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Real Estate M&A

How are key current trends shaping Real Estate M&A?

An increasing shift towards "campus style" properties in central business districts

- These involve mixed use properties and normally consist of office space, retail, residential and leisure.
- Given hybrid working appears to be a permanent fixture in UK life, workers now see coming to the office as a "destination" within itself and want to enjoy benefits such as eating out or retail amenities as part of a day coming into the office.
- The convenience of easy access to on-site leisure and well-being facilities, as well as the value of a sense of community, also continue to support activity in the PRS (private rented sector) and PBSA (purpose-built student accommodation) areas, particularly in and around London and other significant urban centres.

Increased ESG focus

- Given the increased shift in concern towards "ESG" (environmental, societal and governance) credentials across Western European societies, properties that embrace and encompass this (notably the "environmental" element) will continue to become highly sought after (as will developers that specialise in these types of properties).
- Equally, purchasers will increasingly find that, should they wish to purchase properties built only a number of years ago, increasing cost will need to be incurred to diligence the property in question from an ESG perspective.
- Potentially onerous costs associated with remedial work may also need to be incurred to remedy any defects in this area, notably concerning net zero carbon requirements but also cladding and fire safety.

Logistics platforms

- The UK has a highly-developed logistics network, with logistics parks (especially those able to access "last mile" areas of urban centres) increasingly desirable given a shift in consumer habits post pandemic. New players and platforms have entered the market.
- Across Western Europe generally, logistics networks in key hubs and along major access routes are equally desirable and these logistics sites across Western Europe will continue to grow in value and sophistication and attract investor interest.

What is a corporate wrapper deal?

A "corporate wrapper deal" (as it is commonly known) is a share acquisition of an SPV that owns only one asset, i.e.: a property. As such, while the transaction documentation will revolve around a share purchase agreement (and associated ancillaries), and will contain the common warranty protections and limitations that feature in a traditional share sale, a number of the considerations will have very specific real estate concerns, some of which we discuss below in this KeyNote.

When it comes to due diligence on corporate real estate transactions, what are some key issues to look out for?

- What "operating model" does the target use? I.e.: is it owner-operated or managed externally? What would be required to shift from one model to the other? What are the terms of appointment of any external manager, not only in respect of fees and delegated authorities but also term, termination and change of control?
- What is the target's corporate structure? In most property SPV transactions, a "PropCo/OpCo structure" is the most common.
- If the transaction involves the acquisition of a property that has employees and/or management, are the employees directly employed by the target company or by another entity (whether in or outside the group)? Is there a management agreement in place with existing senior employees? TUPE should be considered.
- If the SPV forms part of a group, what are the connections between the group and the SPV (e.g.: finance, services, group elections and incentives)?
- Are there any change of control consents needing to be obtained? If so (and depending on how or if they are material to the purchaser's post-completion business plan), the counterparty's consent will need to be obtained as a condition to closing.
- What development finance (including e.g. forward funding) arrangements have been/will be employed?
- What is the target's base cost in the property? Is there a material latent capital gain by reference to the current market value of the property?
- If the target's sole asset is UK property, it will be a property rich company, and an indirect sale of the target shares could also trigger a UK tax charge. If the target is a collective investment vehicle, or controlled by one, have transparency or exemption elections been exercised?
- Is the target a REIT (Real Estate Investment Trust)? If so, what impact will the acquisition have on its ongoing status as a REIT?
- If the target is not a UK company but holds UK property from which it receives rent, has it registered under HMRC's Non-Resident Landlord Scheme?
- In relation to VAT, has the target exercised an option to tax in respect of the property?

➢ Adjustment of consideration

- In Real Estate M&A, it is very common for any adjustment of consideration to be on a "net asset adjustment" basis (as opposed to a "working capital and net debt" adjustment). This is primarily due to the fact the price payable for the shares will be heavily dependent on one specific line item in the accounts, being the property. It is market standard for the buyer to prepare the completion accounts, although not in circumstances where the property price has been commercially agreed to include valuable chattels etc. (e.g.: expensive art and/or furniture in the common parts or management suite) where it may be that the seller prepares the accounts and the buyer reviews, as it will have greater background and expertise regarding these chattels.

- Any "net asset adjustment" will exclude: (i) reserves or capital created by the upward revaluation of assets subsequent to the balance sheet date; and (ii) the aggregate value of certain known liabilities and provisions of the target (including shareholder debt and external debt).

➢ Specific apportionments: service charge

- This is a unique element to corporate real estate transactions that will need to be apportioned correctly across the periods of ownership of the buyer and seller. Any service charge in arrears will normally be an obligation for the buyer to collect on behalf of the seller before the "Calculation Date" (but then meaning the buyer does not have to pay for it under the net asset adjustment), but this is always subject to commercial discussion.

- Service charge due and payable will be calculated using a specific "service charge statement", which will consist of calculating: (i) total service charge expenditure; (ii) recoverable service charge expenditure; (iii) total service charge receipts; (iv) service charge arrears; and (v) a metric which calculates the extent to which service charge receipts are in "surplus" or "deficit" in relation to the total amount the company has paid to maintain the property.

➢ Specific apportionments: rent

Rents are a line item that are traditionally picked up in specific policies of the completion accounts, calculated using a 365-day basis, and then apportioned accordingly against the "effective time", i.e.: the date completion occurs.

To the extent rents are received before the effective time, they will be for the account of the seller, and after for the account of the buyer. There are sometimes exceptions to this, such as large "occupational leases" that are accounted for separately, although this is beyond the scope of this KeyNote.

➢ Movement of funds

When dealing with an SPA that involves a corporate wrapper, how the deposit is dealt with will be different than under a traditional pure property asset sale.

Under an SPA with a split sign and completion mechanism, the deposit (normally 10% of the purchase price) will be payable on signing, with the balance of the "provisional consideration" (minus the deposit) but adjusted as per the net asset adjustment discussed above, payable on completion.

➢ Interim period

During the period between signing and completion, the normal interim covenants common in any share sale will be relevant, although specific ones to be aware of on a real estate corporate wrapper deal include:

- the seller procuring that the target continues to manage the property in accordance with the principles of "good estate management", and keeping the buyer informed of all material matters relating to the management of the property; and/or
- a prohibition on carrying out any structural alteration or additions to, or effecting any change of use of, the property (or any alteration of access to the property).

➢ W&I Insurance

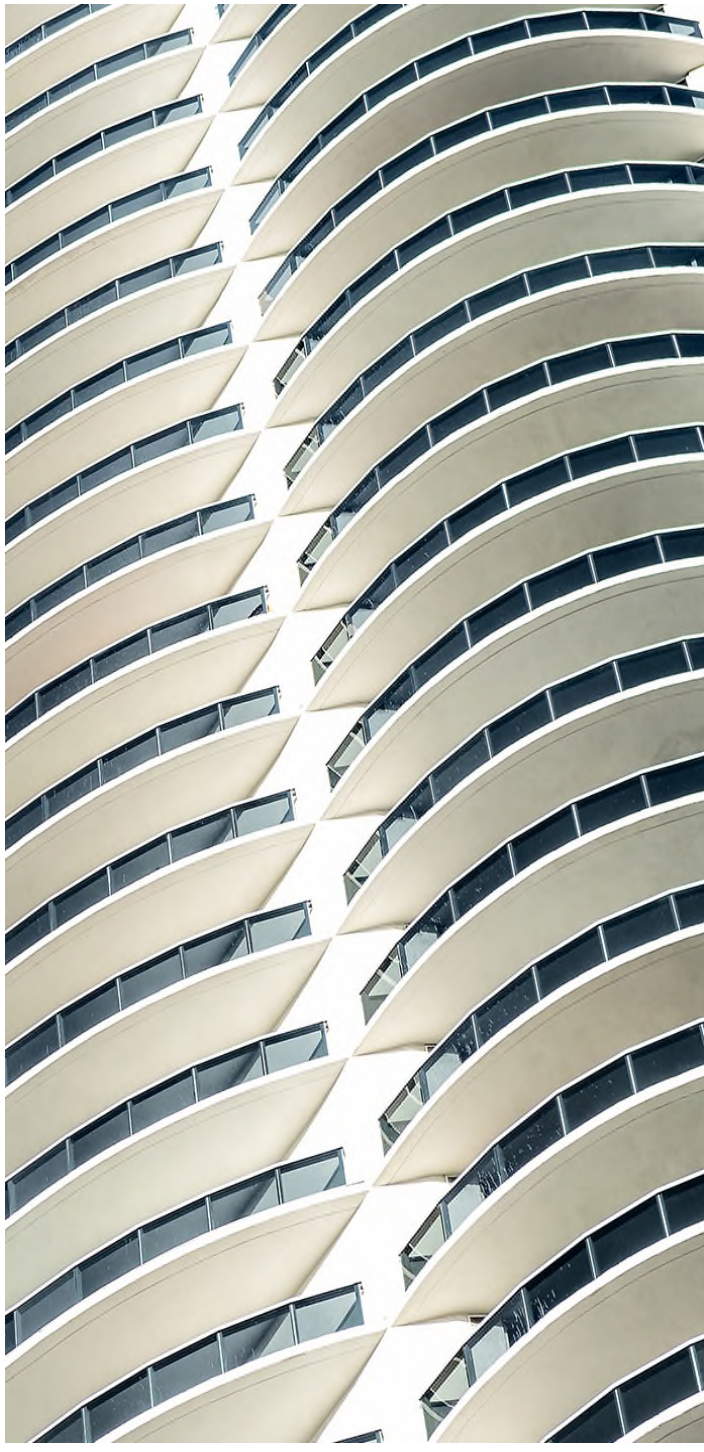
Due to the fact that corporate wrapper transactions frequently involve acquiring or disposing of a "clean" SPV (i.e.: an entity whose only asset is the ownership of the property in question), warranty and indemnity insurance is often taken out.

This typically limits any claims for breach of warranty (or indemnity) to £1 under the SPA, but then whoever has the benefit of the policy (normally the purchaser) will have recourse under the insurance policy.

There are, however, a number of areas that the insurance policy will not cover, including any issues identified in the due diligence phase, as well as certain categories of warranty.

A reputable broker should be engaged who will assist with ensuring the policy is as client-friendly as possible. It will be a matter of commercial negotiation as to who pays for the policy.

Please see our separate M&A KeyNote on Warranty & Indemnity Insurance for a more detailed discussion.



When it comes to corporate real estate transactions, there can often be a joint venture in place:

➢ Market players (such as major financial institutions) will sometimes seek to enter a "co-invest" (that is, a joint venture) with developers, whereby (very generally speaking) they will acquire a majority stake in the JVCo, but will fund the whole development of the property until exit.

Depending on the corporate vehicle used (this is often either an limited company or a limited liability partnership, with the choice as to exactly which structure to follow normally depending on tax structuring), the key document for the JV element is typically either a shareholders' agreement or members' agreement (depending on the choice of JV vehicle).

The level of control of the JV that each party will have will normally depend on their respective shareholding / membership interests in the vehicle and any separate agreements (e.g.: development/ management agreements), and will be important when it comes to agreeing the following:

- which matters are to be reserved for the shareholders to decide (as opposed to the board), and what level of consent is needed. Common reserved matters in property JVs concern: (i) expenditure on the property above a certain threshold; and (ii) renewing / taking on leases above a certain threshold;

- what happens if there is a "deadlock" over a particular matter, and it cannot be resolved. Common ways to resolve this are similar to normal share transactions, but any price payable by one party to another for the shares in the company will usually revolve around the open market value of the property, which crucially will depend at what stage of development the property is in when the dispute arises; and

- if this is a development transaction, the joint-venture parties will have agreed the time period by which to develop the property, and "exit" the investment (that is: market, and then sell the property).

- In addition, it is also common to have the ability for one party to potentially force a sale of the shares in the JVCo – for example, (i) if after a certain time period a property is being leased and it has achieved a certain percentage threshold of occupancy and (ii) in the case of a joint venture with a developer, upon material breach of the development agreement.

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