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Directorate C: National and European Accounts

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Mr Lambert Verjus
President
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Subject: Methodological treatment of the establishment of the dedicated real estate fund SICAFI – ex-ante consultation of Eurostat

Ref.: T/C2/2006/008796 of 18 April 2006

Dear Mr Verjus,

Following your letter of 18 April 2006, I am in a position to reply to the question you asked on the appropriate statistical classification for the case you have presented.

Procedure

There is no explicit Community legislation which governs a procedure by which Eurostat gives its views on operations which have not yet been enforced. Nevertheless, Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it is in possession of all of the necessary background information and provided that it may reserve the right to reconsider its view on the operations if this information turns out to be incomplete, or the nature of the operations changes in some way.

The accounting issue for which a clarification is requested

Our understanding of the case is as follows.

The dedicated real estate fund SICAFI will be jointly created by a private real estate company and government.

The transaction will proceed in the following steps:

Step 1: Government and a private real estate company will transfer to the SICAFI a certain number of their buildings and in exchange will receive shares of SICAFI. Government might not transfer its buildings to SICAFI by means of an outright sale, but instead by: (i) a direct contribution of the buildings to SICAFI, (ii) emphyteusis (droit d'emphytéose) for specific buildings.

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Step 2: At least 30% of the SICAFI shares will be sold to the public during the initial public offering. Eventually, government will remain the minority shareholder and retain 10% of SICAFI shares.

Initially, all or almost all of the buildings transferred by government to SICAFI will be rented back to government and public administration for a period of at least 15 years. Government will be granted pre-emption rights when the rental agreement will come to an end or in case of sale of building at the current market prices.

Similarly, government will be granted a preference right to extend the rental agreement. In case of the disagreement between SICAFI and government about the conditions of this extension, it will be settled by an expert.

Methodological analysis by Eurostat

After having carefully examined the documentation provided, Eurostat has reached the following provisional views.

Sale and leaseback

As far as the sale and leaseback operation is concerned, Eurostat considers (pending of course examination of the final contract) that the operation could be considered as deficit reducing only provided that all risks and rewards are assumed by the entities purchasing the real estate assets.

As a general observation, Eurostat believes that after the transfer of the buildings by government, the SICAFI might not be in a position to obtain full economic property of the buildings, as there would be an incomplete transfer of risks and rewards from government to the SICAFI.

As far as the risks are concerned, all the buildings which will be transferred by government to the SICAFI will be immediately rented back to government, for very long periods exceeding in most cases 15 years.

As far as the rewards are concerned, the SICAFI would not be able to rent the buildings to any other interested party unless government renounces expressly to this right. Even after the expiry of the initial rental contracts, government will have the automatic right to extend the rent of the buildings. That is, unless government decide so, the SICAFI will not have the right to sell or rent the buildings to another entity, and in particular to rent to the highest bidder. Moreover, the private real estate company owning the majority of stakes of the SICAFI, will not be able to sell its shares (and thus make a possible profit) for a period which will be pre-determined by government.

Thus, we are facing a situation in which the transfer of risks and rewards to the SICAFI might be incomplete

Emphyteusis

It is a question whether the emphyteusis is of a nature to a financial lease. Whilst the contract are long leases, they cover real estate assets that comprise fixed asset, the value of which will have mainly amortized by end of the contract, as well as land assets, the value of which is not expected to decrease over time. Thus the transfer of market exposure is very incomplete, and the original holder retains noticeable risks and rewards.

In this context it is recalled that ESA95 Annex III states "*If all risks and rewards of ownership are, de facto though not de jure, transferred from lessor to lessee, the lease is a financial one.*"

It is also important to notice that the Belgium government retains the right to sell those assets.

Conclusion

Eurostat's preliminary views on your questions are:

1. On the basis of the information provided, the SICAFI can be classified outside the general government sector.

2. Concerning the impact on the net lending / net borrowing of government, and depending on different ways of transferring the buildings to SICAFI:

   a) an outright sale has a positive impact, on condition that SICAFI ownership rights of the buildings are not restricted in any way, and that SICAFI is free to rent or sell the buildings at the end of the rental agreement to anyone offering the highest price;

   b) an emphyteusis (droit d'emphytéose) has no impact, as government preserves the right to sell the buildings that are subject to the emphyteusis, and all risks and rewards have not been mostly transferred;

   c) a direct contribution of buildings has a positive impact, under the same condition as described above, for an outright sale.

3. As far as the characteristics of the operating lease are concerned:

   a) The clauses about government being preferred to any other interested party at the end of the initial rental contract might have an impact on the evaluation of the nature of the lease. In such a case, it is not excluded that government will eventually be renting the buildings over all or most of the economic life of the building, what characterises the financial type of lease.

   b) There are no specific recommendations on the leasing period of the operating lease. Eurostat would like to recall that ESA 95 Annex III provides guidance on the period of the operating lease: "*Thus, the leasing period does not cover all, or a predominant part of, the good's economic lifetime.*"

   c) Moreover, concerning the emphyteusis, Eurostat cannot agree to consider it as a financial leasing, as de facto all risks and rewards of ownership will not be transferred to the SICAFI.

Open issues

Note that the following aspects remain unclear:

Concerning the role of the expert involved in settling possible disagreements between the SICAFI and government on the amount of rent: is the similar foreseen also in case of emphyteusis and the sale of the buildings by government.

I wish to stress that these preliminary views of Eurostat are based on the information provided by you and your services. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its views. To this end I would be grateful if you could supply to me the final details of the operation (contract and accompanying papers where relevant) when they are available, or (should this be the case) inform me that the planned operation has been abandoned.

Yours sincerely,

On behalf of
the Director

Laurs Nørlund
Director