8. THE ORCHARDS SHOPPING CENTRE – FIRST YEAR REVIEW

REPORT OF: HEAD OF CORPORATE RESOURCES
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Wards Affected: All
Key Decision: Yes
Report to: Scrutiny Committee for Leader, Resources and Economic Growth
7th March 2018

Purpose of Report

1. To review the operation of the centre, one year on from the purchase of the head lease.

2. This report provides the Committee and the wider public with an overview of the operation of the centre both from a managerial and a financial perspective. As much detail has been included as possible but due to commercial considerations some figures have been summarised. This should not affect the broad thrust of the report.

Summary

3. The head lease was bought in November 2016 for the sum of £23.2m. The yield at the time of purchase was circa 8.6% on an investment basis but before certain costs.

4. The centre is presently fully tenanted with the exception of the two units that have proved difficult to let since the centre was built in 1988.

5. It is considered that whilst the retail environment is difficult nationally, the Orchards is in a favourable location and should continue to trade well into the future.

6. The Council should consider developing a strategy and investing in the centre to extend its retail and leisure interest.

Recommendations

(i) The committee is asked to note this report.

Background

7. The Council bought the head lease from BMO in November 2016 for £23.2m, financed from a combination of internal reserves and external borrowing. Prior to purchase we were advised by BNP Paribas and Capita Asset Management, and extracts from reports were added to reports to the Members of the Audit Committee, this Scrutiny Committee and Council. In addition, Members considered exempt reports on the purchase.

8. Since the purchase, we have agreed the following tenancies and renewals:

Tenant		**Tenure**
The Works		New 5 years
Personal Service Travel		New 5 years
Cards Direct		New 10 years

Carphone Warehouse		5 year renewal

9. The centre is now being managed in-house although for the first year we used an external company while we increased our knowledge of how shopping centres are run on a day to day basis. It became clear that we could integrate some of the more routine work like rent and service charge invoicing into our existing workload, and use our existing contracts for the centre maintenance.

10. This took place in December 2017 and included the transfer of the Centre Manager to the direct employment by the Council. This ensures continuity of service for the tenants whilst bringing direct knowledge in-house; in essence, for tenants and users of the Centre no change should be noticed. The Centre Manager holds a Diploma in Centre Management (2016) and keeps abreast of industry trends to ensure that these can be reflected in our offering where possible.

11. We retain our Letting Agents specialist, GCW Ltd who as previously mentioned have direct contact with the property side of the existing and possible future retailers. It is they who negotiate rents and leases and tenant incentives when leases either renew or start afresh. Whilst it would be possible for this function to be brought in-house, the degree of specialism and infrequency of the service being needed makes it a sensible choice to be contracted out. We would also lack the industry contacts needed to approach new retailers.

Key Performance Indicators

12. Shopping centre management has a range of indicators that show the financial health of a centre. Key amongst those are footfall and weighted average lease length.

Weighted Average Lease Length Term (WAULT)

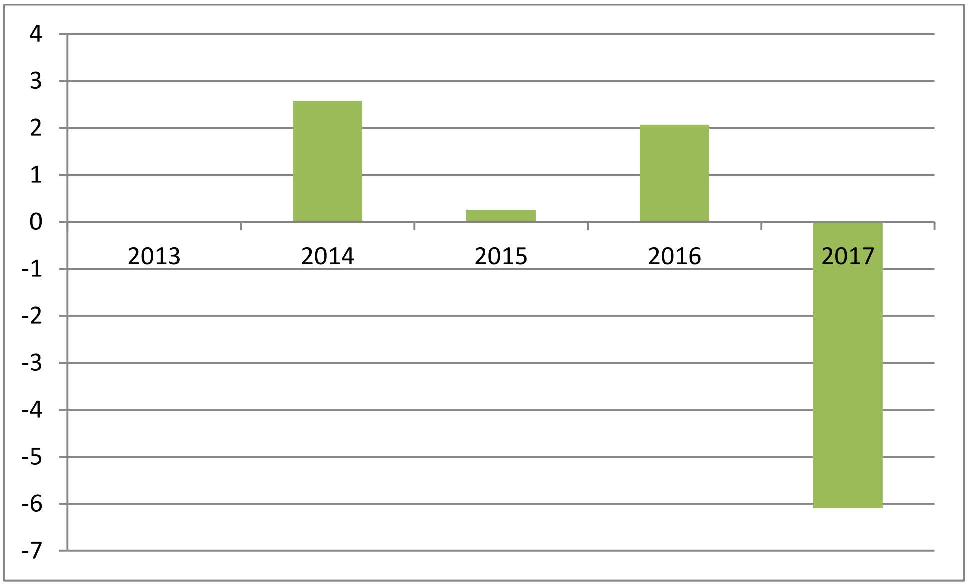
13. This is a measure of the average lease length but gives more weighting to the higher value leases. Simplistically, a low WAULT might be good news in an environment where rents are rising fast and the property is in a strong negotiating position. A higher WAULT is advantageous in weak property markets where rents are falling and/or tenants are looking to move.

14. At purchase, the WAULT of the centre was 6.8 years (source: Sales brochure). Sixteen months later it stands at 6.3, which is considered satisfactory when the retail market is undergoing some turbulence.

Five year footfall

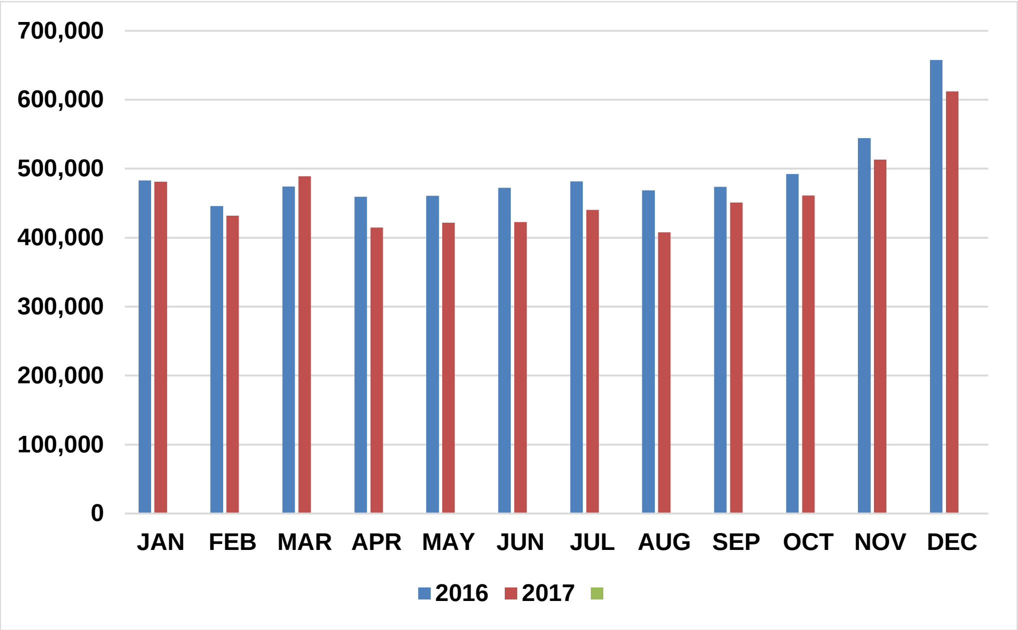
15. Footfall is measured by cameras within the centre and is a good indication of the popularity of the centre; which is a key metric that retailers look at when considering whether to move to a shopping location.

The table below shows the footfall % variances measured over the last five years:



And this table compares the last two years on a month by month basis:

Monthly Footfall Comparison 2016/2017



16. These graphics tell us that 2017 was a year where footfall fell back a little – some 350k compared to the previous year. The monthly graph shows that this started on a consistent basis is April 2017 – the month that Waitrose opened. We know that the Centre was quieter during that month and some stores were particularly affected. Since that time, some trade has returned, but of course much will depend upon the 'offer' within the store, and this is not within our control.

17. From the above it can be seen that the Orchards is performing well in comparison to industry benchmarks. These figures are monitored on a monthly basis as part of the Centre Manager's report to the Head of Service. This ensures that corrective action can be taken on a short term basis and that the longer-term strategy being worked up adequately addresses any deficiencies or needs in the retail environment.

Financing position

18. Members will remember that the purchase was financed with combination of internal reserves and external borrowing. The external borrowing was overseen by the Audit Committee and that committee recently received a report showing that the level of external borrowing was reducing in line with expectations set out at the time of purchase.

Accounting treatment.

19. The purchase in 2016 came too late in the year to prepare for its adding into the Corporate Plan in anything other than a superficial manner. At the time, the increased income to be derived from the centre was to be placed into three main reserves but further analysis shows that this has been overstated.

20. We accounted for the asset on an investment basis rather than a cash or accrual basis. In other words, the effect of tenant incentives were ignored – so that, for example, a six month rent-free period starting from 1st April 2017 was not allowed for. This led to a shortfall against the rent budget and a consequent reduction in the amount to be transferred to reserves.

21. The other area of overstatement concerned the head rent payment that the Council had formerly received. While this had varied from year to year as a result of deductions being made through the previous owners purchasing the flats above the centre, we had budgeted for £200k per year. Given as the direct owners we no longer receive a head rent, this led to an overstatement against budget, if not against actual income.

22. The table at appendix 1 compares the accounting treatment between 2017/18 and 2018/19 with explanations for the differences where appropriate. The table at appendix 2 shows the investment appraisal over the next 10 years. Members should be reassured that the Orchards remains a secure investment for the foreseeable future.

23. However, we cannot be complacent. We know that without investment to reflect shoppers' changing tastes there is a risk that the asset will perform less well in the future.

Future considerations

24. From the outset we have known that some investment in the fabric of the centre will be necessary. Some of that investment can be covered by the tenants' service charge whilst some will remain the responsibility of the landlord. One such area is the flat roofs where around half of the expenditure can be recovered. This however is routine maintenance and does nothing to update the centre for retail trends.

25. Whilst there is a direct link to the emerging Economic Development Strategy and the proposal that a Haywards Heath Town Centre Masterplan be prepared, a view could be taken that the Orchards should be considered in parallel with the town rather than as a dependent part. This would mean recognising that an interdependence exists, with the effect that a strategy could be prepared for the Orchards only.

26. In that case it would be likely to show that the Orchards site would lend itself to some redevelopment, given its acreage and the open air parking which does not efficiently use the space in such a location. Members will be updated accordingly.

Financial Implications

27. There are no financial implications other than those identified in this report.

Risk Management Implications

28. In the preparation of the draft corporate plan and budget, risks will have been assessed and those that can be mitigated will have a plan attached. It is not therefore considered that these proposals bring forward any significant risk.

Equality and Customer Service Implications

29. There are no such implications within this report.

Other Material Implications

30. There are no other material implications other than those already set out in this report.

Background Papers

None

Heading	17/18 budget per Corporate Plan	18/19 BUDGET	18/19 VARIANCE BASED ON CORPORATE PLAN	Comments
	£'000s	*£'000s*	*£'000s*	
Rental income	(2,478)	(1,969)	509	£225k relates to Head Rent
Service charge recovery	(256)	(273)	(17)	
Service charge expenditure	277	273	(4)	Some leases under-recover the service charge.
Service charge - residential units	0	24	24	This is the cost of running the domestic units that cannot be recharged.
Service charge for vacant units	45	5	(40)	The two units that are not let.
Letting/marketing fees	66	30	(36)	
Legal costs	17	24	7	Some now provided in-house
Interest paid	154	154	0	Loan costs
Other expenditure	100	87	(13)	Repairs, electricity, NNDR, promotions
Salaries - Estate Surveyor	0	45	45	New post funded from income
	(2,075)	**(1,600)**	**475**	

10 year investment appraisal at time of purchase

The Orchards, Haywards Heath

Key Metrics Overview

	On 100% funding		Acquisition Costs	
Portfolio Returns				
Purchase Price	£23,500,000			
Acquisition Costs - Stamp Duty, Surveys, fees	£1,522,563		Stamp Duty	£1,175,000
Total Purchase Price	(25,022,563)		Surveys	£71,313
Internal Rate of Return	8.42%		Fees	£276,250
Total Return over 10 years	15,509,255		TOTAL	1,522,563

Cash Flow summary / Running yields	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Rental Income	2,075,480	2,252,865	2,214,623	2,125,828	2,182,680	2,232,610	2,273,775	2,259,411	2,271,276	2,259,729
Service charge recovery	245,045	256,355	254,883	255,909	262,502	268,400	271,821	272,653	274,597	275,451
Service Charge expenditure	(295,384)	(277,047)	(279,817)	(282,615)	(285,441)	(288,296)	(291,179)	(294,091)	(297,032)	(300,002)
Net Property Operating Cashflow	2,025,141	2,232,174	2,189,689	2,099,122	2,159,741	2,212,714	2,254,418	2,237,973	2,248,842	2,235,179
Vacancy Allowance	(41,510)	(45,057)	(44,292)	(42,517)	(43,654)	(44,652)	(45,476)	(45,188)	(45,426)	(45,195)
Asset Management Fees	(59,509)	(65,613)	(64,362)	(63,775)	(65,480)	(66,978)	(68,213)	(67,782)	(68,138)	(67,792)
Leasing Costs	(39,150)	(17,431)	(22,800)	(11,370)	(31,420)	(3,060)	-	(9,080)	(2,570)	(13,750)
NOI Pre Corporate Costs and Interest	1,884,972	2,104,072	2,058,234	1,981,461	2,019,187	2,098,023	2,140,729	2,115,923	2,132,708	2,108,442
Accounting Costs	(8,302)	(9,011)	(8,858)	(8,503)	(8,731)	(8,930)	(9,095)	(9,038)	(9,085)	(9,039)
Interest Paid	(526,926)	(529,415)	(531,515)	(533,551)	(535,768)	(537,841)	(539,090)	(540,337)	(541,915)	(543,439)
Net Corporate Profit	1,349,744	1,565,646	1,517,861	1,439,406	1,474,687	1,551,252	1,592,544	1,566,548	1,581,708	1,555,964
Operating and Leasing Capital expenditure eg incentives.	(117,899)	(100,419)	(113,639)	(82,612)	(136,630)	(63,936)	(56,844)	(80,981)	(63,739)	(94,327)
Capex Drawdown	117,899	100,419	113,639	82,612	136,630	63,936	56,844	80,981	63,739	94,327
Amortisation	-	-	-	-	-	-	-	-	-	-
Total Net Cash Return - Annual	**1,349,744**	**1,565,646**	**1,517,861**	**1,439,406**	**1,474,687**	**1,551,252**	**1,592,544**	**1,566,548**	**1,581,708**	**1,555,964**
Property Yield before AM, Leasing/ Legal Fees & Capex	8.6%	9.5%	9.3%	8.9%	9.2%	9.4%	9.6%	9.5%	9.6%	9.5%
Net Income return after interest and all operating costs	**5.7%**	**6.7%**	**6.5%**	**6.1%**	**6.3%**	**6.6%**	**6.8%**	**6.7%**	**6.7%**	**6.6%**