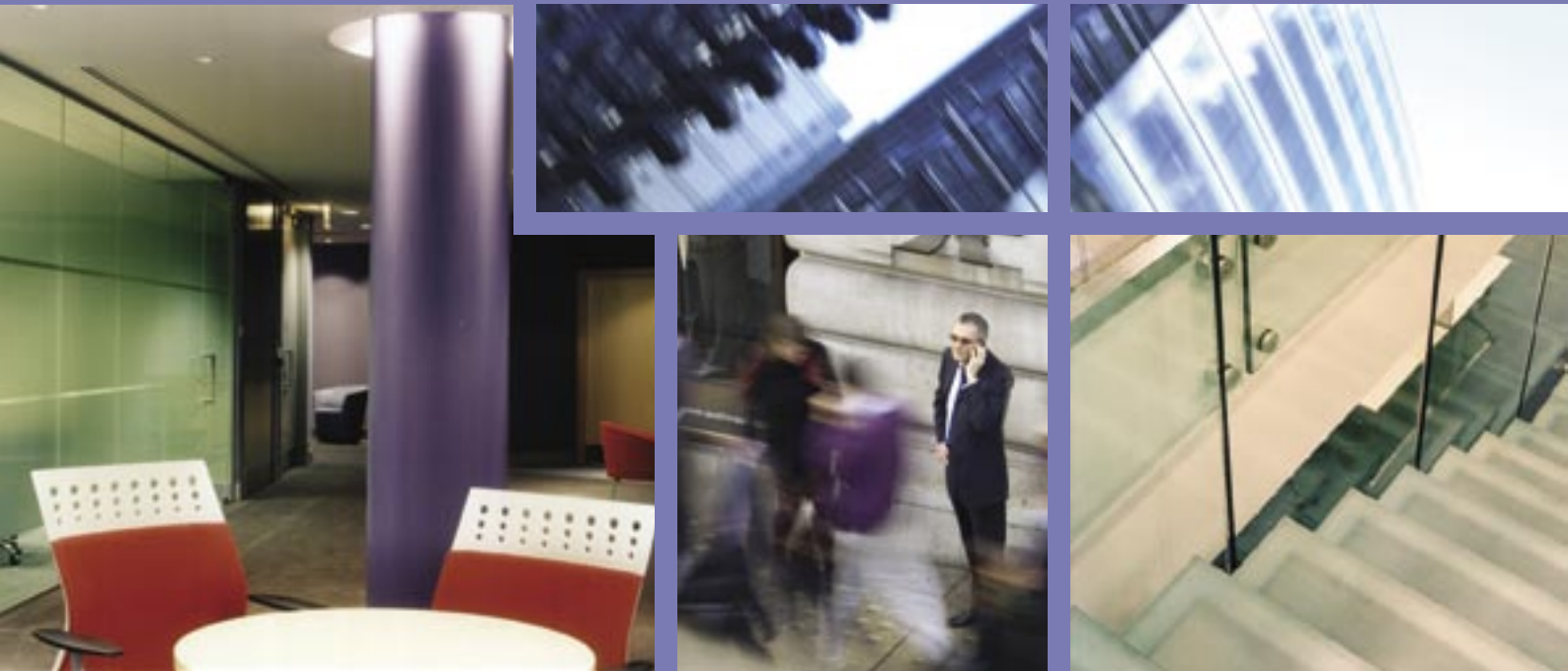


The charity sector in England and Wales: A framework for strategic evaluation of operational property





Foreword

Property is an inflexible and expensive resource. So it is surprising that even though it is typically the second or third largest expense for an organisation after people, it tends to be managed passively and on an as needed basis, with the priority on budget control and managing day-to-day facilities issues. This is particularly true for the charity sector, which does not benefit from the level of in-house real estate expertise generally found amongst corporate occupiers.

Yet at the same time, many charities have successfully invested in property over many years, with proactive management of property investments, within an overall portfolio, providing returns that match or exceed those from other asset classes. For some, this success in asset allocation has led to a bias towards property ownership for operational purposes when what is required is an objective approach which prioritises the working needs of the organisation.

In England and Wales alone, there are some 167,000 main registered charities, with an estimated combined income of around £36 billion. Property plays an important part in how this 'third' sector of the economy operates, and how effectively that income is allocated for use and invested for the future. In this paper, the author argues that the third sector needs to take a balanced and strategic approach to property as an operational resource as well as an investment class, and manage against separate and clear goals and objectives.

Maximising Returns

Property as an investment asset class has been a strong performer in the UK in recent times and certainly deserves its place in a balanced portfolio. Whilst attractive as a hedge against inflation, the lack of liquidity and high dealing expenses compared with equities mean careful asset selection is key. Clearly charity trustees must take a prudent approach about investing their charity's funds, considering the need for income, capital growth and diversification, both in terms of types of investment, and different investments within each type.

In England and Wales, the sector's regulator, The Charity Commission, recommends that for most charities a review should be carried out at least once a year to ensure investments are performing in accordance with the charity's objectives and to identify appropriate action.

Regular reviews will also help to identify and manage risks, and balance those risks against the potential returns from particular investments.

Minimising overheads

As property occupiers, charities may well be less accustomed to giving their operating properties the same level of scrutiny. The Charity Commission certainly does not place charities under any direct obligation to do so. Yet research of its members by The Charity Finance Directors' Group¹ found that only 42% of its sample had a property strategy integrated with their organisation's objectives.

Charities tend to take a reactive approach to property issues – usually responding to problems rather than opportunities – after they have arisen. When action is required, there may be nothing in the budget to fund it.

Occupational property issues tend to be complex and long lasting in their impact and demand professional management. Moreover, the increasing onus on good stewardship of resources generally in the sector and the need for competitive procurement and transparent reporting add further pressure for good management principles to be followed.

Yet, for many organisations, property falls under the responsibility of a non-property professional, usually because the size of the organisation doesn't justify full time property input.

Property audit

Like its investments, a charity must understand how its operational properties meet its objectives. This should be integral to its pursuit of the principles set out by the Charity Commission's "Hallmarks of an Effective Charity"². Managing surplus or shortage of space, as well as capital projects and events like break options must all form part of a considered property strategy.

To do this, charities must collect accurate and timely property information, interpret it, compare it with others and set performance targets with it. This kind of property audit can often

reveal new solutions to reduce cost and unlock precious capital, or pick up situations where money could otherwise be wasted.

Strategic options need to be developed and the status quo challenged. For example, charities are increasingly recognising the economic benefit of relocation, consolidation of buildings and implementation of flexible working practices. At times this represents an enormous challenge for an organisation which has a long tradition and conservative culture.

In each case, options need careful analysis. Trustees should be presented with both quantitative and qualitative analysis, risk appraisal and a properly considered implementation plan as part of business case for change.

Mixing ownership with occupation

The need for scrutiny of property is more acute, when the property occupied by the charity is its sole property investment.

In some cases, the property may be a 'heritage asset' in that it has some historical, artistic or scientific importance and advances the preservation and conservation objectives of the charity. But for most, there will be some historic connection with the property simply through its occupation over time. The building becomes embedded in the culture of the organization even though it may have nothing to do with the mission that the charity has set itself to follow. Trustees can be particularly resistant to relocating even if it is quite clear that there is a mismatch between the location of the building and the areas served by the charities' activities. This resistance to change explains why some headquarters office facilities can be found in up-market residential locations even though the organisation is involved in providing services to the socially disadvantaged.

The problem is that whilst the building itself will not have changed much over time, the charity probably will have. If the building has been converted from residential use, it is unlikely to offer the benefits that modern and flexible office space does in terms of enhancing communication, team-working and development of a professional culture. Old buildings also need more of the charity's limited funds to be allocated to repair and maintenance budgets.

Attachment to ownership comes at a price if it means retaining a building that is no longer big enough or in the right place to meet the objectives of the organisation. Saving rent could be a false economy. What on paper may be a significant and valuable investment may prove in reality to be a liability and could be holding the organisation back from achieving its full potential.

Property investment may be right for the charity, but so is operating out of the best space that the organisation can afford, space that is designed for users' needs, that helps recruit good people and retain them, and inspires them to greater things. If occupied property is to be justified as an investment, then a balanced approach is required that considers both its performance as an investment versus other asset classes, but that also addresses the practical and financial impact on operations.

Managing the decision

Table 1 is provided as a suggested checklist to enable directors and trustees of not-for-profit organisations decide whether they should own or lease administrative operational properties.

TABLE 1: LEASE OR BUY COMPARISON

Criteria	Own	Lease
Choice	<ul style="list-style-type: none"> Limited supply 	<ul style="list-style-type: none"> Wide choice
Exit Potential	<ul style="list-style-type: none"> Price sensitive Timing flexibility Vacant possession or leasing alternatives 	<ul style="list-style-type: none"> Market dependent Depends on lease terms and timing versus rent review and expiry dates
Legal Requirements	<ul style="list-style-type: none"> S36 Charities Act 1993 for disposals Duty of care for acquisitions 	<ul style="list-style-type: none"> Duty of care only
Value for Money	<ul style="list-style-type: none"> Selection dependent Requires whole life approach and active management Rent Savings 	<ul style="list-style-type: none"> Lease flexibility and control are key Market risk Unavoidable recurring expenses
Operational suitability	<ul style="list-style-type: none"> Fixed layout inflexibility DDA compliance issues 	<ul style="list-style-type: none"> Layout flexibility Accommodates change
Cost control	<ul style="list-style-type: none"> Full responsibility Timing control 	<ul style="list-style-type: none"> Normally limited Dependent on landlord
Risk	<ul style="list-style-type: none"> Needs to form part of balanced portfolio 	<ul style="list-style-type: none"> Market risk Others' management
Funding potential	<ul style="list-style-type: none"> Specific fundraising opportunity 	<ul style="list-style-type: none"> Operational expense
Image	<ul style="list-style-type: none"> Sense of permanence Branding opportunity 	<ul style="list-style-type: none"> Building and landlord dependent

Choice of property

Freehold office buildings tend to be in limited supply, so choice will be constrained and the organisation may need to be flexible in timing its move, or to compromise significantly in terms of location or quality. However, for specialist operational property, buying a freehold site or a building for redevelopment may be the only route to deliver the required facility.

There are rarely bargains to be had. Competition for freehold buildings can come from investors as well as occupiers and the price may reflect the potential for special demand from neighbouring users. Keen yields may be out of alignment with underlining occupier demand, making freeholds offer less value for money than expected.

In contrast, leasing provides a far greater range of opportunities, with choices of location, building types in terms of age, shape and size. So unless there is a specialist need for a purpose built solution, leasing is the preferred option.

Exit potential

Freeholds can be disposed of at any time and usually without restriction. But charities can have a tendency to under-spend on

repairs and maintenance. If the property is not in repair, this will impact saleability and potential demand, as well as the price. Demand will be dependent on the desirability of the property and its location, as well as the state of the market. However, provided the price is set at a realistic level, freeholds do sell even in disrepair. In addition, the vendor can choose when to sell and time the sale to match its planned vacation of the property.

As owner, there is also the option to lease up the building, and then sell the benefit of the income created as an investment to a third party. The duration of the lease will impact the type of purchaser that will be attracted and the price achievable.

Leases can be disposed of either by assignment (sale of the lease), sub-letting (grant of a sub-lease of shorter duration than the lease itself) or by agreeing a surrender (selling back to the landlord for a premium – usually paid by the tenant to the landlord).

Whilst leases will set out what disposal rights are granted, the state of the market will in practice dictate how easy it is to dispose of the lease when the time comes. The duration of the lease term and proximity of any rent review will have a

significant impact on disposability. For example, a lease with only two years to run or with a rent review coming up in a year's time may not give enough certainty to a tenant and be difficult to dispose of. It may require the tenant to negotiate a new term with his landlord, who will be under no obligation to accept.

Legal Requirements (in England & Wales)

Section 36 of the Charities Act 1993 requires charities to obtain and consider the contents of a professional valuation of the asset before disposal. There are no equivalent obligations on acquiring property, but charity trustees should consider such decisions within their overall duty of care and require proper due diligence to be carried out.

There are no compliance obligations on disposal or acquisition of property held on short or medium term leases. However, trustees should take professional advice on every occasion to ensure contractual obligations are understood and acted upon.

Value for money

Owning property requires an up front capital investment in the asset, but with the benefit, unlike leasing, that is there is no rent to pay. If the property goes up in value, as owner, the charity will be able to benefit from the capital appreciation. However, it is not a one-way street. An individual property does not always follow the market, and as it becomes older, its value depreciates relative to more modern (and therefore more attractive) property.

Ownership also means responsibility. The asset must be maintained regularly and kept in good repair. Whether under these circumstances the property represents value for money will be dependent on how the owner finances the property cost. If borrowing is required, the cost for comparison is the interest charge and principal repayment versus the annual rent. Where the purchaser is funding the acquisition out of reserves, there is instead the opportunity cost of foregone interest on the capital taken off deposit in the bank, or invested elsewhere.

The cost of leasing can be measured as the projected flow of rental payments over the course of the lease term. Those payments will increase at fixed intervals, usually five yearly, through rent reviews, or through negotiation of a further term on lease expiry. Whether this represents value for money will depend upon the benefits accrued through occupation during the term, and how closely the lease term mirrors the occupier's needs. For example, if a tenant signs a ten year term but outgrows the building, it might be difficult to dispose of the lease and, as a consequence, the cost of the lease might be two additional years' costs to cover the costs of surrender, effectively adding 25% to the planned annual cost.

The need to meet service charge or dilapidations obligations in the lease may often be cited as a further reason for not leasing. However, this overlooks the fact that disrepair in an owned property will diminish its value and money still needs to be spent. Charities can easily ignore or under estimate future capital or revenue expenditure requirements associated with ownership,

whilst the contractual commitment to meet a service charge liability is hard to hide and can often be off-putting.

Ability to match requirements

As well as being in shorter supply, freehold properties offer more physical constraints. By definition, they are whole buildings, so will usually be constructed over a number of storeys. Except for very high value buildings, individual floors will be relatively small and occupiers will have to manage with going up and down the building to see their colleagues. For occupiers looking for the communication benefits associated with single floor occupation, freehold ownership will not be an option.

Taking a building and occupying part is an option but places the risk on the owner of leasing up and managing the remainder and will, as importantly, require a significantly larger up front capital commitment.

The range of opportunities for leasing, both in terms of size, shape and location means that there is usually something to meet the tenant's requirements. Modern office floors provide flexible space so the occupier can choose how much partitioning to install and, within reason, where it should go. In contrast, freehold buildings considered for the same size of occupation will probably have fixed constraints in terms of solid load-bearing walls, and provide additional difficulties in terms of cabling and technology use.

Having a single large floor will not only be more efficient in terms of space planning, but it will also avoid the common issues encountered by owners and occupiers in older buildings when trying to meet UK Disability Discrimination Act requirements.

There are additional merits from leasing, associated with occupation of part of a building on a lease (not possible through freehold acquisition). Occupation of part means that there is some prospect that increases in space requirements in future can be met within the building as other occupiers themselves expand and contract. In contrast for the owner occupier, there is no option other than to move on as a whole, or split sites.

Cost control

Occupiers tend to buy because they anticipate long term occupation. Ownership provides a sense of permanence, which for some is part of the desired image to be achieved from the building. To achieve this permanence, they may be prepared to spend significant sums up front in making the property work for their needs. However, if they do not remain in occupation for the expected duration, they will probably have to write off part of that expenditure. Owner occupiers can be known to over-specify for their own needs because they erroneously over-state the lifetime of their expected occupation of the building. Whilst using the highest quality materials on refurbishment may offer the prospect of whole-life cost savings, the market does not usually value the benefit of such work carried out, especially if it is of a specialist nature.

Otherwise, ownership is helpful because it entitles the occupier to decide how much and when to spend money on the building, without the potentially onerous obligations imposed by a lease. However, big ticket items like roof or lift replacement may be unavoidable and lumpy expenses. And because the occupier owns the whole building, it will bear the whole cost. In comparison for a tenant in a multi-let building, roof repair costs will be spread between all of the tenants according to their occupation. Because of the design of the building, a proportion of the whole may work out to cost less.

One of the benefits of leasing for tenants who occupy whole buildings is that, to an extent, they can control the cost and timing of repairs and maintenance. Most tend to under-spend during the term, recognising that there will be a hit from dilapidations at lease expiry, but somehow hoping that they won't be around that long, or that some other event will come along to remove the obligation, for example, plans by the landlord to redevelop.

Tenants of parts of a building are less fortunate. They will have to pay towards the cost of the maintenance and repair through the service charge and their control of costs will be limited to what they spend on the interior of the premises.

In contrast, with responsibility in the hands of professional property managers, the occupier may well be able to benefit from economies of scale in procurement that would not otherwise be achievable, as well as less management distraction than having to take spending decisions itself.

Risk

Owning carries a variety of risks. The impact of these risks will be greater if the occupier has only one property, with all its eggs effectively in one basket.

It may not be prudent to buy a property for owner occupation when the investment can only deliver capital appreciation (as the occupier is not paying itself a rent as owner). Furthermore, the building's value is market sensitive and ownership carries high entry and disposal costs in the form of stamp duty land tax and fees. These may be disproportionate relative to other asset classes.

Yet for many owner-occupiers, the primary reason for ownership is to avoid the greatest risk associated with leasing, rent escalation. Because rents are market driven they can go up faster than anticipated and could be out of kilter with general inflation, and with the occupier's own view of value. Timing of rent reviews at the top of the market cycle could leave the tenant trying to dispose of the lease at a time when the rent payable cannot be recouped from sub-letting. In practice, however, whilst the distraction of rent reviews may be unhelpful, because charities tend to avoid prime property, the chances are that their rent reviews will fall some way off the market peaks set by competitive bidding.

Lease compliance is sometimes cited as another risk area, with

non-compliance with lease obligations potentially putting the tenant at risk of unforeseen expense. However, in practice these risks are likely to be remote. Furthermore some of the perceived risks of leasing, for example, failure to comply with notice provisions to bring the tenancy to an end, have been removed by recent changes to Landlord and Tenant Act legislation⁴.

Funding

Buying a property is often cited by charities as an important capital fund raising opportunity. It is argued that funds can be found on the back of the project from organisation members or major donors which could not be raised otherwise. This will of course depend on the type of property selected and how well it is perceived to serve the charity's needs. Leasing needs to be funded like any other recurring operational expense. But unlike other expenses that can be turned up and down, rent payments are a contractual obligation that cannot be avoided.

Whether charitable activities, carried out within leased premises or specific facilities created to support them, can attract the same level of funding that buying the premises themselves might, is a question for trustees to ask their fundraising directors. If those facilities or activities are transferable, then it could be argued that they represent a more appealing cause than funds used solely for the sake of investment itself.

Capital fundraising has no apparent "cost of capital". So there is nothing to translate into a discount rate which would be required to support a financially-driven own versus lease decision. It is arguable that a fair comparison can only be made if some imputed cost of capital is used. Senior managers must therefore provide a financially balanced report to their trustees that takes into account foregone operational opportunities as well as the benefits of rent savings.

Image

The image projected from having a front door on to the street, prominent signage and control over branding of the building can be perceived as highly valuable to a charity. However, in contrast, the charity should also consider that the very same building may come across to the outside world either as having been an extravagant purchase, or a liability which is now an expensive burden in terms of maintenance. Those views could be more prevalent if the location of the building is somewhat detached from the area in which the charity's activities are carried out. For these reasons, many charities with central London headquarters, for example, need to regularly review whether their level of presence in the capital is genuinely justified.

For some charities with large property holdings, there could be a case for holding owned properties in their accounts at their original purchase price, rather than at their true current market value. This may be necessary to avoid the perception that the charity is well off, and less deserving of charitable donations than other charities with few or no fixed assets.

With leasing, the image conveyed will both reflect how the landlord manages the building as well as how the charity looks after its own space. Arguably, a more favourable image can be drawn from creating and occupying modern leased space and utilising it in a professional manner than from having an owned building whose style is rather out of keeping with the mission or objects of the charity.

Policy implications

Whether a charity is looking for freehold or leasehold occupancy, the use of a standard process will help ensure that the right decision is made. This is particularly important where responsibility for initiation of the project is held at a regional or branch level where property expertise is likely to be absent.

Property acquisitions should be planned within an approved business case, taking account of costs, benefits and risks and evaluated both qualitatively and quantitatively. Relocations require clear direction from a client sponsor who should ensure that instructions to professional advisors and contractors are being properly co-ordinated for completeness and consistency.

Business Case for Acquisition

Before any property search is commenced, the project sponsor should prepare a formal business case for senior management team approval. The business case should cover the following headings:

1. Summary recommendation/executive summary
2. A statement of how the proposal furthers the organisation's purposes
3. A financial and qualitative comparison between the proposed plan and other options under consideration (including "do nothing")
4. A brief of requirements recording size, location, purpose, type of space, technical requirements and leasing/ownership requirements
5. A statement of capital and revenue cost implications using discounted cash flow analysis where appropriate to show how alternative options compare
6. A professional valuation of any property to be disposed of as part of the programme to accord with the requirements of Section 36 of the Charities Act 1993
7. A programme detailing the key project dates and taking account of any consultation period required to agree the brief of requirements for the property search

8. An outline risk assessment
9. A statement on required professional support required and timing for procurement, including recommendation of the appointment of a surveyor/agent for the acquisition.

An appropriate business case process needs to be followed up by an objective evaluation of suitable property options, ensuring that there is a proper audit trail for the acquisition. Whilst the process should allow weighting of the relative importance of different elements of the brief, the key is to ensure objectivity rather than scientific accuracy. A professional approach should also be taken to negotiation of terms, undertaking due diligence and project management.

Conclusion

The charity sector is less well equipped to manage property decisions than the corporate sector, but the impact of its decisions is likely to be longer lasting and proportionately more significant. Hence, a robust methodology should be adopted to ensure that a brief of requirements is articulated before options are identified and evaluated. As well as including the physical components of the requirement, the brief should tackle up-front the specific issues associated with ownership and leasing.

At the end of the process, the key tests will be:

- Does the property meet the operational needs of the organisation now and can it adapt to change?
- Does the property reflect value for money, taking into account total property costs over the expected lifetime of occupation?
- Are the risks associated with the property recognised and can they be managed to maintain the expected benefits?
- Above all, does the project succeed in enhancing delivery of the core objectives of the organisation?



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