UK real estate insights

Issue 11 – January 2009

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PricewaterhouseCoopers

Introduction

Welcome to the latest edition of UK real estate insights. 2008 was an extremely challenging year for the industry, and attention is now turning to the prospects for 2009. Yields on real estate have moved dramatically since the peak of the market, with further falls anticipated in the short-term.

Commentators are suggesting a fall in capital values from peak to trough of 50%. At the same time interest rates have dropped making the return on other investment assets significantly less appealing. For foreign investors, the fall in Sterling makes UK assets look even cheaper. Shares in real estate companies quoted on the main market and AIM are trading at very significant discounts to even these diminished Net Asset Values and stand at a fraction of where they were at the height of the market. Many well respected investors, analysts at investment banks and research teams at real estate investment managers have in recent weeks made public pronouncements that we are reaching the bottom of the market. The rise in REIT shares earlier this month was seen by some as the turn, although they are still generally trading barely perceptibly above their 52 week lows.

For those with access to funds to invest, real estate whether acquired directly or indirectly via shares in property companies is on the face of it a highly attractive proposition. Furthermore there is limited competition from other buyers, particularly those that rely on debt. However, we are also clearly entering a new phase in the real estate crisis. Until now this has largely been a capital markets crisis. Yields have moved dramatically as risk has been re-priced and liquidity has dried up, but the underlying fundamentals have remained intact. This is now changing and we are entering an occupier crisis. Two sectors in particular are at the forefront of this, retail and financial services. Landlords with significant exposure to the retail sector were watching the Christmas trading very closely. A last minute improvement in sales in the final week of the Christmas period meant that results have not been as dire as some people anticipated, and the first fortnight of January has not been quite the bloodbath of administrations that some

Introduction

of us were expecting. However, the first quarter of the year is traditionally a difficult one for retailers as they need to have accumulated enough cash at Christmas to pay in arrears for their December stock and to last through until Easter. The period between now and the March quarter day for rent is likely to be a lean one and we can expect further administrations in the retail sector. Our colleagues in our retail team will be running a webcast for retail clients on 28th January on the outcomes of the Christmas trading period. Our real estate clients are also welcome to join.
Click here for further details.

The other broad group of tenants with high profile difficulties are those in the financial services sector. As might be expected, the results of the most recent quarterly Financial Services Survey which we produce with the CBI make grim reading, although as with retail, perhaps not quite as grim as might have been expected, particularly in view of the subsequent bad news from the banking sector. The results are covered in more detail elsewhere in this edition of **UK real estate insights.** The problems in the financial services sector have also been a significant contributor to the broader economic malaise. UK gross domestic product declined in the third quarter and and has now contracted by 1.5 percent in the final quarter pushing the UK into recession. This is expected to continue through 2009. **Again, more detail is included later in this edition.** For investors into UK real estate the key question is how far the dramatic difference between property yields and interest rates already prices in declining rents and tenant failures. If UK real estate is not currently underpriced, then the prognosis for tenants is nothing short of calamitous. We are certainly seeing considerably more interest from overseas investors and are now advising on transactions. There are also opportunities arising from specific distressed situations and this will increase as pressure mounts on banks to deal with breaches on loans.

Our annual assessment of the consensus view of the industry in Europe is the Emerging Trends in Real Estate® Europe survey which we and the Urban Land Institute will be launching on the 3rd of February. We will also be holding a breakfast briefing on 10 February at the Hilton Tower Bridge in London at which we will present the findings of the report, with a particular focus on the impact for the UK. More details of the report and the launch are included elsewhere in this publication.

Our Real Estate Business Recovery team led by Barry Gilbertson continues to be extremely busy on the Lehmans Brothers

administration and other matters. On Lehman Brothers, the process of selling a number of equity and/or debt interests held in corporate vehicles has now commenced. For further information please contact Simon Boadle or Barry Gilberston.

The Real Estate Business Recovery team has also recently won the Estates Review First Annual Legal and Advisory Award for Best Real Estate Business Recovery Team 2008.

Our legal practice, PricewaterhouseCoopers Legal LLP has continued to develop its capabilities with the substantial expansion of its real estate group last November. The now ten-strong team will be led by Simon Hardwick with Adam Perry, Tim Hart and Amanda Crowe, who have all joined PwC Legal as partners from national law firm Halliwells. We already provide a comprehensive range of services on real estate related matters for our clients. In particular our transactions offering covers lead advisory, financial due diligence, tax and financial modelling. The substantial expansion of our real estate legal capability will give this a further boost. In the current market many of our clients are looking for support on complex property situations where an integrated service offering is needed.

We have also strengthened our lead advisory capability with the appointment of Marc Titmus Mather as a director to our Corporate Finance practice to bolster the team's capability in advising on Real Estate Transactions. Marc brings 15 years' of deal experience with deep expertise in the Real Estate sector and a strong network across Europe. He has worked for a considerable time in real estate having worked in principal investment and banks such as ABN AMRO and Bank of America. He has led teams focusing on real estate M&A, capital raising, debt financing, and principal investment.

John Forbes
Real Estate Industry Leader
Europe, Middle-East and Africa
PricewaterhouseCoopers LLP

Economic update

As outlined in the introduction to this edition of UK real estate insights, the state of the UK economy has continued to deteriorate. The PricewaterhouseCoopers Macro Consulting team issued its latest update on the UK economy on 2 January.

The key findings are outlined in this article. The outlook continues to remain uncertain and the risks to the economy are heavily weighted to the downside.

UK GDP contracted in the Q3 of 2008, pushing the economy further towards technical recession. Falling consumer spending and investment alongside the prolonged financial market crisis are expected to bear down heavily on growth in 2009.

Key metrics

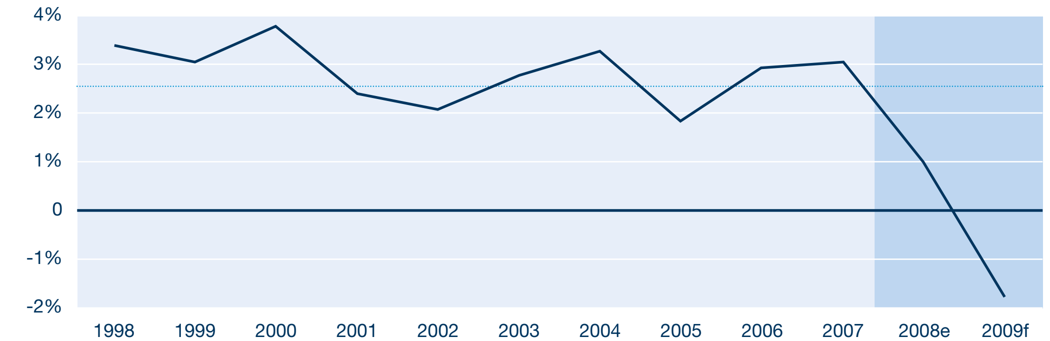
Indicator	2007	2008e	2009f
GDP growth	3.0%	0.9%	-1.8%
Inflation	2.3%	3.5%	1.0%
Base interest rate	5.5%	2.0%	▼*
General outlook			Negative

Source: ONS, Bank of England; PricewaterhouseCoopers estimates (e) and forecasts (f) *Rate as of January 2009 was 1.5%.

Key trends

- GDP growth fell by 0.6% in Q3 2008, the first contraction of the UK economy in 16 years.
- Deteriorating climate has led to unemployment rising to its highest rate in more than eight years.
- Inflation is set to fall rapidly in 2009, providing scope for further monetary loosening.

Economic growth profile



Source: ONS; PricewaterhouseCoopers estimates (e) forecasts (f).

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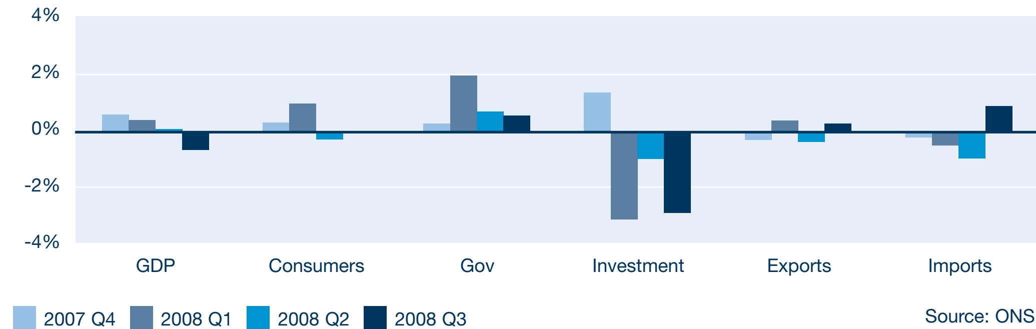
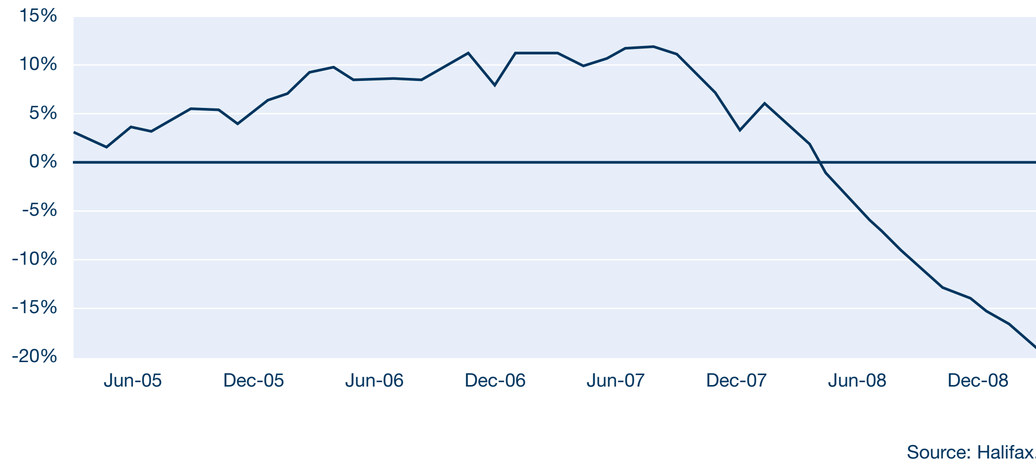
Economic update

Figure 1: Quarter-on-quarter growth rates



Source: ONS.

Figure 2: Year-on-year UK House prices



Source: Halifax.

GDP contracts in Q3

GDP contracted by 0.6 per cent in Q3 2008 after stalling in Q2 (see Figure 1 below). This was the first contraction in UK economic output since mid-1992 and signals that the economy is now almost certainly headed for a technical recession. Output fell in both the manufacturing and services industries and the construction sector also contracted, where housing investment was particularly weak. Business investment also fell markedly in Q3.

Consumer spending fell by 0.2 per cent in Q3, its steepest fall since 1995. The biggest movement in the consumer expenditure category was in transport, where the purchases of motor vehicles fell markedly.

House prices fall and approvals decline

House prices in the UK fell by a further 2.6 per cent in November, according to the Halifax, leaving them around 15 per cent lower than a year earlier (see Figure 2 below). This reflects tight credit constraints and a continuing lack of buyer confidence.

Continued weakness in the manufacturing, construction and services sectors

Activity in the manufacturing, construction and services sectors deteriorated further in November. The Purchasing Managers Indices for all three sectors continued to fall and remain significantly below 50, the point that determines whether output is expanding or contracting. Weak activity in these sectors is expected to persist into 2009.

Unemployment increases

The UK labour market is being weighed down by sluggish economic activity and depressed business confidence. For the three months to October, the unemployment rate rose to 6 per cent (see Figure 3), the highest rate in more than eight years. Turmoil in the global financial markets is hitting employment in the financial sector while jobs are continuing to be cut in the struggling construction and retail sectors. As the economy contracts further in 2009, unemployment levels are likely to continue to rise.

Continued

Economic update

Inflation retreats

Consumer price index (CPI) inflation – the Bank of England's target measure – fell to 4.1 per cent in November. Similarly, retail price index (RPI) inflation, which also takes into account falling house prices and mortgage interest payments, plummeted from 4.2 per cent in October to 3 per cent in November. A major driver of this reversal has been the plunge in oil prices from their mid-July peak. Downward pressure on inflation will also arise from the recent cut in VAT from 17.5 per cent to 15 per cent, effective from 1 December 2008.

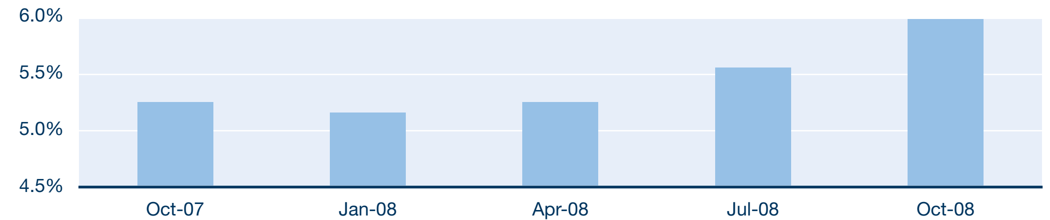
The easing of inflationary pressures over recent months has allowed the Bank of England to cut interest rates by 350 basis points since October, from 5 per cent to 1.5 per cent. Further rate cuts and additional measures to boost the money supply are expected in the New Year.

Further contraction anticipated

The UK economy is expected to contract in 2009, although the depth and length of the recession remains highly uncertain. Despite very low interest rates, fiscal stimulus and a sharp retreat in inflation, consumer spending is expected to decline in 2009. Investment is also expected to contract further while exports are likely to remain muted, despite benefiting from a weaker pound, as the global slowdown continues. Looking ahead, we expect GDP growth to be -1.8 per cent in 2009, following an estimated 0.9 per cent in 2008, with risks remaining weighted to the downside in the short term.

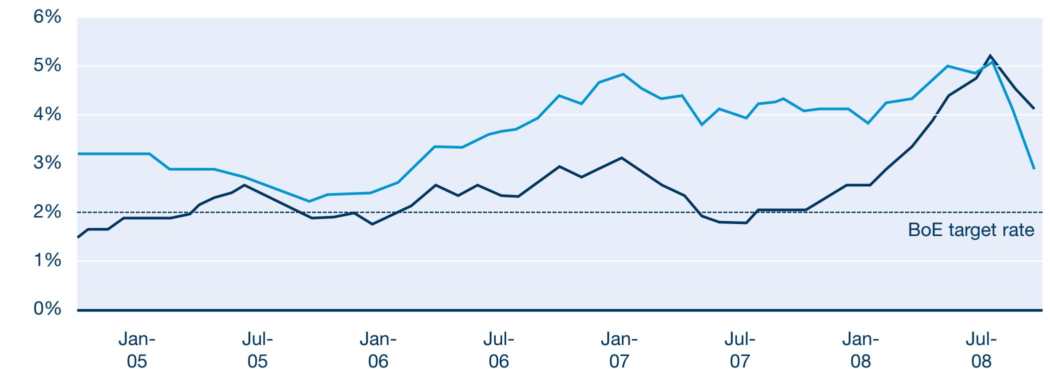
For further information regarding macroeconomic advice for the real estate industry, please contact **Yael Selfin**, who is Head of Macro Consulting, Economics in our Market & Value Advisory practice.

Figure 3: Unemployment Rate (3 months ending)



Source: ONS.

Figure 4: Year-on-year inflation



Source: ONS.

Financial services industry update

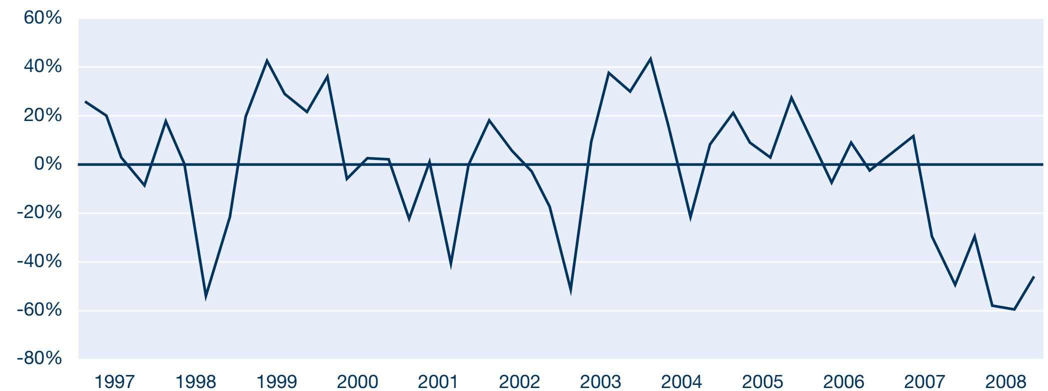
The health of the financial services sector is hugely significant for the real estate industry. First, as lenders to the real estate industry – normal transactional activity will not return to the market until debt liquidity returns. Secondly, in London and Edinburgh particularly, but also more broadly, financial services companies are major occupiers of property. The sector is also a key driver of the broader economy, as an employer, but also through the impact that the availability of mortgages finance has on house prices and via that on consumer spending.

In view of this importance, we have been reporting the results of the quarterly Financial Services Survey which we produce with the CBI. The survey, which has been running since December 1989, is a quarterly survey of the health, perceptions and plans of the financial services industry. According to the latest survey, which covers the period to December 2008, income and profitability levels in the UK financial services sector fell at a record rate.

In a clear sign that tightened credit markets are hitting the wider economy, the amount of business conducted with manufacturers, retailers and other commercial firms also shrank at a record rate, while job losses mounted and investment plans were cut.

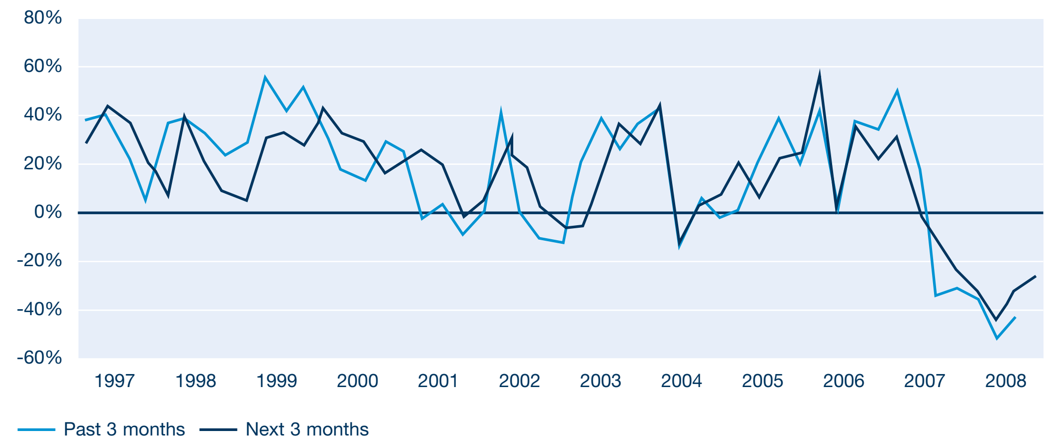
Asked how their business volumes fared in the three months to early December, 17 per cent of firms responding to the CBI/PricewaterhouseCoopers Financial Services Survey said that volumes rose, while 59 per cent said they fell.

Q1 – Optimism versus three months earlier



Source: CBI/PricewaterhouseCoopers FSS, December 2008.

Q3a – Trend in volume of business



Source: CBI/PricewaterhouseCoopers FSS, December 2008.

Continued

Financial services industry update

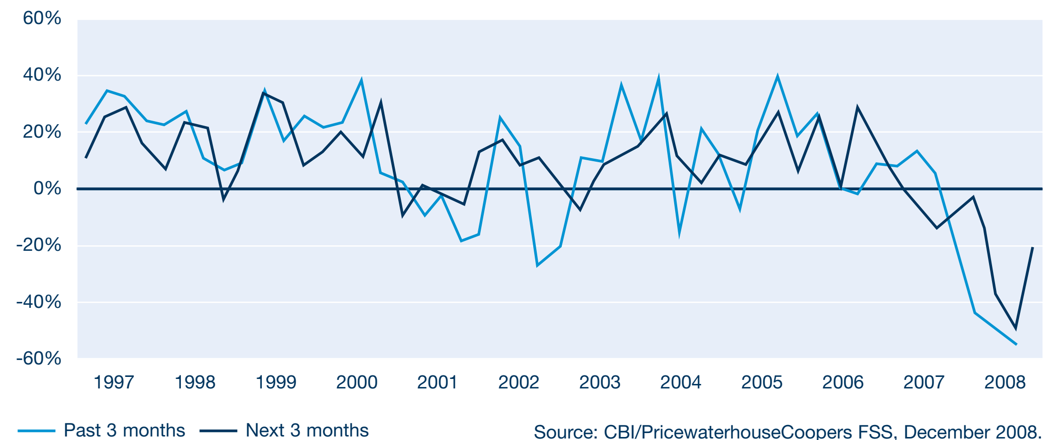
The resulting balance of -42 per cent continued a year-long run of steep declines and was worse than firms had expected. A balance of 25 per cent expect volumes to fall further over the next three months.

Profitability in the sector declined at a record rate for the second survey running, with a balance of 55 per cent of firms reporting a fall. Looking forward, the rate of profit decline is expected to slow, as a net 19 per cent of firms predict profits will drop over the coming three months.

Numbers employed in the sector also fell.

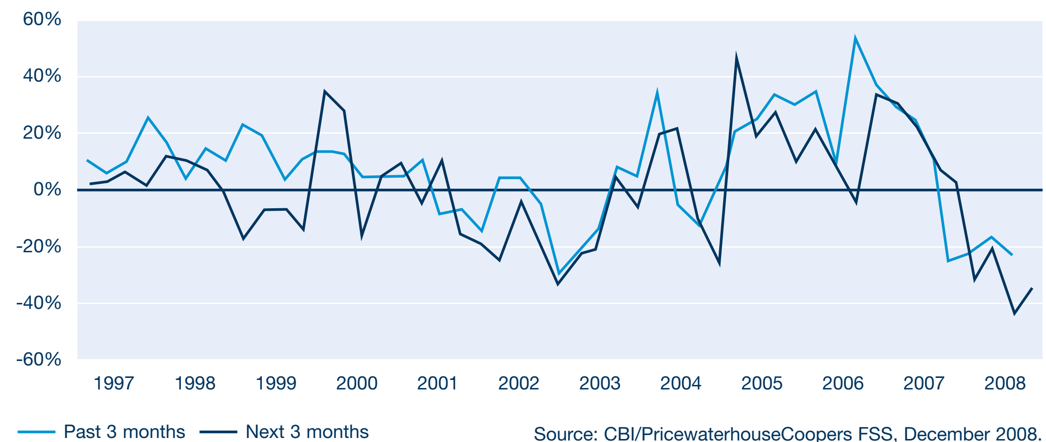
Of particular relevance for the real estate industry is anticipated expenditure on land and buildings. Forty-seven per cent of respondents expect to reduce their expenditure on land and buildings over the next 12 months (23 per cent last quarter). As with the previous quarter, this is particularly the case for banking, with 72 per cent expecting to reduce expenditure (38 per cent last quarter) and life insurance with 91 per cent expecting to reduce expenditure (63 per cent last quarter). In the previous quarter, fund management had bucked the trend with 46 per cent of respondents expecting to increase their expenditure on land and buildings over the next 12 months. This has now fallen back to zero.

Q5h – Trend in overall profitability



Source: CBI/PricewaterhouseCoopers FSS, December 2008.

Q6a – Numbers employed



Source: CBI/PricewaterhouseCoopers FSS, December 2008.

To obtain a copy of the report click here.

UK hotels forecast: the bigger the boom, the bigger the bust

London room rates set to fall further as UK economy weakens

This year's worst case scenario has become stark reality for London hotels, as PricewaterhouseCoopers LLP (PwC) revisit their RevPAR forecasts.

After five years of unbroken revenue growth, September ushered in a period of volatile trading for the hotel sector. The deteriorating economic environment and travel outlook marked a change of fortune for UK hotels with buyers, not sellers, of hotel rooms very much in the driving seat again. In a classic boom and bust sector, it is happening again.[1]

PwC's main scenario in its latest hotel forecast saw the London hotel market staring at an 11.9 per cent RevPAR decline as room rates were expected to fall for the first time in five years. This was based on an expected 0.5% decline in GDP.

But, with the New Year comes a downgrade to the firm's economic outlook and November's downside scenario for hoteliers has now been repositioned as the official outlook. With a 1.8% decline in GDP now forecast, the prediction for 2009 from PwC's Hospitality & Leisure (H&L) team is a near ten per cent tumble in UK RevPAR, with London RevPAR plummeting by 23 per cent, due mainly to a fall in room rates.

The UK could now see RevPAR decline by 9.4 per cent while in the provinces the fall is more muted (3.4 per cent) than the

Capital. For London the impact of reduced corporate travel and spend is more severe, although the impact of Eurozone tourists may soften the blow in the short-term.

Falling consumer spend and investment, combined with the prolonged financial market crisis will restrict economic growth over the next 12 months. We now expect GDP to contract by nearly two

[1] This short article highlights some key findings from PricewaterhouseCoopers latest UK hotels forecast which can be read in full in Issue 18 of PricewaterhouseCoopers Hospitality Directions Europe

Continued

UK hotels forecast: the bigger the boom, the bigger the bust

per cent in 2009, following an estimated 0.9 per cent growth last year. This harsher environment means hospitality and travel budgets are under even more pressure as firms tighten up on cost control. Although visibility is restricted, evidence points to an unprecedentedly poor hotel outlook for the year.

The deteriorating economic climate has spread across the manufacturing, construction and services sectors, causing unemployment to rise to its highest rate in more than eight years. Inflation is set to fall rapidly in 2009, providing scope for further monetary loosening this year. However, very low interest rates and a significant fiscal stimulus may prove unable to kick start the economy this year and with no clear signs as to when business travel demand might be re-stimulated, what was our downside scenario now seems the most likely outcome for 2009 – meaning record RevPAR falls in London this year.

Liz Hall is head of hospitality and leisure research at PricewaterhouseCoopers.

Table 1. UK Hotel Forecast for UK, London and the provinces (premised on a 1.9% GDP decline in 2009)% growth on previous year

Hotel Statistics for the UK	2009f
Average Room Rate (£)	75.29
% Change	-7.70%
Occupancy (%)	74.6
% Change	-1.90%
RevPAR (£)	56.11
% Change	-9.40%

Hotel Statistics for the London	2009f
Average Room Rate (£)	96.41
% Change	-15.90%
Occupancy (%)	72.2
% Change	-8.70%
RevPAR (£)	69.92
% Change	-23.30%

Hotel Statistics for the Provinces	2009f
Average Room Rate (£)	62.9
% Change	-3.70%
Occupancy (%)	68.7
% Change	-0.30%
RevPAR (£)	43.21
% Change	-3.40%

Source: PricewaterhouseCoopers November 2008. Roundings may mean RevPAR does not equal sum of ARR and occupancy.

Grant opportunities for relocating businesses

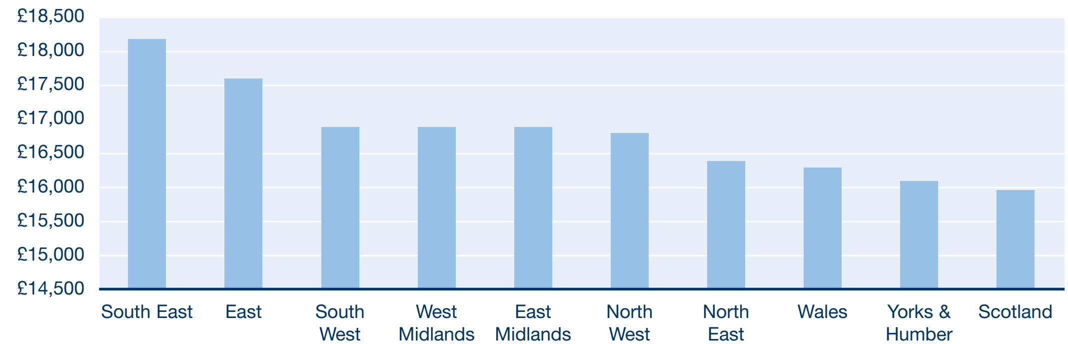
In the current economic climate many businesses are using the 'downturn' to re-evaluate their business strategy and look for opportunities to save cash or make long-term savings.

As a result, many firms, particularly based in traditionally high-cost locations like the South East of England, are now looking at the potential to relocate some of their activities to a location with low labour and property costs and where the labour markets can meet their skills and future growth requirements.

Historically, government departments have been active in moving business out of the South East and many of these have been well documented, such as the Meteorological Office move to Exeter and the Qualifications and Curriculum Authority to Coventry.

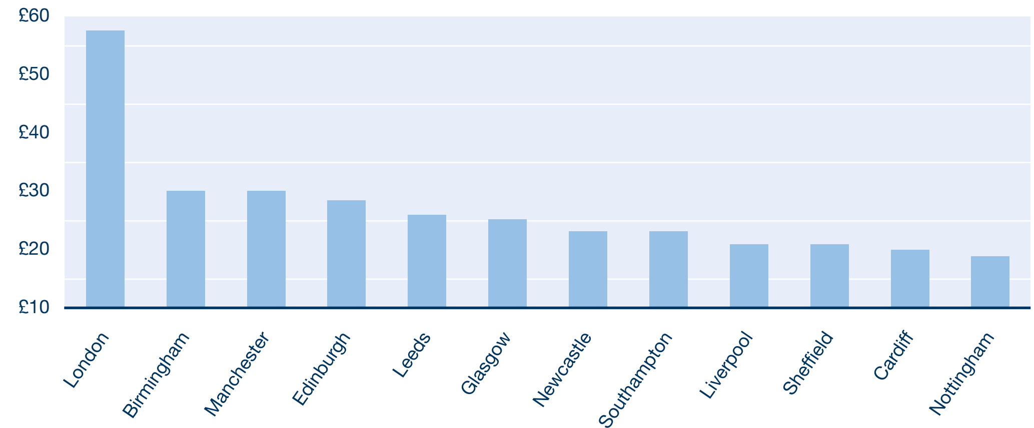
The private sector has also been part of this trend with businesses like the Bank of New York moving business to Manchester, and Legal & General to Cardiff. While most private sector businesses would qualify (except retail and some excluded EC sectors), the focus for the regional agencies has been in attracting businesses creating high- quality jobs in the manufacturing and service sectors, with a particular focus on financial services and activities like shared services, back-office functions and call centres.

Average midpoint salaries for customer service advisors (call centres) 2008



Source: Income Data Services.

City centre office rentals – mid-2008



Source: King Sturge.

Continued

Grant opportunities for relocating businesses

Real estate investors considering the opportunities in the regions need to understand the dynamics that motivate tenants to relocate. Certainly the lure of lower property costs and labour costs in the regions have been and will continue to be attractive as the table to the right demonstrates but what about grant availability?

Regional aid grant is administered by the Regional Development Agencies in England, the Welsh Assembly Government, the Scottish Government, and the Northern Ireland Government. These organisations can potentially bring together attractive grant packages to encourage businesses relocating within the UK and into the UK, to their regions.

The grant packages generally consist of a combination of training packages, employment creation assistance and property assistance, brought together within the overall state aid limits for the particular region concerned. The maximum aid limits for large companies can range from 30 per cent down to 10 per cent of investment costs (salary or capital), depending on the region. The aid limits have been set by the UK Government and European Commission, and linked to the level of GDP per head and the size of the enterprise being assisted. SMEs can attract an additional premium. The regional grants associated with capital investment and employment are only available with designated Assisted Areas in the region. These are areas where regional aid may be granted under European Community law. These areas can be quite small and in some cities and regions the coverage is uneven. Cities like Manchester, Nottingham, Birmingham, London, Plymouth, Sheffield, Glasgow and Cardiff for example have parts of the city that are designated Assisted Areas and some that are not. It is particularly important to establish if your preferred location is in an Assisted Area before committing yourself to the investment.

Grant assistance or support for training is potentially available across the UK and not confined to the Assisted Areas. However, the availability of such funding is linked to the local labour market strategies and available funding of the regional organisations.

What is the principal criteria?

As all grants are discretionary and negotiable the onus is on the applicant to demonstrate why a grant is needed. It is therefore important that no irrevocable commitment is made to a relocation project, that is, signing a property lease before receiving a grant offer. In addition, advertising for staff may also be seen as a commitment and could preclude a company from receiving a grant. Obtaining planning permission, drawing up lease contracts, research and obtaining tenders may not be regarded as an irrevocable commitment to the project proceeding in a grant location.

How much?

Grant levels are influenced not only by the state aid level for the particular region, but also by a combination of the companies need for grant argument, regional cost per job limits, that is, how much the regional agencies believe the project is worth from an added-value perspective and the overall business case, including viability of the applicant.

A great deal of consideration will be given to the benefits the project could bring and under the new Grant for Business Investment/Regional Selective Assistance schemes, quality of the jobs is scrutinised in great detail. Figures produced by the UK government for grant applications – including the SFI/RSA schemes in England, Scotland and Wales, considered by their regional boards, for the year ended 31 March 2008 – make interesting reading. The average grant offers per job for large applications were as follows:

Region	Average grant per job offered £s
East of England	7,136
London/South East	2,990
North East	3,590
North West	9,163
South West	5,990
West Midlands	8,018
Yorkshire & Humberside	7,128
Wales	13,320
Scotland	7,136

Source: Industrial Development Act 1982 Annual Report 2007/08.

These grant awards can vary from year to year and are also influenced by the quality of the project presented for grant.

Continued

Grant opportunities for relocating businesses

Case study

CCA International is one of the leading providers of customer contact centre services in Europe. In the UK, the Company has two centres, based in Bristol and London, and provides a wide range of contact centre services, including both inbound and outbound to a number of blue-chip customers.

For some time the Company has worked with high levels of staff turnover at its London facility and this was restricting growth of the business in the UK. The directors decided to review alternative locations that could meet their long-term labour market requirement and provide a competitive cost base with which to grow the business.

Locations across the UK and Ireland were reviewed, based on the companies initial criteria. We worked with the clients to identify an initial longlist of locations that met the client's principal criteria, namely:

- Population size;
- Grant availability;
- Labour market capacity;
- Salary levels; and
- Skills base.

From the long-listing process, 17 cities were identified from the Republic of Ireland, Northern Ireland, South West of England, Yorkshire, Wales, Scotland, North East, North West and West Midlands, for further detailed analysis.

These were then subjected to more detailed analysis and a range of criteria were agreed and weighted. These were:

Criteria	Weighting %
Availability of labour	30
Labour quality factors	30
Competition and overheating	10
Cost base	15
Communications	15

Following an analysis using independent data and PricewaterhouseCoopers knowledge of the locations, a ranking of locations was arrived at, based on those cities performing well across all the CCA criteria. From this analysis city visits were organised to locations in Yorkshire, the West Midlands and Ireland. The analysis and visits did demonstrate that no location performed outstandingly well, especially in terms of labour quality and availability, which reflected the then current tightness of the labour market.

Following the detailed city visits, CCA decided to shortlist a location in the Republic of Ireland and Hull on the East Riding of Yorkshire. After further due diligence, Hull was selected, primarily because of labour availability and cost factors. PricewaterhouseCoopers assisted the client with their detailed evaluation, helped identify a low-cost property and worked with the client to successfully obtain a grant offer in excess of £1 million.

Key considerations for companies seeking grants

Enterprises interested in obtaining regional grants for a relocation project, need to be aware of the following:

1. Relocation projects are sensitive, both for the region losing and the region attracting the project. The grant schemes have a number of technical hurdles that will need to be addressed early.
2. Anyone seeking a grant should not make an irrevocable commitment to the project prior to receiving a grant offer.
3. All grants have a range of criteria that need to be addressed prior to entering discussions with grant agencies.

Clearly there are also significant commercial concerns that need to be addressed – grants are not the only reason to pursue a relocation.

Companies need to make sure the business case for relocation makes sense and the regions and cities chosen meet their key location criteria.

Ken Poole is a director in our Social Infrastructure Team and leads our grants team.

Keeping in control: the opportunity is now!

As everyone in the industry is aware, property funds have always been complex and the level of complexity has been raised as a result of recent market events. This complexity means that it is essential for property fund managers to have a well-considered and structured approach to risk management in their operations.

In a recent PricewaterhouseCoopers' survey, written in cooperation with the Economist Intelligence Unit, 'Transparency versus returns: The institutional investor view of alternative assets', 66 per cent of respondents indicated that they believed the quality of information provided by real estate funds on risk and controls is average or poor. These perceptions further increase the pressure on fund managers to take risk management seriously.

After a number of years of high levels of transaction activity and new product development, the enforced lower levels of activity on the commercial front presents an opportunity for organisations to reassess and refresh their control environment.

Ever-increasing complexity

Much of the complexity of property funds is caused by the large number of stakeholders involved in their operations, which can range from joint-venture (JV) partners and third-party service providers to the investors and lenders who provide capital to the funds. Multiple relationships, often across multiple geographies, increase the difficulty in coordinating business activities and can result in reduced oversight and less management control.

Recent market events have given rise to even greater complexity for many properties. This has been driven primarily by the consequences of significant declines in property valuations, such as the need to renegotiate debts and higher than expected levels of redemptions by property fund investors. In addition, investors and regulators have an increased focus on the risk exposures of funds, particularly regarding liquidity and credit risk. Strong management control over such activities as debt covenant monitoring and planning for higher levels of redemptions has become crucial for the funds.

Many of those stakeholders, along with the industry's regulators, are demanding more and more information from managers, including better and fuller disclosures with regard to risk management activities and more transparent information about all aspects of the business. These demands have been supplemented by other industry developments, such as the rapid growth of derivatives in the property market, a trend that is expected to continue with the launch of property futures in 2009. When fund managers choose to take advantage of opportunities like a futures market, appropriate controls must be implemented on a timely basis to mitigate any new risks that arise.

Responses and solutions

The challenge of determining responses to this complexity is the responsibility of the property fund manager. First, the manager should ensure that appropriate operating models are in place to meet the needs of the fund. There are three main options:

1. the 'in-house' model where the manager takes responsibility for all aspects of the operation, providing closer control of operations, but often coming with a high cost;
2. working with (JV) partners who provide local knowledge and expertise, but can be challenging to work with; and
3. using third-party service providers, which is often a cost-efficient solution, but introduces increased risks due to the dependency on the third party to deliver.

Whichever model, or combination of models, is chosen by the manager, an effective internal control framework must be established. PricewaterhouseCoopers' recommended methodology to ensure this is successfully established is composed of four key phases.

Continued

Keeping in control: the opportunity is now!

Phase 1: Risk identification

- The manager should assess the key business and operational risks in the property fund and the quality of existing procedures.
- The assessment should incorporate external risks such as market value movements and the risks arising from the operating models adopted by the fund.

Phase 2: Control framework

- The controls that monitor and mitigate the identified risks should be defined and documented.
- Where relevant, responsibility for operating those controls must be agreed between the manager and other organisations, such as third-party service providers, through robust Service Level Agreements.

Phase 3: Monitoring and reporting

- Mechanisms for monitoring the operation of controls should be agreed by senior management and, if appropriate, significant stakeholders and regulators.
- These would usually include a 'dashboard', showing performance against key indicators.

Phase 4: Independent review

- With increased scrutiny over a fund's risk management activities, an independent review of the design and effectiveness of the operation of controls provides significant additional comfort to management and investors.
- Independent reviews can also be requested by property fund managers as a key element of monitoring the effectiveness of controls at JV partners and third-party service providers.

The opportunity is now!

The establishment of an effective internal control framework should not be considered a one-off exercise to be completed when a new property fund is launched. Indeed, an internal control framework is unlikely to remain effective, year after year, unless it is refreshed to take account of the latest market developments, particularly after the events of the past 18 months.

Due to the lower level of commercial activity in property funds at the current time, managers have a fantastic opportunity to reassess their control environment and achieve a step change in their risk management activities. Those that seize this opportunity will be in the strongest position to benefit when real estate values begin to rise again.

Based on a presentation by **Allan McGrath**, Director, Assurance Financial Services at PricewaterhouseCoopers real estate conference in Edinburgh on 7 November 2008, assisted by **Damien Regan**, Real Estate Controls Reporting Team, PricewaterhouseCoopers London.

Current valuation and related financial reporting issues

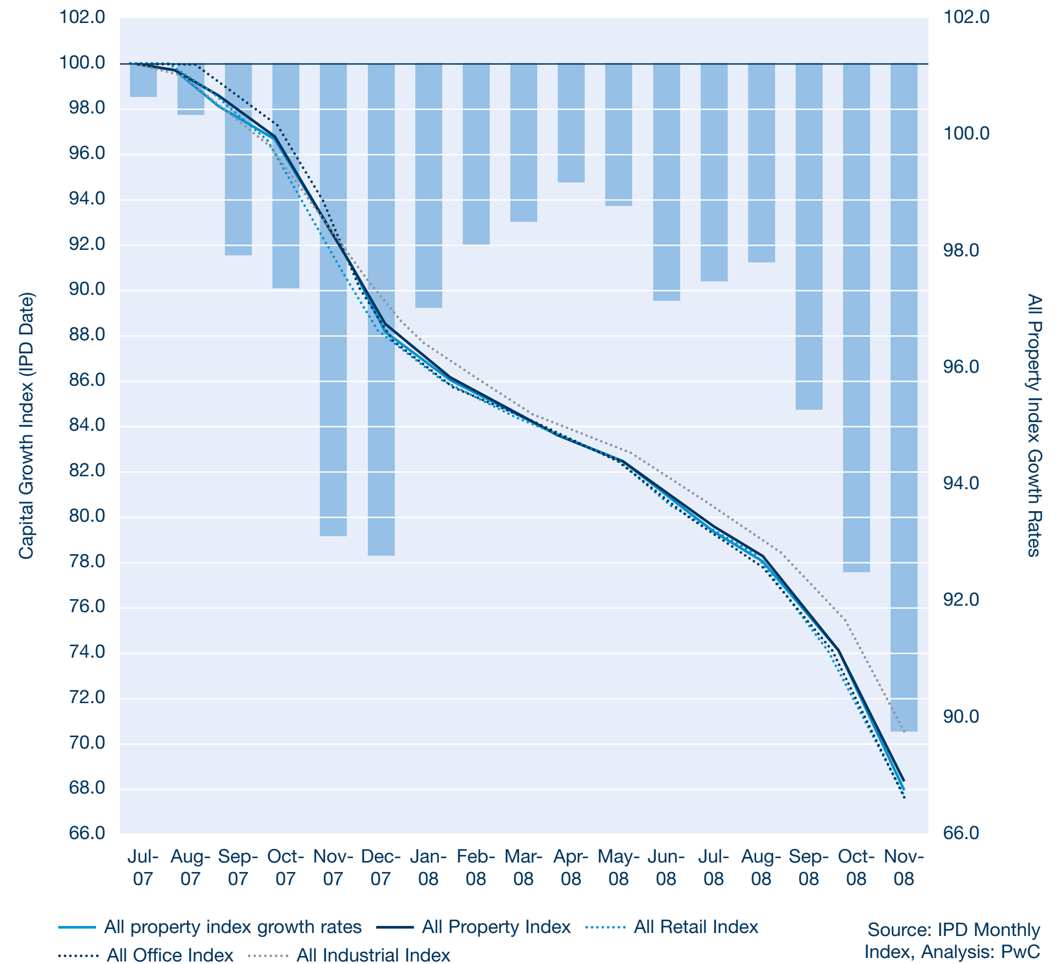
Market correction

As at November 2008, the UK Investment Property Databank Monthly All Property Capital Growth Index was 31.6 per cent lower than at the market peak in Q2 2007, returning to levels prevailing in mid-2003. Pricing has continued to adjust during December 2008.

The speed of the value decline has been dramatic, as seen in the graph to the right, and considerably faster than experienced in previous downturns. As we head into 2009, the consensus is that it will be a tough year and capital growth forecasts suggest that values will continue to decline up to 2010.

Since Q2 2007, values have been pushed lower by a succession of issues, including the unravelling of the exuberance prior to the market peak, the credit crunch and an erosion of the property fundamentals, for example weakening rental values and increased letting voids and incentives. However, without doubt, the overriding factor has been the credit crunch, which has accentuated the downturn following the market peak. Credit restrictions have had a sequential effect on asset prices, confidence levels and the wider economy. While the Bank of England has taken unprecedented steps to lower interest rates, it is the reduced quantity of debt finance that is the main factor impacting upon property values. Capital values had previously risen on a wave of capital targeted at the sector. Without those capital inflows, values have proved unsupportable. Compared with much of continental Europe, commercial property values have fallen more acutely in the UK, but this mirrors the UK market's prior dependency on debt finance and the subsequent withdrawal symptoms.

Comparing The Capital Growth Performance Across The Commercial Property Sectors



Source: IPD Monthly Index, Analysis: PwC Real Estate

Continued

Current valuation and related financial reporting issues

Inevitably, the decline in values has been accompanied by a sharp fall in the volume of investment transactions, with 2008 transaction levels considerably lower than the prior year. At the present time, potential purchasers are typically opportunistic and expect to negotiate price reductions. For vendors not in a forced sale position this could well mean that the final offer price is lower than the intrinsic value of the property and it would not be sensible to proceed.

Investment values

Against this background, real estate valuations and valuers have increasingly come under the spotlight. The standard valuation methodology for property investments in the UK is based on a 'market approach' with the key judgement being the earnings multiple, that is the yield. Valuers are heavily reliant upon comparable sales to derive the yield evidence and with the current, much reduced, transaction volumes, valuers are increasingly being forced to fill in the gaps in market information. Other important inputs to valuations, for example estimated rental values or letting voids are derived from leasing markets, but with a weakening economy, even that information is becoming more scarce and opaque.

Apart from actual sales, valuers have other sources of market intelligence, for example offer prices at which deals did not complete. Information of this type may sometimes be used as a secondary indicator of value, but it is still difficult to decipher at what level a deal would have been struck. A further challenge for valuers is to discern forced sale values from market values. Some would argue that all sales are forced sales in the current environment, but is the sale of a property now because the vendor believes disposal proceeds would be even lower in six months time, a 'forced sale'?

Ironically, in the past, the heavy reliance on the 'market approach' in the UK was perceived as one of the strengths of UK valuations/valuers. Financial reporting standards set out a hierarchy of valuation methods and the methodologies based directly on market inputs are given the highest credence. Alternative methodologies are the income approach, for example discounted cash flow or in the worst case, a cost-based approach.

In continental Europe, valuations have historically been based on a 'model-based' income approach, for example discounted cash flow. For these 'model-based' appraisals, the flexing of the discount rate to reflect changed market circumstances or asset specific factors is often highly judgemental. The market approach, which relies upon actual transactions, normally provides a more readily supportable opinion of value and therefore in practice the two methodologies are often deployed in tandem. Unless UK transaction volumes step up in 2009, it may be the case that UK valuers increasingly have to look towards a model-based income approach to support their opinions of value. For an income-producing investment it is likely that an income approach will be the valuation methodology of last resort; however, if the market continues to deteriorate, the use of a cost-based approach for non-income producing properties cannot be wholly discounted.

The fact that valuers are having to 'fill in the gaps' in market data raises important issues. These include a) does the valuer have full access to the limited market data available (some valuers may be at an advantage in this area), and b) are different valuers interpreting the data and filling in the gaps in the same way? There is a real risk of different house views emerging among valuation firms, particularly on yields.

Continued

Current valuation and related financial reporting issues

Development values

While the environment for property investment is unusually challenging, the development market has suffered a greater hit. Debt finance has virtually dried up and falling capital values do not provide the best backdrop for a development project. Historically, development sites/projects have been valued using the 'residual approach', which is based upon the value of the completed development project (measured at today's levels of value), less the development and financing costs and a profit margin for the developer. Compared with investment properties, the residual valuation approach reflects the operational gearing in development projects and a 10 per cent decline in capital values is likely to result in a much larger decline in the residual value. Development cash flows are inherently more risky than investment cash flows.

With the possible exception of industrial and agricultural land, the majority of development valuations are deemed site-specific and the market value is not based directly on sales evidence, that is a market approach, as any sales are unlikely to be comparable, due to a different development mix, density, and so forth.

In the current environment, the model-based residual valuation methodology needs to be applied very carefully and there is a particular need for fresh thinking when updating an appraisal first prepared in a more buoyant market. With the exception of a possible softening in build costs, it is likely that most of the inputs to the calculation will have moved in an adverse direction, for example timeline, letting prospects and end value.

The residual approach needs to reflect changes in finance costs and it is highly likely that the debt/equity mix will have changed in the past 18 months. However, the biggest challenge for residual valuations is to reflect potential future declines in value. What assumptions should be made about value movements and should this be reflected in a reduced end value or a higher profit margin? There is no doubt that development projects are inherently more risky in the current environment, implying the need for a higher profit margin. Once these issues have been reflected, it is possible that the existing use value or another alternative use value, for example car parking, might produce a higher value than that produced by a residual valuation of the original project. In some locations, the residual approach may well produce a negative figure, albeit there is likely to be a higher value for some other use or for a sale to a long-term speculator.

As residual valuation is model-rather than market-based, there is an ever-present risk of theory overriding reality and there is definitely a need to stand back and ask whether it is realistic to assume that the scheme originally proposed will still be built or was it a vision only viable at the top of a cycle?

Other property categories have also been adversely affected, albeit to differing degrees. For trading properties, for example hospital and leisure, healthcare, serviced offices and self-storage, the pattern of value movements is relatively opaque and is not reflected in existing capital growth indices. Nevertheless, as with investment properties, the value of these properties is influenced by two factors; a) the property/trading fundamentals and b) the availability of capital. Most of these trading property sectors were targeted as alternative investment classes by leveraged investors during the boom years, but new capital from those sources is much diminished in the current environment. It follows that while trading might have proved resilient, values may well have diminished.

It follows that across all UK property types, valuations have become more judgemental than would normally be the case.

Continued

Current valuation and related financial reporting issues

Financial reporting challenges

The fact that real estate valuations have become more subjective has manifested itself in 'valuation uncertainty' clauses appearing in valuation reports, typically emerging with effect from Q3 2008. These clauses are based upon guidance contained within the Royal Institution of Chartered Surveyors Valuation Standards, which require a valuer to draw attention to increased subjectivity in a valuation opinion arising from market uncertainty. The fact that there is market uncertainty and increased subjectivity at the present time is in most cases unquestionable and is widely recognised. Nonetheless, the wording of these clauses needs to be considered at an early stage in the engagement process by both preparers and procurers of valuations, particularly where values are being used in financial statements or other financial reporting.

From a financial reporting perspective, 'unusual' valuation uncertainly clauses may have a significant bearing on the financial statements. 'Unusual' in this context might mean a valuer effectively disclaiming their opinion, for example 'this valuation is indicative only and should not be relied upon' or applying 'special assumptions' to the valuation. Examples of the latter could include 'we have assumed that debt financing would be available to a purchaser on acceptable terms' or 'we have assumed that the income from the property will not be different from that prior to the credit crunch'. A valuer not standing behind a valuation opinion or applying special assumptions is likely to have ramifications from a financial reporting perspective as preparers of financial information rely upon valuers' opinions.

In terms of future value movements, the Investment Property Forum and Capital Economics predict capital value declines of 11.5 per cent and 13.7 per cent in 2009, respectively. Secondary property, with its greater exposure to a weakening economy, appears particularly exposed.

Given the loan-to-value ratios, prevailing, prior to the market peak and the fact that values have already fallen by 30 per cent and are expected to decline further, the number of loan covenant breaches is set to increase. In the current market, as banks seek to deleverage, the risks inherent in a refinancing have also increased significantly. This will have significant implications for the preparers of financial statements in assessing the going concern of the entity. Directors will need to consider the appropriateness of the basis of preparation of the financial statements and the disclosures made regarding going concern in the annual accounts.

To summarise, valuations need more detailed planning and interrogation in the current environment. In some instances, recent market evidence may not exist, in which case valuers will have to increasingly rely upon a model-based approach and it is important that the outputs are sense-checked in a wider context. Where valuations are prepared for financial reporting purposes, particular consideration needs to be given, at an early stage, to valuation uncertainty and possible going concern issues.

For assistance with financial reporting and valuation issues contact **Sandra Dowling**, Partner, UK Head of Real Estate Assurance, or **Nick Croft**, Director, PricewaterhouseCoopers Valuations.

Debt buybacks

The combination of a credit crunch and a recession has resulted in an interesting opportunity for companies, private equity investors and opportunity funds alike: buying debt at a discount.

Over the past year, some companies have started to perform below their expected business plans, which meant they could be near to breaching loan covenants. Such companies, and their shareholders, can however take advantage of this otherwise unfavourable situation to:

- buy back debt at a discount to boost their returns;
- buy back debt to avoid potential covenant breaches;
- buy back debt to avoid hedge funds from buying debt in distressed portfolio companies in so-called loan-to-own strategies.

Some well-publicised transactions are the €200 million buyback in TDC, the €65 million buyback in Lafarge and the €22 million buyback in Fat Face. The discount in case of the TDC buybacks was approximately 10 per cent, while the buybacks in Lafarge and Fat Face are understood to have taken place at only 50–60 per cent to par.

Prompted by this first wave of buybacks, many other companies have approached their legal advisors and relationship banks to find out if they can buy back debt. The majority of debt restructuring transactions we are seeing at present revolve around private equity companies and funds buying back multi-territory portfolio company debt from distressed lenders. In other cases, we are helping the borrower make an opportunistic approach to lenders who may find an early exit, even at a discount, attractive. Many opportunistic investors are also looking at buying debt from third-party companies with a view to making a profit on redemption.

In the real estate market, some companies have made discounted payments to lenders for the early conversion of their convertible debt into equity. This scenario is particularly applicable to the housebuilding sector and, with careful planning, can generate significant accounting profits without a tax cost.

A number of property companies have taken the opportunity to acquire debt from joint-venture partners who wish to exit from the existing arrangements, due to the recent fall in commercial property values and reductions in projected yields. Such situations can provide significant opportunities for medium- to long-term investors with proven asset management capabilities.

Although the structural mechanics of buying debt are reasonably straightforward, the complex commercial, financing, accounting and tax issues that can arise are many and varied. In particular, consideration should be given to the following:

- The external perception of a debt buyback and its potential impact on underlying asset value should not be overlooked. Funds will therefore need to assess the impact that the buyback of debt could have on any fund valuation. Loan-to-value covenants in banking documentation may also restrict real estate funds' ability to execute the buybacks.
- One of the for banks will be what happens to voting rights on the sale of debt as purchasers could potentially build up a blocking stake, meaning that banks would be limited in their ability to act on, for example, covenant breaches. We are aware of circumstances where lenders have refused to approve the amendment of facility documents to allow debt buy backs, apparently because of concerns regarding voting rights.

Continued

Debt buybacks

- In syndicated lending scenarios, negotiating a debt buyback on a bilateral basis between a buyer and an individual member of the syndicate can create legal issues as many such arrangements are implemented on the basis that all lenders should be treated equal.
- In the event that new financing is required to effect the buyback, the provider of capital needs to understand the business sufficiently well to be a long-term holder of the new capital. This then requires a partial or full refinancing exercise.
- Transactions need to be tailored to address the different needs of a distressed borrower or distressed lender. The transfer of good debt at a 'fire sale' price may have quite different consequences from the transfer of an impaired loan asset.
- Debt buybacks, debt buy-ins, capitalisation and forgiveness of debts have tax consequences which, if not managed carefully, can severely reduce the benefits of the transaction.
- Borrowers are specifically concerned to avoid the discount on the debt becoming taxable in the borrowing company at the time of the acquisition. This can create structural issues that need to be resolved.
- Purchasers of discounted debt do not want to be taxed on any profit that arises on redemption or as the receivable is accreted to full value for accounting purposes over the remaining life of the debt.
- There is a need to consider the continuing tax deductibility of the interest in the borrowing company as the new financing structure will provide HMRC with an opportunity to revisit any prior thin capitalisation and transfer pricing agreements. It is also important to mitigate any potential withholding tax on interest payments if the receivable is to be held by a private equity fund.
- The amount of active management required, post-transaction, to align the economic, accounting and tax standing of the debt for both parties should not be underestimated. Bought-in debt has an afterlife; capitalisation has long-term impact on the balance sheet. A holistic approach to tax, accounting, reserves planning and value is required to address these issues as well as the immediate transaction.

To summarise, the current financial climate has given rise to significant opportunities for purchasing debt at a discount. The market has moved from talking about such opportunities to actually implementing debt buybacks and third-party acquisitions. With careful planning, implementation and post-transaction management, significant commercial benefits can be achieved without adverse tax or accounting consequences.

Should you wish more information on this subject, please contact **Ruud Kole** Director, PricewaterhouseCoopers debt advisory team, or **Jonathan Hardwick**, Partner, UK Head of Real Estate Tax.

Property management in a downturn

Plummeting property values in the fallout from the banking crisis have affected the traditional 'players' in the real estate industry. But, with the 'difficult economic times' spilling over into recession in the real economy, we are beginning to see more far-reaching implications for landlords and tenants across the wider business community.

The inherent tension in these relationships is increasingly turning into conflict as landlords pursue 'active management' policies and tenants struggle to control their property costs. We believe these challenges will escalate during 2009, as both sides of the lease divide employ a mixture of old and new strategies to protect their commercial interests.

Service charges

Service charges are typically the second largest property occupation cost – particularly for tenants of retail and office space. The amount and nature of expenditure passed on to tenants via the service charge is, however, controlled by the landlord and its managing agents – who are perceived by tenants to have no incentive to deliver high quality, cost-effective services. It is easy to see how this cocktail of conflicting interests can all too often lead to service charge disputes.

The starting point for any professional landlord is that all expenditure it incurs in running, maintaining or repairing their buildings should be fully recoverable from the tenants. Any under-recovery would adversely affect the net rental income from the property and may impact substantially on its capital value. This principle is reflected in the service charge provisions traditionally found in commercial leases that contain a long list of recoverable heads of expenditure with a wide-ranging sweeper clause. Despite this seemingly comprehensive recovery entitlement, there are several traps for the unwary landlord, which translate into cost mitigation opportunities for the alert, well-advised tenant.

First, landlords must be careful to follow the specific procedure set out in the lease when issuing their service charge invoices and demanding payment of these. A tenant will be able to dispute payment where the landlord does not follow the route set out by the lease for recovery of service charges.[1] It is important that landlords reiterate this message to their managing agents and advisors as it is these parties who are usually in charge of recovery of the service charge costs from the tenants. While it may be easier for managing agents to follow their computer systems and procedures, these may not comply with the requirements set out in the lease.

[1] Leonora Investment Company Ltd v Mott MacDonald Ltd [2008] EWCA Civ 857

Continued

Property management in a downturn

Secondly, it is important for landlords to remember that wide-reaching sweeper clauses are viewed unfavourably by the courts and cannot be relied upon to catch costs that have not been specifically mentioned in the lease. The courts have construed these clauses very restrictively and landlords should be aware of the risk of non-recovery of any costs not covered specifically in the lease.

Finally, there is much case law by which the courts have imposed restrictions on what can be recovered via the service charge. For example, a tenant's liability to pay for significant capital expenditure by the landlord is tempered by reference to the length of their lease and how long is left until the lease term expires.[2] Also, a tenant cannot be held liable for the costs of replacement of plant and machinery where an item is still in good working order.[3] Similarly, where there is a service charge cap for the first few years of the lease, which then reverts to a full charge, a landlord is not able to deliberately hold off on expenditure until such time as the cap is lifted.[4] Finally, if a landlord has retained part of the advance service charge payments of the tenant as a surplus this must be repaid to a tenant at the end of their term.[5]

Dilapidations

Most leases require the tenant to hand the premises back to the landlord at the end of the term in full repair and with all of the tenant's alterations reinstated. Effective enforcement of this obligation is likely to be increasingly important for landlords seeking to maintain continuity of income by promptly reletting the property after the original tenant has moved out.

There are a number of possible techniques to achieve this goal. The first and, potentially most effective, is to consider in good time before the lease expires whether the lease entitles the landlord to enter the premises, carry out the repairs and recover the cost as a debt from the tenant. This radical approach has a number of benefits, including circumventing the statutory cap on the amount a landlord may recover if it follows the more conventional approach of pursuing a dilapidations claim after the lease term has expired.

Landlords must take care in formulating dilapidations claims and take account of the impact of any redevelopment plans on the claim. The courts have penalised landlords where there has been an attempt to serve an inflated dilapidations claim.[6] In one case, the court awarded indemnity costs against the landlord, even though the landlord had technically won the claim – albeit there was a reduction in the dilapidations claimed from approximately £400,000 to £1,000.

There is a revised edition of the Property Litigation Associate Dilapidations Protocol 2008 version (third edition), which should be considered when dealing with dilapidations. It also places an obligation on surveyors to confirm that a dilapidations claim is reasonable to put the premises in the state required by the lease and has taken into account the landlord's intentions for the property after termination of the lease. While the protocol has not been formally incorporated into the Civil Procedure Rules, and is thus not required to be followed by the courts, it is considered to be best practice in the industry and any RICS surveyor could possibly be deemed negligent if they did not comply with it.

[2] *Scottish Mutual v Jardine Public Relations (1999) EGCS 43.*

[3] *Fluor Daniel Properties Ltd v Shortlands Investments Ltd [2001] EGCS 8.*

[4] *Princes House Limited and Princes House (Two) Limited v Distinctive Clubs Limited [2007] EWCA Civ 374.*

[5] *Brown's Operating System Services Limited v Southwark Roman Catholic Diocesan Corporation [2007] EWCA Civ 164.*

[6] *Business Environment Bow Lane v Deanwater Estates Ltd [2008] EWHC 2003 (TCC).*

Continued

Property management in a downturn

There are some potentially powerful weapons in the armoury of a tenant faced with a significant claim for breach of its repairing covenants. First, tenants are afforded substantial statutory protection from dilapidations claims by s 18(1) of the Landlord and Tenant Act 1927. This limits the amount a landlord can charge a tenant for dilapidations to an amount by which the value of the premises is diminished, due to the disrepair. Additionally, a landlord is not entitled to recover dilapidations where the landlord intends to demolish, redevelop or alter the premises in such a way to render the repairs valueless, shortly after the termination of the premises. It is common for the successful application of these principles to lead to substantial reductions in the amounts paid out by tenants to settle a dilapidations liability.

1954 Act lease renewals

Since changes to the Landlord and Tenant Act 1954, which were brought into force in 2004, both tenants and landlords of business tenancies now have the ability to apply to the court for a new tenancy, following service, in the landlord's case, of the requisite s 25 notice on the tenant.

In the current economic climate, faced with the prospect of declining open market rents, it is important for landlords to bear in mind that the level of rent on a statutory renewal of a business tenancy is fixed when the renewal proceedings are decided by the court. Tenants therefore have a financial incentive to let things drift. Landlords should therefore be adopting a proactive approach, by serving the relevant notices at the earliest opportunity and then using the new procedure to bring the renewal proceedings to court as quickly as possible.

Conclusion

The message for the year ahead is that good preparation and planning around all of the usual lease issues will be even more important than ever. Timely advice and a well-implemented strategy that takes account of all the relevant legal, valuation and practical considerations are the keys to protecting landlords' and tenants' respective commercial interests.

Should you wish to discuss the issues raised in this article, please contact **Simon Hardwick**, Partner, PricewaterhouseCoopers Legal.

The reward challenges facing real estate

There is no doubting that the property sector has been one of the hardest hit in the current market turmoil with some of the tales of woe making the horror stories faced by other sectors seem positively tame in comparison. However, for well-run businesses capable of surviving the current downturn there are some exciting and potentially lucrative opportunities for the brave and deserving.

Carry on?

One of the biggest impacts of the downturn is the emergence of underwater carried interest, whereby many fund managers are facing a mountain to climb to deliver positive returns, let alone a decent pot of carry to themselves and their teams. Most fund managers rely on carry to deliver the bulk of their reward for running a fund, and hurdle rates agreed years or even months ago now look incredibly challenging and, for some funds, insurmountable.

Arguably, newly launched funds that are still in the embryonic stages of investing are well positioned to take advantage of some decent opportunities over the short to medium term and with successful decisions, carried interest benefits will materialise. However, some difficult questions need to be answered.

Some fund managers will be looking to negotiate lower watermarks for new products as both economic prospects are revised and the cost of borrowing remains stubbornly high. On the other side of the fence, investors will almost certainly be reticent to give concessions to holders of carry, taking the view that the commitment of capital in the first place is reward enough at the present time. Reductions in hurdles may need to be accompanied by a reduction in the carry levels, meaning not only are management fee rates under downward pressure, performance fees may follow suit.

While this may mean that some hard bargaining will take place over new products, the biggest challenges are reserved for those more mature funds facing a challenging time to deliver both decent returns to investors and any value to existing carry holders.

Fully invested funds will have a tougher time renegotiating carry terms with investors when all that is left for the fund managers to do is realise investments made previously; however, there is no question that such funds require expertise throughout the lifetime of the investments to acquire, manage and dispose of assets. Investors and fund managers must find a balance between retaining and incentivising fund teams to make the best of the remaining opportunities, while not overcharging investors for the privilege.

Funds operating vintage year approaches to carry, rather than fund as a whole, could be at a significant advantage if they are still investing, as fund managers are incentivised to manage their way through the downturn and invest in arguably underpriced assets moving forward. It is common with deal-by-deal carry plans to see an overarching clawback, based on the return of the fund as a whole with this clawback being more likely to bite now than ever before.

So what can be done about underwater carry? In some circumstances it may be in the best interests of both investors and fund managers for carry to be rebased either through:

- Excluding some of the investments made from the carry calculation (or from the clawback calculation if carry is deal by deal), or
- Revaluing some of the investments for the purposes of the carry calculation, or
- Reducing or removing the preferred return hurdle.

If rebasing is commercially desirable, fund managers will need to ensure they do not fall foul of tax legislation and unwittingly incur unforeseen income-tax charges, for example through the rules surrounding the memorandum of understanding or the tax rules governing employment related securities.

Continued

The reward challenges facing real estate

But if carry remains unchanged

For those funds with no other alternative, there are a few examples of management fee-sharing being introduced for fund managers with a co-investment requirement. While investors are likely to be indifferent or supportive of this approach, shareholders must think hard about how this fits with the business model and ensure that such an approach is financially viable before committing.

In order to ensure that a management fee share continues to incentivise fund managers, it may be appropriate to defer payments on an unfunded basis until sufficient levels of cash are delivered to shareholders before the bonus becomes payable.

A greater step is to argue that the current situation makes equity in the manager a potentially attractive tool to retain and incentivise those responsible for driving business recovery. There is arguably no better time to make awards (or allow purchases) of equity in a tax effective manner, and striking the right balance in the share of value generation that flows to shareholders and management can provide a powerful retention and incentive tool.

In summary, although the turmoil in the financial markets and the associated downturn in the real estate markets has hit property businesses where it hurts, well-run organisations and funds will prosper, provided they incentivise key fund management talent to continue to invest and retain a high-quality senior executive cadre to navigate their way through the current challenges.

The tax implications of any rebasing of carry must not be overlooked

Where a fund manager is an employee working in the UK, the carry that he holds is likely to constitute an 'employment-related security' for the purpose of the relevant tax legislation (Income Tax (Earning and Pensions) Act 2003). If the fund manager's carry is rebased, it is likely that its value will increase as a result. If so, the fund manager is potentially subject to income tax on the benefit constituted by this increase in value under a number of provisions in the tax legislation. (It should be noted that, in the Memorandum of Understanding (MoU) of July 2003 between the Inland Revenue (as it then was) and the BVCA, albeit in the context of PE funds, the Inland Revenue stated that where 'arrangements are varied subsequent to the closing of a fund' it will not be bound by the MoU and reserves the right to consider the application of all provisions relating to tax and National Insurance Contributions, including Part 7 ITEPA 2003, which deals with 'employment-related securities'.) In addition, the fund manager's carry is likely to constitute a 'readily convertible asset'. Consequently, the fund manager's employer may also be obliged to operate PAYE and NICs. The issue is therefore a matter, not only for the fund manager, but his employer as well. Careful consideration should be given to structuring any rebasing of carry in a way that avoids, or at least minimises, these potential tax charges.

Where, on the other hand, the fund manager is not an employee, his carry may not constitute an 'employment-related security' and, if so, the issue identified above will not arise. This will occur where, as is frequently the case for a variety of tax and other reasons, the fund manager is a member of an LLP that carries on a fund management business rather than an employee of a company that does so.

Should you wish to discuss any of the issues raised, please contact, **Tim Wright.**

Business rates pre-budget report 2008

The Chancellor announced further changes to business rates in the Pre-Budget Report in November.

Backdated rate bills – eight years to pay, but are they payable?

When premises are identified that should have always been subject to business rates, but have not received rate demands, the Government's view is that business rates bills can be backdated to 1 April 2005 (the last business rates revaluation) and are then due for immediate payment.

To reduce the cash-flow impact on businesses, the Government has announced that businesses facing such bills will be able to pay their liability for previous years in equal interest-free instalments over eight years, rather than immediately. The Department of Communities and Local Government have confirmed this will be available to any ratepayer who receives a backdated rate bill.

However, before agreeing to pay backdated charges, ratepayers should be aware that these charges may not be legally payable. A judgment in 1999 in the case of *Enron Insulation Ltd* v *Nottingham City Council* held backdated rates were not recoverable if the local authority had not acted 'as soon as practicable' in taking steps to levy the business rates.

In these circumstances, advice should be obtained and a review undertaken of how the backdated charges have arisen before any payment is made.

Empty rates

The Government is temporarily increasing the threshold at which an empty property becomes liable for business rates. For rate year 2009/10, empty properties with a rateable value of less than £15,000 will be exempt from business rates.

This move may assist the small property investor, but will do nothing to relieve the property tax burden on speculative developers or owners of medium to large empty commercial property in general.

For properties with a rateable value over £15,000, there are still opportunities to obtain a non-rateable status on:

- Newly constructed properties that have never been occupied;
- End of life, properties awaiting demolition or redevelopment; and
- Properties undergoing refurbishment.

Small business rate relief

An anomaly is to be removed that prevented properties that were not in a rating list on the 1 April in a year, qualifying for small business rate relief in that year. This change should take affect from 1 April 2009.

Simon Tivey is the head of PricewaterhouseCoopers' Rating team.

Tax issues for international investment in UK real estate

As discussed in this edition of RE Insights, yields on UK property are now significantly above bank base rates, and combining this with sterling's depreciation, notably against the yen and the euro, mean that the UK property market is starting to look increasingly attractive to international investors.

This article looks at some important UK corporation and income tax issues surrounding international investment into UK real estate, but is intended to be of a general nature only. Readers should always seek advice specific to their circumstances before transacting, and in particular should consider the accounting, legal and other tax issues such as stamp duty land tax (SDLT), VAT and the availability of capital allowances.

Overview of the UK tax regime for non-residents in relation to UK property

Capital gains

The UK has a relatively benign regime for non residents who are investors in UK real estate and will not generally seek to tax capital gains on the disposal of real estate by a non-resident investor. This contrasts favourably with a number of international regimes, notably the US FIRPTA legislation and Australia's similar 'long arm' capital gains treatment. Readers may also be familiar with the annual French 3 per cent tax regime which, while not a tax on gains, is also cross-border in its application; no such impost is sought by the UK tax authorities.

A commonly used strategy for international investors to structure their investments is therefore to use an offshore vehicle. Where this is done in conjunction with one or more UK investors, proper consideration needs to be given to applicable anti-avoidance legislation. This seeks to apportion capital gains to UK investors or to bring certain gains of a capital nature within the charge to income tax or corporation tax. In all circumstances, it will be critical that the offshore vehicle is not considered to be a UK tax resident.

A non resident company is only liable to pay UK corporation tax on capital gains on the disposal of a property asset if it carries on a trade through a permanent establishment (PE) in the UK (e.g. a separate property trading activity) and the property asset was used or held for the purposes of that PE.

Trading profits

A further key and fundamental question arises as to whether the ownership and operation of the asset constitutes an investment or trading activity. Non-residents are subject to UK corporation tax on trading profits where those profits have arisen from the activities of a UK PE. Grey areas can arise in relation to for example, both property 'dealing' and 'investment' by opportunistic funds.

The treatment of UK construction sites and hotel investments also throws up some interesting questions and planning possibilities for international investors.

Rental income

Income from immovable property usually remains taxable in the country in which the property is situated (Article 6 OECD model convention) and this is true for the UK in relation to property business income. A UK company will pay corporation tax on its net rental income, at the applicable rate (typically 28 per cent). A non-resident company that is not subject to UK corporation tax will still be liable to UK income tax on net rental income at a rate of 20 per cent.

Where the owner or landlord is resident abroad, they may be able to claim relief for any UK tax against the tax payable in their country of residence. In addition, the non-resident landlords (NRL) scheme, to receive rent gross, is available, provided certain conditions are met.

Interest deductions

Leveraging a property investment is often critical to both acquiring the property (or the shares in the entity holding the property) and in achieving the requisite 'leveraged' return.

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Interest paid on third-party debt to acquire real estate should normally be tax-deductible. In addition, it may be possible to further gear the investment by use of shareholder debt. Both loans may be subject to transfer pricing restrictions (e.g. in relation to parental guarantees, the quantum of debt and the applicable interest rate). Consideration should now also be given to whether the worldwide interest cap proposed in the draft provisions relating to the 'Taxation of the Foreign Profits of Companies' will bite to restrict the amount of available interest relief, although these draft provisions do not apply for UK income tax (as distinct from corporation tax) purposes.

The payer of 'yearly interest' with a UK source is normally required to deduct withholding tax (WHT) at 20 per cent from interest payments. However, a number of tax treaties reduce this WHT rate to nil and, in the absence of treaty relief (which must be claimed), it may be possible to issue a quoted Eurobond, for example a bond listed on a Channel Islands stock exchange, to circumvent the withholding requirement. Payments to UK banks or UK branches of overseas banks are not, in any event, caught by the requirement to withhold.

Investment or trade?

The tax treatment of a disposal of UK property will depend on whether the property is held as an investment (so that capital gains are subject to corporation tax or potentially exempt in the case of the non-UK tax resident investor), or on a trading account (so that trading profit is subject to corporation tax when realised through a UK PE or otherwise income tax, subject to treaty).

Badges of trade

There is no statutory definition of what constitutes a trade except that it 'includes every trade, manufacture, adventure or concern in the nature of a trade'. The motive of the taxpayer is the key consideration. However, case law has established a number of 'badges of trade', which provide guidance as to the likely motive: for example, short-term financing, multiple similar transactions and work carried out on the property prior to sale would all be indicative that a trade is possibly being carried on.

If a property that is being let and held as an investment is refurbished, prior to sale, then provided the refurbishment relates to dilapidations that occurred during the investor's period of ownership, this should not in itself be considered to result in trading; but if there is a significant element of improvement in the refurbishment, this could lend weight to the existence of a trading activity.

Property developers, property dealers and opportunistic funds

The purchase and development with the main object of selling the property after development is prima facie a trading activity.

But the distinction between a property investor and a property dealer (or trader) is not always straightforward. Broadly, a property investor acquires or develops property with a view to its retention for rental income, but he will hope to also realise a capital gain when he eventually realises his investment.

On the other hand, a property trader acquires or develops the property with the main intention of selling it on at a profit, but will be happy to earn rental income while he identifies a purchaser. The key question is what was the main intention at the time of acquisition and

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has that intention changed during the course of ownership of a property. If a property investor changes his intention he is required to appropriate investment property to stock, and indeed vice versa in the case of a property trader who subsequently decides to retain his property as an investment.

Opportunistic funds acquire real estate with a view to exiting at a (significant) profit. The assets may or may not be acquired in a distressed situation, but more typically where significant development value is being added. Holding periods can be short and it may be the case that the assets are sold on to 'core' or 'core-plus' funds or other investors, prior to long-term tenants (or indeed any tenants) being found. In such circumstances it may be difficult to argue that anything other than a trading activity is being undertaken by the fund manager.

Is a building/construction site always a UK PE?

It is sometimes suggested that a construction site will always gives rise to a UK PE. This may derive in part from S148 FA 2003, which includes 'a building site or construction or installation project'. Article 5 of the OECD model convention states that a PE will only arise if such a building or construction site 'lasts more than twelve months'.

A construction site is certainly a PE of the person undertaking the construction, and such a person is therefore trading through that PE (although the construction site may be subject to a minimum period of 12 months or similar if an OECD model treaty applies). However, if the building contractor carrying on the construction work is not a dependent agent of the non-resident property trader, then it may be possible to structure a trading activity of the property trader that is not subject to UK corporation tax.

Hotels

Operating a hotel is considered to be a trading activity and the profits will be subject to UK corporation tax for both UK residents and non-residents. A planning opportunity arises if the running of the hotel (i.e. trade) by an Op Co is separated from the ownership and rental of the hotel (i.e. investment) by a Prop Co. Whether this may be easily achieved will depend on factors such as banking covenants, the size of any embedded gain within the current Hotel Co and potential SDLT costs. Recent falls in market values may, however, offer an opportune moment for hotel investors to be reviewing their existing Hotel Co arrangements, in timely preparation for future increases in value.

Offshore holding companies

Tax residence

As the UK does not tax a non-resident on bona fide gains, a commonly used strategy by international investors is to invest through an offshore vehicle to shelter gains on UK real estate. Ideally, a territory that has a tax treaty with the UK will be preferred. EU holding companies have the added advantage of potentially being able to benefit from EU directives, for example the dividends and the interest and royalties directives. If the holding company territory does not tax the gain arising, then it should be possible to, in effect, realise a tax-free gain. If a UK PE does not arise, both capital and trading profits may be realised tax-free.

To ensure that this planning strategy is successful (and that UK corporation tax at 28 per cent is not applicable to the gain), it is critical to ensure that the holding company is tax resident where it is established and does not inadvertently become tax resident in the UK. This could arise if, for example, central management and control is exercised from the UK by UK director(s) of the holding company dialling-in to board meetings from the UK rather than

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attending the board meetings in person. Recent experience suggests that HMRC are looking closely at the implementation of holding company structures.

Failure to observe robust operational guidelines will certainly increase the likelihood of HMRC scrutiny and challenge.

UK investors in overseas holding companies

HMRC seeks to ensure that the ability to shelter gains in the manner noted above is not used in inappropriate circumstances by UK investors, who would have been subject to tax on the capital gain had they not interposed an offshore vehicle. A number of anti-avoidance provisions have been introduced for both corporate and individual shareholders to prevent this occurring. In particular, s 13 Taxation and Chargeable Gains Act (TCGA) 1992 may apportion capital gains arising to UK investors where they have more than a 10 per cent stake. The tax is payable, regardless of whether the proceeds of the gain are remitted to the investor, that is, there is a risk of taxable 'dry' income, without the corresponding cash flow from the investment to pay the tax.

Gains of a capital nature: s 776 Income and Corporation Taxes Act (ICTA) 1988 and s 756 Income Tax Act (ITA) 2007

Anti-avoidance legislation also exists to bring certain gains of a capital nature within the charge to UK tax on income. This legislation would typically apply in the following circumstances:

(i) where a landowner who is not a property trader sells the land to a developer (trader) for a consideration that includes a share of any profit or proceeds from the subsequent development of the land ('slice of action' schemes); and

(ii) where a capital gain is realised by a person who is outside the charge to UK tax and he obtained the opportunity to realise the gain from a UK resident, for example, where a non-resident company acquires land from a connected UK resident company ('diversion' schemes); and

(iii) where a non-resident group acquires UK property in a non-resident investment holding company with the intention of developing the UK property and then selling the non-resident investment holding company on completion of development.

Certain treaties provide some protection against the application of s 13 TCGA and s 776 ICTA or s 756 ITA 2007, so this may be an influencing factor in the choice of holding company jurisdiction.

NRL scheme

Tenants of a non-resident landlord (or agents acting for a non-resident landlord) are required to deduct income tax at the basic rate (20 per cent) from any rent payable net of expenses (or any net rent collectible, respectively). However, a non-resident landlord who can satisfy HMRC that it will comply with the requirements of UK tax law may apply to receive its rent without deduction of tax.

Conclusion

As can be deduced from the above, there are a number of interlinked corporation and income tax issues for an investor to consider in structuring investment into UK real estate, as well as planning opportunities. Although not considered in this article, full consideration should also be given to minimising SDLT costs and VAT leakage, and maximising the availability of capital allowances on any real estate investment.

Bas Kundu is a partner in the London office of PricewaterhouseCoopers, and specialises in the structuring of real estate and infrastructure funds.

Further consultation on offshore funds rules

In our November 2007 edition of UK real estate insights, in an **article on offshore funds** we discussed the consultation document that was issued as part of the Chancellor's pre-budget report on 9 October 2007.

This document proposed various changes to the offshore funds regime, particularly in relation to the definition of such funds. In the 2008 Budget in March it was announced that further consultation with the industry regarding the proposed new ‘characteristics’-based definition of offshore funds was intended before any new statutory definition of an ‘offshore fund’ is enacted, with expected enactment proposed in the Finance Act 2009.

On 16 December 2008, the Government published ‘Offshore funds: further steps’, which provides proposals and draft legislation for the long-awaited new definition of an offshore fund, as well as further comments and draft regulations for the modernisation of the regime. As expected, the new definition of an offshore fund moves away from the existing regulatory definition (which currently requires an offshore fund to be a collective investment scheme) to a ‘characteristics-based’ definition, which could potentially have far-reaching implications for the real estate sector where certain types of closed-ended, limited life corporate vehicles have previously fallen outside the regime.

A copy of this paper can be found at **http://www.hmtreasury.gov.uk/pbr_csr07_offshore.htm**

Comments are invited by 11 February 2009 and PricewaterhouseCoopers will be making representations. For further details contact **Suzanne Ashwell**

Events

What's in store? Live Christmas trading webcast

28 January 2009 – 11.30am

Mark Hudson, Head of UK Retail and Consumer at PricewaterhouseCoopers and Stuart McKee, Corporate Finance Partner will be holding a live post Christmas trading webcast on Wednesday 28 January 2009.

As retailers face one of the most difficult trading periods in 20 years and with consumer confidence at an all time low, unemployment rising and house price falling the outlook doesn't look too positive. Mark and Stuart will discuss the health of the high street, give a view on Christmas and give an outlook for 2009. If you would like to register for the webcast and ask Mark and Stuart questions, please click on the 'register for the event' tab below.

The webcast will last approximately 30 minutes

Register for this event

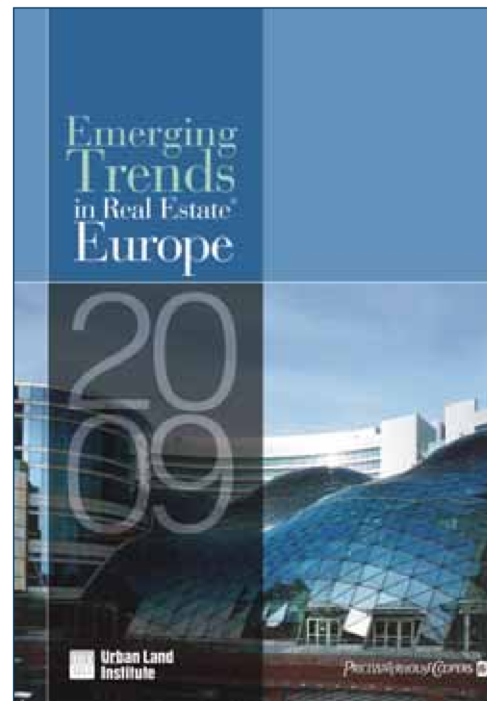
Emerging Trends in Real Estate® Europe 2009

10 February 2009

PricewaterhouseCoopers and the Urban Land Institute will be launching the sixth edition of the Emerging Trends in Real Estate® Europe survey at a breakfast briefing on 10 February at the Hilton Tower Bridge.

We will present the findings of the report, with a particular focus on the impact for the UK. A panel of industry experts will discuss the key findings of the report and the impact on the UK and the rest of Europe.

For further details, please contact the PricewaterhouseCoopers real estate team



Save the date

UK Real Estate Conference

21 May 2009

Our real estate practice will be hosting its annual Real Estate Conference on 21 May 2009. This event will focus on the issues that are affecting the industry.

For further details, please contact the PricewaterhouseCoopers real estate team

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