sooner not only by avoiding any letting void, but also because the tenant will be able to mobilise and progress refurbishment sooner than if the Council undertook the works itself. Further, the income will be secured for 20 years under the lease.

3.5 The Council's advisors have indicated that Phoenix House is very well located and well positioned for future rental growth, notwithstanding competition from an anticipated increase in supply of new office buildings over the next 5 to 7 years. The planned major improvements to the gyratory, the opening of the new US Embassy and letting of Battersea Power Station to Apple will all serve to reposition Vauxhall as a key office location attracting a more diverse range of occupiers. Once there is more market transactional evidence, they believe the yield adopted in the appraisals could see an improvement of 0.25% thereby enhancing capital value further and its attractiveness as an investment, which supports a rationale for retention of the premises and generation of rental income.

3.6 Further detail is provided in the Part II report.

4.0 Legal and Democracy

4.1 Section 123 of the Local Government Act 1972 (‘the 1972 Act’) permits the Council to dispose of land in any manner it wishes, however where it proposes to dispose of land otherwise than by way of a lease of less than seven years, at less than the best consideration that can reasonably be obtained, it must obtain the consent of the Secretary of State to do so.

4.2 Section 111 of the 1972 Act gives the Council the 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 its functions.

4.3 Where a lease is within the security of tenure provisions of the Landlord and Tenant Act 1954, at the expiration of the fixed term, the lease will continue until it is terminated by the landlord serving a valid section 25 notice on the tenant or otherwise in accordance with the termination provisions of the lease. There are limited grounds for a landlord to bring a commercial lease to an end under the 1954 Act, the relevant ones are set out below:

- The tenant has breached their obligations in respect of repairs and maintenance;
- The tenant has persistently delayed paying their rent;
- There have been substantial breaches by the tenant of their obligations under the tenancy, or other reason associated with their management of use of the building;
- The landlord has offered and is willing to offer alternative accommodation;
- On the termination of the current tenancy the landlord intends to demolish or reconstruct the premises and could not reasonably do so without obtaining possession;
- On the termination of the tenancy the landlord intends to occupy the premises for the purposes of carrying out a business.

4.4 The Contract Standing Orders require officers to obtain one written quote for contracts valued up to £5,000 and three quotes for contracts valued between £5,000 and £100,000. Contracts with an estimated value above £100,000 should be competitively tendered. Services contracts valued at £181,305 and more are subject the full rigour of the statutory procurement regime as enacted by the Public Contracts Regulations 2015. Contracts for the Council’s professional consultancy services for monitoring and validating will be procured in a manner which complies fully with Council and OJEU requirements, as applicable.

4.5 This proposed key decision was entered in the Forward Plan on 13 May 2019 and the necessary 28 clear days’ notice has been given. In addition, the Council’s Constitution requires the report to be published on the website for five clear days before the proposed decision is approved by the Cabinet Member. Any representations received during this period must be considered by the decision-maker before the decision is taken. A further period of five clear days - the call-in period – must then elapse before the decision is enacted. If the decision is called-in during this period, it cannot be enacted until the call-in has been considered and resolved.

5. Consultation and co-production

5.1 The re-use of Phoenix House is a corollary of the YNTH wider strategy or rationalisation and consolidation of the Council’s operational space.

6.0 Risk management

6.1 The risk matrix included in the Feasibility Study identified the key risks associated with each option.

6.2 Option 1's greatest risks relate to the quality and security of income, high costs of management and consequent reduction in net revenue receipt and the possible need to incur significant expenditure, if M&E or lifts fail with tenants in occupation. It postpones the comprehensive refurbishment, which will be required and as such adds more to cost than to value.

6.3 Option 2 is lower risk in terms of consents and construction than Option 3 or its sub-options and most of the works are internal. The proposed additions under option 2A address concerns that it might not meet tenant expectations and would therefore impact on rents achievable. It has a smaller capital outlay and shorter programme that Option 3 or any of its sub-options and the income generated while less than Option 3 provides an attractive return on capital.

6.4 Option 3 and each of the sub-options pose higher potential risks. These relate to securing planning and landlord's consent to structural and external alterations, construction costs, letting, delays, the internal procurement process, funding and public perception.

6.5 The proposed refurbishment lease will remove planning, letting and construction risk for the Council as planning and construction will be undertaken by the lessee who will take a lease straightaway. The key risk for the Council is tenant failure. Risk will be mitigated by due diligence prior to entering into legal relations, monitoring of the tenant's scheme throughout (and the tenant will be able to mobilise and deliver its programme over a much shorter period than the Council could) and validation of payment for work undertaken by an independent quantity surveyor acting for the Council at every stage, securing rights to intervene in event of tenant insolvency and a parent company guarantee to guarantee income under the lease and the refurbishment works until completed.

6.6 An early approach will be made to the Council's landlord to de-risk consent as far as possible by taking a sounding on their stance to the proposed works. The landlord will be particularly concerned about vibration and noise from the works for adjoining residential tenants and this may be mitigated by the tenant offering consultation meetings with the tenants, adhering to the Considerate Constructor Scheme criteria and agreeing hours of noisy working.

7. Equalities impact assessment

7.1 The Your New Town Hall EIA addressed the Council's vacation of Phoenix House. An EIA will be completed for the refurbishment of Phoenix House as the tenant's comprehensive refurbishment project progresses and proposals are developed sufficiently to present to Lambeth's landlord and neighbouring residents at consultation meetings. Their feedback will be included in the EIA. It is anticipated there will be temporary noise and disruption for neighbouring residents during the works. However, potential job opportunities during construction and after completion with a new occupier and Lambeth residents will benefit from revenue receipts over the longer term. Consideration will be given to including a contractual requirement for the constructor to take on Lambeth apprentices and/or to give preference to employment of Lambeth residents.

8. Community safety

8.1 N/A.

9. Organisational implications

None. The lease documentation, approval of specification and payments will be managed by VAMS with external professional input and phased payments for works controlled by Finance.

9.1 **Environmental**

Refurbishment of the building will be undertaken by the tenant and they will be permitted to choose which environmental assessment scheme they adopt. They will be required to achieve not less than a 'C' Energy Performance Certificate rating due to reduced energy consumption resulting from the installation of new energy efficient heating and cooling systems and inclusion of enhanced cycle facilities. A minimum reduction in carbon dioxide emissions of 35 per cent should also be achieved. Protective measures will be taken during construction to minimise escape of airborne particles.

9.2 **Staffing and accommodation**
N/A.

9.3 **Procurement**
The main project here is a land disposal rather than a procurement and thus best consideration applies rather than procurement legislation.
The tenant has already adopted a competitive figure for their fit out, as confirmed by the Council's property agents and this figure will be fixed in the lease. Any cost over-runs will be borne by the tenant.

It is proposed to procure professional consultants (building surveyor, quantity surveyor and mechanical and electrical engineer and possibly structural engineer, if structural works are involved) to advise in connection with the refurbishment specification and to monitor the tenant's implementation as well as validate certificates presented to the Council for payment. This will be a reduced requirement compared to a full refurbishment role and the procurement route will depend on the revised fee levels. It may be possible to call off against existing fully OJEU compliant frameworks such as the Crown Commercial Services Framework RM3816.

9.4 Health
N/A

10. Timetable for implementation

10.1 The target timetable for the decision is provided in the table below. An indicative project timetable for Phoenix House refurbishment by the tenant is included in the Part II report. A more accurate programme will be worked up in detail by the tenant's appointed project team.

Activity	Target Date
Publish online	30th August 2019
Decision online	9th September 2019
Exchange of legal documents	10th September 2019

Audit Trail				
Consultation				
Name/Position	**Lambeth directorate / department or partner**	**Date Sent**	**Date Received**	**Comments in paragraph:**
Councillor Andy Wilson	Cabinet Member for Finance	19.07.19	24.07.19	
Councillor Claire Holland	Cabinet Member for Environment and Clean Air and Ward Councillor for Oval	28.08.19		Briefing 22.08.19
Councillor Jack Hopkins	Leader of the Council and Ward Councillor for Oval	29.08.19		Briefing 29.08.19
Christina Thompson	Acting Strategic Director for Finance and Investment	19.07.19	29.08.19	Throughout
Matthew Gaynor Finance	Finance and Investment	14.05.19	20.06.19	
Greg Carson, Legal Services	Legal and Governance	17.06.19	18.06.19	
Maria Burton, Democratic Services	Legal and Governance	26.06.19	16.07.19	
Rachel Willsher, Procurement	Finance and Investment	14.06.19	14.06.19	
Cllr Elliot	Green Party	22.07.19		Briefing with presentation 22.07.19
Cllr Briggs	Conservative Party	18.07.19		Briefing with presentation 18.07.19

Report History	
Original discussion with Cabinet Member	01.05.2019
Part II Exempt from Disclosure/confidential accompanying report?	Yes
Key decision report	Yes
Date first appeared on forward plan	13.05.19
Key decision reasons	Expenditure, income or savings in excess of £500,000
Background information	No public documents were used in the preparation of this report.
Appendices	None

APPROVAL BY CABINET MEMBER OR OFFICER IN ACCORDANCE WITH SCHEME OF DELEGATION

I confirm I have consulted Finance, Legal, Democratic Services and the Procurement Board, and taken account of their advice and comments in completing the report for approval:

Signature: ______________________________________**Date:** ________________

Post: Sophie Linton, Head of Valuation and Strategic Assets

I confirm I have consulted the relevant Cabinet Members, including the Leader of the Council (if required), and approve the above recommendations:

Signature: ______________________________________**Date:** ________________

Post: Cllr Andrew Wilson, Cabinet Member for Finance and Performance

Any declarations of interest (or exemptions granted): None

Any conflicts of interest: None

Any dispensations: None