

DISCUSSION NOTE - BNP PARIBAS REAL ESTATE REVIEW COMMERCIAL ESTATE STRATEGIC REVIEW

This appendix is a summary of discussions with BNP Paribas who are the Council's critical friend and external adviser for the commercial estate strategy.

Background

The Estate comprises approximately 220 assets valued at c£250m, the majority of which are retail premises located in Bath city centre. The Estate makes a significant contribution of c£15m pa to the revenues of the Council.

Discussions with BNP Paribas have considered:

- The progress made in achieving the strategic review
- The emerging asset management strategy to dispose of surplus and underperforming assets to invest in the core estate
- The utilisation of BNP Paribas Real Estate and the benefits that the private sector can bring
- Areas of improvement including resourcing levels or alternative means of resourcing key activities

It was noted that *"the Council has over the past 9 months moved towards a smarter way of looking at its property assets by adopting a whole council approach. For example:*

- *the Estate is contributing to the objectives of ADL, the Council's residential development company, and*
- *local independent trader tenants are regarded as contributing to the wider economy and hence the achievement of corporate objectives".*

Property Market Uncertainty

The discussions are taking place at a sensitive time and it was also noted that:

- Following the Referendum held on 23 June 2016 concerning the UK's membership of the EU, and the decision taken to exit, the commercial property investment and letting markets in the UK have been disrupted. These circumstances are unprecedented.
- Since then there has been little or no empirical evidence of market activity, resulting in a reduced level of certainty that can be attached to forecasts of how the market might perform in the future.

In view of this BNP advised that we should have *"less confidence than usual in the probability of the property occupier and developer markets performing in a way that you currently expect. The consensus of commentators appears to be that there may be a softening in rental growth and a spike in yields"*.

Our advice is submitted on the assumption that there will be no significant disruption to the markets having an impact on the performance of the Estate.

We would recommend that you regularly review your financial appraisals in respect of any developments from which you are anticipating future income”.

The Strategic Review

The Council’s strategic review sets targets for the commercial estate as follows: to increase the net income from the Estate by £1.250m by 2019-20.

A	B	C	D	E	F	G
	Current Estimated Income	Growth in rental income from current Estate	Reductions in SSB	Acquisition s	Total Estimated Income for the Year	Increase
2015-16	£15,335,180					
2016-17	£14,868,592	£905,381	£43,775	£0	£15,817,748	£482,559
2017-18	£15,767,292	£248,469	£30,038	£0	£16,045,799	£278,507
2018-19	£16,097,205	£25,000	£26,120	£312,814	£16,461,139	£363,934
2019-20	£16,469,189	£0	£54,240	£70,760	£16,594,189	£125,000
Totals		£1,178,850	£154,173	£383,574		£1,250,000

The following is a summary of each aspect of this with comments from BNP Paribas.

Growth in rental income from current Estate

A total increase in income of £1,188,500 by 2018-19 is derived from transactions at 15 properties.

Comment: “There is a high degree of certainty that this income will be received because it is derived from contracted transactions. The market would regard the majority of it as “business as usual” income derived from the re-letting of vacant properties with the balance derived from asset management initiatives pursued by Property in respect of individual properties”.

Reductions in SSB (service supported borrowing costs)

This additional saving is achieved by selling property and using the proceeds of sale to write down existing debt secured against the Estate thereby reducing the capital financing charges. The majority of the assets identified for sale are a number of residential units over.

Comment: “There is a high degree of certainty attaching to this projected reduction in debt servicing and consequential increase in net income because the Council is effectively the end buyer and house prices are unlikely to fall in Bath over the plan period”.

Additional capital could be generated from long lease restructures, currently identified as a source of income in Column E and addressed below.

Acquisitions

We have been asked to focus particularly on this initiative.

Comment. *“The decision to retain capital receipts for re-investment in the Estate was a major step forward in your ability to rebalance the Estate. The estate has effectively moved from being a closed estate to a trading estate”.*

It is proposed that the additional income required in 2018-19 will be derived from the following initiatives.

The acquisition of income producing investment properties

A more active approach to the management of the estate is already taking place with a gradual rebalancing of the estate to secure greater diversification whilst generating additional income.

Comment. *“The decision to retain capital receipts for re-investment in the Estate was a major step forward in your ability to rebalance the Estate. The estate has effectively moved from being a closed estate to a trading estate”.*

The plan is for there to be a series of acquisitions funded by short term or longer term borrowing. If there is to be an offsetting capital receipt within (say) 3 years a short term rate can be used. It should be noted long term rates are also at unprecedentedly low levels.

Comment: *“For the reasons set out below we believe there is a high degree of uncertainty attaching to this additional income.*

We have identified a number of constraints that will adversely affect your ability to achieve this target.

- *You have advised us that you are legally constrained from buying investment property outside the B&NES area. This is a severe constraint because the stock of good quality non-retail investments in B&NES is relatively limited. With industrial and distribution warehouse rents forecasted to outperform retail by a significant margin over the next five years, we might well be recommending you to focus on these two sectors. Unfortunately the stock of modern well let industrial and distribution warehouse stock in B&NES is very limited. By contrast there are good opportunities within the Avonmouth area in adjoining Bristol.*
- *Competition for prime property investment stock is intense with relatively poor odds of succeeding in open bidding situations. A strategy of actively seeking out property investments to acquire off and on market will require a dedicated suitably experienced internal resource (which you do not currently have) and supported by external investment agents”.*

The Council is in an unusually advantageous position because it is able to borrow 100% of the total acquisition costs at very low capital financing costs with no fees or costs as compared to the private sector where the Loan to Value Ratio could be typically 60 to 70% for a good quality asset with bank, legal and valuation fees in addition to higher lending margins.

Acquisition of Intermediate interests

It is proposed that Income will also be generated by buying out long leaseholders and taking the benefit of additional rack rented income.

Comment: "Long leaseholders sometimes approach the Council as freeholder to re-negotiate the terms of their ground lease with a view to extending the term to 125 years or to negotiate a surrender of the long leasehold interest. The result is usually the generation of marriage value."

The resulting marriage value would be shared between the Council and long leaseholder either by way of a capital sum or a re-gearing of the ground rent. It is not in the interests of the Council to re-gear the ground rent because your auditors have advised you that rent from new/re-gear long leases cannot be treated as income, thus potentially preventing such additional income from contributing to the income target.

We therefore believe there is a high degree of uncertainty attaching to this additional income because it relies upon the desire of the long leaseholder to negotiate and may in any event not be possible under current accountancy rules if part of the consideration to be received is rent".

Development

The Council has a series of planned developments for regeneration purposes in the Enterprise Area many of which are funded through City Deal. The devolution deal offers the opportunity for these projects to be supported by strong guarantees of funding from government. There are also proposals to generate income by taking the role of developer in aspects of the regeneration using the in house project delivery skills that exist in the combined Property & Project Delivery Division.

Comment. "You have provided us with confidential information regarding the construction of an office building which is pre-let to an occupier. The contribution to net income should come on stream after the Review period but demonstrates the potential to grow the rental income through targeting investment in development projects".

The Emerging Asset Management Strategy

BNP Paribas have set out below their proposed work

"We have worked with Property to identify a number of work-streams to be pursued in order to achieve the above objectives.

- 1. Realise capital receipts from the sale of non/low-income producing assets or lease re-gears in order to write down the debt already incurred in buying assets.*
- 2. Identify under-performing assets for sale in order to build a cash war chest for re-investment in better, preferably non-retail, quality stock thus reducing future management/repair costs and achieving a re-balancing of the portfolio. Alternatively, advantage could be taken of opportunity purchases which would consolidate your ownership.*

3. *Engage positively with your top 45 tenants who pay 50% of your rents with a view to securing that income into the future.*
4. *Develop AMPs for the key retail locations in Bath and your office and industrial stock.*
5. *Identify non-retail investment stock within B&NES (or beyond if legally possible) that would constitute suitable purchases and seek to secure purchases off market.*
6. *When you are in a position to enter the market to acquire replacement assets, build relationships with active property investment agents.*

You have provided us with 5 suggested property management led work streams covering the following topics. Completion of each work stream is expected within the next six months.

- *Development of commercial estate asset management plans*
- *Produce and review a list of potential commercial disposals*
- *Introduce a new flexible form of lease*
- *Establish a framework for the appointment of letting agents*
- *Management of key tenants”*

The Utilisation of BNP Paribas Real Estate

BNP Paribas were appointed in 2013 to the role of Critical Friend and Specialist Adviser. The challenge being faced then, as now, is the same challenge faced by local authorities up and down the country, namely how to harness private sector experience with the in house expertise without handing over the business lock, stock and barrel.

The role is seen as bringing advice and challenge to the process of generating increased levels of revenue and capital income with particular emphasis on achieving the optimum mix of the Estate and the generation of increasing levels of rental income. It is more about working with Property to challenge, shape and develop strategies to achieve this key objective than working for Property.

Central to the relationship is trust. You are entrusting us with highly sensitive commercial data, whilst we are sharing confidential market intelligence. This cannot be done without each trusting the other to respect that confidentiality.

The advantages of working with a company like BNP Paribas Real Estate, or an equivalent organisation, as critical friend were set out by them as part of our discussions:

“Property [would] have daily access to a vast range of expertise and knowledge, the following being a few examples:

- *Access to national retail market intelligence allowing Property to target those national retailers actively looking to acquire premises in Bath as well as those looking to leave*
- *Access to national investment market intelligence including upcoming sales and access to major property owners*

- Access to our Research department
- Access to industry experts in asset management and property management techniques
- Access to Valuation experts providing support on valuation techniques, specialised valuations and the regulatory background

This wider national intelligence is then blended with our local knowledge of your property holdings and our involvement in the local/regional property markets.

The value of having easy and direct access to private sector specialists cannot be under estimated”.

Areas of Improvement

BNP Paribas summarised for us some areas of improvement. Their comments are:

“The initiatives now incorporated in the Strategic Review are most definitely a step forward towards the step change required if the Estate income is to be maximised over the review period.

The further initiatives required will require additional in and out house suitably experienced resource if the income is to be maximised.

We have identified the following areas for improvement.

- *Encourage all asset managers in Property to take advantage of the skills and market knowledge available within BNP Paribas Real Estate and to engage with “best in class” private sector property portfolio asset managers to raise awareness of current best practice*
- *Accelerate and expand the asset management initiatives required in order to extract maximum income from the Estate*
- *Prepare a comprehensive written strategy supported by a range of measurable, time scaled targets for income growth and cost reduction, supported by the asset management initiatives”.*

Summary of Conclusions

The following are BNP Paribas conclusions:

“Much has been done to take a more holistic view of the Council’s property assets and to enhance the performance of the Estate.

- *The Strategic Review is most definitely a step forward towards the step change required if the Estate income is to be maximised over the Review period.*
- *The decision to retain capital receipts for re-investment in the Estate was a major step forward in your ability to rebalance the Estate.*
- *Steps have been taken to reduce the running costs of the Estate*
- *Property have been active in the consideration of one off income generating initiatives and opportunities to acquire new property.*

- *There is a high degree of certainty over the Growth in Income projections (Column C).*
- *There is a high degree of certainty over the proposal to increase net income through the reduction of SSB (Column D)*

However, much remains to be done.

- *There is a high degree of uncertainty over the proposals to grow income through acquisitions supported by short term borrowing (Column E) with no evidence that there are £15m of non-income producing assets required to pay down that debt. We will work with your officers to model an alternative approach utilising long term borrowing.*
- *There is also a high degree of uncertainty over the proposal to grow income during the Review period through commercial property developments. The pre-let office development referred to above is planned to contribute additional income from 2020-21 onwards.*
- *It is essential that the Estate strategy is completed to ensure that existing income is protected and that additional income is extracted from the Estate through a range of measurable time-scaled achievable targets. These must be supported as soon as possible by a range of strategic and tactical Asset Management*
- *Urgent consideration should be given to reviewing the Estate objectives in order to clarify the role some assets are expected to play (e.g. local independent trader tenants) to ensure that the performance of the Estate can be measured against realistic bench marks.*
- *The global income forecasts should additionally reflect the Net income, ensuring that initiatives to reduce running costs, internal fees and debt funding are properly reflected.*
- *Additional suitably experienced resource is needed in the short and long term if the required step change is to be realised. There is an opportunity for BNP Paribas Real Estate to support Property by providing some short term resource”*

Following comments received at PDS Resources there is to be further discussion with the Cabinet Portfolio Holder to ascertain how to develop the strategy and also how to involve external expertise such as that provided by BNP Paribas.