Public sector leads way in property outsourcing

Property sale and leaseback is becoming one of best ways of releasing funds for business, and the UK government is leading the way, says Michael Medlicott of Servus.

For the corporate treasurer, property is emerging from being largely a constraint, to being a potentially attractive source of funds, which can be re-invested in the core business or returned to shareholders. The UK government has led the way with two major property out-sourcings for the Department of Social Security (Project PRIME), and the combined estates of the Inland Revenue and Customs & Excise (Project STEPS). The private sector is now following the government's lead with banks and telecommunications companies at the forefront.

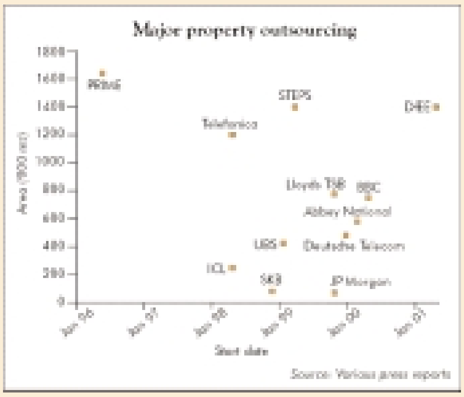
The government has signalled a major shift in its property strategy, which is being implemented through a series of public-private partnership (PPP) transactions. In June 1997, the review of PFI by Sir Malcolm Bates concluded that, "government bodies are moving from being owners and operators of assets into becoming intelligent purchasers of long-term services." The Bates review signalled that, in principle, the government is moving from owning or leasing offices to buying property services. The government is no longer directly interested in bricks and mortar, but instead wants flexible space in which to carry on its core activities effectively.

The sale of government offices in this manner is consistent with the 'Third Way' and its pragmatic focus on managing to achieve solutions that work by combining the best of the public and private sectors.

New approach

In April 1998, the government executed Project PRIME, which was the out-sourcing of almost all of the DSS' office estate of 1.64m square metres spread over 700 offices, 16% (by area) of the total government civil estate. The DSS transferred the ownership and management of this estate, including the ownership of the freehold premises, and responsibility for rental costs, dilapidation liabilities on leased buildings and the costs of upgrading the buildings. The DSS retain rights to occupy the estate for 20 years. The private sector will operate the whole estate in that period, providing services including cleaning, maintenance, catering and security. The DSS' payments can be reduced in the event of poor performance or buildings becoming unavailable. Unlike a conventional property lease, the DSS may vacate without charge up to 35% of the estate during the contract, including 10% of the estate which was declared surplus at the start of the contract, and may vacate a further 10% on making a payment.

FIGURE 1



The report from the National Audit Office (NAO) on Project PRIME concluded that the transaction would reduce the DSS' accommodation costs by 22% or £560m (on an NPV basis) over the contract period. The transaction involved an up-front payment to the government of £250m.

Following the success of Project PRIME, Inland Revenue and Customs & Excise are on course to outsource their combined estate in April 2001. They are looking not only to cut costs, but also to realise an upfront payment of £220m, and to enhance their flexibility by freeing themselves from limitations imposed by their current estate and removing for senior management the distraction of property.

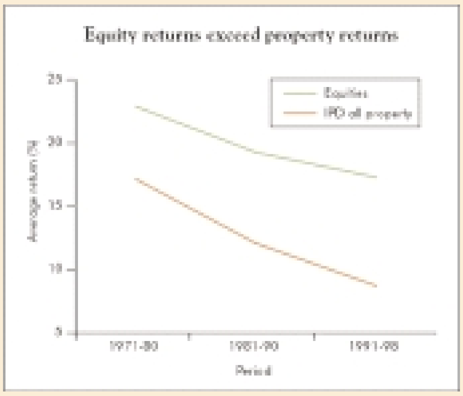
Michael Medlicott

Other public sector deals are in the pipeline, reflecting a pragmatic focus on improving efficiency. Earlier this year, in *Public-Private Partnerships: the government's approach*, the Chief Secretary to the Treasury, Andrew Smith, wrote, "In the modern world, governments are judged, not on what they own, or on how much they spend, but on what they deliver".

A new market for total property solutions

As a result of the PRIME and STEPS projects, and the interest that they have generated in the private sector, the government has created a new market for total property solutions (the out-sourcing of the ownership and management of office estates). The players created by this new market, such as Servus, Trillium and Mapeley, are a new type of company, which efficiently transform legacy estates into flexible space for clients by integrating capital, property management and facilities management (FM) delivery into

FIGURE 2



a single cost-effective package. Investment banks are able to shoulder the major risk transfer entailed by a deal of this type and have taken a lead in establishing these companies with the necessary operating skills in the property and facilities management arenas.

PRIME and STEPS have given UK companies a leadership position in this new market, and the total property solutions providers are now seeking to expand their activities and are marketing to local authorities and major corporates.

Private sector following the public

The private sector is only starting to recognise this opportunity to increase operational flexibility; to cut costs by integrating facilities management and property under a single professional team; and to support their share price by releasing under-employed capital. As properties are typically 35-40% of the fixed assets of FTSE 100 companies there is clearly a significant opportunity. This option, together with the financial, tax and strategic implications, are being tested in the marketplace by major UK organisations, which include Lloyds TSB and the BBC. A leading role is being played by commercial banks who, like the telecom companies, are finding that they have too much property which, in many cases, is in the wrong place and is not necessarily right for the business to go forward. Banks are also subject to considerable cost pressure and need to change their business model as a result of competition from internet and phone based banks.

While the private sector is following a template pioneered by the public sector, it is improving upon the public sector deal process. Although the NAO was satisfied with the procurement process for Project PRIME, the process took 18 months and the aggregate cost to the final three bidders was £27m. The private sector has shown that it can streamline this type of procurement very considerably by, among other things, simplifying the decision-making process and providing bidders with more comprehensive, better-organised and more reliable due diligence information.

The UK is leading Europe

Property out-sourcing is being explored by foreign governments along with a number of other types of PPP pioneered in the UK. Pressure to reduce government budget deficits in order to meet the Maastricht guidelines and the reduction in economic instruments open to governments as a result of Emu all increase the attractiveness of realising capital currently tied up in property. However, in a number of continental countries, the difficulties of shedding labour may favour a transaction in which the facilities management functions are maintained in-house, but ownership of freeholds and responsibilities for leaseholds are outsourced.

In the private sector, the US is leading the way and is the home of a number of significant corporations such as Sara Lee which are light in physical assets, but outsource many of their requirements, including property. In general, UK corporates tend to be more asset-rich and this is even more true of continental companies.

However, the increasing focus throughout Europe is on returns on equity and adding value for shareholders which is leading to a re-assessment of which assets a corporation wishes to hold on its balance sheet. The *Wall Street Journal* Europe quoted the chief executive of Daimler Chrysler AG's real estate unit as saying, "The German philosophy used to be that real estate was a capital reserve. But now property is increasingly seen as a profit centre." However, as a profit centre, property normally underperforms the core business.

This focus on property is resulting in property sales. Deutsche Telekom has announced that it will sell real estate assets worth around £700m. Deutsche Bahn AG is looking to sell workers' housing and is developing surplus properties in prime areas of Frankfurt, Hamburg and Munich. Siemens AG has founded a corporate unit to actively manage its DM3.5bn German real estate portfolio. In May, retailer Metro AG put DM5.4bn of real estate into a joint venture with Westdeutsche Landesbank.

The re-evaluation of property is most obvious among telecom companies, such as Telefonica and Deutsche Telecom who have large property holdings which, due to the reduction in size of telephone exchanges and computerisation of administration, are often in excess of current needs. They are looking for ways to release funds which can be invested with the prospects of high returns in their core business, while retaining flexible accommodation.

The financial cost of holding property

The divergence between the return expected from equity investments and the return generated from the IPD All Property Index (a broad index of returns from institutional property in the UK) reflects a major driver behind the demand for total property solutions.

The message that holding property can have a financial cost is confirmed by benchmarking property sales as a method of raising capital with an alternative of issuing corporate bonds. Although not a perfect comparison, it is interesting that Jones Lang LaSalle estimate that current yields on UK high street properties are in the range of 4.5-5.25%, as compared to the current yield of 6.8% on Boots corporate bonds maturing in 2009.

Implementation of proposed new accounting rules which would require that property leases be shown as liabilities on the balance sheet would highlight the financial impact of traditional leases. It presently appears likely that 'executory' total property out-sourcing contracts would not appear on the balance sheet.

Companies with freehold and office-rich portfolios now have a new strategic option for raising cost-effective capital, which they could profitably explore. The emergence of well-capitalised and experienced companies who are able to purchase existing freeholds and in return provide flexible serviced space has created an option for the boards of major companies, which did not exist just five years ago. ■

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