Land and Property Committee

Date: **16 January 2023**

Item: **Commercial Office Investment Portfolio Joint Venture**

This paper will be considered in public

1 Summary

1.1 This paper seeks approval for TTL Properties Limited (TTLP) to invest in a joint venture to create a growing long-term income steam from a portfolio of high-quality, commercial office assets with best-in-class environmental and wellbeing credentials located near central London transport interchanges. This joint venture is a core element of TTLPs Investment Strategy. As well as long-term income and financial returns that can be reinvested across the portfolio, it will provide investment diversification and should enhance TTLPs environmental sustainability performance and credentials.

1.2 TTLP wishes to form a joint venture with a culturally aligned, financially strong, proven office investor / developer to bring forward suitable opportunities on TTLP's land. The three development sites at Bank station, Southwark station and Paddington station are the initial sites for this joint venture (the 'Seed Sites').

1.3 A paper is included on the Part 2 agenda which contains supplementary information that is exempt from publication by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the business affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendations

2.1 The Committee is asked to note the paper and the exempt supplementary information in Part 2 of the agenda and approve:

(a) Land authority in the suns set out in the paper on Part 2 of the agenda for the transaction (the Transaction) as described in this paper and in the paper on Part 2 of the agenda; and

(b) the formation of a wholly owned subsidiary company for the purposes of entering into the contractual agreements relating to the Transaction.

3 Background

Market Characteristics

3.1 The central London office market is an established investment market with a total investment volume of some £13.3bn and total leasing take-up of 8.5m square feet in 2021.

3.2 Total investment returns in the London office market are cyclical. The chart below shows cycles in total return, income return and capital growth for London offices over the last 20 years.

Chart 1: Income return, capital growth and total return associated with holding central London offices over last 20 years [Source: Jones Lang LaSalle (JLL)]

3.3 The chart shows that, although the returns associated with holding central London offices are volatile, that volatility is driven largely by changes in capital value. Income return over the last 20 years has been relatively stable, with a quarterly average of 1.1 per cent.

Market Stratification and Environmental Social & Governance (ESG)

3.4 The buildings will be constructed on the basis of Net Zero Carbon and the joint venture will collaborate with tenants to target the highest global standards for sustainability and well-being.

3.5 This proposed joint venture is a core element of TTLP's Investment Strategy. As well as long-term income, it will provide investment diversification and will enhance TTLP's environmental sustainability performance and credentials.

3.6 The strategic rationale for this joint venture is founded on the growing demand among London occupiers and investors for the best commercial workplaces. JLL, TTLP's appointed commercial agents, forecasts that demand for the most sustainable Net Zero Carbon buildings in London will significantly exceed supply over the next decade. The independent research firm Property Market Analysis LLP (PMA) forecasts annual rental growth for prime central London offices to average between 1.6 per cent and 2.1 per cent until 2026.

3.7 Indeed, since the 2020 coronavirus pandemic (the pandemic), investment performance has become increasingly stratified between 1) office assets with the highest occupier wellness and ESG credentials, and 2) the remainder of the market.

3.8 A 2022 occupier survey, undertaken by JLL, has shown that this trend is, in part, driven by firms looking for high-quality office space to attract staff back to the office following the pandemic. Another important driver is an increasing focus on office ESG credentials on the part of investors and occupiers. For these reasons, the joint venture will collaborate with tenants to target a rating of BREEAM Outstanding and Platinum WELL v2 Core.

3.9 The Building Research Establishment (BRE) established the Building Research Establishment Environmental Assessment Method (BREEAM) standards as the leading global science-based certification systems for the sustainable built environment. The BREEAM “Outstanding” rating represents the highest achievable certification within the BREEAM assessment.

3.10 JLL research indicates that BREEAM Outstanding buildings let at a nine per cent rental premium to comparable buildings with lower ESG ratings. The same research shows that, on average, a BREEAM Outstanding building is 81 per cent let on practical completion compared to 48 per cent for BREEAM Excellent buildings.

3.11 The International WELL Building Institute (IWBI) created the WELL Building Standard to certify spaces that advance human health and well-being with rigorous performance standards, operational protocols and company-wide practices. WELL Core is a distinct pathway for core and shell buildings seeking to implement features to benefit tenants, and WELL Core Platinum is again the highest available global standard.

TTLP’s Goals and Objectives

3.12 TTLP has a diverse portfolio that has grown organically. A key principle of the Investment Strategy is to provide strategic direction across the portfolio mix, encouraging investment in sectors and assets with medium to long-term growth while supporting the rationalisation of areas with poor performance and / or management issues. This strategy not only seeks to increase the gross income of the portfolio but also the cost efficiency through a higher operating margin.

3.13 The Commercial Office Portfolio is identified in the TTLP Investment Strategy and Business Plan as key to achieving TTLP’s medium-term goals. By developing a portfolio of best-in-class offices that will be retained for income, TTLP will diversify and improve the ESG credentials of its portfolio and associated dividend. It will create new 21st-century offices that achieve the highest sustainability performance, both leading the market and modelling the working environment that will be required to attract people into city centres in a post-pandemic world.

3.14 TTLP’s current asset portfolio includes 100,000 sq ft of offices generating £5m a year. In line with the ‘flight to quality’ among London office occupiers, the Investment Strategy advocates a focus on market-leading, purpose-built office space located near transport nodes, which makes the most of the stations and their environs and drive London’s future growth and transport ridership with new capacity. The strategy also recognises the potential to convert existing secondary office buildings to more modern flexible workspace.

3.15 The core elements of the commercial office strategy for TTLP include:

(a) rationalise / exit existing secondary office portfolio with high vacancy rates and significant capex requirement;

(b) consider scope to convert well-located existing office assets, smaller in size and floorplate, to flexible workspace;

(c) invest in joint venture to create a portfolio of core, high-quality central-London assets at transport nodes;

(d) produce a recurring, growing rental income stream to TTLP;

(e) increase and improve TTLP’s investments in the London office market to bring it in line with the TTLP Investment Strategy and Business Plan.

(f) significantly improve TTLP’s value weighted sustainability performance by developing best in class offices using the Sustainable Development Framework and Mayoral policy (London Plan) on environmental and design standards;

(g) utilise and promote Modern Methods of Construction (MMC) in accordance with TTLP’s wider commitments;

(h) maintain and promote exemplar health and safety both in its construction and development phases; and

(i) provide opportunities for skills and apprentices in line with Mayoral, TfL and TTLP policies.

3.16 The proposed commercial office portfolio joint venture will create commercial revenue and capital from developments that contain a significant commercial-office component.

3.17 It is important for joint venture longevity that the joint venture has the flexibility to trade its investments and recycle its capital into higher performing assets to retain high-quality returns. This includes investing in new assets for development. This will mitigate potential risks such as falling income growth and asset value as the buildings age in the long-term.

3.18 Future iterations of the TTLP Business Plan, including the paper scheduled for the Committee on 23 March 2023, will include recommendations for commercial office investments that will involve our investment in this joint venture.

4 Joint Venture Proposal

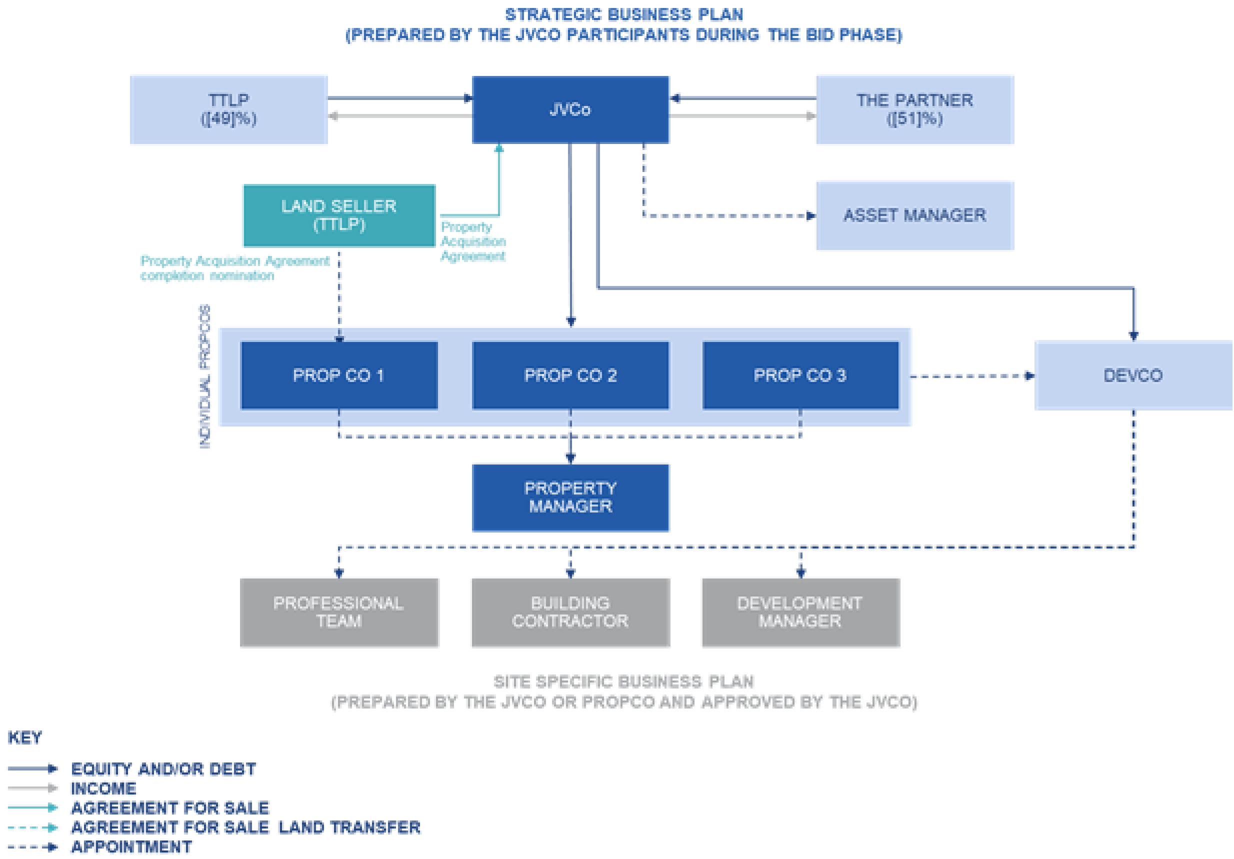
4.1 The proposed joint venture will be formed by a TTLP subsidiary vehicle holding a 49 per cent equity stake whereas the joint venture partner will hold 51 per cent equity stake.

4.2 Key contractual terms of the joint venture are listed below, with an executive summary of the Heads of Terms included in Appendix 1.

4.3 The joint venture will commit to acquire long-leasehold interests in the Seed Sites on an unconditional basis at a fixed purchase price, and on fixed future dates, prior to the joint venture's planned commencement of major construction works. The joint venture's acquisition of Southwark over station development (OSD) will not occur before TfL confirms that the part of the station that will form part of the site is no longer required to operate the station.

4.4 The structure of the joint venture will be determined based on legal and tax advice. The currently anticipated structure is that each property will be held in a separate subsidiary vehicle (Propco). The diagram below shows the proposed structure of the Joint Venture company (JVCo).

Proposed JVCo Structure Chart



4.5 The joint venture proposes to use debt to fund the development of each property at an expected loan to development cost ratio of between 50 per cent and 65 per cent. After practical completion and letting of each property, the joint venture proposes to refinance the debt at a loan to value of up to 60 per cent of the completed property’s value. Refinancing may release equity capital from the completed, income producing buildings depending on the level of leverage utilised at build phase.

4.6 The business of the joint venture will run in accordance with an agreed business plan, and the joint venture agreement will set out a list of “Reserved Matters” and “Major Reserved Matters”, both of which require approval of the joint venture partners.

4.7 The joint venture will appoint a development manager, an asset manager and a property manager based on a pre-agreed scope of services. TTLP’s joint venture partner will provide the development management service and is also likely to provide the asset management service.

5 Partner Procurement Process

5.1 On 20 May 2022, TfL published a Contract Notice to notify the market it was undertaking a Competitive Dialogue process in accordance with the Public Contracts Regulations 2015 to identify a joint venture partner.

5.2 Detailed final tenders from three shortlisted potential partners have informed this paper and authority recommendation. Evaluation is underway, and the preferred partner is anticipated to be selected in late January 2023.

5.3 Following strong SSQ responses, seven of London’s most accomplished office investors and developers were selected in July 2022 for Stage 2 of the process, the Invitation to Submit Outline Solutions (ISOS).

5.4 The ISOS stage ran until September 2022. The three organisations with the best responses were invited to the next stage, Invitation to Participate in Dialogue (ITPD).

5.5 On 30 November 2022, the three short-listed potential partners submitted their final tenders and, TTLP is now concluding the evaluation of them, with the preferred partner anticipated to be selected in late January 2023.

6 TTLP Site Handover Plan

6.1 TTLP needs to undertake preparatory works and maintain each of the Seed Sites before selling long-leasehold interests in the sites to the joint venture.

6.2 The Bank over station development is currently a worksite for the Bank Station Capacity Upgrade (BSCU) project. The BSCU project is nearing its final phases. Once BSCU works on site complete, the site will be handed over to TTLP. TTLP will then be responsible for security and drainage of the site as well as any other maintenance matters until it is leased to the joint venture. The costs associated with this site maintenance and are included in extant Authorities.

6.3 The Paddington site also needs to be maintained for the period until the lease is sold to the joint venture.

6.4 To handover the Southwark site to the joint venture, the assembly of the land interests for the development needs to be completed. The next stage of this is a land exchange with the London Borough of Southwark (LBS) and an associated payment that enables LBS to build 25 new homes on its land. Authority for this exchange and payment is already in place. The exchange will be completed ahead of granting the TTLP lease for the Southwark site.

6.5 The final stage of the Southwark site assembly is Southwark station works that enable release of underutilised back-of-house space at the station that will be incorporated into the basement of the over-station development. The space released from the station must have no detrimental impact on the operation of the station or the passenger experience. Currently, this area is home to critical station systems., and these systems must be relocated, re-routed, or removed if no longer required. The area will then be physically separated from the station. To comply with transport operational fire regulations, the ticket hall internal elevation is to be reconfigured as a new party wall. The station will remain operational throughout this phase of the project.

7 Finance

Investment Performance

7.1 The projected investment performance presented below is TTLP's analysis of the Seed Site projects and informed by TTLP's advisors. The potential partners' responses are expected to be broadly consistent with this modelled performance and within the parameters of the Authority recommendations, which include a margin for TTLP as investor and shareholder to respond to changing market conditions while in joint venture with the selected partner.

7.2 The Seed Sites have planning permission for some 600,000 square feet of commercial office workspace. Once complete, TTLP can expect to receive net income of around £11m per annum from a 49 per cent equity stake in the joint venture. The return on equity investment TTLP is seeking is a yield in excess of seven per cent.

7.3 The development phase of the Seed Site projects will target a 20 per cent profit on cost and a geared internal rate of return exceeding 10 per cent. Depending on the characteristics and risk profile of future projects that the joint venture undertakes the profit on cost may vary from 20 per cent.

7.4 TTLP will manage its investment in the completed buildings through the joint venture, which has been designed to provide liquidity that is market-standard for investment property joint ventures.

7.5 The investment performance of the portfolio of Seed Sites, as assessed and modelled by TTLP, meets TTLP's Business Plan metrics and investment strategy requirements, as endorsed by the Land and Property Committee in June 2022, as summarised in the table below.

Metric	TTLP Business Plan Investment Strategy Metrics
Net Present Value (NPV)[1] @ 6.29% (for the base-case 10-year build and hold scenario)	>0
Unlevered Internal Rate of Return (IRR)[2] for the development period	7-15%
Return on Capital Employed on development projects[3]	20%
Incremental Yield on Expenditure (assessed at stabilisation of asset income)[4]	> 3.6%

8 Guarantees

8.1 The JVCo will need to enter into Works Agreements with London Underground Limited (LUL) for each of the Seed Sites. In addition to securing insurances, the Works Agreements require the JVCo to put in place any mitigations required by LUL's engineers and indemnify LUL against any breaches of the Works Agreement. Other Guarantees are covered in the Part 2 paper.

9 Risks and Opportunities

9.1 The table below summarises some of the key risks identified and their associated mitigations.

Potential Risk	Proposed Mitigation
Market downturn An occupational market downturn could harm the letting of the sites and hence TTLP's cashflow. A weaker capital market at the time the joint venture looks to dispose of one or more of the assets or when TTLP looks to dispose of its interest in the joint venture could reduce TTLP's capital receipts.	The joint venture will consider pre-let both before and during construction in order to limit market risk on delivery. Active asset management will be required in the investment phase in order to further limit this risk. The joint venture and TTLP will be strategic in choosing when to recycle capital into and out of the portfolio in order to best exploit capital market cycles.

[1] Each project is assessed against an IRR hurdle rate equivalent to the market risk rate of return relevant to the asset class, risk and complexity of the project.
[2] The average annual return without debt finance, expressed as percentage.
[3] Net Operating profit (or earnings before interest and taxes (EBITDA) divided by capital employed.
[4] Yearly rent at stabilisation over total development costs (including voids and development finance costs).

Potential Risk	Proposed Mitigation
Cost overrun The financial modelling is based on cost reports and builds in an allowance for inflation, however, there is a risk associated with an inflationary shock driving up construction cost or unforeseen project factors leading to increased cost. This would have the effect of increasing TTLP’s required equity investment in the development phase.	A proactive procurement strategy will be required to ensure that the inflation risk associated with procuring contractor work packages is effectively limited. Ongoing due diligence is required at later design stages to limit the scope for potential cost overruns, and where possible identify efficiencies and savings.
Leveraging TTLP’s strategy calls for project level debt in both the development and investment phases. Whilst this increases returns, it does present risks for the portfolio. Examples include equity call risk and increased downside risk in a downturn.	The loan to cost ratio in the development period and loan to value ratio in the investment period will be managed to ensure they remain at reasonable levels as agreed with the joint venture in order to limit the effects of excessive levels of leverage. The debt funding will be raised on a site-by-site basis providing an opportunity to assess risk exposure before commencement.
Project obsolesce and depreciation There is a risk posed by changing occupier demand and associated rental depreciation and obsolescence. This could reduce rental values of the buildings or require capital intensive refurbishments.	The Seed Sites have been designed with industry-leading ESG credentials in order to align with occupier demand to mitigate this risk in the short to medium term. In the longer term, active maintenance and asset management will be required to mitigate the operational impacts on LUL and appropriately consider the disposal of assets with significant depreciation risk.

10 Assurance and Consultation

10.1 TfL Project Assurance and the Independent Investment Programme Advisory Group (IIPAG) were briefed on this authority submission on 15 December 2022. Project Assurance is providing assurance on an ongoing basis and Targeted Assurance Reviews will be arranged to support future investment decisions.

10.2 TfL Infrastructure Protection (IP) has been involved in the design development of the three Seed Sites to ensure protection of the retained transport assets and premises. IP has been consulted and provided support in collating the technical due diligence and in drafting the legal agreements during the various stages of the procurement process.

List of appendices to this report:

Appendix 1: Executive Summary of the Heads of Terms

Exempt supplementary information is contained in a paper on Part 2 of the agenda.

List of Background Papers:

None

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