Practice&Law

BREAKING UP IS HARD TO DO

Analysis Howard Cooke and Adam Foster examine the relationship between businesses and their corporate real estate, and how many companies continue to increase the size of their surplus leasehold portfolio

Every two years Surplus Property Solutions and CORE Consult undertake a survey of companies in the FTSE 350 to examine how they use corporate real estate (CRE) and the quantity and value of the surplus leases that they hold.

The results of the first survey were published in *Estates Gazette* (21 June 2014, p72). The latest analysis is based on the three years from 2012 to 2014 and is derived from the published accounts of 231 companies. The list excludes property companies, natural resource companies and investment trusts, who all use space in a different way to the norm.

The survey identifies that the commitment to property remains significant for business. Overall it accounts for 10% of business operating costs and there appears to be no significant reduction in that commitment. This is contrary to the often talked about extensive reduction in costs that many companies claim to have undertaken in the past few years.

This continuing high cost is in part due to the restructuring of the portfolio, with a significant increase in the provision made for surplus leasehold property to £4bn. In all cases, clearly business has yet to break from its traditional commitment to property.

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The leasehold commitment

Property remains a significant commitment in most business sectors, accounting for 10% of total business costs and including a rent commitment of £126bn and a total lifetime commitment (includes rates, service charge, etc) of £671bn, equating to £2.9bn per company and equivalent to six years' profits. As the FTSE 350 represents circa 35% of UK business, that suggests the total commitment to CRE is in the order of £1,916bn for UK business.

There has been considerable coverage of companies looking to drive down costs and focus on core business. In theory, a part of this cost focus is a change in the way property is being used. The survey shows that the size of the commitment to CRE is dropping, but slowly. Rent commitment is down 6% over the three years and lifetime total has dropped by 4%. However, an

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ONLINE THIS WEEK

LAW REPORT The Estates Gazette Law Reports are now available exclusively on EGi each week. This week we report *Purrunsing v A'Court & Co (a firm)*.

annualised fall of just 2% per annum in commitment is a relatively small change and the proportion of long leases (those over five years) has barely changed at all, dropping by just 0.7% over three years to 55% with an average length of 11.2 years. This suggests that business is not materially changing the way it deals with its CRE, either in terms of lease profile or financial liability.

In fact, in relative terms, companies do not seem to be making more efficient use of their leasehold property. There has only been a small increase of 5.5% of revenue over the three years to £1,271bn and a fall in profit over the same period of 6.8% to £109bn. The cost of CRE per full-time employee ("FTE") fell in line with CRE costs, by 4.6%, to £17,900 per annum per FTE, reflecting static FTE numbers (6.4m in 2014).

Business may be looking to get more from the space it occupies, but based on this analysis it is not driving down its CRE costs or its commitment to space: these seem to be just drifting down. Indeed, these numbers may flatter the performance of cost reduction because the provision for surplus leasehold liability jumped by £1bn (31.4%) to £4bn.

The increase would suggest that the change in the operational portfolio is the result of companies closing units and making them surplus but does not reflect an absolute reduction in liability. It is probable that there has been a reshaping of the CRE portfolio, with units closed and provided for, and new leases committed to on more suitable space.

Only 108 companies make a separate property provision, an average net liability of £38m per company. Assuming that the net liability represents 20% of the gross liability (total costs to expiry), that translates into a gross liability of £188m per company and £66bn for the FTSE 350 overall. For UK business it suggests a gross liability for surplus property of £188bn.

Sector by sector

There are significant differences in the way business sectors have changed their use of and commitment to CRE.

Retail

Retail remains a "heavy user" of CRE, with a rent commitment of £54bn and lifetime property commitment of £277bn. Some 61% of leases have more than five years to expiry, significantly above the portfolio average. Costs run at £40,700 per FTE, more than twice the average, and CRE accounts for 26% of total costs, close to three times the average. Some of these ratios show marginal improvement, but the sector had virtually static revenue (+3%) and a significant fall in profits (-19%), and hence a significant reduction in property costs could have been anticipated.

KEY FINDINGS

- **Property accounts for 10% of business operating costs**
- **Commitment to commercial real estate is dropping, but slowly overall**
- **Retail and TMT sectors making little headway in aligning their property commitments to business performance, and need a more radical approach**
- **Financial services and manufacturing sectors have made real progress**

Survey comprised 231 of the FTSE 350 companies. Data is for the financial year ending 31 December 2014.

There was a significant change in the property provision, jumping 42% to £908m (£48m for each company that separately provides for surplus property), representing 22% of the total portfolio property provision. This suggests that each company in the retail sector is carrying a gross liability for surplus property in the order of £240m, equivalent to 70% of profits.

Technology, media and telecommunications

Another sector that has a high cost of CRE per FTE is technology, media and telecommunications ("TMT"), at £34,400 per FTE. There was a small increase in FTE numbers of 2% against a fall in revenue of 6% and a very significant 70% drop in profits. Rent commitment fell in line with the drop in revenue to £17bn and the proportion of longer leases fell by 2% per annum to 51%. Surplus leases are a significant issue for the sector, with a property provision of £1,247m, a doubling in size from 2012 to 2014. TMT's property provision represents 31% of the entire portfolio's property provision, whereas the sector only employs 7% of the total workforce and generates only 8% of the revenue.

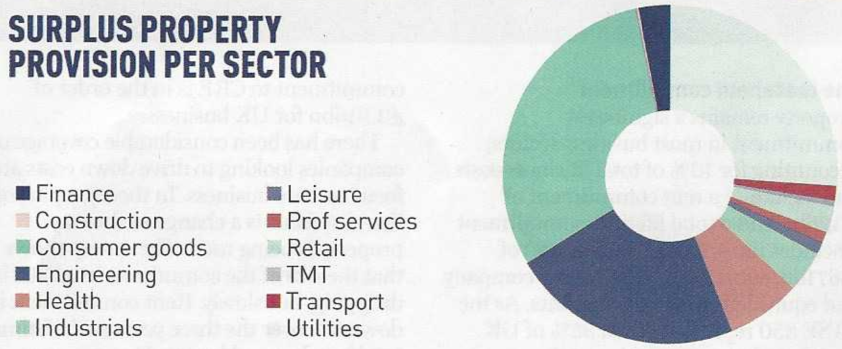
For both retail and TMT the small change to the rent commitment in the operational portfolio and the large increase in the surplus provision suggests that companies are closing poorly performing units but opening new ones. Alternatively they may be re-providing for their existing surplus CRE as they had not provided sufficiently before, or a combination of the two. Both sectors need a more radical approach in order to realign their CRE portfolio to their business needs.

Financial services

One sector that has made significant inroads into its CRE costs and liabilities is the financial services sector. Revenue was flat at £357bn and FTEs fell by 6%, but profits doubled to £37bn as the sector recovered from the effects of the financial crisis. Rent commitment dropped by 22% to £17bn and lifetime commitment was down by 18% to £79bn. While the sector accounts for 28% of the portfolio revenue and 34% of its profits, it only

AVERAGE LEASE COMMITMENT PER COMPANY PER SECTOR

SURPLUS PROPERTY PROVISION PER SECTOR



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DEFINITIONS

- **Lease commitment** Operating property rent commitment
- **Lifetime property commitment** Total of operating property rent commitment + annualised cost of freeholds and long leaseholds + rates, facility management and other costs
- **Surplus property provision** Declared unwanted property lease provision
- **Gross liability** Total cost to expiry
- **Net liability** Gross liability less recoveries/savings

has 13% of the rent commitment. That said, the profile of leases over five years increased significantly to 60%. At the same time, the property provision grew by 48% to £1,062m, representing a property provision of £71m for each company that provides financial services and a gross liability of circa £472m. This suggests that the significant gains in restructuring the operational portfolio and cutting costs is the result of units being closed and costs provided for, rather than leases expiring or breaks being exercised.

Manufacturing

Manufacturing, a composite of consumer goods, engineering and industrials, saw rent commitment decline marginally (4%) to £10bn, in line with the fall in revenue to £201bn. Despite profits falling by 7% (to £28bn) employment rose by 3% and leases over five years increased to half of the total. This group saw the level of property provision fall by 10% to £171m. Operationally, manufacturing is doing more with less CRE. This is not being achieved by increasing their surplus leasehold liability portfolio, as their provision is reducing.

Professional services

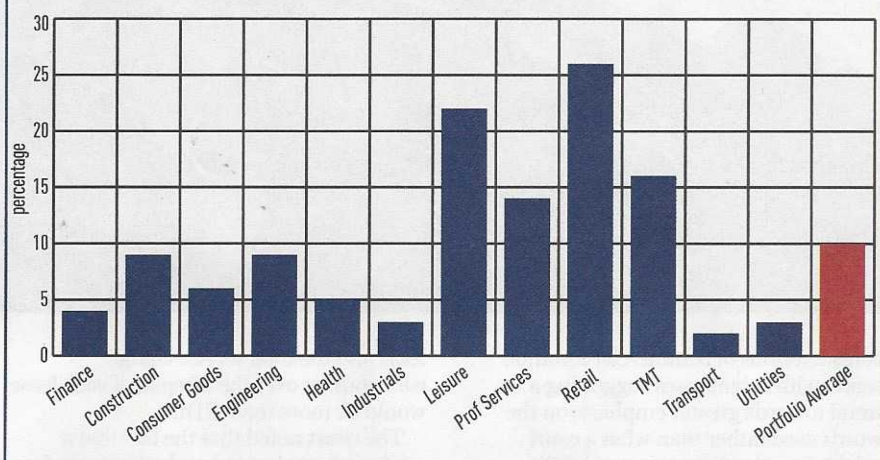
Professional services has a significant proportion of the portfolio's FTEs (27%), but is a low-cost user of CRE, with an average annual CRE cost of just £5,800 per FTE. Revenue was relatively flat (+2%) at £80bn and employment numbers were unchanged, but profits dropped by 15% to £5bn. The sector increased its rent commitment (+12%) to £7bn, but this commitment is relatively short-term as only 26% are longer than five years, the lowest proportion of long leases of all sectors. The property provision was down 23% to £288m which, with the increase in lease costs, could indicate that the sector has been bringing former surplus space back in to use.

Restructuring, but little reduction

Across those sectors that predominantly lease space rather than own it there is evidence of a restructuring of property portfolios. However, there is little evidence of significant reductions in the commitment to property despite numerous articles that discuss the reshaping of demand and the drive for more flexible short-term space. A commitment to operational property for UK business of £1,916bn and a gross surplus lease liability of £188bn does not allow business to be flexible and change what and how it is doing things. The desire to have property remains hard-wired into the minds of decision-makers.

Adam Foster is director of Surplus Property Solutions and Howard Cooke is director of CORE Consult

ANNUAL PROPERTY COSTS AS A PERCENTAGE OF TOTAL COSTS



LEASE LENGTH PROFILES – AVERAGE OVER FIVE YEARS