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Releasing Value from Complex Assets

As companies face increasingly complex disposal situations we examine the options, opportunities, risks and potential solutions available.

Introduction

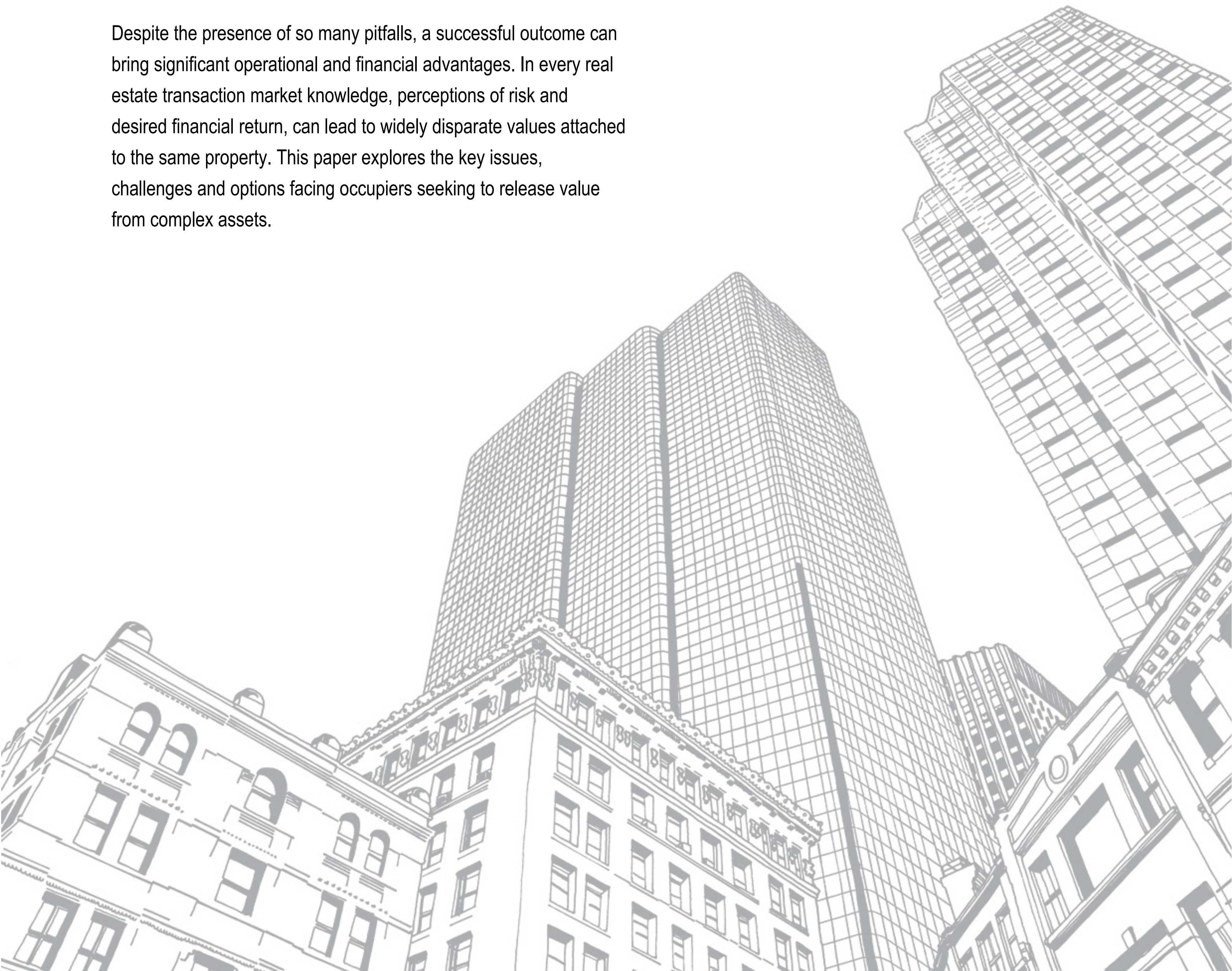
Companies are under greater pressure than ever to drive increasing value from their real estate portfolios. For those companies with portfolios containing complex assets – such as R&D, manufacturing and industrial facilities – releasing value from real estate can present an array of challenges. Increasingly companies are assessing a range of options from ‘commercialising’ just one or two buildings on an on-going operational site, to entire R&D and manufacturing sites.

Such ‘complex’ assets or sites are often owned freehold, may have been held for a long period of time and are frequently bespoke facilities. Disparities between land and book value may be significant and there may not be an obvious target market for disposal. In short, disposal of such assets can be problematic.

Despite the presence of so many pitfalls, a successful outcome can bring significant operational and financial advantages. In every real estate transaction market knowledge, perceptions of risk and desired financial return, can lead to widely disparate values attached to the same property. This paper explores the key issues, challenges and options facing occupiers seeking to release value from complex assets.

Specifically it aims to:

- Outline the factors driving the disposals.
- Examine the operational and real estate issues encountered in a full or partial exit.
- Assess the options for exit, the pros and cons of each, as well as issues and solutions.
- Demonstrate the issues, challenges and solutions through case studies.



What are the business drivers?

A wide range of factors are driving occupiers to analyse real estate portfolios and explore the release of value from any surplus assets. Although these drivers can vary enormously by business and economic sector, some of the drivers are common to all.

Globalisation and emerging markets

Companies are increasingly facing the need to adapt their real estate footprint to new economic realities. Historically the majority of R&D activity and manufacturing activity occurred in the US and Western Europe. This situation continues to change irrevocably. Emerging markets, most notably China and India, not only present growth opportunities, but also prospects for lower cost locations for manufacturing, and increasingly research and development (R&D). We are also seeing firms expand into Russia, Latin America and Africa as companies seek to access growing domestic markets. Many firms are recasting their portfolios to adapt to these emerging geographies, taking advantage of the opportunities to place business processes and functions offshore where possible. Moves such as these inevitably create surplus assets as the corporate geography is reset.

Cost reduction and increasing operational efficiency

The next decade will see closer attention and scrutiny of corporate real estate portfolios than ever before. The global economic crisis has forced companies to analyse and understand all areas of their expenditure. Real estate – given its typical standing as the second greatest business cost – is no exception. Cost reduction will remain a crucial consideration going forward, although the focus will shift steadily from immediate, short term and direct cost saves to some targeted investment aimed at longer term cost avoidance.

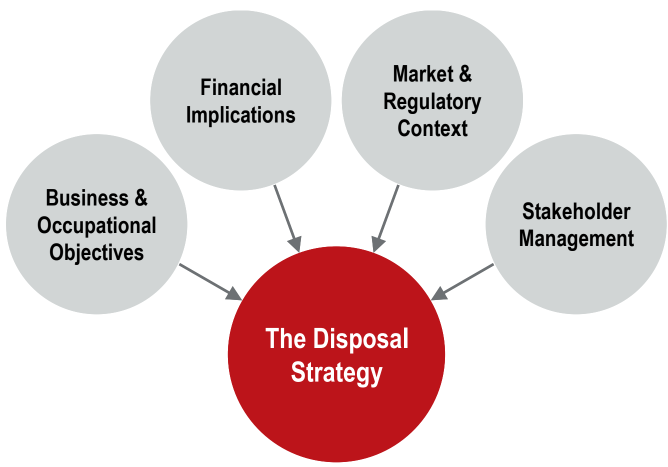
Evidence of this pressure on costs has been seen across all sectors over the last 18 months. Head count reduction and the restructuring of operations has been seen from pharmaceuticals to consumer goods to the oil and gas sector, with many of the largest companies such as BP, Unilever and GlaxoSmithKline publically announcing efforts to reduce costs and drive greater efficiency from their operations.

Mergers, acquisitions and collaboration

Mergers and acquisitions (M&A) is a further key driver behind the need to dispose of complex assets. M&A activity often has a transformational impact on real estate portfolios, particularly for businesses with significant R&D, manufacturing or industrial assets. As companies seek to consolidate their assets and realign business processes and functions, including outsourcing parts of their traditional business processes, the need to dispose of surplus assets is often acute. The pharmaceutical sector in particular witnessed a spate of multi-billion dollar 'mega-mergers' in 2009, with large global firms combining operations. In these cases real estate teams have seen the size of their portfolios virtually double overnight. Once again, the requirement to dispose of complex, and now surplus assets, looms large. In addition to such large scale strategic M&A activity, smaller tactical acquisitions also consistently present challenges for Real Estate teams to dispose of surplus assets. Collaboration projects or joint ventures can also create similar challenges for real estate.

Decision Criteria – Key Issues to consider

So what are the key issues to consider when evaluating whether and how to dispose of a complex site or asset? The reality is that there are a multitude of factors to consider before finalising a strategy and solution for exiting or disposing of such a site or asset. These factors can be divided into four main groups, which are explored below:



Business and occupational objectives

A firm's occupational strategy and objectives are the first critical factor in the decision-making process; ensuring alignment between the asset disposal strategy and broader business objectives is crucial. There are a number of further issues to bear in mind:

- ***Operational integrity*** - Operational integrity is a fundamental concern. Should either a full or partial exit be considered, will this have any effect on operational integrity and security? How will the strategy impact any ongoing business operations? How can operational integrity be protected in such cases? How can the business be reassured that sharing their sites with third parties will not present unacceptable risks?

- ***Risk profile*** - Are you seeking to extract maximum value or just exit quickly? What is the balance between financial and risk priorities? This is a critical balance to determine with the decision makers at the outset.

- ***Timing / phasing of final decision*** - What are the time constraints or preferences? How does this impact on the solutions available? How does the balance between operational imperative and market demand impact upon this?

- ***Legacy, PR and CSR issues*** - How important are legacy issues? How will the disposal strategy impact the firm's PR strategy? Will it be possible to mitigate any adverse impact on CSR objectives?

Financial implications

The financial implications of any course of action make up the second crucial factor on which any disposal strategy will be based. Over the past 18 months sensitivity in this area has been significant, often acting as a break on activity even if such activity is likely to bring longer term savings. There is now growing evidence that a more strategic approach to cost-reduction is returning.

- ***Implications today and tomorrow*** - What are the financial implications of the various options now and in the future? How does this impact project timing or phasing?

- ***Maximise value, minimise liabilities or both? -*** How important is maximising value or releasing cash from disposal? Is the need to minimise liabilities more important? How is vacant property or non-operational real estate impacting your balance sheet?

- ***Cost of write down*** - What is the current book value? How does this compare with the market value?

- ***Willing to pay?*** - Often there is a need for investment and capital expenditure in the short term to achieve exit. What is the realistic cost & payback? What will the businesses appetite be?

- ***Taxation –*** What are the tax implications of the disposal strategy? Are there any capital allowances available? How does leasehold or freehold ownership impact this? How will VAT and stamp duty affect the costs and strategy? What impact will a disposal have on R&D allowances?

Market & Regulatory context

The market context comprises the third crucial aspect of the decision-making process. Market conditions will shape the strategy, timing and solutions considered. Thinking creatively about how to meet market demand and requirements is vital when dealing with complex disposals. Some of the factors to consider include:

- ***Who is your market?*** - Is there demand for the preferred solution? How many potentially interested parties? What if there is no demand for the current use? Is demand testing necessary?

- ***Specialist solutions*** - Who are the specialists that deal in this type of asset? What are their pre-requisites and objectives?

- ***Planning and change of use opportunities -*** Sometimes a change of use can have a positive impact on capital receipts but may impact negatively on project options and timeframes. What is the business appetite here?

- ***Licensing, regulatory framework and decommissioning*** - The legislative framework has the intention that the polluter pays. Should you prevent more environmentally sensitive types of land use thus minimising ongoing liability? What statutory restrictions would there be as a result of contamination issues? Would you need to remediate yourself or leave this to a potential purchaser?

- ***Need to sell to right purchaser -*** Some corporates are reluctant to sell for residential use, due to possible contamination issues. Other groups are uncomfortable selling to an SPV due to a potential lack of accountability in the long term. Would you sell to a competitor?

Stakeholder management

Identification and management of stakeholders, both internal and external, is the final crucial stage of the decision-making process. There is often a wide range of individuals and organisations directly or indirectly impacted by large scale disposals of complex assets. A thorough analysis of who these stakeholders are, how best to engage them and a clear strategy to mitigate the external impacts of the agreed course of action are essential to achieving a successful exit.

- ***Stakeholders - who are they?*** - Early engagement with the local authorities is often crucial. How does the strategy impact employees or the wider community and area? How will the various options for disposal affect PR, ethical and CSR objectives?
- ***Full or partial exit?*** - Is a full exit desirable or realistic, in terms of a complete sale versus an ongoing commercial involvement of the site, such as through a joint venture? Is it possible to walk away and how important is this?
- ***Risk / timing / phasing –*** How does the timing or phasing of the project impact stakeholders? Does this increase the risk?
- ***User profile*** - Occupiers and vendors are often mindful of the profile of any new user and how this impacts stakeholders.
- ***Heritage, legacy and environmental issues*** – What are your objectives in terms of heritage, legacy and the environment? Do the disposal options align with these? Is an absence of ongoing environmental liability a key priority? Is this achievable? How important is the history of the site and its connection to the local community?

The criteria above illustrate just some of the many key issues that need to be considered as part of the strategy development process when dealing with surplus assets. In addition to these there are many technical issues which are also important considerations. Figures 1 and 2 look at two pertinent examples of such issues: accounting implications and empty rates.

On the following page we look at some case studies from GlaxoSmithKline. These highlight some of the often unexpected challenges encountered when disposing of complex assets.

Figure 1: Accounting implications

In an environment of extreme corporate sensitivity to costs and capital expenditure, clarity on the financial and accounting implications of surplus space is critical. Key considerations include:

- International Accounting standard (IAS) 37 requires that a provision is made when leased property becomes surplus, which will mean an up front hit on the P&L.
- The provision should be the best estimate of the expenditure required to settle the obligation at the balance sheet date.
- If an asset becomes surplus as part of a restructuring then according to IAS 36 the asset may be impaired (i.e. its book value may be in excess of its net selling price and its value in use) and an impairment loss should be recognised.
- Assets that are held for sale are presented separately as current assets in the balance sheet under IAS 5, and are no longer depreciated. To be classified as such the following conditions must be met:
    - Management must be committed to a plan to sell
    - The asset must be available for immediate sale
    - An active marketing programme to sell at a reasonable price must be underway
    - A sale must be highly probable within 12 months

Figure 2: Empty rates in the UK

Since the introduction of the 2007 Rating (Empty Property) Act, holding vacant space in the UK has become more onerous and costly.

- Since implementation of the Act on 1 April 2008 full rates are payable on any vacant office/retail space after an initial 3 month void period (as opposed to 50% previously) and 6 month void period for industrial/warehouse (as opposed to nil previously).
- Empty rates will apply in most cases unless the assessment is deleted from the Valuation Office Agency's Rating List, exceptions include listed buildings and those with rateable values of less than £15,000 (2009/10 rate year only)
- Section 44a may allow temporary rate relief on partially occupied space.
- Reoccupation strategies may be able to mitigate empty rate liability.

Case Study: GlaxoSmithKline

Over the last 10 years GSK has had to deal with in excess of 15 surplus manufacturing or R&D sites across the UK. Of those, 7 are current projects and all have involved the range of issues identified throughout this paper.

In particular, the disparity between book value and exit value, depreciation and tax issues have all had a major impact on the solutions adopted. The 3 case studies below also demonstrate that, for a portfolio of varied sites, one size does not necessarily fit all as, in this case, a number of differing exit routes have been employed over time.

Beckenham

Beckenham provides a good example of how planning constraints and organisational change can shape different solutions over time, even for different parts of the same site:

- In this case part of the site, the original R&D facility, was sold over 10 years ago with GSK having to prove then that there was no demand for the facilities to underpin the change of use to residential.
- This process was undertaken at the time by GSK with the benefit of a larger, UK-focused real estate team and stands in direct contrast to the current strategy for the remainder of the site.
- With an extended global mandate and smaller real estate team, GSK are now seeking a purchaser who will take the planning risk for the remaining biotech facility, as opposed to taking on the process themselves.

Dartford

From an environmental perspective, GSK's Dartford site presented a number of challenges around remediation:

- Questions over who would remediate the site, and to what standard, ended in a decision to retain the landfill site, where in other cases sites have been remediated and then sold.
- In such cases, the level to which a site is remediated has frequently been an area of concern, particularly when there has been planning uncertainty over a change of use.
- Attempts to market and sell parts of the site have also presented challenges, with GSK faced with the prospect of retaining and managing part (but not all) of the site.

Greenford

Finally, at the company's Greenford site, a more unusual issue was encountered:

- With the site designated as the organisation's registered office, it was found that the cost to move the official registered office could potentially reach almost as much as the value of the land itself.
- This unexpected financial implication has impacted significantly on the options available to GSK and illustrates the hidden challenges that such disposals can bring.

Options and Solutions

The options and solutions available will vary significantly whether a company wishes to partially exit or fully exit from the site in question. We assume at this stage that all options to dispose of sites as going concerns have been explored and discounted and therefore only real estate options remain. It is common, however, for both business/operational and real estate disposal strategies to be explored simultaneously.

The business drivers, real estate market and regulatory considerations will significantly drive the optimal site disposal route. However the number, type and location of the assets will also help to shortlist the options. With surplus assets there is the option to 'bundle up' a number of assets into a portfolio for disposal, or alternatively the asset can be considered separately and disposed of on an individual basis. With the portfolio disposal route and the single site disposal route there are a wide range of alternative options, these options are shown in Figure 3 below.

Portfolio Disposal route

In first considering the portfolio disposal route, there are a number of critical points to consider:

- ***Number of properties*** – does it constitute a relevant "bundle"?
- ***Geographical distribution*** – are they too dispersed to realistically be disposed of in a single portfolio – e.g. single assets across multiple countries or regions?
- ***Asset type across the portfolio*** – is there a very broad range of office, R&D and manufacturing facilities?
- ***Potential buyers for the distribution and type presented in the portfolio*** – are there viable buyers within the real estate market once business purchasers have been discounted?
- ***Corporate appetite*** – with a certain amount of management time and risk taking required, does the business have the appetite and desire to pursue this route?

Figure 4, opposite sets out the pros and cons of the portfolio routes along with a high level "Red-Amber-Green (RAG)" analysis, to help further aid decision making.

Essentially portfolio routes will only be relevant where there are a number of assets with a commonality, generally in terms of geography but also in terms of asset type. These routes may provide an effective route to maximizing value or shortening the timeline from multiple disposals, whilst the key downside will be the investment required to achieve the solution, in terms of both capital and time.

Figure 3: Options and Solutions

Portfolio Options			Single Site Options				
Development Company	Joint Venture	Portfolio Sales	Joint Venture	Asset Work out	Sale & Leaseback	Straight Sale	Lease
Create vehicle to own surplus assets – sell vehicle	Bring in development partner. Sell assets at current value into Joint venture vehicle, participate in upside	Work out assets and undertake Portfolio sales	Bring in development partner. Sell assets at current value into Joint venture vehicle, participate in upside	Take through planning and change of use then sell with benefit of consent	Sell overall site and lease back for short term or only partially	No operational consideration – sell	initially let to 3rd part – then either hold or sell

Figure 4: Portfolio Options

	Development Company	Joint Venture	Portfolio Sale
Pros	High value potential High level of control Significant investment	Opportunity to maximise value through JV partner expertise and resource, whilst sharing in value	Opportunity to maximise value and then exit completely May involve less resource than a number of individual sales
Cons	Intense resource required Can take time to see results	Have to give value share to partner Short term resource investment in setting up but on-going commitment passed to partner Not core business Takes time to exit	Intense resource required initially Can take time to see results
Risk reward			
Capital Investment			
Level/Timing of Exit			
Timing			
Resource			

Single Asset Disposal

Assuming a portfolio disposal route has been discounted or is not relevant, the single asset options should be considered, whether across multiple sites or for a single asset as appropriate. The same evaluation process can be used across multiple sites, geographies and asset types, albeit the decision criteria may vary.

A base case should be established for each site, in terms of one or both of the following:

1. Mothball – decommission the property and hold; or
2. Demolish and hold.

In considering these options, the financial analysis needs to take into account the facilities management costs resulting from mothballing, the total savings obtainable (and business rates in the UK) versus the costs of demolition.

Alongside the financials, corporate image concerns must be evaluated as these two options are both likely to have a negative impact in terms of public and government perception, unless there is a real possibility of re-use in the future.

The single asset disposal options, pros, cons and RAG are included in Figure 5, whilst some of the key factors necessary for successful joint ventures are detailed in Figure 6.

Figure 5: Single Site Solutions

	Joint Venture	Asset Workout	Sale & Leaseback	Straight Sale (unconditional)	Straight Sale (conditional to planning)	Lease to 3rd Party
Pros	Opportunity to maximise value through JV partner expertise and resource, whilst sharing in value	Opportunity to add value	Opportunity to maximise value, then maintain operations in part or all Quick to deliver Less time	Can be very quick Uncomplicated Little resource required	Opportunity to maximise value Potential to secure overage payments post-planning	Limited resource required Opportunity to sell investment
Cons	Have to give value share to partner Short term resource investment in setting up Takes time to exit Not core business	Need specialist resource to effect workout Can take time to see results Not core business	Swap capital for operating expense (subject to covenant strength)	Value likely to be lower Potentially conditions more onerous on Vendor	Higher risk Reliant on ability of purchaser to deliver planning consent Timing potentially extended	May be limited leasing market for existing use Possibly incomplete exit May need fit-out/capital expenditure
Value						
Risk						
Capital Investment						
Level of Exit						
Timing						
Resource						

Figure 6: Key factors for a successful Joint Venture

Based on our experience of joint venture agreements, an example of a joint venture could be as follows:

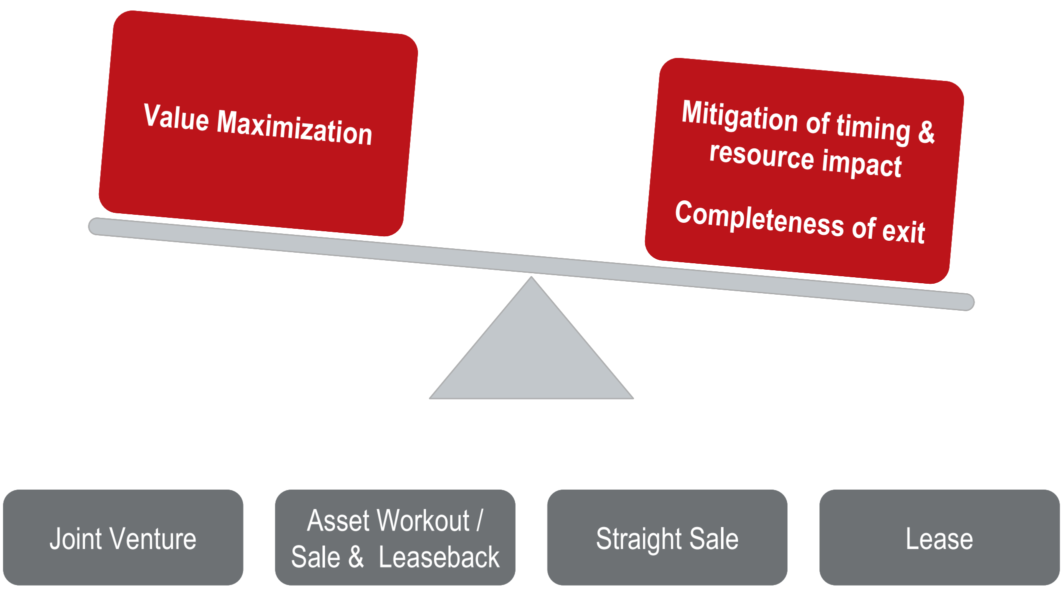
- Agreed business plan and master plan
- Agreed economic objectives
- Opportunity to maximise land value at time of planning consent
- Developer spends the potentially substantial cost of procuring planning consent
- Site Revaluation on receipt of planning
- Developer receives 'gifted' interest and option to buy up to 50% of Land / Shareholding

Getting the right balance

As our analysis highlights, there are a multitude of factors to consider when embarking on a complex disposal process. Getting the right balance for your specific organization and asset is often challenging - but critical to an optimal outcome.

Options can be initially shortlisted by analysing the key decision drivers and although each individual situation will have a different balance between the drivers, the balance usually lies between value maximization and time/resource mitigation.

One thing that is clear is that the factors driving disposals of complex assets: globalisation and expansion into emerging markets; corporate restructuring and change; and the need to drive greater value from real estate, are unlikely to change in the short or medium term. Those who address these issues proactively, partner with industry experts and plan portfolio strategy alongside the wider business are likely to outperform competitors in the years ahead.



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July 2010
Advance publications are topic-driven white papers from Jones Lang LaSalle that focus on key real estate and business issues.

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