APPENDIX 1

CABINET
6 MARCH 2018

FEETHAMS OFFICE DEVELOPMENT – PLOT 1

FINANCIAL POSITION SUMMARY

How much will it cost to build the offices?

1. Based on a design and build contract the estimated cost is £8.343m with additional fees of £0.157m. Total budgeted cost of project is £8.5m. Cabinet have previously released £0.200m and a further £0.500m will be allocated from the Economic Growth Investment Fund (EGIF) for which the Director of Economic Growth has delegated authority. It is requested that Cabinet release the remaining £7.8m (£8.5m, less £0.7m)

2. In addition to the design and build cost the Council will also be contributing land towards the project which will be zero valued for investment purposes. The value of the land based on the building footprint is £0.500m.

How will the Council fund the offices and how much will it need to borrow?

3. Entering into the office development market is inherently risky, particularly in this region where speculative development by private firms has proven difficult to achieve. Given the broader goals of regenerating this site, and creating more opportunities for job growth in the office market, Cabinet are being recommended to progress this scheme.

4. In order to reduce the revenue risk to the Council from the borrowing required to construct and operate the office block, external funding has been sought. Therefore a bid of £2.04m has been made to European Regional Development Fund (ERDF) for a non-repayable grant. Whilst this funding has not been fully secured the indications of success are positive.

5. In addition, subject to due diligence, the Tees Valley Combined Authority (TVCA) have approved funding of £3.23m anticipated to be offered under a full risk/reward share agreement based on the net rental income after taking into account all eligible income and expenditure. In short this means that TVCA will take a share of any deficits or surplus’s that accrue from this development on a 46/54 basis with the larger share to the Council and is based on total capital contributions made. The financial implications for the Council contained in this report assume that this agreement is in place.

6. Given the above the funding of the office build would be made up as below;

(1)	ERDF	£2.04m
(2)	TVCA	£3.23m
(3)	DBC	£3.23m
(4)	DBC – land input	£0.50m

7. The balance of £3.23m would need to be funded by the Council. £0.500m would be from the EGIF and £0.1m has already been incurred in the completion to RIBA Stage 3. The overall borrowing requirement is therefore £2.63m which will be repayable from net rental income arising from the scheme.

8. Given the high level of risk of the scheme, it is advised construction should not commence on the office development without securing all the external funding including the risk share agreement with TVCA.

How much will this cost the Council?

9. The cost of construction to the council is noted above at £3.23m however the whole life costs of the scheme is dependent upon a number of factors including the final build cost. A report has been prepared by the Council's commercial agents and provides advice on what is deliverable in terms of rental levels, voids and occupancy levels based on their market facing expertise. Given the Darlington market lacks quality office accommodation it is anticipated the rent should achieve in excess of £15.00 per sq. ft. and average occupancy level of 80 - 85%. However actual rental levels and occupancy will depend on market demand.

10. The Council's commercial agents have undertaken early marketing activity to identify potential tenants to help manage some of the risk associated with these dependencies and a baseline financial model has been prepared to consider various financial scenarios.

11. A summary of the baseline model is shown in Table 1 below.

Table 1 Feethams Plot 1 (Baseline Model)

Build	
Net Area sq.ft.	32,399
Original Build Cost (less Public Realm)	£8,500,000
Value Engineering	£0
Revised Build Cost	£8,500,000
Funding	
ERDF	£2,040,000
TVCA	£3,230,000
DBC	£3,230,000
DBC Land Value	£500,000
Scheme length (years)	40
PWB Rate	2.44%
MRP Included	Yes
TVCA Risk Share	46%
Operational	
Average Occupancy	85%
Rent per sq ft	£15.00
Service charge per sq ft	£8.83
Expenditure Inflation (annually)	2%
Rent Free Period (months)	18

Financial Position after 40 years	
Net Gain/(Loss) Before Capital Contributions	**£1,198,722**

Average Annual Revenue Surplus/(Deficit)	**£30,000**

12. Reflecting the advice in the business model and assuming the successful award of external funding it is anticipated the Council could expect to see on average a small annual return of approximately £0.03m after repayment of any borrowing.

13. Given the commercial aspects of the scheme which would likely see some rent incentives offered to tenants this may lead to some years where expenditure exceeds income leading to an in year deficit. Any deficits arising from cash flow is expected to be managed within existing Economic Growth resources. Based on best estimates of occupancy over the first five years the cost to the Council is estimated to be £200,000.

Could the Council make more or lose money out of this development?

14. The Feethams masterplan detailed that Grade A offices would support the vitality of the Town Centre and complement the other new investments. This site is currently derelict and in a very prominent strategic location and is considered important to the future regeneration, confidence of the place and well-being of the town centre.

15. As the development is speculative and both rental values and occupancy cannot be known with certainty at this stage there is the possibility that the Council may not receive enough rental income to fully cover borrowing and/or running costs. The overall loss falling onto the Council would be mitigated through the risk/reward share agreement with the Combined Authority.

16. Alternatively, if higher rents or occupancy levels are achieved then the Council will receive net income in excess of the baseline position.

17. Table 2 provides a sensitivity analysis with examples on how changes in rental values and occupancy levels could have on the average annual position over the life of the scheme. The detail behind the summary in Table 2 includes non-domestic rates payable on voids, running costs adjusted to reflect the appropriate occupancy levels, planned maintenance and borrowing which includes both principle and interest repayment. All figures shown take into account any risk/reward share agreements with TVCA and therefore the financial impact on the Council.

Table 2 Sensitivity Analysis - Rent & Occupancy

DBC Average Annual Net Surplus/(Deficit) Over 40 years

	Rent per sq.ft.		
Occupancy	**£14.00**	**£15.00**	**£16.00**
0%	(£315,000)	(£328,000)	(£340,000)
50%	(£116,000)	(£115,000)	(£113,000)
70%	(£37,000)	(£31,000)	(£25,000)
80%	£1,000	£10,000	£19,000
85%	£20,000	£30,000	£40,000
90%	£39,000	£50,000	£62,000
100%	£89,000	£103,000	£117,000

All figures shown before possible claw back of ERDF grant if profit achieved over and above eligible net expenditure.

Baseline model highlighted in grey.

18. The above table highlights the financial risk associated with the scheme. If occupancy was at 50% with rents of £15 per sq. ft., the average annual cost to the Council would be £0.115m; likewise, if the Council failed to find any tenants then the average annual cost would rise to £0.328m pa. Conversely achieving greater occupancy levels or rental values above the baseline level would see additional income received from the scheme.

19. The figures shown in Table 2 are averages based on the total life of the office development; it is unlikely that occupancy would remain at 0% for this length of time. Taking just the first five years the potential annual cost at 0% occupancy would range from £0.164m in year one rising to £0.271m by year five. **On average the cost would be in the region of £0.233m pa across the first five years**. This is therefore the maximum revenue exposure the council would face in the first five years and if such risk arose alternative mitigation would need to be put in place.

20. A breakdown of the average cost applicable to DBC after taking into account the TVCA risk/reward agreement over the first five years if 0% occupancy is shown below in Table 3.

Table 3 DBC Average Annual Cost Over First Five Years

Description	**Average cost (Year 1-5)**
Non-domestic rates	£92,000
Running costs	£20,000
Maintenance fund	£14,000
Borrowing	£107,000
Total average cost	**£233,000**

21. Table 2 illustrates the impact small variations can have on the viability of the project. As an example 1% increase in occupancy would see an additional £0.161m gain to the Council over 40 years, adversely a drop of 1% would see an equal but opposite loss. See Table 4 for further examples.

Table 4 Variation & Impact

		DBC
Description	**Variation +/-**	**Impact +/-**
Build Cost	£0.100m	£0.063m
Rent	£0.25	£0.102m
Occupancy	1%	£0.161m

22. What Tables 2 and 4 show is how marginal the scheme is and small variations can have a significant impact both positive and negative. As a result the project is not without a significant level of risk. This risk could be mitigated by reducing the pressure on the general fund by underwriting any deficits from the EGIF.

23. Until negotiations are underway with potential tenants it is difficult to predict what our financial position will be.

What is being done to mitigate risk?

24. Given the level of risk associated with the project there are a number of actions in place to mitigate the risk where possible. These include:-

    (a) Recovery of investment through rental and business rates income.

    (b) Entering into a risk/reward share funding agreement with the Combined Authority which will see any surpluses or deficits shared between the two organisations.

    (c) DBC has undertaken early marketing activity to identify potential tenants prior to construction.

    (d) Work with commercial agents through a robust marketing strategy to drive for rents above £15 baseline and secure tenants to achieve high and sustained occupancy.

    (e) Reduce build cost through value engineering.

    (f) Look at feasibility of selling the property after 15 years.

    (g) Manage cash flow through existing resource to limit impact on the general fund.

    (h) Underwrite DBC contribution with the EGIF.

    (i) Should the financial risks highlighted occur some could be mitigated by relocating employees from existing offices and freeing them up for sale or lease however the opportunities are limited.