

Surviving the market

A year into the credit crunch and we are yet to see the bottom of the market. With falling values and a more strategic approach to bank lending and investments taking place, the sector and its players still have a way to go before seeing the light at the end of the tunnel. Property businesses should now be reviewing their corporate structure to support a 'survival strategy' as well as financing costs and acquisition financing.

A large, multi-story building with a red-tinted overlay. In the foreground, a sign on a post reads "FOR SALE" in white capital letters on a dark background. The building has several windows and a central entrance area.

**FOR
—
SALE**



Tax strategies and structuring

Get the timing right

Since the removal of Empty Property Rates Relief in April this year, there is a greater focus on the timing of purchases and development of commercial property (even if full or partial demolition is used as a stopgap). Where a developer has a choice over which projects are delayed, tax issues should be taken into account. For example, if a project involves land remediation work to remove Japanese knotweed or to clear a site that has been derelict since March 1998, delaying the start until after April 2009 may have tax benefits, as it is currently proposed that the costs of such work will then qualify for 150% land remediation relief.

Maintaining turnover

Prioritising the most recession-proof developments is just common sense, but it may also be necessary to seek out new partnerships to protect revenue streams. For example, residential developers are likely to benefit from finding new venture capital to help them offer longer term shared equity schemes and sell stock nearing completion.

With residential rental yields holding up, despite many more properties becoming available to rent, many will be tempted to switch from selling to letting their development stock as a short term hedge. However, such arrangements need to be structured carefully to ensure that the corporation tax and VAT implications do not eat into returns too much.

The VAT cost of letting before selling

This approach may be good for cashflow but will have VAT costs that could catch out the unwary developer. The sale of newly constructed homes is liable to the nil rate of VAT (zero rated) and VAT paid on the costs of construction (such as purchases of building materials and professionals' fees) are – with a few exceptions – fully recoverable from HMRC.

Leased property does not have the same favourable VAT treatment: leases of domestic properties are exempt from VAT rather than zero rated. This means that while the tenant is not charged VAT on the rent, the landlord cannot recover VAT attributable to the lease. So, a developer planning to ride out the current downturn by letting properties which it initially planned to sell, faces two VAT problems:

- HMRC may require the house builder to repay some or all of the VAT incurred on the construction of the building
- the builder cannot recover VAT on fees directly connected to the letting (letting agents' fees etc).

Fortunately, HMRC has recently announced that in these exceptional market circumstances, builders can use special methods to calculate what, if any, claw back of VAT is due. These alternative methods allow the builder to bring into the equation an apportionment based on the expected sale value of the house, which helps to minimise any repayment that may be due. Smaller building firms may also benefit from “de minimis” rules under which a VAT repayment due to HMRC below a certain amount does not have to be paid.

Don't forget

Making sure you do the basics right has become even more important. For example, developers planning to dispose of waste from contaminated land into landfill must obtain a landfill tax exemption certificate from HMRC. However, this exemption is being phased out and developers must make claims before 30 November 2008 to secure relief from landfill tax until 31 March 2012.

Property developers and house builders should be reviewing the value of land they currently hold in trading stock to determine if it should be written down to its net realisable value in the accounts. Such write-downs may produce trading losses for tax purposes, which can be set off against profits from the previous 12 months.

Maximising claims for capital allowances is also important. Our experience suggests that many commercial property owners and investors lose thousands of pounds each year as a direct result of lost or under-claimed allowances. With the changes that took effect in April this year, this is an increasingly complex area which needs specialist input, as no two buildings are ever the same.

HMRC is not likely to soften its approach to enforcing good tax compliance simply because the economy is slowing down: indeed, new rules are likely to see increases in tax penalties across the board from next year. In particular, if you are thinking

of making redundancies or changing the way you work with contractors, it is vital to take advice before implementing arrangements – such areas are always top of HMRC's tax risk list.

Downturn offers tax saving opportunities

In a falling market, lower values for property assets can offer the opportunity for assets to be transferred at a low tax cost or none at all, so identifying assets standing at small paper gains or at a loss is a useful exercise. For smaller developers, it may be a good time to consider moving property assets into a pension or into your own name. For larger firms, a group restructuring or break-up now may be less expensive.

Long term strategy

Although short term measures are important, the recent movements may signal longer term changes in the property market. Getting your long term strategy right should involve a careful examination of the tax costs.

Your survival strategy must take a holistic approach, with tax planning playing a key part. Planning must focus on the tax position of the owners as well as the company. Such a review of your corporate structure will always offer opportunities for tax savings.

Financing

Existing financing and increasing costs

There is no doubt that banks have had to reduce their customer loan book. The level of inter-bank borrowings has also dropped considerably. Large provisions are having to be made against the banks' exposure to bad and doubtful debts emanating from the US sub-prime market. All this has had the effect of reducing the capital bases of banks.

Clearly, this has affected a number of high street banks. These banks will be looking at their overall position going forward. Certainly we have seen the following already happening:

- Loan to Value ratios have been corrected and fallen compared to levels seen 18 months ago.
- The 'new loans' market is becoming very limited, with banks turning down new propositions more readily.

- Valuations required for lending purposes are markedly more conservative.
- Banks are mitigating their risk by looking for additional security.
- More banks have moved from Base Rate to LIBOR as the base for lending structures.

This realignment of price, value and lending appetite is expected to remain while the market continues to decline and may become more acute given recent figures and developments.

How do property companies survive during this period? They will have to get a lot smarter about the way they approach facility renewals, covenant monitoring and new borrowing negotiations. They also need to assess their current banker's appetite for lending to their business, and must be prepared to look around for the best deal, as well as keeping a careful eye on the ongoing underlying profitability and cashflow of projects.

Cashflow management and performance monitoring

Businesses must reconsider financial projections that were prepared as part of an annual business plan or project appraisal. Such projections should be reviewed and revised on a monthly basis, with detailed performance variance analysis being undertaken and incorporated into the revisions applied. It is likely that financial projections prepared in the earlier part of 2008 will no longer reflect the performance and cash requirement in the current climate. It is also very probable that financing costs will have increased, along with the costs of energy, base materials and transport/distribution. It is therefore increasingly critical that businesses review their pricing and trading terms with both their clients and suppliers. Such control ensures increases are passed on or that margins remain sufficient to offset any impact, while identifying the best option in terms of service, cost and cashflow implication within the supply chain.

Meanwhile, banks will be carefully monitoring performance against any target data provided initially, historic information and covenants included as part of the facility agreement.

This scrutiny will make a business vulnerable if the bank becomes nervous of its ability to service its debt.

Businesses that look at the bigger picture and carefully consider where savings can be made, or where issues will arise, will be in a strong position to achieve solid results in the medium to long term. In the current climate, banks will not want surprises and will act sooner rather than later to minimise their own exposure.

There will be those businesses which have never prepared financial projections, due to being in a healthy cash position. These businesses will now be able to take advantage of the market if they can plan ahead and appraise whether surplus cash balances can be deposited or used to invest in opportunities – which will certainly arise over the next 18 months.

Acquisition financing

So, can people still raise finance in the market place? The answer has to be yes. While many see obtaining finance as challenging, complex and often confusing there remains both an appetite and willingness amongst lenders to provide facilities. Banks, invoice finance providers and asset based lenders are still businesses, and businesses need to make money.

Facilities are expected to be in the main more structured and designed to meet the business need while also protecting the lender by offering increased levels of control and transparency. Overdraft facilities will become less prevalent, with invoice finance the preferred path where suitable. Additional security to support facilities will become a regular requirement even in situations where finance is being provided against secure assets.

Businesses need to know their business strategy and have a robust business plan to support their financial projections if they are going to be successful in raising funds. Any new project needs to be appraised in fine detail and savings need to be made when and where possible: for example, by delaying planning permission fees by legal drafting of the agreements.

Banks are unlikely to back risky investments, or businesses that have huge contingencies for the unknown quantities. It is also likely that businesses will be encouraged to take insurance against the effect the markets may have on their customers, to minimise the risk to all parties.

However, businesses can and will survive if they act early. If you understand the needs of your business, and can demonstrate the serviceability of debt through strong and robust performance and cash management, your business will continue to thrive even in the current conditions.

Seminar alert

PKF will be running seminars on how to survive the property market in our Leeds, Manchester, Liverpool, London and Bristol offices during November. To express an interest in attending one of these please contact Matthew Heaven on: matthew.heaven@uk.pkf.com

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