

Agenda Item No: 9.5 **Report No:** 84/15
Report Title: Industrial Estate Management Strategy
Report To: Cabinet **Date:** 6th July 2015
Cabinet Member: Cllr Andy Smith
Ward(s) Affected: Seaford North, Newhaven Denton & Meeching
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Purpose of Report:

To agree the principles for dealing with rent reviews and requests for lease extensions across the Council's Industrial Estate properties and to note the potential future investment requirements to maintain and update the assets.

Officers Recommendation(s):

- 1 To approve the recommendations to conduct rent reviews, lease surrenders, and the grant of new leases for tenants across the Council's industrial estates, in line with the principles outlined in this report, including adoption of Option 2 (paragraph 2.36 b), namely the surrender and re-grant of leases, moving to an open market rent over a period of time on a stepped basis.

Reasons for Recommendations

- 1 Periodically, the Council undertakes rent reviews across the investment property portfolio and there is the opportunity to complete rent negotiations in parallel with negotiating surrender and re-granting of leases where appropriate.

Information

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- 2.1** Lewes District Council owns the freehold land at 4 Industrial Estates: Cradle Hill Industrial Estate, Seaford; North Street, Lewes; Avis Way, Newhaven; and Drove Road, Newhaven. The estates date from the late 1960s and make an important contribution to the local and regional economy. The Council has granted a variety of leasehold interests in these sites over a number of years. This report concerns the leases granted by the Council rather than any sub-lettings entered into by the Council's tenants.
- 2.2** Turnover of property on the estates is low and the Council receives on average 1-2 requests per month for warehouse/industrial space along the coastal strip. Rental income from the Industrial Estates (including North Street, Lewes) totals £683,500 per annum.
- 2.3** North Street Industrial Estate is not considered within this report as it is within the North Street Quarter earmarked for redevelopment.
- 2.4** Towards the end of 2014, the Council commissioned a report from Stiles Harold Williams in respect of Cradle Hill and Drove Rd, and from Clifford Dann in respect of Avis Way. The agents were instructed to:
- (a)** Develop an understanding of the existing tenant's aspirations.
 - (b)** Consider alternative ways of improving the rental income from the asset.
 - (c)** Provide advice on estate and common part improvements.

Cradle Hill Industrial Estate, Seaford (CHIE)

- 2.5** CHIE consists of 42 detached (and some terraced) industrial/warehouse buildings developed in the 1960s. There are a variety of businesses located there, including the Household Waste & Recycling Centre operated by East Sussex County Council (ESCC). LDC owns the freehold in its entirety.
- 2.6** CHIE is Seaford's principal industrial estate and is situated to the north of the A259 South Coast Road within 2 miles of Seaford Town Centre. The village of Alfriston is located 4 miles away. With the exception of Blatchington Road, there are no other significant estates of industrial buildings in Seaford, with the main provision being located nearer to Newhaven which offers a range of unit ages and a more accessible road infrastructure.
- 2.7** The entire site is subject to a variety of long leasehold interests ranging from 14 years to 67 years unexpired. The majority of leases are circa 20 years unexpired. The earliest lease dates from 1969. Approximately half the leases (14) expire in either 2036 or 2037 with the majority of the remainder in 2068. The longest dated lease is the lease for units 27 to 42 which expires in 2081. The majority of leases were assigned in the

1970s. An assignment is a transfer of the ownership of the lease from one person to another.

- 2.8** Presently, there is interest from many of the tenants with expiries in 2036/7 to extend their leases before the expiry of the contractual term in order to retain value in a capital asset which is wasting quickly as the lease terms diminish and become unmortgageable. Banks currently in the property lending market generally require a minimum term of 30 years on top of the mortgage length, in effect, 55 years. Out of the 22 leases, 20 have less than 53 years unexpired. Additionally, if a tenant wished to sell their business or assign their lease, they would need to find either a cash buyer or someone with a mortgage payback of less than 25 years
- 2.9** The “contractual term” is the fixed period of time for which the lease is granted. Whilst tenants refer to lease “extensions” the legal process for “extending” a lease before the expiry of the contractual term is the surrender of the current lease and the re-grant of the lease in the form of a new lease. The re-granted lease will be based on a fixed period that extends beyond the original contractual term. The Council is under no legal obligation to enter into a surrender and re-grant.
- 2.10** The units are generally occupied under single leases where the first tenant constructed the building at their own cost. There are a few exceptions; for example block numbers 27-42 on the plan attached at Appendix A were developed under a single headlease.
- 2.11** Tenants have stated that they are generally loath to invest more of their own money into the buildings because of the short length of remaining time on the leases. The overall effect is that the estate is in stasis in terms of development. At the same time, the buildings are ageing which could add to the maintenance burden of the Council. Alternatively, the Council may wish to redevelop at the end of the term.
- 2.12** The buildings subject to the 2036/7 leases are not contiguous and do not form a neat block of property, so the opportunity to redevelop the land is limited.
- 2.13** Some tenants want to surrender their lease without taking a new lease. The leases do not include break clauses. In the absence of agreement by the Council to accept a surrender, the tenant remains liable to pay the rent and comply with the other provisions of the lease until the expiry of the contractual term. The Council is under no legal obligation to enter into a surrender agreement.
- 2.14** All of the leases, with the exception of Unit 17, are protected under the Landlord and Tenant Act 1954, which means that a qualifying tenant is entitled to apply for a new lease to take effect after expiry of the contractual term. The earliest date that the tenant can apply for a new lease under the 1954 Act is 12 months before expiry of the contractual term. Tenants have no statutory right at this point in time to seek a new extended lease.

- 2.15** Unit 17 is the most dilapidated of all of the buildings and the Council took vacant possession of the unit in November 2013. Since then, the unit has been occupied under a Tenancy at Will whilst the new tenant has made significant improvements to the overall appearance and operation of the site and is now ready to enter into a lease with the Council. A tenancy at will is a tenancy where either the landlord or the tenant may bring the tenancy to an end at any time. There is no security of tenure.

Avis Way Industrial Estate, Newhaven (AWIE)

- 2.16** AWIE consists of 34 detached (and some terraced) industrial/warehouse buildings first developed in the 1960s. A considerable part of the estate is let to Rookery Estates Ltd on a 125 year lease and is branded as RICH Industrial Estate (24 units).
- 2.17** AWIE is one of the largest industrial estates in Newhaven and located within easy reach of the main trunk roads and the port. Newhaven has a considerable industrial heritage, but space is hard to come by and turnover within Council owned units is very low.
- 2.18** There are a number of very important and high-profile employers at AWIE. One of the more recent successes involved the relocation of Forfars & Cutress to Newhaven as a result of assistance from the Regional Growth Fund and Locate East Sussex.
- 2.19** The entire site is subject to a variety of long leasehold interests ranging from less than a year to 114 years unexpired. There are 5 units with 53 years or less unexpired and tenants have already made approaches to the Council to negotiate lease extensions.
- 2.20** The road through the estate has been resurfaced and improved. Car parking and general congestion has been highlighted as an issue. The existing estate signage is out of date and faded and negative comments were received from tenants about the lack of maintenance to the verges.

Drove Road Industrial Estate, Newhaven (DRIE)

- 2.21** DRIE is one of the smaller industrial estates within Newhaven. It consists of three detached industrial/retail warehouse buildings developed in the 1980s.
- 2.22** The entire site is subject to two lease interests, both with approximately 95 years unexpired.
- 2.23** Opportunities on the site for future development and/or regeneration projects are limited given the long unexpired lease terms.

Rent Reviews for current leases

- 2.24** The majority of leases contain rent review provisions where there is the potential for rent to be increased at specified points in time. There are overdue rent reviews at CHIE on 15 properties with 4 more rent reviews coming due within the next 12 months. The rent reviews that are

outstanding relate in the main to the units with the shortest unexpired leases. While there are no outstanding rent reviews at either Avis Way, or Drove Road, the same issues around diminishing leases apply.

- 2.25** The existing leases work on the basis that the reviewed rent for the entire contractual term shall disregard the value of the buildings on the land. This is commercially unusual because of problems around gathering suitable comparison rental evidence for the separate land and buildings elements of the review. Where commercial leases are granted at rents that do not reflect the full rental value of both the land and the buildings, then normally the rent review provisions will work on a “gearing” basis. That is, the rent will be reviewed by reference to the open market rental value of comparable property taking account of both buildings and land. The actual rent will then be a pre-agreed percentage of the open market rental value as set out in the lease. The amount attributable to the land element is then a matter of pure arithmetic based on agreed percentages. This avoids uncertainty and makes the rent review process much more straightforward.
- 2.26** The unusual nature of the current rent review provisions is probably partly due to the fact that the leases are old. They are not based on modern lease terms. It is also assumed that the intention was to give the first tenants a low rent to recognise the costs incurred in constructing the buildings. However, the existing leases do not provide for a transition to full market rents once the construction costs have been recouped. Leases of this type tend to work on the basis that the rent will rise over time to become a full market rent. The precise arrangements will turn on a variety of factors including the market at the time the lease is granted, the nature of the premises and the identity of the tenant. One way of achieving the uplift is by means of a stepped rental mechanism, whereby the rent increases by set pre-agreed percentages at certain points throughout the term.
- 2.27** CHIE tenants who are interested in lease extensions have been told that the Council will delay implementing their rent reviews pending a decision as to whether the Council is willing in principle to grant extensions. It is suggested that tenants be given a period of six months in which to complete a surrender and re-grant if Cabinet agrees recommendation 1. If the a surrender and re-grant is not achieved within the period of 6 months from the Council offering to enter into negotiations, the rent review under the current lease should be implemented.

Rents for lease re-grants

- 2.28** The main area for negotiation on any surrender and re-grant will be the rent paid for the new lease.
- 2.29** The starting point is section 123 of the Local Government Act 1972. The Council cannot dispose of its land for a consideration less than the best that can be reasonably obtained in the market, except with the express consent of the Secretary of State. Section 123 covers the rent paid for leases that exceed seven years.

- 2.30** The new lease will also be subject to the Council policy set in July 2008 where Cabinet agreed ‘that a policy of open market rentals be adopted for all Council leaseholders.
- 2.31** As mentioned above the current leases are commercially unusual. It is not recommended that lease re-grants follow the same approach. The reasons are twofold. First, the current rent review mechanism is unsatisfactory because of the problems around gathering suitable comparison rental evidence for the separate land and buildings elements. Secondly, any re-grants should operate on the basis that they transition to full market rents using a stepped rental mechanism (i.e. rent increases by set pre-agreed percentages at certain points throughout the term).
- 2.32** In previous discussions some tenants suggested that the rent for a re-grant should not transition to full market rent because tenants have the right to apply for new leases under the Landlord and Tenant Act 1954. The arguments goes along the lines that the tenants will be entitled as of right to new leases based on the same terms as those found in the current leases including rent. This is not correct for the following reasons:
- (a)** The 1954 gives the right to a “qualifying tenant” to apply for a new lease to take effect after expiry of the contractual term. The earliest date that the tenant can apply for a new lease under the 1954 Act is 12 months before expiry of the contractual term. The right to apply for a new lease is therefore many years away. There is no guarantee that tenants will satisfy the qualifying tenant requirements at the time the application is made.
 - (b)** There are some grounds in the 1954 Act on which the landlord can resist the renewal of the lease. There is no guarantee that the tenant will be able to secure a new lease based on the rights set out in the 1954 Act.
 - (c)** Where the court decides to grant a new lease under the 1954 Act the rent is determined by the court having regard to the terms of the tenancy (other than those relating to rent), the rent that the holding might reasonably be expected to be let in the open market by a willing tenant, and certain specified matters. It follows that the rent for a new 1954 Act lease will normally reflect the value of the land and the buildings.
 - (d)** Case law also provides an opportunity for the landlord to argue that the terms of any new lease should depart from the terms of the existing lease where such a change would be “fair and reasonable”. Officers consider that it would be fair and reasonable to argue that the current low rents were agreed for the defined contractual term only. Once the current term and related bargain has expired the rent payable should change so that the tenant pays the same amount as anyone else would have to pay for the same premises (i.e. the willing tenant position).
- 2.33** In previous discussions some tenants suggested that the rent for a re-grant should not transition to full market rent because tenants have made improvements to the land in the form of buildings and the like. This is a

reference to the tenant's right to compensation for improvements as set out in the Landlord and Tenant Act 1927 (a right separate from the compensation provisions of the Landlord and Tenant 1954 which arise when a renewal tenancy is refused). It is also a reference to what is sometimes called the "21 year" rule.

- (a)** The 1927 Act applies to most leases of property used for a trade or business. The entitlement to compensation arises at the termination of the tenancy and on the tenant "quitting the holding". A leading legal publication (Woodfall) says that it is considered that a tenant that renews its lease cannot carry over the right to compensation into the new tenancy. The tenants cannot therefore argue that a re-grant (which is not a quitting of the holding) should take account of compensation rights that only arise in the event of a quitting the holding. In addition, various improvements do not attract compensation including those made under an obligation imposed on the tenant. Building leases are specifically identified as falling within the scope of this provision.
- (b)** The "21 year rule" arises where a new tenancy is granted under the 1954 Act by the court. In assessing the rent the court must disregard certain factors including the effect on the rent of an improvement (section 34(1)(c)). The improvement must have been completed not more than 21 years before the application for the new tenancy was made and it must not have been carried out in response to an obligation owed to the landlord. The earliest date that the tenant can apply for a new lease under the 1954 Act is 12 months before expiry of the contractual term. Many tenant improvements, including the construction of the original buildings, will therefore fall outside of the scope of improvements that can be disregarded for the purposes of section 34.

2.34 In previous discussions some tenants suggested that the rent for a re-grant should not transition to full market rent because the buildings were put up by the tenants and the buildings are therefore owned by the tenants (i.e. they are tenant's fixtures). This is not correct. Tenant's fixtures comprise chattels (i.e. tangible, moveable assets) attached to the land by the tenant (or a predecessor in title under the tenancy) for the purposes of its trade or business and which are capable of physical removal without causing substantial damage to the land and without the chattel losing its essential utility as a result of the removal. The buildings are not capable of physical removal without causing substantial damage to the land and without the buildings losing their essential utility as a result of the removal.

2.35 .Given that piecemeal redevelopment of the estate is not a feasible way forward based on the existing lettings structure, to help secure the future of a number of the businesses on the estate, it is recommended that the tenancies should be restructured to encourage regeneration and growth.

Options

2.36 There are broadly three options for Cabinet to consider:

(a) Option 1 – Do nothing.

Officers would conduct rent reviews based on the existing lease terms, which are ground rent only. The tenants have no right to a surrender and re-grant at this point in time. However, the current leases are commercially unusual and use an unsatisfactory rent review mechanism. The Council will not benefit from the potential for a stepped rental mechanism transitioning to full market rent prior to the end of the current contractual term. Furthermore, failure to consider the use of re-grants means that some tenants will not want to invest in the buildings because of the short length of the remaining term. .

(b) Option 2 – Agree to new leases based on a surrender and re-grant and move to an open market rent over a period of time on a stepped basis.

By staggering the rental payments due incrementally, businesses will have longer to plan for the additional expense and the Council will benefit from an uplift in rents three times in the next 10 years.

This is the recommended option and further, that Cabinet approve the following principles for individual tenant negotiations, on the understanding that some variation may be needed during negotiations to cater for individual circumstances:

Tenants wishing to surrender their existing leases may do so on the basis that they are released from future rent payments due to the end of the contractual term. This course of action would allow the Council to regain control of the asset and to market at the open market rental value immediately.

That the Council offers a surrender of the existing lease and the grant of a new lease of 99 years duration to those tenants wishing to extend their leases (i.e. a surrender and re-grant). The new leases would be a modern equivalent to the existing leases and contain mutual break clauses. Appendix B shows the difference between the current rents and the open market rents taking into account the land and buildings. The figures are based on the Council's ability to charge rent based on the land and the building(s), but this may vary from lease to lease.

To go from the current to proposed rents may prove to be unaffordable for many of the tenants and so it is also recommended that the rent is phased over a ten year period on the following basis:

- Year 0 (start of lease): a minimum of 33% of open market rent
- Year 5 (1st rent review): a minimum of 66% of open market rent

- Year 10 (2nd rent review): 100% of open market rent

Those tenants who wish to see out their lease will be unaffected and rent reviews will be conducted as per the terms of their existing leases.

It is also recommended that should Members approve Option 2, the offer will be available to tenants for a maximum 6 month period, after which the remainder of the rent reviews will be conducted without further delay.

- (c) Option 3 – Move to open market rent upon commencement of the new lease.

While Option 3 is the most commercially advantageous route, there is an issue of affordability for business owners. The Council has a duty to obtain best consideration through its assets, but the Council can also take into account the impact on the local economy and social wellbeing of an area as part of that consideration. Furthermore, the Council can take account of the fact that the tenant has the right to pay a ground rent up to the expiry of the current term. Whilst the tenant has this existing right, the tenant has no right to demand a new extended lease at this point in time. The granting of a new extended lease crystallises the future potential rights of the tenant so that they are deliverable now. The stepped rental mechanism is therefore a balanced approach which recognises the tenant's existing rights and the fact that the Council is giving the tenant the certainty of a lease extension.

Estate and Common Part Improvements

2.37 In April 2015, the tenants at Cradle Hill were surveyed to gather information on what they believe to be the key issues. A total of 13 questionnaires were sent out and there was a 100% response rate. Key issues identified were:

- (a) Parking at CHIE is very limited and causes congestion.
- (b) 50% of tenants wanted improvements to the access roads, in particular the implementation of a one-way system to reduce congestion.
- (c) The closure of the Household Waste & Recycling Centre is having an impact on tenants. The HWRS is closed Monday to Thursday and tenants have pointed out that the partial closure has resulted in an increase in fly-tipping on the estate and gridlock on a Friday. One tenant is considering leaving unless the problem improves.
- (d) Improved lighting and new estate signage are also high on the list of improvements that tenants wish to see.
- (e) Improved security against vandalism/theft.

Financial Appraisal

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An illustration of the potential maximum rental income and associated profiling is attached at Appendix B. It is important to note that it is for illustrative purposes only and should not be relied upon for budgeting purposes.

Legal Implications

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The legal implications are set out in the body of this report.

Risk Management Implications

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- 5.1** The key risk for the Council is that the tenants who wish to surrender their leases and take up new leases will not agree terms. If this situation prevails, the rent reviews will be concluded on the basis of the existing leases.

Equality Screening

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- 6.1** There are no equality impacts as a result of this report.

Background Papers

7 None

Appendices

- 8** Appendix A: Plan showing lease expiries by time remaining at CHIE.
- Appendix B: Illustration of current and maximum potential rental income if Option 2 is approved. EXEMPT