SPF VOICE

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WELCOME

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It is time to redefine real estate

Miller Mathieson
SPF Chair
Managing Director CBRE Scotland & Northern Ireland

So, this is my last article as your Chair, and I have to say I can scarce believe this year has flown by so quickly. One of the most rewarding experiences of leading the SPF is getting to meet members to discuss the opportunities and challenges facing our diverse sector in Scotland. It was a privilege to represent you at regional and international events and I thank you all for your support.

This year has not been without its trials. The Planning Act was a key challenge for us and I believe our work was crucial to avoid the introduction of an Act that would have simply been unworkable.

There was also no escaping the political uncertainties of this past year. Even now, barely a day seems to pass without a new twist to the Brexit saga. Yet, despite these frustrations, I do believe there are grounds for cautious optimism for our industry and indeed the wider economy.

Scotland remains the second-best performing part of the UK for attracting inward investment after London. The UK institutional investors have continued to be active in Scottish markets and are now heavily involved in emerging sectors such as build-to-rent.

However, we cannot isolate ourselves from wider market-driven changes such as those experienced by the retail sector. Yet retail will continue to thrive as a destination for people and it is now more widely supported by a mix of leisure, residential and employment facilities as part of mixed-use developments.

As the demand for green infrastructure continues to rise, our future places will need to remain attractive to both modern society and investors. This is a positive vision and as an industry focused on the built environment, we have a strong role to play in its delivery.

We must also look to ourselves as key players in the industry and ask how we can better relate to the societies in which we work and live. The public at large knows too little of the industry's support for community facilities and infrastructure. Yes, we have crunched the numbers on industry benefits for the economy, but we must now strive to make this relevant to communities, not just businesses and politicians. In short, we have to win in the court of public opinion, if we are to raise the profile and improve the perception of our industry and redefine real estate.

I hope to see as many of you as possible at our annual dinner on 7 November, where we will welcome your new SPF leader, Robin Blacklock. I am very grateful to Robin for his support as my vice-chair, and I wish him and the SPF every success for the future.

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At Holyrood

October saw the Scottish Government's legislation to introduce three-yearly rates revaluations clear its first hurdle in the Scottish Parliament, when the general principles of the Bill were approved with only the Scottish Greens abstaining.

Also approved was the Scottish Government's Transport Bill, which cleared its final stage of scrutiny. This Bill includes an amendment to allow local authorities to introduce a Workplace Car Parking Levy that will apply a charge to employee car parking spaces.

The SPF attended a round-table discussion with the Infrastructure Commission for Scotland (ICS). Representatives of the ICS were keen to consider four housing-related issues including: housing needs and demands; design; planning, place and infrastructure; and affordability.

We also attended the Scottish Land Commission's Annual Conference themed 'Scotland's Land and Economy'. Among the issues considered at the conference were building Scotland's economy through inclusive growth; concentration of land ownership; and vacant and derelict land.

SPF Vice-Chair, Robin Blacklock spoke at the Movers and Shakers build-to-rent (BTR) conference in Glasgow earlier in the month. Keynote speaker, Housing Minister Kevin Stewart emphasised the government's support for BTR through mechanisms such as the Private Tenancies Act, the Rental Income Guarantee Scheme and tax concessions for multiple dwellings.

Back in our offices, we hosted the Chief Planner, John McNairney, at the SPF Planning and Development Committee meeting. Members had the opportunity to discuss the impact of the implementation of the Planning Act and other planning reforms. Going forward, the SPF will be contributing to several workshops in the coming weeks.

Key responses

A consultation on the The National Transport Strategy

The Energy Efficiency (Private Rented Property) (Scotland) Regulations 2019

Consultation on the Right to Buy Land to Further Sustainable Development (Part 5 of the Land Reform Act 2016)

Open Consultations

Transient Visitor Levy: Consultation
Closes 2 December 2019

Local Energy Position Paper
Closes 4 December 2019

Setting the Agenda

A delegation from the SPF attended a workshop organised by the Scottish Government to inform a consultation paper on planning performance and fees regimes. Among the issues discussed was how planning contributes to the National Performance Framework; what good performance looks like and key markers; the role of the planning improvement coordinator; and enhanced project management applications. The public consultation is expected towards the end of this year.

We also participated in a workshop led by the Scottish Environment Protection Agency (SEPA) to consider its forthcoming draft strategic plan, due to be consulted on in 2020. The plan will herald the next set of SEPA flood risk management plans, which will be consulted on towards the end of 2020. Considering the timescale, the SPF questioned how SEPA's plans would dovetail with the proposed next set of Local Development Plans that are expected to be rolled out after 2022.

We have written to the Scottish Government with some early views on engagement with the forthcoming National Planning Framework 4 (NPF4) programme. Further to the recent Planning Act, NPF4 will also be required to have a more detailed assessment of different housing needs, including healthcare.

Elsewhere, the Scottish Government consultation on short-term lets found wide support for regulation, according to an independent analysis and independent research on the impact of short-term lets on communities. The Scottish Government is considering the analysis and will use the evidence to inform policy proposals, to be announced later this year.

Meanwhile a final proposal for a Bill to establish standard clauses for the sale of new-build homes, including redress for purchasers in respect of defects in construction, was lodged on 30 September 2019. The proposal has cross party support and Graham Simpson MSP, Scottish Conservative Party, who proposed the Bill, has now secured the right to introduce a Member's Bill to give effect to the proposal until 1 June 2020 (or, exceptionally, until 30 September 2020).

Regional Spotlight

ABERDEEN

An SPF working lunch in Aberdeen on 23 Oct. considered the next steps of city growth and market prospects in the city. Aberdeen City Council will report on the economic performance of the city in a conference to be held in the first week of November at the city's new state-of-the-art P&J Live Conference venue. The event will be addressed by Sir Howard Bernstein, former CEO of Manchester City Council and Professor Graeme Roy from the Fraser of Allander Institute.

DUNDEE

The city's V&A museum has had an outstanding first year reporting a profit of some £750K. Council Leader John Alexander, speaking on behalf of the Scottish Cities Alliance, highlighted the benefits of waterfront regeneration and green investment at the local level during a busy two days promoting Scottish cities at MIPIM UK over 14-15 Oct.

GLASGOW

For the seventh year running, Glasgow City Council hosted a stand at the European investment conference EXPO Real, taking place in Munich. The marquee attraction of the stand was an outline map of the city centre, highlighting its considerable success in attracting overseas investment in recent years with Germany and the US featuring prominently.

RESEARCH

savills

CVAs in Scotland 2018/19 impact analysis

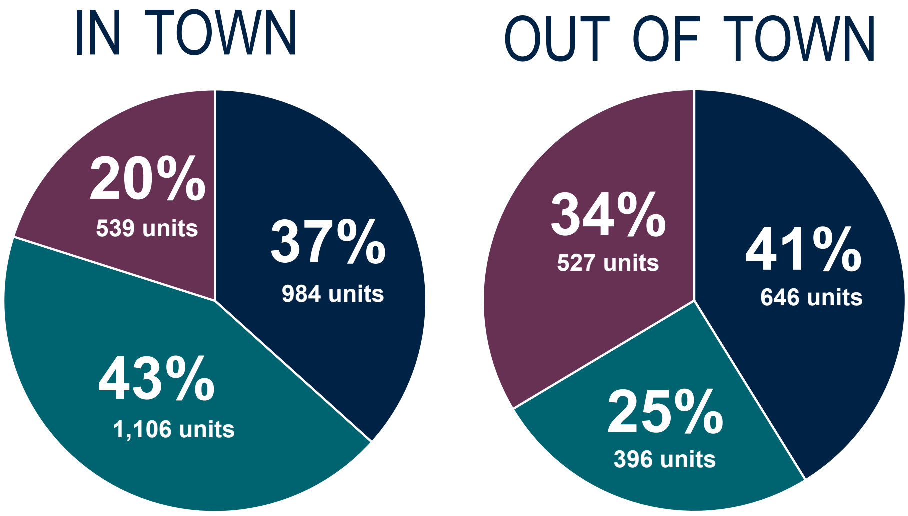
ALL DATA AND ANALYSIS COURTESY OF SAVILLS

CVAs, ADMINISTRATIONS AND LIQUIDATIONS IN SCOTLAND

Scotland seems to fare well compared to other parts of the UK in terms of the number of overall units that have gone through a CVA, administration or liquidation compared to the size of its market. However 95 units have closed representing a third of those that have been through the CVA process in Scotland, higher than the UK average at 24%.

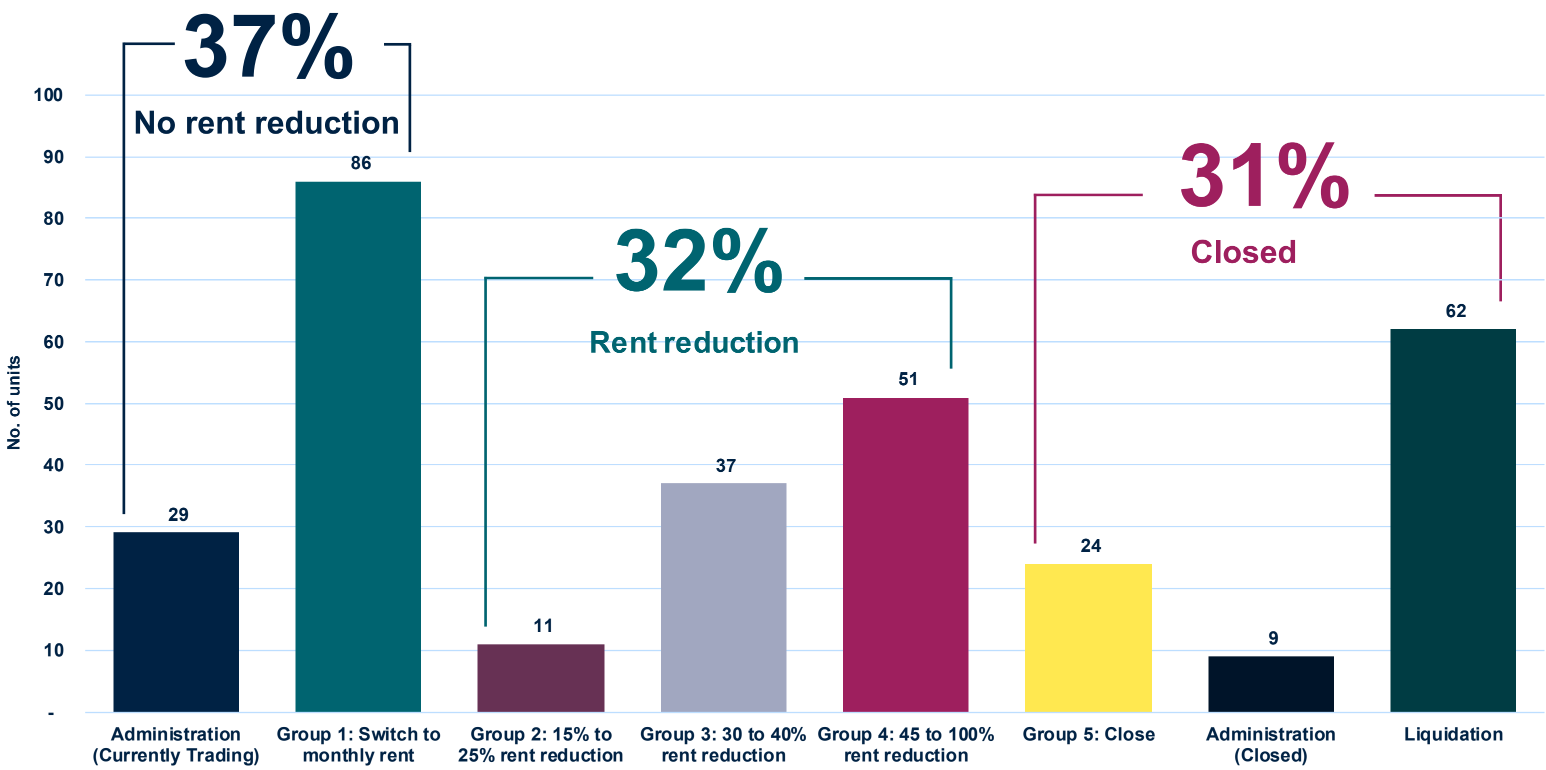
IN TOWN VS OUT OF TOWN IMPACT

Proportionally over two fifths of the affected units in the in-town market lead to a rent reduction, with a further fifth resulting in closure. In the out-of-town market the proportion of closures is much higher at over a third of affected units. However rent reductions only account for a quarter of the market with two fifths leading to no reduction in rent at all.



NO RENT REDUCTION*
RENT REDUCTION**
CLOSED***

*No rent reduction (including CVA stores that have switched to a monthly rent and stores that went through administration that are currently still trading)
**Rent reduction of between 15 and 100% as a result of a CVA
***Closed as a result of a CVA, administration or liquidation



Accounting for Dilapidations, more taxing than you might think

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> *"By recognising all lease liability in more detail, the financial position and strength of a company is easier to review and interrogate."*

When the worlds of Accountancy and Building Surveying combine there is more common ground and similarities than one might expect. These are not two professions you would usually associate with one another (apart from the levels of excitement involved!), but as TFT has recently moved into Exchange Place 3 where Scott Moncrieff is already based, we're reminded of recent research and collaborative working between us, which highlighted some important ties between the two industries. If those ties are not encouraged, there's scope for inaccuracy and misunderstanding, particularly when it comes to company annual reports and property maintenance costs.

As a brief recap, all limited companies need to provide annual reports on their financial position. UK publicly traded companies are currently required by company law to apply IFRS as endorsed and adopted by the EU to their consolidated accounts. All other companies must produce their accounts using either EU-adopted IFRS or UK GAAP. Approximately 55% (1) of commercial property is leased and involves formal contracts between the landlord and the tenant. Most importantly from a building surveying perspective, these leases create a liability on the part of the tenant to maintain the property throughout and at the end of the lease term.

TFT and Scott Moncrieff have noted that the new IFRS 16 accountancy rules have several implications for the property market and, in our view, could affect the future direction of the property market. In particular, the dilapidations process may become more prominent.

The International Accounting Standards Board (IASB) issued IFRS 16 in January 2016 but it was not fully effective until 1 January 2019. It replaces IAS 17 and below we comment on the significant difference and the potential effects on the property market.

Under the old rules, IAS 17, liabilities from a lease were classified differently within annual accounts. These were classified as either finance leases or operating leases. Most property leases did not meet the finance lease criteria and were consequently treated as operating leases. There was no requirement for the operating leases to be reported on a company's balance sheet. This essentially meant that the full picture of the company's financial position was not stated. These off-balance-sheet leases often included some forms of rent and property maintenance. For operating leases the dilapidation provision was considered separately in accordance with IFRS15.

It is understood by the companies involved, investors and associated accountancy firms that property leases create a liability for the parties involved, most notably to the lessee for the liability to maintain the property during the term of the lease and the dilapidations liability at the end of the lease. Applying previous lease accounting requirements, these liabilities were often not accurately reported, the new legislation looks to remove that ambiguity, especially when it comes to dilapidations.

Although the new reporting criteria is due to affect 50% (3) of listed companies in the UK, and perhaps causes some internal confusion, there are some significant benefits. The IASB concluded that by recognising all lease liability in more detail, the financial position and strength of a company is easier to review and interrogate. The result should be better information available to investors and analysts.

Under IFRS16, more detailed information on the lease liabilities must be recorded. This could have significant implications particularly if, for example, many leases within a portfolio come to an end within same reporting period. Under the old standard, entities were able to apply a more generic approach when estimating the dilapidation provision when considering operating leases. A rudimentarily square meter rate was typically multiplied by the areas of the premises in question. It is TFT's experience that this figure was often inaccurate and based on out of date and unsubstantiated cost information. It definitely did not take into account the specific location, current condition and specific legal requirements of the lease for the property in question.

Under the new accounting standard, where most of the leases will be recognised on the balance sheet, the dilapidations provision will need to be assessed at the outset of each individual lease agreement and included in the overall lease liability recognised in the financial statements. In the subsequent period the lessee will need to remeasure the lease liability if there is a change in the amount expected to be payable for the dilapidations.

Fulfilling those obligations will require a change from standard practice, which sees many companies presenting their liability with generic rates across their property portfolio. TFT believes the best way to avoid the misleading consequences of this approach is to ascertain the dilapidations liability with a Dilapidations Liability Assessment of each property.

One benefit of this more rigorous practice is that the potential liability can be reduced if the landlord's intentions for the property reduce the dilapidations liability; something that is not immediately obvious without the input of a building surveyor specialising in dilapidations.

IFRS16 notes that companies should be prepared to *'incur costs to remeasure lease liabilities over the terms of the lease'*. It is difficult to define this expectation but TFT believes this to be where liabilities or circumstances change, such as a material change in the state and condition of the property or the making of alterations to the property. Subsequently, the legislation implies that companies should anticipate undertaking a Dilapidations Liability Assessment.

Although a different subject matter, the RICS Guidance Note for the Reinstatement Cost Assessments of Buildings notes a property should be inspected and the assessment updated every three years. It is not unreasonable for these timescales to be adopted in this instance, depending on the duration of the lease.

It is worth noting that the requirement to recognise only amounts expected to be paid is a change compared to the guidance in the old standard. Under IAS 17 the maximum amount payable by the lessee was to be included in the lease liability. Entities will need to consider what additional procedures are required to determine the amount that is expected to be paid at both initial recognition and subsequently.

Companies need to ensure staff have a knowledge of the new rules and internal systems are in place to manage and track leases.

Looking to the future, the new rules could help the retail market and other lessees that favour sales-linked leases. Under the new rules, fixed payment leases and variable payment terms leases are reported differently. The two types of lease could be viewed as economically similar transaction and may result in similar cash flows, but the companies would be in different economic positions. This is because variable payments that depend on the index or rate are included in the measurement of lease assets and lease liabilities and change in the expected cash flows should be considered in subsequent measurements

The new rules are likely also to affect sale and lease back ("S&LB") transactions. Sale and lease backs have been very popular recently and are a good way for companies to raise capital. Under the old IAS 17 rules, a company could significantly reduce its reported assets and liability while the balance sheet would have implied a smaller asset base and less financial debt as the lease payments would have been off-balance-sheet leases. It was generally anticipated that such transactions may reduce as IFRS 16 reduces the incentive by requiring the recognition of assets and liabilities arising from leaseback, and limiting the gain recognised in the sale. More recent research from CBRE (2) has commented that S&LB still has its place in the market and *'While companies will lose the 'off balance sheet' financing benefit of a S&LB, we believe this will be offset by the more tangible benefits of this form of capital raising, which will be unaffected by these changes. (2)*

In summary, Scott Moncrieff and TFT recommended a review of property lease liabilities be undertaken, especially those where the lease end is within the foreseeable future. The completion of dilapidations liability assessments is a quick and relatively inexpensive way to assess and record a lessee's dilapidations liability.

References

(1) IBF Understanding UK Commercial Property Investors, 2017 Edition
(2) https://news.cbre.co.uk/cbre-sees-bright-future-for-sale--leaseback-despite-new-lease-accounting-changes/
(3) IFRS Leases Project Summary and Feedback Statement

Neil Wotherspoon is a Partner at TFT and is responsible for TFT's Edinburgh Office. Neil has a sound knowledge in Commercial Building Surveying, including Dilapidations, Technical Due Diligence Surveys and Development Monitoring. Neil provides dilapidation services for Screwfix, Homebase, Steinhoff, Tesco and B&Q. Neil is also Development Monitoring the £1billion Edinburgh St James development on behalf of the JV investors, comprising APG and Nuveen Global.

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SPF

8TH ANNUAL DINNER

Thursday 7 November 2019
Edinburgh International Conference Centre
150 Morrison Street, Edinburgh EH3 8EE

KEYNOTE SPEAKER
ED BALLS

Former FT leader-writer, new Labour economic architect and UK Treasury Minister.

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The SPF dinner is a flagship event on the Scottish property calendar, attended by all the key players ... [It] promotes the very best of the Scottish property scene.

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