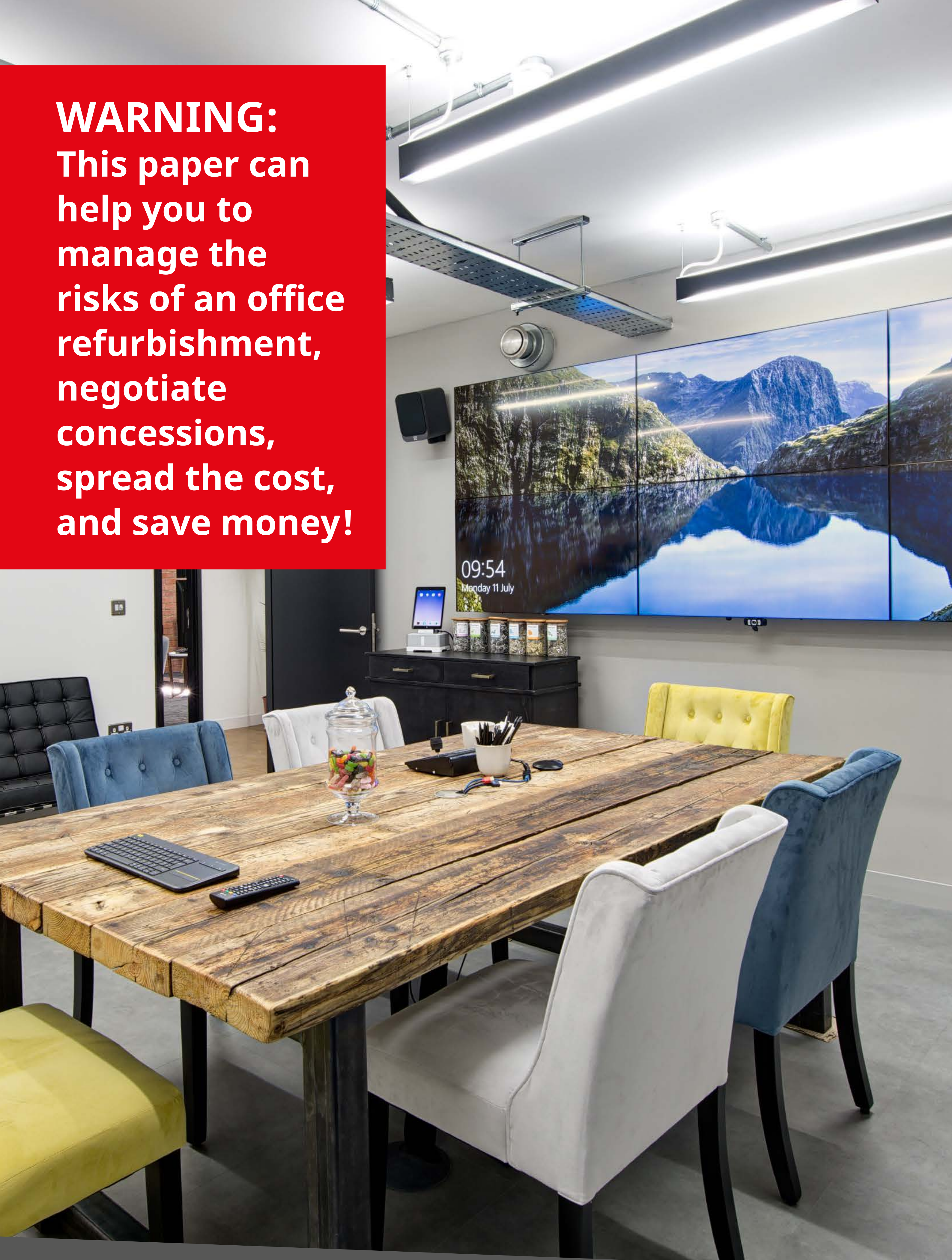
How Working with a Traditional Design and Build Firm Could Cost you Thousands

Your Step-by-Step Guide to Managing the Hidden Risks of an Office Relocation or Refurbishment Project

CCWS

WARNING:
This paper can help you to manage the risks of an office refurbishment, negotiate concessions, spread the cost, and save money!



Moving into a new office – or renovating your current one – is an expensive matter. Not only must you consider the physical costs of fit out, there are also the behind-the-scenes costs of surveys, landlord's permissions, finance costs and professional fees. And, if you're relocating, you may have dilapidations to consider.

As a finance manager, it's your job to ask tough questions about your office relocation, and to make sure your people do, too. These questions should drill down into areas like the ratio between landlord's costs and tenant's costs … all the different iterations of 're-fit' …. the real impact of yield up clauses… the tax consequences of refurbishment …. and whether a lump sum tender really adds up.

Many companies are unaware of the huge cost savings that can be made by managing the hidden risks associated with an office move, or at least, they're not getting joined-up advice. That means you may end up overpaying in project costs and delays, and shelling out cash that is unreasonable, unjustified and unfair.

This white paper looks at seven areas where commercial tenants can roll out significant savings in their office fit out project and truly get "more bang for their buck."

We do hope you find it useful.

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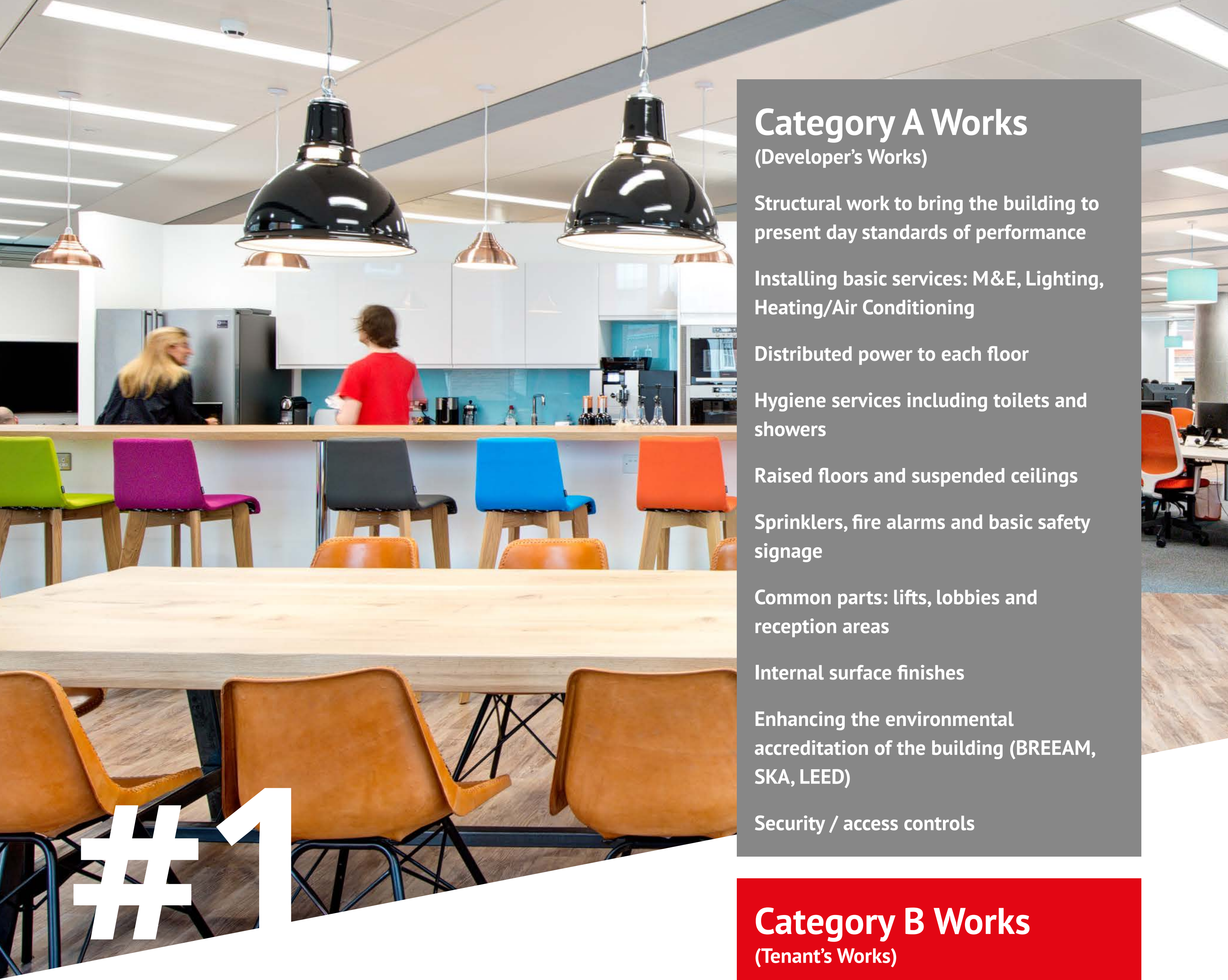


Category A Works
(Developer's Works)

- Structural work to bring the building to present day standards of performance
- Installing basic services: M&E, Lighting, Heating/Air Conditioning
- Distributed power to each floor
- Hygiene services including toilets and showers
- Raised floors and suspended ceilings
- Sprinklers, fire alarms and basic safety signage
- Common parts: lifts, lobbies and reception areas
- Internal surface finishes
- Enhancing the environmental accreditation of the building (BREEAM, SKA, LEED)
- Security / access controls

#1

Whose Fit Out is It, Anyway?

A landlord will typically hand over a building fitted out to a developer's **Category A specification**. The main objective here is to get the property ready as a blank canvas for you to go in with your own fit out partner and create a bespoke workplace solution. A tenant's **Category B fit out** – the part you pay for – will then add the partitions, break out areas, workstations, colours, furniture and so on that bring the space to life.

Unfortunately – and despite what your landlord will tell you – there is no standard definition for a Category A fit out. Ideally, it will include the work set out in the table, but the scope of work varies from developer to developer. In some cases, what is sold as Cat A comprises little more than stripping out of existing fittings and basic redecoration.

Category B Works
(Tenant's Works)

- Private and open plan workspaces, partitions and doors
- Meeting rooms, breakout rooms, kitchen facilities, staff wellbeing facilities
- Reception areas
- Enhanced Lighting
- Suspended ceiling upgrades and modifications
- IT, comms and audio visual equipment
- Carpets and floor finishes
- Enhanced floor and wall finishes
- Enhanced mechanical and electrical services / specialist lighting to suit layout
- Office furniture, branding and decorations

Landlord's Assurances: Not Robust Enough

Since there's no universal standard for Category A works, it's possible – even probable – that the scope of work will fall short in certain areas. For example, it's common for landlords to provide only a basic base-build power/data distribution solution which falls woefully short of today's technology requirements. While the landlord is not doing anything wrong, he effectively is **passing the cost of power and data distribution on to you.**

What kind of costs are we talking about? Price bands are as wide as they are long, but they are likely to be substantial. A medium-specification Category A fit out in London typically runs somewhere between £90 and £100 per square foot.[1] For a mid-range Category B fit out, you're looking at £64 to £88 per square foot (excluding office furniture)[2]. Any item that shifts from category A to category B is a significant cost-saving for the landlord – and a significant cost add on for you.

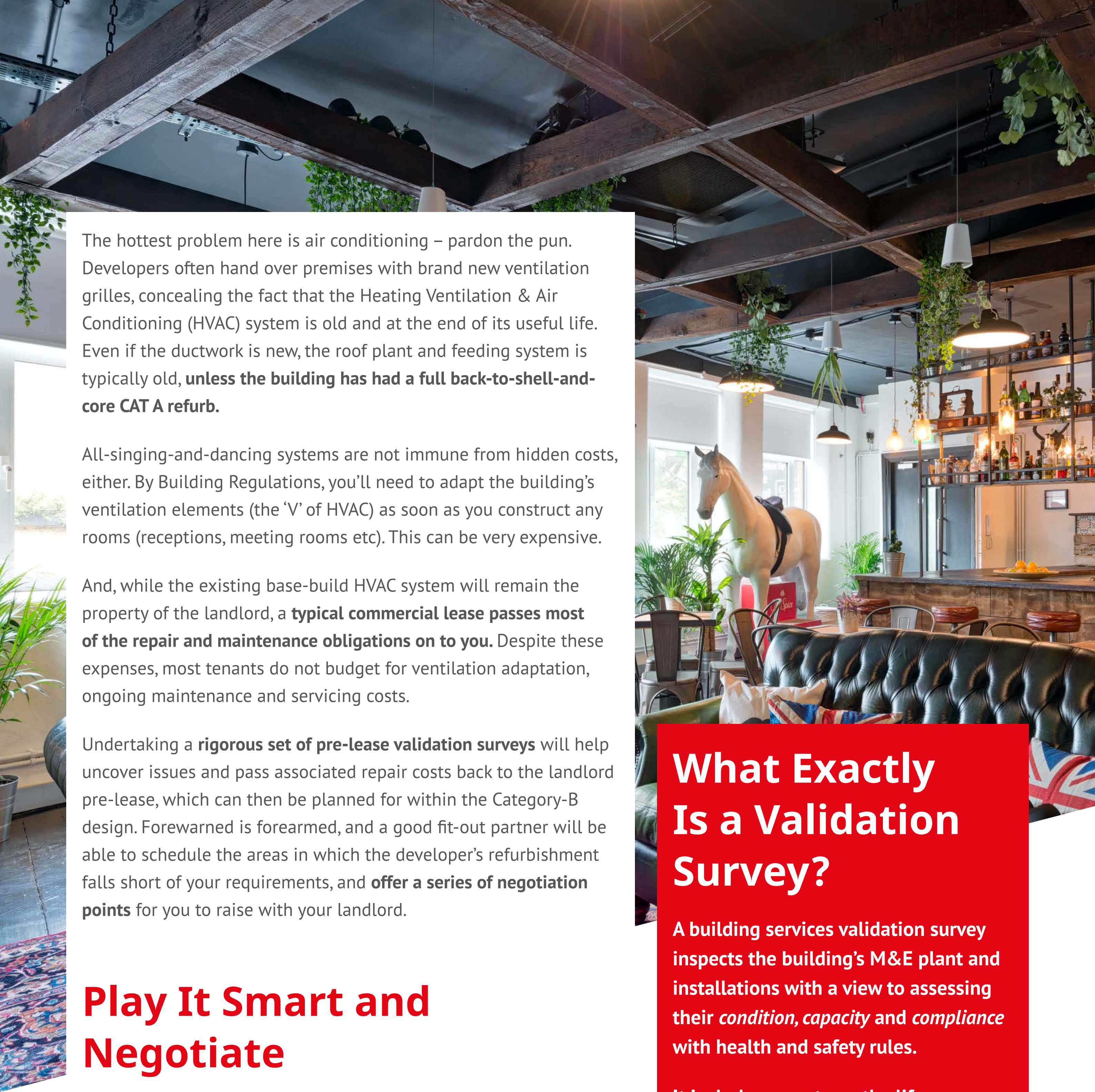
Any item that shifts from category A to category B is a significant cost-saving for the landlord – and a significant cost add on for you.

Validation, Validation, Validation.

One of the biggest fit-out challenges is not knowing what you are going to find under the hood. There are risks associated with hidden construction details of the existing building, and risks associated with the items the landlord has undersupplied during the developer's works. If discovered on site during refurbishment, these **hidden elements can cause costly delays or design changes to the project later on.**

[1] CBRE, "Building Cost Update," Q1 2014.

[2] Cushman & Wakefield, "London Occupier Fit Out Cost Guide," Q1 2017.



The hottest problem here is air conditioning – pardon the pun. Developers often hand over premises with brand new ventilation grilles, concealing the fact that the Heating Ventilation & Air Conditioning (HVAC) system is old and at the end of its useful life. Even if the ductwork is new, the roof plant and feeding system is typically old, **unless the building has had a full back-to-shell-and-core CAT A refurb.**

All-singing-and-dancing systems are not immune from hidden costs, either. By Building Regulations, you'll need to adapt the building's ventilation elements (the 'V' of HVAC) as soon as you construct any rooms (receptions, meeting rooms etc). This can be very expensive.

And, while the existing base-build HVAC system will remain the property of the landlord, a **typical commercial lease passes most of the repair and maintenance obligations on to you.** Despite these expenses, most tenants do not budget for ventilation adaptation, ongoing maintenance and servicing costs.

Undertaking a **rigorous set of pre-lease validation surveys** will help uncover issues and pass associated repair costs back to the landlord pre-lease, which can then be planned for within the Category-B design. Forewarned is forearmed, and a good fit-out partner will be able to schedule the areas in which the developer's refurbishment falls short of your requirements, and **offer a series of negotiation points** for you to raise with your landlord.

Play It Smart and Negotiate

Landlords are usually open to offering **financial contributions** equivalent to the time and cost of the category A items that it does not install, which are then installed as part of the tenant's category B fit-out. You should also be looking for a rent-free period.

Some landlords will also pitch in towards the cost of the tenant's fit out. It really depends on the space leased, lease length and competitiveness in the location. Get your solicitor on board to negotiate the right contribution. The savings can be enormous.

What Exactly Is a Validation Survey?

A building services validation survey inspects the building's M&E plant and installations with a view to assessing their *condition, capacity* and *compliance* with health and safety rules.

It includes reports on the life expectancy of plant and essential information regarding the plant's suitability for the tenant's occupation and future expansion. These reports help designers with specifying equipment for fit out and refurbishment projects.

#2

You Didn't Think You Could Walk Away, Did You?

What are your obligations at the end of the lease?

Most landlords require you to **return the premises you are vacating to its original state** when the tenancy ends, either at the end of the contractual term or when the lease ends prematurely through the exercise of a break clause. To comply with your legal obligations, you're going to have to remove all your fit out works and ensure the premises are, more or less, stripped back to a shell and core condition.

From a landlord's point of view, this is not unreasonable. The incoming tenant will have its own workspace requirements and would obviously want the premises handed over in a shell condition so they can go in and do their own fit out.

The 'yield up' clause in the lease makes it clear what is expected of a tenant as regards repair, decoration and removal of fit out at the end of the term.

From your point of view, however, this is likely to be costly in several ways.

1. The **physical cost** of having to strip out your fit out, make good any damage caused, and leave the premises in a good state of decoration and repair.

2. The **time cost** of stripping out, which includes full or partial loss of use of the premises and, depending on the type of business you run, loss of trade.

3. If you are relocating, the **time and financial cost of co-ordinating the strip out of your current premises and the fit out of your new premises** so that you transition seamlessly from one property to the next. This can be challenging!

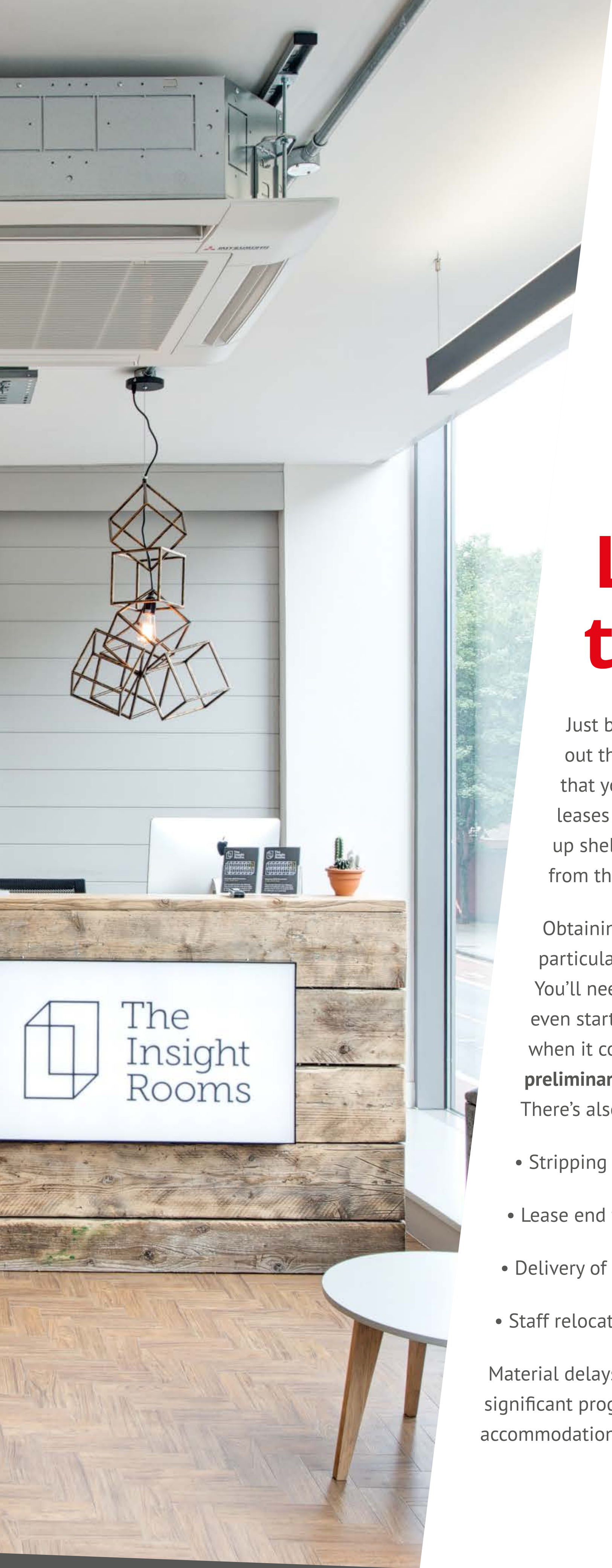
4. The **legal cost** if you don't fulfil your end-of-lease obligations. Leases often provide that, even after the term has ended, the landlord can serve a 'schedule of dilapidations' detailing any strip out and repair works that you should have carried out under the lease but did not. The landlord can use this schedule to reclaim the cost of making good the breach **and the rent the landlord would have received for the period it takes the landlord to do the work** you should have done. Like it or not, you'll also be landed with legal fees and court costs.

Dilapidations are extremely complex from a legal point of view – the case law alone could fill a library. Suffice it to say, if you get it wrong and wind up embroiled in a legal battle, you could end up seriously out of pocket.

How to Protect Yourself

The devil is in the detail, but so is the salvation. It's critical that you work with a fit out partner who understands the dilapidations protocol and can meet the legal and practical requirements of stripping out – often against very short timescales. All contractors are not the same!

With regard to the lease you are negotiating, there are certain things you can do to protect yourself in the future. Have your solicitor negotiate the reinstatement provisions so that you're not obliged to remove big-ticket items like toilets, air conditioning and services with more than five years' useful life remaining. Can you cap the dilapidations at the outset?



Licence to Fleece? #3

Just because you're taking a developer's shell and need to fit out the unit to make it suitable for your use, don't assume that you have carte blanche to do anything. Most commercial leases block significant alterations – anything above putting up shelves and laying a carpet – without specific permission from the landlord.

Obtaining a licence for alterations can be slow and costly, particularly if it coincides with negotiating the lease itself. You'll need a bunch of technical specifications before you can even start the application. This can present real challenges when it comes to **appointing contractors at risk to carry out preliminary design works that might not in the end be permitted.** There's also the problem of synchronising the licence with:

- Stripping out of the premises that are being vacated
- Lease end for the premises that are being vacated
- Delivery of new equipment, furniture, fixtures and fittings
- Staff relocation and removals programs.

Material delays in getting the landlord's licence can result in significant program delays, additional costs, or the need for temporary accommodation. Have you included a contingency in your budget?

What If the Landlord Says 'No'?

In England and Wales, landlords cannot unreasonably withhold consent to your proposed alterations – but they can impose house rules.

Restrictions on working hours, noise nuisances, waste handling and the use of lifts for materials and furniture can all add to the time and cost of a fit-out project. Understand the rules before you finalise the fit-out contract. Make sure your contractor has the ability to work weekends and nights to suit the landlord's requirements

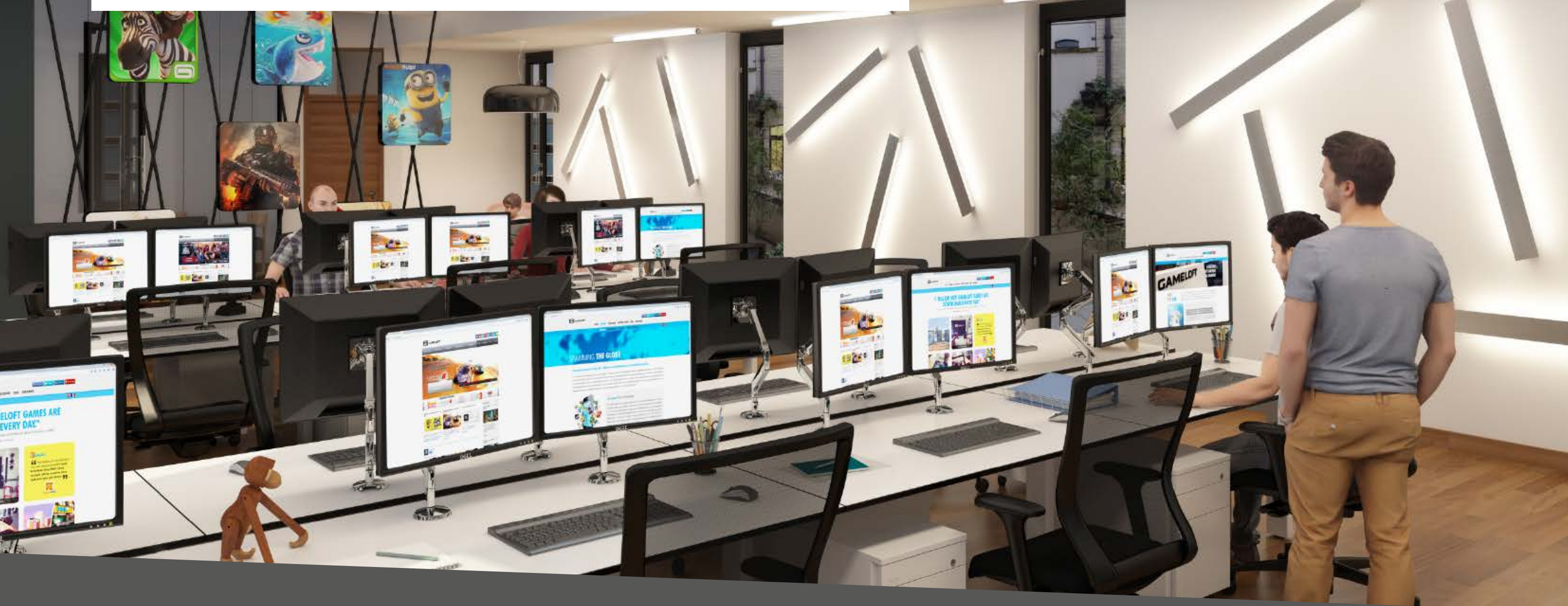
The More Time You Have, The Better Your Bargaining Position Will Be

Start early! Consult with the landlord as soon as possible to determine whether a licence is necessary, the likelihood of permission being granted, the timescale for obtaining a licence, and any requirements for carrying out the works

This is another area where choosing the right fit-out partner can pay dividends. Pick a partner who can guide you through the legalities; who can strike the right balance between your workspace vision and the realities of lease restrictions; who can avoid costly and unnecessary squabbles; and who can synchronise the many complex aspects of your project.

Things you'll need for a licence to alter:

- Specifications for the works
- Drawings showing the existing and proposed layout
- Structural drawings and calculations
- Building services drawings
- The works programme
- Method statements
- Risk assessments
- A copy of the F10 notification under Part 1 CDM Regulations
- Copy of insurances
- Copy of planning permissions, building regulations permissions and other statutory approvals



#4

Ethical contractors will be transparent with their costs. Provisional sums will be clearly noted at every stage.

When Is a Lump Sum Contract Not a Lump Sum Contract?

Where an item can't be fully described in the specification, the contractor will include an estimate as a Provisional Sum. This amount is often not included in the contractor's price and programme, and the total is added only when the work is carried out.

Most businesses require a high level of price certainty and favour fixed-price contracts. But if a contract is peppered with Provisional Sums, then the price you're paying is far from fixed. What appears to be a solid lump sum contract is essentially toothless, **leaving you exposed that the final cost may be significantly greater than the original contract price.**

If this situation sounds unpalatable – and it should – you have two options:

- Refuse to engage a contractor that presents cost plans littered with Provisional Sums. It may be impractical to avoid all provisions sums since, for example, the quote might include the cost of installing a wooden staircase where specific type of wood (and therefore its price) is not yet known. But there is scant justification for including Provisional Sums that give no certainty on cost or time.

- Require that Provisional Sums are defined (as opposed to undefined). Defined Provisional Sums are fully accounted for within the contractor's price build up, such that the **contractor is taking the risk that their estimate will be sufficient.**

Provisional Sums are provided for in different ways in different forms of construction contract, and some contracts are fuzzy about how Provisional Sums should be handled. Read up on your obligations. Know your potential exposure. And don't assume that an inflated Provisional Sum will be substituted by an appropriate valuation when the work is actually carried out.

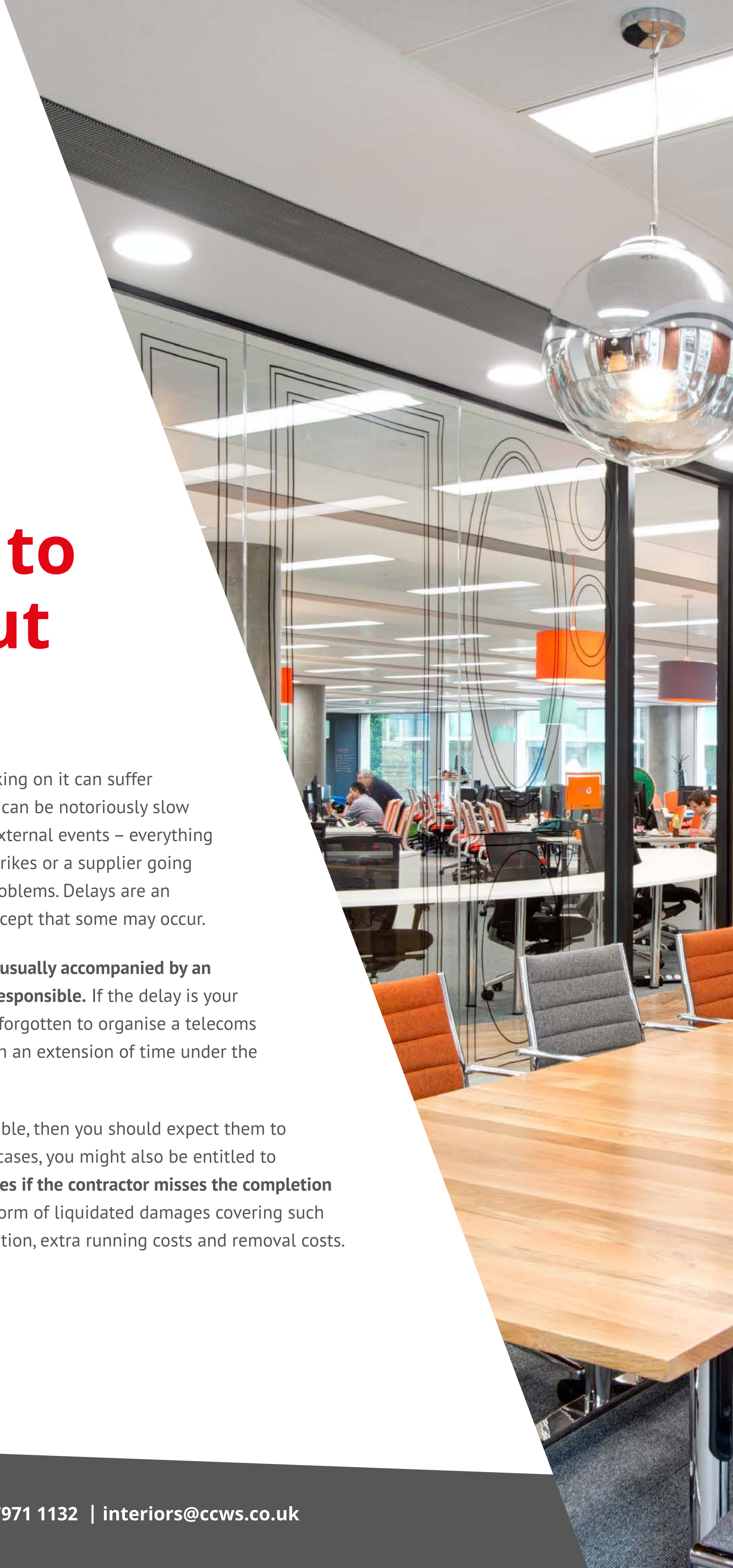
#5

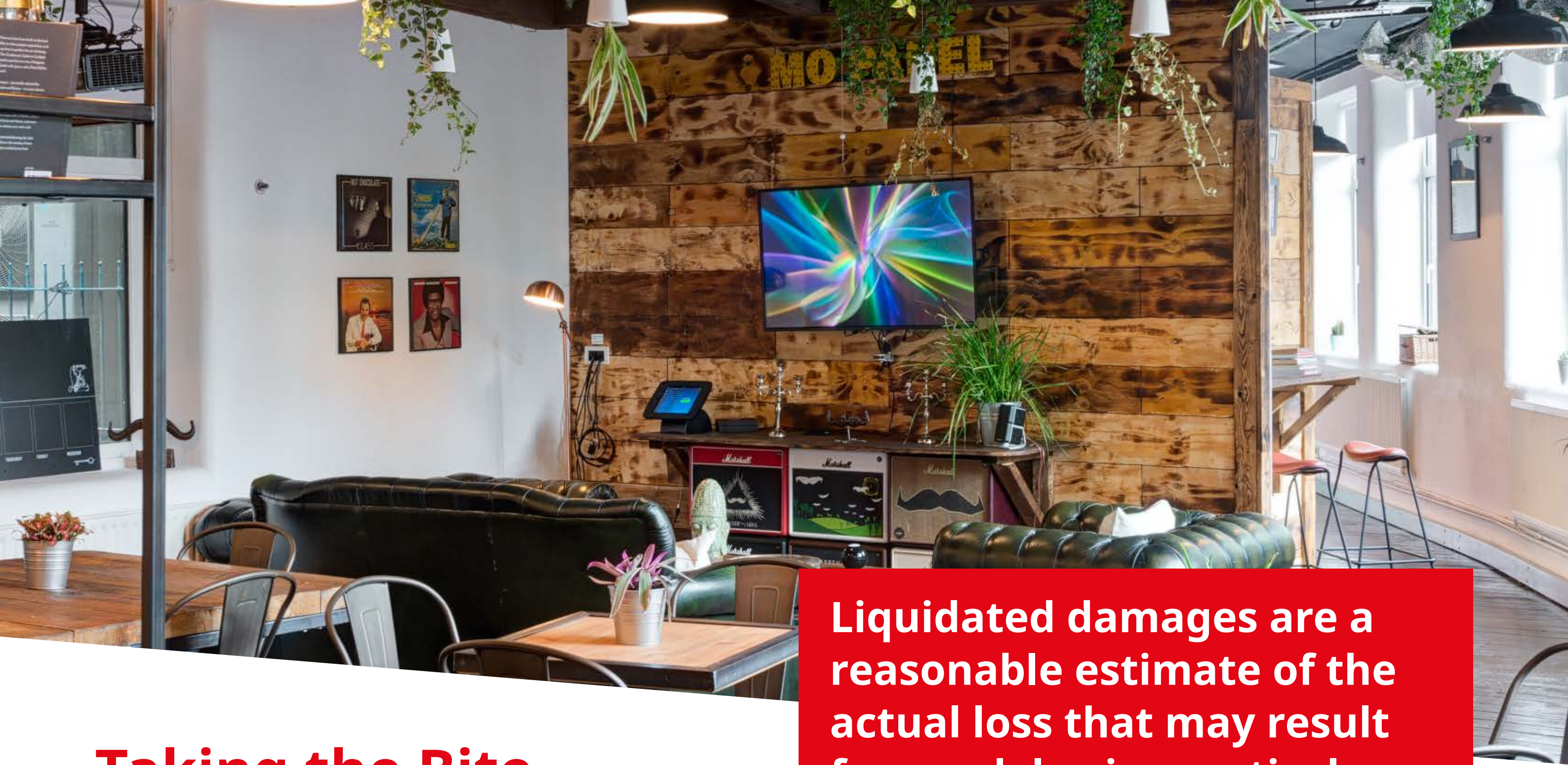
We Need to Talk About Delays

Even a fit out with the best teams working on it can suffer delays. Landlords and local authorities can be notoriously slow in granting the relevant permissions. External events – everything from bad weather and traffic jams to strikes or a supplier going out of business – can cause delivery problems. Delays are an occupational hazard in this industry. Accept that some may occur.

The delay in completion of a project is usually accompanied by an increase in cost, for which *someone* is responsible. If the delay is your responsibility, perhaps because you've forgotten to organise a telecoms connection, then you may be stung with an extension of time under the works contract and for costs.

Conversely, if the contractor is responsible, then you should expect them to absorb any additional costs. In certain cases, you might also be entitled to **compensation to cover your actual losses if the contractor misses the completion date.** Compensation usually takes the form of liquidated damages covering such costs as rent on temporary accommodation, extra running costs and removal costs.





Taking the Bite Out of Delays

Liquidated damages are a reasonable estimate of the actual loss that may result from a delay in practical completion. It isn't a penalty, but a *protection* that you won't be out of pocket if delay occurs.

Achieving practical completion with minimal delay and no adverse cost consequences for either party is the gold standard. How to achieve this? The answer is by thinking strategically and making careful investments in key areas that wring better results from your fit-out program.

1. **Start by building some slack into the works program.** By all means have a contract finish date to work towards, but have an actual backstop date that allows for some flexibility if delays occur.

2. Make sure that your fit out contractor **partners with reliable suppliers** who have a reputation for timely deliveries and a solid financial track record.

3. **Focus on your lead times.** Alongside the landlord's licence, other aspects of an office fit out require significant lead in. Telecoms providers, for example, have a go-live time frame anywhere between 6 and 12 weeks from ordering the lines and transferring deposits. A credible office design company will provide a highly detailed strategy that highlights lead-in times, especially for big-ticket items likes IT and furniture. We can't stress enough the importance of getting the lead-in right!

4. We mentioned this in Section One but it bears repeating – **validate the building's systems before you sign the lease.** Don't take the risk of uncovering HVAC problems after you've committed to a property and a programme; by then you'll have run out of time and other options.

5. Hire a contractor that will **write a liquidated damages clause *upfront* into your works contract.** Not only will this enable you to recover a fixed sum as compensation for delay instead of facing the time and expense of proving the losses which the delay has caused you, it will also induce the contractor to complete the works punctually. No one enjoys being stung with a penalty clause.

#6

Capital Allowances – Too Taxing For Tenants?

Tax relief in the form of Capital Allowances is available to businesses who are incurring capital expenditure on fitting out or refurbishing their premises. Claiming these allowances is a highly effective way of reducing the after-tax cost of fitting out property, providing a welcome cash flow advantage.

Here's a quick summary of the main types of allowance:

Integral features comprises assets that are 'integral' to the building – electrical systems, lifts, hot and cold water installations, heating and air conditioning. They provide a writing down allowance of 8% per year on a reducing balance basis[3].

General plant includes such items as data systems, telecoms installations, security systems, fire alarms, carpets, blinds, signage, reception desks, lighting and sanitary wear. Businesses can write them down at 18% per year on a reducing balance basis[4].

Enhanced Capital Allowances allow a 100% first-year write off against taxable profits for businesses that invest in qualifying energy and water-saving technologies[5]. ECAs effectively accelerate the allowances, which would otherwise be written down over many years at 8% or 18%.

Due the abundance of plant and machinery in a commercial office space, **we can often identify 80% of the fit-out money spent as qualifying for capital allowances.** Despite the enormous tax savings, they are often overlooked and undervalued by commercial tenants.

There's No Tax Relief If You Don't Claim

The main reason allowances are missed is because of the lack of detail in construction cost information provided by fit-out contractors. Where the information consists of high-level summaries, your tax accountant will struggle to break down and isolate qualifying costs which can result in lost allowances.

This is an area where hiring the right fit-out partner can save future complications and generate a significant tax benefit. Does your contractor have a track record in maximising capital allowances? Will they provide a specialist survey in order to identify and correctly value tax deductible items that are contained within the tender document?

3 Information correct for the tax year 17/18. Page retrieved 25 September 2017 from https://www.gov.uk/work-out-capital-allowances/rates-and-pools

4 Ibid.

5 Chartered Institute of Building Surveyors, "The Enhanced Capital Allowance Scheme for Energy-Saving Plant and Machinery," 2013

#7 Where to Go When You Need the Cash Flow

Leasing a fit out is tax allowable and spreads the cost over a number of years. This can help you get a better fit out than you originally assumed was affordable.

Cash flow is a major worry for most businesses engaging in an office fit out. The traditional method of financing is a capital purchase, but this has obvious disadvantages. Paying out of capital reserves ties up capital in assets that tend to depreciate quickly, which leaves your cash flow vulnerable. Using a bank loan or an existing line of credit compromises future working capital.

Both options can limit the budget and restrict the scope or quality of the fit out.

To Own Or Not To Own?

It comes as a surprise to many that **you don't have to use cash or bank lines of credit to fund your office fit out.** Leasing allows you to 'rent' your fit out and spread the cost based on a fixed budget, which can help you to plan around regular monthly outgoings.

Besides the clear advantage in terms of cash flow, finance leases are extremely tax efficient. Due to legislative restrictions, HMRC may only allow you to claim capital allowances against 65-80% of the fit-out project. However, **lease repayments are 100% allowable against taxable profits.** This makes leasing the most tax efficient method of financing a fitout.

Leasing facilities are generally available for everything from telecoms equipment through to office furniture – even software can be leased through specialist providers. In many cases, **an entire Category B fit-out including labour and tertiary costs can be wrapped into one finance package.** This means you might be able to acquire a better and more expensive interior than what you originally assumed was affordable.

Leasing isn't right for everyone, but for a sizeable proportion of businesses the advantages are compelling. Don't leave cash on the table. Choose a fit-out contractor that works with a dedicated finance partner to offer you a cost-effective alternative to using cash. Consider all the options before you buy.

Conclusion:
Talk to the Experts

This white paper has shown several areas where business leaders need a deeper, more granular understanding of the risks associated with office fit-out and refurbishment. In our experience, many cost-saving tactics are not well-understood by those involved with negotiating leases and tender documents, leaving valuable cash on the table.

The brutally honest truth is that office fit-out contractors are not consistent in terms of quality or experience. With the right partner by your side, it is much easier to manage the risks and business downtime during renovation. If in doubt, ask the experts!

To find out more about how to protect your company, talk to our Founder and Managing Director David Keane.

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www.ccws.co.uk | Tel 020 7971 1132 | interiors@ccws.co.uk