St Edmundsbury
BOROUGH COUNCIL

Z526

Cabinet
11 February 2009

Asset Management Plan: Reassessment of the Council's Ground Lease Portfolio (Feb 09/12)

1. Summary and Reasons for Recommendations

1.1 In accordance with the Asset Management Plan (AMP) Action Plan, all of the Council's property assets are being systematically assessed This report follows the adopted processes for the assessment of the Council's non-operational assets. In August 2006, Cabinet considered the land let as ground leases. This report reassesses the decisions made and assesses other low or nil rent ground lease assets not part of that AMP review.

1.2 The assessment process includes assessing each property asset against the adopted property objectives, it explains the matters considered in order to score each property, including possible reasons for retaining or disposing of particular assets, then applies the decision tree of option appraisal, in order to arrive at an objective decision. The particular reasoning and scoring for each asset is contained in Exempt Appendix 3. Community management and ownership of assets, as recommended in the Quirk Review, forms part of this options appraisal.

1.3 The reason for undertaking the AMP process, and in recommending rationalisation of the portfolio in some cases, is to make better use of property resources, in accordance with good asset management planning.

2. Recommendations

2.1 That the proposals identified in the Exempt Appendix 3 attached to Report Z526, which relate to individual assets, be approved. These proposals include retain, work in partnership, sell when opportunities arise and consider further.

3. Corporate Objectives

3.1 The recommendations meet the following, as contained within the Corporate Plan:-

(a) Corporate Priority: *'to raise corporate standards and efficiency'*

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4. Key Issues

4.1 The Council has a diverse non-operational portfolio. These are properties owned by the Council and leased to third parties. The portfolio has been partly inherited and partly assembled over a period of decades in both an ad hoc and planned manner. The Council has granted long leases at a capital premium, with either no rent or very low rents, or has granted leases for community uses at nominal rents where there have been strategic reasons for the Council to retain the freehold of the land, in order to influence future estates management. Some of the reasons for retaining these ground leases may not now be so significant and ownership may not be important in terms of delivering corporate priorities.

4.2 There are 27 ground leases identified, out of a total of around 300 leased land and buildings. As at 1 April 2008, the market value of these assets was £457,000. Their annual rent roll for 2008/2009 is £6,200, giving an average yield of 1.4%. Twenty-two of the 27 ground leases yield nil or income of £10 per annum or below. Therefore unlike the investment portfolio, which represents 9% of all leased properties, but 59% of the total income of the non-operational portfolio, the ground leases also represent around 9% of all leased properties, but well below 1% of the income. They are very poor assets in the context of the Council's corporate investment policy and they do not comply with the Property Strategy, in achieving a return favourable with that received from the Council's invested funds. The AMP assessment therefore needs to challenge if there are service or strategic reasons to retain them. The capital values of the ground leases are low, as represented by the income stream, but often there are opportunities to increase this value. This is explained below.

4.3 In accordance with the AMP Action Plan, the Council is challenging ownership of its entire property portfolio. In August 2006, Cabinet considered the land let as ground leases. In May 2006, Cabinet had already considered residential assets held on short-term leases and ground leases. This report reassesses the decisions made and assesses other nil or low rent ground lease assets not part of those AMP reviews. The adopted assessment process and options appraisal for ground leases is complex and full details are contained in Appendix 2 and Exempt Appendix 3. The decision tree model, which is part of the process, forms Appendix 1.

The Quirk Review of community management and ownership of assets

4.4 Cabinet in September 2007 considered the findings of the Quirk Review and the Government's response and implementation plan. It was resolved that the Council would consider as an option in all AMP reviews, community management and ownership of assets. This has been taken into consideration in coming to some of the recommendations concerning ground leases.

5. Other Options considered

5.1 The process for assessing the ground leases includes option appraisal. The agreed options are to retain, to consider the feasibility of alternative uses or with partners, to better meet the Council's property objectives, or to sell and reallocate capital to better achieve corporate objectives.

5.2 In many cases, the decision to sell or retain will be hard to judge, particularly for those assets where the Council has already resolved through previous AMP reviews to retain the assets. However, asset management planning is a continuous process and decisions made a few years ago may not be relevant in today's economic climate and financial position of the Council, in terms of raising capital receipts to meet capital programme commitments, or in value for money considerations of staff resources in managing assets which do not reflect real achievements in service delivery priorities.

5.3 In considering the options:-

(a) if sold, can an equivalent amount of service return be raised from alternative investments (property or otherwise)? Costs of sale, acquisition, Stamp Duty and management also have to be taken into account;

(b) are there any contractual obligations which have to be taken into account, such as lease covenants, grants, etc, which will affect value?;

(c) does the property fulfil a community need, which may be lost if the property is sold;

(d) does the property have unique characteristics which are important for the Council to protect;

(e) is there potential, with surrounding land, to improve the service return or investment, by combining sites or changing their use, which may mean additional investment?;

(f) are there long-term strategic reasons for holding the property?;

(g) is there a more pressing need for alternative capital investment which would justify sacrificing current service return (particularly if latent capital value can be realised)?; and

(h) should the property be retained by the Council because of its importance in direct service delivery?

5.4 **The Current Market for Ground Leases**

Historically, there has been an apetite in the market for long reversionary interests, that is, ones where there is a long lease in place, and little risk from the tenant because the rent is nil or very low. The results of nationally held auctions and private treaty sales over the last few years show that high sales values are consistently achieved, where the investor is looking to hold ground leases long-term, in anticipation of eventual capital gain through termination of the leases or opportunities to redevelop, by buying out the tenants. The Council was very successful in February 2008 in selling at auction a number of ground lease assets declared surplus from the original AMP review of ground leases, achieving capital receipts far higher that traditional market valuations. A similar sale by private treaty of a ground lease at Nowton Court has been approved.

5.5 Recent discussions with the auctioneers indicate that this market is prone to fluctuations, in line with current economic circumstances, but sales are still being achieved, albeit not at such high capital to rental values. It would therefore be good practice to have decisions in place where there is a resolution to declare surplus, to be able to take advantage of the improving market, or when negotiating with sitting tenants the purchase of the Council's freehold.

5.6 There are a number of particular questions which need to be considered whether to retain or sell ground leases:-

(a) value as an investment: what would a speculator pay for a particular ground lease, or group of ground leases (as described above)?;

(b) value to sitting tenant: what would the sitting tenant(s) pay to own the freehold? The tenant is a 'special purchaser' and may pay over market value, if he wants to invest, for instance;

(c) current value to Council: rental income against management costs (ie service return, value for money); and

(d) strategic considerations: opportunities for the Council to maximise income or capital by active management or partnerships.

5.7 Both the general factors in paragraph 5.2 and the specific factors for ground leases have been taken into account in the assessment of the 27 ground leases. Exempt Appendix 3 includes reasoned arguments for proposing particular options whether to keep, consider further at a more appropriate time, or sell.

6. Community impact *(including Section 17 of the Crime and Disorder Act 1998 and diversity issues)*

6.1 General

6.1.1 There is no adverse community impact and no implications for the Crime and Disorder Act 1998 in making the decisions for individual property assets contained in the exempt appendix.

6.2 Diversity

6.2.1 There are no diversity implications.

7. Consultation

7.1 The Portfolio Holder for Economy and Asset Management has been consulted.

8. Resource implications *(including asset management implications)*

8.1 As stated in paragraph 4.2, the income received through rents from the ground leases is minimal in relation to the entire non-operational portfolio. Therefore implementing the options proposed for particular assets will not impact on the Five Year Programme.

8.2 The assessment process has resulted in the potential to dispose of some ground leases. Exempt Appendix 3 does, in a number of cases, suggest that although a disposal may be the eventual outcome, the sale will not be immediate. The values to the sitting tenants or to speculative investors have been assessed conservatively and the capital values of the more valuable assets have been included in the AMP Disposals Programme.

8.3 The Council has established a self-financing Property Fund for acquisition of key strategic or investment property. It is unlikely that this facility will be necessary in implementing the options proposed for the ground leases.

9. Risk Assessment *(including Health & Safety, potential hazards or opportunities affecting corporate, service or project objectives)*

9.1 Risk is part of the AMP process. There are no health and safety risks.

Risk area	**Inherent level of Risk** (before controls)	**Controls**	**Residual Risk** (after controls)
The economic climate takes longer than anticipated to recover	High	The proposed recommendations for each asset will be implemented at the appropriate time; proactive discussions with sitting tenants are initiated	Low
Disposal plans not achievable and not in line with 5 year model	High	5 year model is updated with the disposal plan and reviewed on a monthly basis in line with the latest actual income	Medium

10.	**Legal or policy implications**
10.1	There are no legal or policy implications. Strategic property decisions are made in compliance of Section 123 of the Local Government Act 1972.

Wards affected	All	**Portfolio Holders**	Economy and Asset Management and Resources and Efficiency
Background Papers	Paper X8 Cabinet 24 May 2006; Paper X151 Cabinet 2 August 2006; Paper Y239 Cabinet 19 September 2007	**Subject Area** Property Management	

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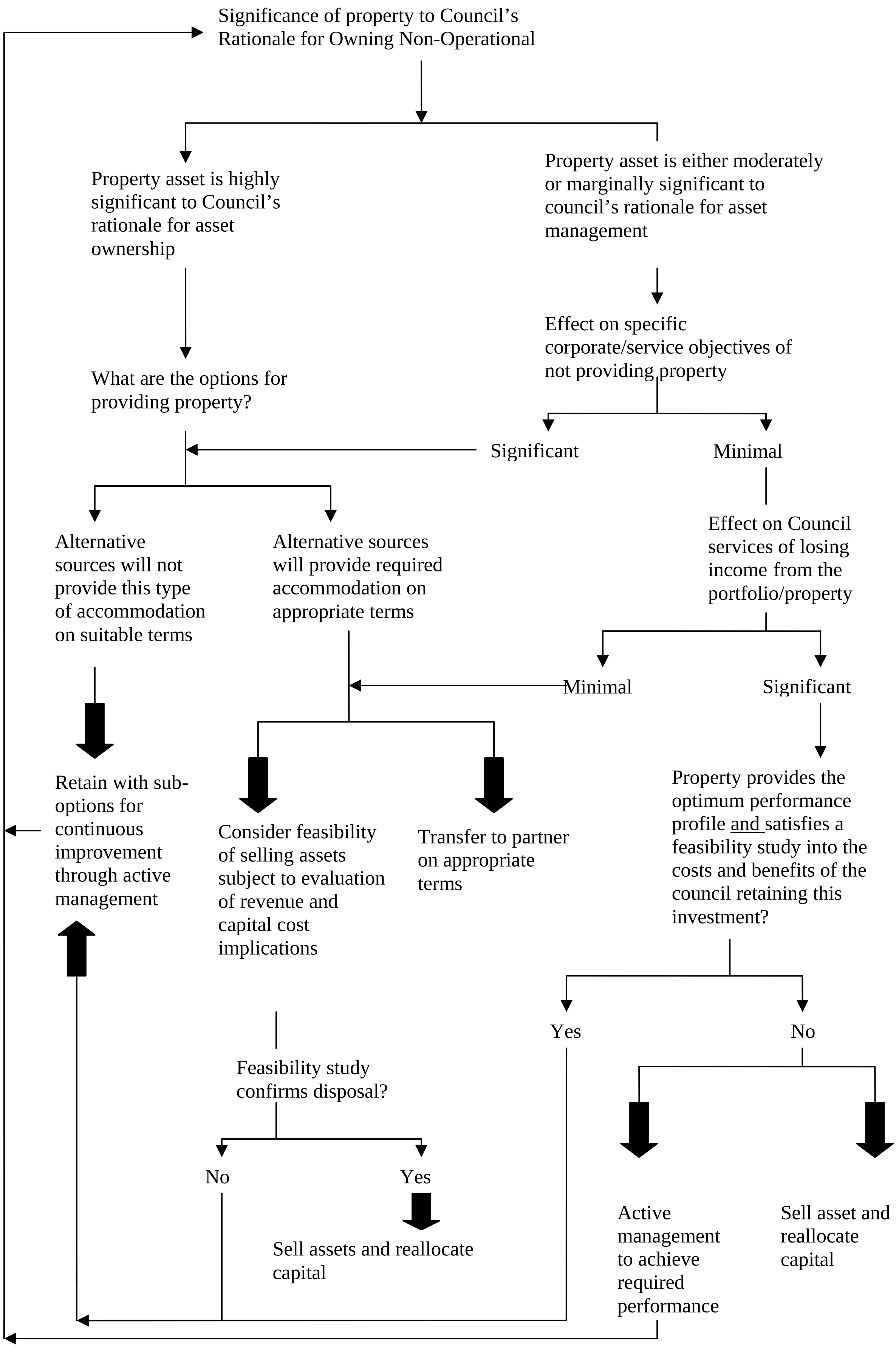
APPENDIX 1

GROUND LEASES INVESTMENT PORTFOLIO DECISION TREE FOR REVIEW AND CHALLENGE



APPENDIX 2

ASSESSMENT AND OPTIONS APPRAISAL OF GROUND LEASES

Overview

Best Value Committee on 21st January 2002 adopted the objectives for non-operational property and the assessment framework. The model was amended in September 2003 to align it to current corporate objectives.

Property Objectives

The 3 adopted property objectives for all non-operational asset reviews are:

Service return:
To achieve or support the achievement by others of Corporate and Community Plan aims and objectives, and to ensure that any properties leased to other organisations do likewise;

To increase the Council's influence in land use, vitality and viability and to influence the quality of design and construction, and, by example, to act as a catalyst in driving forward change.

Financial return:
To ensure that the financial return from investment and surplus properties is maximised where consistent with meeting the Council's corporate requirements.

Value for money:
To obtain value for money by the efficient, effective, economic and sustainable use of assets to achieve financial and service return.

The Property Strategy is directed to optimising the benefits of owning non-operational property to achieve these property objectives. In respect of the non-operational portfolio, the properties are to be assessed in order to rationalise existing holdings, to improve upon the performance of retained assets and to meet future requirements. This is to:
a) facilitate the development of key strategic sites in support of the Council's corporate and/or service objectives; and
b) secure revenue and/or capital returns that compare favourably with alternative means of investment return.

The Assessment Framework

The criteria for scoring (range -1 to 3 per criteria) against the property objectives are:
Service return – direct link with one or more of the Corporate Priorities;
Financial return - short-term rental growth prospects, internal rate of return (commercial measure and benchmark of income and capital performance over time) and level of risk.

Value for money - justifiable need for the asset, management costs, property condition and property service performance.

As well as scoring the properties, the assessment framework uses a **Decision Tree.** This allows the user to consider if there is a justifiable need for each property. This questions the rationale for owning the ground lease portfolio, then leads through questions on the impact of ownership, considers alternative investments and the impact of losing each property. In some cases, it may not be a simple decision and further feasibility studies may be necessary before deciding on one of the options. The options are:

Retain – active management to achieve required performance;
Retain – consider feasibility of property in alternative use or with partners, which better meet the Council's property objectives;
Sell – reallocate capital to better achieve corporate objectives and priorities.

Assessment of Ground Leases

The Council has a diverse non-operational portfolio, which has been partly inherited and partly assembled over a period of decades in both an ad hoc and planned manner. The Council has granted long leases at a capital premium, with either no rent or very low rents, or has granted leases for community uses at nominal rents where there have been strategic reasons for the Council to retain the freehold of the land, in order to influence future estates management. Some of the reasons for retaining these ground leases may not now be so significant and ownership may not be important in terms of delivering corporate priorities.

There are 27 ground leases identified, out of a total of around 300 leased land and buildings. The market value of these assets, as at 1st April 2008, is £457,000. Their annual rent roll for 2008/09 is £6,200, giving an average yield of 1.4%. Twenty-two of the 27 ground leases yield nil or income £10 p.a or below. Therefore unlike the investment portfolio, which represents 9% of all leased properties, but 59% of the total income of the non-operational portfolio, the ground leases also represent around 9% of all leased properties, but well below 1% of the income. They are very poor assets in the context of the Council's corporate investment policy and they do not comply with the Property Strategy, in achieving a return favourable with that received from the Council's invested funds. The AMP assessment therefore needs to challenge if there are service or strategic reasons to retain them. The capital values of the ground leases are low, as represented by the income stream, but often there are opportunities to increase this value. This is explained below.

A list of the 27 assets is shown in the matrix at the end of exempt Appendix 3.

Considerations for the Assessment

Some of the factors taken into account in assessing the assets against the adopted property objectives are:

Service return – The prime corporate aims for holding a ground lease portfolio are: Managing future growth and development of the Borough; Future development of Haverhill; Cattle Market redevelopment; Enhancing rural services. Because of the very low rents, ground lease assets do not raise corporate standards and efficiency.

Financial return – It is important that the non-operational portfolio generates growth in annual income and it could be questioned that if ground lease assets do not generate growth, then why retain them? However, there may be other financial qualities, such as the degree of risk of receiving the income and the amount of latent capital growth, if the land may be of strategic importance in the future. In some cases, the potential for future gains may outweigh short-term rental growth prospects.

Value for money – The third criteria is value for money, where factors include property condition and management and professional costs. The most important indicator here is the Decision Tree (illustrated in Appendix 1).

In many cases, the decision to sell or retain will be easy to judge, supported by the matrix scores and ranks. For other assets, it will be harder to judge and further feasibility studies may be needed. Considerations are:

- If sold, can an equivalent amount of income be raised from alternative investments (property or otherwise)? Costs of sale, acquisition, Stamp Duty and management also have to be taken into account.
- Are there any contractual obligations which have to be taken into account, such as lease covenants, grants, etc, which will affect value?
- Does the property fulfil a community need, which may be lost if the property is sold?
- Does the property have unique characteristics which are important for the Council to protect?
- Is there potential, with surrounding land, to improve the investment, by combining sites or changing their use, which may mean additional investment?
- Are there long-term strategic reasons for holding the property, which outweigh the current under-performance?
- Is there a more pressing need for alternative capital investment which would justify sacrificing current income (particularly if the capital value has increased more than rental value)?
- Could the property be retained by the Council and used for direct service delivery?

Cabinet on 11th January 2006 approved the establishment of a self-financing Property Fund for acquisition of key strategic or investment property (Paper W487 refers). It may be appropriate to use this facility to improve the performance of some existing assets, if opportunities arise.

The Current Market for Ground Leases

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- Value to sitting tenant: what would the sitting tenant(s) pay to own the freehold? The tenant is a 'special purchaser' and may pay over market value, if he wants to invest, for instance;
- Current value to Council: rental income against management costs (ie service return, value for money);
- Strategic considerations: opportunities for the Council to maximise income or capital by active management or partnerships.

Decision Tree Options for the Investment Portfolio

The matrix at the end of this exempt Annex lists the assets which form the ground lease portfolio. It scores and ranks each criterion and gives a total score and rank for each property. This enables performance to be compared for different criteria and against other properties. Poor and strong overall performers can be identified and then considered in broad terms whether to keep, vary or sell.

By comparison, the average score for a ground lease is 5, whereas the average score for an investment property was 17. The highest scoring ground lease is 10, which is well below the poorest investment assets.