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WHAT DOES IFRS 16 MEAN FOR LANDLORDS?

Roger Thornton and Jamie Tomlin address the impacts for tenants and landlords of incoming reporting standards that will transform lease accounting

International Financial Reporting Standard (IFRS) 16 significantly changes lease accounting for tenants, requiring all tenants to report their property operating lease liabilities on their balance sheets.

Currently operating lease liabilities are not shown on the balance sheet, so analysts and investors have to guess what they are when assessing a company's covenant. The idea behind the new standard is to bring greater transparency to companies' assets and liabilities for analysts and investors. It seems harmless enough.

However, it is estimated that this will bring something like £2.3tn worth of lease commitments onto the balance sheets of the world's listed companies for the first time. It is estimated there are £100bn of operating lease commitments in the top 50 FTSE 100 companies.

The businesses most likely to be affected by the new rules are those which are heavy users of real estate leases, so sectors such as retail, hotels and restaurants will be particularly affected. To take one example, it is estimated that the average reported balance sheet debt for retailers will triple.

Tenants that are most likely to see a big increase in their balance sheet debt will be those with large lease portfolios or large lease obligations relative to their size, and also businesses with a thin capital base compared to lease liabilities such as professional services firms. Companies with an already high debt level will also be adversely affected.

The new standard comes into operation on 1 January 2019 and the new accounting rules will apply to all real estate leases, except those with a term of less than 12 months, which do not need to be shown on balance sheet. Licences, which give a personal right to occupy rather than exclusive possession under a tenancy, are also outside the scope of the new rules. Business occupiers may need legal advice to analyse whether a particular arrangement is a lease or licence.

What is the impact on tenants?

1. Tenants may want shorter leases, to reduce the potential lease liabilities which will come on balance sheet.

If the lease is protected under the Landlord and Tenant Act 1954, then there will be the usual statutory renewal rights, so tenants may be comfortable relying on that to give them a longer term.

Tenants who want to keep lease balance sheet debt to a minimum might also consider a shorter lease term combined with an option to extend/renew the term, but there is a potential trap.

The new standard requires tenants to calculate the liability reflecting the full lease term if it is reasonably certain to be longer (ie if the option to extend the term is reasonably certain to be exercised). This will be a judgment call for the accountants. So a five-year term with a five-year option to extend could be treated as a 10-year term on balance sheet if the tenant is reasonably certain to extend.

Conversely, what would happen if a longer lease was granted with a tenant's break right? If a 10-year lease had a tenant break in year five, could this be treated as a five-year term on balance sheet? Again, if the tenant's break right is reasonably certain not to be exercised, then the full term will be taken into account on balance sheet.

It seems, in practice, accountants will take a cautious view and assume a longer term without the tenant's break being operated.

Landlord break rights are ignored for the purposes of calculating the lease term under the new rules, so rent for the full lease term will be a liability on the tenant's balance sheet.

2. To minimise lease rent liabilities, tenants may push for longer rent-free periods and a discounted rent in the early years instead of initial capital contributions or other cash incentives.

Obviously there is a trade-off between the tenant's business requirements, the tenant's cash flow for tenants' fit-out, and the need to keep the balance sheet indebtedness down.

3. The changes may encourage a move away from five-yearly rent reviews, to avoid big surprise increases that go on the balance sheet as liabilities.

Where open market rent is subject to five-yearly rent reviews, the lease liability is re-assessed and re-calculated on the balance sheet to reflect the revised rent. This may lead to large increases in indebtedness on balance sheet for tenants.

Indexed or fixed uplift rental payments are also included as lease liabilities on the balance sheet, but they give a more predictable rental pattern for tenants than open market rent reviews. There is already a trend in this direction, which may accelerate as a result of the new accounting rules.

Interestingly, variable rental payments such as turnover rents are not included as rental liabilities on balance sheets under the new rules, because they are unpredictable. They are already common in retailand leisure and they may become more attractive under the new rules.

The IFRS effect

Over the next few years, the new rules could exacerbate and speed up current trends in the real estate market:

- **Shorter leases – now five years on average**
- **Indexed rent reviews, instead of open market five-yearly reviews**
- **Turnover rents**
- **More serviced office sector growth in preference to subletting – especially small and medium-sized enterprises**
- **SPVs taking leases rather than parent companies**

4. The new accounting rules may make sale and leaseback transactions less attractive for companies.

Previously this was a source of off-balance sheet financing for companies – they could sell an asset off balance sheet and lease back again off balance sheet, so creating cash in the business. Now the lease back rent will be shown as a liability on balance sheet and increase company indebtedness.

5. The new rules could have an impact on the subletting market, too.

Tenants have often taken more space than they currently need, on the basis they can sublet surplus space in the short term. The new rules, however, may make it more difficult to find sub-tenants, who may be looking instead for more flexible arrangements, which stay off the balance sheet.

6. It is likely that the new rules will further encourage the already booming serviced office sector. Tenants will want more flexibility, and shorter leases, thereby not encumbering their balance sheet.

Leases of less than 12 months are off-balance sheet. In fact, many of the serviced office arrangements are in effect licences rather than leases, are not be subject to the new accounts rules anyway, and will not appear on balance sheet.

The new accounting standard may, of course, affect the serviced office operators. Their large portfolios of leasehold properties could mean increased indebtedness on their balance sheets although, in practice, their leases tend to be taken by special purpose vehicles (SPVs), so the real increase in balance sheet indebtedness will be on the SPV, rather than the serviced operator parent company itself.

It is interesting to note that a lot of the serviced operators are beginning to push for turnover rents on their head leases too, keeping them off-balance sheet in any event. The more successful their businesses and income, the more they pay to landlords, so while the sector is thriving, this could be an attractive option for both landlord and tenant.

7. There may be a significant impact on the financial ratios of tenant companies, particularly on their debt ratios. The average increase in interest-bearing debt on a retailer's balance sheet is estimated to be 213% and, on hotels and food services, 100%, which – at least on paper – will make them a weaker financial covenant.

The increased indebtedness and adverse effect on gearing ratios will feed into the various financial covenants these tenant companies have given, for example to banks in loan agreements. They may need to renegotiate these covenants to avoid potential breaches of their financial covenants and default on loan arrangements which might trigger repayment of loans.

It will be interesting to see how this issue develops in the lending market and what view banks will take. They will be aware that these changes are caused by the new accounting standards rather than any fundamental change to the underlying covenant strength of tenant borrowers.

But will this change nevertheless lead to a tighter lending market, or a more expensive one?

What is the impact on landlords?

From an accounting perspective there is no significant change from the current accounting rules but the various issues highlighted above will have a knock-on impact on the real estate investment market:

- If corporates are less willing to sign long leases the supply of prime investment long yield annuity style product will be constrained, which will in turn place upward pressure on pricing of current stock.
- Securing a longer lease or renewal lease on secondary property may become more challenging, and therefore exacerbate the gap between prime and secondary property values.
- The ability to fund prelet development will be restricted, as shorter leases will not provide the security for funders and investors. Given that speculative development is currently already limited outside London this could seriously limit the availability of prelet development stock in non-prime areas and sectors.
- Shorter leases are likely to lead investors to focus more on the quality of the underlying asset class and to push up values in the highly sought-after asset classes such as alternatives, industrial and logistics.
- More turnover rents and discounted fixed rents could impact values.
- The adverse effect on financial covenants and debt ratios for tenant companies will have an impact on tenant covenants and therefore potentially an adverse effect on values. It will also be relevant when considering tenant covenants on lease assignments and financial on assignments. How should landlords react?

Roger Thornton is a partner at Maples Teesdale and Jamie Tomlin is a corporate audit associate director at Moore Stephens LLP