Solving the surplus: Leasehold liability transactions

Nicholas Cheffings and Laura Oliver offer an answer to the problem of surplus leasehold liabilities.

Leasehold properties become surplus to requirements for any number of reasons: individual stores become unprofitable; changes in working practices mean less office space is needed; or a takeover means rationalisation.

Deciding that a leasehold property is not needed is rarely the end of the story. If the end of the lease term is not imminent, the business may have to carry on paying rent and other outgoings for years. The problem is that surplus real estate tends to receive little attention at board level – but it is a real cost to the business.

The solution

With active management, it may be possible to negotiate piecemeal surrenders with landlords. Third parties may be interested in taking on all or parts of the properties. There may also be rates saving schemes available which could reduce some of the overhead cost.

It is, though, very rare that the business itself will be best placed to secure these deals once the easy wins have been taken. In addition to the management time required, the necessary expertise does not usually exist in house. So what is the solution? It may be a leasehold liability transaction (LLT), where the business outsources the problem to a specialist manager. By carefully structuring the outsourcing, a third party is incentivised to reduce the liabilities swiftly and with maximum long-term benefit for the business.

From an accounting perspective, the effective disposal of lease liabilities at one hit (as opposed to over a protracted period by way of single surrenders and assignments in difficult markets) provides increased certainty, the removal of market risk and possible tax efficiencies.

How it's done

The business makes a capital payment or series of payments to the manager which, in turn, takes responsibility for all of the business's obligations under the leases. The parties enter into a management agreement under which the manager contracts to fulfil those obligations and is given a power of attorney to enable it to do so. As a matter of law, the business remains the tenant under the lease and so the landlord is unaffected. In practice, it is the manager that deals with the landlord in relation to all aspects of the lease and the property.

The capital payment is often paid by instalments reflecting the decreasing liability over time. Essentially, the transfer price is assessed by reference to a best estimate of the cost to settle the various leasehold obligations. The gross liability is the cost of rent and other outgoings under the leases plus a sum for the inevitable dilapidations liability. Against that, one sets off estimated rental income from subletting, making allowances for void periods, rent-frees, anticipated rental changes and the like. The resulting net liability is based on accounting provisioning.

The primary risk to the business is that the actual liability under the leases proves to be higher than the payment made to the manager. This can be covered off by careful staging of payments and the use of charged accounts and restrictions on the manager making distributions to shareholders. In effect, the manager is backing itself to beat the provision. It works like this: if the gross liability is £40m, the business might pay £27m to the manager and the manager might be able to pay down the liabilities for £25m. So, the business saves money, as well as the hassle, and the manager makes £2m profit.

Who's doing it?

The precise requirements of the business dictate the terms of the transaction, but the starting position will always be a reasonable number of surplus leases which have proved, or may prove, difficult to eliminate. For this reason, the businesses involved tend to be large household names, including Whitbread, B&Q and Santander.

According to Charles McKendrick, Morrisons' Director, Estates and Asset Management, its key driver was "risk mitigation in a cost-controlled way" which allowed the company to refocus its in-house resources on high-value-add areas. McKendrick added: "The portfolio was diverse with a range of short- and long-leasehold tenures, tenants and locations. Surplus Property Solutions (SPS) has dealt with the portfolio much quicker than we would have achieved ourselves with eight of the 12 long-leasehold properties dealt with in the first year, and the gross liability for the long-lease element reduced by 87.5%."

These transactions have also proven popular with public and quasi-public bodies which need to reduce their overheads, including the Department for Business, Innovation and Skills (BIS) and Royal Mail.

Roger Taylor of UK Shared Business Services structured an LLT for BIS in 2014 as part of its major estate rationalisation programme. This was a first for government. He said: "It has proved to be a successful innovation that has delivered in excess of what the business plan projected. There were a number of reasons for taking this approach, including time, available resource, and some challenging interests, which expert asset managers such as Greenhills had the skill and knowledge to resolve in ways which we did not."

Tellingly, he added: "As we look at further estate rationalisation, this is certainly an approach that I would consider once again where it is appropriate." He is not alone in thinking this way.

The market has developed over the years and there is now a specialist pool of managers with dedicated resource, experience and track record: notably SPS, Greenhills and Legacy Portfolio. A key ingredient for success is a relationship of trust between the manager and the business. Reputations must be protected. The fact that LLTs have been quietly growing in popularity and have been successfully used across a range of sectors and asset classes is a testament to their value as a viable solution to a very real problem. Expect to see more of them.

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Nicholas Cheffings
Chair, London
T +44 20 7296 2459
nicholas.cheffings@hoganlovells.com

Laura Oliver
Senior Associate, London
T +44 20 7296 2000
laura.oliver@hoganlovells.com