THE REAL ESTATE M&A AND PRIVATE EQUITY REVIEW

SIXTH EDITION

Editors
Adam Emmerich and Robin Panovka

THE LAWREVIEWS

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PREFACE

For real estate investment trusts (REITs), the covid-19 pandemic has been a tale of two cities, of boom and bust, with the seismic changes in the world leading to strength in some sectors of commercial real estate and huge market dislocations and disruptions in others. In general, companies with assets that service the digital economy – cell towers, logistics and industrial properties, and data centres – benefited from the pandemic's acceleration of the digital economy. However, several traditional sectors continued to confront difficult issues involving liquidity, rent collection, dividend payouts, disclosure and guidance, as well as navigating the uncertain and sometimes shifting guidance from regulatory authorities regarding the timeline of reopening. While the distribution of the vaccine to many individuals in the US and certain other countries has blunted the pandemic in some areas, inequitable distribution has yielded an uneven economic recovery internationally. Additionally, and for many traditional REITs most importantly, there are still many unknowns with respect to how soon and to what extent people will return to their offices and resume traditional offline shopping and travel, and which of the many other changes in real estate usage will become permanent or semi-permanent. The eventual 'new normal' that emerges from the pandemic will likely have rippling effects throughout the REIT industry for years to come. As always, strategic planning and risk management will be critical to adjust to changing times. Last year, we wrote of our hope of a clearer picture of our new normal in time for the publishing of this edition. While the vaccines and new year have brought hope for a path forward out of the pandemic, and certain jurisdictions have fully 'reopened' stores, offices and restaurants, we still have longer to wait to find out how many of the pandemic shifts (work from home, massive growth in online retail, shift away from 24/7 cities) are permanent, and which will fade with time.

Stepping back from the recent market dislocations, prior to covid-19, publicly traded real estate companies and REITs, with help from real estate private equity, have steadily transformed the global real estate markets over the past 25 years. Their principal innovation, and 'secret sauce', has been liquid real estate. Unlike traditional property ownership, equity in publicly traded real estate vehicles is highly liquid, and can be bought and sold in large volumes, literally in minutes, on numerous global exchanges. Indeed, during the pandemic, REITs have issued more than US$10 billion in public equity, taking advantage of the massive amounts of liquidity washing over financial markets beginning in spring 2020.

Publicly traded real estate vehicles have an aggregate market capitalisation of approximately US$1.5 trillion globally, including over US$1 trillion in the United States and approximately US$150 to US$250 billion in each of Europe and Asia. As public REITs and other vehicles have aggregated these properties and grown in scale and sophistication, so too have real estate-focused private equity funds, playing an important role catalysing hundreds of billions of dollars of REIT and real estate M&A transactions and IPOs.

However, despite that massive growth and despite the pandemic, potential growth is far larger both in long-standing REIT markets and in newer REIT jurisdictions, where the trend is more nascent. With increasing development and urbanisation, the world is producing more and more institutional-grade properties, and a growing percentage of this expanding pool – an estimated US$5 trillion and counting, so far – will inevitably seek the advantages of liquidity by migrating to the publicly traded markets. The growth is expected to be both local and cross-border, with nearly 40 countries already boasting REIT regimes.

REITs and other publicly traded vehicles for liquid real estate have grown because they are often a superior vehicle for stabilised assets. Greater liquidity and transparency – and often superior governance – are attractive to investors, resulting in a lower cost of capital and superior access to vast amounts and varieties of capital in the public markets. In addition to cheaper capital, REITs and other public vehicles benefit from efficiencies of scale, sophisticated management and efficient deal structures, to name just a few advantages. With these advantages, the global march of real estate to the public markets seems unstoppable.

This publication is a multinational guide for understanding and navigating the increasingly complex and dynamic world of liquid real estate and the transactions that mostly produce it. The sea change in the markets, sometimes called the 'REIT revolution', has meant that major real estate transactions have migrated from 'Main Street' to 'Wall Street'. They now often take the form of mergers, acquisitions, takeovers, spin-offs and other corporate transactions conducted in the public markets for both equity and debt. They have grown exponentially in complexity and sophistication, and increasingly represent cross-border multinational transactions fuelled by the now global real estate capital markets and M&A deal professionals. And they are often intermediated by international investment banks rather than local brokers, and financed with unsecured bonds or commercial mortgage-backed securities. In a fair number of cases, they are catalysed by private equity firms or similar actors, sometimes building portfolios to be taken public or sold to public real estate companies, and sometimes through buyouts of public real estate companies for repositioning or sale.

To create this publication, we have invited leading practitioners from around the globe to offer practical insights into what is going on around the conference tables and in the markets in their jurisdiction, with an eye to cross-border trends and transactions. As will quickly become evident, the process of liquefying real estate and transactions involving public real estate companies requires a melding of the legal principles, deal structures, cultures and financial models of traditional real estate, public company M&A and private equity. None of this, of course, happens in a vacuum, and transactions often require expertise in tax, corporate and real estate law, not to mention securities laws and global capital markets. Each of our distinguished authors touches on these disciplines.

We hope this compilation of insight from our remarkable multinational authors produces clarity and transparency into this exciting world of liquid real estate and helps to further fuel the growth of the sector.

Adam Emmerich and Robin Panovka
Wachtell, Lipton, Rosen & Katz
New York
July 2021

Chapter 15

UNITED KINGDOM

Richard Smith, Ed Milliner and Graham Rounce[1]

I OVERVIEW OF THE MARKET

Sadly, the devastating global impact of the covid-19 pandemic has continued to dominate the past 12 months. The pandemic is without doubt the most significant and damaging event in a generation. This tragic event has taken its human toll with over 178 million global cases and more than 3.8 million deaths. With the world's leading economies under intermittent lockdown, the covid-19 health crisis has become a global financial crisis.

Real estate has been hardest hit by covid-19 with a sharp decline in values across all sectors. Retail and leisure were already in serious decline and have suffered the most, as footfall has fallen off a cliff. Any increase in online activity has fallen well short of compensating for the collapse in overall sales. Squeezed property companies have been caught in the middle with their tenants unable or unwilling to pay rent and their funders continuing to look for interest and loan repayments. The government has sought to encourage collaboration between landlords, tenants and funders and has introduced limited measures to prevent 'rogue' landlords from taking enforcement action against struggling tenants. A significant amount of arrears has accrued since March 2020. Negotiations in respect of those arrears, as well as ongoing liabilities, are likely to continue for some time and it will be interesting to see to what extent, if any, the government chooses to intervene in commercial landlord and tenant negotiations. The message remains that the situation is not the fault of any particular party and that all those involved are in this for the long term.

In case we forget, the UK finally left the EU on 31 January 2020 and the transition period came to an end on 31 December 2020. While there have been some difficulties in adjusting to the new status quo, the much prophesied economic Armageddon has not materialised. The UK was successful in rolling over the majority of trade agreements that it enjoyed access to as an EU member state, has struck a deal of its own with Japan, and is making good progress in talks with Australia and New Zealand.

Covid-19 has had a profound effect on the office market as occupiers across the spectrum have been forced to re-evaluate their UK and global requirements. Most occupiers are looking to 'right size' their office space requirements and flexibility remains a priority. Unsurprisingly, the office letting market has been subdued and volumes are down significantly on 2019. Despite this, there are signs of stability and larger corporates and professional firms have continued to see the need for a landmark headquarters building to identify with their brand. Major deals included JLL's new London headquarters at 1 Broadgate and new

1 Richard Smith is a partner, Ed Milliner is a senior counsel and Graham Rounce is a professional support lawyer counsel at Slaughter and May.

Docklands offices at 20 Water Street, The Office Group's offices at 210 Euston Road, NW1, BP's pre-let of offices at Cargo, North Colonnade, E14, Linklaters' new London headquarters at 20 Ropemaker Street, EC2Y, Covington & Burling's London offices at 22 Bishopsgate, EC2N, Baker McKenzie's new London headquarters at 280 Bishopsgate and Diageo's new headquarters at 16 Marlborough Street, W1. The London office market offers flexibility to occupiers adjusting to new ways of working over the coming months. In addition to landmark headquarters buildings, flexible short-term serviced office space will prove attractive as businesses settle on their preferred working model. Vacancy rates in the regions have remained higher though the attraction of regional hubs will help spread demand across the country. Real estate investment volumes have also been badly affected. Although there has been some resurgence in investment activity in recent months, this follows record lows in the first half of the year. Major transactions included L&G's acquisition of the Sanctuary Buildings, SW1 for £300 million, Link Reit's £380 million acquisition of 25 Cabot Square, E14, NTT Urban Development Corporation's acquisition of 130 Wood Street, EC2, Sun Ventures' purchase of 1 New Oxford Street, WC1 for £173 million, M&G's acquisition of Fleet House, EC3 for £111.7 million, Brookfield's £472 million sale of 1 London Wall Place, EC2Y and Derwent London's sale of 2&4 Soho Place, W1. Somewhat symbolically, Topshop's flagship Oxford Street building has been put on the market for £420 million. Investment transactions have been dominated by overseas capital, with Singaporean investors being particularly active, while activity from UK buyers has tended to focus on smaller lots. Continued interest from overseas investors suggests that London remains a safe haven for investment capital in uncertain times. In the last quarter of 2020, investment volumes reached £4.9 billion with overseas investors accounting for 72 per cent.

Although the construction pipeline is reasonably strong, much of the space has been pre-let, helping to maintain healthy competition for new space. Outside of London, the regions will continue to benefit from continued decentralisation and cities such as Manchester, Edinburgh and Birmingham have proved particularly attractive for occupiers and investors, offering a strong talent pool combined with attractive amenities. While London will undoubtedly retain its attraction as a key global city in which to live, work and do business, rapidly evolving technology and flexible working practices established in lockdown mean that not everyone needs to be in the office all the time. While major businesses are likely to still look for a flagship central London headquarters building, that building may well be smaller than before and repurposed away from simply providing desk space. Sustainability is becoming increasingly important as landlords, tenants and funders come under pressure to achieve Environmental, Social and Governance (ESG) targets. This will focus demand on new developments allowing an occupier to impose its green credentials as part of its corporate identity. Landlords, tenants and funders are beginning to work together as enforceable green lease provisions start to become a reality, replacing earlier token statements of intent. A two-tier market is emerging with increasing vacancy rates in second-hand space and modern, safe and environmentally friendly buildings letting at a premium.

Professional service firms, including major international law firms, have been the dominant force in the letting market closely followed by the TMT sector. A number of leading international law firms have announced pre-lets of new London headquarters and others have taken the opportunity to re-gear and re-focus their existing space. Although the co-working sector has taken an immediate hit, the demand for flexible space will continue. However, in addition to connectivity and facilities, providers will need to ensure that they can offer a safe place in which to work. The co-working sector has become an established part of the market, including the development of sub-markets, as operators have sought to establish niche appeal. The sector will continue to be driven by demand for good quality office space, available on flexible terms and in well-located, safe and sustainable office buildings.

The covid-19 pandemic has caused the UK population to rethink its relationship between home and work. For many, working from home has become the new normal. Rapid advances in technology mean that long commutes to and from the office have ceased to be an essential, and time consuming, part of the working day. This has led to an increase in demand for larger properties with outside space, while the market for flats in urban areas has been badly affected. Interest has been strong outside of urban areas with increased demand in traditional second home locations such a Cornwall, the Cotswolds and Norfolk. Other factors affecting the residential market include the government's stamp duty holiday, concerns about cladding and the safety of taller blocks of flats, and the release of pent-up demand following the first lockdown. Self-storage suffered in lockdown with a drop in demand of between 30 per cent and 50 per cent. The country's housing crisis continues as successive governments have failed to meet new build targets and the UK's rising population will ensure that residential property will continue to provide opportunities for investors. Covid-19 has slowed construction with delays in the supply of building materials and difficulties in ensuring the availability of a skilled and unskilled workforce. In difficult times, high net worth individuals have started to return to the capital's super-prime market, prompting optimism for the previously deflated central London investment market. The wider residential market may be tougher later in 2021 as the economy struggles with the ongoing legacy of covid-19. In particular, a slowdown is predicted when the government's stamp duty holiday comes to an end at the end of September 2021.

With the exception of the major supermarkets and established online retailers, it has been a particularly disastrous year for the UK's retail sector. A succession of household names, including New Look, Edinburgh Woollen Mill, Arcadia, Debenhams and Laura Ashley joined the seemingly endless list of casualties in a sector struggling even before lockdown. Property companies and investors exposed to the high street have been badly hit as rent recovery rates have plummeted. Intu Properties, the owner of some of the UK's largest shopping centres, has been the most notable landlord casualty. London's normally resilient high end retail offering has been hit badly by the absence of overseas visitors. Traditional retailers have been forced to adapt to the changing habits of their customers, while online retailers and delivery companies have benefited from a significant increase in custom. Technology has adapted rapidly to the situation and there has been a particular growth in e-commerce sales from mobile devices. Investors will continue to rethink how they see retail assets and there will be a renewed focus on repurposing available space for residential, logistics and other uses. A number of high street retailers, including Fenwick, John Lewis and House of Fraser, have confirmed plans to repurpose upper floors of flagship stores as offices or residential. Despite high vacancy rates, there is some cause for optimism as a number of value operators have confirmed plans to expand and smaller independent operators have the opportunity to take prime space vacated by larger chains on flexible and affordable terms. The industrial sector continued to attract investment and well-located, high-specification distribution centres in the right locations continued to benefit from the boom in e-commerce. Logistics has been a rare success story in 2020 with online retailers such as Ocado and Amazon looking to expand their distribution networks. The sector has proved to be an attractive target for investment capital with logistics assets high up on the shopping lists of a range of overseas and domestic investors.

Alternative assets have become an established part of the investment market, alongside the traditional office, retail and industrial sectors. The build-to-rent boom continued as institutional investors looked to increase their market share and there has been an increase in the number of new projects in the construction pipeline, both in London and the regions.

Despite immediate covid-19 related operational difficulties, confidence remains high for operators in the specialist retirement living and student housing sectors, where major institutional investors are looking to increase their portfolios. For example, Legal & General entered into a £4 billion partnership with Oxford University to provide student and staff accommodation, as well as innovation space. Perhaps not surprisingly, there has been a surge of interest in the life services sector, with the Oxford-Cambridge arc attracting the most attention. The hotel and leisure sector is desperate for a return to healthy occupancy rates. Confidence in the travel industry is essential with foreign tourists required to fill an increasing number of available beds. More than 200 new hotels are currently planned for London, including the redevelopment of the former American Embassy on Grosvenor Square into a 137-bedroom luxury hotel. Opportunities can be found in the pub sector where some leading pub chains have expressed an interest in expanding their estates. Alternative real estate assets seem likely to offer opportunities as investors are forced to be more flexible in their quest for growth in this rapidly evolving and increasingly important sector.

It has been a difficult year for the UK lending market with an increase in defaults, restructurings and refinancing. The retail and leisure sectors have been particularly badly hit. Banks are anticipating problem loans and have reconstituted their bad bank structures to work out portfolios of non-performing loans. Businesses will struggle with increased levels of debt and face liquidity problems. Landlords and developers have found themselves squeezed in the middle as rental recovery rates have stalled badly, making it difficult for borrowers to meet their loan obligations. Development loans have been adversely affected by delays and defaults on construction contracts. This has led to an increase in lending costs. Despite caution in the banking sector, it is hoped that an already diverse lending market will help maintain liquidity. A significant development has been the emergence of green financing. Derwent London was the first UK REIT to sign a green revolving credit facility to finance projects meeting its green criteria, Tritax Big Box REIT issued the first sterling green bond by a UK REIT to finance or refinance new or existing green projects and Qatari Diar secured a £450 million green loan to finance the construction of The Chancery Rosewood. Inevitably, the stress of the pandemic will prove to be too much for a number of borrowers and there will be increased opportunities for investors in distressed assets and mortgage debt.

In 2020, the world became a very different place. We have not witnessed a global event of this magnitude in modern times. In the first half of 2020, covid-19 brought real estate M&A and private equity activity to a grinding halt. The second half of the year witnessed a significant increase in activity across all sectors. In particular, private equity funds sitting on substantial funds have been attracted by low valuations and take private opportunities, particularly in currently unfashionable sectors. Blackstone's £1.24 billion offer for St. Modwen Properties has been accepted, Loan Star acquired McCarthy & Stone for £647 million and The Wellcome Trust acquired Urban&Civic for £506 million. More recently, global markets have been buoyed by positive news regarding the development and roll-out of various covid-19 vaccines. Despite this remarkable scientific achievement in such a short period of time, it is clear that confidence will not return fully until those vaccines have taken effect and the pandemic is finally brought under control. The world faces an enormous logistical challenge as millions of doses need to be manufactured, distributed and administered across the entire globe. By the time we reach a point broadly approaching normality, aspects of how we design, build and use buildings will have changed forever. However, it is not all gloom and doom. The gap between share price and net asset values has made real estate companies attractive targets, consolidation is expected in many sectors and there will be opportunities in distressed M&A.

II RECENT MARKET ACTIVITY

- Issa and TDR Capital have acquired Asda from Walmart for £6.8 billion. The Asda property estate has backed a subsequent £2.75 billion bond sale.
- Blackstone has acquired a majority stake in Bourne Leisure, the operator of Haven, Butlin's and Warner Leisure Hotels.
- Blackstone acquired iQ student accommodation from Goldman Sachs and Wellcome for £4.66 billion.
- L&G purchased Sanctuary Buildings, SW1 for £300 million from Hana Asset Management.
- Cara Real Estate acquired 7–10 Waterloo Place, SW1 for £71 million.
- Hamilton Hotel Partners has acquired Pyramid Advisors Limited Partnership.
- The Freshwater Group of Companies has acquired a further stake in Daejan Holdings Plc for £269 million.
- Pollen Street Capital has acquired Urban Exposure Lendco for £113.8 million.
- AustralianSuper Pty Ltd has acquired a 25 per cent interest in Peel Ports Group Limited for £1 billion from Deutsche Bank and a private investor.
- Capital & Counties Properties has acquired a 26.25 per cent in Shaftesbury Plc from Samuel Tak Lee for £435.78 million.
- FirstPort has merged with Mainstay Group to create the largest residential leasehold block manager in the UK.
- Starwood Capital agreed to acquire a 29.42 per cent stake in RDI REIT P.L.C. from Redefine Properties International for £106.28 million and the remaining stake for £331.15 million.
- M7 Real Estate has been the first company to float an asset on the IPSX with the IPO of Mailbox REIT.
- Allianz acquired a 75 per cent stake in a West End office portfolio from British Land for £401 million.
- Sun Venture acquired 1 and 2 New Ludgate EC4 for £552.2 million.
- Blackstone has moved to take St Modwen Properties Private for £1.2 billion.
- Welcome Trust acquired Urban & Civic PLC for £506 million.
- APG Group has agreed to acquire a 50 per cent stake in VIA Manco (UK) Limited for £1.25 billion.
- Lone Star Funds have acquired McCarthy & Stone Plc for £708.54 million.
- Connells has acquired Countrywide Plc for £223.73 million.
- CPPIB Credit Investments acquired the Trafford Centre Limited shopping complex from Intu Properties in a debt-equity swap transaction.
- Goldman Sachs and Pitmore have acquired the Thistle build to rent portfolio of Gatehouse Bank and Sigma Capital for £150 million.
- Oxford Properties Group acquired M7 Real Estate Limited.

- Greystar Worldwide has acquired Nido's student accommodation portfolio from KKR for £291 million.
- Oakley Capital has invested in Dexters as part of a management buyout.
- Elite Partners Capital acquired a £70 million portfolio of government-let properties.
- Home REIT raised £240.5 million with its IPO.
- Cain International raised €324 million for its European Real Estate Opportunity Fund 1.
- Gallagher Holdings acquired the remaining stake in housebuilder Abbey, valuing the business at £328.8 million.
- Cadillac Fairview acquired a £250 million interest in the White City Place development project.
- Pontegadea acquired 21 St James's Square for £190 million from Columbia Threadneedle.
- Frasers Hospitality acquired Malmaison and Hotel du Vin for £363.4 million.
- Carlyle has acquired senior living developer Beechcroft from Alchemy Partners.
- ActivumSG has raised €550 to target distressed hotels across Europe.

III REAL ESTATE COMPANIES AND FIRMS

i REITs

The UK REIT regime came into force in January 2007. It exempts from corporation tax the income and capital gains of a UK REIT's property rental business. The income and capital gains of any other business, including from acquiring or developing property for sale, is taxed at the main corporation tax rate. While not all property companies are REITs by any means, the largest corporate real estate groups are structured as REITs to benefit from these tax advantages. As a result, M&A involving UK REITs will have specific considerations that will need to be taken into account.

Main conditions

A UK REIT can consist of either a single company or a group of companies. The basic conditions that must be met by the company or parent company of a group are as follows:

a it must be resident only in the United Kingdom for tax purposes;

b it can have only one class of ordinary shares, which must be admitted to trading on a recognised stock exchange, and either listed or actually traded on such an exchange;

c it must not be a close company (a company that is controlled by five or fewer shareholders), although close companies that are controlled by certain institutional investors, such as pension funds, charities, certain collective investment schemes and other REITs, are allowed; and

d the property rental business must constitute at least 75 per cent of the total profits and assets of the company or the group.

There are also diversification rules requiring a business to hold at least three properties, each representing no more than 40 per cent of the total value of its portfolio.

To ensure that the property income generated by a property rental business is ultimately taxed, at least 90 per cent of the income profits of the business must be distributed annually by way of dividends. A UK REIT is subject to a tax charge to the extent that it falls short of this.

A leverage requirement is also imposed such that the gross income of a UK property rental business must cover the external financing costs of the entire property rental business by a ratio of at least 1.25:1. Again, a tax charge is imposed on UK REITs to the extent of any excess financing cost.

Takeover of a UK REIT

If a UK REIT, whether a single company or a group, becomes part of another REIT, it will remain within the UK REIT regime as long as the conditions continue to be met. A takeover may well cause the company (or parent company of a group REIT) to become a close company unless the terms of an acquisition are such that at least 35 per cent of the ordinary shares remain in public hands. UK and equivalent foreign REITs are now recognised as institutional investors, which should deal with that point in most cases – however, it will not always be the case that a foreign entity labelled as a REIT will be equivalent to a UK REIT, so a degree of circumspection is required. In a cross-border context, the impact of the leverage requirement – in that it looks at gross income of the UK property rental business only but takes into account the external financing costs of the worldwide property rental business – will need to be considered.

ii Recent developments

The introduction of UK REITs in 2007 coincided with the beginning of a major downturn in the commercial real estate market. UK REITs were conceived during a UK property boom and consequently faced challenges during the financial crisis.

However, as property prices have recovered, there has been a renewed interest in UK REITs as a tax-efficient investment structure, especially following the abolition of a 2 per cent entry charge on seeding assets in 2012. The UK REIT regime is an improvement to the tax environment for UK real estate companies and has consequently had a positive impact on the UK-listed real estate sector. That said, the recent introduction of the indirect chargeable gains charge (discussed in more detail below) has possibly soured things a little by making disposals by non-residents of holdings in UK REITs subject, in principle, to UK tax. The UK REIT sector now includes some of the United Kingdom's largest real estate companies, such as Land Securities, Derwent London, British Land, SEGRO, Great Portland Estates, Hammerson and Canary Wharf Group. The number of UK REITs has grown significantly in recent years (including externally managed UK REITs) to over 50.

iii Real estate private equity firms

Structure

In the United Kingdom, real estate private equity firms can be structured in a number of ways. As a result of regulatory and tax issues, which affect the operation of a fund and its investors, the most common structure in the United Kingdom is an English (or Scottish) limited partnership. These vehicles have no legal status in their own right; they exist only to allow the partners to act collectively. Each partnership:

a has a finite life (usually 10 years with a possible two-year extension, although some have investors with rolling annual commitments);

b has one general partner with unlimited liability for the liabilities of the partnership;

c has a number of limited partners (LPs) whose liability is limited to the amount of their equity investment in the partnership; and *d* is managed by an investment manager on behalf of all the partners.

The investment manager is a separate entity (owned collectively by the private equity fund managers). It is structured as a partnership (then an offshore limited partnership). The manager receives a fee from each fund it manages.

The general partner is a company owned by the investment manager and, in compliance with the Limited Partnerships Act 1907, must have unlimited liability for the liabilities of the private equity fund. However, the individual partners cap their liability by investing through a limited company. Individual partners of the private equity fund manager are required to invest their own money directly in the fund (usually between 1 and 5 per cent of the fund).

External investors are LPs. Their total liability is limited to the amount of capital they have invested. LPs themselves may be structured as corporations, funds or partnerships.

Footprint

Private equity firms have been major investors in UK real estate in recent years. Investment has been made across a wide range of sectors including hotels, residential schemes, housebuilding, healthcare, student housing, restaurants, serviced offices, logistics and retail.

Private equity firms have continued to raise large amounts of capital for investment in UK and European real estate and investment activity has been buoyed by the relatively low risk opportunities afforded by real estate in terms of a reliable income stream and capital growth.

IV TRANSACTIONS

i Legal frameworks and deal structures

Legal frameworks

When investors acquire or dispose of real estate in the United Kingdom, the majority of deals do not involve a transfer of title to the relevant property from the seller to the buyer. While smaller deals may involve the direct transfer of real estate assets, for a number of reasons (the main driver is often tax, as outlined below), the acquisition or disposal of real estate assets is made through share purchases of corporate vehicles that own the property in question. It is unusual for there to be a direct transfer of real estate.

Various structures are used to acquire and hold real estate. The optimum structure will depend on, in each case, a number of factors and considerations (including funding, tax and exit routes (for private equity funds)). Typical structures include:

a companies limited by shares: body corporates with a legal personality distinct from those of their shareholders and directors; these companies are governed by the Companies Act 2006;

b limited partnerships: discussed above in relation to private equity firms;

c limited liability partnerships (LLPs): bodies corporate with a legal personality distinct from those of their members. Members have limited liability in that they do not need to meet the LLP's liabilities. They are governed by the Limited Liability Partnerships Act 2000 and the Companies Act 2006;

d joint ventures: there are no laws relating specifically to joint ventures under English law. their structure will be determined by the nature and size of the enterprise, the identity and location of the parties and their commercial and financial objectives. The relationship between the parties will be subject to, depending on the structure, general common law rules, the legislative provisions of company and partnership law and the provisions of the joint venture agreement;

e trusts of land: any trust that includes land as part of a trust property will be a trust of land. Trustees have the power to sell the property, but no obligation to do so, unless this is expressly provided for. They are governed by the Trusts of Land and Appointment of Trustees Act 1996; and

f REITs.

Deal structures

Share acquisitions with cash consideration remain the predominant form of real estate transaction structure. This is likely attributable to the relative simplicity of completing a transaction structured as a share acquisition and, from a valuation perspective, the certainty of receiving cash consideration.

Fixed-price transactions (often in the form of locked boxes) are the structure of choice for private equity sellers, although they are increasingly used by trade sellers conducting auctions. Earn-outs and deferred consideration are not common features of the UK real estate M&A market.

Post-completion adjustments to the purchase price are also a common feature, particularly where there is a delay between signing and completion (see below). Adjustments are most commonly made to account for variations in working capital and net debt.

The use of escrow structures has also increased in the real estate private equity M&A market as a way to make contractual claims in respect of warranties and post-completion purchase price adjustments.

Acquisition agreement terms

As previously noted, typically real estate assets will change hands through a sale of the shares in a corporate vehicle that owns those assets. As with any share deal, the buyer will take on the target's existing liabilities and commitments and the seller will provide warranties and certain indemnities. The title to the real estate assets will usually be certified by the seller's counsel. The extent of the sales and purchase agreement (SPA) provisions will vary depending on the nature of the transaction, the real estate assets in question and the due diligence undertaken. However, there are a number of aspects to consider.

Conditionality

A number of conditions may need to be satisfied before a real estate transaction can complete (such as obtaining planning permission, third-party consents or even practical completion of a property development). Any such conditions must be satisfied or waived before the real estate transaction can complete.

Splits between signing and completion

For any split between signing and completion, several practical matters should be considered, including whether:

a shareholder (or equivalent) approval is required by either party;

b EU merger clearance is required;

c any warranties given at signing need to be repeated at completion;

d rescission is possible between signing and completion;
e any deposit paid at signing should be returned to, or forfeited by, the buyer if the transaction does not complete; and
f management of the underlying properties is required and, if so, whether the buyer will exercise control.

Rescission

Where there is a split between signing and completion, this may affect whether a buyer is able to negotiate a rescission right, as mentioned above, during that time.

Where sellers are required to obtain shareholder approval for a real estate transaction after signing but before completion, it will be difficult for them to argue that during this period the buyer should face the potential risks and be unable to rescind.

In contrast, where the reason for a split is as a result of the time required by the buyer (e.g., to procure debt finance), it is less likely the buyer will be able to negotiate a rescission right for anything other than material breach of any restrictive conduct provisions.

Buyer protections

In UK real estate acquisitions, buyer protections are particularly important as the buyer is not afforded any statutory or common law protection on acquisition; caveat emptor (buyer beware) applies. Where a buyer purchases a target group and is to inherit all related obligations, liabilities and commitments, a robust package of warranties and appropriate indemnities will be required from the seller. These will normally be limited to the corporate vehicle and taxation matters; the buyer will usually be expected to satisfy itself on title to the real estate assets through a normal due diligence exercise or reliance on certificates of title issued by the seller's lawyers. Recently we have seen a move towards title insurance as a way for buyers to deal with title due diligence, sometimes in combination with purchaser due diligence or certificates of title, or both of these. A combination of approaches is not uncommon on portfolio deals with properties of various values or significance.

Warranties

Although sellers (particularly private equity sellers) will not want to provide a large number of warranties on the sale of real estate assets, they are important to provide buyers with some contractual protection. An SPA will not generally include long-form property warranties; the buyer's property enquiries will be answered by the seller in the form of representations.

Buyers are increasingly succeeding in extending the scope of warranty coverage, although sellers often succeed in disclosing all due diligence information against such warranties. Private equity sellers have also conceded business warranties on occasion (however, these tend to be in respect of identified issues that cannot be addressed through further diligence or otherwise reflected in the price).

The repetition of warranties at completion is usually limited to core warranties regarding title to shares or real estate assets and the capacity and authority of the seller to enter into a transaction.

Indemnities

Where a buyer identifies (through due diligence) a particular risk or liability that it is unwilling to assume (e.g., environmental risks or planning liabilities) and that risk is not easily quantifiable, specific indemnities will be sought, shifting the exposure to the seller. Warranty claims are difficult to make in practice, so indemnities are preferable from the buyer's perspective. Sometimes title insurance to protect against a specific title defect can be obtained.

Seller protections

The limitations on a seller's liability under an SPA will be dependent on the particulars of each transaction. In practice, however, the parties will agree that certain warranties (i.e., core warranties) will be capped at the overall consideration for the deal. Depending on commercial and competitive pressures, there may be a different cap on liability for other warranty breaches (e.g., 15–20 per cent of the overall consideration).

General warranties are likely to have a duration of 18 months to two years, while tax warranties are more likely to have a duration of four to six years. There is also likely to be a *de minimis* threshold that must be reached before a claim is brought.

As previously noted, the seller's exposure under the warranties will be limited by the disclosures made in the disclosure letter (which the buyer will ensure are sufficiently detailed so that a view can be taken on its liabilities).

There is a growing tendency for both sellers and buyers to obtain warranty and indemnity insurance in the UK M&A market. Insurers such as Aon and Willis are increasingly marketing their willingness to offer warranty insurance, although they expect that careful due diligence will be carried out in the normal way by the buyer. This trend has been driven by sellers seeking a clean exit – a broader set of warranties can be presented with limited post-completion financial exposure. Similarly, buyers are arranging insurance to supplement or cover gaps in the protection provided by sellers – securing sufficient protection can allow buyers to proceed with a transaction without raising a seller's exposure and potentially prejudicing the competitiveness of any offer.

ii Financing considerations

Real estate investors are usually backed by a mixture of debt and equity. Lenders will require typical security packages in relation to real estate lending, which will consist of:

a charges by way of legal mortgages over real estate assets;
b charges over rents receivable;
c potential charges over bank accounts into which rents are paid; and
d additional charges over certain contracts (such as leases, insurance policies and development and construction contracts).

Depending on the circumstances, lenders may also seek protection against borrower default through conditions precedent and direct covenants in the facility agreement, property valuations, parent company guarantees and bonds, and cash collateral, and by obtaining floating charges from the parent company.

Where development and construction are anticipated, lenders may also require approval of material development documentation as a condition precedent to drawdown and may expect to receive collateral warranties or third-party rights from contractors, designers and key sub-contractors. Step-in rights may also be sought to take over a contract in the event of default.

iii Tax considerations

Stamp duty land tax (SDLT) is payable by the buyer of commercial real estate and is a percentage of the purchase price, varying depending on the consideration paid for the property. SDLT is currently payable at 2 per cent on the portion of consideration between £150,001 and £250,000, and 5 per cent on the portion of consideration above £250,000. For investors to avoid paying high tax rates for individual real estate assets, it is better for the shares in the vehicles themselves to change hands. SDLT does not apply to the purchase of shares in companies holding real estate assets (at least, not yet – see below). The rate of stamp duty on the transfer of shares in a UK-incorporated company is 0.5 per cent.

If real estate assets are sold and purchased directly, the default position is that the sale or purchase in the United Kingdom is not subject to VAT, although owners can opt to tax property at the standard rate of 20 per cent. Generally, most owners opt to tax – the exceptional cases tending to be where the occupational tenant is one with restricted VAT recovery, such as a bank or insurer. Where a property is currently let or a letting has been agreed, VAT can be mitigated by ensuring the sale is treated as outside the scope of VAT as a transfer of a business as a going concern, provided the buyer continues letting the business and opts (and notifies HMRC that it has opted) to tax. Otherwise, even if the buyer can recover all of the VAT charged on the sale, the VAT amount will count as part of the consideration on which the SDLT charge is calculated and thus create an absolute cost in all cases.

Interest charges on borrowings are, generally speaking, deductible expenses for tax purposes, so gearing will generally result in tax efficiency. Many real estate investors introduce borrowing to achieve this result. In such circumstances, it is important that any loan arrangement is at arm's-length. Loans that do not meet that commercial threshold will not qualify as being deductible.

With effect from April 2017, the UK introduced a new restriction on the deductibility of debt finance for corporation tax purposes, similar to those that have existed for some time in other jurisdictions (such as Germany). The UK regime limits interest deductions to 30 per cent of a group's taxable EBITDA. The intention is more to discourage groups shifting a disproportionate amount of debt into the UK than to attack debt finance as such. Accordingly, groups that are highly geared on a worldwide basis may benefit from making an election that permits the use of a percentage based on the ratio of the group's net interest expense to its global accounting EBITDA. There is also an exemption for third-party debt incurred by infrastructure companies that, somewhat generously, extends to companies carrying on a UK property letting business (provided the leases in question are to third parties and do not exceed a duration of 50 years).

A significant change to the taxation of offshore investors in UK real estate was announced as part of the 2017 Budget. With effect from April 2019, non-resident companies became subject to tax on profits and gains arising from holding or disposing of UK real estate in the same way as UK resident companies. Previously, non-resident investors paid only income tax on rents, and, although disposals of residential property by non-residents have been subject to capital gains tax since 2015, the new tax charge covers all forms of UK property. A more surprising part of this package was that non-residents that dispose of indirect interests in UK property (essentially, shareholdings in UK property-rich companies or collective investment schemes) are now in principle liable to UK tax on any gain, subject to any exemption and the terms of any applicable double taxation treaty. A company will be UK property-rich if more than 75 per cent of its gross asset value is attributable to UK real estate (whether held directly or via subsidiaries). A non-resident will be subject to tax on any gain if it holds a 25 per cent or greater interest in the company, or has done so within the preceding two years and with interests held by connected parties being aggregated. However, investors in collective investment schemes (including UK REITs) do not benefit from this 25 per cent threshold unless the vehicle they invest in is widely held and is marketed as being invested as to no more than 40 per cent (by market value) in UK real estate.

The UK had not before attempted to tax non-residents in this way, and this change has received much negative comment. It is also widely seen as a precursor to the introduction of indirect SDLT, similar to the German real estate transfer tax, although no formal proposals for this have yet been announced. Instead, the focus now in terms of new real estate taxes is a proposed 'Residential Property Developer Tax', to be introduced in 2022. This tax has the rather specific object of raising at least £2 billion over a 10 year period to fund the remediation of unsafe cladding in residential apartment blocks, a policy brought about following the Grenfell Tower tragedy of 2017 and the realisation that a number of apartment blocks in the UK were fitted with cladding, previously considered to be safe, that was now understood to present a fire hazard. The proposed new measure would in effect be a surtax on the profits of businesses undertaking residential property development in the UK, whether for investment or sale.

One noteworthy fiscal response to the pandemic was the decision taken in the 2021 Budget to increase the UK's corporate tax rate from 19 per cent to 25 per cent with effect from April 2023. This represents a significant reversal of the policy first adopted by the last Labour government in 2007 of reducing the rate from its high point of 30 percent – at that stage to 28 per cent – and further under the Coalition and the current Conservative governments to its present rate of 19 per cent.

V OUTLOOK AND CONCLUSIONS

More than ever it is impossible to predict the future. Covid-19 has thrown much of what we know and trust into confusion. The pandemic has had a profound effect on how people around the world live and work. Although a crystal ball is required to determine the outlook for the real estate, M&A and private equity sectors, some trends are starting to emerge. Despite positive news regarding the progress of vaccine programmes, it is very clear that covid-19 in some shape or form will remain with us for some time to come, and real estate and the wider economy will feel its legacy for longer still. Most of the UK has already been in lockdown at least twice and the sheer scale and complexity of the pandemic make it difficult to completely rule out future preventative measures. Although rent receipts are improving, there are wide gaps between the retail, leisure, office and warehouse sectors. The government will need to consider carefully how it encourages economic growth while at the same time lifting the protection offered to businesses during lockdown. The vast amount of accumulated rent arrears is another problem that will not disappear overnight. The government is considering to what extent, if any, it should intervene in negotiations between landlords, tenants and funders.

Although flexible working practices will clearly become a more accepted part of how we work, the lockdown has also confirmed that face-to-face contact is a key part of our working lives. Although fewer workers may need to be in the office, those workers will be more conscious of social distancing and businesses will need to comply with new rules and regulations as to how space can be used. The gap between new-build products and second hand office space will widen and this will result in a repurposing of redundant buildings. The City of London Corporation has indicated that more offices are likely to be converted to residential housing. The industrial sector has fared best in the current crisis. Demand for logistics space remains strong to meet the requirements of internet shopping and UK-wide distribution. In particular, there has been a post-Brexit spike in demand for commercial storage space and a move to refocus existing buildings for distribution and storage use. The industrial sector has become the top performer and the new safe haven for investors. The boom in life sciences also seems set to continue. There has been a surge of interest in film and studio space as the industry seeks to catch up with consumer appetite for new content. With the exception of the major supermarkets, the retail and leisure sectors face an uncertain future and we will see further insolvencies and restructurings. Discount and value operators will take up some of the space vacated and there will be opportunities for new entrants and independents to take space at affordable rents. The pub sector is an obvious target for bargain hunters and chains planning to expand their footprint. Even when the threat of lockdown is lifted fully, it will take some time for confidence to bounce back and for footfall to return to viable levels. Out of town retail parks that lend themselves to social distancing requirements may recover ahead of traditional high street outlets. Rental structures are likely to evolve further to enable landlords and tenants to share the pain and gain by reference to turnover and commercial success. The obtaining and sharing of data will become an increasingly important part of the landlord and tenant relationship, not only in relation to turnover rents but also to help meet respective ESG targets. It will be fundamental that people feel safe where they live, work and relax. The normally robust hotel sector may also take time to recover as confidence returns and global travel restrictions are lifted. The serviced apartment sector may benefit as people prioritise their own personal space and facilities. Demand for housing is likely to remain strong in the residential sector, although the lockdown may involve a rethink in the design and location of new developments. Those finding themselves working from home on a much more regular basis may start to prioritise space over location and convenience. A combination of covid-19 and Brexit have already led to problems in the supply chain, and issues associated with ensuring both a skilled and unskilled workforce may lead to delays on construction projects. Covid-19 will also cause a major rethink on major infrastructure projects as we revaluate our transport requirements and funding becomes stretched. Crossrail 2 for example has been put on ice as part of the funding agreement reached between the government and a cash-strapped Transport for London, and the proposed expansion of Heathrow will remain open to political and economic debate.

The covid-19 pandemic has put concerns about leaving the EU into perspective. In order to recover, the market needs certainty and that certainty will only arrive once the covid-19 threat is contained. As and when covid-19 and its many variants are under control, renewed optimism is likely to prompt a surge in activity. There is no shortage of global investment capital and it is reasonable to believe that UK real estate will remain high up on investor shopping lists. London in particular will retain its position as a leading global city. However, competition will be strong and the UK must work hard to ensure that it remains attractive as a place in which to live, invest and do business. Much will depend on the steps taken to stimulate the economy by a government saddled with increased debt. To that extent at least, the world has become a more level playing field. Lest we forget, there remains the small issue of Brexit and the UK will need to come to terms with its new relationships with Europe and the rest of the world. Although minor in comparison with covid-19, Brexit will no doubt provide an extra layer of complication as we seek to return to some sense of normality. Despite the all-encompassing doom and gloom of the past 12 months, there are signs of a post-covid bounce. The EY Item Club has raised its growth forecast for the UK economy from 5 per cent to 6.8 per cent and the FTSE 100 has managed to break back through the 7,000 level. Interest from Asian investors has been strongest followed by the US and the lifting of travel bans will only encourage activity from overseas investors looking for an attractive destination for their pent-up capital. When The National Security and Investment Act 2021 comes into effect later this year, the government will have enhanced powers to scrutinise transactions based on national security considerations. Although it applies to both domestic and overseas investors, it is the latter that are perhaps more likely to be affected when considering their UK investments. The Act will have retrospective effect from 11 November 2020. After a gloomy 2020 dominated by the covid-19 pandemic, it is sincerely hoped that next year's edition brings with it much more positive news from the UK and the rest of the world.

Appendix 1

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