



# THE MARKET FOR SALE AND LEASEBACKS

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TACTICAL REPORT | SEPTEMBER 2012

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# TABLE OF CONTENTS

Executive Summary	3
Preamble	4
Report Outline	5
SLB History	5
SLBs in Europe	6
SLBs in Eastern Europe	6
SLB Sales By Country	7
SLB Sales By Sector:	7
Industrial & Logistics	7
Retail	7
Offices	8
Other Sectors	8
SLB Activity Summary	9
The Investment & Corporate Demand Context	10
The Investment Perspective	11
The Corporate Perspective	12
Tax & Legal Drivers of Change	14
Tax & Legal Summary	15
Long-Term Management & Capital Costs	15
Conclusion	16

## EXECUTIVE SUMMARY

### The Opportunity

- > An analysis of arms' length, European commercial real-estate investment transactions highlights that Sale and Leaseback activity accounts for ca. 10% of all reported transactions since 2007. This figure drops to ca. 7% when only 'standard/full' (i.e. where 100% of space is leased back by the vendor for more than 1 year) SLBs are accounted for.
- > SLB transactions have figured less prominently in Eastern Europe over the last decade or so. In fact at only ca. €1.6 billion, the SLB market represents a meagre 4.5% of historic investment turnover. The one consistent trend between SLB transaction activities in Eastern Europe relative to Europe as a whole is the proportionate increase in the volume of completed SLBs during the peak financial crisis years from end of 2007 to end 2009.
- > Although no SLB transactions have been recorded in Eastern Europe during 2012 to date, current market conditions comprising a combination of restricted credit, muted economic growth and subdued debt provision provide a strong platform for Sale and Leaseback (SLB) investment transactions to occur.
- > SLBs can serve the need for corporate entities to raise cash whilst allowing investors to access secure, longer-term income streams, thus enabling better financial terms – a transaction medium that can benefit both parties. Furthermore, SLB transactions need not just be associated with the main commercial property sectors. Our analysis of historic SLB transaction activity shows that they can be conducted across a variety of sectors, uses and lot sizes often involving both well-established and specialised corporate and real estate investors. It is a relatively liquid sub-sector in its own right.
- > Longer term, if freehold assets held by corporate bodies in Europe amounts to an estimated 83% of the total commercial real estate market in Europe\* the potential scope for Sale and Leaseback activity is significant, especially given changes in the long held view that 'real estate should remain in corporate hands as a cultural norm'.

### The Key Considerations

- > From an occupier perspective, the major benefits of selling property, relative to selling all or part of the company are that the corporate occupier maintains control over the day-to-day management and planning of the business, especially where the occupier can retain and partially control the use of the space, via the lease terms and conditions which are set out in the sale agreement. Re-investing the capital receipts back into the business is critical.
- > From an investor perspective, a strong covenant from the vendor will enable an investor to secure more favourable capital financing terms, especially if a vendor can opt to agree to year terms longer than 3-5 years. If the assets in question are non-prime or too specialist in nature, with limited alternative use value, this could equally reduce the likelihood of securing more favourable capital financing terms.
- > How assets are valued, and how a sale and/or leaseback (or leases) are treated in legal, accounting & financial terms can create significant complexity and thus advice must always be taken. For example:
  - > In most jurisdictions a property transfer tax (or similar transfer tax/stamp duty charge), and/or capital gains or corporate tax charge could be triggered if the sale is via an asset deal. Where the seller currently has the property on the balance sheet of its operating company, this may require preliminary steps, such as an 'Opco Propco' de-merger to take place.
  - > Typically the lease would need to be signed concurrently with the sale transaction. If an SPV is being sold, this would normally give rise to a related party transaction. This is subject to transfer pricing regulations, and the deal thus needs to be demonstrated to be on an arms' length basis.
  - > It is also worth noting that any lease incentives negotiated as part of a SLB transaction are accounted for and taxed by spreading their impact over the lives of the underlying leases. If a SLB transaction takes place where an incentive such as rent free is granted, the buyer could end up initially paying taxes on income which does not generate any cash.
- > In summary, SLBs are worthwhile transaction mediums, but require careful planning and consideration to be successful for both the vendor and purchaser over the established duration of the transaction. Professional real estate, valuation, financial, legal and taxation advice is paramount, enabling a positive transaction for all parties.

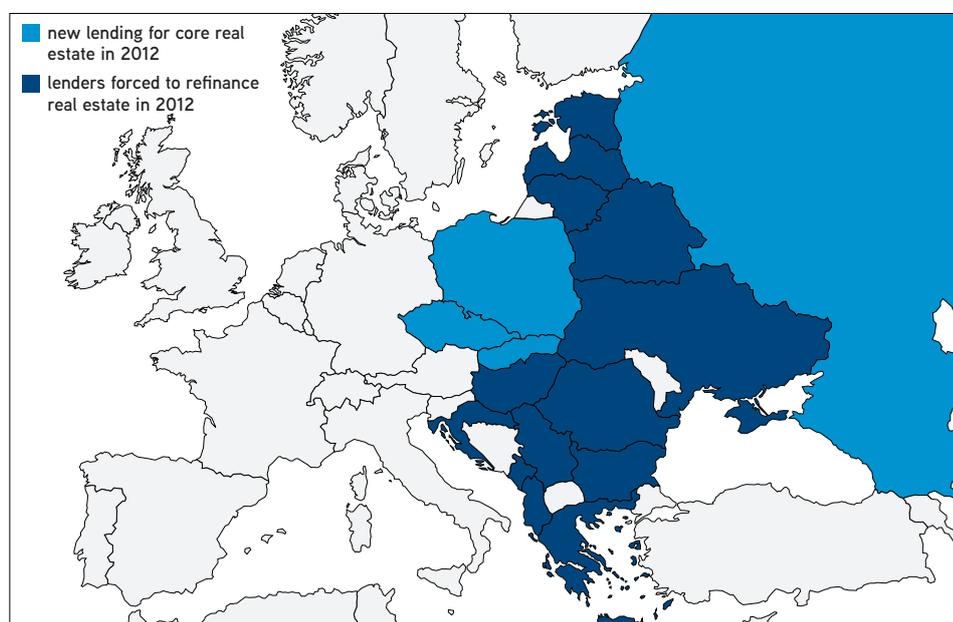
\*Hordijk & Ahlqvist, 2004

## PREAMBLE

So far in 2012 we have noticed a significant slow-down in investment transactions across the region, which is concurrent with trends across Europe. This is no major surprise - as discussed and described in our earlier report on Banks, Regulation and Property Markets of March 2012 - with volumes far down on 2011 and closer to 2010 transaction levels.

The reduced lending capacity of banks brought about by EBA capital test requirements - a precursor to Basel III - was already starting to bite in most of Eastern Europe at the end of 2011. The short-term outcome being that for 2012, traditional non-domestic (bank) lending appears to be restricted to core assets in Poland, the Czech Republic, Russia and Slovakia.

FIG. 1: EASTERN EUROPE - 2012 COMMERCIAL REAL ESTATE FINANCE DESTINATIONS



Even in these more liquid/core markets of Eastern Europe, there are few lenders who fund in excess of €100 million and the typical lot sizes for new senior debt is well below €50 million. With syndication markets all but closed, banks are forced to assemble financing clubs before closing, with each lender having a smaller allocation than in the past (a €25-€50 million stake is common).

The impact is that processes supporting large scale senior financing transactions take far longer than before and are prone to unexpected hiccups e.g. when one club partner drops out mid-stream.

For the time being, as far as commercial real estate goes, it is an investment market for equity driven players. Although the maturity of existing loans will help drive new transactional activity going forward, such transaction volumes have been limited to date.

Besides the more traditional forms of buying and selling real estate, we ask ourselves what other alternatives are there to generate capital from commercial real estate. This report focuses on one capital raising avenue - the Sale and Leaseback.

## REPORT OUTLINE

In order to assess the potential for Sale and Leaseback (SLB) transactions we have undertaken the following work to understand size of the market to date and the drivers which may or may not support an increase in SLB activity, in addition to the wider economic and financial backdrop.

- > An analysis of historic SLB transactions.
- > An exploration of the rationale for corporate bodies and investors to engage in SLB activity, including the various ownership, management, tax and legal considerations.

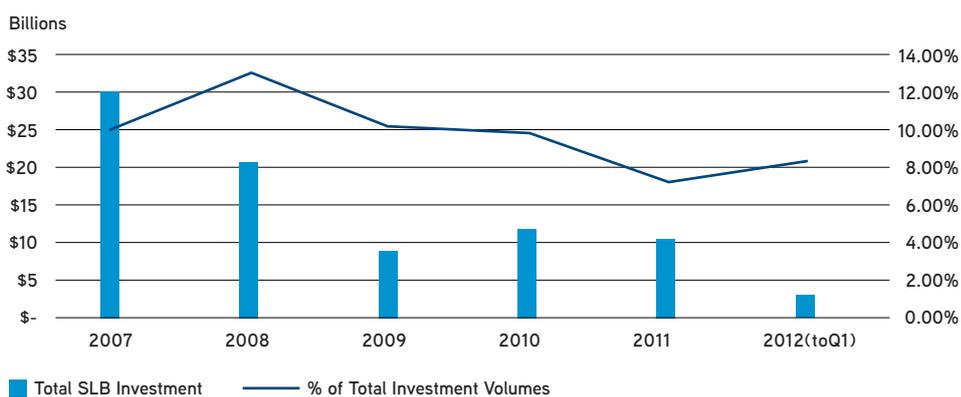
## SLB HISTORY

The potential scope for SLB activity is enormous. According to a research study produced by *Hordijk & Ahlqvist in 2004 (largely consistent with research by Prudential Financial)*, this points to an estimate that corporate bodies hold ca. 83% of the European commercial property market. The remaining 17% represents the volume of invested commercial real estate.

So more SLB activity would actually help deepen the size of the institutional investment market. Coupled with changes in the long held view that 'real estate should remain in corporate hands as a cultural norm', SLBs could become a significant source of investment transactions in years to come.

A combination of restricted credit, muted economic growth and subdued debt provision, makes this an interesting transaction medium at the present juncture of financial, economic and property market cycles. The need for corporate entities to raise cash whilst allowing investors to access secure longer-term income streams, thus enabling better financial terms, is a sound basis for transactions to happen benefiting both parties. So how strongly have SLBs featured to date?

FIG 2. SLBS ACROSS EUROPE: 2007 TO DATE



Source: Real Capital Analytics/Colliers International

## SLBS IN EUROPE

According to data provided by Real Capital Analytics, all forms of SLBs are estimated to have accounted for ca. 10% of all reported, arms' length European commercial real-estate investment transactions since 2007. This figure drops to ca. 7% when only 'standard/full' (i.e. where 100% of space is leased back by the vendor for more than 1 year) SLBs are accounted for.

These transactions do not include owner funded leaseback structures which in domestic markets account for a substantial volume of transactions well above the amounts quoted by Real Capital Analytics. In addition, the European investment market is far from what we would describe as transparent, with large numbers of transactions never being widely reported.

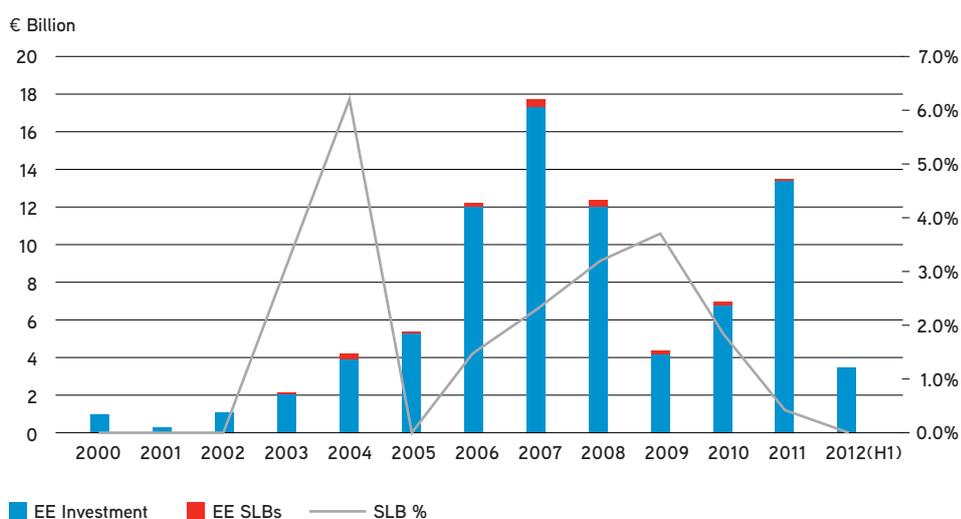
What is interesting to note is the extent to which these reported SLB transactions occurred, at least in proportionate terms, during the post-Lehman crisis times reaching ca. 13% of the market in 2008, falling back to around 7.2% in the more buoyant investment period of 2011. As of mid 2012, the volume of SLB deals in proportionate terms has again started to trend-up, as overall deal-flow and market conditions tighten.

## SLBS IN EASTERN EUROPE

Subject to our caveat regarding owner funded leaseback structures and the lack of transparency or reporting of transactions, SLB transactions have figured less prominently in Eastern Europe over the last decade or so. In fact at only ca. €1.6 billion, the SLB market represents a meagre 4.5% of historic investment turnover – half the proportion of deals conducted across Europe as a whole.

The one consistent trend between SLB transaction activities in Eastern Europe relative to Europe as a whole is the proportionate increase in the volume of SLBs conducted during the end of 2007 to end 2009 – highlighting the potential contra-cyclical quality of SLB transactions - although no SLB transactions have been recorded in 2012 to date.

FIG. 3: SLBS ACROSS EASTERN EUROPE - 2000 TO 2012 (H1)

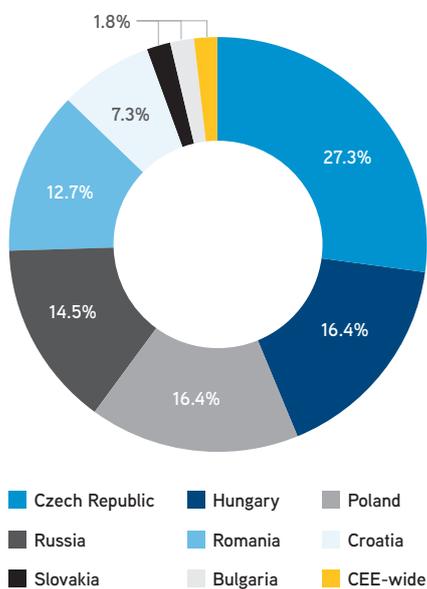


Source: Colliers International

Outside of this period, the only other notable increase in SLBs in Eastern Europe (in % terms) was in 2004. This included some of the largest SLB transactions to have concluded in the region to date, notably the structuring and sale of the pan-CEE Bainbridge Capital Retail Portfolio by Atrium for over €100 million. This portfolio comprised thirteen retail properties located across Poland, the Czech Republic and Slovakia each anchored by either Carrefour or Tesco.

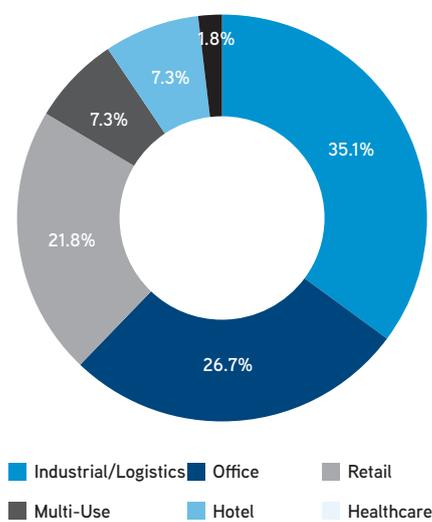
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FIG. 4: SLB SALES BY COUNTRY



Source: Colliers International

FIG. 5: SLB SALES BY SECTOR



Source: Colliers International

## SLB SALES BY COUNTRY

In terms of location, the majority of reported deals have been conducted in the larger Visegrad markets.

- > The Czech Republic leads the way having conducted fifteen SLB transactions, comprising over 27% of all activity.
- > Hungary and Poland have seen an equal amount of deals, nine apiece and account for ca. 17% of all activity respectively.
- > Collectively these three countries (including the Bainbridge Capital Retail Portfolio CEE-wide deal with assets in all these locations) account for 63% of the SLB market.
- > Russia has witnessed a total of eight deals, followed by Romania with seven, which combined make up just over 25 % of the market.
- > Of the remaining 12% only Croatia (4), Slovakia (1) and Bulgaria (1) have seen any direct SLB deal activity.

## SLB SALES BY SECTOR

By sector, we see a significant split in terms of the number of deals conducted.

### Industrial Logistics

The industrial/logistics sector has been by far the busiest sector in the region, conducting close to 35% of all SLB transactions.

- > This has included key deals such as the sale of Kuehne & Nagel's portfolio of Polish properties in 2008, which were acquired by Goodman's European Logistics Fund for ca. €220 million.
- > Other key deals include the sale by Tesco of their distribution centres in Poland, Czech Republic and Hungary in 2009. DEKA Imobilien acquired the facilities in Poland and the Czech Republic; WP Carey acquired two warehouses in Hungary.

### Retail

Retail has been less prominent accounting for only 22% of the market. To many this may be a surprise, but for SLB practitioners, multi-let retail schemes are far more complex than single-let covenants and therefore many retail properties do not lend themselves to SLB structures.

Excluding the Bainbridge CEE portfolio, the only other notable transactions have been:

- > The Ahold portfolio of Czech stores, acquired by Europolis back in 2003, for ca. €60million.
- > More recently, the acquisition of Konzum stores across Croatia by WP Carey in both 2008 and 2010, for an estimated combined €103 million.

### Offices

The office sector accounts for ca.27% of all deals, where notable transactions include:

- > The sale of Konzum's HQ in Zagreb, Croatia acquired by WP Carey in 2010 for ca. €77million
- > The sale of Prokom's office in Gdynia, Poland in 2007 to First Property for ca. €68 million.

### Other Sectors

Other sectors also feature highlighting the potential diversity of SLB transactions. For example:

- > The Medicover private hospital deal, concluded in Warsaw in 2011 for an estimated €40 million was the first of its kind in the region.
- > Equally, the Telefonica portfolio sold in the Czech Republic in 2007 comprised a mix of office, retail, storage, technology and residential uses in 293 properties nationwide, selling for ca. €158 million.
- > There have also been hotel deals, including the sale of the Novotel in Bucharest by Accor back in 2006, which was sold to Sparkassen Immo Invest for close to €30 million.

In summary, it highlights that SLB transactions need not just be associated with the main commercial property sectors. SLBs can be conducted across a variety of sectors, uses and lot sizes and often involve both well-established and specialised corporate and real estate investors, as highlighted by Table 1 below.

**TABLE 1: THE TOP 15 SLB TRANSACTIONS BY VALUE**

Country	Year	Name	Sector	Price €million	Purchaser	Vendor
Poland	2008	Portfolio of K&N properties	Industrial	€ 220,00	Goodman's European Logistics Fund (GELF)	Kuehne & Nagel
Czech Republic	2007	Telefonica Portfolio	Multi-Use	€ 158,00	Bohemia Real Estate	Telefonica
CEE-wide	2004	Bainbridge CEE portfolio	Retail HP	€ 100,00	Bainbridge Capital Retail Properties	Tesco & Carrefour
Croatia	2004	Agrokor warehouse	Logistics	€ 77,00	W. P. Carey International LLC	Agrokor
Croatia	2010	Konzum's HQ	Office	€ 77,00	W. P. Carey International LLC	Agrokor
Hungary	2007	Rynart	Industrial	€ 70,00	Industrial Securities	Rynart
Poland	2007	Prokom Building	Office	€ 68,00	First Property	Prokom Investment
Poland	2004	Daimler Chrysler	Office	€ 65,47	BankhausWölbern & Co. (IFP Erste Immobilienfonds für Polen)	Daimler Chrysler
Hungary	2009	Tesco Logistics Portfolio	Industrial	€ 63,00	WP Carey	Tesco plc
Czech Republic	2003	Ahold Portfolio	Retail hypermarkets	€ 60,00	Europolis Invest	Ahold
Croatia	2008	Konzum Stores	Retail	€ 53,70	Dawnay Day	Agrokor
Croatia	2010	Konzum stores	Retail	€ 49,00	W. P. Carey International LLC	Agrokor
Russia	2006	FM Logistic complex	Industrial	€ 47,81	AIG European Real Estate Fund	FM Logistic
Poland	2011	Medicover Hospital	Healthcare	€ 40,00	Private Investor	Medicover
Czech Republic	2009	Tesco Distribution Centre	Logistics	€ 36,00	DEKA Immobilien	Tesco plc
Poland	2009	Tesco	Industrial	€ 34,00	DEKA Immobilien	Tesco plc
Russia	2008	Alpi City	Retail	€ 31,93	Troika Dialog	ALPI

## Some High Profile SLBs in Europe:

- › Aberdeen's Pan-Nordic Fund acquired the 42,000 m<sup>2</sup> HQ of Swedish Match in central Stockholm for ca. €108 million in 2007.
- › In 2008, Santander sold their HQ near Madrid for €1.9 billion as part of a wider-sell off of Spanish real-estate assets.
- › Also in 2008, Nokia Siemens Networks sold a 50,000 m<sup>2</sup> R&D office centre in Tampere, Finland to Aberdeen Property Investors for ca. €100 million.
- › The same year, Sony Europe and Macquarie Global Property Advisors (MGPA) completed an agreement for the sale and leaseback of eight office and logistics properties spanning six European countries for €121.1 million in 2008. Sony remains the major tenant of the portfolio, leasing back 65% of the property. The properties were acquired on behalf of MGPA's MGP Europe Fund II.
- › In 2011, Mercedes Benz sold their Spanish HQ in northern Madrid for ca. €28 million to Mapfre Inmuebles for a yield of over 6% on a 10-year lease.
- › MWB Group Holdings PLC sold an 80-room Malmaison hotel development in Aberdeen, UK to Aviva Investors Property Trust for £ 16.1 million. Malmaison agreed to lease the property back on a 35 year lease, with 5yr rent reviews, at an initial rent of £1.2 million per year. MWB had previously sold four projects to Deka Immobilien and Legal & General Property for £86.8 million in another SLB deal.

## SLB TRANSACTION ACTIVITY SUMMARY

One of the challenges for SLBs is the (often unfounded) negative perception that conducting a SLB is a final 'last-ditch' effort to raise cash.

During the mid-noughties a number of high-profile SLB transactions were conducted as vendors looked to tap into rising property values across Europe, with deals dominated by activity in Germany and the UK.

For example, HSBC sold their London docklands HQ to Metrovacesa for £ 1 billion in 2007. HSBC then managed to buy the building back from a distressed Metrovacesa for £ 200 million less than they sold it for.

Retailers such as Tesco and Woolworths have sold their assets but with mixed success. Whilst this worked for Tesco and Sainsbury's, allowing them to push ahead with expansion plans whilst retaining some control of the assets and rental terms, Woolworths eventually went to the wall. This was predominantly due to the fact that they sold virtually everything, took money out of the business and agreed to index link rents above market rents. When the market crashed in 2007, their rents kept going up and they were ruined by increasing borrowing costs and outgoings versus declining revenue.

The most recent high profile failure is probably Southern Cross, a UK homecare provider. Blackstone bought the group for £ 162 million in 2004 and floated it in 2006 for £ 423 million with a plan to buy up smaller companies and sell their properties at a profit. The result was a loss of operational control of key assets, resulting in falling occupancy as homes were allowed to deteriorate. They also agreed to restrictive 30-year leases, with rental increases at 2.5% per annum, at a time their demand-base was undergoing cut-backs. The company share price fell to less than 10p in 2011, from above 600p in 2007, and was subsequently broken-up for sale in October of last year. This model was not designed to work through hard times.

Alternatively, Tesco have been one of many successful SLB protagonists regularly disposing of assets as part of a multibillion-pound SLB programme, playing a significant role in their corporate expansion strategy. Some assets were sold into JVs with institutions such as British Land, some were sold into its own pension fund.

With this in mind, it is worth reviewing the many factors which need to be assessed when conducting SLB transactions.

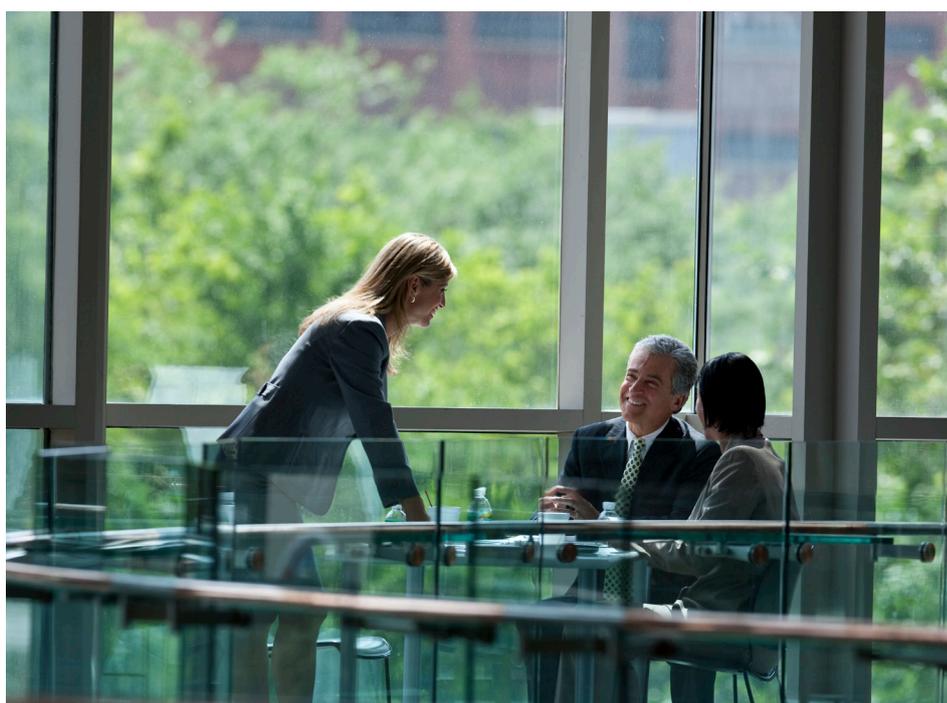
## THE INVESTMENT & CORPORATE DEMAND CONTEXT

It is clear that conducting a SLB transaction requires careful consideration. So what are the main considerations behind the decision making process of both a corporate occupier and investor, in order for them to engage in a successful SLB transaction?

We have outlined the main pros and cons of entering into a SLB transaction below, with further details explaining the background and nuances of each on pages 10-13.

**FIG. 6: CORPORATE DECISION MAKING DRIVERS**

<p><b>Investment/Lending Rationale For</b></p> <ul style="list-style-type: none"> <li>› Low covenant risk (yield/risk match)</li> <li>› Income security/Single tenant</li> <li>› Specific &amp; Specialist Buyers/Lenders</li> <li>› Tax &amp; Legal</li> </ul>	<p><b>Investment/Lending Rationale Against</b></p> <ul style="list-style-type: none"> <li>› Complexity</li> <li>› Prime versus Non-prime /Recourse Limit</li> <li>› Geography</li> <li>› Tax &amp; Legal</li> </ul>
<p><b>Corporate Rationale For</b></p> <ul style="list-style-type: none"> <li>› Medium-term Cash</li> <li>› Limited/No Alternatives</li> <li>› Control Options</li> <li>› Tax &amp; Legal</li> </ul>	<p><b>Corporate Rationale Against</b></p> <ul style="list-style-type: none"> <li>› Management Time</li> <li>› Company Value</li> <li>› Complexity &amp; IFSA Changes</li> <li>› Tax &amp; Legal</li> </ul>



## THE INVESTMENT PERSPECTIVE

The main motivations and considerations for an investor considering a SLB transaction are highlighted below.

THE CASE FOR SLBs	THE CASE AGAINST SLBs
<p><b>1. Strong covenant of 'corporate tenant'</b></p> <p>With a strong covenant from the vendor, an investor will be better able to secure favourable capital financing terms.</p>	<p><b>1. Complexity</b></p> <p>Deals are often far more complex from a business, tax and legal planning context. Buyers need to be patient and knowledgeable in order to see a transaction through. The process may prove too complex and time consuming for some.</p>
<p><b>2. Income Security/ Single-tenant</b></p> <p>Leases longer than the typical 5yr term are possible, with many vendors opting to agree to 10 year terms. This provides an opportunity to secure favourable capital financing terms. Having a single tenant in place should allow for reduced management costs, thus lowering the gross to net discount on income received.</p>	<p><b>2. Non-prime v Prime</b></p> <p>Specialist uses within the property and specialist occupier needs often mean that properties for sale are non-prime, rather than prime institutional grade assets. Specialist buyers are often attracted to the income first and property second, so this can be a drawback for buyers wanting to invest in the property. Manufacturing assets can be particularly specialist in nature. This leads to questions about the nature and extent of potential recourse including guarantees.</p>
<p><b>3. Specific &amp; Specialist Buyers</b></p> <p>Many institutional buyers have been engaged in SLB acquisitions, meaning this is a liquid sub-sector. Additionally, specialist players such as WP Carey enhance the opportunity to conduct an SLB transaction (WP Carey raises US\$50m per month –in addition to their US\$10bn global portfolio).</p>	<p><b>3. Geography</b></p> <p>While assets may be non-prime, the places in which they are located are often non-central which leads to wider covenant concerns where the occupier may fail (alternative tenant/use). This is especially the case for logistics and manufacturing facilities which can be in isolated locations, outside the boundaries of major urban areas.</p>
<p><b>4. Tax &amp; Legal</b></p> <p>*see Tax and Legal Section, Page 14</p>	<p><b>4. Tax &amp; Legal</b></p> <p>*see Tax and Legal Section, Page 14</p>

The main motivations and considerations for an investor considering a SLB transaction do tend to counteract each other, with an improvement in income security via a single-tenant with a strong covenant on a 10yr+ lease term being potentially offset by a lower-grade, non-core property, for example.

We assess the tax and legal considerations in a separate section on pages 14-15 of the report.

## THE CORPORATE PERSPECTIVE

Whilst the investor considerations seem relatively straightforward, there is often greater consideration required on behalf of the actual occupier-vendor to be, as highlighted below.

### THE CASE FOR SLB'S

#### 1. Medium-term Cash

The rationale for an owner occupier conducting a SLB transaction is typically to raise 'medium-term' cash, helping the business to function and/or grow with limited impact on day-to-day operations.

A SLB transaction negates any need to rationalize or cut resources which are otherwise critical for the business. If this cash is put to good use, i.e. returns are generated, it can help to drive a company's share performance over the long term.

#### 2. Alternatives Exhausted

What are the alternatives for companies to raise cash?

For publicly traded companies there is the option to sell shares and/or issue corporate bonds. Selling shares is at the whim of the equity markets and not something which can be controlled.

Corporate bonds have been a very viable opportunity for a number of large corporations (with 2010 & 2011 being very successful for bond issuance). Uncertain market conditions, however, often curtail bond issuance. As of May 2012, global issuance had fallen dramatically despite a positive Q1 in 2012 amidst growing appetite from institutional investors picking up bonds at yields which match their returns.

For privately traded companies, the realistic option for occupiers would be to sell shares in their company, for example on a JV or M&A basis, but this can create operational control issues for the business.

### THE CASE AGAINST SLBS

#### 1. Management Time

A variety of important questions need to be considered in detail by senior management prior to considering the sale of any property assets. For example:

- › Are any major changes of operation or company strategy envisaged – short, medium or long-term?
- › Does the property suit the operational need in terms of size, location, brand image, specification?

The time required could deter some companies from engaging in the SLB process.

#### 2. Company Value

If the value of a company is underpinned by the value of the commercial property assets held, the trading of these assets could well be a non-starter, especially if these assets are held as security for any corporate or other borrowing.

Also, companies valuations of underlying real estate assets are rarely adjusted every year, thus book value may be well below market value, meaning that a latent capital gains tax liability could be incurred on sale.

If market value has fallen and is close to book value, the actual trading of assets may not generate sufficient profit to undertake the transaction. Equally, if debt is held against each of these assets and market value is close or equal to the value of debt held, this will diminish the cash result.

Finally, 'Opco Propco' structures are often viewed negatively as leaving businesses vulnerable in a downturn, especially whereby vendors fail to value freehold ownership adequately.

### 3. Control Options

The major benefits of selling property, relative to selling all or part of the company are that the corporate occupier maintains control over the day-to-day management and planning of the business, especially where the occupier can retain and partially control the use of the space, via the lease terms and conditions which are set out in the sale agreement.

This ultimately gives owners the opportunity to realign their real estate needs with core business needs. If the real estate owned is non-critical to the operational, core function of the business, by structuring an appropriate lease term, the SLB can be a very viable alternative.

This will also minimise the on-going impact on the P&L.

### 4. Tax & Legal

\*see Tax and Legal Section, Page 14

### 3. Complexity and International Financial Reporting Changes

How a property sale and/or leaseback (or leases) are treated in accounting & financial terms can create significant complexity for a SLB being undertaken.

At present operating leases are not recorded on balance sheets, and thus do not result in amortisation charges in the P&L of a company. They do, however, impact cashflow and operational costs before EBITDA.

The International Accounting Standards Board is currently deliberating significant changes to the way in which leases are accounted for. This could involve tenants being required to record assets they lease on their balance sheets, and is likely to further affect key financial ratios such as equity to debt and liquidity ratios. While clear guidance remains some way off, given that the leases entered into now are likely to run for some time, it is important to consider the potential implications, as they will have an impact in the foreseeable future.

### 4. Tax & Legal

\*see Tax and Legal Section, Page 14



## OCCUPIER PERSPECTIVE SUMMARY

The main motivations and considerations for an occupier undertaking a SLB transaction also tend to counteract each other, but clearly require significant operational and financial planning. In addition, as per the considerations of an investor, the tax and legal considerations also require significant thought and advice.

## TAX & LEGAL DRIVERS OF CHANGE

SLB transactions can take a number of forms from a tax or legal perspective. Which is most suitable in particular circumstances largely depends on the starting position and the desired outcome. For example, a retailer may construct its own premises and carry them on the balance sheet of its operating company. On the other hand, it may set up a special purpose vehicle (“SPV”) in which to construct the premises.

As with other property sales, the sale part of the transaction can take place either as an asset sale or as a sale of shares in the SPV which holds the property. The lease would either be with the new owner or with the SPV itself. There are a number of tax and financial considerations which both vendor and purchaser need to take into account when deciding on the most efficient way in which to perform the SLB.

### Property taxes and other taxes

In most jurisdictions, an asset sale would be subject to a property transfer tax charge, similar transfer taxes or stamp duty (for example in the Czech Republic, there is a 3% property transfer tax charge).

Capital gains or corporate taxes could also be triggered if the sale is via an asset deal. These would be calculated on the difference between the selling price and its tax book value. For these reasons, it is often preferable for the sale to take place as the sale of shares in an SPV. Where the seller currently has the property on the balance sheet of its operating company, this may require preliminary steps, such as an ‘Opco Propco’ de-merger to take place.

It is worth noting, however, that when a property is sold through a share deal, capital gains or corporate taxes are not typically triggered immediately and the existing tax value of the property is taken over by the new owner. This has two significant implications:

- > first, the tax shield provided by the property is significantly lower than its market value, which means that the new owner will not be able to fully deduct for tax purposes the amount it is paying for the property;
- > second, if the property were subsequently sold in an asset deal, a substantial taxable capital gain could be realised.

These factors can give rise to a latent capital gains tax discount.

### Structure of the lease

Typically the lease would need to be signed concurrently with the sale transaction. If an SPV is being sold, this would normally give rise to a related party transaction. Such transactions are subject to transfer pricing regulations, and need to be demonstrated to be on an arms’ length basis.

It is also worth noting that any lease incentives negotiated as part of a SLB transaction are accounted for and taxed by spreading their impact over the lives of the underlying leases. If a SLB transaction takes place where an incentive such as rent free is granted, the buyer could end up initially paying taxes on income which does not generate any cash.

The VAT treatments of both the sale and lease legs of the transaction also need to be considered. In particular this is important if there is a VAT exempt sale of the property, or if the lessee is restricted in its ability to recover VAT paid, for example a bank.



### TAX & LEGAL SUMMARY

The extent of the challenges and considerations from a tax and legal perspective, are numerous. This highlights the need for the involvement of an independent expert at some stage in the process, ideally at the earliest opportunity.



### LONG-TERM MANAGEMENT & CAPITAL COSTS

One other, longer-term consideration in the SLB equation from a vendor's perspective in particular, is the ongoing need for property management and capital expenditure concerning assets which are currently owned.

The ownership, management and administration of real estate can often be burdensome and expensive. It can also be costly without the right skill-set and resources in place to repair, upgrade and manage the property assets.

Looking further forward, EU Regulations on the need for energy efficiency compliance of all commercial real estate will require owners to undertake renovations in order to meet minimum energy requirements. Such energy efficiency needs are being implemented into the national legislation of each EU country during 2012 so that all new buildings, and some older buildings, move toward a 'nearly Zero Energy' target by 2020.

Even though this may not be a realistic target, the EU strategy will continue to push the requirement for energy efficient commercial stock. This additional requirement, especially the time, skills and costs required undertaking the process of renovation and management could lead to many owner occupiers disposing of their assets.

## CONCLUSION

Although SLBs can be more efficient than bank borrowing for many an occupier, particularly in the current climate, deals must be properly structured allowing for the transaction to work long-term for both parties.

### Vendor-Occupiers

The money raised by the vendor clearly needs to be invested back into the business – with at least enough cash in place to cover the new rental costs. Most problems seem to occur with SLBs when businesses either agree to too high rents and/or poorly structured lease terms and conditions, but proceed to take the money (receipts) out of the business.

Such deals clearly require expert advice from a real estate, operational, tax and legal planning perspective in order for them to be successful.

### Investors

As for the investor community, the ability to secure assets with a strong income profile fits with many a core strategy in the current climate.

Given that SLBs typically account for 10% of all transactions in Europe, but only ca. 4.5% of known transactions in Eastern Europe, this suggests there is capacity for growth in these type of transactions. This is particularly the case under current financial market conditions.

### Owner-Occupiers

Interestingly, on the flip-side of SLBs, current market conditions provide an opportunity for owner occupier sales to be conducted as many corporate institutions are in a strong cash position. With an estimated US\$1,900 billion of cash sitting 'idly' on corporate balance sheets of non-financial companies in 2011, according to the Financial Times, there is cash waiting in the wings for fresh acquisitions. According to analysis from HSBC, corporate debt to equity is now at its lowest level for 20 years and in the US markets cash represents the biggest proportion of total assets than at any time in the past 50 years.

Whilst many companies wisely sit on a solid cash buffer as they demonstrate lessons learned from the previous crisis, current property market conditions make this an attractive time in the cycle to consider owner occupation.

For those that are not so cash-rich or considering a strategic shift in their business, SLBs present a very viable alternative to raising cash.



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