Executive Report

Ward(s) affected: Friary St. Nicolas Ward

Report of Director of Strategic Services

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Wey House: Proposed surrender of existing and re-grant of a new lease

Executive Summary

Wey House, Park Street is a prominent office building providing 45,382 sq. ft. of accommodation (net internal area excluding communal space) spread over four floors located in the heart of the town centre on the gyratory opposite Guildford's mainline station. The building is let in its entirety as the HQ premises for Stevens & Bolton LLP who are an established legal firm. The central location is very convenient for office staff with easy access from all public transport links and nearby car parking.

The property was purchased by the Council as an investment asset in 2016 for £22.65 million and is the biggest single income producing property asset within the Council's portfolio. The outcome of the Asset Management Plan recommended retention due to its significant income return, strong tenant covenant and minimal management costs.

The property is held on a lease dated 3 March 2010 which expires on 2 March 2027. The tenant holds an Option for a Reversionary Lease for a term of 10 years from 3 March 2027 subject to a tenant only break clause on 3 March 2032. Stevens & Bolton pay a rent of £1.3 million per annum which is due for review in March 2025. The lease is inside part II of the Landlord & Tenant Act 1954 and therefore provides the tenant with security of tenure upon expiry. Recent agreement has been reached for the top two floors of the building to be sub-let to Media Molecule (a gaming company owned by Sony Corporation).

The tenant approached the Council with a proposal to remain in the building beyond the expiry date of the current lease in March 2027 subject to upgrading the heating and air conditioning system along with installation of Cat A low energy LED lighting

throughout the building being carried out at the Council's cost. The cost of these works is estimated to be £800,000. As a result, officers have agreed terms with the tenant to surrender the current lease and enter into a new lease for a term of 15 years without break at a rental income of £1.3 million per annum subject to a 12 month rent free period, upwards only rent reviews in March 2025 and 5 yearly thereafter, and a landlord's contribution to tenant works up to a maximum of £800,000.

Officers recommend proceeding with the surrender of the existing lease and regrant of a new lease as outlined above. This will secure the current rental income of £1.3 million per annum for 15 years, with a 12 month rent free period from completion and will be of considerable financial advantage to the Council. It will ensure a minimum annual rental income of £1.3 million for the additional 10 years beyond the unexpired lease term. It will also avoid the risk of the building falling vacant on lease expiry in less than 5 years' time at which point the Council would be highly likely to incur a considerably higher level of capital expenditure to refurbish ahead of securing a new tenant, compared to the £800,000 landlord's capital contribution proposed in the terms for the surrender and regrant. Officers recommend funding the £800,000 capital contribution from the Property Acquisitions budget in the approved capital programme.

The terms of the proposal include a 12 month rent-free period spread over 24 months. In effect, 50% of the rent i.e., £650,000 is received for the first two years of the lease and £1.3 million per annum is received from year three onwards. However, in accounting terms the rent free is spread over the full term of the lease therefore the projected rental income on the Council's balance sheet will re-profile to £1.213 million per annum over 15 years.

Recommendation to Executive

The Executive is asked to approve

1) the surrender of the existing lease to Stevens & Bolton and a simultaneous regrant of a new 15-year lease with no break clause at the current passing rent of £1.3 million per annum subject to an upwards only rent review in 2025 and 5 yearly thereafter with 50% reduced rent over first two years

2) that the Head of Asset Management (Climate Change Lead) be authorised to take such actions as are required to negotiate any minor amendments and finalise terms referred to in this report for the surrender and regrant of a lease to Stevens & Bolton subject to being satisfied that the Council will receive the best consideration reasonably obtainable and in consultation with the Lead Councillor for Resources, the Joint Strategic Director (Place) and the Joint Executive Head of Service for Finance.

3) the spending of the approved Property Acquisitions budget to fund a landlord's capital contribution towards tenant improvement works

Reason for recommendation

This recommendation is being made to the Executive to secure the rental income of £1.3 million per annum for a further 10 years beyond the expiry of the existing lease in place and which will be subject to upwards only rent reviews in 2025 and 5 yearly thereafter. Thus, it will remove the risk of the building falling vacant in 2027 when the current lease expires, and the likely significant level of investment required to refurbish the building (estimated at £5 million) to attract a new tenant. It is therefore considered the most financially advantageous option to the Council and will improve the investment performance of the asset for the next 15 years.

Is the report (or part of it) exempt from publication? No

1. Purpose of Report

1.1 The purpose of the report is to ask the Executive to approve the recommendation to surrender the lease currently in place with the Council's tenant of Wey House, Stevens & Bolton, and to simultaneously grant a new 15-year lease on the terms outlined in this report.

1.2 The report explains that approval of the proposal will secure a continuation of the current rental income to the Council of £1.3 million per annum for 15 years without break and thus avoid the risk of the building falling vacant on expiry of the current lease in 5 years' time. Were the latter to occur, the asset would require a considerably higher level of capital expenditure to refurbish ahead of securing a new tenant compared to the £800,000 capital expenditure proposed as part of the surrender and regrant.

1.3 The report also explains the impact of the new lease on budget. In line with the CIPFA Accounting Code of Practice the Council must project rental income in the financial accounts on a straight-line basis over the life of a lease. For this asset, the current projected income for 2022/23 is £1.3 million. By securing the longer lease and giving a 12-month rent free, the annual income to the revenue account will be £1.213 million per annum for 15 years.

2. Strategic Priorities

2.1 A well-managed, income producing property investment portfolio supports all the fundamental themes of the Corporate Plan and the Council's strategic priorities as follows:

We will ensure Guildford is a place where business can thrive... Access to high quality housing and jobs is crucial to the health and wellbeing of our communities.

We will work with our business community and Business Improvement District to ensure our local economy remains competitive and will actively seek new inward investment.... We will support these dynamic businesses, which are critical to our economic recovery and renewal.

Our Values

- We will support our local economy

Homes & Jobs *Residents having access to the homes and jobs they need*

- Support our business community and attract new inward investment
- Create employment opportunities through regeneration

Environment *Protecting our environment*

- Engage with businesses to encourage them to act in more environmentally sustainable ways.

3. Background

3.1 Stevens & Bolton currently occupy Wey House via a lease due to expire in March 2027. The current rent is £1.3 million per annum which is due for review in March 2025. The tenancy contains an Option for a Reversionary Lease for a term of 10 years from 3 March 2027, which includes provision for the tenant only to break the lease on 3 March 2032.

3.2 Covenants within the existing lease require the tenant to maintain and repair the current air conditioning and heating plant and lighting systems. However, this equipment is nearing the end of its economic life. Were the tenant to vacate the premises on lease expiry in five years' time, this equipment would require upgrading. The replacement cost would fall to the Council (less any payment received for dilapidations).

3.3 Council officers were approached by the tenant to explore the opportunity of remaining in occupation of the building beyond the expiry date of the current lease in March 2027 subject to upgrading the heating and air conditioning system along with an upgrade to Cat A low energy LED lighting throughout the building being carried out at the Council's cost. These works have been estimated at £800,000.

3.4 Officers have agreed terms to surrender the current lease and grant a new lease for a term of 15 years without a break clause, which will add a further 10 years certain to the current lease term. The initial rent will remain the same as existing (£1.3 million per annum) subject to upwards only rent reviews in March 2025 and 5 yearly thereafter. The terms include a 12 months' rent-free period split over the first 2 years of the lease. This level of rent-free incentive is reflective of the current market for similar quality buildings available within the locality and similar quality of tenant covenant.

3.5 The terms include for the Council to meet the capital cost of the upgrade works up to a maximum of £800,000. By securing a new lease with the current tenant accepting a landlord's capital contribution, this would reduce the risk of the Council having to replace the equipment itself at what is likely to be a greater cost than £800,000 in less than five years' time were the property to then fall vacant.

3.6 If the Council were to forego this opportunity and do nothing, it runs the risk of the tenant vacating at lease end in less than 5 years from now when the Council would have to not only meet the cost of upgrading the heating and ventilation system and the LED lighting (£800,000) but would likely have to invest considerably more capital to refurbish the building (estimated cost £5 million) to an improved standard to attract a new tenant. A rental incentive of 12 months for a 10-year term of lease would similarly likely need to be offered as an incentive. Officers commissioned capital valuations for the two scenarios; that is, the lease expiring in 5 years and the tenant vacating, expenditure required to refurb etc. versus proceeding with the surrender and re-grant of the new lease with proposed incentives. The valuations demonstrated the recommended option to be of considerably greater value to the Council and therefore the terms of the proposal are considered to satisfy the Council's requirement to achieve best consideration reasonably obtainable, thereby satisfying the requirements of section 123 of the Local Government Act 1972.

3.7 The recent sub-letting of the upper two floors of the building to Sony-owned, Media Molecule, should also be noted. This offers the benefit of another occupant with a strong covenant. The proposed improvements to the building's specification assisted in securing the sub-tenant's occupation.

3.8 Upon satisfactory completion of the improvement works, the Council will be required to pay the cost of the works, not exceeding £800,000 plus VAT. The new lease will define these works as Landlord's improvements, thereby allowing these to be taken into account at the next (upwards only) rent review on 3 March 2025 and 5 yearly thereafter. Officers recommend funding the £800,000 capital contribution from the Property Acquisitions budget in the approved capital programme.

4. Consultations

4.1 The Lead Councillor for Resources has been consulted and supports the recommendations.

4.2 The Ward Members will be consulted.

5. Key Risks

5.1 There are three main risks identified, as follows:

1) Failure of the proposed works to achieve desired improvements to regulate temperatures within the office and to improve energy consumption via led lighting.

2) Failure of the Contractor to complete the works as per the specification.

3) Failure of the tenant's business.

5.2 Risks 1) and 2) will be mitigated via collateral warranties to be provided to the Council that will extend to the design team and contractor in the event of either outcomes. The Council will only be responsible for payment of the £800,000 plus VAT once it has been confirmed by the Council's building surveyor that the works have been carried out to a satisfactory standard and practical completion has been reached.

5.3 Stevens & Bolton is an established Legal 500 firm of circa 150 lawyers with a financial summary for 2021 that demonstrates a gross profit of £7.35 million. Whilst it is not possible to guarantee the performance of a tenant over a term of 15 years, as at today the tenant's business health appears strong.

6. Financial Implications

6.1 A capital sum of £800,000 is to be payable by the Council on practical completion of the works (proposed to be funded from the Property Acquisitions Budget on the approved capital programme).

6.2 A building surveyor will need to be appointed by the Council to monitor the works and attend site meetings during progress to ensure they are being carried out to the agreed specification and programme. Officers anticipate this work can be absorbed in-house. Officers will seek advice from a Quantity Surveyor (QS) to verify accuracy of the cost breakdown for the works proposed prior to proceeding - this will require the appointment of an external consultant at a cost which should not exceed £5,000. The tenant has agreed to contribute a sum of £5,000 towards the Council's costs in the matter.

6.3 A rent-free incentive of 12 months has been proposed. The CIPFA Accounting Code of Practice states that income from leases has to be spread over the life of the lease. The proposed rental terms mean the projected income will re-profile to £1.213 million per annum, thereby limiting the impact of the rent free period on the General Fund.

7.1 Legal Implications

7.1 Officers have consulted with the Council's in-house legal team on the preparation of the necessary agreements, lease and licence for alterations required. The legal team have been informed that completion of the agreements is required by 25 August, subject to Executive approval, and are working to this timetable but this is subject to agreement of the documentation by the Tenant.

7.2 Local authorities are given general powers under the Local Government Act 1972, to dispose of land in any manner they wish, including sale of their freehold interest, granting a lease or assigning any unexpired term on a lease, and the granting of easements, subject to certain legal constraints. A disposal such as the lease proposed in this report must be for the best consideration reasonably obtainable, as set out in section 123 Local Government Act 1972, unless the Secretary of State consents to the disposal.

7.3 It is confirmed at paragraph 3.6 of this report that the rent negotiated is the best consideration reasonably obtainable, thereby satisfying the requirements of section 123 of the Local Government Act 1972.

7.4 Where a lease is granted within the security of tenure provisions of Part II of the Landlord and Tenant Act 1954, a landlord may only bring the lease to an end at the end of the term by serving a section 25 notice on very limited statutory grounds. Security of tenure also means that at the end of the term, the tenant will be able to hold over on the terms of the lease regardless of expiry of the term granted and they will have the right to call for a new lease on similar terms except, broadly, as to rent and the landlord will be obliged to renew the lease. Therefore, the Tenant could request a new lease at the end of the lease term.

7.5 In order to grant a new Lease during the term of an existing Lease, the existing Lease must be surrendered. The surrender can take place in a number of ways, whether implied or express, and the recommendation is that a formal Deed of Surrender is entered into along with a surrender of the option for a further lease.

8. Human Resource Implications

8.1 No HR implications apply.

9. Equality and Diversity Implications

9.1 This duty has been considered in the context of this report and it has been concluded that there are no equality and diversity implications arising directly from this report.

10. Climate Change/Sustainability Implications

10.1 From April 2018, landlords of buildings with the scope of the Minimum Energy Efficiency Standards (MEES) Regulations are prohibited from renewing existing tenancies or granting new tenancies where the building has less than the minimum energy efficiency (EPC) rating of E. This will apply to all existing leases from April 2023 and increasing to a D rating from April 2025 and thereafter C with effect from April 2027. The proposed works to upgrade the air conditioning plant and to install low energy LED lighting to the building are likely to assist in improving the building's energy efficiency from its current rating of D, reduce carbon emissions and thereby futureproof the ability for the asset to remain in occupation. No Environmental Impact Assessment has been undertaken, however.

11. Summary of Options

11.1 These are as follows;

a) Do nothing and wait for the current lease to expire in March 2027. This will expose the Council to the risk of the tenant vacating on expiry at which point the Council is likely to have to carry out the upgrade works being proposed and, in addition, likely to have to undertake a full refurbishment (estimated cost of £5 million) to attract a new tenant, with the loss of income during the works programme and marketing period whilst the building remains empty.

b) Proceed with the lease surrender and simultaneous grant of a new 15-year lease thereby securing the rental income (currently £1.3 million per annum) for an additional 10 years subject to meeting a capital contribution requirement of £800,000 and a rent-free incentive of £1.3 million.

12. Conclusion

12.1 If the Council chooses to do nothing and allow the current lease to Stevens & Bolton to run until expiry in March 2027, it will receive a further £1.3 million per annum rental income (this may increase at rent review which is upward only in 2025) until expiry (circa £6 million in total). At this point, there would be a very real risk of the building becoming vacant. Having regard to its age, fit out and most of the mechanical and electrical equipment nearing the end of its economic life, it is likely that a refurbishment will need to be carried out to attract a new tenant. This could cost in the order of £5 million. Plus, a void period for marketing as well as a rent-free incentive of circa 12 months (for a 10-year term of lease) would likely need to be allowed for to secure a tenant of good covenant.

12.2 Whereas, if the Council proceeds with a surrender of the existing lease to Stevens & Bolton and a simultaneous grant of a new 15-year lease without break adding an additional 10 years to the current term, the Council would then expect to receive a minimum of circa £19 million in rental income (this may increase at rent reviews which are upward only in 2025, 2030 & 2035).

12.3 In return the Council would be required to meet the capital expenditure costs of improvement works (which will not exceed £800,000 plus VAT) and make allowance for one year's rent free (totalling £1.3 million) to be accounted for in the budget over the life of the new lease.

12.4 Officers recommend proceeding with the surrender of the existing lease which has only 5 years to expiry and entering into a new lease with a 15-year term without break to secure the rental income for an additional 10 years. This is viewed as being the most financially advantageous option.

14. Background Papers

None.

15. Appendices

None.