City of Fremantle

May 2015

Kings Square Business Plan – response to community concerns

Background/context

There has recently been some public debate questioning the integrity of the City of Fremantle's Business Plan for the Kings Square Project. The business plan was released for public consultation in 2012 and signed off by the council in February 2013. In an attempt to answer the questions raised it is necessary to understand the project.

<u>Issue 1 – the approach</u>

The Kings Square project involves the redevelopment of Queensgate Centre and Car Park, Spicer site, and Council administration centre facilities, including the public realm around the Square. Including the Myer building, this project has an estimated value of $220 million. It will provide approximately 12,000 square metres of retail space and 30,000 square metres of commercial office space. To put that into context, the current City administration and library is about 5,000 square metres.

There were a number of factors that contributed to this project being established:

- The general decline in office and retail space in Fremantle
- The Myer building had recently been purchased by Sirona Capital and Myer had indicated its intention to leave Fremantle (which it ultimately did)
- Hoyts had advised the City that it would not renew its lease at Queensgate because of significant financial losses from this operation (it too has vacated)
- No other cinema chain was prepared to take on the Queensgate cinemas because of the cost of refurbishment and adaptation to operate digitally
- The council had a position of replacing its facilities (adopted in 2004)
- The state government announcement that the Department of Housing would be relocated to Fremantle
- The threat of local government amalgamations that could potentially have seen Fremantle merged with Melville and the administrative offices for the new entity to be located outside of the Fremantle CBD (further weakening the economy of Fremantle)

After considering other options to guarantee a good development outcome to address these issues, the City determined that the best outcome could be achieved through a fully integrated development, rather than separate the development into segments. We were very aware of the risk that an open market sale of City property may not lead to a redevelopment of some or all properties.

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The City was seeking an agreement that could guarantee that the total development would occur before it relinquished complete control of its property. In order to achieve that outcome the project needed to be a fully integrated development. Making each component interdependent was agreed as the best way to achieve the integrated development outcome.

The project ideas were then progressed through an MOU with Sirona, to allow exploration of how a fully integrated development could occur. Having reached some level of agreement of principles the City then commenced more detailed planning through the business plan process.

There has been a suggestion that the City should have completed separate business plans for each property disposal and the redevelopment of the City's facilities. The above explains the City's approach and the reasons for one business plan.

Local Governments are required to prepare business plans when undertaking certain activities, a project of this size that involves the disposal of land being one of those activities.

The City's Business Plan released for public comment in November 2012, explicitly states in the very beginning of the document at item 1.1:

"The project vision is to instigate a generational re-investment of the City's community, civic and administrative facilities and underpin economic development and the urban environment.

Fundamentally this involves:

- **a.** ***The City's proactive role as a major anchor and catalyst through the staged re-investment of its library, civic, tourism and administration facilities (on its Kings Square land holding)***
- **b.** ***Funded via the sale of strategic (non-core) sites to a third party commercial partner with the capability and experience to deliver mutually beneficial and complementary economic development anchors in a timely manner***
- **c.** ***Reposition the Kings Square precinct as an iconic public realm centrepiece of the Fremantle CBD."***

The business plan was very clear about what was being proposed.

Issue 2 – release of the business case for scrutiny

In preparing the business plan for public release, the City engaged independent consultants, Leedwell Strategic, who had undertaken similar work in South Australia for both state and local governments.

A business case was prepared for the City to assist in the preparation of the business plan. The business plan is what is required to be released for public comment, not the working papers which are essentially what the business case is. The business plan that was released was a comprehensive 56 page document containing much more information for public scrutiny than required by the Local Government Act for a local government business plan.

The business case is not available for release to the public as it contains (still) commercially sensitive detailed information and although the content is the property of the City of Fremantle, the construction of that business case has intellectual property value for the consultant who prepared it for the City.

Issue 3 – Investment reserve funds

There has been some speculation that the City is in breach of the Trustees Act by utilising investment reserve funds for this project.

Firstly, the Trustees Act does not apply to local government public projects. Secondly, the City's Investment Reserve Fund Policy is a policy created by council. It has no higher statutory authority than a guidance document created by council for council.

Issue 4 – Net Present Value (NPV) assessment and business plan assumptions

The most contentious debate relates to the City's NPV analysis. The NPV is a resultant calculation after a number of inputs and is designed to test the value of money in a long-term transaction. The confusion about the Kings Square Project NPV is based on some assertions that:

a. the discount rate is not justified
b. council facilities values should not be included
c. the valuation of the Queensgate building is incorrect.

An NPV analysis is subject to the input assumptions - if the assumptions change the NPV changes. The following provides the assumptions used by the City in calculating the NPV.

Issue 4a – Discount rate

A discount rate is the rate used to discount future cash flows to the present value – and is a key variable in an NPV assessment. The rate used by the City in the business plan was 5.5%, arrived at by applying 4% (being the long term borrowing rate for local governments) PLUS a 1.5% risk margin. The discount rate aims to fundamentally reflect two variables namely:

a. the risk of the timing of cash flows
b. the risk in the quantum of cash flows.

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The consultant (Leedwell Strategic) that prepared the business case advises - *"In other projects we have undertaken for state and local governments the discount rate adopted is generally in the range of 1%-1.5% margin over opportunity cost of funds (long term)".*

The City elected to adopt the high end of this risk range, reflecting the conservative nature of the assessment.

The local government long term borrowing rates have decreased since this business plan was prepared. Assuming all other inputs are equal, an NPV assessment done using today's inputs would actually be more positive than it was at the time it was undertaken in 2012.

<u>Issue 4b – Inclusion of council asset values</u>

This issue has the greatest impact on the NPV calculation. The debate centres on whether the City's buildings should be included in the NPV assessment since they are non-commercial.

The reason the City's facilities should be included is because they are on freehold land and the building has both a real and accounting value. The land value has not been included in any NPV assessment so there is no growth factor applied to the land value, however the buildings have:

a real value - because the City could sell this asset (albeit highly unlikely) and decide instead to lease property for its administration, library etc. (It would then be faced with commercial leasing costs). The City's facilities will also have retail and commercial spaces for lease, providing the City with a revenue stream through rent.

an accounting value - because the value of this asset MUST be included in the City's balance sheet. To not do so would be in breach of Australian accounting standards.

There has also been suggestion that the future value assigned to the City's buildings was inflated. The value of the City buildings at completion (without land value) was estimated at $44.75m: the value in 20 years was assessed at $97.23m, calculated by applying a 3.5% price indexation rate each year.

The City believes this figure is conservative given that historically property prices increase at better than CPI. The business plan includes an appropriate annual maintenance charge for the facilities to ensure they are kept in good condition and retain their value. Just think about your own house – it has probably increased in value by something closer to 7% per annum (cumulative) over the past 20 years, so again a 3.5% growth in value is very much at the conservative end of the estimates.

<u>Issue 4c – Queensgate building valuation</u>

There is an argument that selling the Queensgate building for the valuation price of $6.4m is undervaluing this asset. If this asset was a fully functioning and performing asset I would absolutely agree. In fact it took elected members and staff a long time to come to terms with this valuation. It is true that the City could have put the building on the market in an “as is” state and possibly got a better value, however it would have been highly unlikely it would have been redeveloped, undermining our whole vision for an integrated redevelopment of the area.

And whilst the rental returns at the time suggested the property value was much higher, Hoyts who had the lease for the Queensgate Cinemas were seeking to relinquish their lease. That lease provided a very significant part of the revenues for this building and the loss of that lessee significantly impacted on the rental returns, which in turn decreases the value of the property.

The City had discussions with three other major cinema chains to determine whether it could attract another cinema tenant in the existing space. Unfortunately none showed any interest at all in the current space, given its age and structure, and lack of adaptability for digital projection.

The City then spent a lot of time exploring a refurbishment of the existing building to open up the opportunity for a wider range of tenants, including office tenants. However, since nearly 60% of the floor plate of this building is the cinema space – and that space does not have a flat floor (it has an angled concrete floor) any refurbishment would require demolition of a substantial part of the building. That scenario was tested rigorously by the City, but the valuation under that scenario was assessed at $6.35 million by professional valuers (CBRE). That is actually $50,000 less than a total demolition valuation which the City assessed ultimately as the better option.

<u>Issue 5 – Tier assumptions</u>

Although not specifically raised as an issue, it is important to reiterate to the community that the City’s business plan was prepared on a conservative basis with a very low risk appetite.

The City is well aware that it is investing hard earned ratepayer funds into a revitalisation project and council needed to be assured that this project would not have a detrimental effect on future generations of ratepayers.

In undertaking the NPV assessment, the City included all tier 1 (direct) costs and revenues associated with this project. It also included tier 2 costs and revenues (indirect but clearly identifiable, such as future rate revenues from redeveloped properties). What is not included are any tier 3 revenues resulting from a general uplift in the economy from this project. Successfully implemented, this project will deliver a significant uplift in the local economy which means additional new businesses open, values generally go up and the City rate base is significantly improved as a result. What we know from the Myer departure is that the retail sector in Fremantle has suffered a downturn in business that is averaging around 15%. This project aims to reverse and improve that situation.

Issue 6 – Timing delays

This is an area that is frustrating for all of us. That frustration emanates from a lack of state government commitment to its announcement in 2011 that the Department of Housing would be relocated to Fremantle, occupying around 20,000 square metres of office space and bringing over 1,000 workers. Sirona Capital has to date invested significant time and energy working through government processes to obtain that commitment to this project. If the Department of Housing (or a viable alternative anchor) can't be secured in the next 12 months, this project in its current structure will "fall over". This is clearly understood by the City and we are currently developing alternative structures to ensure we're prepared should such a scenario eventuate.

In the meantime the delays, whilst frustrating, do not mean the business plan has unravelled. The business plan has risk and escalation (CPI) factored into the plan and as noted above, the fact that the borrowing rate has decreased since the plan was prepared actually supports an improved financial outcome.

It is true that the City has lost some lease revenue from the vacated tenancies in Queensgate as a result of the delays, but this has been largely offset by non-refundable deposits from Sirona totalling $400,000.

Issue 7 – Debt funding

There has been some speculation about how the City will fund its portion of the development and what the implications of this will be on ratepayers.

The business plan indicates the City will need to borrow about $15 million to fund its portion of the completed project. It is anticipated that the revenues from the project (eg retail and surplus office space income) will service a significant part of this debt.

Although the 10 year financial plan, which takes into account the Kings Square Project's financial implications, doesn't show any above average increase in rates over the cycle, future councils may decide to increase rates by a small amount to accelerate repayment or it could apply funds from the sale of other assets to reduce or retire the debt.

As has been mentioned there will also be an organic uplift in rates that will occur as properties in Fremantle (including those as part of the Kings Square Project) are developed and improved in the Fremantle CBD which will help to further reduce this gap.

As the business plan notes, the impact on the City's overall financial position is relatively minor.

Summary

The City approached the business plan with the utmost conservatism, but never shied away from the fact that it was disposing of three properties and using the proceeds to redevelop its own facilities.

This is to be a catalytic project that will provide Fremantle with a much needed economic boost through increased retail and commercial activity. Most importantly, it is an integrated project, deliberately structured this way to guarantee all properties are developed as envisaged for the maximum benefit of the community. It would be a very poor outcome to separate these asset sales on purely commercial grounds, accept the price from the highest bidder, and not see any development.

This project is not unlike the City's Point Street project that will see the Hilton Hotel chain on the former City site in Adelaide Street alongside other retail and residential uses. That project has taken eight years to get to its current stage of development. We are keen to get this one going much quicker because Fremantle really can't afford to stagnate any longer.

Graeme Mackenzie
Chief Executive Officer
City of Fremantle