

Appendix 5: Income Strip Lease Structure

1. Structure Overview

- 1.1. The income strip lease structure is similar to a simple sale and lease-back arrangement. An institutional UK Fund ("the Fund") purchases a long leasehold interest in land from the Council. The Council would then enter into an occupational lease (typically for between 35 – 50 years) with the Fund and would have the option to purchase the reversionary property interest for a £1 at the end of the lease term.
- 1.2. In this arrangement an external developer would enter into a Development Agreement with the Fund obliging it to construct the development. As such, the Fund would provide all of the development funding the external developer would be responsible for all development risk.
- 1.3. All figures included in the below are illustrative to demonstrate the impact of the different potential options of the model.

2. Tenancy Arrangement

- 2.1. The lease from the Fund to the Council would contain market standard Full Repairing and Insuring (FRI) terms, including annual rent reviews which could be linked to Retail Price Index (RPI), Consumer Price index (CPI) or fixed annual uplifts. If it is RPI or CPI it will be subject to a minimum increase (e.g. 1%) and maximum increase (e.g. 4.00%) per annum, or a fixed annual uplift. The type of rent review in place will have an impact on the overall pricing from the fund.
- 2.2. On expiry of the occupational lease term, the Council would have the option to acquire the long leasehold interest for £1.
- 2.3. If required, the lease could include assignment provisions to provide an exit mechanism for the Council. The number of assignments would need to be agreed but is likely to be limited to one; it is expected that the fund would require this to be an entity with the equivalent credit rating of the Council and an authorised guarantee agreement is likely to be required.

3. Benefits of the Structure

- 3.1. Risk transfer

The Council benefits in the income strip arrangement by being able to transfer financial and development risks to a Fund. The development would be financed by the Fund (sheltering the Council from the risk of borrowing long-term itself) and, as they appoint the developer, the development risk would also be with the Fund.

3.2. Rent profit

There is also a potential financial benefit to the Council where a profit is made on the gap between rental income and expenditure (being the difference between the lease payment due and rent receivable). If the Council continues to be able to increase the rent receivable with inflation then it would continue to enjoy a surplus. However, there is a risk that in the future, lease payments will exceed income received (see paragraph 4.1).

3.3. Other benefits

- The freehold property interest is retained by the Council.
- The Council has an option to purchase the reversionary property interest for £1 at the end of the Occupational Lease (subject to no default).
- Receipt of a premium by the Council on execution of the Head Lease.
- Capital receipt to the Council on practical completion of the development / execution of the occupational lease.

4. **Risks**

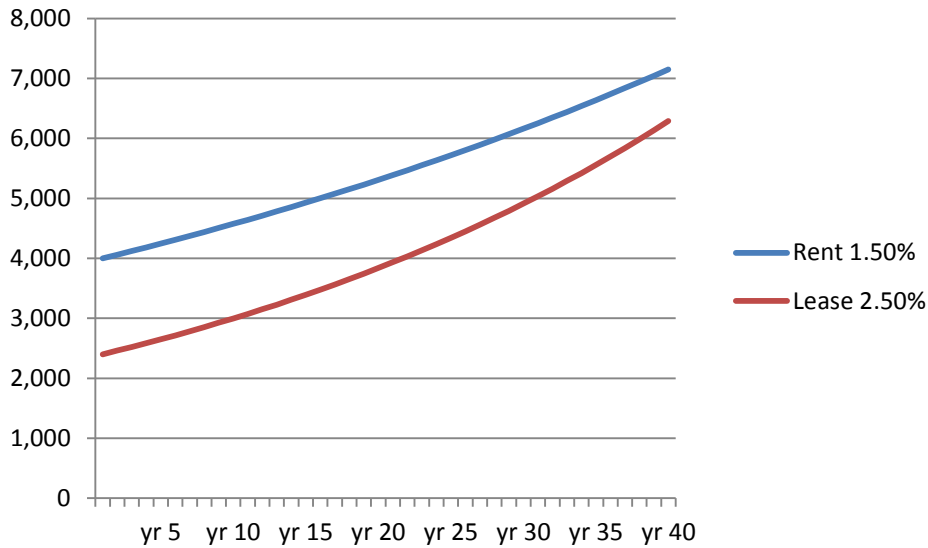
4.1. Rent loss

The rental income achievable by the Council would be subject to market forces. There is a risk that rents received from the developed units will not increase by RPI/CPI over the full term of the occupational lease in order to keep pace with the rent paid by the Council to the developer. It is possible that a significant shortfall in income could arise.

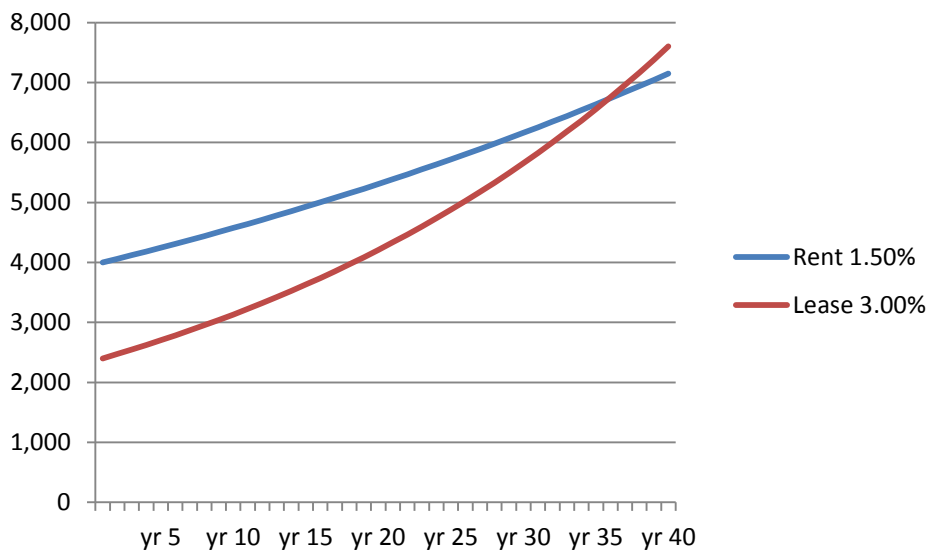
4.2. One option to mitigate this is to create an earmarked reserve funded by an agreed difference between rents received and rents payable early-on in the agreement.

4.3. The scale of the possible shortfall in income (and therefore cost to the Council in later years of the agreement) is sensitive to the rate of increase for both the rent receivable (subject to the market) and rent payable by the Council (fixed inflationary increase in the lease agreement). Scenarios of the impact of rent and lease payments increasing at different rates are illustrated as follows (N.B. these are illustrative values only and do not represent actual rentals expected on the Station Approach scheme):

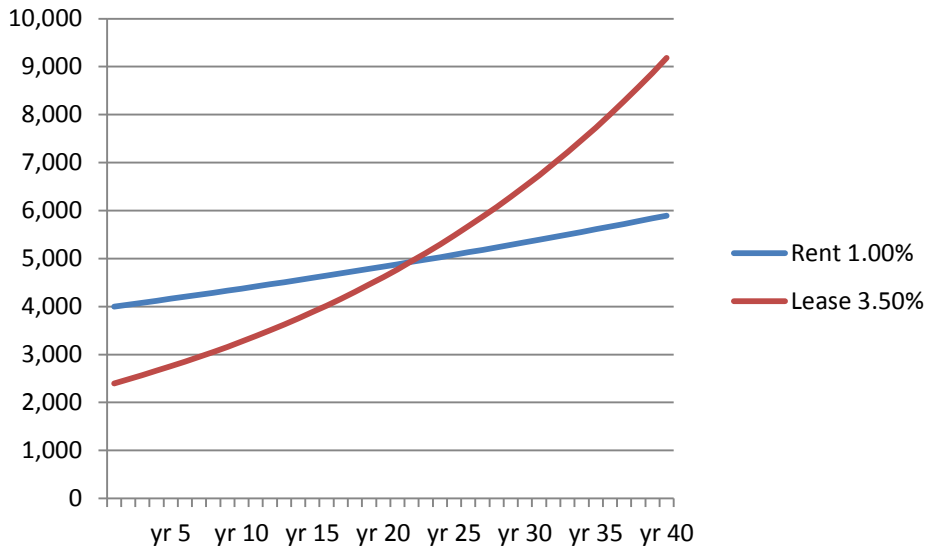
4.4. Rent income increases at 1.5%
Head lease payments increase at 2.5%



4.5. Rent income increases at 1.5%
Head lease payments increase at 3.0%



4.6. Rent income increases at 1.0%
Head lease payments increase at 3.5%



4.7. Letting risk

There is a risk that the Council’s sub-tenants choose not to renew their lease and/or, that in periods of adverse market conditions or potentially through business failure that voids may result. In those circumstances, if new sub-tenants cannot be found or not found at rents of at least the then rate that the Councils is paying under the head lease, the Council could potentially find itself with annual deficits.

4.8. The Council would, in addition to taking all of the letting risk, be liable for managing the building. This would encompass rent collection; the operation and running of service charges; and managing all repairs and maintenance to the building (even though these would not be recoverable through service charges).