

Sale-and-leaseback as a British Real Estate Model

Malvern TIPPING and Prof Richard K BULLARD, United Kingdom

Key words: capital release, investor, operational business, outsourcing, sale-and-leaseback

SUMMARY

Many established trading companies have had considerable capital value locked into their operational properties. These properties have been identified as producing lower returns on invested capital than core business activities. Consequently, there has been a growing trend for the splitting of operational property from core business activity. In the United Kingdom, the hiving-off of operational property has most commonly taken the form of the sale-and-leaseback model. This paper reviews the existing literature and some past transactions in order to identify the motivations of both operational businesses and property investors in adopting the model. Some transaction case studies are also highlighted. Accounting considerations had been a motive behind this trend. Recent reforms to accounting standards have offset that impetus. However, taxation considerations and the desire to release capital from real estate have continued to drive the model. The model has become increasingly popular in the United Kingdom during the past two decades. Originally the domain of those companies with especially strong covenants, it has more recently become much more widespread. The model has been a property strategy much favoured by 'blue chip' trading companies, including the principal British retail banks. More recently, high demand from investors has resulted in their acceptance of sale-and-leaseback transactions by trading companies with much weaker covenants. Some of these weaker covenants have since failed, leaving investors with investment properties diminished in value. This paper examines recent trends and seeks to identify how the sale-and-leaseback model may develop in the United Kingdom. Furthermore, the application of the model in the United Kingdom may give some insight into its application in other parts of the world, where it is either gaining further acceptance or may have greater potential application.

In memoriam Professor Dr. Richard K. Bullard, FRICS (1935-2007)

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1. INTRODUCTION

Historically, many large United Kingdom companies have amassed large portfolios of freehold real estate. This property was either acquired through organic growth over a considerable time or through the amalgamation and takeovers of existing businesses. Where such properties were acquired long ago, they have often become debt free. The properties are treated as having no current cost due to there being neither rents nor mortgages to pay.

However, there is an opportunity cost to all property held on an historic basis. The question that arises is "Could the capital stored in these properties be better deployed elsewhere?" During the past twenty years, there has been a growing trend for leading British companies to separate the ownership of their operational real estate from their principal trading activities.

This paper identifies the principal models used in the United Kingdom for the separation of operational property from trading activities. It identifies the motives behind separation and how these are met through the sale-and-leaseback model. Recent trends in the sale-and-leaseback model are highlighted and likely applications of the model are discussed.

1.1 Research Methodology

This paper focuses on engagement with the literature on the sale-and-leaseback model. Literature on the model is reviewed and discussed. The sale-and-leaseback model is examined within the context of all the principal approaches to holding operational property in the United Kingdom. These other models are discussed. The extant literature on the approaches to holding operational property is reviewed. As a result, the motives driving the present trends for the ownership of operational real estate are considered. The way in which these impact upon the adoption of the sale-and-leaseback model in the United Kingdom is examined.

1.2 Outcome of the Paper

The discussion on past and present theories on the holding of operational property in the United Kingdom identifies the current trends amongst those British companies splitting their real estate from their core business activities. It identifies what has driven the sale-and-leaseback model in the United Kingdom to date. It also considers what might drive the model in the immediate future and therefore what aspects both property investors and operating companies are likely to consider in subsequent sale-and-leaseback transactions.

2. MECHANISMS FOR OWNING OPERATIONAL PROPERTY

Sale-and-leaseback is not the only model capable of application to the ownership of operational property. Indeed, not all operational property is let by a third party landlord at arms' length to a tenant trading business or company. Each model is capable of some form of variation. However, the principal models presently used in the United Kingdom for the holding of operational property are:

- Inclusion of all operational property within the structure of a single trading entity
- Separate property and trading divisions
- Sale-and-leaseback
- Sale-and-manageback
- Property outsourcing

These approaches are capable of adaptation and variation. In addition, a number of premises have never been owned by operating companies. Instead, they have always been rented from landlords.

2.1 The Single Entity

Other than where the practice has always been for operational property to be rented, it was the norm until recent decades for operational property to be owned by the entity conducting the business. This usually meant the two being held by either an individual, a partnership or a company. From the latter part of the nineteenth century, larger businesses tended to convert into limited companies. Smaller, family businesses tended to follow suit several decades later during the twentieth century. Now virtually all but the very smallest of British businesses are incorporated.

Business entities that have retained real estate as an integral element of the same entity have over the fullness of time either reduced the debt on their properties to very low levels or eliminated it altogether. These properties tend to be viewed on an historic cost basis. They are also regarded as a free asset, since no rent or mortgage payments are made on these longstanding properties. In times of adversity, these premises can be used as a life-line, against which borrowings can be secured. Often, these properties are taken for granted by the directors and shareholders, who fail to appreciate and realize the present values of the premises. Instead they pay regard to the historic cost.

Devaney and Lizieri (2004) state that most businesses can expect their normal trading activities to achieve a considerably greater return than that which could be expected from property yields. They argue that where this is so, the holding of operational property has a detrimental effect on the value of the business. Hence, if the capital locked into property were to be released and re-deployed in the business, that business could be more profitable. Holding both the business and the operational property within a single company will distort the company's accounts. Placing them into separate entities can overcome this.

2.2 The Property and Operating Company Split

The placing of the business' estate into a separate company is the first step towards dividing the operational property from the business. Not only can that be an end in itself, but it can facilitate the adoption of other structures for holding the operational property.

This simple splitting of the core business activities and properties takes the form of placing the respective parts into what are often known as *Opco* and *Propco* companies. Hence, an internal market is created, whereby the operating company is expected to pay the property company a market rent for the property. At the same time the operating company is able to focus its resources and expertise on its main business activities. It is able to concentrate on doing what it knows best. Likewise, the property company is able to call upon focused real estate expertise.

The splitting of business operations and property into separate companies can be a first step towards spinning-off the estate from the group altogether. The structure has evolved so that the estate can be either partially or completely spun-off. A partial spin-off can be achieved through the creation of joint venture arrangements with specialist property investors. Such joint ventures are normally structured through devices often known as Special Purpose Vehicles (SPVs). Commonly, SPVs are companies that are jointly owned by the operating company and a specialist property company. The SPVs are owned only by the two partners, usually with each having an equal stake. They are a means by which trading companies can dispose of some of the equity in their operational properties whilst still retaining a stake in some of the future rewards that might be generated by those properties.

As an example, the supermarket chain, Tesco, has recently been pro-active in the use of property joint ventures in the United Kingdom (Northedge, 2005 and KPMG, 2006). Tesco has adopted several approaches to hiving-off parts of its estate. Its SPV approach has retained some of the attributes of a sale-and-leaseback transaction inasmuch as Tesco did lease the premises back (KPMG, 2006). Also, in one of the transactions Tesco retained an option to re-purchase the properties at a later date. Another approach piloted by Tesco was to place some properties in a Jersey Property Unit Trust. However, the company has since decided to continue with the sale-and-leaseback approach (Chesters, 2006).

The division into *Opco* and *Propco* is capable of further adaptation. Furthermore, it is an important device for the adoption of other models. In particular, it is very useful for the adoption of the sale-and-leaseback model. It may also be used for other models such as sale-and-manageback and outsourcing.

2.3 Sale-and-leaseback

The normative sale-and-leaseback transaction is one in which the owner of a property sells that property to a third party and simultaneously takes a lease on that property from the third party (Adams and Clarke, 1996). In other words, the original owner sells the property to an investor, who immediately becomes his landlord.

Adams and Clarke state that the sale-and-leaseback model can be traced back in the United Kingdom to the late 1920s and early 1930s, having been used there by a number of retailers to raise capital. The model's first large-scale use was in the United States, where it was first used in 1936 by Safeway Stores (Adams and Clarke, 1996). Here it was used for several supermarket premises. Usually, it was used as a device to facilitate the takeover of family-owned supermarket businesses. Often, the capital released from the sale-and-leaseback of a supermarket premises raised sufficient capital to pay for both the premises and the business. This set the precedent for the large-scale growth of the model for many types of operational property in the United States.

The widespread use of the model in the United States has since seen the model adopted in much of Europe. Many European banks have adopted the model with respect to their own operational properties. In Germany, the model has been adopted by Dresdner Bank; in Switzerland by the Union Bank of Switzerland; and in the United Kingdom by all the leading retail banks to varying degrees. Another example in Europe is the telecommunications industry, which has embraced the model to fund expansion and new technologies. Also retailers and parts of the leisure industry have been active in adopting the model.

The renaissance of the sale-and-leaseback model in the United Kingdom came with its use by the variety store chain Woolworths. Between 1987 and 1991, Woolworths disposed of one hundred and twenty-one of its premises by sale-and-leaseback. This was followed by Boots, the high street health-care product chain, which applied the model to fifty of its freehold premises between 1988 and 1991.

At the start of the twenty-first century, the sale-and-leaseback model has become much more widespread in the United Kingdom. It has been adopted by a number of leading FTSE 100 companies. These include supermarkets, the main retail banks and leading high street retailers. It has even been applied to some government buildings. These are all considered secure covenants. However, more recently the model has seen large-scale expansion in sectors comprising less secure covenants. For example, it has been more recently applied to public houses, convenience stores and off-licences.

Many of the sale-and-leaseback properties have been sold as individual lots at public auction. Usually, portfolios of individual lots occupied by the same operating company have been offered at the auctions. There has been high demand for these individual lots sold at public auction. Small, private investors have entered the market and increased demand for these lots. As a result, lower yields and higher hammer prices have been achieved. Other lots have been offered as parts of large portfolios sold en masse by private treaty. These have been sold to specialist, large property investment companies and to investment funds.

Professional advisors have become aware that there are two important aspects to ensure that sale-and-leaseback deals achieve optimal results for vendors. These two aspects are sufficient length of lease and strong covenant. They are vital to secure favourable third party funding. These factors are especially applicable where individual properties are purchased at auction

by private investors. Typically, financiers are looking to terms of fifteen years unexpired on the leases. There are pressures on lessees to enter into shorter leases. Currently, an approach to bridging this gap is for the adoption of fifteen or twenty year leases, but with options to break after ten and fifteen years respectively. This trend seems to be the market's present approach in the United Kingdom to meeting the expectations of both parties.

Another recent trend has been for the forces of supply and demand to enable even operating companies with considerably weaker covenants to offer investors less favourable terms in sale-and-leaseback transactions. Since the turn of the century, companies with weaker covenants have sought to release capital through adopting the sale-and-leaseback model. Originally, to buoy up investor demand the properties of these weaker covenants were offered with leasebacks for much longer periods. Thirty-five years was not at all untypical. Another incentive was to offer investors guaranteed up-lifts in rent every three or five years based upon an annual compounding of a prescribed rate. As the operating companies and their advisors realized that there was an almost insatiable demand for sale-and-leaseback investments, the terms became less favourable over time. Particularly in 2004 and 2005, the lengths of the leases were considerably shortened and the rates at which the rental increases were compounded were successively reduced. During the last eighteen months, several of these weaker covenants have collapsed. In the public house sector, London & Edinburgh Group and Provence Commercial Properties are high profile examples. Other high profile examples are the Unwins off-licence chain and the S-Mart convenience store chain.

The disposal of entire portfolios of operational property to a single investor by private treaty is not at all unusual. This method has been favoured a great deal in mainland Europe over the selling of individual lots at auction. For example, in December, 2005, Fortress purchased €2 billion worth of Dresdner Bank's operational premises in Germany on a sale-and-leaseback basis (KPMG). Also in December, 2005, Prakiker sold €500 million worth of its properties in Germany, Portugal and Hungary on sale-and-leaseback terms (KPMG). Deutsche Bank sold much of its operational estate in Germany through sale-and-leaseback deals in November, 2003 and December 2004 (Deutsche Bank, 2004). In the United Kingdom, there have been some well-publicized disposals of portfolios on sale-and-leaseback terms. Several of the main retail banks have sold tranches of property on this basis. Towards the end of 2006, Bank of Ireland was seeking to sell a portfolio of thirty-six of its retail branches in the Republic of Ireland on sale-and-leaseback terms for more than €230 million (Hipwell, 2006).

The disposal of entire portfolios of operational property on sale-and-leaseback terms is an approach much used in United Kingdom. Many of the principal retail banks have sold entire portfolios of their operational property en masse to single investors in this way. Even those banks that have sold branches individually at public auction have adopted this alternative approach for other parts of their estates. Examples during 2006 alone include:

- Barclays Bank's sale-and-leaseback of 15 prime branches to Prudential for £85m
- Halifax Bank of Scotland's £72m sale-and-leaseback of 15 branches to an Irish investor
- Barclays Bank's sale-and-leaseback of 24 branches to Flodrive for £67m

Other recent sale-and-leaseback deals comprising large portfolios of operational property in the United Kingdom include:

- Boots' £298 million sale to Reit Asset Management in August, 2005
- Debenhams' £495 million sale to British Land in March, 2005
- Goldman Sachs' £280 million sale to Trishman Speyer in June, 2005
- IBM's sale in excess of £120 million to Highcross in November, 2005
- Tesco's £366 million sale to Consensus Business Group in March, 2005
- Tesco's £270 million sale to Morley Fund Management in November, 2005
- Travel Lodge's £400 million sale to Prestbury in October, 2004

Source: KPMG (2006)

In a minority of cases, operating companies have expressed dissatisfaction with their sale-and-leaseback arrangements. Blackstone, prior to seeking to take over the Center Parcs holiday villages business in the United Kingdom, had said that if successful in the takeover it would seek to reverse Center Parcs existing sale-and-leaseback structure. It claimed that the business had become over-loaded by the cost (Gibson, 2006).

The sale-and-leaseback model has become a mainstream approach to the holding of operational property in the United Kingdom. Its exponential growth has been a consequence of its popularity with both investors and operating companies. The model has not only become increasingly widespread during the past twenty years, but the way in which it has been applied has been subject to adaptation to meet market pressures and opportunities. As a result, properties have been sold both individually and as parts of substantial portfolios; and lease lengths and other terms have evolved to meet changing circumstances.

2.4 Sale-and-manageback

As an alternative to sale-and-leaseback, sale-and-manageback has found favour for application to some real estate types. In particular, it has found favour in the leisure industry sector. This model involves the operating company selling its property to an investor, which then grants a management contract, instead of a subsidiary interest in the property, to the operator. Specifically, the sale-and-management model has been applied to a number of hotel properties. It has been applied to many large hotels here in Hong Kong for several years. Back in the United Kingdom, the model has caught on more in the hotel sector in recent years. The model has even been adopted there by established hotel chains as a preferred way of separating the real estate from the hotel business.

Billions of pounds' worth of hotels have been placed into manageback structures by the large hotel chains in recent years (Schäfer-Surén, 2005). The perception is that hoteliers can attain higher returns on their capital by releasing it from the real estate. The model also avoids having to show leases as liabilities on balance sheets as now required by International Accounting Standard 17. The downside, according to Schäfer-Surén, is that management contracts may not deliver to the hotelier as much profit per hotel. He argues that under

manageback, it may be necessary to operate many more hotels to achieve the same overall profit levels. Though, of course, the model does not require so much capital.

In the long-term, tax considerations may have some impact upon the adoption of manageback. Stamp Duty Land Tax (SDLT) is not payable by lessees when taking back a lease as part of a sale-and-leaseback transaction. However, on the creation of subsequent leases, the lessee would be subject to SDLT calculated on the basis of the length of the new lease. All manageback agreements are presently free of SDLT in the United Kingdom. Only the property investor pays SDLT on the initial acquisition of the premises.

Sale-and-management contracts can be fraught with potential difficulties. The law looks at the substance rather than the language of the agreement. Unless, the contract is carefully drafted, what was intended to be a sale-and-manageback agreement could end up being interpreted at law as a sale-and-leaseback. This could undo the accounting and taxation benefits that had been sought from the sale-and-manageback. Also, from the property investor's point of view, it would grant the operating company unintended security of tenure rights under the Landlord and Tenant Act 1954.

2.5 Outsourcing

Property outsourcing is a model capable of differing versions. However, in generic terms it can be defined by the investor also providing property management services (Kingsmill, 2005). Outsourcing providers claim to provide both short-term and long-term solutions to real estate needs through taking on the ownership, management and development of the estate, thereby providing an holistic service (Land Securities Trillium, 2004).

In the United Kingdom, the model was first used in 1996 by the Ministry of Defence for the outsourcing of the armed services' married quarters to Annington Homes. According to George and Pazzi-Axworthy (2002), this deal had many of the attributes of a standard sale-and-leaseback and the first true outsourcing contract in the United Kingdom was PRIME project. This was concluded with the United Kingdom's Department of Social Security.

The number of outsourcing providers has been restricted. Mapeley Limited and Land Securities Trillium plc have been the main two providers in the United Kingdom. Mapeley's outsourcing contracts have included the STEPS contract with respect to some of H.M. Revenue & Customs premises and virtually the entirety of the retail bank Abbey National's operational estate.

The model has been scrutinized by the telecommunications sector. British Telecom outsourced most of its estate in 2001 to reduce its debt. Also, in 2001 Deutsche Telekom used the model to release capital to invest in expansion and new technology. However, Cable & Wireless retreated from the model before a deal could be concluded.

3. THE IMPETUS BEHIND THE SALE-AND-LEASEBACK MODEL

Separating operational real estate from normal operational activities is currently much favoured in leading British business circles (Northedge, 2005). Several motives have driven this thinking. These differing motives and the disparate perceptions of companies have resulted in adoption of different property strategies.

The main motives driving the sale-and-leaseback model, which are not necessarily mutually exclusive, are:

- Finance
- Accounting
- Taxation
- Specialization
- Flexibility

3.1 Finance

The release of capital is presently one of the main factors driving the sale-and-leaseback model in the United Kingdom. The attractions are that a trading company may be able to better optimize its capital through focusing on trading activities or may be able to reduce its borrowings through adoption of the model. Sometimes, only one of these two attractions can be met. However, sometimes it might be possible to meet both.

The directors and shareholders of businesses need to be able to separate the operational and the property components of those businesses. They must be able to view the property component as being distinct from their businesses. They are then capable of unlocking the capital retained within their property assets. In coming to this view, the directors and shareholders cease to view the property assets in terms of historic cost or as being a free input. Merely establishing an internal market for these two components within a business allows them to focus on the value of the estate. From this point, the property either can be treated within the group at its current value or can be spun-off altogether in order to release capital.

Apart from the possibility of capital release, the hiving-off of property can have an impact upon a company's financial reporting and its earnings per share. The conventions for evaluating the performance of trading and property companies are different. Trading companies' performance is assessed on the basis of earnings per share, whereas property companies rely on net asset value. The two types of company are generally treated differently in terms of borrowing costs. A property company should be able to raise finance secured against its estate at a cheaper rate than a trading company could for the funding of its normal operational activities. Therefore, the property component can be exploited as a cheaper source of finance when property and trading activities are split into separate vehicles.

A further consideration is that operating activities return a better yield than property on capital invested. A trading company ought to achieve a twenty per cent return on its capital each year. Property yields are unable to meet such a target. Moreover, the differential is

exaggerated during peaks in the property cycle, when property yields are at their lowest point. This differential makes a further case for the release of capital from the property assets for use within the operational activities of a business.

On the other hand, some listed companies have adopted a strategy of using their estates to try to make themselves less attractive to hostile takeover bids (McClary, 2006). The cost of having to bid for a company comprising a valuable property portfolio, as well as an operational business, might make a takeover too costly to fund. In contrast, some predators have financed their takeover bids on the basis of a subsequent sale-and-leaseback of the business's property assets. The Debenhams department store chain and the Big food Group are examples where this approach was adopted to fund business takeovers in the United Kingdom (Kingsmill, 2005). Also, owning real estate capable of returning value either through active management or through re-development might make a company attractive to a hostile takeover bid. A recent example of this phenomenon in the United Kingdom is the interest that has been shown in the Wyevale Garden Centres group. A number of property investors had identified the property development potential of many of the Wyevale properties (Dover, 2005). For the largest United Kingdom listed companies the prospect of their operational properties being used to leverage hostile takeovers has been less of a concern (McClary, 2006). Consequently, sale-and-leaseback has continued to remain a popular model with the largest operators, including the leading retail banks.

Financial considerations currently seem to be the principal motives for the adoption of the sale-and-leaseback model in the United Kingdom. In particular, the model is driven by the demand for capital release. However, in a note of caution, Devaney and Lizieri (2004) have argued that the equity markets might take the view that a company has exposed itself to enhanced risk by divesting itself of its real estate. This is because the real estate might be viewed as less risky than the trading activities. Also, the process of releasing capital through the disposal of the real estate cannot be repeated.

3.2 Accounting

Accounting factors continue to have a diminishing influence on the adoption of the sale-and-leaseback model. This is due to the effects of reforms to accounting policies. These reforms have made the model less attractive from purely an accounting perspective.

In recent years, the increasingly global nature of business has increased pressures for the adoption of international accounting standards. British accounting standards previously made a distinction between operating leases and finance leases. Until recently, property leases were generally treated as operational leases, whereas other leased assets were treated as finance leases for accounting purposes (Lawson, 2001). This distinction had been criticised by accountants, since it enabled lease liabilities to be treated as being off balance-sheet. These critics argued that long-term lessees, in particular, bear most of the risk associated with property and that such risk should be reflected in the accounts.

Calls for reform were addressed by International Accounting Standard (IAS) 17, which made provision for longer leases to be reflected in accounts as finance leases. Accordingly, they were to be capitalized and shown on balance sheets as liabilities. Under European Union directive, IAS 17 become mandatory as from January, 2005 for all companies publicly listed in the European Union (Preston, 2004). Hence, IAS 17 requirements now apply to all sale-and-leaseback structures with respect to British publicly listed companies. IAS 17 reporting standards could soon be applied to all other companies.

The current IAS 17 requirements are likely to influence the way in which new leases are framed. All terms in excess of one year need to be capitalized. A greater liability will be recorded in the balance sheet where the term of the lease is longer. Net present value as at the accounting date now forms the basis of the liability to be recorded in the accounts. This will have a detrimental affect on companies' gearing and profitability. In turn, these may affect those companies' credit ratings and capacity to borrow (Lawson, 2004). A likely response to this is that lessees will be under greater pressure to seek shorter leases. This is in contrast to the pressures that some tenants had been to seek longer leases as a result of the need to spread out fitting-out costs. A likely compromise might be the greater use of break clauses, as the new accounting standards only require the lease liabilities to be shown up to the date of the break clause.

Another pressure for longer leases remains in the need of investors to have a sufficient number of years' income secured on properties to support the financing of their investments. Again, the adoption of break clauses has been used to address this issue whilst limiting the adverse effects with respect to the balance sheet. In the last year or so, this is an approach that has been adopted in the United Kingdom by Barclays Bank for example.

The IAS 17 reforms are in their infancy in the United Kingdom. Concerns remain over how the need to show the capitalization of lease liabilities will affect occupiers' credit ratings. Some early responses to the reforms have been identified. However, it remains to be seen how the market reacts in the longer term. In spite of the implementation of IAS 17, the sale-and-leaseback model remains popular amongst leading British companies.

3.3 Taxation

Although taxation was a driving force behind the initial large-scale adoption of the sale-and-leaseback model in the United States, its influence in the United Kingdom has been different. In the United States property has been capable of depreciation for taxation purposes. This provided a large incentive for sale-and-leaseback deals in the United States, especially when marginal rates of taxation there were particularly high (Adams and Clarke, 1996). In contrast, property is not capable of depreciation for tax purposes in the United Kingdom. With the exception of Enterprise Zones, capital allowances have only been applied to plant and machinery rather than buildings in the United Kingdom.

Other forms of tax relief are available on leased property in the United Kingdom. In the United Kingdom, occupiers are able to claim tax on the rent that they pay. If a company, an

occupier can offset rental payments for the purposes of assessing its liability for Corporation Tax. In contrast, owner occupiers can only offset the interest element of their mortgages for taxation purposes. They cannot offset any mortgage capital repayments. Hence, leasing operational property creates an annual tax benefit for businesses in the United Kingdom. United Kingdom taxpayers are subject to Capital Gains Tax (CGT) on gains made on their properties at the time of disposal. This could act as a deterrent for those operators considering a sale-and-leaseback transaction. However, CGT liabilities can be reduced through the application of indexation and the timing of disposal.

Stamp Duty Land Tax (SDLT) becomes payable by those acquiring an interest in real estate in the United Kingdom. SDLT is imposed on both freehold and most leasehold interests. Intra-group transfers are presently exempt from SDLT, but the tax is levied on third party investors. Property investors acquiring interests in sale-and-leaseback transactions are subject to SDLT. However, operators selling a property interest on a sale-and-leaseback basis are exempted from SDLT with respect to their new leases forming part of that transaction (H.M. Revenue & Customs, 2004).

3.4 Specialization

Irrespective of whether disposal of operational property is intra-group or to a third party investor, the division does permit focus. A separate property company allows that company to exploit the property assets without the distractions of the operating business. Separate and specialist sources of finance are able to be tapped. The separate company can also develop a property expertise (Devaney and Lizieri, 2004).

A sale-and-leaseback arrangement may deliver greater benefits than an intra-group split. It may be more efficient, as the property investors may have greater access to finance tailored to real estate, and they may be better able to build teams of property specialists to manage the assets. These aspects may be additional benefits arising from sale-and-leaseback, but the other considerations are likely to determine whether the model is applied in the United Kingdom.

3.5 Flexibility

Businesses can become constrained by their operational property. Real estate is considered illiquid and inflexible. Moreover, mortgaged property not only creates debt, but can make the properties even less flexible.

Leasing of property does to some extent increase flexibility. However, even leased property might be considered to be inflexible in the medium term. From 1996, the outsourcing model has been developed in the United Kingdom. That model was used to release capital either to reduce debt or to facilitate investment in modernization and expansion. It was viewed as a model that delivered flexibility. Certainly, Abbey National, the British retail bank, sought flexibility with respect to its operational property in its outsourcing deal with Mapeley. Nevertheless, some of the British outsourcing deals have been criticised for being costly.

Abbey National's outsourcing deal was considered to be very expensive (Devaney and Lizieri, 2004).

The greater use of break clauses in sale-and-leaseback deals has already been discussed. Their use is another way of delivering greater flexibility within the confines of the sale-and-leaseback model. Certainly, an increasing number of recent British sale-and-leaseback transactions have included break clauses.

4. THE COLLAPSE OF SOME BRITISH LESSEES

Most of the British sale-and-leaseback deals have featured operating companies with strong covenants. These have been considered secure investments with reduced risk. Typically, these strong covenants have included FTSE 100 companies, banks and major retailers. The high reputation of these tenants has helped to fuel the apparently insatiable demand from investors for sale-and-leaseback properties.

Much weaker companies have been able to raise capital on the back of the high demand from investors for sale-and-leaseback properties. Since the end of 2005, there have been some high-profile collapses of companies, which had recently sold their operational premises on sale-and-leaseback terms. As a result, hundreds of these properties were left vacant and with unpaid rent. Furthermore, a large proportion were left in a dilapidated state. Since, the properties had tended to be over-rented, there was little chance of re-letting them at their former rents. As a result some smaller investors have been destroyed by the collapses. These collapses have tended to feature public houses, off-licences and convenience stores.

It remains to be seen if there are to be any more sale-and-leaseback collapses in the United Kingdom, especially as some of the high street traders are reporting difficult trading conditions. Additional failures remain a possibility.

5. CONCLUSIONS

The benefits of hiving-off operational property from core business activities has become increasingly recognized in the United Kingdom. The sale-and-leaseback model is increasingly used to achieve this end. Its use by leading British companies has become widespread, especially since the turn of the century.

The model is driven by different factors, including finance, accounting, taxation, expertise and flexibility. All these need to be considered when assessing the optimal means for holding operational property. Adverse reforms to accounting standards do not appear to have diminished the enthusiasm of British operating companies to enter into sale-and-leaseback structures. Finance, as in the need to release capital and to optimize its use, seems to be the principal determinant supporting the model's adoption.

Some recent failures have highlighted the need for investors to assess adequately the risk attached to sale-and-leaseback by any given operating company. Nevertheless, investors' demand for those sale-and-leaseback deals benefiting from strong covenants remain high.

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BIOGRAPHICAL NOTES

Malvern Tipping graduated from Portsmouth University with B.Sc. Urban Land Administration in 1986 and is presently a part-time professional doctorate research student at the Anglia Ruskin University, UK. He is a professional member of the Royal Institution of Chartered Surveyors (RICS) and is a director of Tipping Estates Limited and other companies. His areas of experience include valuation, property investment and development.

Prof. Richard K. Bullard sadly passed away shortly before the completion of this paper, which is dedicated to his memory. He was qualified as a chartered surveyor for over fifty-two years and consulted in forty-four countries primarily in geomatic, cadastral, land management and land reform matters. Between 2002 and 2004, Richard served as chairman of the RICS Geomatics Faculty, having already sat on RICS Governing Council. He had served as a member of staff for several years at North-East London Polytechnic and the University of East London before moving to Anglia Ruskin University, where he remained until his death. He frequently attended and presented papers at FIG congresses.

CONTACTS

Mr Malvern Tipping
Tipping Estates Limited
Uggeshall
Beccles NR34 8BE
UNITED KINGDOM
Tel. + 44 1502 578784
Fax + 44 1502 578784
Email: admin@tipping-estates.co.uk